Insight

Understanding Treasury's New Guidance on Inversions

GORDON GRAY | NOVEMBER 20, 2015

Inversions occur when U.S. companies reincorporate abroad. In recent years, this has typically occurred as part of a cross-border merger or acquisition. These deals usually make strategic business sense, but the outmoded U.S. corporation income tax (that features a very high rate and worldwide base) drives the decision to headquarter abroad.

In response to the continued political firestorm that accompanies inversions, the Treasury Department issued new guidance on Thursday aimed at curbing them. The Treasury's latest guidance follows up on related guidelines issues in September of 2014. Specifically, the latest notice broadly addresses a class of inversions in which the former U.S. firm owns at least 60 percent, but less than 80 percent, of the new foreign entity. Existing law continues to treat the firm as a U.S. headquarters if the U.S. firm remains an 80 percent or greater owner of the new foreign corporate entity. At the other end of the spectrum, it imposes no strictures on U.S. corporate movements abroad, or "expatriations," if the formerly U.S. domiciled firm owns less than 60 percent of the new firm. The latest guidance would apply three new changes to transactions falling in this 60-80 percent band, all designed to limit the ability of U.S. firms to relocate abroad for tax purposes.

First, the new guidance would limit the ability of U.S. firms to merge with a foreign firm in country, but reside for tax purposes in a third country. In general, the new guidance would disregard the fraction of stock ownership in the new corporation held by the original foreign partner, and thus disregard the inversion entirely. Consider the example of U.S. Corporation A, deciding to merge with UK Corporation B into Ireland Corporation C. Under the new entity, 65 and 35 percent shares of corporation C would be owned by shareholders of corporations A and B, respectively. In this instance the new treasury guidance would ignore the 35 percent ownership share of corporation B in corporation C. For U.S. tax purposes, the new entity would thus remain a wholly owned U.S. company, and would not be recognized as having expatriated.

Second, for an inversion to be recognized, the new corporate entity must have "substantial business activities" in its new corporate home. This provision, in current law, is designed to preclude mere paper inversions, where firm that is for all intents and purposes a U.S. business moves abroad for tax purposes. The current law standard requires that a firm must have 25 percent of firm's employees, group assets, and group income in its parent country. However foreign tax law does not necessarily align with this standard, meaning a firm may be headquartered in one country, where it may claim substantial businesses activities for the purpose of U.S. law, but may reside for tax purposes in a third country. The new guidelines state Treasury's intentions to issue regulations to require that country in which the new entity has its headquarters for purposes of the "substantial business activity" also by the country of residence for tax purposes.

Third, the new guidelines would seek to limit the practice of "stuffing" a foreign partner for the purpose of a corporate inversion or expatriation. Recall that the applicability of many of the prongs of "anti-inversion" rules are contingent upon ownership ratios of foreign and domestic entities in the new or "top tier" corporate entity. Many of these strictures are obviated if the foreign partner is sufficiently large, providing incentive to inflate the value of the foreign partner. The new Treasury guidance would disallow consideration of certain assets in the valuing the size of the new corporate entity, which could materially affect ownership ratios for the purposes of anti-inversion rules.

These new provisions would only affect future transactions. The new guidance also contained some retroactive provisions. The Treasury guidance tightened existing limitations on certain tax preferences for inversions falling in the 60-80 percent ownership ratio band, and corrects and clarifies the guidance issued by Treasury in September of 2014. IT should be noted that Medtronic, which acquired Ireland-based Covidien in January of 2015 stated that the new guidance would, "not have a material financial impact on the company."

While lacking force of law or a formal rule, guidance is generally not ignored by regulated entities, and Treasury has promised to follow-up these notices with rulemaking.