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Firms That Incorporate Abroad for Tax Purposes: Corporate “Inversions” and “Expatriation”

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Summary

Recent reports indicate that an increasing number of U.S. firms have altered their structure by substituting a foreign parent corporation for a domestic one. Such "inversions" typically involve creation of a new foreign corporation in a country with low tax rates (a "tax haven") that becomes the parent of the firm's foreign and U.S. corporations. A chief motive for inversions is apparently taxes: the inversions can save firms substantial amounts of corporate-level U.S. income taxes. One source of tax savings is U.S. tax on a firm's foreign income. The United States taxes corporations chartered in the United States on both U.S. and foreign income but taxes foreign-chartered corporations only on their U.S.-source income. By locating its parent firm in a low-tax foreign country, an inverting firm can avoid U.S. taxes. An additional source of tax saving is apparently "earnings stripping," or the shifting of U.S.-source income from taxable U.S. components of the firm to the tax-exempt foreign parts by means of tax-deductible interest payments.

In the long run, inversions may be accompanied by some increased level of U.S. investment abroad; a firm that inverts reduces its tax burden on new foreign investment. However, any such shift may be small, and the recent corporate inversions do not appear to be accompanied by substantive shifts of economic activity from the United States to locations offshore. This leaves the impact of inversions on tax revenues as probably the leading near-term economic effect. As a consequence, one policy issue inversions present is that of tax equity: unless offset by spending cuts or larger budget deficits, the lost revenue is made up with higher taxes on other U.S. taxpayers. Several bills introduced in the 107th Congress appear to have the revenue losses and tax equity as their primary concern and generally would re-impose U.S. taxes when inversions occur. The Homeland Security Act passed in November 2002, included a provision preventing the new Homeland Security Department from contracting with "inverted" corporations. However, the bill contains relatively broad conditions under which the prohibition can be waived.

Inversions have been viewed by some as symptomatic of a burden they believe the U.S. tax system places on the competitive position of U.S. firms in the global marketplace. A May 2002 report issued by the U.S. Treasury Department sees inversions as just one result of competitive problems posed by U.S. taxes. Accordingly, that report calls for a more general reexamination of the U.S. international tax system, with an eye towards competitiveness. The report's near-term recommendations for more stringent tax rules are confined to changes aimed at protecting the domestic tax base rather than U.S. tax revenue from foreign income. Recent policy discussions of the U.S. international tax system have included calls by some for adoption of a "territorial" tax system, under which U.S. taxes would not longer apply to foreign-source income. Inversions can be viewed in this larger context; they have been described as "do-it-yourself" territoriality and present many of the same policy issues. Indeed, if the question of adopting a territorial tax system moves to the fore of the tax policy debate, the debate over inversions may have provided a preview in certain respects. This report will be updated as events in Congress and elsewhere occur.

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Firms That Incorporate Abroad for Tax Purposes: Corporate "Inversions" and "Expatriation"

Introduction

Recent news reports and articles in professional tax journals have drawn the attention of policymakers and the public to a phenomenon sometimes called corporate "inversions" or "expatriation" — 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. According to press reports, reorganizations that have recently occurred or have been planned include those of Ingersoll-Rand, Tyco, the PXRE Group, Foster Wheeler, Nabors Industries, Coopers Industries, and Stanley Works. (Stanley Works, however, subsequently announced that it would not undertake its planned reorganization.) According to the U.S. Treasury Department, the transactions are increasing in size, scope, and frequency.[1]

Firms engaged in the inversions cite a number of reasons for undertaking them, including creating greater "operational flexibility," improved cash management, and an enhanced ability to access international capital markets.[2] Prominent, if not primary, however, is the role of taxes: each of the firms in the above list expects significant tax savings from its reorganization.

The tax structure that permits tax savings through inversions has long been a part of the U.S. tax system. The question then arises: why now? A rigorous study has not been conducted, but several suggested reasons have been offered. One plausible reason is the recent decline in the stock market. As described in more detail below, an inversion is accompanied by a required payment of tax on capital gains; lower stock prices may mean that capital gains are smaller and capital gains taxes less onerous. Another suggestion has been that increased globalization of markets has exposed U.S. firms to more competitive pressures, leading them to more avidly pursue tax-saving strategies. And yet another reason is simply momentum: firms may have been reluctant to incorporate abroad for fear of public relations damage. Once several firms undertook reorganizations, the damage potential may have been perceived to have fallen, and other firms followed.

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[1] BNA *Daily Tax Report*, May 13, 2002, p. G-10.

[2] These reasons are cited by Stanley Works in a February 8, 2002 press release. See also the November 2, 2001 proxy statement by Ingersoll-Rand, 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].

