

The Inversion Experience in the United States

ITPF/TPC Conference on Corporate Inversions and Tax Policy

Paul W. Oosterhuis

Skadden, Arps, Slate, Meagher & Flom

Washington, D.C.

January 23, 2015

Beijing

Boston

Brussels

Chicago

Frankfurt

Hong Kong

Houston

London

Los Angeles

Moscow

Munich

New York

Palo Alto

Paris

São Paulo

Shanghai

Singapore

Sydney

Tokyo

Toronto

Washington, D.C.

Wilmington

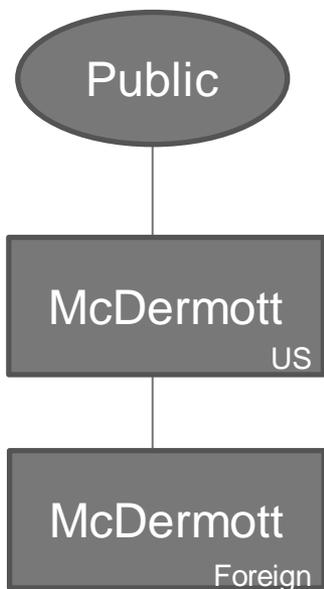
Skadden

EVOLUTION OF INVERSION TRANSACTIONS

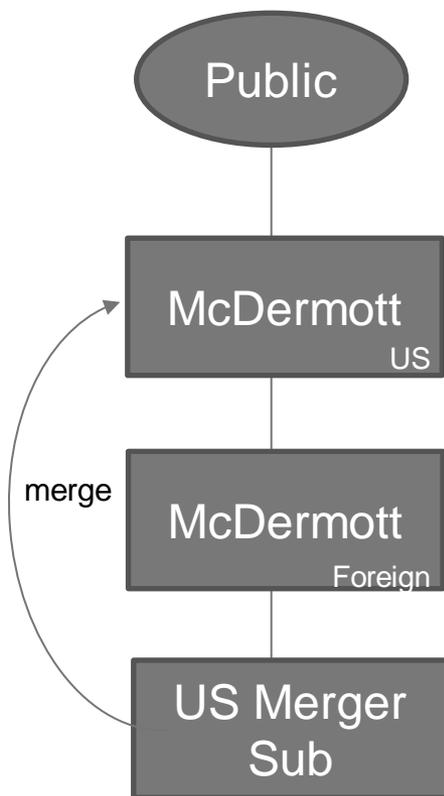
- This presentation provides background regarding various “inversion” related transactions, and the evolution of those transactions in response to the changing legal landscape.

- The basic concept of an inversion is a transaction in which a U.S. parent becomes a subsidiary of a new foreign parent corporation (“NFP”).
 - If done alone under NFP this is a “self inversion” (Aon, Enesco, etc.).
 - If done in connection with a target (typically foreign) under NFP this is a combination migration transaction (Eaton/Cooper, Medtronic/Covidien, etc.).

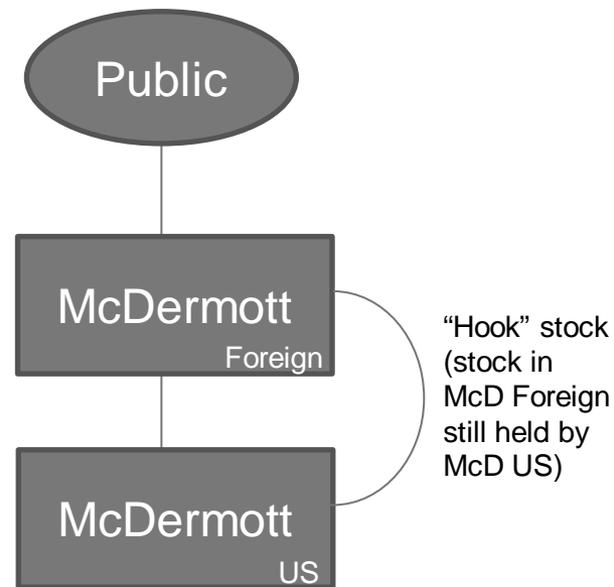
- Inversions offer four main areas of potential tax benefits:
 - 1) Future foreign expansion under NFP outside of the U.S. tax “net”
 - 2) Tax efficient leverage on the group’s U.S. operations
 - 3) Restructuring of legacy foreign operations owned by the U.S. group
 - 4) Better access to offshore cash for NFP dividends, share buybacks, etc.



