

New Regulations Expand Reach Of Anti-Inversion Ownership Rules

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The Treasury Department and the Internal Revenue Service (the “**IRS**”) yesterday released **temporary regulations** (the “**Temporary Regulations**”) incorporating and expanding upon the rules set forth in **2009 guidance** (the “**Notice**”) under Section 7874 of the Internal Revenue Code, as amended (the “**Code**”). The Temporary Regulations make it more difficult for a non-U.S. corporation (the “**Non-U.S. Corporation**”) to count stock issued in exchange for cash, marketable securities and certain other assets, in a transaction that also involves the acquisition of a U.S. corporation (the “**U.S. Corporation**”) by the Non-U.S. Corporation, in determining whether the Non-U.S. Corporation satisfies the ownership tests (the “**Ownership Test**”) under Section 7874 that apply for purposes of determining whether a U.S. Corporation has successfully inverted. Given their narrow focus, the Temporary Regulations generally do not affect inversion transactions involving the combination of a non-U.S. corporation and a U.S. corporation that both are in active operating businesses, like Actavis-Warner Chilcott, Applied Materials-Tokyo Electron and Omnicom-Publicis. However, in a development that may have wider ramifications, the preamble to the Temporary Regulations asks for comments as to the potential application of Section 7874 to a common leveraged buyout structure.

Under the statutory Ownership Test, the Non-U.S. Corporation in an inversion transaction (the “**Transaction**”) will be treated as a U.S. corporation if, after the acquisition,¹ former shareholders of the U.S. Corporation own at least 80% (by vote or value) of the stock of the Non-U.S. Corporation by reason of their ownership of stock in the U.S. Corporation (any such ownership percentage, the “**Ownership Percentage**”).² Under the Code, stock of the Non-U.S. Corporation sold in a public offering related to the Transaction is excluded from the Ownership Test (the “**Public Offering Exclusion**”). The Notice expanded the Public Offering Exclusion to private offerings.

Temporary Regulations. The Temporary Regulations implement the Notice and, in certain respects, expand upon its scope. The highlights of the Temporary Regulations follow.

- ▶ Disqualified Stock Exclusion. Subject to the limitations noted below, the Temporary Regulations modify the Ownership Test by excluding from the denominator of the Ownership Test stock of the Non-U.S. Corporation (“**Disqualified Stock**”), that is:
 - transferred to a person other than the U.S. Corporation in exchange for (i) cash, (ii) “marketable securities,” (iii) property acquired with a “principal purpose of avoiding the purposes of section 7874” or (iv) certain obligations ((i) through (iv) together, “**Nonqualified Property**”); or
 - transferred to a person in exchange for property and, pursuant to the same plan, the transferee subsequently transfers such stock in satisfaction of one or more obligations associated with such property (“**Obligation Transfer Rule**”).³

¹ We assume that the Non-U.S. Corporation does not satisfy an alternative test under which it will be treated as having successfully inverted if it meets very high thresholds for business activities in its home jurisdiction.

² If the Ownership Percentage is at least 60%, the inversion is respected but certain limits are imposed on the use of the U.S. Corporation’s tax attributes.

³ As illustrated by an example in the Temporary Regulations, under the Obligation Transfer Rule, the Ownership Percentage would be calculated in the same manner regardless of whether the Non-U.S. Corporation issued 75 shares to the U.S. Corporation in (cont.)

As with the Notice, these rules (the “**Disqualified Stock Exclusion**”) apply without regard to whether the Disqualified Stock is issued in a public offering. In addition, unless the Obligation Transfer Rule otherwise applies, stock of the Non-U.S. Corporation transferred to a person other than the U.S. Corporation in exchange for the satisfaction or assumption of an obligation of the transferor of the stock in a transfer related to the Transaction will be treated as transferred in exchange for cash in an amount equal to the fair market value of such stock. The Notice did not include any of the rules regarding obligations.

