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Treasury Department Expands Anti-Inversion Rules, Earnings Stripping Rules

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On April 4, 2016, the United States Department of the Treasury issued proposed regulations that expand the scope of transactions subject to the rules designed to eliminate the US tax benefits of "inversions." The proposed regulations also formalized anti-inversion rules that were first announced in Notice 2014-52 and Notice 2015-79 (see related coverage). Finally, the Treasury Department issued proposed regulations designed to constrain certain transactions involving intercompany debt that, when combined with inversions, can significantly reduce a US company's US income tax liability.

In general, an inversion is a transaction in which a US corporation is acquired by a smaller foreign corporation. The US tax consequences vary depending on the amount of the stock held in the acquiring foreign corporation by shareholders of the US corporation after the transaction, (which is referred to as the "ownership percentage"). If the ownership percentage is at least 80%, the foreign corporation is treated as a US corporation for US tax purposes. If instead the ownership percentage is less than 80% but at least 60%, the foreign corporation is respected as a foreign corporation for US tax purposes, but the acquired US corporation, its affiliates and shareholders will suffer certain adverse tax consequences. If the ownership percentage is less than 60%, an inversion potentially offers significant US tax benefits but will generally be a taxable transaction for US taxpayers if the ownership percentage is not less than 50%.

The new proposed regulations, which are effective on April 8, 2016, expand the scope of transactions subject to the punitive anti-inversion rules described above:

- **Serial inverters**. The higher the value of a foreign acquiring corporation's stock, the lower the ownership percentage. Current law effectively prevents a foreign corporation from avoiding the inversion rules by increasing its value through cash financings. Under the new proposed regulations, a foreign corporation generally cannot increase the value of its stock by acquiring multiple US corporations in a short time period. The Internal Revenue Service may now disregard stock of a foreign corporation that is attributable to the assets of a US corporation that was acquired within 36 months of the signing date of the latest acquisition.
- **Multiple-step acquisitions**. In some cases, the anti-inversion rules may apply to a foreign corporation's acquisition of an unrelated foreign corporation that recently acquired a US corporation if the acquisitions were part of a plan. By contrast, prior to the issuance of the proposed regulations, the acquisition of one foreign corporation by another was generally not subject to the inversion rules.

A US corporation that is acquired by a foreign corporation often borrows from the acquiring foreign corporation or a related foreign entity. The interest expense deducted by the US corporation reduces its US taxable income while the related party lender pays little or no tax on the interest income if it is resident in a low-tax country. The new proposed regulations attempt to curb these and similar "earnings stripping" arrangements by recharacterizing debt instruments issued to a related party as equity, thereby depriving the borrower of the tax benefit of interest deductions. Under the proposed regulations related-party debt is recharacterized as equity in the following circumstances:

- **Distributions of intercompany debt**. A US subsidiary distributes its debt to its parent (or another shareholder). Recharacterization is more likely if no new capital is raised at the subsidiary level in connection with the distribution and if the transaction lacks substantial non-tax business purpose.

- **Debt issued in exchange for affiliate stock**. A subsidiary uses its debt to acquire from its parent the stock of a brother/sister corporation.
- **Debt issued in an internal asset reorg**. A corporation uses its debt to acquire the assets of a related corporation. For example, a subsidiary issues debt to acquire from its parent the stock of a brother/sister corporation and the parent subsequently liquidates the acquired corporation (or files a check-the-box election with respect to the acquired corporation) in a Type D reorganization.
- **Debt issued to fund certain related-party transactions**. A corporation issues its debt instrument to an affiliate with a principal purpose of funding (1) a distribution of cash or other property to a related corporate shareholder, (2) an acquisition of affiliate stock from an affiliate, or (3) certain acquisitions of property from an affiliate pursuant to an internal asset reorganization.

Additionally, the proposed regulations enable the IRS to treat intercompany debt as part-debt and part-equity. Prior to the issuance of these proposed regulations, debt instruments were generally treated as wholly debt or recharacterized as wholly equity. A 50% common ownership test is applied to test relatedness.

Finally, the proposed regulations require certain entities to prepare and maintain documentation supporting the characterization of related-party indebtedness as debt for US tax purposes. If these requirements are not satisfied, the instrument will be treated as equity for tax purposes. The documentation requirements focus on evidencing four hallmarks of indebtedness: (1) a binding obligation to repay the funds advanced, (2) creditor/holder's rights to enforce the terms of the instrument, (3) a reasonable expectation of repayment, and (4) a genuine debtor-creditor relationship.

These proposed regulations apply to instruments issued on or after April 4, 2016 and to any debt instrument treated as issued before April 4, 2016 as a result of a check the box election filed on or after April 4, 2016.

Key Contacts

Aaron Pomeroy Colorado	apomeroy@cooley.com +1 720 566 4108