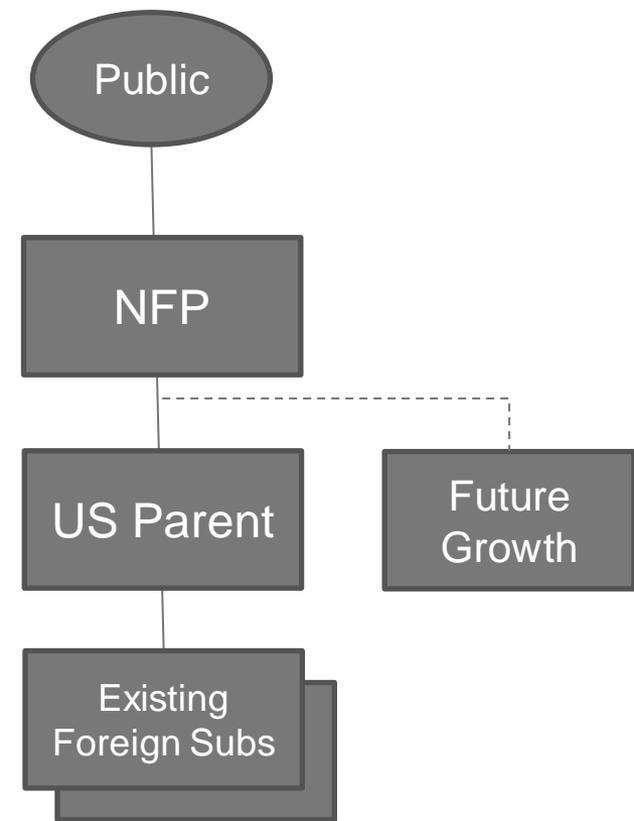
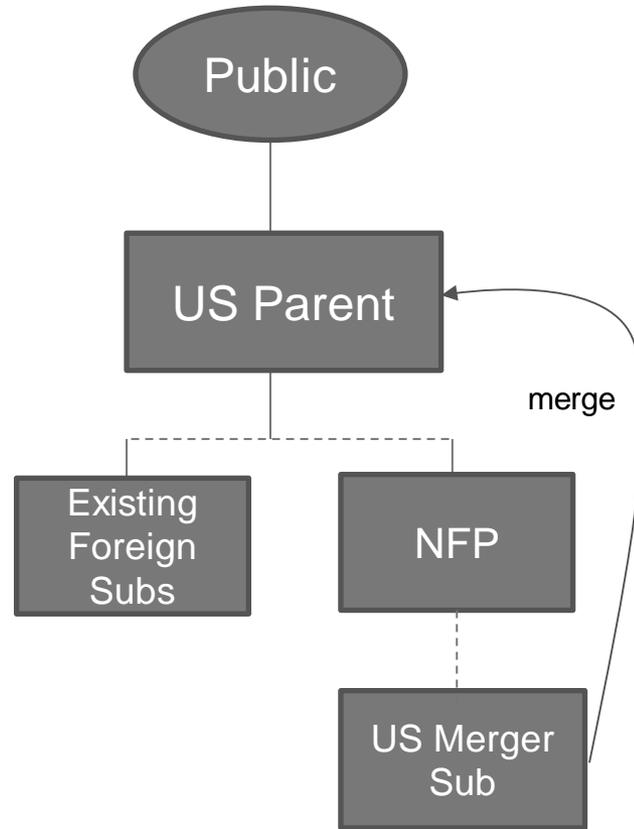
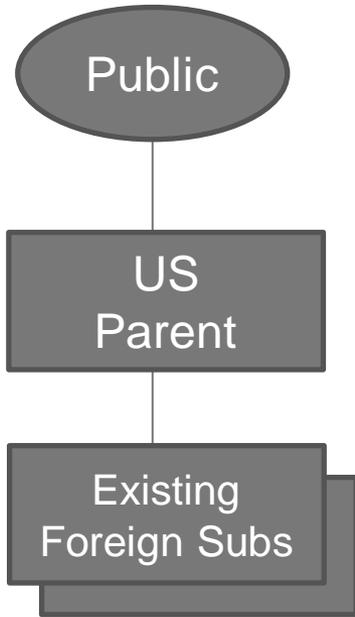
- McDermott Foreign corp tenders for McDermott US stock in exchange for McDermott Foreign stock



