

U.S. INVERSIONS – WHAT ARE THEY, AND WHAT ARE THEIR RESULTS FOR A FOREIGN ACQUIROR?

January 20, 2020

Michael Cadesky
mcadesky@cadesky.com

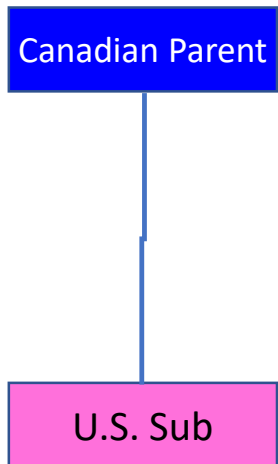
Andreas Apostolides
apostolides@ruchelaw.com

U.S. Tax Cuts and Jobs Act (2017)

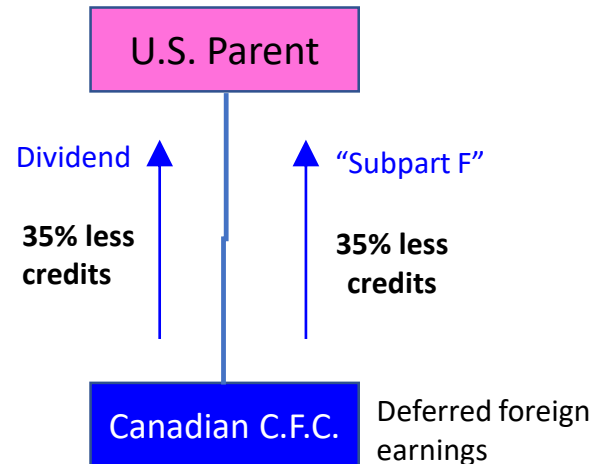
1. PRE-2017 U.S. TAX REFORM — Worldwide Taxation, Deferral & Repatriation Planning

