Fact Sheet: Additional Treasury Actions to Rein in Corporate Tax Inversions

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What is a corporate inversion?

A corporate inversion is a transaction in which a U.S. based multinational restructures so that the U.S. parent is replaced by a foreign parent, in order to avoid U.S. taxes. Current law subjects many inversions that appear to be based primarily on tax considerations to certain potentially adverse tax consequences. However, the continued occurrence of these transactions indicates that for many corporations these consequences are acceptable in light of the potential tax benefits.

Under current law, an inverted company is subject to potential adverse tax consequences if, after the transaction: (1) less than 25 percent of the new multinational entity’s business activity is in the home country of the new foreign parent, and (2) the shareholders of the former U.S. parent end up owning at least 60 percent of the shares of the new foreign parent. If these criteria are met, the tax consequences depend on the size of the continuing ownership stake of the shareholders of the former U.S. parent. If the continuing ownership stake is 80 percent or more, the new foreign parent is treated as a U.S. corporation (despite the new corporate address), thereby nullifying the corporate inversion for tax purposes. If the continuing ownership stake is at least 60 but less than 80 percent, U.S. tax law respects the foreign status of the new foreign parent but other potentially adverse tax consequences may follow. The notice being issued today involves transactions in this continuing ownership range of 60 to 80 percent.

Only legislation can decisively stop inversions. The Administration has been working together with Congress for several years in an effort to reform our business tax system, make it simpler and more pro-growth, and address the incentives that encourage companies to engage in inversions.

In the absence of legislative action, on September 22, 2014, Treasury announced guidance that both made it more difficult for U.S. companies to invert and reduced the tax benefits of doing so by eliminating techniques used by inverted companies to access overseas earnings without paying U.S. tax. Today, Treasury is taking additional actions to make it more difficult for U.S. companies to invert and to further reduce the tax benefits of inversions.

Specifically, today’s notice makes it more difficult for U.S. companies to invert by:

Strengthening the requirement that the former owners of a U.S. company own less than 80 percent of the new combined entity

Limit the ability of U.S. companies to combine with foreign entities when the new foreign parent is located in a “third country” (Action under section 7874 of the code)

- In certain inversion transactions, a U.S. company combines with a smaller existing foreign corporation using a new foreign parent whose tax residence is different from that of the existing foreign corporation. In other words, the new foreign parent will be a tax resident of a “third country.” The third country chosen generally will have a favorable tax system and income tax treaty with the United States. The decision to locate the tax residence of the new foreign parent outside of both the United States and the jurisdiction in which the existing foreign corporation is a tax resident generally is made to facilitate U.S. tax avoidance after the inversion transaction.

- Today’s notice provides that in certain cases when the foreign parent is a tax resident of a third country, stock of the foreign parent issued to the shareholders of the existing foreign corporation is disregarded for purposes of the ownership requirement, thereby raising the ownership attributable to the shareholders of the U.S. entity, possibly above the 80-percent threshold.

- The rule addressing “third country” inversions will prevent U.S. firms from essentially cherry-picking a tax-friendly country in which to locate their tax residence.

Limit the ability of U.S. companies to inflate the new foreign parent corporation’s size and therefore avoid the 80-percent rule, (Action under section 7874 of the code)

- Companies can successfully invert when a U.S. company has, for example, a value of 79 percent, and the foreign “acquirer” has a value of 21 percent of the combined group. However, in some inversion transactions, the foreign acquirer’s size may be inflated by “stuffing” assets into the foreign acquirer as part of the inversion transaction in order to avoid the 80-percent rule.

- Current law disregards the stock of the foreign parent corporation that is attributable to such assets, thereby raising the U.S. entity’s ownership, possibly above the 80-percent threshold. However, certain taxpayers may be narrowly interpreting the anti-stuffing rules to apply only to passive assets.

- Today’s notice clarifies that the anti-stuffing rules apply to any assets acquired with a principal purpose of avoiding the 80-percent rule, regardless of whether the assets are passive assets.