The corporate inversions apparently involve little, if any, shifts in actual economic activity from the United States abroad, at least in the near term. (See, however, the section below on "Policy Issues" for a discussion of possible long-run effects.) Bermuda and the Cayman Islands are the location of many of the newly created parent corporations — jurisdictions that have no corporate income tax but that do have highly developed legal, institutional, and communications infrastructures. But the actual headquarters of inverted firms typically remain in the United States, and an inversion does not apparently involve the outflow of capital from the United States abroad or the shifting of corporate jobs to foreign locations.

Instead, the chief near-term economic impact of inversions is on U.S. federal tax revenues, which are reduced by the reorganizations, and concern has been expressed about the potential erosion of the U.S. corporate tax base.[3] This has led some to draw conclusions about their impact on tax equity: unless federal spending is cut or the deficit is increased, the reduction in tax revenue must be made up by tax increases on other taxpayers.[4] Some policymakers have sought a remedy in incremental changes to the U.S. system for taxing international transactions. As discussed below in the section on alternative policy responses and proposals, a set of bills introduced in the 107th Congress would seek to stem inversions by re-imposing U.S. taxes when they occur.

Others view inversions as symptomatic of more general problems with the U.S. tax system that have become evident as the world economy has become more integrated. Rather than disallowing inversions, they recommend a more general reevaluation of the tax code "that drives them to do such a thing."[5] The U.S. Treasury Department views inversions as evidence of competitive problems with the U.S. tax system. The Administration initiated a study of inversions in February, 2002 and issued a preliminary report in May 2002. The report stated that a near-term response to inversions should ensure that inversions "cannot be used to reduce inappropriately the U.S. tax on income from U.S. operations", and thus makes

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[3] One commentator maintains that they may result in a "significant" erosion in the corporate income tax base, and terms them "the most significant policy question the Congress and the U.S. Treasury Department face regarding the federal corporate income tax." Samuel C. Thompson, Jr., "Section 367: A 'Wimp' for Inversions and a 'Bully' for Real Cross-Border Acquisitions," *Tax Notes*, vol. 94, Mar. 18, 2002, p. 1506. Another analyst, however, maintains that "corporate inversions are not a threat to the U.S. tax system." Willard B. Taylor, "Corporate Expatriation – Why Not?", *Taxes*, vol. 78, Mar. 2002, pp. 146-152. The U.S. Treasury Department has expressed concern over tax-base erosion, but only in connection with the ability of inverted firms to shift U.S.-source income to the foreign parent corporation. U.S. Department of the Treasury, Office of Tax Policy, *Corporate Inversion Transactions: Tax Policy Implications*, May 2002, p. 2. Available online at [http://www.treas.gov/press/releases/docs/inversion.pdf?IMAGE.X=33\&IMAGE.Y=12].

[4] For example, columnist Robert Trigaux of the St. Petersburg Times compares the tax savings by inverting firms with liabilities of individual taxpayers, and asks: "If more companies head offshore, guess who's going to be stuck with the bills?" Robert Trigaux, "Maybe Evading Taxes Isn't Such a Great Idea," *St. Petersburg Times*, Mar. 10, 2002, p. 1H.

[5] House Ways and Means Committee Chairman William Thomas, as quoted in BNA *Daily Tax Report*, Apr. 16, 2002, p. G-7.

several proposals designed to protect U.S. tax revenues generated by U.S. income.[6] In keeping with its concern for competitiveness, however, the report does not propose more stringent rules for foreign-source income and calls for a reexamination of the U.S. international tax system.

Inversions have thus been discussed in terms of tax equity and competitiveness. A more detailed look at their implications for the U.S. tax system in general is presented below in the section entitled "Policy Issues." First, however, it is useful to look at the mechanics of inversions and how they generate tax savings.

How Inversions Generate Tax Savings

Anatomy of an Inversion

Although each corporate inversion has unique features, a common reorganization is apparently a "triangular" stock transaction merger, where a new foreign corporation is created that is chartered in a foreign country with low tax rates. The new foreign entity creates a U.S.-chartered "merger subsidiary," owned by the new foreign corporation. The U.S. parent corporation is then merged into the domestic merger subsidiary and becomes a subsidiary of the new foreign parent. For stockholders of the U.S. corporation — for example, individuals, institutional investors, and other firms — shares of the old U.S. parent automatically becomes shares of the new foreign parent.[7] Other forms of inversions are "asset transfers," where the domestic parent transfers its assets to a newly created foreign corporation, and "drop-down" transactions, where the domestic parent transfers its assets to a foreign corporation, but the foreign corporation transfers some of those assets to a domestic subsidiary.[8]

The Basic Structure of U.S. International Taxation

To see how inversions such as these generate tax savings, it is useful first to look at the general structure of the U.S. international tax system. In the international context, the United States bases its tax jurisdiction on residence: it taxes corporations chartered in the 50 states or the District of Columbia on their worldwide income, foreign as well as domestic. At the same time, the United States generally exempts corporations chartered in foreign countries from U.S. tax on their foreign-source income.[9]

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[6] U.S. Department of the Treasury, Office of Tax Policy, *Corporate Inversion Transactions: Tax Policy Implications*, May, 2002, p. 30.

