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KIRKLANDPEN

Private Equity Newsletter

September 30, 2014

U.S. Treasury Moves to Limit Corporate Inversions

PENpoints

A recent U.S. Treasury Department Notice limits certain tax benefits from inversion transactions, effective immediately.

A large number of high profile transactions combining a U.S. parented multi-national group and a foreign (i.e., non-U.S.) corporation under a newly formed or existing foreign corporation (commonly referred to as an "inversion") have recently been effectuated or proposed, leading to considerable public debate in the press, Congress, and the Obama administration about whether (and how) to curtail such transactions. On September 22, 2014, the U.S. Treasury Department issued a Notice describing in broad terms regulations it intends to issue in the future limiting certain tax benefits from an inversion transaction that are perceived as abusive.

What is an Inversion?

A U.S. corporation with significant foreign operations can often take advantage of lower foreign tax rates by conducting its foreign operations through a foreign subsidiary, and can generally defer paying U.S. tax on the foreign subsidiary's foreign income until such income is (1) repatriated to the U.S. (e.g., by paying a dividend to its U.S. parent) or (2) otherwise used to acquire U.S. property (e.g., by making a loan to the U.S. parent).

Under pre-existing law, the U.S. tax advantages can be improved if the U.S. parent combines with a foreign corporation and becomes a subsidiary of the foreign corporation (with the shareholders of both corporations receiving stock in the new foreign parent), so long as a substantial portion of the combined foreign entity is owned by the historic foreign corporation's shareholders.[1] Such a transaction is commonly called an "inversion."

September 22 Treasury Notice

Treasury's September 22 Notice states that the as-yet unwritten regulations generally apply to any inversion closed on or after September 22, 2014, even if the parties had signed binding transaction documents before such date.

The Notice is aimed at (i) certain transactions that might allow a U.S. parent access to foreign subsidiaries' "trapped cash" (i.e., cash accumulated by the foreign subsidiary's earnings not yet subjected to U.S. tax), (ii) certain perceived abuses used by taxpayers to avoid running afoul of the tax code's pre-existing anti-inversion rules, and (iii) potential additional limitations on U.S. interest deductions on corporate debt owed to an affiliated foreign corporation.

- **Hopscotch loan to access trapped cash.** Under longstanding tax law, when a cash-rich foreign subsidiary uses its foreign earnings to make a loan to its U.S. parent, the amount of the loan is taxed in the U.S. as income to the U.S. parent. However, if the U.S. parent had inverted (so that the ultimate parent is a foreign corporation), the cash-rich foreign subsidiary could make a loan to its indirect foreign parent, rather than to its direct U.S. parent, without triggering U.S. tax, a so-called "hopscotch loan" because the foreign subsidiary's loan jumps over the foreign subsidiary's old U.S. parent and goes directly to the new foreign parent.

  Under the Notice, if a U.S. group is involved in an inversion, and one of its foreign subsidiaries makes such a hopscotch loan, the U.S. group is subject to immediate U.S. tax, in the same manner as if the loan were made to the old U.S. parent. A foreign subsidiary's purchase of stock in the new foreign parent would similarly be taxable.

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- **Disregard decontrol transaction.** Under pre-existing tax law, after an inversion the new foreign parent could acquire a direct controlling interest in the U.S. group's foreign subsidiaries — e.g., the new foreign parent could purchase from the foreign subsidiary enough newly issued stock to give the new parent control — without imposition of U.S. income tax. Because the foreign subsidiary was no longer controlled by the U.S. parent, the U.S. parent was no longer taxed on the use of the foreign subsidiary's retained foreign earnings to buy U.S. property.

  Under the Notice, certain transactions which cause the old U.S. parent to no longer own a controlling stock interest in the foreign subsidiary without imposition of U.S. tax are disregarded, and the U.S. parent is treated as continuing to control the foreign subsidiary, so U.S. tax continues to be due on use of the foreign subsidiary's earnings just as before the inversion.

