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# Corporate Expatriation, Inversions, and Mergers: Tax Issues

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## Summary

News reports in the late 1990s and early 2000s drew attention to a phenomenon sometimes called corporate “inversions” or “expatriations”: instances where U.S. firms reorganize their structure so that the “parent” element of the group is a foreign corporation rather than a corporation chartered in the United States. The main objective of these transactions was tax savings and they involved little to no shift in actual economic activity. Bermuda and the Cayman Islands (countries with no corporate income tax) were the location of many of the newly created parent corporations.

These types of inversions largely ended with the enactment of the American Jobs Creation Act of 2004 (JOBS Act, P.L. 108-357), which denied the tax benefits of an inversion if the original U.S. stockholders owned 80% or more of the new firm. The act effectively ended shifts to tax havens where no real business activity took place.

However, two avenues for inverting remained. The act allowed a firm to invert if it has substantial business operations in the country where the new parent was to be located; the regulations at one point set a 10% level of these business operations. Several inversions using the business activity test resulted in Treasury regulations in 2012 that increased the activity requirement to 25%, effectively closing off this method. Firms could also invert by merging with a foreign company if the original U.S. stockholders owned less than 80% of the new firm.

Two features made a country an attractive destination: a low corporate tax rate and a territorial tax system that did not tax foreign source income. Recently, the UK joined countries such as Ireland, Switzerland, and Canada as targets for inverting when it adopted a territorial tax. At the same time the UK also lowered its rate (from 25% to 20% by 2015).

Several high profile companies have more recently indicated an interest in merging or plans to merge with a non-U.S. headquartered company, including Pfizer, Chiquita, AbbVie, and Burger King. For Pfizer, which has accumulated substantial profits in subsidiaries in low tax foreign countries that would be taxed if paid to the U.S. parent, the territorial tax system is likely the most important tax benefit from such a merger. This “second wave” of inversions again raises concerns about an erosion of the U.S. tax base.

Two policy options have been discussed in response: a general reform of the U.S. corporate tax and specific provisions to deal with tax-motivated international mergers. Some have suggested that lowering the corporate tax rate as part of broader tax reform would slow the rate of inversions. Although a lower rate would reduce the incentives to invert, it would be difficult to reduce the rate to the level needed to stop inversions, especially given the effect of the revenue loss on the budget. Other tax reform proposals suggest that if the United States moved to a territorial tax, the incentive to invert would be eliminated. There are concerns that a territorial tax could worsen the profit-shifting that already exists among multinational firms.

The second option is to directly target the merger inversions. H.R. 4679, S. 2360, and the President’s FY2015 budget proposal would treat all mergers as U.S. firms if the U.S. shareholders maintain control of the merged company. H.R. 1554, H.R. 3666, and S. 268 are among the proposals that would limit the tax benefits of an inversion, while H.R. 694 and S. 250 would, in addition to limiting tax benefits for merged firms, eliminate deferral. H.R. 5278 and S. 2704 would disallow awarding federal contracts to inverted firms. Other legislative and administrative proposals to reduce the benefits of inversions have been proposed. On September 22, 2014, the Treasury announced regulatory measures to limit some of the benefits of inversions.



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## Introduction

The U.S. corporate income tax is based on worldwide economic activity. If all of a corporation's economic activity is in the United States, then tax administration and compliance is relatively straight-forward. Many corporations, however, operate in several jurisdictions, which creates complications for tax administration and compliance. Further, corporations may actively choose where and how to organize to reduce their U.S. and worldwide tax liabilities. Some of these strategies have been referred to as expatriation, inversions, and mergers. This report examines them in light of recent expansion of their use and growing congressional interest.

This report begins with a brief discussion of relevant portions of the U.S. corporate income tax system before examining how inversions were commonly structured. The report then looks at how Congress and Department of the Treasury have reduced the benefits of inversions. The report concludes with an examination of methods that remain to invert and policy options available to prevent or limit these inversions.

Achieving tax savings using an inversion became more difficult with the enactment of the American Jobs Creation Act of 2004 (JOBS Act, P.L. 108-357). The JOBS Act denied or restricted the tax benefits of an inversion if the owners of the new company were not substantially different from the owners of the original company. The act also allowed a firm to invert only if it had substantial business operations in the country where the new headquarters was to be located.

Although the 2004 legislation largely prevented the types of inversions that drew attention prior to its adoption, several companies have successfully inverted in the past few years by using the substantive business operations mechanism or merging.<sup>1</sup> Treasury regulations have subsequently limited the former mechanism.<sup>2</sup>

In the spring of 2014, several high-profile companies indicated an interest in merging or plans to merge with a non-U.S. firm, including Pfizer,<sup>3</sup> Chiquita,<sup>4</sup> and Omnicom (an advertising firm).<sup>5</sup> News reports indicated that a group of Walgreens investors were also urging such a move.<sup>6</sup>

<sup>1</sup> John D. McKinnon and Scott Thurm, "U.S. Firms Move Abroad to Cut Taxes: Despite '04 Law, Companies Incorporate Overseas, Saving Big Sums on Taxes," *Wall Street Journal*, August 28, 2012, [http://online.wsj.com/news/articles/SB10000872396390444230504577615232602107536?mod=WSJ\\_business\\_LeadStoryCollection&mg=reno64-sj&url=http%3A%2F%2Fonline.wsj.com%2Farticle%2FSB10000872396390444230504577615232602107536.html%3Fmod%3DWSJ\\_business\\_LeadStoryCollection](http://online.wsj.com/news/articles/SB10000872396390444230504577615232602107536?mod=WSJ_business_LeadStoryCollection&mg=reno64-sj&url=http%3A%2F%2Fonline.wsj.com%2Farticle%2FSB10000872396390444230504577615232602107536.html%3Fmod%3DWSJ_business_LeadStoryCollection); Bret Wells, "Cant and the Inconvenient Truth about Corporate Inversions," *Tax Notes*, July 23, 2012, pp. 429-439; Reuven S. Avi-Yonah, "Territoriality: For and Against," *Tax Notes International*, May 13, 2013, pp. 661-663.

<sup>2</sup> Treasury Decision, T.D. 9592, July 12, 2012.

<sup>3</sup> Pfizer failed in its initial bid to acquire Astra-Zeneca, but a takeover could still occur. Inyoung Hwang, "AstraZeneca Bullish Options Gain on Pfizer Comeback Bets," *Bloomberg News*, September 2, 2014, <http://www.bloomberg.com/news/2014-09-02/astrazeneca-bullish-options-gain-on-pfizer-comeback-bets.html>.

<sup>4</sup> A company may invert even if it does not currently expect to pay U.S. tax. See *10K Filing of Chiquita Brands International, Inc. to the Securities and Exchange Commission*, March 31, 2009.

<sup>5</sup> Omnicom has abandoned its proposed merger. See David Gelles, "At Odds, Omnicom and Publicis End Merger," May 8, 2014, *New York Times*, <http://dealbook.nytimes.com/2014/05/08/ad-agency-giants-said-to-call-off-35-billion-merger/>.

<sup>6</sup> Ameet Sachdev and Peter Frost, "Walgreen Pressured To Move Headquarters To Europe," *Chicago Tribune*, April 14, 2014, [http://articles.chicagotribune.com/2014-04-14/business/chi-walgreens-headquarters-to-europe-\(continued...\)](http://articles.chicagotribune.com/2014-04-14/business/chi-walgreens-headquarters-to-europe-(continued...))

