Corporate Expatriation, Inversions, and Mergers: Tax Issues

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Summary

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

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

However, two avenues for inverting remained. The act allowed a firm to invert if it has substantial business operations in the country where the new parent was to be located; the regulations at one point set a 10% level of these business operations. Several inversions using the business activity test resulted in Treasury regulations in 2012 that increased the activity requirement to 25%, effectively closing off this method. Firms could also invert by merging with a foreign company if the original U.S. stockholders owned less than 80% of the new firm. If the original U.S. shareholders owned less than 60%, the firm was not considered as inverting.

Two features made a country an attractive destination: a low corporate tax rate and a territorial tax system that did not tax foreign source income. The U.K. joined countries such as Ireland, Switzerland, and Canada as targets for inverting when it adopted a territorial tax in 2009. At the same time, the U.K. also lowered its rate (from 25% to 20% by 2015). Inverted firms could reduce worldwide taxes by stripping taxable earnings out of the new U.S. subsidiary, largely through allocating debt to that subsidiary.

Soon after, several high-profile companies indicated an interest in merging with a non-U.S. headquartered company, including Pfizer, Chiquita, AbbVie, and Burger King. This "second wave" of inversions again raised concerns about an erosion of the U.S. tax base. Chiquita and AbbVie canceled their plans in the wake of 2014 Treasury regulations, but Burger King and other firms completed merger plans. Pfizer subsequently terminated its planned merger with Allergan after Treasury regulations issued in 2016. Evidence suggests that these Treasury regulations have been an important factor in subsequently decreasing these merger-related inversions.

Two policy options had been discussed in response: a general reform of the U.S. corporate tax and specific provisions to deal with tax-motivated international mergers. In December 2017, P.L. 115-97 (popularly known as the Tax Cuts and Jobs Act) lowered the corporate tax rate as part of broader tax reform which some argued would slow the rate of inversions. Other tax reform proposals suggested that if the United States moved to a territorial tax, the incentive to invert would be eliminated. There were concerns that a territorial tax could worsen the profit-shifting that already exists among multinational firms. P.L. 115-97, while moving in some ways to a territorial tax, also instituted a number of measures aimed at combatting profit shifting, including a global minimum tax on intangible income that limited the tax benefits of a territorial tax.

The second option is to directly target inversions. The 2017 act included several provisions that discouraged inversions. In addition, further anti-inversion provisions have been introduced, most recently H.R. 5108 and S. 2459 in the 115th Congress, to treat all firms in which former U.S. shareholders have more than 50% ownership (or in which management and control is in the United States) as U.S. firms. These bills also provided that debt could also be allocated to the U.S. member of a worldwide operation in proportion to the U.S. ownership of assets.

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Introduction

The U.S. corporate income tax is based on worldwide economic activity. If all of a corporation's economic activity is in the United States, then tax administration and compliance is relatively straightforward. Many corporations, however, operate in several jurisdictions, which creates complications for tax administration and compliance. Further, corporations may actively choose where and how to organize to reduce their U.S. and worldwide tax liabilities. Some of these strategies have been referred to as expatriation, inversions, and mergers.[1]

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

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

Although the 2004 legislation largely prevented the types of inversions that drew attention prior to its adoption, several companies have successfully inverted in the past few years by using the substantive business operations mechanism or merging.[2] Treasury regulations have subsequently limited the former mechanism.[3]

In spring 2014, several high-profile companies indicated an interest in merging or plans to merge with a non-U.S. firm, including Pfizer,[4] Chiquita,[5] and Omnicom (an advertising firm).[6] News

[1] For a law review article that reviews inversions and their development in detail, see Cathy Hwang, "The New Corporate Migration: Tax diversion Through Inversion," *Brooklyn Law Review*, vol. 80, no. 3, (2015), pp. 807-856, https://www-cdn.law.stanford.edu/wp-content/uploads/2015/09/Inversions-final.pdf. For a detailed list of inversions from 1982 through 2016, see Arjen H. L. Slangen, Marc Baaij and Riccardo Valboni, "Disaggregating the Corporate Headquarters: Investor Reactions to Inversion Announcements by US Firms," *Journal of Management Studies*, July 3, 2017.

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

[3] Treasury Decision, T.D. 9592, July 12, 2012.

[4] Pfizer failed in its initial bid to acquire Astra-Zeneca. Inyoung Hwang, "AstraZeneca Bullish Options Gain on Pfizer Comeback Bets," *Bloomberg News*, September 2, 2014, http://www.bloomberg.com/news/2014-09-02/astrazeneca-bullish-options-gain-on-pfizer-comeback-bets.html.

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

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

reports indicated that a group of Walgreens investors was also urging such a move.[7] Although the Pfizer and Omnicon mergers and Walgreens headquarters shifts ultimately did not take place, other firms announced mergers in the late spring and early summer. A number of firms in the medical device or pharmaceuticals fields announced mergers or proposed mergers with a shift of headquarters: Medtronics,[8] Salix,[9] AbbVie,[10] Mylan,[11] and Hospira.[12] In August 2014, concern about inversions increased with the announcement that Burger King was in talks to merge with Tim Hortons, a Canadian firm, with the merged firm's headquarters in Canada.[13] An agreement was announced on August 26. Although Burger King is a smaller firm than AbbVie, for example, it is a household name and this proposed inversion garnered much attention.

In September 2014, the Treasury Department released a notice of regulatory changes that would restrict some aspects of inversions or their benefits and indicated that other actions may follow.[14] AbbVie, Chiquita, and some other firms canceled their plans in the wake of these Treasury regulations, although new merger proposals were also announced.[15] In November 2015, the Treasury announced additional regulatory restrictions.[16] Although new inversions slowed significantly, others continued but in many cases have been structured to avoid the regulations by reducing ownership below 60%. Most notable of these is the proposed merger of Pfizer with Allergan in November 2015. Pfizer terminated the merger after the release of the April 4, 2016, regulations.[17]

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[7] Ameet Sachdev and Peter Frost," Walgreen Pressured To Move Headquarters To Europe," *Chicago Tribune*, April 14, 2014, http://articles.chicagotribune.com/2014-04-14/business/chi-walgreens-headquarters-to-europe-20140414_1_walgreen-co-tax-rate-tax-deals.

[8] David Gelles, "In Medtronic's Deal for Covidien, an Emphasis on Tax Savings," *New York Times Dealbook*, June 16, 2014, http://dealbook.nytimes.com/2014/06/16/in-medtronics-deal-for-covidien-an-emphasis-on-tax-savings/?_php=true&_type=blogs&_r=0.

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

[10] Nathan Vardi, "AbbVie To Buy Shire For $54 Billion In Biggest Inversion Deal Ever," *Forbes*, July 18, 2014, http://www.forbes.com/sites/nathanvardi/2014/07/18/abbvie-to-buy-shire-for-54-billion-in-biggest-inversion-deal-ever/.

[11] Ronald Barusch, "Dealpolitik: Mylan's Simpler Inversion Structure Could Set Trend," *Wall Street Journal*, July 16, 2014, http://blogs.wsj.com/moneybeat/2014/07/16/dealpolitik-mylans-simpler-inversion-structure-could-set-trend/.

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

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

[14] U.S. Department of Treasury, "Rules Regarding Inversions and Related Transactions," Treasury Notice 2014-52, September 22, 2014. See also the Treasury, "Fact Sheet: Treasury Actions to Rein in Corporate Tax Inversions," press release, September 22, 2014, at http://www.treasury.gov/press-center/press-releases/Pages/jl2645.aspx.

[15] See Kevin Drawbaugh, Factbox: "Another U.S. Tax 'Inversion' Implodes, Pending Deals Dwindle," *Reuters*, October 24, 2014, at http://www.reuters.com/article/2014/10/24/us-usa-tax-pending-inversions-idUSKCN0ID1VR20141024, and Andrew Pollack, "Wright Medical Will Merge With Tornier in All-Stock Deal," *Bloomberg*, October 28, 2014, http://www.bloomberg.com/news/2014-10-27/wright-medical-will-merge-with-tornier-in-all-stock-deal.html.

[16] Treasury Notice 2015-79. See Treasury's press release at https://www.treasury.gov/press-center/press-releases/Pages/jl0282.aspx and U.S. Department of the Treasury, "Fact Sheet: Treasury Issues Inversion Regulations and Proposed Earnings Stripping Regulations," press release, April 4, 2016, at https://www.treasury.gov/press-center/press-releases/Pages/jl0404.aspx. Final regulations on debt-equity were issued on October 21, 2016, T. D. 9790, https://www.irs.gov/irb/2016-45_IRB/ar09.html.