- **Prohibit down-sizing and cash box inversions.** Under long-standing tax law, if the pre-inversion shareholders of the U.S. parent own, after the inversion, 80% or more of the new foreign parent, the new foreign parent is treated as a U.S. taxpayer and thus does not obtain any tax benefit from the inversion (the "80% test").

  Treasury was concerned that in recent inversions taxpayers were inappropriately reducing the post-inversion percentage of the new foreign parent owned by the old U.S. parent's shareholders for purposes of the 80% test by (1) causing the U.S. parent to make significant pre-inversion distributions of cash or other property in order to down-size the percentage of the new foreign parent's stock owned post-inversion by the old U.S. parent's shareholders or (2) combining the U.S. parent with a foreign target whose value was artificially inflated by the presence of cash or other passive assets not used in the conduct of the foreign target's business in order to up-size the percentage of the new foreign parent's stock owned post-inversion by its pre-inversion stockholders.

  Under the Notice, the new regulations will disregard (1) certain pre-inversion asset distributions by the old U.S. parent to its pre-inversion shareholders during the 3-year period prior to the inversion, thus artificially increasing the percentage of the new foreign parent's stock hypothetically owned by the old U.S. parent's pre-inversion shareholders, and (2) a portion of the new foreign parent's stock received by former owners of the foreign target to the extent of the value of significant cash and other passive assets[2] (a so-called "cash box") held by the foreign target immediately before the inversion, thus artificially decreasing the percentage of stock hypothetically owned by the new foreign target's pre-inversion shareholders. Thus, these new rules increase the percentage of stock deemed owned by shareholders of the old U.S. parent, increasing the likelihood of running afoul of the 80% test.

- **Limitations on interest deductions.** Under long-standing tax law, a U.S. corporation may (subject to certain limitations) issue debt to its foreign parent (or a foreign affiliate) and deduct interest on such debt paid annually, thus reducing U.S. taxable income (so-called "earning-stripping"). The Notice states that if Treasury (after further study) ultimately issues regulations further limiting deduction of such interest, such regulations would be effective for transactions closed on or after September 22, 2014.[3]

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1 In transactions where historic shareholders of the U.S. group own 80% or more of the combined entity, the combined entity continues to be taxed as a U.S. corporation, despite its foreign incorporation, and hence derives no tax benefits from the inversion. In cases where historic shareholders of the U.S. group own between 60 and 80% of the combined entity, the combined entity is not treated as a U.S. corporation, but its ability to use certain tax attributes to move assets offshore is severely limited.

2 This rule applies only where the foreign target's cash and other passive assets represent more than 50% of such foreign target corporation's gross assets.

3 This portion of the Notice (like the other portions of the Notice) is effective for a transaction closed on or after September 22, 2014, even though Treasury has neither stated the substance of the possible future regulation nor even whether such a regulation will ultimately be promulgated.

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

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SEC Sanctions Delays in Beneficial Ownership Reporting by Private Fund Sponsors

PENpoints

The SEC's recent sanctions are a reminder of the value of a robust culture of compliance and strict adherence to routine filing and reporting requirements.

The Securities and Exchange Commission ("SEC") recently sanctioned a number of parties, including several private fund sponsors, for failing to timely report securities holdings and transactions in company stock.[1] Because these are strict liability provisions, the SEC may impose such sanctions even if the failure to file was inadvertent, unintentional or unknowing. The obligation to make such filings applies irrespective of whether the filer made any profit or the filer's reasons for engaging in a reportable transaction. The SEC's actions in these cases serve as a reminder to all market participants of the importance of strict compliance with the reporting requirements under Section 16(a) and Sections 13(d) and (g) of the Securities Exchange Act of 1934.

Under Section 16(a), directors, officers and greater-than-10% beneficial owners of a registered class of equity security are required to file reports of their beneficial ownership and transactions on Forms 3, 4 and 5. Transactions reported on Form 4 must be filed within two business days of the transaction. Sections 13(d) and 13(g) of the Exchange Act require beneficial owners of more than 5% of a class of equity securities to report their ownership on Schedule 13D or, if eligible, Schedule 13G.

