Anti-Inversion Legislation May Impact Non-Inverted Private Equity Deals

Corporate inversions have been the target of regulatory or statutory tax proposals for many years. However, the recently attempted combination of Pfizer and AstraZeneca received prompt and more far-reaching attention in the U.S. Congress, both in the House of Representatives and Senate. Rep. Sander Levin and Sen. Carl Levin (both D-Mich.) proposed legislation to be known as the Stop Corporate Inversions Act of 2014. Aside from a specific end date for the legislation, which is contained in the Senate bill, but not in the House bill, the bills are identical. The purpose of this article is to describe the current tax laws impacting inversion transactions, and the proposed changes thereto, and, in particular, to alert private equity fund sponsors to a risk that these rules may apply to adversely impact foreign portfolio companies that have not been inverted in the typical sense.

Corporate Inversions – What They Are and Why We Do Them

Generally speaking, in a corporate inversion, a U.S. corporation will become a subsidiary of a foreign corporation. For example, assume that shareholders (U.S. and foreign) own stock of DelCo, a Delaware corporation. BermudaCo, a Bermuda corporation, is incorporated to effect the inversion transaction, and, in turn, forms U.S. Acquisition Corporation to effect the inversion transaction. DelCo then may be merged with and into U.S. Acquisition Corporation, or, more likely, U.S. Acquisition Corporation may be merged with and into DelCo. The consideration in each case would be stock of BermudaCo. After the transaction, former shareholders of DelCo would become the shareholders of BermudaCo, and BermudaCo would become the parent corporation of DelCo. Going forward, any expansion of the business outside the United States would be accomplished by BermudaCo and/or non-U.S. subsidiaries of BermudaCo. U.S. expansion would continue to be accomplished by DelCo and/or its domestic subsidiaries.

Relatively speaking, the United States is a high corporate tax jurisdiction. The top U.S. corporate income tax rate is 35 percent, compared to 21 percent in the United Kingdom, and 25 percent to 31 percent (depending on the province) in Canada. Moreover, unlike other countries, such as the United Kingdom, the United States taxes the earnings of non-U.S. subsidiaries when that income is distributed or, in certain cases, even before it is distributed. Finally, the United States taxes the dividends paid by U.S. corporations to their shareholders (including foreign shareholders).

Compare the above description to the case of the inverted structure with a Bermuda corporation, discussed above. While DelCo will continue to pay U.S. tax on its earnings, through various planning events, such as intercompany debt, the U.S. tax base can be minimized. In addition, distributions to BermudaCo will be subject to U.S. withholding tax. However, earnings from the foreign operations will not be subject to tax in the United States, either at the BermudaCo level, or in the hands of non-U.S. recipients of dividends from BermudaCo. Moreover, Bermuda will not tax any of the earnings of BermudaCo or its subsidiaries or shareholders.

Current Anti-Inversion Rules

Treasury’s first attempt to target inversions came when it modified the existing regulations that treat transactions that otherwise would be tax-free to shareholders as taxable. Under these regulations, U.S. persons who transfer stock of a U.S. corporation to a foreign corporation in an otherwise tax-free
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transaction will be subject to tax unless certain requirements are satisfied. Most importantly, tax-free treatment is turned off where the U.S. transferors own in the aggregate 50 percent or more of the foreign transferee corporation. Thus, where the U.S. target is larger than the foreign acquiring company, U.S. shareholders of the target will be subject to tax. This provision, while still in effect, was insufficient to prevent inversion transactions.

In 2004, Congress enacted anti-inversion legislation. The legislation was enacted retroactive to transactions effected after March 4, 2003. The rules (which currently are in effect) apply to foreign corporations which effect the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation. The acquisition of stock of a domestic corporation is treated as an indirect acquisition of its properties. Under the anti-inversion rules, if shareholders (whether U.S. or foreign) of a U.S. corporation own 80 percent or more (determined by vote or value) of the foreign transferee corporation by reason of their ownership in the U.S. corporation, the foreign corporation is treated as a U.S. corporation for all U.S. federal income tax purposes. In other words, the tax purpose of the inversion transaction is thwarted.