- US merger sub merges into McD US with MCD US surviving; tax free reorganization to public shareholders
- McD US stock converted into McD Foreign stock and US Merger Sub stock converted into McD US stock



- McD Foreign no longer a "CFC"
- Congress enacted rules that would require former US parent (like McD US) to include in income all the earnings of the former foreign subsidiary (like McD Foreign)



- Taxpayers responded to new law by not using an existing foreign sub (like McD Foreign in prior slide), but instead using a newly formed foreign sub with no earnings as NFP
- Avoids “hook” stock issue

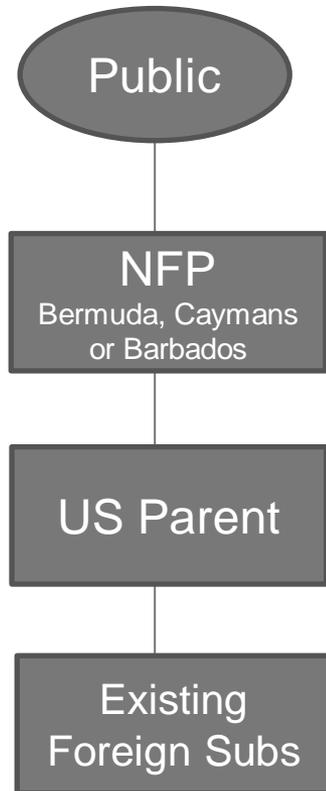
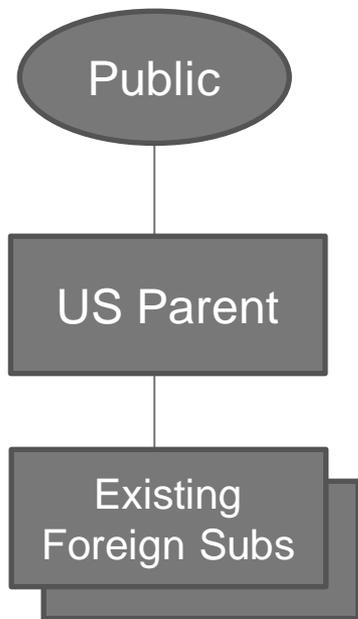
- US merger sub merges into US Parent with same results as prior page; tax free reorganization to US Parent shareholders
- NFP typically formed in tax haven (Bermuda, Caymans, Barbados)

- Potentially use “Inversion” transaction to insert leverage into US group
- New growth under NFP
- Potential restructuring of US Parent’s Existing Foreign Subs

- The IRS issued Treasury Regulations (under section 367) that require in self inversions (and other combination transactions) that US shareholders of US parent recognize gain, but not loss, on the exchange of their US parent stock.
- This renders taxable an exchange that otherwise would be non-taxable.
- These rules still exist today; focus on situations where US shareholders of the former US parent, collectively, own more than 50% of NFP stock (“50% continuity rule”).
 - All self inversions were subject to the rule because they typically had 100% continuity.
 - Combination transactions where the US company was bigger were also caught.
- The shareholder level tax imposed by this “50% continuity” test did not stop some inversion transactions because the shareholder level tax was not a big enough obstacle (tax exempt holders of stock like pension funds, stock holdings without significant built in gains, etc.).

- 1996-1998
 - Triton Energy, Tyco International, Gold Reserve
- 1999
 - Transocean, Fruit of the Loom, FXRE Corp., Xoma Ltd., White Mountain Insurance
- 2000
 - Seagate Technology, Everest Reinsurance
- 2001
 - Foster Wheeler, Accenture, Ingersoll-Rand, Global Santa Fe
- 2002
 - Noble Corp., Cooper Industries, Weatherford, Stanley Works (abandoned)