[7] This is the form taken by the recent Ingersoll-Rand inversion. See Lee A. Sheppard, "Ingersoll-Rand's Permanent Holiday," *Tax Notes International*, Jan. 14, 2002, pp. 107-111.

[8] For a more detailed description of these categories and specific examples of each, see Willard B. Taylor, "Corporate Expatriation – Why Not?", *Taxes*, vol. 78, Mar. 2002, pp. 146-152.

[9] U.S. taxes generally do apply, however, to a foreign corporation's income from the conduct
(continued...)

Under the residence system, a firm's U.S. tax on foreign income depends on how the firm's foreign operations are organized, and a result of the system is a feature known as the "deferral principle," or simply "deferral." Under deferral, income that a U.S.-chartered corporation earns directly through a branch that is not separately incorporated is generally taxed by the United States on a current basis since the income is earned by a U.S. "resident." In contrast, foreign income earned through a separate foreign subsidiary corporation is generally not subject to U.S. tax until it is remitted to the U.S. parent corporation as dividends or other income: it is tax-deferred. Because of discounting,[10] this deferral confers a tax benefit on income earned in foreign countries with relatively low tax rates.

The system has several additional complicating features. One is the U.S. foreign tax credit, which is designed to alleviate double-taxation where foreign countries tax U.S. firms' foreign income. Under its provisions, the United States permits its taxpayers to credit foreign taxes they or their foreign subsidiaries pay against U.S. taxes they would otherwise owe. The foreign tax credit is generally limited to offsetting U.S. tax on foreign and not domestic income, but if a firm pays sufficient foreign taxes, it may use the credit to eliminate its entire U.S. tax liability on foreign-source income, whether U.S. pre-credit taxes are deferred or apply on a current basis.

Another important feature is a set of "anti-deferral" regimes that limit the availability of deferral in some cases. The broadest and most important of these is the tax code's Subpart F provisions that were enacted in 1962 as a means to limit the concentration of passive-investment income by firms in tax havens. Under Subpart F, U.S. parent firms can in some cases be taxed on particular types of subsidiary income, even if it is not repatriated to the U.S. parent firm. Subpart F, however, only applies where a foreign subsidiary is controlled (more than 50%-owned) by those U.S. stockholders who own large blocs (at least 10%) of the subsidiary's stock. The type of income subject to Subpart F is generally income from passive investment and certain types of income whose source is thought to be easily manipulated.

A second anti-deferral regime is the passive foreign investment company, or PFIC rules. In contrast to Subpart F, the PFIC provisions apply to foreign corporations that invest intensively in passive-type assets, regardless of the degree or concentration of U.S. ownership and even to income that is not itself from passive investment. Although the PFIC rules permit a deferral of U.S. tax in some cases, the rules apply an interest charge to the delayed tax payment, thus negating the benefit of deferral.

Before explaining how an inversion within this U.S. tax structure generates tax savings, we first note that foreign taxes are not irrelevant. Foreign countries frequently tax corporations chartered within their borders — as does the United States. Thus, whatever U.S. tax savings an inversion generates could be offset if the

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[9] (...continued)
of a U.S. trade or business and on certain investment income earned in the United States.

[10] Discounting is the fundamental economic principle that a given increment of funds – say, a dollar – is more valuable the sooner an economic actor has control of it. For a firm, this is because the sooner a dollar is received, the sooner it can be invested and earn a return.

country where the new parent corporation is chartered were not to have corporate tax rates lower than those of the United States. Indeed, Bermuda and the Cayman Islands have been a frequent destination for recent inversions, and neither imposes a corporate income tax.[11]

U.S. Tax Consequences of Inversions

Given the U.S. tax structure, inversions potentially provide tax savings in two general ways: by reducing U.S. tax on foreign source income; and by reducing U.S. tax on U.S. income that is shifted outside the United States in "earnings stripping" or similar transactions. Where they occur, these tax savings are ongoing but only save taxes at the corporate level under the corporate income tax. Inversions can potentially trigger a one-time tax on gain that is required to be recognized when an inversion occurs; the capital gains tax can apply to individual stockholders or at the corporate level. Further, inversions may be unable to generate tax savings to firms whose foreign tax credits have eliminated U.S. tax on foreign income.