For purposes of the Temporary Regulations, “marketable securities” generally include any security with respect to which there is a market on an established securities market other than stock of a corporation that becomes a member of the “expanded affiliated group” that includes the Non-U.S. Corporation, unless an anti-abuse rule applies.⁴

- ▶ Net Value Limitation. The Disqualified Stock Exclusion applies only where the stock exchanged will result in an increase in the fair market value of the assets of the Non-U.S. Corporation or a decrease in the amount of its liabilities. The Notice did not provide a similar limitation. This limitation is intended to clarify that transfers of stock of the Non-U.S. Corporation between shareholders (as opposed to issuances of stock by the Non-U.S. Corporation) generally do not give rise to Disqualified Stock.
- ▶ De Minimis Exception. The Disqualified Stock Exclusion does not apply if (i) the Ownership Percentage, determined without regard to the Disqualified Stock Exclusion, is less than 5% (by vote and value) and (ii) after the Transaction former shareholders of the U.S. Corporation in aggregate (and applying certain attribution rules) own less than 5% (by vote and value) of the stock of each member of the expanded affiliated group that includes the Non-U.S. Corporation (the “**De Minimis Exception**”). The De Minimis Exception does not apply with respect to Disqualified Stock transferred in a transaction related to the Transaction “with a principal purpose of avoiding the purposes of section 7874.” According to the preamble, the De Minimis Exception was provided in response to comments arguing that transactions in which former shareholders of the U.S. Corporation received significant non-stock consideration do not implicate the policies of Section 7874. Treasury disagreed, except to the extent the former shareholders only owned a *de minimis* amount of stock in the Non-U.S. Corporation after the Transaction.
- ▶ Transfer Prohibition. In order to prevent the avoidance of the Disqualified Stock Exclusion, stock of the Non-U.S. Corporation that would otherwise be taken into account in the Ownership Test shall not be excluded from the Ownership Test as a result of a subsequent transfer of such stock, even if such Transfer is related to the Transaction. The preamble notes that, absent such a rule, the Ownership Percentage could be manipulated by causing the stock of the Non-U.S. Corporation to be transferred pursuant to a binding commitment in effect at the time of the Transaction.
- ▶ Effective date. With respect to regulations described in the Notice, the Temporary Regulations apply to transactions completed on or after September 17, 2009. Otherwise, the Temporary Regulations apply to transactions completed on or after the date on which the Temporary Regulations are published in the Federal Register.

(cont.)

exchange for 100x of the U.S. Corporation’s assets subject to 25x of liabilities, or instead issued 100 shares of stock in exchange for 100x of the U.S. Corporation’s assets and the U.S. Corporation used 25 shares to satisfy 25x of related liabilities (in the latter case, 25 shares would be disregarded under the Obligation Transfer Rule).

⁴ “Expanded affiliated group” means “affiliated group” for purposes of the consolidated return rules but including foreign corporations and partnerships and using ownership of more than 50% to measure affiliation, as determined at the end of the day on which the Transaction is completed.

Anticipated Public Offerings. According to the preamble, the IRS is concerned that a Transaction that appears to resemble a leveraged buyout by a newly-formed privately-held Non-U.S. Corporation of a public U.S. Corporation that meets the De Minimis Exception by reason of management rollover equity, which is followed at some later time by a sale by the buyer of the stock of the Non-U.S. Corporation in a public offering “can be viewed as inconsistent with the policies underlying section 7874” if one of the possible exit strategies contemplated by the buyer at the time of the Transaction was a sale of stock of the Non-U.S. Corporation in a public offering. The IRS said such a transaction would “have the effect of converting a publicly traded domestic corporation into a publicly traded foreign corporation over time. . . .” The preamble appears to focus on the continuing equity interest of management as the “hook” for the potential application of Section 7874, although it is questionable under many common fact patterns whether compensatory shares issued to management would be construed as having been received “by reason of” management’s status as a shareholder of the U.S. Corporation. The IRS and Treasury have requested comments with respect to such transactions. It is far from clear that the IRS and Treasury have authority under the Code to issue such regulations.

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