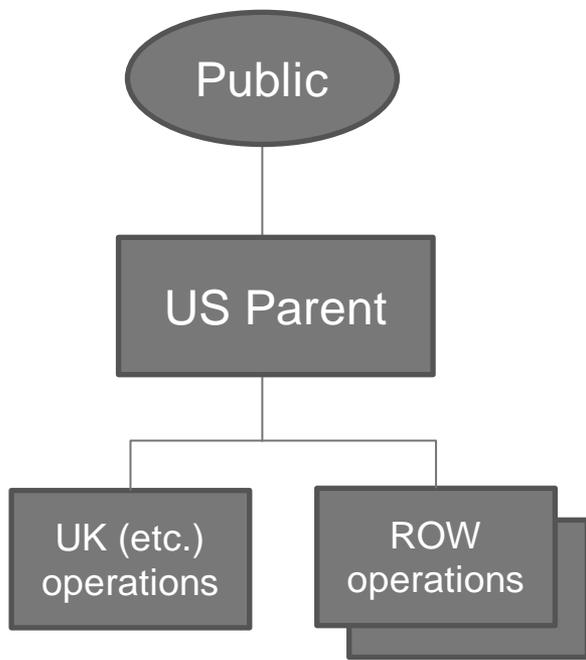
- Congress enacted a new Code provision (section 7874) that limited these inversion transactions (self inversions mostly) NOT at the shareholder level with a tax (although those rules were also retained), but at the NFP level (and sometimes at the US Parent level)
- Section 7874's main weapon is to treat NFP as a domestic corporation for all US tax purposes if certain conditions are met.
- Three conditions need to be met for this treatment:
 - 1) A foreign corporation acquires substantially all the assets (or stock) of a domestic corporation or partnership (the “sub all” test),
 - 2) former shareholders of the US company own >80% of NFP (the “shareholder continuity” test), and
 - 3) The overall group, tested after the deal, does not have “substantial business activities” in the country where NFP is incorporated (the “SBA Test”).
- If the above conditions are met except that former shareholders of the domestic corporation own $\geq 60\%$ but $< 80\%$ of the stock of NFP, an excise tax is imposed on the untaxed value of officers' and directors' stock-based compensation, and limits are placed on the use of the domestic corporation's tax attributes with respect to transactions with NFP and other related foreign corporations.



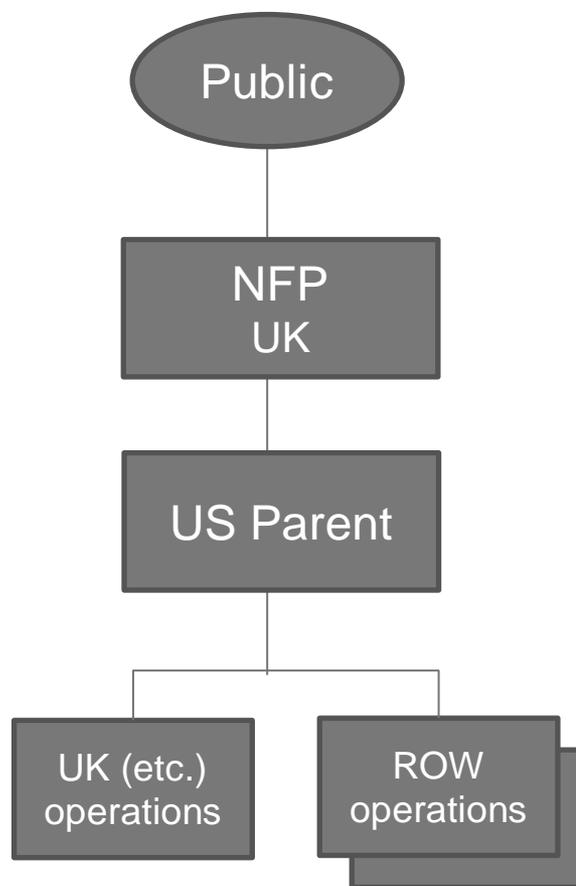
- These transactions generally run afoul of section 7874's three test.
- Typically 100% continuity so 80% test met.
- Typically little or no business activities (assets, employees, revenue) in Bermuda, Caymans, or Barbados, so flunk the SBA Test.
- Result would be to treat NFP as a domestic corporation for all US tax purposes.

- In the years from 2005-2012 there were a modest number of combination-migration transactions (perhaps most prominently Biovail/Valeant in 2010 and Eaton/Cooper in 2012), but also a number of self inversions that met the substantial business activities test.

- These included:
 - 2005 – Luna Gold (Canada)
 - 2007 – Fluid Media Networks (Canada)
 - 2008 – Patch International (Canada)
 - 2009 – Tim Hortons (Canada), Ensco International (U.K.)
 - 2010 – Platinium Polymer (Netherlands)
 - 2012 – Rowan (U.K.), Aon (U.K.), DE Master Blenders (Netherlands)



- Do the same inversion transaction (NFP, US merger Sub, etc.) but with NFP formed in a jurisdiction in which the corporate group had a meaningful presence.

