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Proposed Legislation Would Significantly Limit Inversion Transactions

May 21, 2014 | Client Update | 4-minute read

As expected, Senator Carl Levin and thirteen other Democratic Senators yesterday introduced a bill that would significantly limit, for a two-year period, the ability of U.S. corporations to engage in the type of acquisitive "inversion" transactions that have been increasingly completed or proposed by many U.S. corporations, particularly in the pharmaceutical sector. *1*

The typical acquisitive inversion transaction involves (i) putting a newly-formed non-U.S. holding company on top of the existing U.S. corporation, with the shareholders of the U.S. corporation becoming shareholders of the non-U.S. holding company, in conjunction with (ii) the acquisition by the non-U.S. holding company of a foreign target corporation, in a transaction in which the former shareholders of the foreign target corporation receive more than 20% of the stock of the non-U.S. holding company. The transaction avoids the most detrimental aspects of current U.S. "anti-inversion" rules (Section 7874 of the Internal Revenue Code), which would otherwise generally treat the non-U.S. holding company as a U.S. tax resident corporation if the former shareholders of the existing U.S. corporation received 80% or more of the stock of the non-U.S. holding company in the transaction. In many of these transactions, the executive officers and senior management of the existing U.S. corporation became the executive officers and senior management of the non-U.S. holding company and remained located substantially in the United States, a fact that is not relevant for purposes of the current anti-inversion rules.

Effective for acquisitions completed after May 8, 2014 and before May 9, 2016, the Levin bill would amend Section 7874 as follows: *2*

- The required stock ownership of the non-U.S. holding company by the former shareholders of the foreign target corporation would be increased from more than 20% to at least 50%.
- Even if the stock ownership requirement is met, the non-U.S. holding company would still be treated as U.S. tax resident corporation if (i) "management and control" of the non-U.S. holding company group occurs, directly or indirectly, primarily within the United States, and (ii) the group has significant U.S. business activities. *3*

  - At a minimum, management and control of the group would be treated as occurring, directly or indirectly, within the United States if "substantially all" of the executive officers and senior management of the group (regardless of title) who exercise "day-to-day" responsibility for making decisions involving "strategic, financial and operational policies" of the group are based or primarily located in the United States.
  - A group would have significant U.S. business activities if at least 25% (or such lower percentage as may be specified in regulations) of the group's employees (by headcount or compensation), assets or income is located or derived in the United States, as determined by reference to existing regulations under Section 7874.
  - If the bill is enacted, and a U.S. corporation undergoes an inversion transaction that meets the new ownership requirement but would otherwise be caught by this new management and control test, the bill may have the effect of forcing a substantial portion of the executive officers and senior management of an inverting U.S. corporation to relocate outside the United States.

After May 9, 2016, the amendments made by the Senate bill would no longer be in effect and the current anti-inversion rules would come back into force for transactions occurring after that date. Senator Levin has indicated that the temporary nature of the amendments made by the bill is intended to effectively place a temporary "moratorium" on typical inversion transactions while Congress works on corporate tax reform, and is an attempt to make the bill more palatable to those members of Congress who would prefer corporate tax reform as a permanent solution to the inversion "problem." However, the fact that the bill has to date attracted only Democratic co-sponsors in the Senate is indicative of the difficulties that proponents of the bill may have in getting the bill passed in both the Senate and the Republican-controlled House of Representatives.

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1 Representative Sander Levin introduced a substantially identical bill in the House of Representatives, with nine other House Democrats, although the House bill did not contain the two-year sunset provision.

2 The following discusses only the provisions of the bill that relate to the types of inversion transactions described above. The bill would also make other, more technical changes to the existing anti-inversion rules that could affect other types of transactions.

3 This amendment to Section 7874 would generally apply to any non-U.S. corporation that acquires, directly or indirectly, substantially all of a U.S. corporation or a domestic partnership *of any size or in any type of transaction, including an all-cash acquisition*. This provision could apply, for example, to a foreign corporation that was the result of a prior inversion transaction that subsequently acquires another U.S. corporation, or even a foreign corporation, if the foreign target had a U.S. subsidiary.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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