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

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Summary

In the early 2000s, reports indicated 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 involved the 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. component corporations. A chief motive for inversions was apparently savings by firms on their U.S. corporate income tax. One source of savings was 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. An inversion can thus potentially reduce a firm's U.S. taxes on foreign income. Other tax savings apparently result from "earnings stripping," or the shifting of U.S.-source income from taxable U.S. components of the firm to the tax-exempt foreign parts.

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 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. 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 108th Congress appear to have had the revenue losses and tax equity as their primary concern, and tax legislation aimed at restricting inversions was included in the American Jobs Creation Act of 2004 (P.L. 108-357), an omnibus tax bill addressing business and international tax issues. In 2006, additional tax restrictions were proposed in the Senate-passed version of the Tax Increase Prevention and Reconciliation Act (TIPRA; P.L. 109-222) but were not contained in the final act. In March 2007, the Senate passed a tax package that included inversion provisions as part of H.R. 1591, a supplemental appropriations bill. However, the measure was not included in the conference agreement on the bill. There are indications that the 111th Congress may again look to the corporate income tax as an area where revenue-raising measures might be found to offset tax cuts provided elsewhere.

Some have viewed inversions as symptomatic of a burden they believe the U.S. tax system places on the international competitiveness of U.S. firms. A May 2002 U.S. Treasury report saw inversions as just one result of competitive problems posed by U.S. taxes and called for a more general reexamination of the U.S. international tax system. 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 no 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. This report will be updated as events in Congress and elsewhere occur.

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Introduction

News reports and articles in professional tax journals in the early 2000s drew the attention of policymakers 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. A May 2002 study by the U.S. Treasury Department concluded that while inversions are not new—the statutory framework making them possible has long been in existence—there has been a "marked increase" in their frequency, size, and visibility.[1] A comprehensive list of firms that have inverted has not been compiled. Some of the more high-profile inversions, however, include 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.[2]

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.[3] 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? One plausible explanation is the decline in the stock market that followed the bull market of the 1990s. As described in more detail below, an inversion is accompanied by a required payment of tax by individual shareholders on capital gains. The capital gains tax may thus serve as a brake on inversions. Lower stock prices, however, 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.[4]

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

[1] U.S. Department of the Treasury, Office of Tax Policy, *Corporate Inversion Transactions: Tax Policy Implications* (Washington: May, 2002), p. 1.

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

[3] 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.

[4] For an analysis of the reasons firms undertake inversions, see Mihir A. Desai and James R. Hines, Jr., "Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions," *National Tax Journal*, vol. 55, September 2002, pp. 409-439.

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.[5] This has also 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.[6] Some policymakers have sought a remedy within the existing U.S. system for taxing international transactions. As discussed below in the section on "Alternative Policy Responses and Proposals," the 107th and 108th Congresses have considered a variety of proposals aimed at stemming the growth of inversions. The proposals range from re-imposing U.S. taxes in a manner that would undo the effect of the inversion to more incremental approaches, such as denying the applicability of foreign tax credits and net operating losses to one-time U.S. "toll" taxes that may be triggered by an inversion. The latter, more incremental approach was taken by the enacted version of the American Jobs Creation Act of 2004 (P.L. 108-357).

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."[7] 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 several proposals designed to protect U.S. tax revenues generated by U.S. income.[8] 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.

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[5] 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, March 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, March 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.

[6] 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*, March 10, 2002, p. 1H.

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

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

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.[9] 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.[10]

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.[11]

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,[12] 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

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

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

[11] U.S. taxes generally do apply, however, to a foreign corporation's income from the conduct of a U.S. trade or business and on certain investment income earned in the United States.

[12] 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.

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 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.[13]

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

[13] 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.

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; 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."[14] 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.[15]

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.[16] The purpose of the provision is to prevent

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

[15] 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, February 1994, pp. 111-117.

[16] 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, November 1997, pp. 310-314.

capital gains from flowing out of U.S. tax jurisdiction without being subject to U.S. tax at some point.[17]

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 approve the reorganization and the lawsuits were settled.[18] For its part, Stanley Works has pointed out that only 40% of its shares are in taxable accounts.[19]

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.[20]

Economic Effects of Inversions

Tax Equity

As noted above, the chief near-term economic effect of inversions is to reduce U.S. tax revenue.[21] 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

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[17] 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.

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

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

[20] 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 website at http://www.shareholder.com/ir/edgar.cfm?Page=14.