[17] Treasury Notice 2015-79. See Treasury's press release at https://www.treasury.gov/press-center/press-releases/Pages/

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

Data released by the Bureau of Economic Analysis indicated that acquisitions by foreigners, which rose substantially in 2015, fell by 15% in 2016, and by 32% in 2017. Some of the largest declines were in countries associated with inversions, such as Ireland, where acquisitions fell from $176 billion in 2015, to $35 billion in 2016, and to $7 billion in 2017.[18]

In December 2017, a tax revision (P.L. 115-97), often called the Tax Cuts and Jobs Act (TCJA), and subsequently referred to as the "Act," made major changes to the corporate tax and the international tax rules, along with some specific revisions aimed at discouraging inversions.[19] Although data for 2018 are not yet available, one planned inversion, by Assurant, Inc., was revised to retain the headquarters in the United States.[20] Ohio-based Dana, Inc. announced plans to merge and move the headquarters to the U.K., although the merger would leave the U.S. shareholders with less than 60% ownership, and therefore not make them subject to anti-inversion penalties.[21]

U.S. International Tax System

The United States uses a system that taxes both the worldwide income of U.S. corporations and the income of foreign firms earned within U.S. borders. All income earned within U.S. borders is taxed the same—in the year earned and at statutory tax rates of 21% (reduced from 35% by the Act).

Under pre-Act law, U.S. corporate income earned outside the United States was also subject to U.S. taxation, though not necessarily in the year earned. This treatment occurred because U.S. corporations could defer U.S. tax on active income earned abroad in foreign subsidiaries until it was paid, or repatriated, to the U.S. parent company as a dividend.[22] To mitigate double taxation, tax due on repatriated income was reduced by the amount of foreign taxes already paid.

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jl0282.aspx and U.S. Department of the Treasury, "Fact Sheet: Treasury Issues Inversion Regulations and Proposed Earnings Stripping Regulations," April 4, 2016, at https://www.treasury.gov/press-center/press-releases/Pages/jl0404.aspx.

[18] See Bureau of Economic Analysis, "New Foreign Direct Investment in the United States: 2017," news release, July 11, 2018, https://www.bea.gov/news/2018/new-foreign-direct-investment-united-states-2017. See also Andrew Velarde and Zoe Sagalow, "As Inversions Dried Up, Foreign Direct Investment Fell in 2016," *Tax Notes*, July 24, 2017, pp.430-431.

[19] The original title of the law, the Tax Cuts and Jobs Act, was stricken before final passage because it violated what is known as the Byrd rule, a procedural rule that can be raised in the Senate when bills, like the tax bill, are considered under the process of reconciliation. The actual title of the law is "To provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." For more information on the Byrd rule, see CRS Report RL30862, *The Budget Reconciliation Process: The Senate's "Byrd Rule"*, by Bill Heniff Jr.

[20] See "Assurant and The Warranty Group Amend Deal Structure," *Business Wire*, January 9, 2018, at https://www.businesswire.com/news/home/20180109005906/en/Assurant-Warranty-Group-Amend-Deal-Structure.

[21] Chester Dawson and Theo Francis, "Despite U.S. Tax Overhaul, Ohio-Based Dana Considers a Move Abroad," *Wall Street Journal*, March 9, 2018, https://www.wsj.com/articles/dana-to-take-over-gkns-automotive-driveline-business-1520614366.

[22] CRS Report R40178, *Tax Cuts on Repatriation Earnings as Economic Stimulus: An Economic Analysis*, by Donald J. Marples and Jane G. Gravelle. Income from branches and passive income earned directly, such as interest and royalties,

The Act substituted a new system (Global Intangible Low-Taxed Income, or GILTI) that taxed foreign source income of U.S. subsidiaries currently but with an exemption for a deemed return of 10% on tangible assets and a deduction from the remaining income (for 50% of income through 2025 and 37.5% afterward). It allows a credit for 80% of foreign taxes. The new system also allows U.S. firms a deduction for foreign derived intangible income, or FDII, which was designed to reduce tax rates on foreign earnings from the use of intangible assets held in the United States. The deduction is 37.5% of this estimated income through 2025 and 21.875% afterward.[23]

Income from certain foreign sources earned by subsidiaries—which generally includes passive types of income, such as interest, dividends, annuities, rents, and royalties, and is referred to as Subpart F income—is generally taxed in the year it is earned and was retained by the Act. Subpart F applies only to shareholders who may be able to influence location decisions at the corporate level.[24] These subsidiaries are referred to as controlled foreign corporations (CFCs).

The Act also adopted the Base Erosion and Anti-Abuse tax (BEAT), an alternative minimum tax with the tax based increased by certain payments to related foreign parties. Its primary focus was to address profit shifting between foreign parents and U.S. subsidiaries, but it applies in general. Notably, it excludes payments for costs of goods sold and for costs of services under some pricing rules.

One way of shifting profits was to locate debt in high-tax countries. Preexisting thin capitalization rules limited interest to 50% of earnings before the deduction of interest, taxes, and amortization, depreciation, and depletion (EBITA), although firms with a debt-to-asset rate of 1.5 or less were exempt. The new law adopted much stricter thin capitalization rules to prevent firms from deducting large amounts of interest. The new law lowers the cap to 30% of profits, eliminates the exemption based on the debt-to-asset ratio and, after 2021, measures the cap as a share of profits after amortization, depreciation, and depletion deductions.

The Act also adopted some tax provisions targeted at discouraging inversions, which are discussed subsequently.

Anatomy of an Inversion

A corporate inversion is a process by which an existing U.S. corporation changes its country of residence. After the inversion, the original U.S. corporation becomes a subsidiary of a foreign parent corporation. Corporate inversions occur through three different paths: the substantial activity test, merger with a larger foreign firm, and merger with a smaller foreign firm.[25] Regardless of the form of the inversion, the typical result is that the new foreign parent company faces a lower home country tax rate and no tax on the company's foreign-source income.[26]

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is taxed currently.

[23] See CRS Report R45186, *Issues in International Corporate Taxation: The 2017 Revision (P.L. 115-97)*, by Jane G. Gravelle and Donald J. Marples for a discussion of this new law and how it compares to prior law.

[24] These stockholders are defined as owning at least 10% of a subsidiary's stock and only subsidiaries that are at least 50% owned by 10% U.S. stockholders.

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

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

The U.S. firm can use inversions to reduce taxes using various techniques. Foreign operations in the future can be formed as subsidiaries of the new foreign parent in a country with a territorial tax, so that future foreign income can be exempt from tax. Accumulated and future foreign income from the U.S. company's foreign subsidiaries (which would be taxed by the United States if paid to the parent as a dividend) may be effectively repatriated tax free by lending or otherwise investing in the related foreign firm, such as a low-interest loan to the foreign parent holding company. These borrowed funds could then be used, for example, to pay dividends to shareholders or make loans to the U.S. firm.[27]

In addition, the combined firm can engage in "earnings stripping": reducing income in the U.S. firm by borrowing from the U.S. company and increasing interest deductions.[28] For example, a foreign parent may lend to its U.S. subsidiary. This intercompany debt does not alter the overall company's debt, but does result in an interest expense in the United States (which reduces U.S. taxes paid) and an increased portion of company income being "booked" outside the United States. Royalty payments, management fees, and transfer pricing arrangements are other avenues for earnings stripping, but are thought to be of lesser importance than intercompany debt.[29]

Substantial Business Presence

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

U.S. Corporation Acquired by a Larger Foreign Corporation

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

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

> Ensco was headquartered in a jurisdiction that has a favorable tax regime and an extensive network of tax treaties, which can allow the combined company to achieve a global effective tax rate comparable to Pride's competitors.[30]

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

[28] U.S. Department of Treasury, Report to Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties, November 2007.

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

[30] Ensco-Pride International Inc. Joint Proxy Statement, "Recommendation of the Pride Board of Directors and Its Reasons for the Merger," April 25, 2011, http://www.sec.gov/Archives/edgar/data/314808/000095012311039244/d80026b3e424b3.htm.

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

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

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

While this form of inversion may be driven by business considerations, tax considerations may also be part of the decision. An example is the Eaton Cooper merger. The following is an excerpt of a U.S. corporation's (Eaton's) press release announcing the acquisition of an Irish company (Cooper), with the company headquartering in Ireland (with a 12.5% tax rate and a territorial system).

> At the close of the transaction ... Eaton and Cooper will be combined under a new company incorporated in Ireland, where Cooper is incorporated today. The newly created company, which is expected to be called Eaton Global Corporation Plc or a variant thereof ("New Eaton"), will be led by Alexander M. Cutler, Eaton's current chairman and chief executive officer.[31]

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

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

Response to Initial Inversions: The American Jobs Creation Act

In the late 1990s and early 2000s, news reports drew the attention of 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. Among the more high-profile inversions were Ingersoll-Rand, Tyco, the PXRE Group, Foster Wheeler, Nabors Industries, and Coopers Industries.[32]

These corporate inversions apparently involved few, if any, shifts in actual economic activity from the United States abroad, at least in the near term. In particular, inverted firms typically continued to maintain headquarters in the United States and did not systematically shift capital or employment abroad post inversion.[33] Further, Bermuda and the Cayman Islands were the location

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[31] Eaton Corporation, "Eaton to Acquire Cooper Industries to Form Premier Global Power," press release, May 21, 2012, http://www.eaton.com/ecm/groups/public/@pub/@eaton/@corp/documents/content/pct_361385.pdf.

