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Cross-border M&A: Putting the recently finalized inversion regulations into context

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On July 11, 2018, the U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (the IRS) issued final regulations (the Regulations) continuing efforts aimed at curbing cross-border corporate expatriation transactions — commonly referred to as inversions — and diminishing the tax advantages associated with inversions.

The Regulations generally follow the guidance provided in notices and temporary and proposed regulations promulgated during the 2014-2016 period (the Prior Guidance), with certain clarifications and modifications.

Differences between the Regulations and the relevant Prior Guidance are generally technical, and the Regulations do not change fundamental policy decisions reflected in such guidance.[1]

This Client Alert outlines notable changes and considerations raised by the Regulations given the Tax Cuts and Jobs Act (the 2017 Act).[2]

Considering these latest updates in the context of how inversion issues can impact the M&A market is important, including in light of how the significant 2017 Act fits into the key decisions surrounding cross-border M&A, selecting a holding company jurisdiction, and designing a global platform for a multinational corporation.

Central concepts

The Prior Guidance had a fundamental impact on the M&A market by limiting both:

- The ability to qualify a transaction under the anti-inversion rules (that is, the rules increased the possibility that a foreign holding company would be treated as domestic)
- Post-inversion planning, such as certain cash repatriation and group restructuring techniques

The rules included in the Prior Guidance remain in full force, with the Regulations simply clarifying certain provisions. Thus, all of the restrictions imposed under the Prior Guidance remain applicable to current transactions, with no indication of regulatory or legislative relief on the horizon.

As enacted, those provisions can impact deals that, five years ago, would have been far outside the scope of the anti-inversion rules, thus resulting in a surprise inversion issue for senior management or investment bankers analyzing a potential transaction.

The 2017 Act was, fundamentally, never intended or designed to make an inversion or corporate expatriation easier. Rather, the 2017 Act aimed to reduce the appeal of such a transaction — and of a foreign holding company structure — by enacting a more competitive US corporate tax regime with a lower corporate tax rate and a partial participation exemption for foreign earnings.

Finally, the 2017 Act actually made the inversion trap harsher in that engaging in a transaction in which the inversion fraction is 60 percent or more can now result in:

- A recapture of the 2017 Act transition tax on foreign earnings at a full 35 percent rate without foreign tax credits (as opposed to a 15.5 percent rate with such credits)
- An increased base erosion and anti-abuse tax
- The taxation of shareholders on distributions at ordinary income (as opposed to qualified dividend) rates (together, the 2017 Act Inversion Penalties)

Thus, while under the original statutory provision many transactions were structured so that the inversion fraction was simply below 80 percent, the 2017 Act Inversion Penalties move the goalposts.

Parties will now find it critical to structure their transactions so that the inversion fraction is below 60 percent in order to avoid the 2017 Act Inversion Penalties. Indeed, one might say that after the 2017 Act, "60 is the new 80."

GOING FORWARD

Taking into account these factors — and as described in Latham's January 2018 White Paper on the 2017 Act[3] — dealmakers and their advisers will in most cases continue to opt for a foreign holding company, if such a path is available in a deal, which increases the relevance of these rules and the Regulations as the business community and their advisors look to a post-2017 Act M&A market.

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In that regard, these rules may only become more important going forward, particularly as the financial benefits associated with debt investments decreases due to the limitation imposed by the 2017 Act on interest deductions under Section 163(j),[4] a limitation which becomes more onerous beginning in 2022.

The continued tightening of tax benefits associated with debt financing will likely prompt dealmakers to increase the use of share consideration for target companies, perhaps coupled with a spin-off.

As has been abundantly clear over the last several years, whenever a foreign acquirer issues equity in a deal, the US anti-inversion rules require analysis, even in cases in which their application seems far from the original intent of the statute.

NOTES

[1] For further discussion of certain portions of prior pronouncements specifically addressed by the Regulations, see Latham's 2016 Client Alert, Treasury Issues Stringent Inversion Regulations, Proposes Far-Reaching Related-Party Debt Rules, https://bit.ly/2OkBwiG.

[2] Public Law No. 115-97 (Dec. 22, 2017). Shortly before final Congressional approval of the Act, the Senate parliamentarian ruled that the previously attached short title, the "Tax Cuts and Jobs Act," violated procedural rules governing the Senate's consideration of the legislation. Accordingly, the Act does not bear a short title, although commentators generally have continued to refer to it as the Tax Cuts and Jobs Act.

[3] Latham's January 2018 White Paper can be found at https://bit.ly/2ORTR7K.

[4] All references to "Section" refer to sections of the Internal Revenue Code of 1986, as amended (the Code), unless otherwise indicated. All references to "§" refer to sections of the Treasury Regulations promulgated under the Code.

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