



Tax Structuring: A Primer on Inversions

**ASC 740 Accounting for Income Taxes:
Foreign Tax Provisions and US International Tax Issues**

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What is an inversion?

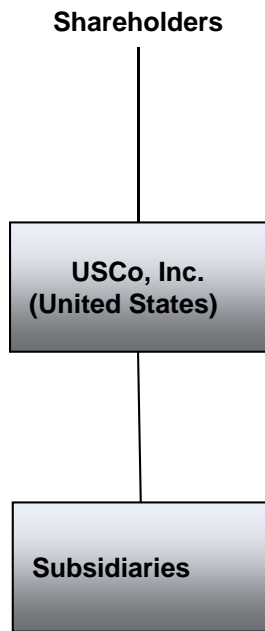


- In the international tax context, an “inversion” generally is a transaction in which a domestic corporation or a domestic partnership is acquired by a foreign corporation
- The foreign corporation either acquires the assets or the equity of the domestic target
- Some or all of the shareholders (or partners) of the domestic target may become shareholders of the new foreign parent
- There may be significant tax benefits from inverting under a foreign corporation. However, the anti-inversion rules must be considered

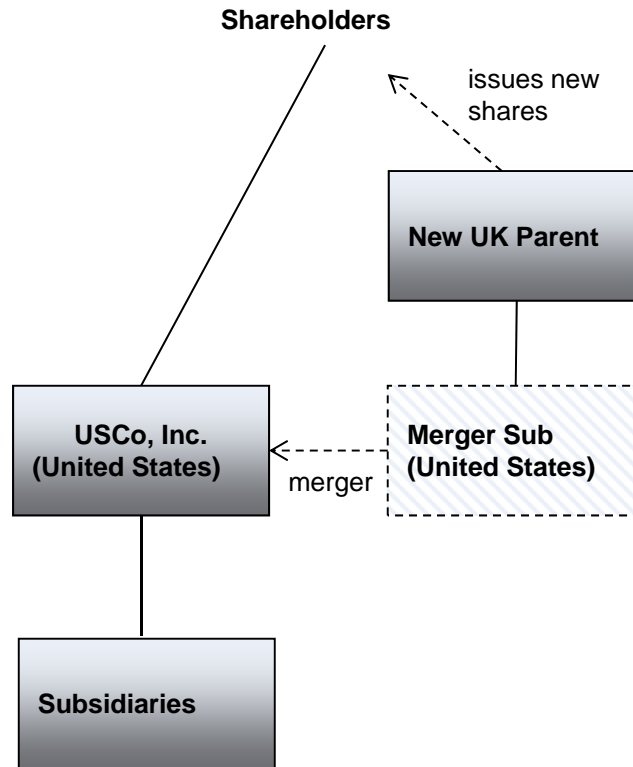
Illustrative transaction



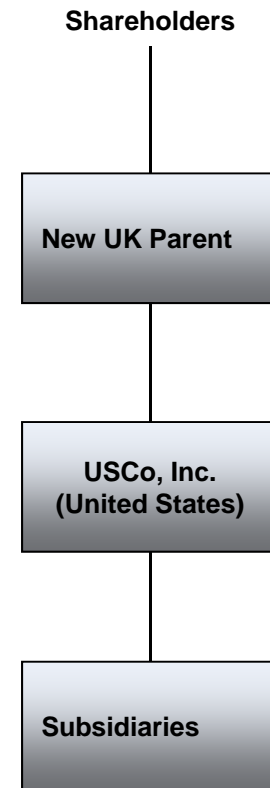
Original Structure



Inversion Transaction



Final Structure



Final Structure



The inversion on its own does not entirely escape the US tax net

- There is still a US company in the structure, subject to 35% tax
- If non-US IP (and the associated profit entitlement) is owned by a non-US IP holding company, the non-US IP holding company would still be under the US company so non-US profits must be repatriated through the US company
- Non-US subsidiaries under the US company are still CFCs

But there are new opportunities to drive tax efficiencies

- New non-US IP, non-US ventures and non-US subsidiaries can be directly under the UK parent. The UK corporate income tax rate will be 20% in 2015
- Furthermore, profits repatriated to the UK may qualify for the UK participation exemption, in which case those profits permanently escape corporate taxation at the parent level, rather than merely deferring corporate taxation
- There may be opportunities to reduce US taxable income through intercompany transactions or leverage
- Depending on the US exit costs, CFCs and non-US IP under the US company could be transferred to the UK parent