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

[33] U.S. Government Accountability Office, *Cayman Islands: Business and Tax Advantages Attract U.S. Persons and Enforcement Challenges Exist*, GAO-88-778, July 24, 2008.

of many of the newly created parent corporations—jurisdictions that have no corporate income tax but that also do have highly developed legal, institutional, and communications infrastructures.

A 2002 study by the U.S. Treasury Department concluded that while inversions were not new—the statutory framework making them possible has long been in existence—there had been a "marked increase" in their frequency, size, and visibility.[34]

Taken together, these facts suggested that tax savings were one goal of the inversion, if not the primary goal. Beyond taxes, firms engaged in the inversions cited a number of reasons for undertaking them, including creating greater "operational flexibility," improved cash management, and an enhanced ability to access international capital markets.[35]

The 2002 Treasury report identified three main concerns about corporate inversions: erosion of the U.S. tax base, a cost advantage for foreign-controlled firms, and a reduction in perceived fairness of the tax system.[36] These concerns, along with a growing awareness of inversion transactions, may have resulted in congressional concern and debate about how to address the issues surrounding inversions, culminating with the enactment of an anti-inversion provision (Section 7874) in the American Jobs Creation Act of 2004 (AJCA; P.L. 108-357).

The AJCA adopted two alternative tax regimes applicable to inversions occurring after March 4, 2003. The AJCA treats the inverted foreign parent company as a domestic corporation if it is owned by at least 80% of the former parent's stockholders. In these cases, the AJCA would deny the firm any tax benefits of the inversion (i.e., it would continue to be taxed on the combined group's worldwide income). The second regime applies when there is at least 60% continuity of ownership but less than 80%. In this case, the new foreign parent is not taxed like a domestic corporation, but any U.S. toll taxes (taxes on gains) that apply to transfers of assets to the new entity are not permitted to be offset by foreign tax credits or net operating losses. The AJCA also exempted corporations with substantial economic activity in the foreign country from the anti-inversion provisions, but it did not define substantial business activity in the statute.[37]

Post-2004 Inversions and Treasury Regulations of 2012

Although the 2004 act largely eliminated the generic naked inversions, two alternatives remained that allowed a firm to shift headquarters and retain control of the business: the naked inversion via the business activity exemption, and merger with a smaller company.[38] Using the business

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

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

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

[37] Treasury initially defined substantial business activity as being 10% of worldwide activity in regulation and in 2012 revised the regulation to redefine substantial business activity as being 25% of worldwide activity.

[38] The third form of inversion, merger with a larger foreign corporation, would result in control moving outside the United States.

activity route would require significant economic operations in the target country. An inversion by merger would require a large firm that would be at least 25% of the size of the U.S. firm.

The post-2004 approaches to inversions no longer involved countries such as Bermuda and the Cayman Islands, but larger countries with substantial economic activity such as the U.K., Canada, and Ireland. The U.K., in particular, has become a much more attractive headquarters. Because of freedom of movement rules in the European Union, the U.K. cannot have anti-inversion laws, which may have played a role in both moving to a territorial tax and lowering the corporate tax rate.

A 2012 report in the *Wall Street Journal* highlighted some recent moves abroad.[39] This report claimed 10 companies had inverted since 2009, with 6 within the past year or so. This was a small number of companies, but it is useful to look at the methods involved. The *Wall Street Journal* article identified by name 5 of the 10 companies that had moved abroad recently: Aon, ENSCO, Rowan, Eaton, and DE Master Blenders 1763. (The article also referred to Transocean and Weatherford International, but these were firms that had inverted before the 2004 legislation: Transocean first to the Cayman Islands, and then Switzerland, and Weatherford first to Bermuda, and then Switzerland.) The remaining firm mentioned in the *Wall Street Journal* article is Eaton. Eaton's move abroad was a merger; it merged with Coopers, a firm effectively operating its headquarters in the United States, but one that had inverted prior to the 2004 law change.

An article by Bret Wells identified Aon, ENSCO, and Rowan as having inverted via the substantial business activity exemption (where the only apparent objective is tax savings).[40] All three moved to the United Kingdom, where a recent move to a territorial tax, as well as decisions in the European Court of Justice that limited their anti-abuse rules, had made their tax system more attractive.[41] The U.K. was also in the process of lowering its own corporate rate. Two of the firms are oil drilling firms; drilling in the North Sea might have affected their ability to use this exemption. Aon is an insurance firm.

Wells mentions another firm, Tim Hortons, which also used a naked inversion using the substantial business activity exemption in 2009 to relocate to Canada. In doing so, the firm was returning to its origins, as it was founded in Canada. It became an American company when Wendy's acquired it in 1995, but it was subsequently spun off in 2006.[42] DE Master Blenders 1763, like Tim Hortons, was returning to its origins as well (a Netherlands firm), as it was spun off from Sara Lee, which had acquired it in 1978.[43]

In response to increased use of the substantial business activity exemption, Treasury Regulations (T.D. 9592, June 12, 2012) increased the safe harbor for the substantial business activities test from 10% to 25%, effectively closing off this avenue in the future.[44] This action could be done by

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

[40] Bret Wells, "Cant and the Inconvenient Truth about Corporate Inversions." *Tax Notes*, July 23. 2012, pp. 429-439.

[41] Cadbury-Schweppes, September 12, 2006. The U.K. rule required that income subject to a tax rate much lower than the U.K. rates be taxed; this rule was not accepted by the court. See Cleary Gottlieb, "Cadbury Schweppes: UK CFC Rules Too Restrictive," http://www.cgsh.com/files/News/9e29ed20-66c5-4558-93eb-dc8ab51c54c9/Presentation/NewsAttachment/2fcdb202-5144-4e40-8498-dd0d04f99926/cadbury-schweppes.pdf.

[42] Tim Hortons, "The Story of Tim Hortons."

[43] DE Master Blenders 1753, "Our Heritage," 2012 (visited), http://www.demasterblenders1753.com/en/Company/Our-heritage/.

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

regulation because the statute did not specify how the substantial business activity test was to be implemented.

A number of mergers have either been effectuated or were proposed: Chiquita, Actavis, and Perrigo (the latter two are pharmaceutical firms) moving to Ireland; Valeant Pharmaceuticals and Endo Health Services moving to Canada; and Liberty Global (a cable company) to the U.K. Subsequently, the new Irish firm Actavis (itself the result of two prior mergers) merged with Forest Labs.[45] Omnicom (an advertising firm) planned a move to the U.K. (after proposed merger with a French firm, creating a Netherlands holding company, resident in the U.K. for tax purposes), but has abandoned its merger.[46] Chiquita canceled its plans after Treasury regulations were issued in September 2014.[47]

Most of these firms are not household names or industry giants. Thus, perhaps none created as much interest as the attempt by pharmacy giant Pfizer to acquire AstraZeneca with a U.K. headquarters, or the urging of some stockholders of Walgreens to invert to Switzerland. Pfizer represented a significant potential loss of future tax revenue, as much as $1.4 billion per year.[48] According to a study by Martin Sullivan, in 2005, when a temporary tax exclusion of 85% of dividends (the repatriation holiday) was in force, Pfizer repatriated $37 billion, the single largest amount of repatriations of any firm.[49] In 2009, Pfizer repatriated $34 billion (and paid U.S. taxes on that amount) to finance the acquisition of Wyeth, but earnings abroad grew from $42 billion in 2009 (after the repatriation) to $73 billion by 2012. These earnings have not been repatriated and taxed in the United States.[50] An inversion by Pfizer would, however, result in current shareholders paying capital gains taxes on any stock appreciation when they are converted into shares of the new company. Shares held in IRAs and 401(k)s would not typically owe this tax, but shares

371.

[45] For news reports, see Zachary R. Mider "Companies Flee U.S. Tax System by Reincorporating Abroad," *Bloomberg*, January 27, 2014, http://www.bloomberg.com/infographics/2014-01-27/companies-flee-u-s-tax-system-by-reincorporating-abroad.html and "Companies Fleeing Taxes Pay CEOs Extra as Law Backfires," *Bloomberg*, January 27, 2014, http://www.bloomberg.com/news/2014-01-27/companies-fleeing-taxes-pay-ceos-extra-as-law-backfires.html. "Actavis, Forest Labs In Biggest Merger In Specialty Pharma," May 5, 2014, *Investor's Business Daily* http://finance.yahoo.com/news/actavis-forest-labs-biggest-merger-223800951.html;_ylt=A0LEV1G3kWdT7jEAEGFXNyoA;_ylu=X3oDMTEyaGV0M2l0BHNlYwNzcgRwb3MDMwRjb2xvA2JmMQR2dGlkA1FJMDQ5XzE-.

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

[47] See Kevin Drawbaugh, Factbox: "Another U.S. Tax 'Inversion' Implodes, Pending Deals Dwindle," Reuters, October 24, 2014, http://www.reuters.com/article/2014/10/24/us-usa-tax-pending-inversions-idUSKCN0ID1VR20141024.