Corporate tax rate: 35%

"Inbound" Structure

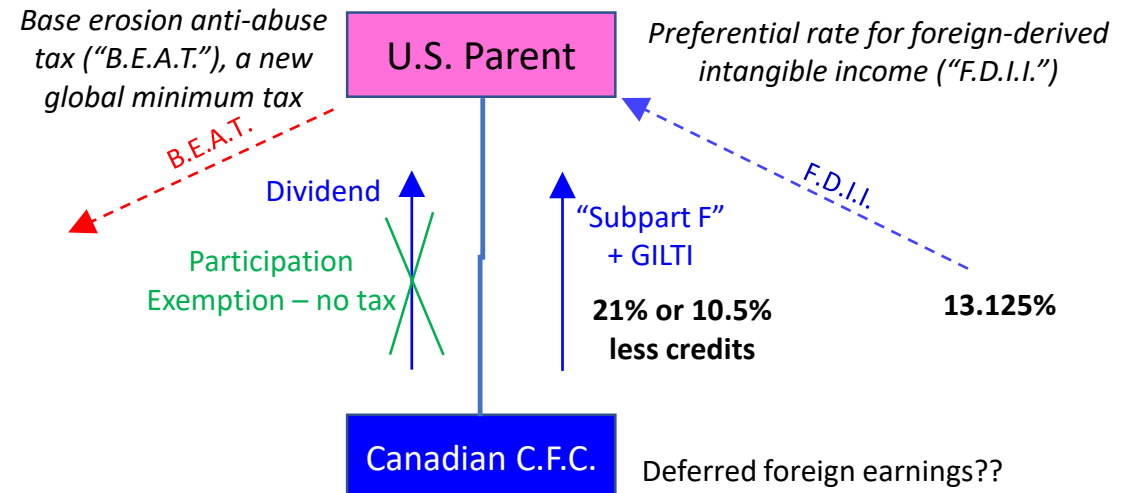


"Outbound" Structure

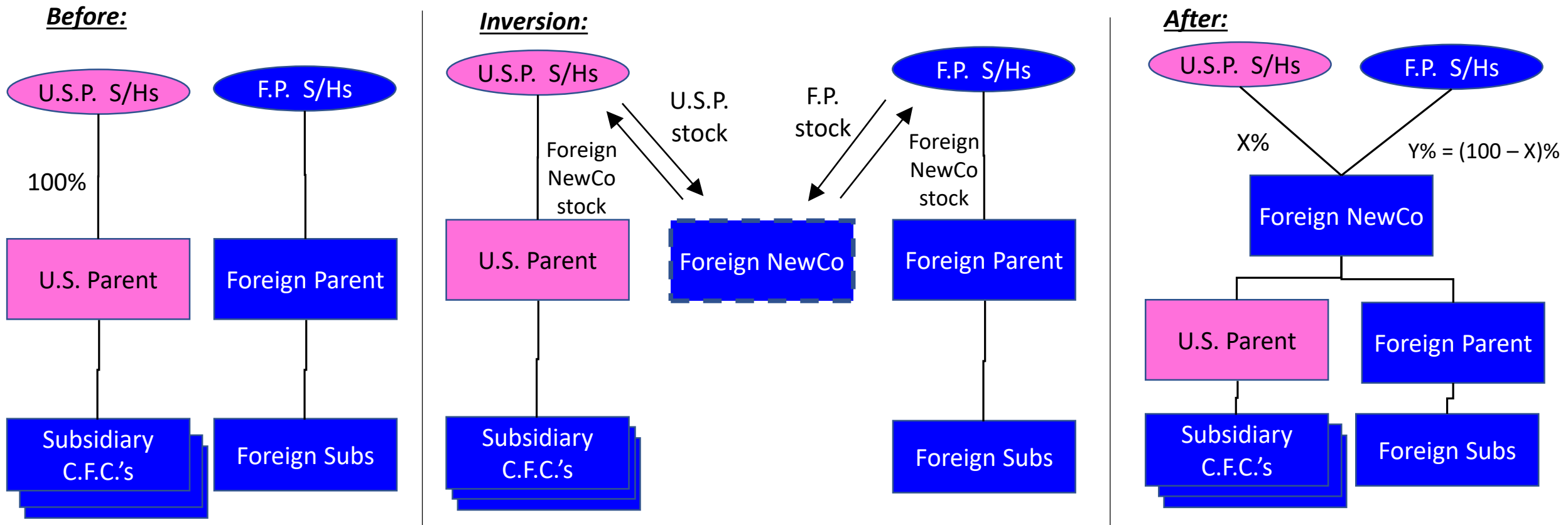


2. AFTER 2017 TAX REFORM — "Quasi"-Territorial System with Global Minimum Tax and Participation Exemption

Corporate tax rate: 21%



Typical fact pattern



- Often the next step was “out-from-under” planning for C.F.C.’s or issuance of debt or stock to bring cash into the U.S. tax-free

§7874 – Ownership Fraction

- §7874 focuses on the percentage ownership of the former U.S.P. shareholders in the new Surrogate Foreign Corporation “by reason of” their former shareholding in U.S.P.
 - **80%-Ownership** – (i) the U.S. entity’s former U.S. shareholders (or members) own directly at least 80% of Surrogate Foreign Corporation’s stock “by reason of” their former holdings in U.S. entity, and (ii) the expanded affiliate group of the acquirer does not have substantial business activities in the foreign country of incorporation
 - **Consequence:** Surrogate Foreign Corporation is treated as a U.S. corporation for all U.S. Federal tax purposes for a period of 10 years
 - Overrides conflicting Treaty provisions
 - **60%-Ownership** – same test as above, but former U.S. shareholders numerical ownership in Surrogate Foreign Corporation is in the 60–79.99% range
 - **Consequence:** foreign residence of Surrogate Foreign Corporation is regarded for U.S. tax purposes, however, the U.S. corporation must pay tax on any “inversion gain” and cannot use U.S. tax attributes (N.O.L.’s and credits) to offset such tax

Penalties under §7874

- Treatment as a U.S. corporation, regardless of what bilateral tax treaties may provide
- **“Inversion gain”** – income and gains from shifting assets outside of the U.S. taxing jurisdiction to the foreign acquirer or to related persons are taxed currently by the U.S. for a 10-year period, including any income or gain received or accrued by the “expatriated entity” in consequence of the inversion by reason of license of any property
- 15% excise tax imposed on specified stock compensation of certain disqualified insiders with respect to the former U.S.-incorporated entity
- **Interaction with T.C.J.A.** – after tax reform the “inversion trap” makes inverting much harsher:
 - Recapture of Transition Tax at 35% rate without foreign tax credits (as opposed to 8-15.5% rate with credits);
 - Increased “base erosion and anti-abuse tax” (B.E.A.T.), and
 - Taxation of shareholders on distributions at ordinary income rates up to 37% (rather than qualified dividend rates up to 20%)
- **Result:** some companies are exploring become US domiciled again

§7874 – additional considerations

- **Lower than 60% ownership** – where former shareholders own more than 50% and less than 60% of Surrogate Foreign Corporation by reason of their former stockholdings in the U.S. entity (and no stock is recharacterized or otherwise excluded from the Ownership Fraction under the Regulations), §7874 rules are inapplicable
- **I.R.S. Rules issued through 2018** – addressed in detail concepts like the “serial acquisition rule”, the “multiple domestic entity” rule (rolling 36 month lookback aggregating series of separate acquisitions), rule for “skinny-down dividends” (also referred to as “non-ordinary course distributions” that companies used to tweak the ratio of values of the U.S. operations to those of the Foreign Acquiring, potentially in order stay out of the 60-80% ownership band), all of which affect computation of the “Ownership Fraction”
 - in addition, Treasury Regulations defined terms like “substantial business activities” of the expanded affiliate group (“E.A.G.”), important for determining when an inversion may be excepted from §7874

Discussion – recent client experiences

- Recent examples from practice involving Canadian acquiring corporations and U.S. targets