- Inversion transactions are not new. Early, well-known examples include McDermott Inc. (1982) and Helen of Troy (1993)
- **Section 367(a)** has been tightened periodically to address inversions. Section 367(a) may impose shareholder-level gain on transfers of appreciated property by a US person to a foreign corporation in an otherwise tax-free transaction
- After well-publicized inversions in the late 1990s and early 2000s (e.g., Ingersoll-Rand, Noble Drilling, Nabors Industries, Stanley Works) Congress determined that a corporate-level solution was needed to discourage inversions
 - The threat of shareholder-level tax under Section 367(a) may not discourage shareholders with little built-in gain or shareholders that are not subject to US tax
- **Section 7874** was introduced in 2004. This is now the primary corporate-level anti-inversion statute
 - Note that Section 367 may still apply at the shareholder level

Section 7874(a): inversion gain



- Section 7874(a) generally will apply to an inversion if three conditions are satisfied:
 1. A foreign corporation acquires substantially all of the properties of a domestic target
 2. After the acquisition, at least 60% of the stock of the foreign corporation is owned by the former shareholders or partners of the target
 3. After the acquisition, the foreign acquiror does not have “substantial business activities” in the jurisdiction of the foreign acquiror

- If Section 7874(a) applies, then for a ten-year period the domestic target will be subject to tax on its “inversion gain.” This is gain related to certain transfers and licenses

- This is largely designed to preclude “out from under” planning to get CFCs, IP and other assets out from under the domestic target and into the new foreign parent

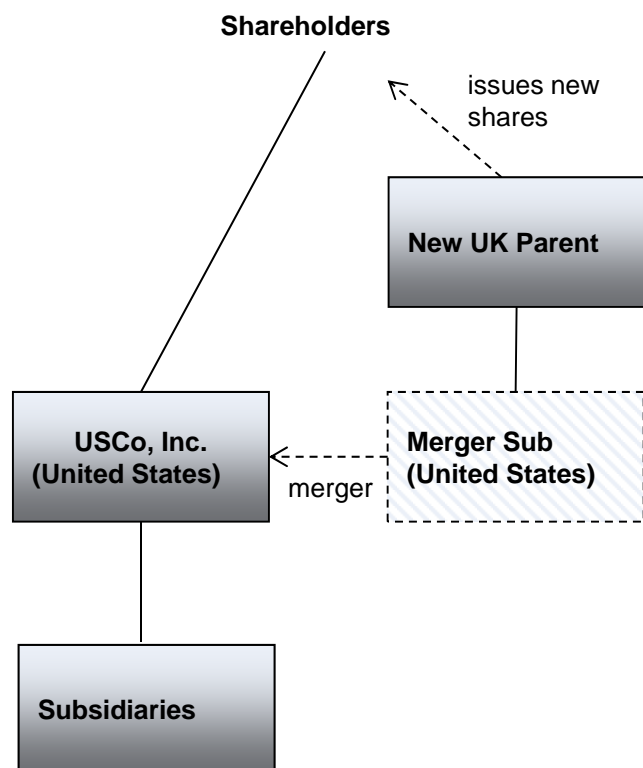
Section 7874(b): deemed US corporation



- If Section 7874(b) applies, then the foreign parent company will be treated as a domestic corporation for all purposes of the Code
- Section 7874(b) will apply if, after the inversion, at least 80% of the stock of the foreign corporation is owned by the former shareholders or partners of the domestic target (and the other requirements of Section 7874(a) are satisfied)
 - Note: A recent legislative proposal would lower this threshold to less than 50%
- An inversion may still have tax benefits even if at least 60% but less than 80% of the shares of the foreign corporation is owned by the former shareholders or partners of the domestic target (i.e., even if Section 7874(a) applies)
- But if the 80% threshold is crossed and Section 7874(b) applies to the inversion, then the inversion essentially has had no US tax effect

Section 7874: failed inversion

Failed inversion: New UK Parent is a Deemed US Corporation



- Assume shareholders of a US company form a new UK company (without substantial business activities in the UK) and contribute the US company in exchange for all of the UK shares
 1. This is an acquisition of substantially all of the properties of a US company
 2. There are no substantial business activities in the UK
 3. Former shareholders of the US company own 100% of the UK company
- After this unilateral inversion, the UK Parent is treated as a US corporation for US tax purposes

- To recap, Section 7874 hinges on three issues:
 1. Has there been acquisition of substantially all of the stock or assets of a domestic target?
 2. Is at least 60% of the stock of the new foreign parent owned by former shareholders of the domestic target?
 3. Does the new parent have “substantial business activities” in its jurisdiction?

- If supported by the facts, there are two straightforward ways to avoid Section 7874 in a complete inversion of a domestic corporation:
 1. Substantial business activities: The prospective foreign parent has “substantial business activities” in a favorable tax jurisdiction
 2. Strategic combination: The shareholders of the new foreign parent are different (or at least 40% are different) from the former shareholders of the domestic target as a result of business combination with another company

What is the threshold for substantial business activities?