If the existing shareholders of the U.S. corporation acquire at least 60 percent, but under 80 percent, of the foreign transferee corporation, (i) the U.S. corporation cannot use tax attributes (such as net operating losses) to reduce inversion gain; (ii) certain foreign-source income is recharacterized as U.S.-source income for foreign tax credit purposes (which reduces the limit on the use of foreign tax credits; and (iii) an excise tax is imposed on the stock compensation of certain officers and directors of the U.S. corporation.

In order to permit transactions not effected for tax purposes, the above rules do not apply where the foreign corporation (together with its “expanded affiliated group”) has substantial business activities in its country of formation. Treasury Regulations provide that an expanded affiliated group that includes the foreign acquirer will satisfy this rule where at least 25 percent of the total number of group employees and at least 25 percent of the group assets are located in, at least 25 percent of the employee compensation is incurred in, and at least 25 percent of the total group income is derived in the foreign acquirer’s country of incorporation.

The rules for determining the percentage of the foreign transferee corporation’s stock that is owned by former shareholders of the U.S. corporation are somewhat surprising, and designed to maximize the number of transactions caught by the anti-inversion legislation. In particular, stock of the foreign corporation that is issued for cash, marketable securities or certain obligations (so-called “disqualified stock”) is excluded from the denominator of the ownership fraction. For example, assume that a private equity fund intends to acquire USCo. Its plans for growth include expansion outside the United States, so it decides to acquire USCo through a Luxembourg S.à r.l., (Luxco) treated as a corporation for U.S. tax purposes. Assume further that existing shareholders of USCo will roll over their investment in USCo in return for 10 percent of the shares of Luxco. On its face, this would not appear to constitute an inversion transaction, as the private equity fund owns 90 percent of Luxco. However, under this special rule, as the fund acquired its stock in Luxco for cash, all of the Luxco stock issued to them would be treated as disqualified stock, and, thus, disregarded in the denominator. Existing shareholders of USCo would be treated as receiving 10 percent/10 percent (or 100 percent) of the stock of Luxco, and Luxco would be treated as a domestic corporation. There is, however, a de minimis exception that would permit a roll over of up to 5 percent of Luxco stock.

2014 Proposed Modification to the Anti-Inversion Rules

The anti-inversion provisions described above did not halt all inversion activity. The current proposals, therefore, go significantly further to treat transactions as inversion transactions, and acquiring foreign corporations as U.S. domestic corporations for U.S. tax purposes.

The proposed legislation would reduce the current 80 percent threshold to 50 percent. The reduction is significant, because it means that in order for a transaction to escape the inversion rules, the former owners of the U.S. corporation will have to give up control of the foreign transferee.
The Levin proposals also would add a “management and control” alternative test to the anti-inversion rules. Thus, if a foreign corporation acquires substantially all of the properties held directly or indirectly by a domestic corporation and, after the acquisition,

- management and control of the expanded affiliated group of which the foreign corporation is a member occurs (directly or indirectly) primarily in the United States, and
- the expanded affiliated group has significant domestic business activities,

then, the foreign corporation is an “inverted domestic company” and is taxed as a U.S. corporation.

Treasury is given broad authority to prescribe regulations for determining whether management and control of an expanded affiliated group is treated as occurring primarily in the United States (directly or indirectly). However, the bills provide that Treasury Regulations will provide that management and control of an expanded affiliated group will be considered to be primarily in the United States if substantially all of the executive officers and senior management of the expanded affiliated group who exercise day-to-day responsibility (or other individuals who in fact exercise such day-to-day responsibilities) for making decisions involving strategic, financial and operational policies of the expanded affiliated group are based or primarily located in the United States. Note that unlike some of the European concepts of management and control, the focus is on the day-to-day activities, rather than on where directors meetings are held. Additionally, there is no requirement that the persons who exercise such day-to-day decision-making responsibilities be employees or former employees of the domestic target corporation.

The expanded affiliated group will be considered to have significant domestic business activities if at least 25 percent of the employees are located, employee compensation is incurred, assets are located, or income is derived in the United States. The 25 percent threshold and the tests appear to have been taken from the Treasury Regulations addressing whether a foreign corporation will be considered to have a substantial business activities in its country of formation. However, that test requires that the 25 percent threshold be satisfied for each factor (i.e., employees, compensation, assets and income), while the test for determining whether the group has significant domestic business activities requires that the 25 percent threshold be satisfied for any one of the factors. Moreover, although the proposed legislation retains the exception from inversion treatment for foreign corporations with significant business activities in its country of formation, the proposal specifically authorizes Treasury to increase the threshold from the current 25 percent. Finally, as with the management and control test, there is no requirement that the employees, compensation, assets or income be attributable to the domestic target corporation.

