

M&A Update

Treasury Department Proposes To Expand Anti-Inversion Rules

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The Treasury Department, in its Fiscal Year 2015 Revenue Proposals (the “**Green Book**”), has proposed to significantly tighten Section 7874 of the Internal Revenue Code, effective January 1, 2015, reducing the ability of a U.S. corporation or partnership (each, a “**U.S. company**”) to “invert” or be acquired by a foreign company that is then substantially owned by the U.S. company’s former equity owners. The prospects for the enactment of any significant tax legislation, including legislation relating to Section 7874, in the current year are uncertain at best. The completion of any inversion transactions by December 31, 2014 would avoid the application of these and any similar amendments that Treasury re-proposes in 2015 or later with the same effective date of January 1, 2015.

Current Rules

The current Section 7874 rules treat a foreign company as a U.S. corporation for U.S. tax purposes after an acquisition if 80% or more of its equity is owned by former U.S. company equity owners, the foreign company acquires substantially all of the assets of the U.S. company, and the “affiliated group”, *i.e.*, the foreign company, the U.S. company, and certain subsidiaries, does not have “substantial business activities” in the foreign company’s home jurisdiction. The current Section 7874 rules also limit the use of losses or credits by the U.S. company and its U.S. affiliates to shelter “inversion gain” resulting from the inversion transaction and outbound transfers or licenses of property to related parties in the subsequent ten-year period if 60% or more, but less than 80%, of the foreign company equity is owned by former U.S. company equity owners, the foreign company acquires substantially all of the assets of the U.S. company, and the affiliated group does not have “substantial business activities” in the foreign company’s home jurisdiction. Officers are subject to an excise tax on equity compensation in connection with certain inversion transactions subject to Section 7874.

Proposed Anti-Inversion Amendments

The proposal would treat a foreign company as a U.S. corporation for U.S. tax purposes after an acquisition if:

1. More than 50% of the foreign company equity is owned by former U.S. company equity owners, the foreign company acquires substantially all of the assets of the U.S. company, and the affiliated group does not have “substantial business activities” in the foreign company’s home jurisdiction; OR
 - Thus, the proposal would reduce the current 80% threshold before a foreign company is treated as a U.S. corporation to 50%.
 - Currently, an affiliated group has “substantial business activities” in the foreign company’s home jurisdiction if at least 25% of each of the affiliated group’s employees, assets and income is located or derived in the jurisdiction. The Green Book does not indicate whether the amendments are intended to modify the “substantial business activities” definition.
2. The affiliated group has “substantial business activities” in the United States, and the foreign company is primarily managed and controlled in the United States.
 - This broad rule would appear to apply even if a large foreign company meeting these conditions were to acquire substantially all of the assets (or possibly less) of a very small U.S. company, thus causing the large foreign company to be treated as a U.S. corporation as a result of this “foot fault”. It is unclear whether this rule would apply in a transaction where the former U.S. company equity owners received only cash (and received no equity in the large foreign company). Treasury officials have acknowledged this concern and suggested that the final version of the proposal may have a *de minimis* exception. There is no guarantee that such an exception would be enacted.

It is unclear whether or how the officer excise tax on equity compensation would be imposed under either of these proposals.

The proposal would also broaden Section 7874 as it currently applies to partnership transactions.

Takeaways

The proposal, if enacted in its current form, would significantly reduce the opportunities for U.S. companies to invert. The completion of any inversion transactions by December 31, 2014 would avoid the application of these proposed Section 7874 rules and any similar rules that Treasury re-proposes in 2015 or later with the same effective date of January 1, 2015.

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If you have any questions, please contact any of the following attorneys or your Cadwalader contact:

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