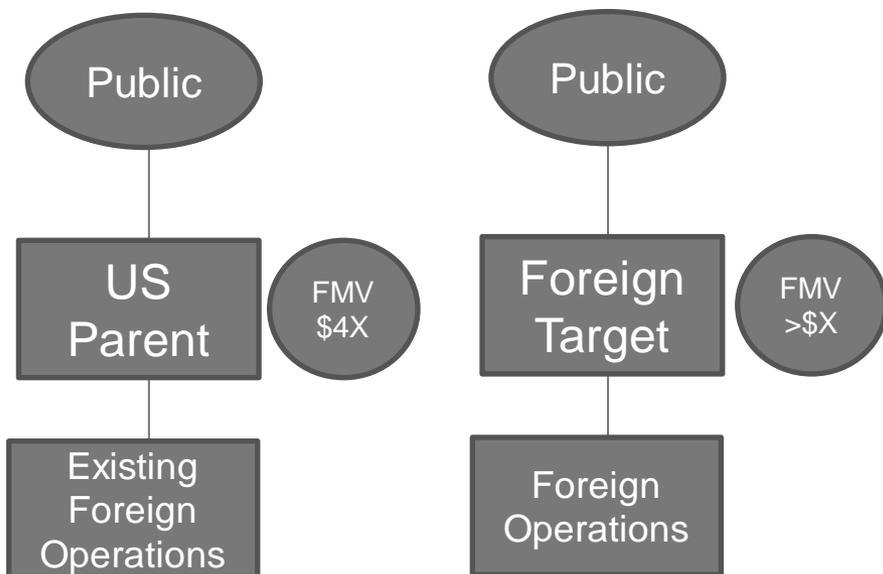


- Response for self inversions was to stop having NFP formed in a “tax haven”
- Instead, form NFP in a country where the overall group, tested after the transaction, can satisfy the SBA Test (here the UK)
- Still flunks the continuity test (generally 100% continuity in these cases) but focus on the SBA Test to comply with the section 7874 rules

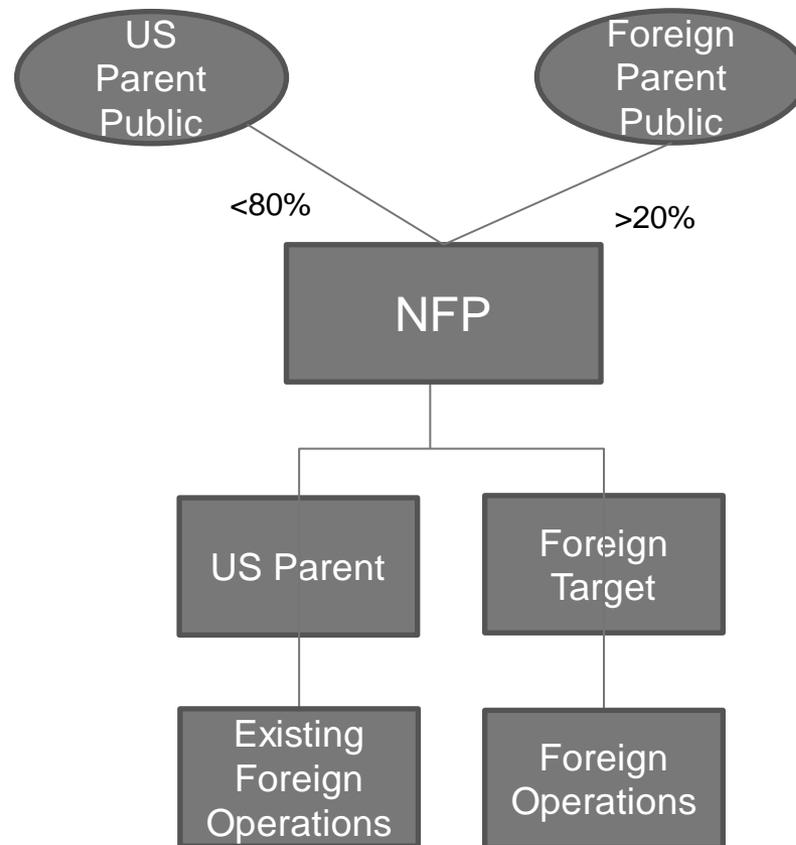
- The SBA Test has evolved through a series of regulatory regimes. Current regulations impose a strict test that cannot generally be satisfied by reasonably geographically diversified multinationals.
- 2006 Regulations provided both
 - a safe harbor (10% of relevant factors – sales, property, employees, and payroll – in NFP’s jurisdiction of incorporation); and
 - a facts and circumstances test.
- 2009 Regulations
 - Dropped the safe harbor.
- 2012 Regulations
 - Dropped the facts and circumstances test in favor of a very stringent “bright line” 25% test (25% of each of gross income from sales, property, employees, and payroll in NFP’s jurisdiction of incorporation).
 - » It is possible for a corporate group *not* to have SBA in the U.S. and for 7874 to still apply.
 - » It is possible for a corporate group not to have SBA in *any* country under this definition.
 - Since the 2012 regulations, only one substantial self inversion – Liberty Global/Virgin Media – has been completed (Burger King/Tim Hortons also claims to satisfy the SBA test, but appears to be relying on <80% shareholder continuity as well).

