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KIRKLAND **M&A UPDATE**

April 10, 2014

Inversions — Upside for Acquisitions

While the tax rules and deal structures in acquisition inversions are complex, the significant opportunities mean that exploring the possibility of an inversion will continue to be a necessary and desirable element of many cross-border M&A transactions.

With U.S. corporate tax rates among the highest in the world, U.S.-based companies with international operations regularly look for structuring opportunities to reduce the exposure of their overseas earnings to U.S. taxes. A recent trend driving deal activity is the prevalence of acquisition-related inversions whereby the acquiring company redomiciles to a lower-tax jurisdiction concurrently with completing the transaction. While not the exclusive driver, a significant benefit of these inversions is reducing the future tax exposure of the combined company. The tax rules applicable to these inversion transactions are inherently complex and situation-specific. Below, we outline some of the very general principles, as well as some of the opportunities and challenges presented by these transactions.

In general, a U.S. company can redomicile to another jurisdiction (referred to as a "self-inversion") without running afoul of the punitive IRS anti-inversion rules if it has substantial business activities (generally, 25% or more of its sales, assets, income and employees) in the new jurisdiction. Being that most U.S. multinationals would not be able to meet this self-inversion test in any jurisdiction, interest has grown in an alternative test applicable to an inversion completed in connection with the purchase of a foreign-incorporated M&A target (referred to as an "acquisition inversion"). Under this test, the target and buyer often can be combined under a new holding company in a lower-tax foreign jurisdiction, which does not have to be the domicile of the foreign target, if at completion more than 20% of the combined company's stock is owned by former shareholders of the foreign target.

While challenges exist in finding a foreign target that presents an otherwise attractive strategic fit and is right-sized compared to the buyer to satisfy the >20% test described above (noting that for larger targets acquirer cash can also be used in addition to sufficient stock meeting the test), significant tax benefits can accrue if an appropriate target is identified and the companies are combined under a new foreign parent. These opportunities include reducing current or future non-U.S. earnings being passed through a U.S. parent taxed at the higher U.S. rates, optimizing intercompany indebtedness, and better positioning for future acquisitions where the benefits of the new structure can be applied to future targets. Depending on the circumstances, the inversion transaction may be taxable to acquirer shareholders and have additional tax consequences on compensation for acquirer executives — these possible negatives need to be weighed against the potential savings of the transaction.

Inversion transactions present a number of challenges from a corporate and capital markets perspective. Given the reincorporation and share issuance, the acquisitions almost always require approval by acquirer shareholders (as well as target shareholders). In addition, acquirers will have to consider the governance and capital markets issues associated with redomiciling under a parent company in a non-U.S. jurisdiction (such as Ireland or the U.K.). The legal and governance regimes applicable in these countries are different from, and often less certain than, those in the United States, and may include being subject to unfamiliar takeover regimes and requiring that certain supervisory board and executive actions occur in those countries.

The recent spate of inversion transactions has attracted the attention of U.S. authorities, including within overall reconsideration of the U.S. corporate tax regime. For example, the Obama Administration's budget proposal includes a recommendation that the acquisition inversion test be modified for transactions completed after 2014 to require that more than 50% (rather than the current >20%) of the combined company's shares be held by former shareholders of the foreign target in order to avoid the anti-inversion rules. While it is impossible to predict the outcome of this or other U.S. and foreign legislative and regulatory proposals, dealmakers should be mindful of potential rule changes that could affect the executability and/or future benefits of inversion transactions.

Inversions have been a significant catalyst in cross-border M&A activity over the last couple of years. While most of the transactions have been concentrated in the pharmaceutical sector (e.g., Actavis/Warner Chilcott, Endo/Paladin, Perrigo/Elan), there have been a number in other industries (e.g., Eaton/Cooper, Applied Materials/Tokyo Electron, Liberty/Virgin, Chiquita/Fyffes). In addition, already-completed inversions can be drivers of further M&A opportunities — either by positioning the inverted company as an advantaged potential acquirer of future targets (e.g., Actavis/Forest Labs) or perhaps by making the now-enlarged inverted company a target for an even larger U.S. company seeking yet another inversion. While the tax rules and deal structures in these acquisition inversions are complex, the significant opportunities mean that exploring the possibility of an inversion will continue to be a necessary and desirable element of many cross-border M&A transactions.

If you have any questions about the matters addressed in this *M&A Update*, please contact the following Kirkland authors or your regular Kirkland contact.

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