[21] 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.

of its reduction, as with inversions) likely falls on the corporate stockholders. 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-income, on the one hand, and foreign-source income, on the other. Their proposals 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. method of taxing foreign-source income may be in order. The 2002 Treasury Department report, for example, recommended more stringent treatment of U.S.-, but not foreign-source income—for example, more effective measures of limiting earnings-stripping—and called for a general reexamination of the U.S. system of taxing foreign income.

Congressional Proposals

The House and Senate ETI Bills

A number of bills were introduced in the 108th Congress that addressed inversions. Prominent among these were two broad business tax bills passed in 2004 by the Senate and House—S. 1637 and H.R. 4520, respectively—that had as a primary focus the controversy over the U.S. extraterritorial income exclusion (ETI) tax benefit for exporting. Both bills proposed to repeal the ETI benefit and proposed a variety of tax cuts both for domestic and overseas investment. The bills contained many overlapping provisions but also contained differences, including some in the area of inversions. The differences between the bills were resolved in October by a conference committee, and the conference committee version of H.R. 4520 was enacted as the American Jobs Creation Act of 2004 (P.L. 108-357).

S. 1637 (Senator Grassley) was approved by the Senate Finance Committee on October 1, 2003, and included several inversion-related provisions among a variety of revenue-raising proposals designed to offset the cost of the bill's investment tax benefits.[22] S. 1637 proposed to impose two new tax regimes on inversions, depending on ownership thresholds and on when the inversions occurred. Under the first regime, S. 1637 would have taxed a foreign parent corporation like a domestic corporation if it passed a continuity-of-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 required the

[22] The inversion proposals were similar to those contained in the Senate-passed version of the May, 2003 tax-cut bill (JGTRRA, the Jobs and Growth Tax Relief and Reconciliation Act; P.L. 108-27), but which were not included in the conference committee bill.

foreign parent and its affiliates not have "substantial business activities" in the country of incorporation, and applied only to inversions that occur after March 20, 2002.

S. 1637's second regime was based on a 50% ownership test and would potentially have applied whether the inversion occured 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.

An additional provision of S. 1637 proposed to impose an excise tax on stock options related to inversions, thus addressing an area in which the interests of corporate officers with respect to inversions might diverge from those of stockholders. (See the discussion of capital gains taxes at the shareholder level, above on page 5.) Under the provision, 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 an inverting 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. The bill also contained provisions that would extend current law's earnings-stripping restrictions on the deductibility of interest paid to related corporations (see page 4, above) to partnerships and S corporations. The restrictions currently apply only to corporations.

According to estimates by the Joint Committee on Taxation, S. 1637's inversion provisions would have increased tax revenue by $2.6 billion over 10 years.

The House passed H.R. 4520 (Representative Thomas) on June 17, 2004. Like S. 1637, H.R. 4520 included more stringent treatment of inversions in conjunction with a broad set of unrelated provisions that would repeal ETI while enacting other investment tax benefits. The House bill's inversion provisions, however, were generally narrower than those of the Senate bill. (Note however, that a temporary inversion provision comparable in scope to that of S. 1637 was included in H.R. 6, the House-passed energy bill, as described below.) Under current law, the transfer of foreign subsidiaries or other assets from a U.S. parent corporation to a new foreign parent corporation may give rise to corporate-level tax (sometimes referred to as "toll charges") under several different tax code provisions. However, "tax attributes" such as foreign tax credits or net operating losses (if available) may offset the tax. H.R. 4520 proposed to deny the applicability of tax attributes in the case of inversions.

Like the Senate bill, the House bill contained a provision that applied an excise tax on stock options related to inverted corporations. The applicable rate of the tax, however, would be 15% rather the 20% rate imposed by S. 1637.

Unlike S. 1637, the House-passed bill did not contain restrictions on interest deductions aimed at limiting earnings stripping. In this respect, it is distinct from the 2003 Ways and Means Committee bill (H.R. 2896), which did contain earnings stripping provisions.

According to Joint Committee on Taxation estimates, the House bill's inversion and earnings stripping provisions would together increase tax revenue by an estimated $488 million over fiscal years (FY) 2004-2014.

