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CANADIAN TAX *Highlights*

Inversion Regs: Private Placements

The IRS has announced that it will issue new regulations governing foreign inversions, further limiting the ability of a foreign corporation to acquire a USco without triggering unfavourable US tax results (Notice 2009-78, 2009-40 IRB 452). Congress first enacted the corporate inversion regime in 2004 to address the expatriation of UScos in circumstances that appeared to lack a legitimate business purpose. Since then, the IRS has gradually tightened the rules through a series of temporary regulations. The latest regulatory change addresses third-party investments in foreign acquisitions of a USco.

A corporate inversion occurs when (1) a foreign acquiring corporation (forco) acquires substantially all of a USco's properties; (2) the post-acquisition "expanded affiliated group," which includes the forco, does not have substantial business activities in the foreign country where the forco was organized; and (3) after the acquisition, at least 60 percent of the forco's stock (determined by vote or value) is owned by the USco's former shareholders. Similar rules apply if the forco acquires substantially all the properties constituting a US partnership's trade or business. Certain forco stock is disregarded in determining how much is owned by the former USco shareholders: (1) forco stock held by members of the expanded affiliated group, which includes the USco, and (2) forco stock sold in a public offering related to the acquisition.

Sixty percent stock ownership is the minimum level that invokes the inversion rules. Once that level is attained, an inversion's tax consequences depend on whether the former USco shareholders' ownership in the forco reaches 80 percent or more. If the former USco shareholders own between 60 and 80 percent of the forco acquiror's shares, the forco's status as a foreign corporation is respected, but certain corporate-level "toll charges" that may apply cannot be offset by tax attributes such as net operating losses or foreign tax credits. If the former USco shareholders own 80 percent or more of the forco's stock after the acquisition, the forco is treated as a US domestic entity for all US tax purposes: it is subject to US income tax on its worldwide income and its stock is considered to be a US-situs asset subject to US estate tax--an important consideration for any non-US shareholder.

Until the latest regulations were announced, the USco shareholders could minimize their forco share ownership for the purposes of the 80 percent ownership test by bringing in an outside investor. For example, the USco shareholders could transfer all of their USco stock to a newly formed forco in exchange for less than 80 percent of the new forco's stock. In a related transaction, the investor transferred cash to the new forco in exchange for more than 20 percent of its stock; because these forco shares were not "sold in a public offering" to the investor, they were counted for the purposes of determining whether the former USco shareholders owned at least 80 percent of the forco. The former USco shareholders owned less than 80 percent of the forco shares, and thus the forco's status as a foreign entity was respected for US tax purposes.

The new regulations are intended to curb this private placement practice, which the IRS believes manipulated the inversion rules by using a third-party investor. Under the new regulations, applicable to acquisitions completed after September 16, 2009, forco stock issued in exchange for "nonqualified property" in a transaction related to the acquisition--whether or not the stock is publicly traded--is not taken into account for the purposes of applying the ownership test. With certain exceptions, the term "nonqualified property" is defined as (1) cash or cash equivalents, (2) marketable securities, and (3) any other property acquired in a transaction whose principal purpose is avoidance of the inversion rules. Marketable securities generally do not include stock (or a partnership interest) issued by a member of the post-acquisition expanded affiliated group, which includes the forco.

The following example illustrates the new regulations' effect. Individual A wholly owns USco. Forco X, a newly formed corporation, acquires all of USco's stock in exchange for Forco X stock only. In a transaction related to the USco stock acquisition, a Canadian partnership transfers marketable securities to Forco X solely in exchange for Forco X stock. Under the new regulations, Forco X stock issued to the Canadian partnership is not taken into account in determining

the amount of stock owned by the former USco shareholders. The former USco shareholder is treated as owning 100 percent of Forco X's stock after the acquisition, and Forco X is treated as a US domestic entity for US tax purposes.

The new regulations thus expand the type of forco stock that is disregarded for the purposes of applying the ownership test to encompass stock issued under a private placement. Combined with the June 2009 temporary regulations' removal of the "substantial business activities" safe harbour (TD 9453, 2009-28 IRB 114), the new regulations will have a chilling effect on the acquisition of a USco by a forco.

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