To see how these results occur, we look at the straightforward example of a firm that is initially "uninverted;" the firm includes a U.S.-chartered parent corporation that is publicly owned and traded on U.S. stock exchanges. The parent corporation earns foreign income through foreign subsidiaries. Under current law, as long as a firm has a dearth of foreign tax credits, at least some U.S. tax burden applies to the firm's foreign income. Some of the income may be taxed on a current basis either through Subpart F or the PFIC provisions. And while other foreign income may be tax-deferred, it is nonetheless ultimately taxed when it is repatriated. At the stockholder level, shareholders who are private individuals generally pay individual income tax on dividends from the U.S. parent corporation and on capital gains when the stock is sold. However, some shareholders may hold their stock in tax free vehicles — for example, individual retirement accounts (IRAs) — while other shareholders — for example pension funds — may be tax exempt.

Now, suppose the firm inverts, so that the both the former U.S. parent corporation and the foreign subsidiaries become subsidiary to a new foreign parent corporation. First, since the conglomerate's foreign income is now earned by a foreign-chartered corporation, U.S. corporate-level tax on the foreign income that was either deferred or currently paid under the anti-deferral regimes is eliminated. Thus, one source of tax saving is U.S. tax on foreign income.

Inverted firms may also employ earnings stripping to reduce U.S. tax on domestic income. Earnings stripping shifts U.S.-source income from a U.S. corporation to a foreign parent by means of transactions between the related parts of the firm. While the transactions can take a variety of forms, a prototypical earnings stripping transaction involves a foreign parent lending funds to a domestic subsidiary;

[11] As an illustration, Ingersoll-Rand reported to its shareholders that the firm's payments to Bermuda will be limited to a fixed annual fee whose current amount is $27,825. In addition, Bermuda's Minister of Finance has assured Ingersoll-Rand that even if Bermuda enacts an income tax, it will not apply such a tax to Ingersoll-Rand until 2016. See the proxy statement posted at [http://www.shareholder.com/ir/edgar.cfm?Page=2].

the subsidiary is able to deduct interest payments to its parent from its U.S. taxable income, thereby reducing its U.S. tax liability. According to the Treasury report on inversions, "a feature common to many inversions is the presence of substantial indebtedness from the former U.S. group to the new foreign parent or one of its foreign subsidiaries."[12] Foreign corporations are generally subject to a U.S. "withholding tax" on U.S.-source interest received from related U.S. corporations; the withholding tax rate is generally 30%. However, the withholding tax is in many cases reduced or eliminated by tax-treaty provisions. Thus, if an earnings-stripping transaction is structured so that interest payments are made to a related lender in a treaty country, the tax can be avoided.

Provisions designed to limit earnings stripping by foreign firms investing in the United States were enacted with the Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239). The provisions deny deductions for interest payments to related corporations, but apply only after a certain threshold of interest payments and level of debt-finance is exceeded.[13]

As noted above, although inversions can generate ongoing tax savings at the corporate level under the corporate income tax, they may generate taxes at the shareholder level, under the individual income tax. One source of new taxes may be capital gains: Section 367 of the tax code and Treasury regulations issued under that section impose capital gains tax on transfers of stock by U.S. stockholders to foreign corporations. Thus, for a shareholder of an inverted firm's domestic parent, any appreciation that occurred from the time of purchase to the time of the inversion is generally subject to capital gains tax.[14] The purpose of the provision is to prevent capital gains from flowing out of U.S. tax jurisdiction without being subject to U.S. tax at some point.[15]

The triggering of capital gains tax suggests a divergence of interests among an inverting firm's stockholders, with those of taxable shareholders differing from those whose stock is not taxed (e.g., pension funds and those with holdings in IRAs). Indeed, lawsuits were filed by some Ingersoll-Rand shareholders that sought to block the firm's inversion, although stockholders subsequently voted overwhelmingly to

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[12] U.S. Department of the Treasury, Office of Tax Policy, *Corporate Inversion Transactions: Tax Policy Implications*, p. 22.

[13] For further information on the earnings stripping provisions, see Aaron A. Rubenstein and Todd Tuckner, "Financing U.S. Investments After the Revenue Reconciliation Act of 1993," *Tax Adviser*, vol. 25, Feb., 1994, pp. 111-117.

[14] For a detailed description of Section 367, see Vikram A. Gosain, "Working With the New Section 367 Rules After the Final Regs. And TRA '97," *Journal of Taxation*, vol. 87, Nov. 1997, pp. 310-314.