Although the Pfizer and Omnicon mergers and Walgreens headquarters shifts ultimately did not take place, other firms announced mergers in the late spring and early summer. A number of firms in the medical device or pharmaceuticals fields announced mergers or proposed mergers with a shift of headquarters: Medtronic,<sup>7</sup> Salix,<sup>8</sup> AbbVie,<sup>9</sup> Mylan,<sup>10</sup> and Hospira.<sup>11</sup> In August, concern about inversions increased with the announcement that Burger King was in talks to merge with Tim Hortons, a Canadian firm, with the merged firm's headquarters in Canada.<sup>12</sup> An agreement was announced on August 26. Although Burger King is a smaller firm than AbbVie, for example, it is a household name and this proposed inversion garnered much attention.

This “second wave” of inversions again raises concerns about an erosion of the U.S. tax base. While the substantial business avenue appears to have been largely eliminated by new Treasury regulations that increased the required share of activity, the option of merging with a smaller foreign company remains. U.S. firms may also merge with larger firms, although in this case the tax benefits are less likely to be key factors in the decision to merge.

The Treasury Department has recently released a notice of regulatory changes that would restrict some aspects of inversions or their benefits, and has indicated that other actions may follow.<sup>13</sup>

## U.S. International Tax System

The United States uses a system that taxes both the worldwide income of U.S. corporations and the income of foreign firms earned within U.S. borders. All income earned within U.S. borders is taxed the same—in the year earned and at statutory tax rates up to 35%.

U.S. corporate income earned outside the United States is also subject to U.S. taxation, though not necessarily in the year earned. This occurs because U.S. corporations can defer U.S. tax on active income earned abroad in foreign subsidiaries until it is paid, or repatriated, to the U.S.

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<sup>7</sup> David Gelles, “In Medtronic’s Deal for Covidien, an Emphasis on Tax Savings,” *New York Times Dealbook*, June 16, 2014, [http://dealbook.nytimes.com/2014/06/16/in-medtronics-deal-for-covidien-an-emphasis-on-tax-savings/?\\_php=true&\\_type=blogs&\\_r=0](http://dealbook.nytimes.com/2014/06/16/in-medtronics-deal-for-covidien-an-emphasis-on-tax-savings/?_php=true&_type=blogs&_r=0).

<sup>8</sup> Simeon Bennett and Alex Wayne, “Salix to Merge With Cosmo in Latest Tax Inversion Deal,” *Bloomberg*, July 9, 2014, <http://www.bloomberg.com/news/2014-07-08/salix-to-merge-with-cosmo-in-latest-tax-inversion-deal.html>.

<sup>9</sup> Nathan Vardi, “AbbVie To Buy Shire For \$54 Billion In Biggest Inversion Deal Ever,” *Forbes*, July 18, 2014, <http://www.forbes.com/sites/nathanvardi/2014/07/18/abbvie-to-buy-shire-for-54-billion-in-biggest-inversion-deal-ever/>.

<sup>10</sup> Ronald Barusch, “Dealpolitik: Mylan’s Simpler Inversion Structure Could Set Trend,” *Wall Street Journal*, July 16, 2014, <http://blogs.wsj.com/moneybeat/2014/07/16/dealpolitik-mylans-simpler-inversion-structure-could-set-trend/>.

<sup>11</sup> David Gelles, “Drug Maker Hospira and France’s Danone in Talks on \$5 Billion Inversion Deal,” *New York Times Dealbook*, July 27, 2014, [http://dealbook.nytimes.com/2014/07/27/hospira-and-danone-in-talks-on-5-billion-inversion-deal/?\\_php=true&\\_type=blogs&\\_r=0](http://dealbook.nytimes.com/2014/07/27/hospira-and-danone-in-talks-on-5-billion-inversion-deal/?_php=true&_type=blogs&_r=0).

<sup>12</sup> Liz Hoffman and Dana Mattioli, “Burger King in Talks to Buy Tim Hortons in Canada Tax Deal: Tie-Up Would Be Structured as Tax Inversion With a Combined Market Value of About \$18 Billion,” *Wall Street Journal*, August 25, 2014, <http://online.wsj.com/articles/burger-king-in-talks-to-buy-tim-hortons-1408924294>.

<sup>13</sup> Treasury Notice 2014-52, September 22, 2014. See also the Treasury Press Release, Fact Sheet: Treasury Actions to Rein in Corporate Tax Inversions, at <http://www.treasury.gov/press-center/press-releases/Pages/jl2645.aspx>.

parent company as a dividend.<sup>14</sup> To mitigate double taxation, tax due on repatriated income is reduced by the amount of foreign taxes already paid.

Income from certain foreign sources earned by subsidiaries—which generally includes passive types of income such as interest, dividends, annuities, rents, and royalties and is referred to as Subpart F income—is generally taxed in the year it is earned. Subpart F applies only to shareholders who may be able to influence location decisions at the corporate level.<sup>15</sup> These subsidiaries are referred to as controlled foreign corporations (CFCs).

## Anatomy of an Inversion

A corporate inversion is a process by which an existing U.S. corporation changes its country of residence. Post-inversion the original U.S. corporation becomes a subsidiary of a foreign parent corporation. Corporate inversions occur through three different paths: the substantial activity test, merger with a larger foreign firm, and merger with a smaller foreign firm.<sup>16</sup> Regardless of the form of the inversion, the typical result is that the new foreign parent company faces a lower home country tax rate and no tax on the company's foreign-source income.<sup>17</sup>

The U.S. firm can use inversions to reduce taxes using various techniques. Foreign operations in the future can be formed as subsidiaries of the new foreign parent in a country with a territorial tax, so that future foreign income can be exempt from tax. Accumulated and future foreign income from the U.S. company's foreign subsidiaries (which would be taxed by the United States if paid to the parent as a dividend) may be effectively repatriated tax free by lending or otherwise investing in the related foreign firm, such as a low interest loan to the foreign parent holding company. These borrowed funds could then be used, for example, to pay dividends to shareholders or make loans to the U.S. firm.<sup>18</sup>

In addition, the combined firm can engage in “earnings stripping”: reducing income in the U.S. firm by borrowing from the U.S. company and increasing interest deductions.<sup>19</sup> For example a foreign parent may lend to its U.S. subsidiary. This intercompany debt does not alter the overall company's debt, but does result in an interest expense in the United States (which reduces U.S. taxes paid) and an increased portion of company income being “booked” outside the United

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<sup>14</sup> CRS Report R40178, *Tax Cuts on Repatriation Earnings as Economic Stimulus: An Economic Analysis*, by Donald J. Marples and Jane G. Gravelle. Income from branches and passive income earned directly, such as interest and royalties, is taxed currently.

<sup>15</sup> These stockholders are defined as owning at least 10% of a subsidiary's stock and only subsidiaries that are at least 50% owned by 10% U.S. stockholders.

<sup>16</sup> The techniques corporations use to invert—stock-for-stock inversions, asset transfers, or drop-down inversions—apply to all forms of inversions. In drop-down inversions, assets are transferred to the new parent, and some of those assets are transferred to a domestic subsidiary.

<sup>17</sup> William McBride, *Corporate Exits Accelerating, Taking Jobs with Them*, Tax Foundation, April 25, 2014, <http://taxfoundation.org/blog/corporate-exits-accelerating-taking-jobs-them>.

