New York State Bar Association Tax Section Report on Outbound Inversion Transactions [*]

Corporate inversions are a major news story. This seemingly dry, technical tax issue has given rise not only to numerous news stories in the tax press, but also several prominent stories in major newspapers such as the New York Times,[1] including four front page stories, the Wall Street Journal,[2] the New York Post,[3] the Houston Chronicle[4] and in weekly magazines such as U.S. News and World Report[5] and even The New Yorker.[6] Inversions have also captured the interest of legislators on both sides of the aisle, who have introduced several bills intended to stop this phenomenon in

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* This report was prepared by an ad hoc committee of the New York State Bar Association Tax Section chaired by David Sicular. Substantial contributions to the report were made by Peter Canellos, Alan Granwell, Stuart Leblang, Michael Levin, Paul Seraganian and Sally Thurston. Helpful comments were received from: Andrew N. Berg, Kimberly S. Blanchard, William G. Cavanagh, Benjamin J. Cohen, William S. Dixon, Michael Farber, Gary M. Friedman, Peter Glicklich, David Hariton, Robert A. Jacobs, David Levere, Michael L. Schler, F. Roy Sedore, Andrew P. Solomon, and Willard Taylor.

1 E.g., David Cay Johnston, "U.S. Corporations Are Using Bermuda To Slash Tax Bills," N.Y. Times, February 18, 2002, at A1; David Cay Johnston, "Tax Treaties With Small Nations Turn Into a New Shield for Profits," N.Y. Times, April 16, 2002, at A1; David E. Rosenbaum, "Taking On Offshore Tax Havens," N.Y. Times, May 6, 2002; David Cay Johnston, "Vote on Offshore Tax Plan is Testing Company's Values," N.Y. Times, May 9, 2002, at A1; "The Bermuda Tax Triangle," editorial, N.Y. Times, May 13, 2002 ("Even in the best of times, it is outrageous for companies to engage in offshore shenanigans to avoid paying their fair share of taxes."); David Cay Johnston, "Officers May Gain More Than Investor In Move To Bermuda," N.Y. Times, May 20, 2002, at A1.

2 E.g., John D. McKinnon, "New Penalties, Constraints Seen For Tax Dodgers," Wall Street Journal, March 14, 2002; John D. McKinnon, "Senators Plan to Curb Relocations To Bermuda, Other Tax Havens," Wall Street Journal, March 22, 2002; John D. McKinnon, "Pricewaterhouse's Spinoff Discovers Bermuda Loophole," Wall Street Journal, May 9, 2002, at A3; "The Flight to Bermuda," editorial, Wall Street Journal, May 16, 2002 ("Far from being an unpatriotic tax dodger, Stanley Works is merely a messenger; alerting the politicians to what will happen in the absence of reform. The patriotic move for Congress is to take Judge Hand's words to heart, stop bashing businesses for practicing capitalism, and get to work on reforming the tax code.").

3 Paul Tharp, "Corporations Heading South—Looking for the Great Tax Dodge," N.Y. Post, February 12, 2002.

4 Nelson Antosh, "5 Firms Answer Call of Islands/Houston Companies See Offshore Reincorporation As Way To Boost Profits, Despite Potential Backlash," Houston Chronicle, April 20, 2002.

5 Randall E. Stross, "Oh, For Haven's Sake," U.S. News & World Report, May 13, 2002, p. 41. This column takes a humorous approach to the issue, presenting a number of tongue in cheek multiple choice questions about inversions.

6 James Surowiecki, "Tax Cheat, Inc.," The New Yorker, April 22, 2002, p. 62.

its tracks, and the Treasury, which has recently released a preliminary report on the issue.[7]

Outbound inversions raise a number of complex and troubling issues.[8] The issues range from whether some or all of the current series of transactions should be stopped to whether the inversion phenomenon is a symptom of larger problems in the United States tax system for outbound (and to some extent inbound) investment that need to be addressed. We believe that the answer to both questions is yes. Inversions should be addressed because they may undermine our corporate tax system in two respects: (1) they result in tax avoidance that, even if technically permissible under current law, runs contrary to many of its policies, and (2) they create problems of perception that may undermine the integrity of our voluntary compliance system. At the same time, however, the inversions phenomenon highlights that certain aspects of our current tax system (primarily the rules relating to outbound investment), and the policies that underlie them, need to be re-examined seriously. It would be extremely unfortunate, in our view, if legislative action targeting inversions were not accompanied by a thorough reconsideration of these aspects of our tax system, although we believe that prompt action on inversions is urgent and should not await the results of this reconsideration.