- With the pick-up in M&A activity generally starting in 2013, there has been an increase in combination-migration transactions:
 - Actavis/Warner Chilcott (Ireland)
 - Pentair/Tyco International's Flow Control Business (Switzerland)
 - Perrigo/Elan (Ireland)
 - Applied Materials/Tokyo Electron (Netherlands)
 - Endo Health/Palladin (Ireland)
 - Actavis/Forest Laboratories (Ireland)
 - Horizon Pharma/Vidara Therapeutics (Ireland)
 - Mylan/Abbott Laboratories subsidiary (Netherlands)
 - Covidien/Medtronic (Ireland)
 - Tim Hortons/Burger King (Canada)
- Other transactions were considered, but not completed for various reasons:
 - Pfizer/AstraZeneca, Chiquita/Fyffes, Walgreens/Alliance Boots, AbbVie/Shire, Auxilium/QLT, Salix/Cosmos

CONTINUING INVERSIONS COMBINATION-MIGRATION TRANSACTIONS



- Combination transactions ignore the SBA test and focus instead only on the continuity test
- Focus is on a Foreign Target that is worth more than 25% of US Parent



- Combination complies with inversion rules because Foreign Target shareholders, collectively, receive more than 20% of NFP (80% continuity test is not met).
- The SBA Test is irrelevant because NFP is out of the rules under the continuity test, so NFP can be formed anywhere
- Still taxable to the former US shareholders of US Parent because of the 50% continuity rule.

RECENT ANTI-INVERSION GUIDANCE UNDER NOTICE 2014-52

- **On September 22, 2014, Treasury and the IRS announced their intention to issue regulations under sections 367, 956(e), 7701(l), and 7874.**
 - Final Regulations will generally apply to companies that undertake inversion transactions on or after 9/22/14
 - Section 3 generally only applies if shareholder continuity is $\geq 60\%$; 59/41 inversions are not impacted by Section 3
- **Most of the provisions in the Notice cover two main areas:**
 - Section 2: The application of sections 7874 and 367 to inversion transactions occurring on or after 9/22/14; and
 - Section 3: The application of certain other sections of the Code to groups that inverted ($\geq 60\%$) on or after September 22, 2014.
- **Potential future guidance on earnings stripping – TBD.**

NEW RULES GOVERNING SECTIONS 367(A) & 7874: NON-ORDINARY COURSE DISTRIBUTIONS

- The consequences under both section 367(a) and section 7874 depend in effect on the relative size of the U.S. company and the foreign merger partner.
- Thus, in theory, distributions that shrink the size of the U.S. company could be used to mitigate or eliminate the adverse consequences under those provisions.
- Section 7874(c)(4) already contains rules disregarding distributions done with a principal purpose of avoiding section 7874.
- Existing regulations under section 367(a) do not contain such rules.