<sup>18</sup> The U.S. firm cannot shift its existing foreign subsidiaries to the new parent without paying a corporate level tax, although it might be able to transfer intangible assets of the U.S. firm or its subsidiaries at a below market price.

<sup>19</sup> U.S. Department of Treasury, Report to Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties, November 2007.

States. Royalty payments, management fees, and transfer pricing arrangements are other avenues for earnings stripping, but are thought to be of lesser importance than intercompany debt.<sup>20</sup>

## **Substantial Business Presence**

In this form of inversion, a U.S. corporation with substantial business activity in a foreign company creates a foreign subsidiary. The U.S. corporation and foreign subsidiary exchange stock—resulting in each entity owning some of the other’s stock. After the stock exchange, the new entity is a foreign corporation with a U.S. subsidiary, as the exchange is generally in proportion to the respective company valuations. As this form of inversion does not require any change in the effective control of the corporation, it is referred to as a “naked inversion.”

## **U.S. Corporation Acquired by a Larger Foreign Corporation**

In this form of inversion, a U.S. corporation would like to bolster its foreign operations and, perhaps, lower its U.S. tax. To do so, the U.S. corporation merges with a larger foreign corporation, with the U.S. shareholders owning a minority share of the new merged company. This results in the effective control of the new company being outside U.S. borders.

While this form of inversion may be driven by business considerations, tax considerations may also be part of the decision. An example of this can be seen in the following statement by the board of directors of a U.S. corporation recommending approval of a merger with a UK corporation. The board of directors pursued the merger in part because:

... Ensco was headquartered in a jurisdiction that has a favorable tax regime and an extensive network of tax treaties, which can allow the combined company to achieve a global effective tax rate comparable to Pride’s competitors.<sup>21</sup>

In this case, a U.S. firm, Pride, merged with a UK firm, Ensco, and the headquarters remained in the UK.

## **A Smaller Foreign Corporation Acquired by a U.S. Corporation**

In this form of inversion, a U.S. corporation would like to bolster its foreign operations and lower its U.S. tax. To do so, the U.S. corporation merges with a smaller foreign corporation, with the U.S. shareholders owning a majority share of the new merged company. This merger results in the effective control of the new company staying with the shareholders of the U.S. corporations.

While this form of inversion may be driven by business considerations, tax considerations may also be part of the decision. An example is the Eaton Cooper merger. The following is an excerpt of a U.S. corporation’s (Eaton’s) press release announcing the acquisition of an Irish company

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<sup>20</sup> U.S. Congress, House Committee on Ways and Means, *Statement of Pamela F. Olson, Acting Assistant Secretary for Tax Policy*, Hearing on Corporate Inversions, 107<sup>th</sup> Cong., 2<sup>nd</sup> sess., June 6, 2002.

<sup>21</sup> Ensco-Pride International Inc. Joint Proxy Statement, “Recommendation of the Pride Board of Directors and Its Reasons for the Merger,” April 25, 2011, <http://www.sec.gov/Archives/edgar/data/314808/000095012311039244/d80026b3e424b3.htm>.



(Cooper), with the company headquartering in Ireland (with a 12.5% tax rate and a territorial system).

At the close of the transaction ... Eaton and Cooper will be combined under a new company incorporated in Ireland, where Cooper is incorporated today. The newly created company, which is expected to be called Eaton Global Corporation Plc or a variant thereof ("New Eaton"), will be led by Alexander M. Cutler, Eaton's current chairman and chief executive officer.<sup>22</sup>

At the close of the merger, it was expected that the shareholders of the U.S. company would control 73% of the combined company, with the shareholders of the Irish company controlling the remaining 27%. The press release notes expected tax benefits from the merger at \$165 million in 2016, out of \$535 million of total cost savings.

In this case, a U.S. corporation used a merger to achieve an inversion while its shareholders retained a significant majority of shares.

## Response to Initial Inversions: The American Jobs Creation Act

In the late 1990s and early 2000s, news reports drew the attention of policy makers and the public to a phenomenon sometimes called corporate "inversions" or "expatriations": instances where firms that consist of multiple corporations reorganize their structure so that the "parent" element of the group is a foreign corporation rather than a corporation chartered in the United States. Among the more high-profile inversions were Ingersoll-Rand, Tyco, the PXRE Group, Foster Wheeler, Nabors Industries, and Coopers Industries.<sup>23</sup>

These corporate inversions apparently involved few, if any, shifts in actual economic activity from the United States abroad, at least in the near term. In particular, inverted firms typically continued to maintain headquarters in the United States and did not systematically shift capital or employment abroad post inversion.<sup>24</sup> Further, Bermuda and the Cayman Islands were the location of many of the newly created parent corporations—jurisdictions that have no corporate income tax but that also do have highly developed legal, institutional, and communications infrastructures.

A 2002 study by the U.S. Treasury Department concluded that while inversions were not new—the statutory framework making them possible has long been in existence—there had been a "marked increase" in their frequency, size, and visibility.<sup>25</sup>

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<sup>22</sup> Eaton Corporation, "Eaton to Acquire Cooper Industries to Form Premier Global Power," press release, May 21, 2012, [http://www.eaton.com/ecm/groups/public/@pub/@eaton/@corp/documents/content/pct\\_361385.pdf](http://www.eaton.com/ecm/groups/public/@pub/@eaton/@corp/documents/content/pct_361385.pdf).

<sup>23</sup> "While Companies Shift Addresses to Tax Havens, CEO's Stay Put," *Bloomberg Visual Data*, May 4, 2014, <http://www.bloomberg.com/infographics/2014-05-04/companies-shift-addresses-abroad.html>.

<sup>24</sup> U.S. Government Accountability Office, *Cayman Islands: Business and Tax Advantages Attract U.S. Persons and Enforcement Challenges Exist*, GAO-88-778, July 24, 2008.

<sup>25</sup> U.S. Department of the Treasury, Office of Tax Policy, *Corporate Inversion Transactions: Tax Policy Implications* (Washington: May, 2002), p. 1.

Taken together, these facts suggested that tax savings were one goal of the inversion, if not the primary goal. Beyond taxes, firms engaged in the inversions cited a number of reasons for undertaking them, including creating greater “operational flexibility,” improved cash management, and an enhanced ability to access international capital markets.<sup>26</sup>

The 2002 Treasury report identified three main concerns about corporate inversions: erosion of the U.S. tax base, a cost advantage for foreign-controlled firms, and a reduction in perceived fairness of the tax system.<sup>27</sup> These concerns, along with a growing awareness of inversion transactions, may have resulted in congressional concern and debate about how to address the issues surrounding inversions, culminating with the enactment of an anti-inversion provision (Section 7874) in the American Jobs Creation Act of 2004 (AJCA; P.L. 108-357).

The AJCA adopted two alternative tax regimes applicable to inversions occurring after March 4, 2003. The AJCA treats the inverted foreign parent company as a domestic corporation if it is owned by at least 80% of the former parent’s stockholders. In these cases, the AJCA would deny the firm any tax benefits of the inversion (i.e., it would continue to be taxed on the combined group’s worldwide income). The second regime applies when there is at least 60% continuity of ownership but less than 80%. In this case, the new foreign parent is not taxed like a domestic corporation, but any U.S. toll taxes (taxes on gains) that apply to transfers of assets to the new entity are not permitted to be offset by foreign tax credits or net operating losses. The AJCA also exempted corporations with substantial economic activity in the foreign country from the anti-inversion provisions, but it did not define substantial business activity in the statute.<sup>28</sup>

## Post-2004 Inversions and Treasury Regulations of 2012

Although the 2004 act largely eliminated the generic naked inversions, two alternatives remained that allowed a firm to shift headquarters and retain control of the business: the naked inversion via the business activity exemption, and merger with a smaller company.<sup>29</sup> Using the business activity route would require significant economic operations in the target country. An inversion by merger would require a large firm that would be at least 25% of the size of the U.S. firm.