In this regard, we have considered how best to address the inversions problem in both the short run and long run. While our members have expressed a wide

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7 "Treasury Department News Release and Preliminary Report on Tax Policy Implications of Corporate Inversion Transactions," reprinted in BNA Daily Tax Report, May 20, 2002, at L-3 (hereinafter the "Treasury Inversions Report").

8 This report only covers inversions involving foreign corporations (i.e., outbound inversions). For a discussion of issues raised by other inversion transactions, see NYSBA Tax Section, "Report on Notice 94-93 and Rev. Proc. 94-76," 95 TNT 31-26 (January 31, 1995).

range of views, we believe that some form of immediate legislation is appropriate to address the widely publicized phenomenon of long-standing U.S. corporations employing mere form to "shed" their technical U.S. residency in order to avoid U.S. tax. We have concluded that the portion of the provisions of the legislation introduced by Senators Baucus and Grassley on April 11, 2002 (S. 2119)[9] that covers "pure inversions" (i.e., cases where former shareholders retain 80% ownership and control of the inverted corporation) is an appropriate immediate response, because (a) it would address directly the problem, and (b) it would have limited impact on legitimate business combinations, in that it would not apply where former shareholders retain less than 80% of the inverted corporation. We discuss certain technical issues about the bill in Part IV, below.

We have significant concerns, however, about whether this response would be the best long-term solution to the inversions problem. We believe that developing a long-term solution requires careful consideration of a number of fundamental issues ranging from whether the definition of a domestic corporation should be revised to incorporate a facts and circumstances standard (i.e., a "managed and controlled" concept) to whether the U.S. taxation of inbound or outbound investments should be revised. We therefore recommend that if the Baucus/Grassley proposal or similar legislation is enacted, it should "sunset" in three years.[10] We also think such legislation should be accompanied by a directive to the Secretary to undertake a more detailed study that reaches specific conclusions or presents alternative recommendations

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9 The "Reversing the Expatriation of Profits Offshore Act" introduced on April 11, 2002 by Senators Baucus and Grassley (hereinafter, the "REPO Bill" or "Baucus/Grassley").

10 A similar temporary approach appears in H.R. 4756, introduced on May 16, 2002 by Representative Nancy Johnson (the provisions of the Act do not apply to transactions beginning after December 31, 2003).

regarding some of these fundamental issues. The purpose of the sunset and the study would be to make it clear that the legislation is a temporary solution designed to prevent a continuation of inappropriate transactions while Congress considers whether there might be a better long-term solution to the multi-faceted inversions problem. We would be pleased to assist in any way that might be helpful in this process.

We also have significant concerns about the provisions proposed in S. 2119 that address so-called "limited inversions" (i.e., cases where former shareholders retain less than 80% of the ownership and control of the relevant foreign corporation and certain transactions completed prior to March 20, 2002). Our concerns include (a) the impact such transactions might have on legitimate business combinations, (b) the administrability and appropriateness of the particular remedies that the Bill proposes to adopt and (c) retroactivity issues. At the same time, in such cases, we see a less compelling need for an immediate, stopgap response. We therefore believe that these provisions, if enacted, should be substantially revised. We note, however, that these provisions are designed to have retroactive effect which raises issues as to how to deal with past transactions. We do not otherwise take a position, however, on effective dates or retroactivity.

This report is divided into five parts. Part I provides historical background on outbound inversion transactions and prior government efforts to restrict those transactions. Part II describes the current wave of inversion transactions, including motivating factors and tax policy issues raised. Part III discusses ways in which current law may be able to address the problems of inversion transactions. Part IV discusses the legislative proposals that have been made to date, with particular focus on the Baucus/Grassley bill. Part V briefly discusses possible broader reforms.

I. BACKGROUND

One of the first outbound inversion transactions to attract significant IRS attention was the 1983 McDermott-McDermott International transaction. Pursuant to this transaction, shareholders of McDermott, a U.S. corporation, exchanged their McDermott shares for shares in McDermott International (an existing Panamanian subsidiary of McDermott with substantial earnings and profits), and ended up owning 90 percent of the latter corporation. Although the transaction was apparently taxable to shareholders,[11] the IRS objected to the collateral tax consequences of the arrangement, which included the removal of future earnings of McDermott International from the Subpart F net and substantial avoidance of Section 1248 of the Code.[12] In the Tax Court and the Sixth Circuit, the IRS argued unsuccessfully that the inversion transaction was a taxable distribution to shareholders of McDermott from McDermott International pursuant to Section 304(a).[13] The McDermott transaction did, however, prompt Congress to enact Section 1248(i) in order to prevent the avoidance of Section 1248 that the McDermott inversion had achieved.[14]

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[11] D. Tillinghast, "Recent Developments in International Mergers, Acquisitions and Restructurings" 72 Taxes 1061 (1994). Apparently, at least some of McDermott's shareholders had losses they wished to recognize. Id. at 1063.