The sanctions continue the SEC's trend to use streamlined investigations to target potential violations of securities laws, even more technical, non-fraud violations that have not traditionally been the focus of the SEC's Division of Enforcement. They also represent the SEC's increased use of sophisticated data analytics to identify potential violations of securities laws. According to the SEC press release, the staff used quantitative data sources and ranking algorithms to identify individuals and companies with filing delinquencies. In past years, the SEC's use of such initiatives was limited to more serious enforcement actions, such as ones targeting insider trading, Ponzi schemes and financial reporting and accounting fraud.

Finally, the actions are emblematic of Chair Mary Jo White's "broken windows" enforcement strategy. As outlined in Chair White's remarks at the Securities Enforcement Forum last fall, "minor violations [the so-called broken windows] that are overlooked or ignored can feed bigger ones, and, perhaps more importantly, can foster a culture where laws are increasingly treated as toothless guidelines. And so, I believe it is important to pursue even the smallest infractions."

The Division of Enforcement will continue to identify new enforcement priorities and leverage new investigative techniques in an effort to identify and prosecute new areas of misconduct and investor harm. This latest example not only reinforces the importance of timely reporting of stock transactions and holdings required under Sections 13 and 16, but also should remind private fund sponsors of the value of a robust culture of compliance and the necessity of strict adherence to even the most routine of filing and reporting requirements. Sponsors and their publicly-traded portfolio companies may wish to review their policies and procedures to ensure that they are reasonably designed to facilitate compliance with Sections 13 and 16 requirements.

1 *SEC Announces Charges Against Corporate Insiders for Violating Laws Requiring Prompt Reporting of Transactions and Holdings* (Sept. 10, 2014) http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542904678#.VBW59J0pAiR

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CFTC to Permit General Solicitation by Exemption Filers

On September 9, 2014, the Commodity Futures Trading Commission ("CFTC") issued much-anticipated relief [1] permitting private fund sponsors to take advantage of JOBS Act general solicitation and advertising provisions that had previously been unavailable to CFTC exemption filers.

As discussed in a previous *KirklandPEN*, in July 2013 the SEC adopted Rule 506(c) governing the conditions under which issuers may engage in general solicitation and advertising. However, sponsors whose hedging or other activities (e.g., entering into swap transactions) require them to file for certain CFTC exemptions [2] on behalf of their private funds were unable to employ general solicitation and advertising due to historical language in those CTFC exemptions prohibiting "marketing to the public" in the United States.

The new relief harmonizes the CFTC's exemptions with the SEC's rules, and permits CFTC exemption filers to engage in general solicitation on behalf of their private funds, subject to certain conditions, including requiring the relevant offerings to comply with Rule 506(c) and the sponsor to make a notice filing with the CFTC via e-mail.

1 http://www.cftc.gov/LawRegulation/CFTCStaffLetters/14-116

2 I.e., those under CFTC Regulations 4.13(a)(3), commonly known as the "*de minimis* exemption," and 4.7, which permits sponsors to take a "registration light" approach to the operation of the relevant fund(s).

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PENbriefs

Books and Records Demands Becoming an Open Book

A recent Delaware court decision highlights the growing risk to companies of statutory "books and records" demands, which are often speculative fishing expeditions in the guise of investigating alleged corporate wrongdoing. In light of these developments, companies should be thoughtful about their document creation practices and policies. To learn more, see our recent *Alert*.

U.S. Sanctions Update: Russia

In light of the ongoing conflict in the Ukraine, the United States, the European Union and other governments have imposed sanctions on various sectors of the Russian economy, particularly in the areas of energy, finance and defense. To learn more, see our recent *Alert* and its update.

PENnotes

PLI Hot Topics in Mergers & Acquisitions 2014
New York, New York
October 2, 2014

The M&A markets were relatively flat throughout 2013, punctuated by episodic but unsustained bursts of activity. By contrast, 2014 appears to be off to a more robust start. An expert faculty of lawyers, general counsels, regulators and investment bankers will explore the fascinating state of M&A and trends for the year ahead. Kirkland partners R. Scott Falk and Sarkis Jebejian are co-chairs of the event, and partner Stephen Fraidin will speak at the seminar as well. Click here for more information.