The post-2004 approaches to inversions no longer involved countries such as Bermuda and the Cayman Islands, but larger countries with substantial economic activity such as the UK, Canada, and Ireland. The UK, in particular, has become a much more attractive headquarters. Because of freedom of movement rules in the European Union, the UK cannot have anti-inversion laws,

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<sup>26</sup> These reasons are cited by Stanley Works in an SEC registration statement dated June 21, 2002. The statement is available on the SEC website at <http://www.sec.gov/Archives/edgar/data/93556/000095013002004501/0000950130-02-004501.txt>. See also the November 2, 2001, proxy statement by Ingersoll-Rand (IR), which cites “a variety of potential business, financial and strategic benefits.” The statement is available on the IR website at <http://www.shareholder.com/ir/edgar.cfm?Page=2>.

<sup>27</sup> U.S. Department of the Treasury, Office of Tax Policy, *Corporate Inversion Transactions: Tax Policy Implications*, May 2002, p. 21.

<sup>28</sup> Treasury initially defined substantial business activity as being 10% of worldwide activity in regulation and in 2012 revised the regulation to redefine substantial business activity as being 25% of worldwide activity.

<sup>29</sup> The third form of inversion, merger with a larger foreign corporation, would result in control moving outside the United States.

which may have played a role in both moving to a territorial tax and lowering the corporate tax rate.

A report in the *Wall Street Journal* in August 2012 highlighted some recent moves abroad.<sup>30</sup> This report claimed 10 companies had inverted since 2009, with 6 within the past year or so. This was a small number of companies, but it is useful to look at the methods involved. The *Wall Street Journal* article identified by name 5 of the 10 companies that had moved abroad recently: Aon, ENSCO, Rowan, Eaton, and DE Master Blenders 1763. (The article also referred to Transocean and Weatherford International, but these were firms that had inverted before the 2004 legislation: Transocean first to the Cayman Islands, and then Switzerland, and Weatherford first to Bermuda, and then Switzerland). The remaining firm mentioned in the *Wall Street Journal* article is Eaton. Eaton's move abroad was a merger; it merged with Coopers, a firm effectively operating its headquarters in the United States, but one that had inverted prior to the 2004 law change.

An article by Bret Wells identified Aon, ENSCO, and Rowan as having inverted via the substantial business activity exemption (where the only apparent objective is tax savings).<sup>31</sup> All three moved to the United Kingdom, where a recent move to a territorial tax, as well as decisions in the European Court of Justice that limited their anti-abuse rules, had made their tax system more attractive.<sup>32</sup> The UK was also in the process of lowering its own corporate rate. Two of the firms are oil drilling firms; drilling in the North Sea might have affected their ability to use this exemption. Aon is an insurance firm.

Wells mentions another firm, Tim Hortons, which also used a naked inversion using the substantial business activity exemption in 2009 to relocate to Canada. In doing so, the firm was returning to its origins, as it was founded in Canada. It became an American company when Wendy's acquired it in 1995, but it was subsequently spun off in 2006.<sup>33</sup> DE Master Blenders 1763, like Tim Hortons, was returning to its origins as well (a Netherlands firm), as it was spun off from Sara Lee, which had acquired it in 1978.<sup>34</sup>

In response to increased use of the substantial business activity exemption, Treasury Regulations (T.D. 9592, June 12, 2012) increased the safe harbor for the substantial business activities test from 10% to 25%, effectively closing off this avenue in the future.<sup>35</sup> This action could be done by regulation because the statute did not specify how the substantial business activity test was to be implemented.

<sup>30</sup> John D. McKinnon and Scott Thurm, "U.S. Firms Move Abroad to Cut Taxes: Despite '04 Law, Companies Incorporate Overseas, Saving Big Sums on Taxes," *Wall Street Journal*, August 28, 2012.

<sup>31</sup> Bret Wells, "Cant and the Inconvenient Truth about Corporate Inversions," *Tax Notes*, July 23, 2012, pp. 429-439.

<sup>32</sup> Cadbury-Schweppes, September 12, 2006. The UK rule required that income subject to a tax rate much lower than the UK rates be taxed; this rule was not accepted by the court. See Cleary Gottlieb, "Cadbury Schweppes: UK CFC Rules Too Restrictive," <http://www.cgsh.com/files/News/9e29ed20-66c5-4558-93eb-dc8ab51c54c9/Presentation/NewsAttachment/2fcd202-5144-4e40-8498-dd0d04f99926/cadbury-schweppes.pdf>.

<sup>33</sup> Tim Hortons, "The Story of Tim Hortons," [http://search.yahoo.com/search;\\_ylt=A0oG7kHeX4VQXGkAjbVXNyoA?p=tim%20horton's%20inc.&fr2=sb-top&fr=yfp-t-701](http://search.yahoo.com/search;_ylt=A0oG7kHeX4VQXGkAjbVXNyoA?p=tim%20horton's%20inc.&fr2=sb-top&fr=yfp-t-701).

<sup>34</sup> DE Master Blenders 1753, "Our Heritage," 2012 (visited), <http://www.demasterblenders1753.com/en/Company/Our-heritage/>.

<sup>35</sup> Bret Wells, "Cant and the Inconvenient Truth about Corporate Inversions," *Tax Notes*, July 23, 2012, pp. 429-439; Kristen A. Parillo, "Government Defends Business Activities Test in New Regs." *Tax Notes*, July 23, 2012, pp. 370-371.

A number of recent mergers have either been effectuated or are in process: Chiquita, Actavis, and Perrigo (the latter two are pharmaceutical firms) moving to Ireland; Valeant Pharmaceuticals and Endo Health Services moving to Canada; and Liberty Global (a cable company) to the UK. Subsequently, the new Irish firm Actavis (itself the result of two prior mergers) merged with Forest Labs.<sup>36</sup> Omnicom (an advertising firm) planned a move to the UK (after proposed merger with a French firm, creating a Netherlands holding company, resident in the UK for tax purposes), but has abandoned its merger.<sup>37</sup>

Most of these firms are not household names or industry giants. Thus, perhaps none created as much interest as the attempt by pharmacy giant Pfizer to acquire AstraZeneca with a UK headquarters, or the urging of some stockholders of Walgreens to invert to Switzerland. Pfizer represented a significant potential loss of future tax revenue, as much as \$1.4 billion per year.<sup>38</sup> According to a recent study by Martin Sullivan, in 2005, when a temporary tax exclusion of 85% of dividends (the repatriation holiday) was in force, Pfizer repatriated \$37 billion, the single largest amount of repatriations of any firm.<sup>39</sup> In 2009, Pfizer repatriated \$34 billion (and paid U.S. taxes on that amount) to finance the acquisition of Wyeth, but earnings abroad grew from \$42 billion in 2009 (after the repatriation) to \$73 billion by 2012. These earnings have not been repatriated and taxed in the United States.<sup>40</sup> An inversion by Pfizer would, however, result in current shareholders paying capital gains taxes on any stock appreciation when they are converted into shares of the new company. Shares held in IRAs and 401(k)s would not typically owe this tax, but shares owned directly by individuals and in mutual funds would owe tax even if they did not sell their stock.<sup>41</sup>