[12] Unless otherwise indicated, all Section references herein are to the Internal Revenue Code of 1986, as amended (the "Code").

[13] See, Bhada v. Com'r., 89 T.C. 959 (1987), *aff'd*, 892 F2d 39 (6th Cir., 1989).

[14] Section 1248(i) provides that shareholders in a transaction like McDermott recognize gain as if the stock of the parent foreign corporation received had been issued to the inverted domestic corporation

The 1994 Helen of Troy transaction was the first of the modern wave of outbound inversions and has come to be regarded as the prototypical "pure" inversion transaction. In this transaction, shareholders of Helen of Troy Corporation, a U.S. corporation ("HOT USA"), exchanged their shares for shares in Helen of Troy Limited, a newly created Bermuda corporation ("HOT Bermuda"), in a transaction intended to qualify as a Section 368(a)(1)(B) reorganization.[15] Under the then applicable regulations, Section 367(a) did not apply to make this transaction taxable to the U.S. transferors. Subsequent to the inversion, (i) HOT Bermuda contributed its stock in HOT USA to a Barbados corporation in order to obtain the benefit of the U.S.–Barbados tax treaty with respect to payments of dividends or interest originating from HOT USA; and (ii) HOT USA appears to have in effect transferred the operations of its foreign subsidiaries to HOT Bermuda (and its foreign subsidiaries) in order to cause those operations no longer to be subject to the controlled foreign corporation ("CFC") rules,[16] and (iii) Helen of Troy presumably intended to make all future non-U.S. acquisitions and investments through HOT Bermuda for the same reason.

The IRS response to the Helen of Troy transaction was swift. In particular, acting on its concern that, "widely-held U.S. companies with foreign subsidiaries recently have undertaken certain restructurings for tax-motivated purposes," and that "these transactions, or related transactions undertaken pursuant to the

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and then distributed to the shareholder in redemption or liquidation, triggering recognition under Section 1248 at the level of the inverted domestic corporation.

15 Section 1248(i) did not affect the Helen of Troy transaction because the foreign parent company was newly formed and so had no accumulated earnings and profits taxable pursuant to Section 1248.

16 Tillinghast, supra. Note 11 at 1064 (citing the Helen of Troy prospectus).

restructurings, present opportunities for avoidance of U.S. tax," the IRS published Notice 94-46[17] which announced certain modifications of regulations under Section 367(a). Notice 94-46 made all transfers by U.S. persons of stock and securities of a domestic corporation to a foreign corporation taxable under Section 367(a) if U.S. transferors owned, in the aggregate, 50 percent or more in vote or value of the transferee foreign corporation immediately after the exchange.[18] In essence, the IRS did not target the particular tax abuses inherent in the Helen of Troy transaction, but instead adopted a Section 367(a) "toll charge" intended to prevent this type of transaction from occurring in the first place.

The regulatory modifications announced in Notice 94-46 raised significant technical issues, particularly with respect to public transactions, and were criticized as being overly broad in their application.[19] Although our prior report,[20] along with other commentary, recommended limiting the scope of Notice 94-46, the Treasury Department released temporary and proposed regulations in 1995 that more or less mirrored the rules contained in Notice 94-46, with fairly minor alterations. Final regulations were

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[17] 1994-1 CB 356.

[18] Prior to Notice 94-46, pursuant to proposed regulations under section 367(a) and Notice 87-85, 1987-2 CB 395, if U.S. transferors owned 50 percent or more of either the total voting power or value of the transferee foreign corporation, the transfer was (i) not taxable to U.S. transferors owning less than 5 percent of both the total voting power and value of the foreign corporation after the transfer, and (ii) taxable to U.S. transferors owning 5 percent or more of the total voting power or value of the foreign corporation after the transfer unless such U.S. transferor entered into a 10 year gain recognition agreement ("GRA") (note that a GRA was not available however where one U.S. transferor owned more than 50 percent of either the total voting power or value of the foreign transferee corporation).