The American Jobs Creation Act (AJCA; P.L. 108-357)

Like the Senate bill, the conference agreement on H.R. 4520 adopted two alternative tax regimes applicable to inversions; which one applies depends on continuity-of-ownership thresholds. The new rules applied to inversions occurring after March 4, 2003. The new law provides that when a new foreign parent is at least 80% owned by the former parent's stockholders, the new law treats the foreign parent as a domestic corporation, thus generally denying to the firm the tax benefits of the inversion. The second regime applies when there is at least 60% continuity of ownership but less than 80%. In the latter case, the new foreign parent is not taxed like a domestic corporation, but (in a manner similar to the House bill) any toll taxes 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 conference agreement provides an excise tax on stock options, as did both the House and Senate bills. The rate of the tax, however, will be the maximum capital gains tax rate for an individual: 15% through 2008 and 20% thereafter.

According to JCT estimates, the conference agreement's inversion provisions will increase tax revenue by $937 million over 10 years.

Contracting Restrictions

Several bills not directly pertaining to taxes have contained anti-inversion provisions. 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 Secretary of Homeland Security certifies that it is essential to national security. The provision was included in section 101 of division L of the conference committee version of the bill that became P.L. 108-7.

2006 Budget Reconciliation Legislation (H.R. 4297)

Additional tax legislation aimed at restricting inversions was included as one of several revenue-raising "offsets" in the version of budget reconciliation legislation passed by the Senate in November, 2005. The proposal would have applied restrictions to inversions occurring after March 20, 2002, rather than those occurring after March 20, 2003, as under the AJCA. In addition, the plan would have reduced the 60% threshold that applies to AJCA's second inversion regime to a 50% continuity-of-ownership threshold, thus expanding the scope of AJCA's restrictions. The proposal would also have tightened the tax code's earnings-stripping restrictions (see above) in the case of inverting firms. The Senate proposal was not contained in the final version of reconciliation legislation enacted in May 2006 (Tax Increase Prevention and Reconciliation Act; P.L. 109-222).

2007 Senate Small Business Tax Bill

On January 17, 2007, the Senate Finance Committee approved S. 349, containing a package of tax benefits for small business along with a set of revenue-raising measures designed to offset part of the tax benefits' revenue loss. The bill included expanded restrictions on inversions, a scaled-back version of the 2005 proposals described above, as one of the revenue-raisers. The provisions were subsequently included in H.R. 2, the minimum wage bill passed by the full Senate in February, and in H.R. 1591, the supplemental appropriations bill approved by the Senate in March. The inversion measure was not, however, included in the conference agreement reached on H.R. 1591, nor was it in the small business tax package that Congress ultimately passed as H.R. 2206 (P.L. 110-28).

The Senate inversion provision generally applied a part of AJCA's anti-inversion regime, which are the provisions applicable to firms meeting the 80%-or-greater test, to inversions occurring up to (approximately) a year earlier than the effective date specified by AJCA. As described above, AJCA's provisions apply to inversions occurring after March 4, 2003. With some modifications, the Senate measure also applied the AJCA provisions to inversions occurring after March 20, 2002. The modifications were apparently designed to limit the retroactivity of the expanded date. Under their terms, the tax regime that AJCA applied to 80% inversions—treatment of the new offshore parent as a domestic corporation—do not apply until the first year after tax years beginning in 2006.

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.[23]

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

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

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.[24]

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."[25]

The Treasury Department report noted that earnings stripping is not confined to inversions, but can occur within foreign-controlled groups in general. The report's concern with the practice was 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 concluded that "the prevalent use of foreign related-party debt in inversion transactions is evidence that these rules should be revisited." The report listed a number of specific ways the rules could be tightened.[26] The report also suggested 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.[27]

As with earnings stripping, the Treasury report's concern for competitiveness was broader than just inversions. The report viewed inversions as being one aspect of a more general result of the U.S. tax system. The report's analysis concluded 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.[28] The report viewed not only inversions, but a growing number of acquisitions of U.S. firms by foreign companies as possible symptoms of the disadvantage.[29]

As a result of its concern for competitiveness, the Treasury report stopped 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 stated:

> 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

[24] 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.

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

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

[27] Ibid., p. 26.

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

[29] Ibid., p. 19.

> encouraging a shift to other forms of transactions to the detriment of the U.S. economy in the long run.[30]

As a more general response, the report recommended 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.[31]

The report was 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 appeared more closely akin to the capital import neutrality perspective described above.

Conclusion

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 exemption from U.S. tax of a firm's foreign income.[32] 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.

[30] Ibid., p. 2.

[31] Ibid., p. 29.

[32] 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.

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