Strengthening the substantial business activities exception (Action under section 7874 of the code)

- Under current law, a U.S. company can successfully invert if, after the transaction, at least 25 percent of the combined group’s business activity is in the foreign country in which the new foreign parent is created or organized. This is the case regardless of whether the new foreign parent is a tax resident of that foreign country.

- The standard for determining tax residence of a corporation for U.S. income tax purposes is where the entity is created or organized. Thus, a corporation is treated as domestic if it is created or organized under the law of the United States or of any State and as foreign if it is created or organized under the law of a foreign country. This standard, however, may not align with standards of foreign countries, which, for example, may be based on criteria such as the location in which the entity is managed or controlled.

- Today’s notice provides that the combined group cannot satisfy the 25-percent business activities exception unless the new foreign parent is a tax resident in the foreign country in which it is created or organized. Thus, this rule will limit the ability of a U.S. multinational to replace its U.S. tax residence with tax residence in another country in which it does not have substantial business activities.
These actions apply to deals closed today or after today.

Specifically, today's notice reduces the tax benefits of inversions by:

Preventing inverted companies from transferring foreign operations “out from under” the U.S. tax net without paying current U.S. tax

Expand the scope of inversion gain for which current U.S. tax must be paid (Action under section 7874 of the code)

- Under current law, U.S. multinationals owe U.S. tax on the profits of their controlled foreign corporations (CFCs), although they do not usually have to pay the tax until those profits are paid to the U.S. parent as a dividend. Profits that have not yet been repatriated are known as deferred earnings. However, to the extent a CFC has passive income the U.S. parent is treated as if it received a taxable deemed dividend from the CFC.
- Under current law, an inverted company must pay current U.S. tax on inversion gain (the gain recognized when the inverted company transfers stock in its CFCs or other property to the new foreign parent) without the benefit of otherwise applicable tax attributes (such as net operating loss carryovers) to offset the gain. Thus, these rules impose penalties on post-inversion transactions that are designed to remove income from foreign operations from the U.S. taxing jurisdiction.
- Today’s notice expands the scope of inversion gain to include certain taxable deemed dividends recognized by an inverted company. Specifically when that dividend is attributable to passive income recognized by a CFC when the CFC that transfers foreign operations to the new foreign parent.

Require that all built-in gain in CFC stock be recognized, without regard to the amount of deferred earnings, upon a restructuring of the CFC (Action under section 367 of the code)

- After an inversion transaction, the new foreign parent may acquire CFC stock held by the former U.S.-parented group, with the result that the CFC is no longer under the U.S. tax net. Under current law, the former U.S. parent must recognize built-in gain in the CFC stock as a result of the transfer, but not in excess of the deferred earnings of the CFC.
- Today’s notice provides that all the built-in gain in the CFC stock must be recognized as a result of the post-inversion transfer, regardless of the amount of the CFC’s deferred earnings, thereby potentially increasing the amount of current U.S. tax paid as a result of the transfer.

These actions apply to inversions completed on or after September 22, 2014.

Additional actions

Make corrections to the rules in Notice 2014-52 that limit the ability of U.S. companies to invert:

Limit the ability of companies to count passive assets that are not part of the entity’s daily business functions in order to inflate the new foreign parent’s size and therefore evade the 80-percent rule – known as using a “cash box.” (Action under section 7874 of the code)

- Today’s notice corrects the “cash box” rule that disregards stock of the foreign parent that is attributable to existing passive assets in the context of the 80-percent threshold. The correction ensures that assets used in an active insurance business are not treated as passive assets.

Prevent U.S. companies from reducing their size by making extraordinary dividends. (Action under section 7874 of the code)

- Today’s notice corrects the rule that would disregard certain pre-inversion extraordinary dividends for purposes of the ownership requirement. The correction ensures that the extraordinary dividend rule does not apply when a foreign corporation acquires a U.S. company in an all-cash or mostly cash acquisition.

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