[19] Many of the criticisms grew out of a concern that the rules announced in the notice would defer "legitimate" M&A transactions.

[20] NYSBA Tax Section, "Report on Notice 94-46 Relating to Certain Outbound Stock Transfers", "65 Tax Notes 913, (November 14, 1994) (hereinafter "NYSBA Report on Notice 94-46").

promulgated in 1996.[21] Although these regulations addressed certain of the technical problems of Notice 94-46 and the temporary regulations, they raise issues of their own.[22]

Technical issues aside, the premise that underlies Notice 94-46, the 1995 temporary and proposed regulations, and the final regulations appears to be that shareholder-level taxation of built-in gains pursuant to Section 367(a) would serve as an effective deterrent against outbound inversions. The boom of completed and announced outbound inversions in recent months appears to indicate that this is not the case.

II. INVERSION TRANSACTIONS TODAY

A. Why Are They Happening?

1. Factors motivating corporations to invert

A review of public securities filings shows that U.S. corporations are implementing (or at least considering implementing) inversion transactions primarily to save taxes.[23] The special lure of the inversion transaction is that it appears to permit substantial tax savings without any meaningful operational or financial statement change. The particular tax goals of inversions appear to be:

(1) To achieve a more beneficial "territorial" system of taxation for their non-U.S. earnings, and

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21 Treas. Reg. § 1.367(a)-3(c), T.D. 8702, 1997-8 I.R.B. 4.

22 See generally, Samuel C. Thompson Jr., "Section 367: A 'Wimp' for Inversions and a 'Bully' for Real Cross-Border Acquisitions," 2002 TNT 53-39 (March 19, 2002); and Paul W. Oosterhuis, "Taxing Cross-Border Combinations: Nationalistic Rules in a Global Economy," 75 Taxes 858 (December, 1997).

23 See, e.g., The Stanley Works, Proxy Statement/Prospectus, April 2, 2002; Nabors Industries, Proxy Statement/Prospectus, March 22, 2002; Coopers Industries, Inc., Registration Statement, March 8, 2002; see also, Treasury Inversions Report, at L-4 ("U.S.-based companies and their shareholders are making the decision to reincorporate outside the United States largely because of the tax savings available.").

(2) To reduce U.S. tax applicable to earnings generated within the United States.

In the case of both objectives inverters would likely argue that they are simply reducing costs, as any for-profit corporation should, and putting themselves on a more level playing field with their competitors. As noted by Treasury, "The U.S. international tax rules can operate to impose a burden on U.S.-based companies with foreign operations that is not imposed on their foreign competitors. These rules can serve to create a competitive disadvantage for U.S. companies operating in the global marketplace."[24]

U.S. multinationals may have competitors from many European jurisdictions which have tax systems that are more "territorial" than our own. For example, their competitors based in Germany, Netherlands, Switzerland and France, and, most recently, the U.K., can in some circumstances invest in foreign subsidiaries, pay tax in the country in which they make their investment, and pay no (or very little) tax when the earnings from abroad are paid back to the home country.[25] In contrast to a credit system, the home country exclusion generally is not directly dependent on the rate of tax imposed in the local country.

U.S. multinationals, on the other hand, are taxed on their worldwide income, with double taxation mitigated through foreign tax credits. Under this system, U.S. multinationals have to run their foreign investments through the intricate rules of

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24 Treasury Inversions Report, at L-17.

25 The jurisdictions listed above incorporate various elements of a territorial tax system. In its pure form, a territorial tax system does not impose taxation on worldwide income. Rather, tax is imposed on domestic operations, and only foreign country tax is imposed on foreign country operations. Many jurisdictions have a modified territorial system that does not afford an exclusion for certain types of income, such as passive income and income earned through tax-haven subsidiaries, and many of those jurisdictions have some form of controlled foreign corporation or similar rules.

Subpart F, the foreign tax credit regime, interest and expense allocations, overall foreign losses, and the like.[26] Even in a perfect credit system, there is residual home country tax if the home country rate is higher than the local country rate. These corporations would likely argue that the U.S.'s intricate system of baskets, interest and expense allocations, OFL rules and the like, in their view, results in a deeply imperfect credit system. Thus, in the view of many corporations, they will pay tax on their foreign investments at a rate that exceeds the overall rate paid by their competitors from territorial jurisdictions.