[48] Zachary R. Mider, "Tax Break 'Blarney': U.S. Companies Beat the System With Irish Addresses," *Bloomberg*, May 5, 2014, http://www.bloomberg.com/news/2014-05-04/u-s-firms-with-irish-addresses-criticized-for-the-moves.html.

[49] Martin A. Sullivan, "Economic Analysis: Pfizer's Tax Picture Dominated by U.S. Losses, Repatriation," *Tax Notes*, July 8, 2013, http://www.taxanalysts.com/www/features.nsf/Articles/8A8A34FCBD7C3C3F85257BA200497696?OpenDocument.

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

owned directly by individuals and in mutual funds would owe tax even if they did not sell their stock.[51]

Policymakers and the public remained interested in the issue of inversions through 2014. Although the initial Pfizer merger did not occur, the spate of mergers or proposed mergers in the medical device and pharmaceuticals industries continued in 2014. One example included one of the largest proposed mergers yet, AbbVie's acquisition of Shire, an Irish firm. The announcement of a proposed merger between Burger King and Tim Hortons also generated interest in the issue.[52] As is the case with Chiquita, AbbVie canceled its plans after the issuance of Treasury regulations in September 2014, but Burger King planned to complete its merger and did so on December 12, 2014.[53]

Treasury continues to regulate inversions where regulations are possible. For example, in 2014 it took action to close a loophole stemming from the coordination of two sets of regulations—the "Anti-Killer B Regulations" and the "Helen of Troy Anti-Inversion Regulations"—that allowed Liberty Global shareholders to avoid some capital gains taxes.[54]

Treasury Notice 2014-52, September 22, 2014

In response to the new wave of inversions, the Treasury Department released a notice of regulatory actions that would restrict inversions and their benefits.[55] Treasury news releases, however, indicated that legislative action is the only way to fully rein in these transactions.[56] Following this notice, several firms announced they were canceling plans to merge, and one firm, Medtronic, announced a change in financing plans (no longer using earnings abroad to pay acquisition costs). Other firms, however, have announced inversion plans.[57] There is no way to know how many unannounced mergers were, or will be, prevented by these regulations.

The regulatory actions address two basic aspects of inversions. One set of changes limits the ability to access the accumulated deferred earnings of foreign subsidiaries of U.S. firms. The second regulatory action restricts certain techniques used in inversion transactions that allowed firms to qualify with less than 80% ownership. This regulation is effective for inversions that

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[51] Laura Saunders and Jonathan D, Rockoff, "Pfizer Holders Could Face Tax Hit in a Deal for AstraZeneca," *Wall Street Journal*, May 8, 2014.

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

[53] See Kevin Drawbaugh, Factbox: "Another U.S. Tax 'Inversion' Implodes, Pending Deals Dwindle," *Reuters*, October 24, 2014, http://www.reuters.com/article/2014/10/24/us-usa-tax-pending-inversions-idUSKCN0ID1VR20141024 and Nasdaq, "Long-awaited Burger King-Tim Hortons Merger Completed - Analyst Blog," December 15, 2014, at http://www.nasdaq.com/article/long-awaited-burger-king-tim-hortons-merger-completed-analyst-blog-cm423414.

[54] IRS Notice 2014-14. See "IRS Aims at Innovative M&A Inversion Structure," Sidley Austin LLP, at http://m.sidley.com/04-29-2014-Tax-Update/.

[55] Treasury, "Fact Sheet: Treasury Actions to Rein in Corporate Tax Inversions," press release, at http://www.treasury.gov/press-center/press-releases/Pages/jl2645.aspx.

[56] See Treasury press release, "Treasury Announces First Steps to Reduce Tax Benefits of Corporate Inversions," at http://www.treasury.gov/press-center/press-releases/Pages/jl2647.aspx.

[57] See Kevin Drawbaugh, "Factbox: Another U.S. Tax 'Inversion' Implodes, Pending Deals Dwindle," *Reuters*, October 24, 2014, October 13, 178-179.

closed on or after September 22, 2014. The regulations do not prevent inversions via merger and do not address earnings stripping by shifting debt to the U.S. firm, although Treasury has indicated future action in this area.[58]

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

In an inversion, the foreign subsidiaries of the original U.S. firm remain subsidiaries so that any dividends paid to the U.S. parent would be taxed.[59] Regulations also treat other direct investments in U.S. property, such as loans to the U.S. parent, as dividends.[60] Once a firm has inverted and the U.S. firm is now a subsidiary of a foreign parent, there are methods of accessing the earnings of overseas subsidiaries by transactions between the new foreign parent and the U.S. firm's foreign subsidiaries. The regulation is intended to address three such methods.

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

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

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

Addressing Techniques to Achieve Less Than 80% Ownership Requirement

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

[58] See Andrew Velarde "Next Inversion Guidance May Affect Interest Deductions and Debt," *Tax Notes*, November 3, 2014, pp. 490-491.

[59] Transfers of the stock or assets of these foreign subsidiaries to other parts of the new related group would incur a corporate level transfer tax that is generally prohibitive.

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

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

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

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

Inversions After Treasury Notice 2014-52 and the 2015 Treasury Regulations

After the 2014 Treasury regulations were issued, some firms revised their plans, and the pace of inversions slowed. Some mergers were structured to avoid the anti-inversion rules and Treasury regulations, by an ownership share of less than 60%. Among what appear to be inversions is the merger of telecom firm Arris and Pace (a U.K. firm), CF Industries (fertilizer) and OCI NB (a Netherlands firm), Terex with Konecranes (a Finnish firm), and a consolidation of European Coca-Cola bottling firms (one such firm, Coca-Cola Enterprises, was a U.S. headquartered firm).[61] Waste Connections Inc. merged with Progressive Waste Solutions Ltd (a Canadian Firm), with 70% ownership and a headquarters in Canada.[62] Monsanto's proposal to merge with Syngenta (a Swiss firm) was called off.

Some mergers that did not qualify as inversions under the tax law also occurred. The most significant in size was the proposed Pfizer merger. On November 23, 2015, Pfizer announced a proposed merger with Allergan, an Irish company, and the move of its headquarters to Ireland. This merger, which would result in the largest pharmaceutical company in the world, is not covered under the anti-inversion rules because Pfizer will own 56% of the value of the new firm.[63] Allergan itself is the product of a merger involving both stock and cash acquisition by Actavis in 2015, with former Allergen shareholders owning a minority of the new company. Thus, this merger as well was not an inversion under the tax law. Actavis, in turn, was a former U.S. firm that inverted by merger with Warner Chillcott, an Irish firm, in 2013 (where the former shareholders of the U.S. firm acquired 77% of the stock).[64] Pfizer terminated its merger with Allergen after the April 4, 2016, regulations (discussed below). Other notable mergers not subject

[61] For a discussion of some of these mergers, see Arash Massoudi and Nathalie Thomas, "Cranes Deal Lifts Tally of Tax Inversions," *AFRWeekend*, August 12, 2015, http://www.afr.com/news/world/cranes-deal-lifts-tally-of-tax-inversions-20150811-gix34y.

[62] Anne Steel, "Waste Connections, Progressive Waste Strike $2.7 Billion Inversion Deal," *Wall Street Journal*, January 19, 2016, https://www.wsj.com/articles/waste-connections-progressive-waste-strike-inversion-deal-1453211211.

[63] See Jackie Wattles and Heather Long, "Avoiding U.S. Corporate Taxes," *CNN Money*, November 23, 2013, http://money.cnn.com/2015/11/23/investing/pfizer-allergan-merger/ and Kevin McCoy, "Experts: U.S. Unlikely to Block Pfizer-Allergan Deal, *USA Today*, November 23, 2015, http://www.usatoday.com/story/money/2015/11/23/experts-treasury-unlikely-block-pfizer-allergan-deal/76268708/.

[64] Actavis to Acquire Warner Chilcott to Create Premier $11 Billion Revenue Global Specialty Pharmaceutical Company, http://ir.actavis.com/phoenix.zhtml?c=65778&p=irol-newsarticle&ID=1821961.

to anti-inversion rules were the acquisition of Salix, a pharmaceutical company, by Valeant (a Canadian company); the acquisition of Auxilium by Endo (after Auxilium backed out of an inversion with Canadian firm QLT); the merger of Cyberonics with Italy's Sorin (to be headquartered in the U.K.); and the merger of Broadcom (a chipmaker) with Avago (a Singapore firm).[65] Information and analytics provider HIS announced a merger with Markit Ltd, a U.K. firm, to be headquartered in the U.K., but the ownership share of HIS would be less than 60% of the firm.[66] Johnson Controls also merged with Tyco, one of the earlier inverted firms.[67]

The 2015 Treasury regulations appear to have more limited consequences for inversions than the 2014 regulations did. Three regulatory changes were made by the notice.[68] First, in the case where the foreign parent is a tax resident of a third country, stock issued by that parent to the existing foreign firm will be disregarded for purposes of the ownership requirement. That change will prevent a U.S. firm from merging with a partner and then choosing a tax friendly third country to headquarter in. The second provision would clarify the so called "anti-stuffing" rules, where the foreign firm's size is inflated by adding assets to that firm. The notice clarifies that this rule applies to any assets, not just passive assets. Third, the current business activity exception requires 25% of business activity to be in the foreign country where the new parent is created or organized, but does not require it to be a foreign parent. This rule requires the business activity to be in the foreign parent. It prevents inversion based on the business activity test when the foreign parent has a tax residence in another country without substantial business activities.

