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Anti-Inversion Regulations Announced

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In the last week of September, the U.S. Treasury submitted proposed regulations to the White House Office of Management and Budget to prevent U.S. companies from engaging in so-called "earning stripping". This practice consists of a foreign controlled-domestic company making loans to its U.S. subsidiary with purposes of accruing deductible interests from its overall earnings. In so doing, the U.S. entity creates a tax expense that reduces its income tax base and shifts its earnings overseas.

Those interests are usually received by an inverted company located either in a jurisdiction with a low income tax rate or in a tax haven that does not levy passive income, such as interests received from abroad. Therefore, the U.S. profits are subject to a reduced or nonexistent income taxation. Under the proposed regulations, the interests would be treated, for U.S. tax purposes, as dividends, and thus no tax deduction would apply.

Such inversion transactions normally involve a cross-border merger operation where a U.S. company is absorbed by a foreign related party. Subsequently, the head-office and legal residence of the company shifts overseas. To combat these maneuvers, the Treasury issued regulations which seek to disregard three years of past mergers in determining the size of the foreign company. This makes the foreign company smaller in relation the U.S. subsidiary. As a result, Controlled Foreign Corporations Rules (CFC Rules) would apply.

This is relevant because when the shareholders of a former U.S. company remain owners of at least 80% of the combined business, then domiciled outside of U.S., the post-merger business combination is subject to U.S. income tax, regardless of its formal current domicile.

These measures would affect recent cross-borders transactions such as Pfizer Inc. and Allergan PLC. Not surprisingly, business and industry groups have announced lawsuits against the inverted companies' and earnings stripping regulations on grounds of their possible side effects on legitimate business reorganizations. The regulations may also affect the capacity for a business group to use available cash from a jurisdiction or a business line to lever investments in another jurisdiction or another business line.

The Organization for the Economic Cooperation and Development (OECD) has proposed tools to fight earnings shifting and base erosion. The Treasury has considered some of these measures, including BEPS, in its design of the anti-inversion policy. Indeed, CFC rules and limits on the deductibility of interests have followed the OECD's guidelines.

It is expected that the White House Office of Management and Budget will decide whether or not it will adopt the regulations by the end of December.