Policy makers and the public remain interested in the issue of inversions. Although the Pfizer merger has yet to occur, the spate of mergers or proposed mergers in the medical device and pharmaceuticals industries continues. A recent example includes one of the largest mergers yet,

<sup>36</sup> For news reports, see Zachary R. Mider “Companies Flee U.S. Tax System by Reincorporating Abroad,” *Bloomberg*, January 27, 2014, <http://www.bloomberg.com/infographics/2014-01-27/companies-flee-u-s-tax-system-by-reincorporating-abroad.html> and “Companies Fleeing Taxes Pay CEOs Extra as Law Backfires,” *Bloomberg*, January 27, 2014, <http://www.bloomberg.com/news/2014-01-27/companies-fleeing-taxes-pay-ceos-extra-as-law-backfires.html>. “Actavis, Forest Labs In Biggest Merger In Specialty Pharma,” May 5, 2014, *Investor’s Business Daily* [http://finance.yahoo.com/news/actavis-forest-labs-biggest-merger-223800951.html;\\_ylt=A0LEV1G3kWdT7jEAEGFXNyOA;\\_ylu=X3oDMTEyaGV0M2l0BHNIYwNzcgRwb3MDMwRjb2xvA2JmMQR2dGlkA1FJMDQ5XzE-](http://finance.yahoo.com/news/actavis-forest-labs-biggest-merger-223800951.html;_ylt=A0LEV1G3kWdT7jEAEGFXNyOA;_ylu=X3oDMTEyaGV0M2l0BHNIYwNzcgRwb3MDMwRjb2xvA2JmMQR2dGlkA1FJMDQ5XzE-).

<sup>37</sup> Tom Fairless, “Publicis, Omnicom Merger Tangled in Tax Red-Tape,” *Wall Street Journal*, April 25, 2014, <http://www.marketwatch.com/story/publicis-omnicom-merger-tangled-in-tax-red-tape-2014-04-25> and David Gelles, “At Odds, Omnicom and Publicis End Merger,” May 8, 2014, *New York Times*, <http://dealbook.nytimes.com/2014/05/08/ad-agency-giants-said-to-call-off-35-billion-merger/>.

<sup>38</sup> Zachary R. Mider, “Tax Break ‘Blarney’: U.S. Companies Beat the System With Irish Addresses,” *Bloomberg*, May 5, 2014, <http://www.bloomberg.com/news/2014-05-04/u-s-firms-with-irish-addresses-criticized-for-the-moves.html>.

<sup>39</sup> Martin A. Sullivan, “Economic Analysis: Pfizer’s Tax Picture Dominated by U.S. Losses, Repatriation,” *Tax Notes* July 8, 2013, <http://www.taxanalysts.com/www/features.nsf/Articles/8A8A34FCBD7C3C3F85257BA200497696?OpenDocument>.

<sup>40</sup> For a news article on the proposed Pfizer merger see Kevin Drawbaugh, Pfizer Move to Join Tax-Driven Deal-Making Raises Red Flags in U.S., *Reuters*, April 14, 2014, <http://www.reuters.com/article/2014/04/28/us-usa-tax-pfizer-analysis-idUSBREA3R1FL20140428>. For an article on Walgreens see, Ameet Sachdev and Peter Frost, “Walgreen Pressured to Move Headquarters to Europe,” *Chicago Tribune*, April 14, 2014, [http://articles.chicagotribune.com/2014-04-14/business/chi-walgreens-headquarters-to-europe-20140414\\_1\\_walgreen-co-tax-rate-tax-deals](http://articles.chicagotribune.com/2014-04-14/business/chi-walgreens-headquarters-to-europe-20140414_1_walgreen-co-tax-rate-tax-deals).

<sup>41</sup> Laura Saunders and Jonathan D. Rockoff, “Pfizer Holders Could Face Tax Hit in a Deal for AstraZeneca,” *Wall Street Journal*, May 8, 2014.

AbbVie's acquisition of Shire, an Irish firm. The announcement of a proposed merger between Burger King and Tim Hortons has also generated interest in the issue.<sup>42</sup>

Treasury continues to regulate inversions where regulations are possible. For example, it recently took action to close a loophole stemming from the coordination of two sets of regulations—the “Anti-Killer B Regulations” and the “Helen of Troy Anti-Inversion Regulations” that allowed Liberty Global shareholders to avoid some capital gains taxes.<sup>43</sup>

## **Treasury Notice 2014-52, September 22, 2014**

In response to the new wave of inversions, the Treasury Department recently released a notice of regulatory actions that would restrict inversions and their benefits. The press release accompanying the notice indicated that other regulations are under consideration.<sup>44</sup> Treasury news releases, however, indicated that legislative action is the only way to fully rein in these transactions.<sup>45</sup>

The regulatory actions address two basic aspects of inversions. One set of changes limits the ability to access the accumulated deferred earnings of foreign subsidiaries of U.S. firms. The second regulatory action restricts certain techniques used in inversion transactions that allowed firms to qualify with less than 80% ownership. This regulation is effective for inversions closing on or after September 22, 2014. The regulations do not prevent inversions via merger and do not address earnings stripping by shifting debt to the U.S. firm.

### **Limiting the Access to Earnings of U.S. Foreign Subsidiaries**

In an inversion, the foreign subsidiaries of the original U.S. firm remain subsidiaries so that any dividends paid to the U.S. parent would be taxed.<sup>46</sup> Regulations also treat other direct investments in U.S. property, such as loans to the U.S. parent as dividends.<sup>47</sup> Once a firm has inverted and the U.S. firm is now a subsidiary of a foreign parent, there are methods of accessing the earnings of overseas subsidiaries by transactions between the new foreign parent and the U.S. firm's foreign subsidiaries. The regulation is intended to address three such methods.

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<sup>42</sup> Nathan Vardi, “AbbVie To Buy Shire For \$54 Billion In Biggest Inversion Deal Ever,” *Forbes*, July 18, 2014, <http://www.forbes.com/sites/nathanvardi/2014/07/18/abbvie-to-buy-shire-for-54-billion-in-biggest-inversion-deal-ever/>; Liz Hoffman and Dana Mattioli, “Burger King in Talks to Buy Tim Hortons in Canada Tax Deal: Tie-Up Would Be Structured as Tax Inversion With a Combined Market Value of About \$18 Billion,” *Wall Street Journal*, August 25, 2014, <http://online.wsj.com/articles/burger-king-in-talks-to-buy-tim-hortons-1408924294>.

<sup>43</sup> IRS Notice 2014-14. See “IRS Aims at Innovative M&A Inversion Structure,” Sidley Austin LLP, at <http://m.sidley.com/04-29-2014-Tax-Update/>.

<sup>44</sup> Fact Sheet: Treasury Actions to Rein in Corporate Tax Inversions, at <http://www.treasury.gov/press-center/press-releases/Pages/jl2645.aspx>.

<sup>45</sup> See Treasury press release, Treasury Announces First Steps to Reduce Tax Benefits of Corporate Inversions, at <http://www.treasury.gov/press-center/press-releases/Pages/jl2647.aspx>.