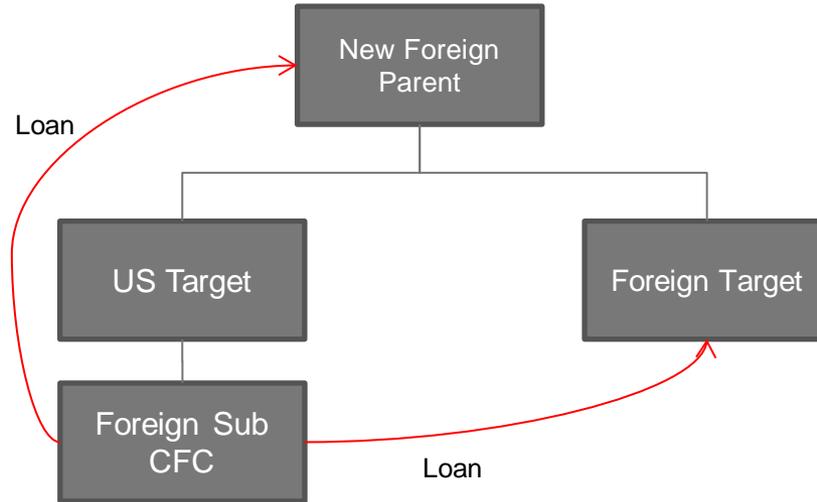
NEW RULES GOVERNING SECTIONS 367(A) & 7874: NON-ORDINARY COURSE DISTRIBUTIONS

- Notice 2014-52 adopts strict new rules disregarding “non-ordinary course distributions”
 - For purposes of section 7874 and 367, non-ordinary course distributions by the domestic entity during the 36-month period ending on the acquisition date are disregarded.
 - A Non-Ordinary Course Distribution is the excess of all distributions made during a taxable year by the domestic entity over 110% of the average of such distributions over the thirty-six month period preceding such taxable year.
 - » Effectively need to consider all distributions over the prior six-year period.
 - » All distributions are included, regardless of E&P, and including redemptions and spin-offs/split-offs.
 - » Section 355 spin-offs are included in definition of distributions.
 - » Definition also includes boot in the acquisition if sourced directly or indirectly from the domestic entity.

NEW RULES GOVERNING SECTIONS 367(A) & 7874: FOREIGN “CASH BOX”

- Section 7874 measures the relative share ownership of NFP by the former U.S. company and Foreign Target shareholders.
- Certain stock issued to the foreign target shareholders can be “disregarded” thus inflating the shareholder continuity percentage of the U.S. company shareholders.
 - Section 7874(c)(2)(B) disregards stock of NFP which is sold in a public offering related to the acquisition.
 - Regulations under section 7874 (Treas. Reg. 1.7874-4T) disregards stock of NFP that is issued – whether in a private or public offering – for passive assets.
 - » BUT, stock of NFP issued in respect of foreign target stock is not disregarded even if foreign target holds passive assets.
 - Under Notice 2014-52, stock of NFP issued to foreign target shareholders is disregarded if, and to the extent that, more than 50 percent of “foreign group property” consists of “foreign group nonqualified property”
 - » Generally, applies if more than 50 percent of foreign acquirer's assets are passive.

NEW RULES GOVERNING INVERTED COMPANIES: EXPANDED DEFINITION OF SECTION 956 PROPERTY



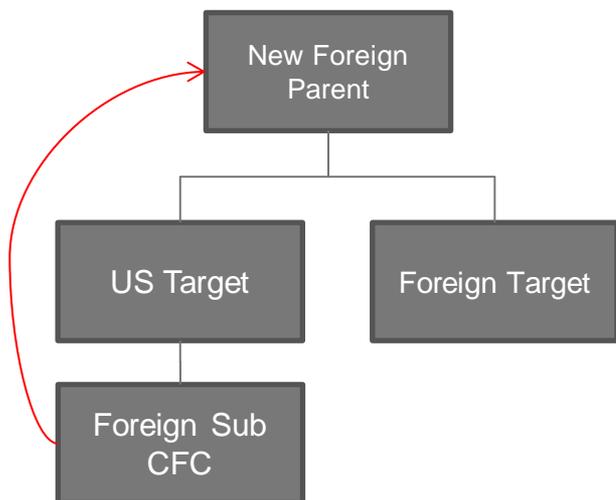
- Any obligation or stock of a “foreign related person” (generally related foreign corporations that are not CFCs) will be treated as U.S. property to the extent such obligation or stock is acquired by an “expatriated foreign subsidiary” (generally, CFCs of US Target) during the applicable period (generally, ten-year period beginning on date of the inversion transaction).
- Thus, loans by Foreign Sub CFC to NFP or Foreign Target will give rise to deemed dividends to US Target.

