Fact Sheet: Treasury Issues Inversion Regulations and Proposed Earnings Stripping Regulations

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What is a corporate inversion?

A corporate inversion is a transaction in which a U.S.-parented multinational group changes its tax residence to reduce or avoid paying U.S. taxes. More specifically, a U.S.-parented group engages in an inversion when it acquires a smaller foreign company and then locates the tax residence of the merged group outside the United States, typically in a low-tax country. Typically, the primary purpose of an inversion is not to grow the underlying business, maximize synergies, or pursue other commercial benefits. Rather, the primary purpose of the transaction is to reduce taxes, often substantially.

After a corporate inversion, multinational corporations often use a tactic called earnings stripping to minimize U.S. taxes by paying deductible interest to their new foreign parent or one of its foreign affiliates in a low-tax country. Treasury has previously said it was considering potential guidance in this area.

In September 2014 and November 2015, Treasury announced guidance that made it more difficult for companies to undertake an inversion and reduced the economic benefits of doing so. Today, we are taking additional action to address this problem by issuing temporary regulations on inversions and proposed regulations to address earnings stripping.

Specifically, today's temporary regulations make it more difficult for companies to invert by:

Limiting inversions by disregarding foreign parent stock attributable to certain prior inversions or acquisitions of U.S. companies (Action under section 7874 of the code)

- Some foreign companies may avoid section 7874 – the tax code's existing curbs on inversions - by acquiring multiple American companies over a short window of time or through a corporate inversion. The value of the foreign company increases to the extent it issues its stock in connection with each successive acquisition, thereby enabling the foreign company to complete another, potentially larger, acquisition of an American company to which section 7874 will not apply. Over a relatively short period of time, a significant portion of a foreign acquirer's size may be attributable to the assets of these recently acquired American companies.

- It is not consistent with the purposes of section 7874 to permit a foreign company (including a recent inverter) to increase in its size in order to avoid the inversion threshold under current law for a subsequent acquisition of an American company. For the purposes of computing the ownership percentage when determining if an acquisition is treated as an inversion under current law, today's action excludes stock of the foreign company attributable to assets acquired from an American company within three years prior to the signing date of the latest acquisition.

In addition, today's proposed regulations address the issue of earnings stripping by:

1. <u>Targeting transactions that increase related-party debt that does not finance new investment in the United States (Action under section 385 of the code)</u>

    - Under current law, following an inversion or foreign takeover, a U.S. subsidiary can issue its own debt to its foreign parent as a dividend distribution. The foreign parent, in turn, can transfer this debt to a low-tax foreign affiliate. The U.S. subsidiary can then deduct the resulting interest expense on its U.S. income tax return at a significantly higher tax rate than is paid on the interest received by the related foreign affiliate. In fact, the related foreign affiliate may use various strategies to avoid paying any tax at all on the associated interest income. When available, these tax savings incentivize foreign-parented firms to load up their U.S. subsidiaries with related-party debt.

    - Today's action makes it more difficult for foreign-parented groups to quickly load up their U.S. subsidiaries with related-party debt following an inversion or foreign takeover, by treating as stock the instruments issued to a related corporation in a dividend or a limited class of economically similar transactions. For example, the proposed regulations:
        - Treat as stock an instrument that might otherwise be considered debt if it is issued by a subsidiary to its foreign parent in a shareholder dividend distribution;

        - Address a similar "two-step" version of a dividend distribution of debt in which a U.S. subsidiary (1) borrows cash from a related company and (2) pays a cash dividend distribution to its foreign parent; and

        - Treat as stock an instrument that might otherwise be considered debt if it is issued in connection with certain acquisitions of stock or assets from related corporations in transactions that are economically similar to a dividend distribution.

    - The proposed regulations generally do not apply to related-party debt that is incurred to fund actual business investment, such as building or equipping a factory.

    - In addition, the proposed regulations only apply to debt issued between related corporations, subject to a general anti-abuse rule for structured transactions involving unrelated persons, that are members of groups that have more than $50 million of intercompany debt that otherwise would be treated as stock under the regulations.

These proposed regulations apply to instruments issued after April 4. Treasury intends to move swiftly to finalize them.

2. <u>Allowing the IRS on audit to divide a purported debt instrument into part debt and part stock (Action under section 385 of the code)</u>

- Under current law, instruments are generally treated as entirely debt or entirely equity for federal tax purposes. This all-or-nothing approach can create distortions when the facts support treating debt as part debt and part stock. The proposed regulations would implement statutory authority to treat an instrument issued to a related party as in part debt and in part equity to eliminate these distortions.

3. Requiring documentation for members of large groups to include key information for debt-equity tax analysis (Action under section 385 of the code)

   - Under current law, it can be difficult for the IRS to obtain information to conduct a debt-equity analysis of related-party instruments, especially information that demonstrates the intent to create a genuine debtor-creditor relationship. This lack of detail in a taxpayer's documentation can make IRS enforcement difficult.

   - Under today's action, companies are required to undertake certain due diligence and complete documentation up front to establish that a financial instrument is really debt.

   - Specifically, the proposed regulations require key information be documented, including a binding obligation for issuer to repay the principal amount borrowed, creditor's rights, a reasonable expectation of repayment, and evidence of ongoing debtor-creditor relationship.

   - If these requirements are not met, instruments will be characterized as equity for tax purposes.

Additional action

The U.S Treasury Department has issued formal temporary regulations implementing the previous two actions released in 2014 and 2015.

- The temporary regulations also set forth certain new rules, in addition to the rule described above that disregards foreign parent stock attributable to certain prior acquisitions of U.S. companies. The new rules include:

  - A rule that addresses a technique by which U.S. companies may seek to avoid section 7874 by structuring an inversion as a multi-step transaction using back-to-back foreign acquisitions; and

  - A rule that requires a foreign subsidiary of the inverted U.S. group to recognize all realized gain upon certain post-inversion transfers of assets that dilute the inverted U.S. group's ownership of those assets.

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