Securities Enforcement Forum 2014
Washington, D.C.
October 14, 2014

This one-day conference brings together current and former senior SEC and DOJ officials. securities enforcement and white collar attorneys, in-house counsel and compliance executives to discuss the most important issues currently facing attorneys and professionals in the SEC enforcement area. Kirkland partner Robert Khuzami will serve on the historic Directors' Panel for the event, which will feature five current or former SEC Directors of Enforcement and their discussion of SEC enforcement issues and developments over the past four decades. Click here for more information.

PLI Understanding the Securities Laws Fall 2014
Chicago, Illinois
October 23-24, 2014

This program provides an overview and discussion of the basic aspects of the U.S. federal securities laws by leading in-house and law firm practitioners and key SEC representatives. Emphasis will be placed on the interplay among the Securities Act of 1933 and the Securities Exchange Act of 1934 and related SEC regulations and how those laws were affected by the Sarbanes-Oxley Act, the Dodd-Frank Act and the controversial Jumpstart Our Business Startups ("JOBS") Act, which created the concept of "emerging growth companies." Kirkland partner Theodore Peto will speak at the event. Click here for more information.

9th Annual Kirkland Real Estate Private Equity Symposium
New York, New York
November 19, 2014

Please save the date for the upcoming "Kirkland Real Estate Private Equity Symposium." The 9th Annual Kirkland Real Estate Private Equity Symposium, titled "Looking Over the Crest: Tomorrow's Investment Risks and Opportunities" will be hosted in Kirkland's New York office. Kirkland welcomes Sam Zell, Founder and Chairman of Equity Group Investments, as the keynote speaker. More information to come.

RR Donnelley SEC Hot Topics Institute
Chicago, Illinois
November 20, 2014

RR Donnelley will host its annual SEC Hot Topics Institute in Chicago. Renowned experts will examine the latest developments and trends, provide insight into what lies ahead and impart practical, actionable guidance on the crucial issues facing today's corporate and securities law practitioners and finance professionals. Kirkland partner Robert Hayward will be co-chairing the event and will be speaking at the event along with Stephen Fraidin. Click here for more information.

PLI Securities Regulation Institute (46th Annual)
New York, New York
November 5-7, 2014

PLI presents its annual review of the current state of securities regulation and corporate law and practice. This year's agenda reflects significant developments in the securities laws and changes in the business and legal environment, including continued implementation of the Dodd-Frank and JOBS Acts; developments in the IPO process, capital formation and M&A; panels on activism, communications to investors and crisis management; accounting and disclosure developments; ongoing aggressive enforcement efforts; and the active private litigation environment. Kirkland partner Robert Khuzami will speak at the event. Click here for more information.

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Kirkland & Ellis' nearly 400 private equity attorneys have handled leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 400 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in 2012, 2013 and 2014 by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. Kirkland & Ellis was named "Law Firm of the Year" in Mergers and Acquisitions Law by U.S. News Media Group and Best Lawyers in their 2014 "Best Law Firms" rankings. The Firm was named "Best M&A Firm" at *World Finance*'s 2014 Legal Awards, "Law Firm of the Year in North America: Fund Formation" at Private Equity International's 2013 Private Equity International Awards and "Private Equity Deal of the Year" at the 2014 IFLR Americas Awards.

In 2012, 2013 and 2014, Chambers and Partners ranked Kirkland as a Tier 1 law firm for Investment Funds in the United States, United Kingdom, Asia-Pacific and globally. The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011, 2012 and 2013*, and has consistently received top rankings among law firms in Private Equity by The Legal 500, the Practical Law Company and IFLR, among others.

The Lawyer magazine has recognized Kirkland as one of its "Transatlantic Elite" every year since 2008, having noted that the Firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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