NEW RULES GOVERNING INVERTED COMPANIES: RECHARACTERIZATION OF DE-CONTROL TRANSACTIONS

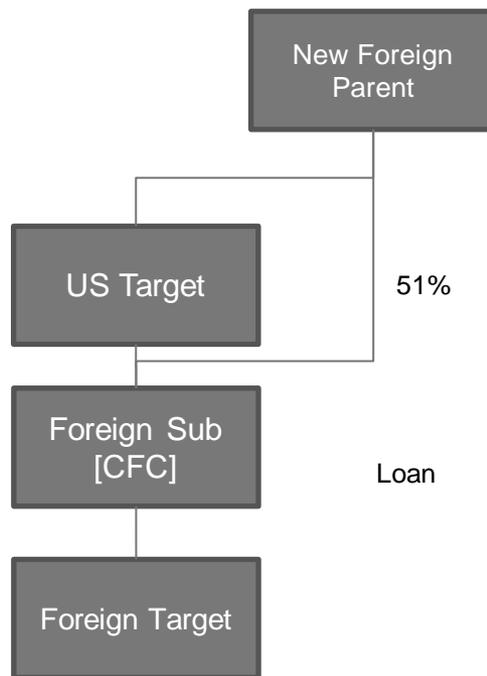
- Regulations under section 7701(l) will re-characterize certain “specified transactions” occurring during the applicable period (10 years after the inversion)
 - A “specified transaction” is a transaction in which stock in an expatriated foreign subsidiary (“specified stock”) is transferred (including by issuance) to a “specified related person.”
 - A “specified related person” means a non-CFC foreign related person, a U.S. partnership that has one or more partners that is a non-CFC foreign related person, or a U.S. trust that has one or more beneficiaries that is a non-CFC foreign related person.
- If specific stock is issued to a specified related person, then the transaction is recharacterized as:
 - An deemed issuance of stock for property by the section 958(a) U.S. shareholder(s) of the expatriate foreign subsidiary; and
 - A contribution by the section 958(a) U.S. shareholder(s) of such consideration to the expatriated foreign subsidiary
 - Recharacterization is permanent (i.e., consequences not limited to the 10-year post-inversion period).

NEW RULES GOVERNING INVERTED COMPANIES: RECHARACTERIZATION OF DE-CONTROL TRANSACTIONS

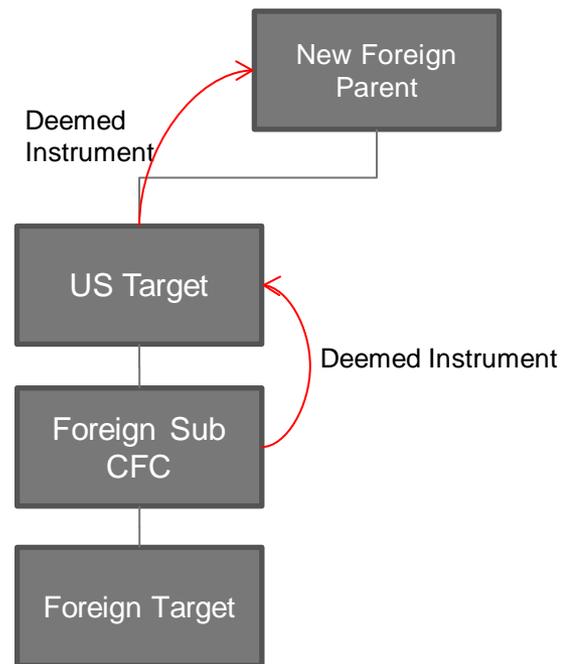
NFP contributes stock of Foreign Target to Foreign Sub CFC in exchange for 51% of stock of Foreign Sub



Actual Result



Deemed Result



- Public comments by Treasury and IRS officials indicate that additional anti-inversion guidance could be in the works.

- Notice 2014-52 asked for comments regarding potential anti-base erosion rules – i.e., rules limiting U.S. interest deductions of inverted groups.
 - Any such rules, whenever released, would apply to groups that inverted on or after 9/22/14.
 - Basis for such rules – section 163(j)? Section 385? Other?

- Other guidance under section 7874?

- Other guidance under generally applicable tax rules?