<sup>46</sup> Transfers of the stock or assets of these foreign subsidiaries to other parts of the new related group would incur a corporate level transfer tax that is generally prohibitive.

<sup>47</sup> U.S. property includes tangible property in the United States, stock of a domestic corporation, and obligations of a U.S. person. It also includes the right to use patents; copyrights; inventions, models or designs; secret formulas or processes; or any other similar right in the United States. U.S. property is defined in Section 956(c)(1) of the Internal Revenue Code.

First, the new regulation prevents the access to funds by, for example, a loan from the U.S. company's foreign subsidiary to the new foreign parent (called "hopscotching"). Before the regulation, funds of this type could have been used to pay dividends to the individual shareholders or for other purposes. Under the regulation, acquiring any obligation (such as a loan) or stock of a foreign related persons is treated as U.S. property subject to tax.

Second, the regulation addresses "decontrolling," where the foreign acquiring corporation issues a note or transfer of property for stock in the U.S. firm's foreign subsidiaries. If a majority of stock is obtained, the U.S. firm's subsidiary is no longer a controlled foreign corporation (CFC) and not subject to Subpart F, which taxes currently certain passive or easily shifted income. However, even a less than majority share can allow partial access to deferred earnings without a U.S. tax. This regulation prevents this by treating acquisition of foreign subsidiary stock as acquisition of stock in the U.S. parent.

Third, the regulation addresses transactions where the foreign acquiring corporation sells stock of the former U.S. parent corporation to that U.S. parent corporation's CFC in exchange for property or cash. If such a transaction is structured properly, some interpretations of the old regulations would have permitted the income to avoid taxation. The new regulations would prevent that and would apply regardless of the firm's inversion status.

## **Addressing Techniques to Achieve Less Than 80% Ownership Requirement**

A firm can realize the tax benefits of an inversion only if the shareholders of the original U.S. firm retain, after the merger, less than 80% of the ownership in the new company. The new regulation contains several provisions that limit certain techniques for achieving this goal. The avoidance techniques include inflating the foreign firm, shrinking the U.S. firm, and inverting only part of the U.S. firm.

First, it prevents firms from reaching the less than 80% goal by inflating the size of the foreign merger partner (which must have more than 20% ownership subsequent to the merger) by use of passive assets (e.g., an interest bearing bank deposit). This notice disregards passive assets of the foreign firm if more than 50% of its value is in passive assets. (Banks and financial service companies are excluded.)

Second, it prevents firms from shrinking the size of the U.S. firm by paying extraordinary dividends before the merger. The notice disregards this reduction in value.

Third, it prevents an inversion of part of a U.S. company (a "spinversion") by spinning it off to a newly formed foreign corporation, by treating the new "foreign" company as a domestic corporation.

## **Policy Options**

The AJCA was successful at limiting a form of inversions, at least initially. In particular, the AJCA stopped the practice of basic "naked inversions," in which little activity or presence in the new jurisdiction is required and the new parent is domiciled in a tax haven. Further, through regulation, Treasury has limited the use of the substantial business activity test safe harbor to



invert. Recent activity, however, suggests that mergers continue to be used as a vehicle for corporate inversions.

These more recent mergers are increasingly resulting in a UK parent company, due to policy decisions by the UK government. Specifically, the UK lowered its corporate tax rate and adopted a territorial tax system. In addition, anti-abuse provisions for foreign source income were weakened by the European Union courts. The UK has also proposed taxing certain intangible income at a 10% rate. (This is referred to as a patent box.)

To restrict the occurrence of tax motivated inversions, both a general reform of the U.S. corporate tax and specific provisions to deal with tax-motivated international mergers have been discussed.

## **U.S. Corporate Tax Reform**

Interest in reforming the corporate income tax is long-standing,<sup>48</sup> with recent interest calling for explicit accommodation of international concerns.<sup>49</sup> As noted earlier, two aspects of the U.S. corporate tax system are particularly relevant to corporate location decisions: the corporate tax rate and the taxation of foreign-source earnings. Taken together, these factors can yield a substantial reduction in taxes paid. In the case of the proposed merger of Forest Laboratories Inc. (a U.S. company) and Actavis (an Irish company), the tax reduction is estimated to be roughly \$100 million.<sup>50</sup> However, before examining proposals that address these concerns, a discussion of each separately is warranted.

### **Lower the Corporate Tax Rate**

The U.S. corporate statutory tax rate is higher than both the average statutory rates of the other Organisation for Economic Co-operation and Development (OECD) countries and that of the 15 largest economies in the world.<sup>51</sup> This has led many to assert that the U.S. statutory tax rate needs to be lowered to reduce the incentive for inversion transactions.<sup>52</sup> While lowering the corporate tax rate would reduce the incentive to invert, there are reasons to suggest that it would be impractical to reduce the rate to the level needed to stop inversions. Namely, to stop inversions through a reduction in the corporate tax rate would require a U.S. corporate tax rate set equal to the lowest tax rate of a destination company, or zero.

A lower corporate tax rate would reduce the incentive for corporate inversions, primarily by reducing the tax rate applied to repatriated earnings.<sup>53</sup> For a company like Pfizer, with large foreign earnings, a rate reduction could yield significantly lower taxes paid. However, as

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<sup>48</sup> CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle.

<sup>49</sup> CRS Report RL34115, *Reform of U.S. International Taxation: Alternatives*, by Jane G. Gravelle.

<sup>50</sup> Forest Labs, *Acquisition of Forest Laboratories, Inc. by Actavis Plc Call*, February 18, 2014, <http://www.sec.gov/Archives/edgar/data/38074/000119312514058927/d679348d425.htm>.

<sup>51</sup> CRS Report R41743, *International Corporate Tax Rate Comparisons and Policy Implications*, by Jane G. Gravelle.

<sup>52</sup> Hank Gutman, Principal, Director of the Tax Governance Institute, KPMG LLP, *Changes in the Tax Law: How Are Effects Measured, and Who is Affected?*, May 2, 2014.

<sup>53</sup> A corporate rate reduction would also reduce taxes due on U.S. earnings. This is incidental to a corporation's incentive to invert or its competitiveness, because there is no difference of the taxation of U.S. earnings between U.S. and foreign corporations.

discussed below, the benefit of a lowered rate is negligible relative to the benefit to corporate taxpayers afforded by territorial tax systems, when income earned in low- or no-tax foreign jurisdictions is never subject to U.S. tax.

Two factors present challenges for lowering the corporate tax rate. First, if revenue neutrality is a goal, there may not be enough base broadening provisions with revenue offsets to provide deep cuts in the corporate tax; and, if such offsets were found, they might have their own consequences for investment. Of course reducing the corporate tax without corresponding base broadening would likely reduce corporate tax revenue, adding to chronic budget deficits.

## **Adopt a Territorial Tax System**

The United States is one of the few countries that has a worldwide tax system and levies a tax on the foreign-source income of domestic corporations. Changing corporate tax residence to a country with a territorial tax system (where foreign earnings would not be taxed at all) is thought to drive inversion decisions. This issue has led to proposals for the United States to adopt a territorial tax system to stop inversion transactions.<sup>54</sup>

One concern about adopting a territorial tax system is the strain it would likely place on the current transfer pricing system.<sup>55</sup> From this perspective, the current worldwide tax system provides a backstop on the amount of profit shifting or base erosion possible, because shifted profits will eventually be repatriated. Under a territorial tax system, this is not the case. Research has found evidence of significant profit shifting, especially related to mobile intellectual property, suggesting a lot of income from foreign sources is really U.S. income in disguise.<sup>56</sup>

Numerous other issues surround the adoption of a U.S. territorial tax. For example, while some support a territorial tax to eliminate the incentive to keep earnings abroad, others oppose it because it likely discourages domestic investment and activity in the United States.<sup>57</sup>

Adopting a territorial tax, as in the case of a rate reduction, would likely reduce corporate tax revenue and add to current budget pressures unless it is offset by other tax increases.