Treasury Regulations, April 4, 2016

On April 4, 2016, the Treasury Department issued temporary and proposed regulations formalizing rules contained in Notices 2014-52 and 2015-79 limiting corporate tax inversions, as well as adding new rules addressing inversions and earnings-stripping transactions.[69] In response to these new regulations, the proposed merger between Pfizer and Allergen PLC has been terminated.[70]

Anti-Inversion Regulations

The April 4, 2016, Treasury regulations put in place several anti-inversion rules that target groups that have engaged in a series of inversion or acquisition transactions as well as a rule that restricts postinversion asset dilution.

[65] Several of these mergers are discussed in Amanda Athanasiou, "Is the Anti-Inversion Notice Doing its Job?" *Tax Notes*, March 9, 2015, pp. 1185-1186.

[66] Anne Steele and Shayndi Raice, "HIS and Market to Merge in an Inversion Deal, Creating Data Heavyweight, March 21, 2016, *Wall Street Journal*, https://www.marketwatch.com/story/ihs-and-markit-to-merge-in-an-inversion-deal-creating-data-heavyweight-2016-03-21.

[67] Nasdaq, "Johnson Controls to Proceed With Tyco Merger Plan," April 21, 2016, http://www.nasdaq.com/article/johnson-controls-to-proceed-with-tyco-merger-plan-20160421-00578.

[68] Treasury Notice 2015-79. See Treasury's press release at https://www.treasury.gov/press-center/press-releases/Pages/jl0282.aspx.

[69] U.S. Department of the Treasury, *Fact Sheet: Treasury Issues Inversion Regulations and Proposed Earnings Stripping Regulations*, April 4, 2016, https://www.treasury.gov/press-center/press-releases/Pages/jl0404.aspx.

[70] Andrew Velarde, "Treasury Finally KOs Pfizer Inversion," *Tax Notes*, April 11, 2013.

Multiple Domestic Entity Acquisition Rule

The temporary regulations target inversion transactions involving a new foreign parent that previously acquired one or more U.S. entities in inversions or acquisitions in which the new foreign parent issued stock. These prior acquisitions would generally increase the value of the foreign entity, enabling it to subsequently engage in an inversion transaction with a larger U.S. company while remaining below the 60% or 80% ownership thresholds. The temporary regulations disregard stock of the new foreign parent to the extent the value of such stock is attributable to its prior U.S. entity acquisitions during the prior three years. According to analysis by Americans for Tax Fairness, the implementation of this rule would have increased Pfizer's share of the merged company to roughly 70% from 56% prior to the rule.[71]

Multiple-Step Acquisition Rule

Similar to the multiple domestic entity acquisition rule, the multiple-step acquisition rule targets certain inversions that are structured as back-to-back foreign acquisitions. Specifically, it targets transactions that are part of a plan in which a foreign corporation acquires substantially all of the assets of a U.S. entity and, subsequent to this first acquisition, a second foreign corporation acquires substantially all of the assets of the first foreign corporation. The temporary regulations, under certain circumstances, treat each acquisition as an acquisition of a U.S. entity that may be subject to anti-inversion rules. Unlike the multiple domestic entity acquisition rule, which has a three-year look-back period, the multiple-step acquisition rule can be applied to all acquisitions that are part of the same plan regardless of time.

Asset Dilution Rule

A third rule modified existing regulations to restrict the ability of inverted companies to avoid paying tax on unrealized gains (under Section 965) through a transfer to a controlled foreign corporation (CFC) (under Section 351). This would address situations where a CFC of an inverted U.S. company engages in a postinversion exchange that could dilute a U.S. shareholder's indirect interest in the exchanged asset, allowing the U.S. shareholder to avoid U.S. tax on any realized gain in the asset that is not recognized at the time of the transfer. The rule requires a CFC of an inverted U.S. group to recognize all realized gain with respect to any such postinversion Section 351 exchange.

Earnings-Stripping Regulations

The earnings-stripping regulations aim to restrict the ability of foreign-parent groups to shift earnings out of the United States through dividends or other economically similar transactions (under Section 385).[72] In these cases certain related-party debt will be characterized as equity for tax purposes. The result of equity classification is that interest deductions will be disallowed, and withholding obligations of 30% (or lower rate based on an applicable income tax treaty) could

[71] Frank Clemente, *New Treasury Dept. Anti-Inversion Rule Would Prevent Pfizer's Estimated $35 Billion Tax Break*, Americans for Tax Fairness, April 5, 2016.

[72] The regulations apply broadly to any related firms including all U.S. subsidiaries of foreign parents, any other cross border firms including U.S. multinationals and their subsidiaries, and domestic corporations, although inverted firms are noted as a concern in the April 4, 2016 Treasury press release and the Section 385 regulations were issued jointly with other regulations affecting inversions.

ensue. The regulations do not normally apply for related-party debt that is incurred to fund actual business investment, such as building or equipping a factory.

The regulations also require documentation of debt instruments issued and held by certain members of an expanded group to establish that such instruments are properly characterized as debt. The regulations also allow the IRS on audit to treat an instrument issued to a related party as in part debt and in part equity.

The final regulations issued on October 21, 2016,[73] scaled back the original regulations in response to the comment period. The final regulations removed the general bifurcation rule that would have allowed a debt instrument to be classified as part debt and part equity and an exemption for debt for foreign issuers. The rules also provided exemptions for cash pools (a pool of cash to be accessed for short-term needs), short-term loans, regulated financial entities, and pass-throughs (firms not taxed as corporations). The Treasury delayed documentation rules for a year on July 28, 2017.[74] Treasury announced on July 7, 2017, that these debt-equity regulations were to be among eight rules targeted for review.[75]

The Treasury issued final regulations for the temporary regulations introduced in April 2016 on July 12, 2018, as TD 9834 with minor changes.[76]

Inversions After the April 4, 2016, Treasury Regulations

Two days after the regulations were issued, Pfizer withdrew from its merger with Allergen, an Irish-based company that was an inverted firm. It appears that this merger was affected by the multiple-entity rule, which has come to be called "serial inversion."[77] Mergers between Shire (Ireland based) and Basalta, and between HIS and Markit Group Inc. (U.K. based) went forward.[78] The CF Industries merger with OCI NV (based in the Netherlands) was also called off; Johnson Controls and Tyco went forward.[79] A merger between Konecranes (a Finnish firm) and Terex was scaled down to an acquisition of a share of Terex with the U.S. firm owning 25%, thus avoiding the effect of regulations.[80]

In May 2016 Cardtronics, Inc., an ATM operator, announced a plan to move to the U.K. using the substantial business activities test.[81] Also in May, an oil and gas industry service and technology

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[73] T. D. 9790, https://www.irs.gov/irb/2016-45_IRB/ar09.html.

[74] Notice 2017-36, https://www.irs.gov/pub/irs-drop/n-17-36.pdf.

[75] Notice 2017-38, https://www.irs.gov/pub/irs-drop/n-17-38.pdf.

[76] Treasury Decision 9834, at https://www.federalregister.gov/documents/2018/07/12/2018-14693/inversions-and-related-transactions.

[77] New Treasury Dept. Anti-Inversion Rule Would Prevent Pfizer's Estimated $35 Billion Tax Break, Americans for Tax Fairness, April 5, 2016, https://americansfortaxfairness.org/new-treasury-dept-anti-inversion-rule-would-prevent-pfizers-estimated-35-billion-tax-break/.

[78] Andrew Velarde, "Treasury Finally KOs Pfizer Inversion," *Tax Notes Today*, April 7, 2016.

[79] Andrew Velarde, "Year in Review: Immense Change, Contentious Talk in Debt-Equity Classification," *Tax Notes*, January 2, 2017, pp. 15-17.

[80] Andrew Velarde, "Terex-Konecranes Merger Downsized After Lost Tax Benefits," *Tax Notes*, May 23, 2016, pp. 1032-1033.

[81] Amanda Athanasiou, "ATM Operator Cardtronics Seeks Friendlier Tax Regime in U.K.," *Tax Notes Today*, April 29, 2016.

firm announced a merger with Technip SA (France) to form a U.K. company, with each firm holding about half the stock and thus avoiding any of the recent regulations and establishing a new headquarters in another country.[82] In 2017, Praxaire (a U.S. industrial gas company) announced a merger with Linde AG (a German gas and technology company), also with each owning half of the new company.[83]

As noted in the introduction, statistical data suggest a decline in inversions from 2015 to 2016, and again from 2016 to 2017, and these data are consistent with the limited news reports of major inversions.[84] Pfizer's CEO has recently indicated that deals are on hold generally while tax reform is being considered.[85]

P.L. 115-97, the 2017 Act

The 2017 legislation not only made fundamental changes to the overall treatment of corporate income at home and abroad, but also adopted several provisions specifically aimed at inverted corporations (those with 60% to 80% ownership).