[15] U.S. Congress, Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, joint committee print, 98th Cong., 2nd sess. (Washington: GPO, 1984), p. 427.

approve the reorganization and the lawsuits were settled.[16] For its part, Stanley Works has pointed out that only 40% of its shares are in taxable accounts.[17]

The anti-deferral regimes may also be a factor at the shareholder level. Inversions commonly result in stockholders at large owning the new foreign parent corporation. Subpart F, with its thresholds requiring control and concentration of ownership, are not likely to be a factor. The PFIC rules, however, may be more likely to apply. If a foreign parent passes the PFIC passive-investment and income thresholds, individual stockholders may be subject to the PFIC regime where they previously were not.[18]

Economic Effects of Inversions

Tax Equity

As noted above, the chief near-term economic effect of inversions is to reduce U.S. tax revenue.[19] If the U.S. government has a fixed revenue requirement, inversions' revenue loss has implications for fairness: the lost revenue is made up by higher taxes elsewhere, either on other corporations and businesses, or on individual taxpayers. Equity is one of the chief grounds on which inversions' critics have assailed them.

Economic theory, however, points out that equity is a difficult concept to apply in the case of the corporate income tax. To begin, corporations are not people but agglomerations of stockholders, employees, creditors, and managers, each of whom has his own particular income and wealth characteristics. It is therefore not very informative to compare the tax burden of a corporation with that of an individual, no matter how eye-catching the comparison may be. To make equity comparisons even more difficult, the ultimate repository of the tax's burden is difficult to determine with any certainty. In the short run, the burden of corporate income tax (or the benefit of its reduction, as with inversions) likely falls on the corporate stockholders.

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[16] Pamela Sebastian Ridge, "Economy Hinders Progress of Ingersoll-Rand Revamping," *The Wall Street Journal*, Dec. 26, 2001, p. B3.

[17] John M. Moran, "Stanley Tax Plan Could be Double-Edged Sword," *Hartford Courant*, Feb. 9, 2002, p. E1.

[18] In the Ingersoll-Rand (IR) reorganization, its domestic corporations received "class B" non-voting stock amounting to 45% of the value of all the new Bermuda parent's shares. IR's proxy statement states that IR does not expect its new Bermuda corporation to be classified as a CFC. However, the statement mentions the possibility that the Internal Revenue Service may classify the class B stock as voting stock, which could trigger the application of Subpart F. The statement also states that IR does not expect the Bermuda parent to be classified as a PFIC. The statement is available on the IR web site at [http://www.ingersoll-rand.com/proxy.pdf].

[19] The Joint Committee on Taxation has estimated that H.R. 3884, a bill aimed at limiting inversions, would increase federal tax revenues by $4 billion over 10 years. BNA *Daily Tax Report*, June 3, 2002, p. G-1.

In the long run, however, economic analysis suggests that market adjustments and behavioral reactions to the tax result in its burden being spread beyond corporate stockholders to all owners of capital. Thus, inversions may reduce the tax burden on capital in general relative to the burden on labor income. And to the extent capital income is associated with individuals with higher incomes, inversions may reduce the progressivity of the tax system.

Investment and "Competitiveness"

In the short run, inversions probably have little impact on real economic activity. Firms undertaking inversions have indicated that they are only changes in legal structure and substantive headquarters functions will continue to be conducted in the United States. At the same time, however, inversions do reduce the corporate tax burden on foreign-source income relative to that on domestic income. An inverted firm may face a lower overall tax rate on investment in low-tax countries than it does on investment in the United States. As a consequence, a more long-run result may be for inverted firms to shift some amount of investment and business operations from the United States to locations where foreign income taxes are low.

What are the implications of this possible impact on investment flows? In assessing the impact of taxes on investment, economic analysis focuses on economic efficiency and — ultimately — on economic welfare. According to traditional economic theory, taxes best promote economic efficiency when they are least distorting of investment decisions; when taxes do not distort investment decisions, investment is generally employed in its most productive location. As a consequence, economic welfare is maximized. Economic theory also holds that taxes are least distorting of the location of investment when the tax burden on investment is the same in every location. In the international context, taxes do not distort investment location when the tax burden on foreign source income is the same as that on domestic income. (In tax parlance, a tax policy that promotes equal taxation of foreign and domestic investment is a policy of "capital export neutrality.") Since inversions reduce the tax burden on foreign income compared to domestic income, their availability likely nudges the U.S. tax system away from capital export neutrality with a corresponding loss in economic efficiency and economic welfare.