## **Tax Reform Proposals**

Two recent proposals that involve comprehensive reform, the Wyden, Coats, and Begich proposal from the 112<sup>th</sup> Congress (S. 727) and the proposal by Chairman Camp of the Ways and Means Committee (The Tax Reform Act of 2014),<sup>58</sup> would reduce the corporate rate to 24% and 25%, respectively. The first would move away from a territorial tax by ending deferral. Eliminating

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<sup>54</sup> McBride (2014).

<sup>55</sup> Gutman (2014).

<sup>56</sup> See CRS Report R40623, *Tax Havens: International Tax Avoidance and Evasion*, by Jane G. Gravelle for a review of methods and the empirical evidence on profit shifting by U.S. multinational firms.

<sup>57</sup> A territorial tax lowers the tax on returns to investment abroad, increasing after-tax returns and encouraging firms to displace domestic investment with foreign investment.

<sup>58</sup> U.S. Congress, Joint Committee on Taxation, Technical Explanation of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title IV—Participation Exemption System for the Taxation of Foreign Income, committee print, 113<sup>th</sup> Cong., February 26, 2014, JCX-15-14.



deferral would raise a significant amount of revenue that would have been used to reduce the corporate tax rate from 35% to 24%.<sup>59</sup> The second proposal would adopt a territorial tax and reduce the corporate tax rate, along with other changes.<sup>60</sup> The proposal also contains anti-abuse provisions to tax intangible foreign source income. There has been some agreement that adopting a territorial tax without some significant anti-abuse provisions (which the Camp proposal contains) could be problematic, as it would likely increase profit shifting abroad by U.S. firms.<sup>61</sup> The Senate Finance Committee also issued several tax reform discussion drafts in 2013 that proposed, in the international arena, a current but lower tax on foreign source income (without specifying the type of corporate tax that would be feasible).<sup>62</sup>

Reforming the U.S. corporate tax system may be a desirable objective that can contribute to economic efficiency and growth. However, the types of corporate rate cuts that are feasible given revenue constraints and the concerns about profit shifting for moving to a territorial tax, as reflected in these proposals, suggest that reforming the tax code for the purpose of discouraging tax driven mergers may reduce—but not eliminate—the incentive to invert.<sup>63</sup>

## Targeted Approaches

Legislative approaches, and more recently possible administrative remedies, targeted at inversions and the benefit inversion bestows, are alternatives to tax reform legislation.

## Legislative Proposals

One alternative is to directly restrict the ability of U.S. firms to invert by merger. The President's FY2015 budget proposal contains a provision that would further restrict the use of inversions.<sup>64</sup> The proposal would modify the 80% test enacted in the AJCA to a 50% test and eliminate the 60% test. In effect, this proposal would reduce the percentage of shareholders that are owners of the "old U.S. company" and the "new foreign merged company." The proposal would also require that the new foreign corporation be managed and controlled from outside the United States and prohibit transactions where the new foreign company has substantial business activities in the United States.

Representative Levin, the ranking Member of the House Ways and Means Committee, has introduced a bill, the Stop Corporate Inversions Act of 2014 (H.R. 4679), which would reflect the Administration's proposed changes, retroactive to May 8, 2014. The inversion would not be recognized if the U.S. stockholders have 50% of the shares or if 25% of the business activity is in

<sup>59</sup> Revenue estimates of an earlier version of the bill are available at <http://www.wyden.senate.gov/download/?id=1ba9073f-9ee8-4f8b-a2e3-2b70ebc96d35&download=1>.

<sup>60</sup> CRS Report IF00011, *The Tax Reform Act of 2014 (In Focus)*, by Molly F. Sherlock.

<sup>61</sup> All of the proposals to move to a territorial tax have been accompanied by provisions that attempt to limit profit shifting, particularly of intangible income. See CRS Report R42624, *Moving to a Territorial Income Tax: Options and Challenges*, by Jane G. Gravelle, for further discussion.

<sup>62</sup> United States Committee on Finance, *Baucus Unveils Proposals for International Tax Reform*, <http://www.finance.senate.gov/newsroom/chairman/release/?id=f946a9f3-d296-42ad-bae4-bcf451b34b14>.

<sup>63</sup> See Martin Sullivan, "Don't Count On Tax Reform To Stop Inversions," *Forbes*, August 5, 2014, <http://www.forbes.com/sites/taxanalysts/2014/08/05/dont-count-on-tax-reform-to-stop-inversions/>.

<sup>64</sup> Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals*, <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf>.

the United States. A companion bill, which would sunset in two years to provide time for tax reform, has been introduced in the Senate by Senator Levin (S. 2360).<sup>65</sup> The Joint Committee on Taxation has estimated the permanent proposal to gain \$19.5 billion in revenue over FY2015-FY2024. The two-year proposal would raise \$0.8 billion over the same period.<sup>66</sup>

In addition, a number of legislative proposals have been introduced that would limit the tax benefits associated with inversions for certain corporations. For example, H.R. 1554 (Doggett), H.R. 3666 (DeLauro), H.R. 3793 (Maffei), S. 268 (Levin), S. 1533 (Levin), and S. 1844 (Shaheen) would each treat corporations managed and controlled from the United States as domestic corporations regardless of their legal tax home or status as an inverted company.

Other proposals, H.R. 694 (Schakowsky) and S. 250 (Sanders), would eliminate deferral (taxing foreign source income currently), in addition to limiting the benefits of inversions when management and control continues to reside in the United States.

Legislative proposals are also under discussion by Representative Levin (announced July 31, 2014) and by Senator Schumer (announced August 14, 2014) to address earnings stripping, where foreign parent companies borrow from the U.S. subsidiary to increase interest deductions and reduce taxable income in the United States. Both of these proposals would tighten the rules allowing interest deductions by reducing the current limit on interest deductions relative to adjusted income from 50% to 25% and repealing an alternative safe-harbor debt-to-equity test. Both proposals would also eliminate or limit interest carryforwards. The Schumer proposal is intended to apparently apply to inverted firms while the Levin proposal applies generally. The Levin proposal would also limit other transactions between related parties within the firm that allow untaxed investment of funds in the United States. The restrictions on interest in the Levin bill are the same as those initially proposed in the House in 2004.<sup>67</sup>

Senator Schumer introduced his proposal, S. 2789, the Corporate Inverters Earnings Stripping Reform Act of 2014. Its limits on interest deductions would apply to inverted firms where U.S. shareholders own more than 50% of the firm. The restriction also applies to firms that inverted using the substantial business activities test. The bill has nine Democratic co-sponsors; five of them are on the Senate Finance Committee.

H.R. 5278 (DeLauro) and S. 2704 (Levin), introduced May 30, 2014, would disallow awarding federal contracts to inverted firms.

Senators Brown and Durbin have proposed S. 2895, the Pay What You Owe Before You Go Act, which would tax the accumulate deferred earnings of inverting firms.