Here is an example that illustrates the potentially disturbing impact of the proposed anti-inversion legislation: Assume that a private equity fund owns all of the stock of UKCo, a corporation formed in the United Kingdom, which conducts a global business, owns all of the stock of DC, a Delaware corporation. UKCo formed DC several years ago, and has, to date, grown it organically, and not through acquisitions. UKCo’s growth in the United States has been such that executive officers and senior management of DC who exercise day-to-day responsibility (or other individuals who in fact exercise such day-to-day responsibilities) for making decisions on behalf of the UKCo group involving strategic, financial and operational policies are located in the United States. After May 8, 2014, UKCo acquires DT, a Delaware corporation, in a fully taxable transaction, and none of the former shareholders of DT receive any stock of UKCo in the transaction. Happy with their lucrative payout in the transaction, all executive officers of DT retire. DT represents only a small addition, constituting only 10 percent of the assets of UKCo. Following the transaction, the group including UKCo, DC and DT derives the majority of its income outside the United States (though less than 25 percent of the income is derived in the United Kingdom, and at least 25 percent of the income is derived in the United States), and a majority of the employees and assets are located in the United Kingdom. Moreover, a majority of the employee compensation is incurred outside the United States. Finally, assume that under Treasury Regulations, the group is considered to be managed and controlled primarily in the United States. In this case, UKCo will be treated as a domestic corporation for tax purposes, though DT contributes little in the way of income, assets or management of the group. Although a majority of the income is derived outside the United States, and a majority of the assets and employees are located in, and compensation is incurred in, the United Kingdom, the exemption for corporations with substantial business activities in a foreign country will not apply, because UKCo derives less than 25 percent of its income from the United Kingdom – the country of its formation. Moreover, although all of the executive officers of DT retire in connection with the transaction, the management and control test may be satisfied based on the pre-acquisition employees of DC.
In addition, returning to our prior example regarding the acquisition of USCo by a private equity fund through Luxco, this transaction likely would be caught under the proposed legislation even if existing shareholders of USCo received no stock of Luxco. Notwithstanding the de minimis ownership test, Luxco likely would be treated as an inverted domestic corporation (and, thus, treated as a U.S. corporation for tax purposes) based on the existence of management and control primarily in the United States.

Both bills are proposed to be effective retroactive to May 8, 2014. Although some commentators believe that it is inappropriate to enact retroactive legislation, we only have to look back to the anti-inversion legislation of 2004 to see that Congress will enact retroactive legislation when it feels it is important. The Senate bill includes a sunset. Under the Senate bill, the provision would fall away in two years. The reason for this is to give Congress time to adopt comprehensive tax reform. Sen. Levin felt that the “immediate threat” of inversion transactions required immediate relief, and that Congress should not wait until it adopts comprehensive tax reform to put a moratorium on inversion transactions. The two-year moratorium would give Congress the opportunity to debate and tweak while preserving the Treasury.

**Conclusion**

It remains to be seen whether the Stop Corporate Inversions Act of 2014 will become law. If it does, then, like the current anti-inversion legislation, it may well be enacted with retroactive effect to transactions completed after May 8, 2014. Moreover, the sweeping broad scope of the proposed legislation may well catch transactions not typically considered inversion transactions. Private equity firms, and strategic or financial acquirers considering transactions that could be caught by these rules, should seriously consider how to structure transitions and manage operations to avoid the impact and/or whether stock purchase agreements should include an escape clause in the event the legislation is enacted.

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**Endnotes**

1. The rules similarly apply to a foreign corporation that acquires substantially all of the properties constituting a trade or business of a domestic partnership.

2. As with the current inversion rules, the proposed legislation includes similar rules where a foreign corporation acquires substantially all of the properties constituting a business of a domestic partnership.

**About the Author**

Steven D. Bortnick is a partner in Pepper Hamilton’s Tax Practice Group and the firm’s Investment Funds Industry Group, which is an interdisciplinary industry group comprised of more than 60 lawyers who assist all types of investment funds throughout their entire life cycle.