But any loss in economic efficiency that may result from inversions is not likely to be large, because features of the U.S. tax system that exist quite apart from inversions already reduce the tax burden on foreign investment. The ability of firms to defer U.S. tax on subsidiary earnings in low-tax countries reduces the tax burden on foreign investment as do certain U.S. foreign tax credit rules. While inversions likely do reduce the tax burden on foreign income by granting a permanent tax exemption rather than just a deferral of tax, it is likely their incremental change in the tax burden is not enormous.

While capital export neutrality is thought by economists to maximize world economic welfare, business leaders and others have emphasized the importance of taxes' impact on U.S. competitiveness and the ability of U.S. firms to compete in world markets. This analysis recommends a policy sometimes called "capital import neutrality" under which the United States would not tax income from foreign business operations, and would limit its tax jurisdiction to U.S.-source income. For example, several European countries operate "territorial" tax systems that do not apply home-country taxes to foreign income; it is argued that the United States should likewise adopt a territorial system to place its firms on the same tax footing as firms from territorial countries.

The availability of corporate inversions introduces an element of capital import neutrality into the U.S. system. Supporters of capital import neutrality are likely to view inversions in a more positive light than supporters of capital export neutrality; capital import neutrality recommends an exemption for foreign income and inversions accomplish that for inverted firms. And as noted above, some policymakers have suggested that inversions may signal a need for tax changes that would make the U.S. tax system more "competitive."

Alternative Policy Responses and Proposals

Proposed policy responses to inversions vary widely, depending on what is viewed as their chief threat. For example, those that are chiefly concerned about the revenue and tax equity results of inversions make little distinction between inversions' loss of tax revenue from U.S. source and foreign sources. Their proposals, including a set of bills introduced (but not passed) in the 107th Congress, seek to re-impose U.S. taxes on firms when inversions occur. In contrast, others view inversions as symptomatic of a competitive burden imposed by the U.S. tax system, and have suggested more general reforms of the U.S. system may be in order. The recent Treasury Department report, for example, recommends more stringent treatment of U.S.-, but not foreign-source income, and calls for a reexamination of the U.S. system of taxing foreign income.

Congressional Proposals

A number of bills have been introduced in the 108th Congress that address inversions. **S. 2**, the broad tax-cut bill approved by the Senate Finance Committee on May 8, contained provisions to restrict inversions as one of a number of revenue-raising measures designed to offset part of the revenue loss from the bill's tax-cut provisions. (The measure was later approved as **S. 1054** for procedural reasons; the proposal was earlier included as provision of **S. 9**, a pension bill introduced by Senator Daschle.) According to estimates by the Joint Committee on Taxation, the bill's inversion provisions would increase revenue by $2.7 billion over fiscal years (FY) 2003-2013.

The bill would impose two new tax regimes on inversions, depending on ownership thresholds and when the inversions occur. Under the first regime, S. 1054 would tax a foreign parent corporation like a domestic corporation if it passes an ownership threshold, thus nullifying much of the tax benefit an inversion can generate. The test would be met if at least 80% of the foreign corporation is owned by the former shareholders of a domestic corporation or partnership that had transferred substantially all of its property to the foreign parent. The threshold also requires the foreign parent and its affiliates not to have "substantial business activities" in the country of incorporation, and applies only to inversions that occur after March 20, 2002.

S. 1054's second regime is based on a 50% ownership test and would potentially apply whether the inversion occurs before or after March 20, 2002. (The second set of rules would not apply, however, to post-March 20 inversions subject to the bill's first regime.) The second regime would act as a type of toll tax on the shifting of the firm's foreign subsidiaries from the former U.S. parent to the new foreign parent. The tax would apply the highest corporate tax rate (or the highest individual tax rate, in the case of partnerships) to stock received by the former domestic parent from the new foreign parent in exchange for ownership of the firm's foreign subsidiary corporations. Neither foreign tax credits nor net operating losses would be permitted to offset the tax.

Additional rules designed to limit earnings stripping would have applied under the 50%-ownership regime. Under the bill, a domestic subsidiary in an inversion arrangement was required to enter into an agreement with the Internal Revenue Service that would govern the allocation of deductible costs and the particulars of other transactions between the subsidiary and foreign parent. The agreement would be designed to ensure that the deductions accurately reflect the respective incomes of the related firms. Failure to enter such an arrangement would result in the disallowance of any deductions resulting from transactions between the related corporations. Also, the bill would have reduced for inverted firms the debt-finance threshold that triggers the tax code's earnings stripping rules.