Recapture of Deemed Repatriation Rate Reduction

Under the new law, existing untaxed earnings held abroad are taxed under a deemed repatriation rule, but at a lower rate (8% for earnings reinvested in noncash assets and 15.5% for earnings held as cash or cash equivalents). A special recapture rule applies on deemed repatriations of newly inverted firms. This recapture rule applies if a firm first becomes an expatriated entity at any time during the 10-year period beginning on December 22, 2017. In this case, the tax will be increased from 8% and 15.5% to 35% tax for the entire deemed repatriation, with no foreign tax credit allowed for the increase in tax rate. The additional tax is due on the full amount of the deemed repatriation in the first tax year in which the taxpayer becomes an expatriated entity.

Inclusion of Cost of Goods Sold in BEAT

BEAT excludes payments which reduce gross receipts with the result that payment for the cost of goods sold is not included under BEAT. An exception applies for firms that invert after November 9, 2017, where payments to a foreign parent or any foreign firm in the affiliated for cost of goods sold is included in BEAT.

Modification of Attribution Rules

The constructive ownership rules for purposes of determining 10% U.S. shareholders, whether a corporation is a CFC and whether parties satisfy certain relatedness tests, were expanded in the 2017 tax revision. Specifically, the new law treats stock owned by a foreign person as attributable to a U.S. entity owned by the foreign person (so-called "downward attribution"). As a result, stock owned by a foreign person may generally be attributed to (1) a U.S. corporation, 10% of the value of the stock of which is owned, directly or indirectly, by the foreign person; (2) a U.S.

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[82] Amanda Athanasiou, U.S. "Company FMC Technologies to Merge With France's Technip," *Tax Notes*, May 30, 2016, pp. 1181-1182.

[83] Amanda Althanasiou, "Praxair to Merge With Germany's Linde," *Tax Notes*, January 2, 2017, pp. 62-63.

[84] For a list of major inverted corporations see *Bloomberg*, Tracking Tax Runaways, Updated March 1, 2017, https://www.bloomberg.com/graphics/tax-inversion-tracker/. This list does not address the exact circumstances or owrnership share of each firm.

[85] Stephanie Cumings, Pfizer CEO Says Big Deals Delayed by Tax Reform, *Tax Notes*, August 7, 2017, pp. 685-686.

partnership in which the foreign person is a partner; and (3) certain U.S. trusts if the foreign person is a beneficiary or, in certain circumstances, a grantor or a substantial owner.

The downward attribution rule was originally conceived to deal with inversions. In an inversion, without downward attribution, a subsidiary of the original U.S. parent could lose CFC status if it sold enough stock to the new foreign parent so the U.S. parent no longer had majority ownership. With downward attribution, the ownership of stock by the new foreign parent in the CFC is attributed to the U.S. parent, so that the subsidiary continues its CFC status, making it subject to any tax rules that apply to CFCs (such as Subpart F and repatriation taxes under the old law, and Subpart F and GILTI under the new law).

Other Provisions Affecting Stockholders and Stock Compensation

Dividends (like capital gains) are allowed lower tax rates than the rates applied to ordinary income. The rates are 0%, 15%, and 20% depending on the rate bracket that ordinary income falls into. Certain dividends received from foreign firms (those that do not have tax treaties and PFICs)[86] are not eligible for these lower rates. Dividends paid by firms that inverted after the date of enactment of P.L. 115-97 are added to the list of those not eligible for the lower rates.

In 2004, an excise tax of 15% was imposed on stock compensation received by insiders in an expatriated corporation; the new law increases it to 20%, effective on the date of enactment for corporations that first become expatriated after that date.

Inversions After the Act

As noted earlier, there are no aggregate data available yet for 2018, but there are also indications that most tax-motivated inversions had already been discouraged by the 2016 regulations. Considering announcements of individual companies, one planned inversion, by Assurant, Inc. was revised to retain the headquarters in the United States.[87] Ohio-based Dana, Inc. announced plans to merge and move the headquarters to the U.K., although the merger would leave the U.S. shareholders with less than 60% ownership, and therefore not make them subject to anti-inversion penalties.[88] A recent announcement indicated that the Dana merger was called off.[89] Some firms may be considering reversing their headquarters decisions.[90]

[86] A PFIC is a passive foreign investment company, a foreign corporation that primarily holds passive assets. It does not fall under CFC rules, but has a separate set of anti-avoidance rules that generally were not changed by the new law.

[87] See Assurant and The Warranty Group Amend Deal Structure, *Business Wire*, January 9, 2018, at https://www.businesswire.com/news/home/20180109005906/en/Assurant-Warranty-Group-Amend-Deal-Structure.

[88] Chester Dawson and Theo Francis, "Despite U.S. Tax Overhaul, Ohio-Based Dana Considers a Move Abroad," *Wall Street Journal*, March 9, 2018, at https://www.wsj.com/articles/dana-to-take-over-gkns-automotive-driveline-business-1520614366.

[89] DANA, "Dana Comments on Decision by GKN Shareholders," news release, at https://danaincorporated.gcs-web.com/news-releases/news-release-details/dana-comments-decision-gkn-shareholders-0.

[90] David Morgan, "U.S. Tax Cuts Prompt Rethink by Some 'Inverted' Companies," *Reuters*, August 3, 2018, https://www.reuters.com/article/us-usa-tax-inversions/u-s-tax-cuts-prompt-rethink-by-some-inverted-companies-idUSKBN1KO2HH.

Policy Options

The AJCA was successful at limiting a form of inversions, at least initially. In particular, the AJCA stopped the practice of basic "naked inversions," in which little activity or presence in the new jurisdiction is required and the new parent is domiciled in a tax haven. Further, through regulation, Treasury has limited the use of the substantial business activity test safe harbor to invert. Recent activity (as noted above), however, suggests that mergers continued to be used as a vehicle for corporate inversions after these changes.

These more recent mergers have increasingly resulted in a U.K. parent company (e.g., FMC-Technip, HIS-Markit), due to policy decisions by the U.K. government. Specifically, the U.K. lowered its corporate tax rate and adopted a territorial tax system. In addition, anti-abuse provisions for foreign source income were weakened by the European Union courts. The U.K. has also proposed taxing certain intangible income at a 10% rate. (This is referred to as a patent box.)[91]

To restrict the occurrence of tax-motivated inversions, both a general reform of the U.S. corporate tax and specific provisions to deal with tax-motivated international mergers were discussed. Some important changes were made in 2017; other options remain.

U.S. Corporate Tax Reform and the 2017 Act

Interest in reforming the corporate income tax was long-standing,[92] including calling for explicit accommodation of international concerns.[93] As noted earlier, two aspects of the U.S. corporate tax system are particularly relevant to corporate location decisions: the corporate tax rate and the taxation of foreign-source earnings. Taken together, these factors, under prior law, could yield a substantial reduction in taxes paid. In the case of the proposed merger of Forest Laboratories Inc. (a U.S. company) and Actavis (an Irish company) in 2014, the tax reduction was estimated to be roughly $100 million per year.[94]

Lowering the Corporate Tax Rate

Prior to the 2017 changes, the U.S. corporate statutory tax rate was higher than both the average statutory rates of the other Organisation for Economic Co-operation and Development (OECD) countries and that of the 15 largest economies in the world.[95] Many asserted that the U.S. statutory tax rate needed to be lowered to reduce the incentive for inversion transactions.[96] With the rate lowered from 35% to 21%, the combined central and subnational corporate tax rates are similar to most rates in the OECD.[97] While lowering the corporate tax rate would reduce the

[91] CRS Report R44522, *A Patent/Innovation Box as a Tax Incentive for Domestic Research and Development*, by Jane G. Gravelle.

[92] CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle.

[93] CRS Report RL34115, *Reform of U.S. International Taxation: Alternatives*, by Jane G. Gravelle.

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

[95] CRS Report R41743, *International Corporate Tax Rate Comparisons and Policy Implications*, by Jane G. Gravelle.

[96] Hank Gutman, Principal, Director of the Tax Governance Institute, KPMG LLP, *Changes in the Tax Law: How Are Effects Measured, and Who is Affected?*, May 2, 2014.

[97] OECD.Stat, Table 11.1 Statutory Corporate Income Tax Rate, https://stats.oecd.org/index.aspx?DataSetCode=TABLE_II1, site visited March 5, 2019.

incentive to invert, there are reasons to suggest that it would be impractical to reduce the rate to the level needed to stop inversions. Namely, to stop inversions through a reduction in the corporate tax rate would require a U.S. corporate tax rate set equal to the lowest tax rate of a destination company, or zero.

A lower corporate tax rate alone reduced the incentive for corporate inversions, primarily by reducing the tax rate applied to repatriated earnings.[98] For a company like Pfizer, with large foreign earnings, a rate reduction could yield significantly lower taxes paid. However, as discussed below, the benefit of a lowered rate is negligible relative to the benefit to corporate taxpayers afforded by territorial tax systems, when income earned in low- or no-tax foreign jurisdictions is never subject to U.S. tax.