Senate Finance Committee Chairman Ron Wyden has proposed having draft legislation in place in September, and also referred to Schumer's earnings stripping proposal.<sup>68</sup> Senator Wyden previously announced that any changes would be retroactive to May 8, 2014.<sup>69</sup>

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<sup>65</sup> See "Senators Announce Bill to Reduce Corporate Inversion 'Loophole,'" *Tax Notes Today*, May 21, 2014.

<sup>66</sup> Memorandum from Thomas Barthold to Karen McAfee, May 23, 2014, <http://democrats.waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/113-0927%20JCT%20Revenue%20Estimate.pdf>.

<sup>67</sup> These restrictions were, however, removed prior to enactment of the AJCA.

<sup>68</sup> The United States Senate, Committee on Finance, "Wyden Statement Regarding Plans to Address Corporate Inversions," press release, August 14, 2014, <http://www.finance.senate.gov/newsroom/chairman/release/?id=4ed00da0-> (continued...)

While some support these targeted approaches, others argue that corporate tax reform should be addressed first.<sup>70</sup>

## Administrative Changes

President Obama has encouraged Congress to act directly to limit inversions, but has also indicated on August 6, 2014, that administrative changes to limit inversions are under examination.<sup>71</sup> Prior to that announcement, Steve Shay, a Harvard professor and former practitioner and Treasury official, wrote an article outlining two regulatory actions that he believed could be taken.<sup>72</sup> The first is one that would limit earnings stripping by reclassifying debt as equity due to excessive related party debt in an inversion.<sup>73</sup> The second relates to current rules that require certain investment by U.S. foreign subsidiaries, such as making a loan to the U.S. parent, to be treated as effective taxable repatriations (dividends). This change would extend this type of treatment to certain loans of these foreign subsidiaries to other related parties (such as the new foreign parent). For example, if a foreign subsidiary lent to the new foreign parent and the new foreign parent in turn lent to the U.S. subsidiary, this loan would be considered a dividend to the U.S. parent. It would also appear that loans for other purposes, such as buying back stock of the foreign parent, could also be treated as taxable repatriations under regulatory authority.<sup>74</sup> Some of the second category of proposals were adopted in Treasury Notice 2014-52, discussed above.

A number of other administrative proposals that have been suggested include the following.<sup>75</sup>

(...continued)

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<sup>69</sup> Ron Wyden, “We Must Stop Driving Businesses Out of the Country,” *The Wall Street Journal*, May 8, 2014, <http://online.wsj.com/news/articles/SB10001424052702303701304579548433123065724>.

<sup>70</sup> The United States Senate Committee on Finance, “Amid Inversion Talk, Hatch Calls for Internationally Competitive Tax Code to Keep Job Creators in U.S.,” press release, May 8, 2014, <http://www.finance.senate.gov/newsroom/ranking/release/?id=5db6e959-641c-42b3-9442-8719a031c2e6>.

<sup>71</sup> Josh Lederman, “Facing Logjam in Congress, Obama Seeks Steps to Curb Tax Breaks for Firms Moving Overseas,” *U.S. News and World Report*, August 5, 2014, <http://www.usnews.com/news/politics/articles/2014/08/05/obama-seeks-executive-ways-to-limit-tax-inversions>.

<sup>72</sup> Stephen E. Shay, “Mr. Secretary, Take the Tax Juice Out of Corporate Expatriations,” *Tax Notes*, July 28, 2014, pp. 473-479.

<sup>73</sup> This change would be based on authority under Section 385 of the Internal Revenue Code. A somewhat different technique has been suggested by Steven M. Rosenthal, “Professor Shay Got It Right: Treasury Can Slow Inversions,” *Tax Notes*, September 22, 2014, pp. 1445-1449.

<sup>74</sup> Stephen E. Shay refers to authority in Section 956(e), 7701(l), 7874 (g) and 7805.

<sup>75</sup> See Mindy Herzfeld, “What Can Treasury Do About Inversions?” *Tax Notes*, August 24, 2014, pp. 895-897, who summarizes the four bullets plus the two proposals of Stephen Shay. For additional proposals, including those relating to stockholders, taxes on executives, using definitions of effectively connected income, and enforcing arms-length transfers of U.S. assets, as well as discussions of regulatory approaches in general, see Joseph DiSciullo, “Academics Offer Suggestions for Discouraging Corporate Inversions,” *Tax Notes*, August 25, 2014, pp. 943- 945; Samuel C. Thompson, Jr. Letter to Honorable Jacob J. Lew, et al., Re Legislative and Administrative Proposals re Inversions, August 12, 2014; letter to Jacob J. Lew, from Jeffrey M. Kadet, August 11, 2013; Samuel C. Thompson Jr., “Professor Says Debt/Equity Regs can Apply to Inversions,” *Tax Notes*, April 18, 2014, pp. 883-884; Alex Parker, “Executive Action on Inversions? Not So Fast,” August 8, 2014, Bloomberg International Blog, <http://www.bna.com/executive-action-inversions-b17179893937>; Howard Gleckman, “Is Treasury About to Curb Tax Inversions on Its Own?” Tax Policy Center, August 19, 2014, <http://taxvox.taxpolicycenter.org/2014/08/19/treasury-curb-tax-inversions/#sthash.B2GgcGbV.dpuf>

- Expanding the scope of Section 7874 (which treats inverted firms as U.S. firms) by combining multiple transactions into single ones, or vice versa. The scope of Section 7874 could also be expanded by treating certain stock as disqualified (because it is expected to be held temporarily or because it is accompanied by restrictions on voting rights);
- Potentially recognizing accumulated deferred earnings as currently taxable under authority such as Subpart F, Section 367, or other rules;
- Issuing regulations that would generally tighten restrictions on interest deductions under the thin capitalization rules of Section 163(j). These changes would probably apply to corporations in general, and not just to inverted corporations;
- Stricter regulations under Section 367 to immediately include foreign earnings in the case of actions that attempt to move foreign operations out from under the U.S. parent. This would make future earnings of these operations nontaxable;
- Strengthening and modernizing the effectively connected income rules that determined whether trade or business activity is taking place in the United States by foreign firms; and
- Closely monitoring the creation of non-U.S. subsidiaries owned by the foreign parent after inversion, and ensuring that assets (including intangibles such as inventions, knowhow, etc.) transferred from the U.S. firm are transferred at arms-length prices.

There is disagreement among experts about whether the types of regulatory changes discussed in this section are feasible or desirable.<sup>76</sup>

## Concluding Thoughts

The debate in Congress on inversions is fluid. Some, as noted above, prefer a targeted approach. Others believe that inversions should be addressed only in the context of comprehensive tax reform. While Ways and Means Chairman Camp's Tax Reform Act of 2014 discussion draft does not directly address profit shifting aspects of inversions, it does include elements that may have an impact on such transactions. Profit shifting practices and inversion techniques may be addressed more directly as tax reform proposals unfold. Finance Chairman Ron Wyden has indicated that he would address inversions—his approach is similar to Senator Levin's, as described above—when Congress returns in September. He has indicated support for making changes relating to inversions retroactive to May 8, 2014. Administrative remedies recently promulgated and under consideration may contribute to policymaking but are limited in their scope, thus legislative measures continue to be under consideration.

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<sup>76</sup> See, for example, Stuart L. Rosow and Martin T. Hamilton, "A Response to Professor Shay: Leave Inversions to Congress," *Tax Notes*, September 8, 2014, pp. 1187-1190.

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