The inversion provisions of S. 1054 are similar in many respects to those of S. 2119, proposed in the 107th Congress and approved by the Senate Finance Committee in June 2002. S. 1054, however, adds a set of stock option provisions that were not in S. 2119. Under its terms, officers, directors, and 10% owners of inverted firms would be subject to a 20% excise tax on compensation that is directly linked to the value of the corporation's stock. Such compensation would include stock, certain stock options (generally nonqualified stock options), and other stock-based compensation. For stock options, the tax would apply to the value of the option at the time of the inversion, determined by an option-pricing model specified by the Treasury Department. The excise tax would apply, however, only when the inversion in question triggers recognition of shareholder level capital gains.

H.R. 737 (Representative Neal) and **S. 384** (Senator Reid) would tax inverting corporations as domestic corporations and impose a two-tier continuity-of-ownership test in determining when a firm is considered to be "inverted." If the new foreign parent does not have "substantial" business activities in the country of incorporation and its stock is publicly traded in the United States, the triggering threshold would be 50% (i.e., more than 50% of the new parent's stock is owned by the former parent's shareholders); the threshold would be 80% ownership otherwise. The bills' rules would apply in all tax years to inversions occurring after September 11, 2001. Inversions occurring before that date were covered by the rules beginning with tax year 2004. Mr. Neal introduced the proposal in the 107th Congress as H.R. 3884, and stated that the Joint Tax Committee estimated the proposal would increase federal tax revenue by $4 billion over 10 years.

On April 3, the House Ways and Means Committee approved as a revenue-raising component of an energy tax-incentive bill (**H.R. 1531**, the Energy Policy Act) a provision imposing a moratorium on inversions. The bill's inversion provisions are similar to those contained in H.R. 5095, a broad international tax bill introduced by Committee Chairman William Thomas in the 107th Congress. The proposal would deny the tax benefits of inversion to those occurring after March 4, 2003, and before January 1, 2005, by classifying a newly inverted foreign parent firm as a domestic corporation. Firms would generally be classified as inverted if 80% or more of the new foreign entity is owned by the stockholders of the erstwhile U.S. parent. The bill also states that it is the sense of Congress that legislation should be enacted addressing pressures in the tax code that encourage inversions.

Other tax bills in the 108th Congress that address inversions include S. 135 (Senator Dayton), which would tax inverted corporations as domestic corporations and would apply a 50% continuity-of-ownership test; the bill would apply to tax years after 2002, regardless of the date of the inversion.

Anti-inversion legislation has included measures containing restrictions other than taxes. In the 107th Congress, Section 835 of the Homeland Security Act (P.L. 107-296) contained restrictions on the agency's contracting with inverted corporations. The measure that was approved contained broader waiver conditions than those in the earlier House or Senate bills and provided that the prohibition can be waived in the interests of homeland security, to prevent the loss of jobs, or to prevent the government from incurring higher costs.

In the 108th Congress, the Senate returned to the procurement restrictions issue. On January 23, 2003, the Senate approved an omnibus appropriations bill (**H.J.Res. 2**) that would tighten the enacted waiver conditions by making a waiver of the contracting restrictions possible only if the President certifies to Congress that it is essential to national security. The provision was included in the final conference committee version of the bill that became P.L. 108-7.

Other Approaches

An approach to inversions that is similar to those contained in the legislative proposals would modify the "anti-deferral" regimes contained in subpart F or the PFIC provisions. These proposals have not, however, been introduced as legislation. As with the legislative proposals, these suggestions would identify reorganizations that qualify as inversions and apply their tax rules in such situations. The subpart F or PFIC rules would be modified so that the stockholders of foreign-chartered inverted parent corporations would be subject to U.S. tax on at least some of its foreign income.[20]

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[20] Samuel C. Thompson, Jr., "Section 367: A 'Wimp' for Inversions and a 'Bully' for Real Cross-Border Acquisitions," *Tax Notes*, vol. 94, Mar. 18, 2002, p. 1506; and Jim Ditkoff, "Closing the Bermuda Loophole: An Easier Approach Than the REPO Bill," BNA *Daily Tax Report*, Apr. 26, 2002, p. J-1.