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

Adopt a Territorial Tax System

Prior to the 2017 revision, the United States was one of the few countries that had a worldwide tax system and levied a tax on the foreign-source income of domestic corporations. Changing corporate tax residence to a country with a territorial tax system (where foreign earnings would not be taxed at all) was thought to drive inversion decisions. This issue led to proposals for the United States to adopt a territorial tax system to stop inversion transactions.[99]

One concern about adopting a territorial tax system is the strain it would likely place on the current transfer pricing system.[100] From this perspective, the worldwide tax system provided a backstop on the amount of profit shifting or base erosion possible, because shifted profits will eventually be repatriated. Under a territorial tax system, this is not the case. Research has found evidence of significant profit shifting, especially related to mobile intellectual property, suggesting a lot of income from foreign sources is really U.S. income in disguise.[101]

Numerous other issues surround the adoption of a U.S. territorial tax. For example, while some supported a territorial tax to eliminate the incentive to keep earnings abroad, others opposed it because it likely discourages domestic investment and activity in the United States.[102]

The revisions in 2017 maintained a worldwide system, but with some changes. Income from U.S. subsidiaries is taxed on a current basis but at a lower rate and with an exemption for a deemed return on tangible assets. It also provided a subsidy for locating intangible assets with earnings from abroad in the United States. Many of the inverting firms had significant intangible assets,

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

[99] McBride (2014).

[100] Gutman (2014).

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

[102] A territorial tax lowers the tax on returns to investment abroad, increasing after-tax returns and encouraging firms to displace domestic investment with foreign investment.

and it is not clear whether this new regime (a lower tax rate but on a current basis) is more or less generous to firms considering inverting.

Tax Reform Proposals

Moving closer to a pure territorial tax, as in the case of a rate reduction, would likely reduce corporate tax revenue and add to current budget pressures unless it is offset by other tax increases, although this effect would be less costly at the lower 21% tax rate. In 2027, GILTI is projected to raise $21 billion.[103] GILTI could be retained and the rate lowered or the temporarily lower rate could be made permanent.

There has been some agreement that adopting a territorial tax without some significant anti-abuse provisions could be problematic, as it would likely increase profit shifting abroad by U.S. firms.[104]

Targeted Approaches

Evidence suggests that administrative remedies were successful at dramatically slowing inversions; the targeted legislative changes in the 2017 Act may have had some impact as well. There are further changes that could be made to discourage inversions. This section discusses the history of these proposals, both legislative and administrative.

One approach would be to extend the rate recapture enacted in the 2017 Act for a period longer than 10 years, or to make it apply indefinitely to future inversions.

A second alternative is to directly restrict the ability of U.S. firms to invert by merger. The President's FY2015, FY2016, and FY2017 budget proposals contained a provision that would have further restricted the use of inversions.[105] The proposal would modify the 80% test enacted in the AJCA to a 50% test and eliminate the 60% test. In effect, this proposal would reduce the percentage of shareholders that are owners of the "old U.S. company" and the "new foreign

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[103] See Joint Committee on Taxation, General Explanation of P.L. 115-97, December 20, 2018, at https://www.jct.gov/publications.html?func=startdown&id=5152.

[104] All of the proposals to move to a territorial tax have been accompanied by provisions that attempt to limit profit shifting, particularly of intangible income. See CRS Report R42624, *Moving to a Territorial Income Tax: Options and Challenges*, by Jane G. Gravelle for further discussion. Such measures were in the 2014 bill introduced by then Ways and Means Chairman Dave Camp, U.S. Congress, Joint Committee on Taxation, Technical Explanation of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title IV—Participation Exemption System for the Taxation of Foreign Income, committee print, 113th Cong., February 26, 2014, JCX-15-14. The Senate Finance Committee also issued several tax reform discussion drafts in 2013 that proposed, in the international arena, a current but lower tax on foreign source income (without specifying the type of corporate tax that would be feasible). See United States Committee on Finance, Baucus Unveils Proposals for International Tax Reform, http://www.finance.senate.gov/newsroom/chairman/release/?id=f946a9f3-d296-42ad-bae4-bcf451b34b14. The Finance Committee set up working groups in 2015 and the international group reported a general framework, where moving to some form of hybrid territorial tax system was discussed. Senate Finance Committee, International Tax Reform Working Group: Final Report, Senator Rob Portman and Senator Charles Schumer, Co-Chairs, July 2015, http://www.finance.senate.gov/newsroom/chairman/release/?id=e9eefc66-7e11-4276-939f-3eca6fd6d959.

[105] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals*, March 2014, http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf; Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals*, February 2015, https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf; and Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals*, February 2016, https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf.

merged company." The proposal would also require that the new foreign corporation be managed and controlled from outside the United States and prohibit transactions where the new foreign company has substantial business activities in the United States. In November 2015, then-Senate Finance Committee Chairman Hatch indicated the possibility of adding an anti-inversion provision to legislation to extend expired provisions.[106]

Many of these bills were introduced in the 115th Congress.

- H.R. 1931 (Doggett), the Corporate EXIT Fairness Act, and H.R. 3434 (Levin) and S. 1636 (Durbin, along with a number of cosponsors), the Stop Corporate Inversions Act, would have treated all mergers as U.S. firms when the U.S. firm's shareholders hold more than 50% or when management and control primarily takes place in the United States.
- H.R. 1932 (Doggett) and S. 851 (Whitehouse), as with bills introduced in the 114th Congress, would have included anti-inversion provisions as part of a broader proposal to address tax havens and deferral.
- H.R. 3603 (Levin) would have addressed earnings stripping of inverted corporations. H.R. 3424 (DeLauro) would disallow federal contracts for inverted firms.
- H.R. 1451 (Schakowsky) and S. 586 (Sanders) would make major changes in the tax treatment of foreign source income and include anti-inversion rules.

Following the change in the international system adopted at the end of 2017, Representative Doggett and Senator Whitehouse introduced the "No Tax Break for Outsourcing Act" (H.R. 5108, S. 2459) which, in addition to other changes, would have treated foreign corporations that are managed and controlled in the United States as domestic corporations and treated inverted firms as U.S. firms when the shareholders of the former U.S. company own more than 50% of the shares.

These bills would have also limited interest deductions in the United States to the proportionate share of the firm's assets.[107] The last proposal (to allocate worldwide interest) was in both the House and Senate versions of the legislation (H.R. 1; 115th Congress) in somewhat different form but was not retained in the final legislation. While this proposal was not specifically targeted at inverted firms it would have increased the restrictions that limit earnings stripping.

Administrative Changes

Former President Obama had encouraged Congress to act directly to limit inversions, but had also indicated on August 6, 2014, that administrative changes to limit inversions were under examination.[108] Prior to that announcement, Steve Shay, a Harvard professor and former practitioner and Treasury official, outlined two regulatory actions that he believed could be

[106] Stephen K. Cooper, Kat Lucero, and Kaustuv Basu, Finance Members See International Tax Reform and Extenders Deal, *Tax Notes*, November 16, 2015, pp. 896-897.

[107] See https://doggett.house.gov/media-center/press-releases/rep-doggett-sen-whitehouse-introduce-bill-end-tax-breaks-exporting-jobs. The allocation of interest in H.R. 5108 and S. 2459 is based on the U.S. domestic corporation's share of worldwide earnings before interest, taxes, depreciation, and amortization (EBITDA).

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

taken.[109] The first would limit earnings stripping by reclassifying debt as equity due to excessive related party debt in an inversion.[110] (The second provision is no longer relevant under the new international tax regime.)[111]

A number of other administrative proposals that have been suggested (such as provisions relating to taxing accumulated deferred earnings) are no longer relevant and others have been adopted in the regulatory changes discussed above.[112]

- Expanding the scope of Section 7874 (which treats inverted firms as U.S. firms) by combining multiple transactions into single ones, or vice versa. The scope of Section 7874 could also be expanded by treating certain stock as disqualified (because it is expected to be held temporarily or because it is accompanied by restrictions on voting rights); this provision was adopted in Treasury regulations;
- Potentially recognizing accumulated deferred earnings as currently taxable under authority such as Subpart F, Section 367, or other rules (this provision is no longer relevant with the end of deferral, but it may have influenced the decision to tax deferred earnings of newly inverted firms at the full 35% rate for the next 10 years);
- Issuing regulations that would generally tighten restrictions on interest deductions under the thin capitalization rules of Section 163(j). These changes

[109] Stephen E. Shay, "Mr. Secretary, Take the Tax Juice Out of Corporate Expatriations," *Tax Notes*, July 28, 2014, pp. 473-479.