- The 2006 Treasury Regulations provided a safe harbor and a facts and circumstances test. The safe harbor generally required at least 10% of group headcount, assets and sales in the foreign jurisdiction
- In 2009, the safe harbor was dropped, leaving taxpayers with only the facts and circumstances test
- In 2012, the IRS dropped the facts and circumstances test, and adopted a bright line rule which generally requires that at least 25% of the employees (and employee compensation), group assets (counting only tangible property) and group income be located in the relevant foreign jurisdiction
- Unsurprisingly, this heightened threshold for substantial business activities had a chilling effect on inversions that are dependent on having substantial business activities in a favorable tax jurisdiction

- The recent trend has been to use strategic business combinations as an opportunity to invert

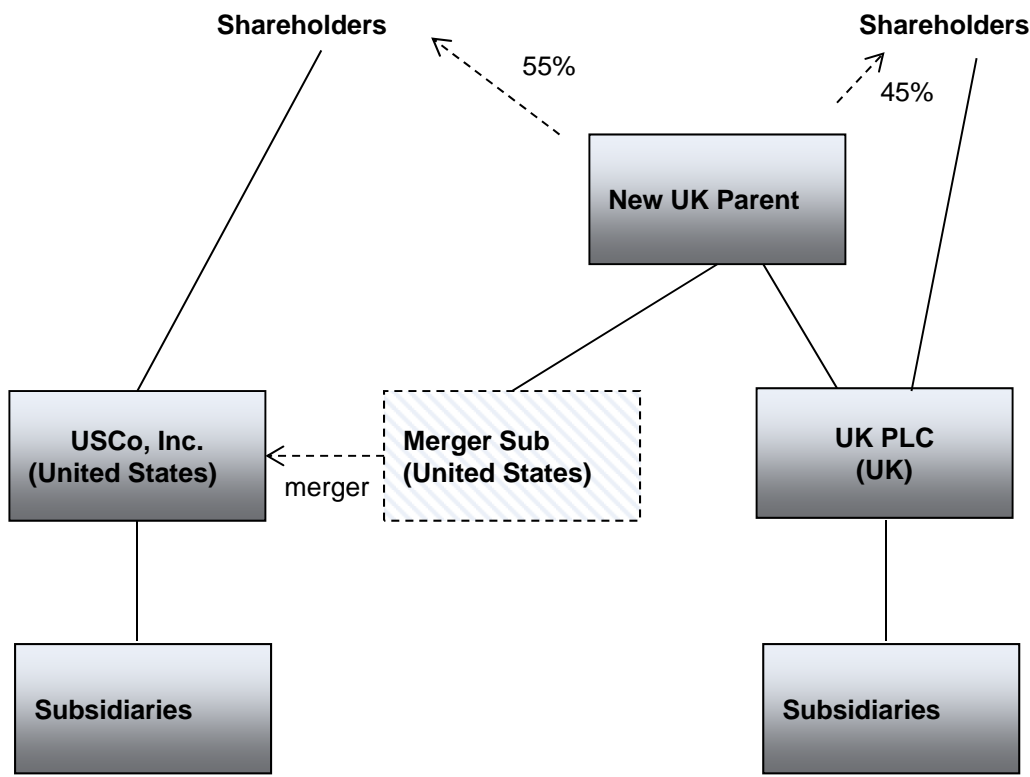
- If a US company and a foreign company combine, and the foreign company would comprise greater than 20% of the value of the combined company, the US company may invert in connection with the combination

- Example: Applied Materials (US) and Tokyo Electron (Japan) combined under a Dutch holding company
 - This transaction will be taxable to US shareholders under Section 367
 - Furthermore, because former shareholders of Applied Materials will receive at least 60% (but less than 80%) of the Dutch holding company, for ten years Applied Materials will be subject to tax on any “inversion gain”
 - Nevertheless, the prospect of reducing the effective tax rate of Applied Materials tax rate from 22% to 17% may be sufficient incentive

- Example: Recently proposed (but not accepted) proposed combination of Pfizer (US) and AstraZeneca (UK) under a UK holding company in a deal valued at \$119 billion

Section 7874: inversion in connection with a business combination

Successful Inversion: Section 7874 does not apply



- Assume a US company is contributed to a new UK company and a UK company is contributed to the new UK company. The new UK company does not have substantial business activities in the UK. Former shareholders of the US company receive 55% of the new UK company
 1. This is an acquisition of substantially all of the properties of a US company
 2. There are no substantial business activities in the UK
 3. But former shareholders of the US company only own **55%** of the new UK company
- After this business combination, Section 7874 does not apply
- **BUT NOTE:** If the threshold were reduced to less than 50% under the recent legislative proposal, this would be a failed inversion

Questions?



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