In contrast to the proposals that would apply only when inversions occur, another suggested approach would modify the tax code's concept of residence. Such an approach would be more fundamental, and might be viewed as treating the cause rather than the symptoms. One analyst has pointed out that the residence test applied by the British tax system looks beyond the place of incorporation and generally establishes a firm's residence as the country from which the firm is centrally managed and controlled. Such a system would appear to avoid some potential administrative problems inherent in attempting to identify inversions by means of thresholds, as do the legislative proposals. On the other hand, the British system has apparently encountered difficulties in identifying the substantive location of management and control: control can in some cases be established in tax havens simply by conducting *pro forma* board meetings there.[21]

The May 2002 Treasury Report

The Treasury Department's May 2002 report voiced three principal concerns: that the earnings-stripping opportunities from inversion may erode the part of the U.S. tax base consisting of U.S.-source income; that the current tax system may give foreign-controlled firms a competitive advantage; and that inversions "reduce confidence in the fairness of the tax system."[22]

The Treasury Department report notes that earnings stripping is not confined to inversions, but can occur within foreign-controlled groups in general. The report's concern with the practice is reflected in a number of proposals aimed at restraining the practice. As described above, the tax code already places limitations on interest deductions when certain thresholds are exceeded; the Treasury concludes that "the prevalent use of foreign related-party debt in inversion transactions is evidence that these rules should be revisited." The report lists a number of specific ways the rules could be tightened.[23] The report also suggests that "further work is needed" in income-shifting areas apart from related-party debt, specifically, the tax system's transfer pricing rules in the area of intangible assets.[24]

As with earnings stripping, the Treasury report's concern for competitiveness is broader than just inversions. The report views inversions as being one aspect of a more general result of the U.S. tax system. The report's analysis concludes that the U.S. system places U.S.-controlled and headquartered firms in general at a disadvantage relative to foreign-controlled firms, a disadvantage that is believed to occur because the United States taxes the worldwide income of its corporations while some foreign countries use "territorial" systems that exempt foreign income.[25] The

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[21] For a discussion of the British system and how it compares to U.S. legislative proposals, see Lee A. Sheppard, "Preventing Corporate Inversions," pp. 10-11.

[22] U.S. Department of the Treasury, Office of Tax Policy, *Corporate Inversion Transactions: Tax Policy Implications*, May 2002, p. 21.

[23] Ibid., pp. 21-25.

[24] Ibid., p. 26.

[25] Two examples of countries with "territorial" systems are France and the Netherlands.

report views not only inversions, but a growing number of acquisitions of U.S. firms by foreign companies as possible symptoms of the disadvantage.[26]

As a result of its concern for competitiveness, the Treasury report stops short of proposals that would negate the tax savings on foreign-source as well as domestic-source income, a contrast with bills listed above. Instead, the report states:

> the policy response to the recent corporate inversion activity should be broad enough to address the underlying differences in the tax treatment of U.S.-based companies and foreign-based-companies, without regard to how foreign-based status is achieved. Measures designed simply to halt inversion activity may address these transactions in the short run, but there is a serious risk that measures targeted too narrowly would have the unintended effect of encouraging a shift to other forms of transactions to the detriment of the U.S. economy in the long run.[27]

As a more general response, the report recommends evaluating the merits of exempting foreign-source business income and re-evaluating the usefulness of the anti-deferral regimes and limitations on the foreign tax credit.[28]

The report is generally confined to describing the current legal framework and presenting policy options; it does not present a rigorous economic analysis of inversions or the broader impact of U.S. taxes in the international context. With its focus, however, on protecting the domestic rather than foreign U.S. tax base and its concern with competitiveness, the report's perspective appears more closely akin to the capital import neutrality perspective described above.

Conclusions

The apparent recent increase in corporate inversions has aroused concern in its own right. The spectacle of U.S. corporations engaging in "expatriation" in a tax-saving technique not available to most individual taxpayers may, in the words of the Treasury Department, "reduce confidence in the fairness of the tax system." But inversions can be viewed in a broader context. Recent tax policy debate has tended to focus on the international economy, sparked in part by the European Union's successful challenge of the U.S. Foreign Sales Corporation export tax benefit, and in part by the perceived new challenges posed by an increasingly integrated world economy. Some observers and policymakers have suggested that the time is right to consider fundamental reform of the U.S. tax system; one approach might be to adopt a territorial tax system under which the United States would exempt foreign business income from tax.

Inversions present many of the same policy issues as would be presented by adoption of a territorial system. The end result of an inversion, after all, is the

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[26] Ibid., p. 19.

[27] Ibid., p. 2.

[28] Ibid., p. 29.

exemption from U.S. tax of a firm's foreign income.[29] Accordingly, the debate over the respective merits of capital import neutrality and capital export neutrality occur in much the same manner over inversions as they occur in a debate over territoriality. And the administrative problems inversions present in protecting the U.S. domestic tax base — the problems presented by earnings stripping and income shifting transactions — would be presented by a territorial tax system. Thus, if the question of adopting a territorial tax system moves to the fore of the tax policy debate, the debate over inversions may have provided a preview.

[29] However, an inversion exempts all foreign income from U.S. tax, including income from passive investment. Some territorial tax proposals would only exempt income from active business operations.