[110] This change would be based on authority under Section 385 of the Internal Revenue Code. A somewhat different technique has been suggested by Steven M. Rosenthal, "Professor Shay Got It Right: Treasury Can Slow Inversions," *Tax Notes*, September 22, 2014, pp. 1445-1449. The second related to rules at that time that required certain investment by U.S. foreign subsidiaries, such as making a loan to the U.S. parent, to be treated as effective taxable repatriations (dividends). This change would extend this type of treatment to certain loans of these foreign subsidiaries to other related parties (such as the new foreign parent). For example, if a foreign subsidiary lent to the new foreign parent and the new foreign parent in turn lent to the U.S. subsidiary, this loan would be considered a dividend to the U.S. parent. It would also appear that loans for other purposes, such as buying back stock of the foreign parent, could also be treated as taxable repatriations under regulatory authority.

[111] The second provision related to rules at that time that required certain investment by U.S. foreign subsidiaries, such as making a loan to the U.S. parent, to be treated as effective taxable repatriations (dividends). This change would extend this type of treatment to certain loans of these foreign subsidiaries to other related parties (such as the new foreign parent). For example, if a foreign subsidiary lent to the new foreign parent and the new foreign parent in turn lent to the U.S. subsidiary, this loan would be considered a dividend to the U.S. parent. It would also appear that loans for other purposes, such as buying back stock of the foreign parent, could also be treated as taxable repatriations under regulatory authority. Stephen E. Shay refers to authority in Section 956(e), 7701(l), 7874 (g) and 7805. Some of the second category of proposals were adopted in Treasury Notice 2014-52, discussed above, and the April 4, 2016, Treasury regulation addressed related party debt for U.S. subsidiaries of foreign firms, in general.

[112] See Mindy Herzfeld, "What Can Treasury Do About Inversions?" *Tax Notes*, August 24, 2014, pp. 895-897, who summarizes the four bullets plus the two proposals of Stephen Shay. For additional proposals, including those relating to stockholders, taxes on executives, using definitions of effectively connected income, and enforcing arms-length transfers of U.S. assets, as well as discussions of regulatory approaches in general, see Joseph DiSciullo, "Academics Offer Suggestions for Discouraging Corporate Inversions," *Tax Notes*, August 25, 2014, pp. 943- 945; Samuel C. Thompson, Jr., Letter to Honorable Jacob J. Lew et al., Re Legislative and Administrative Proposals re Inversions, August 12, 2014; letter to Jacob J. Lew, from Jeffrey M. Kadet, August 11, 2013; Samuel C. Thompson Jr., "Professor Says Debt/Equity Regs can Apply to Inversions," *Tax Notes*, April 18, 2014, pp. 883-884; Alex Parker, "Executive Action on Inversions? Not So Fast," August 8, 2014, Bloomberg International Blog, http://www.bna.com/executive-action-inversions-b17179893937; Howard Gleckman, "Is Treasury About to Curb Tax Inversions on Its Own?" Tax Policy Center, August 19, 2014, http://www.taxpolicycenter.org/taxvox/treasury-about-curb-tax-inversions-its-own; and Jeffery M. Kadet, "Attacking Profit Shifting: The Approach Everyone Forgets," *Tax Notes*, July 13, 2015, pp. 193-206.

would probably apply to corporations in general, and not just to inverted corporations (this change was made in the 2017 tax revision);

- Stricter regulations under Section 367 to immediately include foreign earnings in the case of actions that attempt to move foreign operations out from under the U.S. parent. This would make future earnings of these operations nontaxable;
- Strengthening and modernizing the effectively connected income rules that determined whether trade or business activity is taking place in the United States by foreign firms; and
- Closely monitoring the creation of non-U.S. subsidiaries owned by the foreign parent after inversion, and ensuring that assets (including intangibles such as inventions, knowhow, etc.) transferred from the U.S. firm are transferred at arms-length prices.

There is disagreement among experts about whether the types of regulatory changes discussed in this section are feasible or desirable.[113]

[113] See, for example, Stuart L. Rosow and Martin T. Hamilton, "A Response to Professor Shay: Leave Inversions to Congress," Tax Notes, September 8, 2014, pp. 1187-1190.

Appendix. Legislative Proposals in the 113th and 114th Congresses

A number of legislative proposals were advanced in 2014, when the wave of inversions through merger began. Representative Levin, the ranking member of the House Ways and Means Committee, introduced the Stop Corporate Inversions Act of 2014 (H.R. 4679), which would have reflected the Administration's proposed changes, retroactive to May 8, 2014. The inversion would have not been recognized if the U.S. stockholders had 50% of the shares or if 25% of the business activity is in the United States. A companion bill, which would have sunset in two years to provide time for tax reform, was introduced in the Senate by Senator Levin in 2014 (S. 2360).[114] The Joint Committee on Taxation estimated the permanent proposal to gain $19.5 billion in revenue over FY2015-FY2024. The two-year proposal would have raise $0.8 billion over the same period.[115] In the 114th Congress, these legislative proposals were introduced as H.R. 415 (Levin) and S. 198 (Durbin). Senator Casey proposed an anti-inversion amendment to an education bill (S. 1177).

In the 114th Congress, H.R. 297 (Doggett) and S. 174 (Whitehouse) included anti-inversion provisions as part of a broader proposal to address tax haven abuses and restrict the benefits of deferral. S. 922 (Sanders) and H.R. 1790 (Schakowsky) also included anti-inversion provisions, as well as earnings-stripping provisions (discussed below) and broader provisions, including the repeal of deferral.

In 2014 a number of legislative proposals were introduced that would limit the tax benefits associated with inversions for certain corporations. For example, H.R. 1554 (Doggett), H.R. 3666 (DeLauro), H.R. 3793 (Maffei), S. 268 (Levin), S. 1533 (Levin), and S. 1844 (Shaheen) would each treat corporations managed and controlled from the United States as domestic corporations regardless of their legal tax home or status as an inverted company. This provision was also included in S. 922 (Sanders) and H.R. 1790 (Schakowsky).

Other proposals in 2014, H.R. 694 (Schakowsky) and S. 250 (Sanders), would have eliminated deferral (taxing foreign source income currently), in addition to limiting the benefits of inversions when management and control continues to reside in the United States.

Legislative proposals were also under discussion in 2014 by Representative Levin (announced July 31, 2014) and by Senator Schumer (announced August 14, 2014) to address earnings stripping, where foreign parent companies borrow from the U.S. subsidiary to increase interest deductions and reduce taxable income in the United States. Both of these proposals would have tightened the rules allowing interest deductions by reducing the current limit on interest deductions relative to adjusted income from 50% to 25% and repealing an alternative safe-harbor debt-to-equity test. Both proposals would have also eliminated or limited interest carryforwards. The Schumer proposal was intended to apparently apply to inverted firms while the Levin proposal would have applied generally. The Levin proposal would have also limited other transactions between related parties within the firm that allow untaxed investment of funds in the United States. The restrictions on interest in the Levin bill were the same as those initially proposed in the House in 2004.[116]

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[114] See "Senators Announce Bill to Reduce Corporate Inversion 'Loophole,'" *Tax Notes Today*, May 21, 2014.

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

[116] These restrictions were, however, removed prior to enactment of the AJCA.

Senator Schumer introduced his proposal, S. 2786, the Corporate Inverters Earnings Stripping Reform Act of 2014. Its limits on interest deductions would have applied to inverted firms where U.S. shareholders own more than 50% of the firm. The restriction also would have applied to firms that inverted using the substantial business activities test. The bill had nine Democratic cosponsors; five of them were on the Senate Finance Committee.

In the 114th Congress, S. 922 (Sanders) and H.R. 1790 (Schakowsky) included general earnings-stripping provisions for firms with a foreign parent. Earnings stripping provisions were also addressed in the report of the Senate Finance Committee's working group on Tax Reform.[117]

H.R. 5278 (DeLauro) and S. 2704 (Levin), introduced May 30, 2014, would have disallowed awarding federal contracts to inverted firms. These proposals were introduced in the 114th Congress as H.R. 1809 (DeLauro) and S. 975 (Durbin). In 2014, Senators Brown and Durbin proposed S. 2895, and Representative Doggett introduced H.R. 5549, the Pay What You Owe Before You Go Act, that would have taxed the accumulated deferred earnings of inverting firms.

Then Senate Finance Committee Chairman Ron Wyden had proposed having draft legislation in place in September 2014, and also referred to Schumer's earnings-stripping proposal.[118] Senator Wyden had previously announced that any changes would be retroactive to May 8, 2014.[119]

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117 Senate Finance Committee, International Tax Reform Working Group: Final Report, Senator Rob Portman and Senator Charles Schumer, Co-Chairs, July 1015, http://www.finance.senate.gov/newsroom/chairman/release/?id=e9eefc66-7e11-4276-939f-3eca6fd6d959.

118 The United States Senate, Committee on Finance, "Wyden Statement Regarding Plans to Address Corporate Inversions," press release, August 14, 2014, http://www.finance.senate.gov/newsroom/chairman/release/?id=4ed00da0-0be6-4f3d-8619-76bf2981d126.

119 Ron Wyden, "We Must Stop Driving Businesses Out of the Country," *The Wall Street Journal*, May 8, 2014, http://online.wsj.com/news/articles/SB10001424052702303701304579548433123065724.