One common solution to the perceived twin problems that the foreign tax credit system is not as favorable as the territorial system, and that the U.S.'s foreign tax credit system does not operate as well as it should, is the permanent reinvestment of earnings offshore. Taking this route allows the U.S. multinational, at least to a certain extent, to report higher GAAP earnings and thus to enhance the value of its shares. While we are not economists, we conjecture that keeping money offshore may be imperfect from the perspective of both United States macroeconomic policy,[27] and for the business needs of the U.S. multinational corporation. Moreover, even if the multinational has a need for funds offshore, it may be a different jurisdiction, and Subpart F, among other factors, imposes great restrictions on a multinational's ability to redeploy cash within its overall structure.

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26 See Treasury Inversions Report, at L-16.

27 Creating incentives for a U.S. corporation to invest abroad rather than in the United States seems contrary to capital export neutrality that apparently informs much of the existing U.S. rules on outbound investment. See generally, Treasury Department, "The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study," reprinted in 2001 TNT 1-1 (December 29, 2000).

U.S. multinationals further argue that these problems inappropriately burden their major transactions.

For example, in bidding on a potential foreign investment, a U.S. multinational will take into account that its overall tax burden likely will be higher than its competitor organized in a territorial-type tax jurisdiction that is bidding on the same investment. If such a competitor bidder expects to enjoy an after-tax return from an investment that is higher than the return that will be enjoyed by its United States competitor, the competitor may be willing to pay a higher price to succeed in its bid. Alternatively, U.S. multinationals may believe that if they make the exact same bid as their territorial system competitor, and succeed in making the acquisition, they will have lower after-tax earnings and, in the long run, if not in the short, their stock price will suffer in comparison to their competitor's. We understand that many U.S. multinationals believe that they have lost out on potential acquisitions for these reasons.

A U.S. multinational can also be at a disadvantage in operating and potentially disposing of an investment. For example, in a joint venture owned by corporations from territorial jurisdictions and foreign subsidiaries of United States corporations, the differences in the tax systems may introduce tensions in the day to day business operations of the joint venture as important decisions about moving cash and making investments raise Subpart F issues for the U.S. ventures. Similarly, differences in tax consequences can lead to disagreements about dispositions of jointly held businesses, as the venturer from the territorial system is able simply to realize its sales proceeds without home country tax, while the U.S. group cannot. We understand that differences of this type have killed transactions that otherwise made non-tax economic sense. Thus, U.S. multinationals would likely argue that the existing tax rules on outbound investments burden their operations and place them at an inappropriate competitive disadvantage, and that inversion transactions are an appropriate response.

Many of the inverting corporations might be more circumspect in defending the earnings stripping/base erosion aspects of inversion transactions. However, privately they might make many of the same business arguments. As managers, they should be following lawful means to reduce expenses (income taxes) and thus increase earnings, which should lead to increased stock price and lower cost of capital. Moreover, they might also point out that the same competitors discussed above (non-U.S. based multinationals) can and do reduce their U.S. tax burdens on their U.S. operations with earnings stripping/base eroding payments without necessarily paying taxes in their home countries on those amounts.

2. <u>Section 367(a) is ineffective as a deterrent</u>

As noted above, the recent increase in inversion activity suggests that the Section 367(a) Helen of Troy regulations may not be an effective deterrent to outbound inversion transactions. At the time of its issuance, Notice 94-46 seemed to deter inversion transactions, as it appears that few occurred in its immediate aftermath. The recent troubled economic climate has, however, weakened the effectiveness of Notice 94-46 and the Section 367(a) regulations that implemented it in combating inversions without necessarily reducing the importance of the tax issues that inversions raise. The shareholder level tax imposed by Section 367(a) may not be very costly today given the depressed level of stock prices.[28] Its impact is also lessened to the extent that the corporation's shares are held by tax-exempt institutions and foreign taxpayers on which Section 367 has no effect, or by other institutional investors that may be relatively indifferent to shareholder level taxes.[29] At the same time, however, the perceived benefits of inversion transactions may be unaffected (or indeed as a matter of perception, enhanced, as more and more taxpayers focus on the potential base erosion benefits as well as the benefits relating to foreign income). These benefits (tax reduction over time) are not directly affected by the short-term factors that may temporarily depress the corporation's share price. In addition, the benefits with respect to foreign income may be unrelated to the value of the corporate group as a whole, if, for example, the U.S. operations and stock price are depressed, but the foreign operations are relatively prosperous.

The sensitivity of the Section 367(a) rules to short-term economic conditions and other factors seemingly unrelated to the tax issues that inversions raise demonstrates the fundamental disconnect between the punishment (shareholder level taxation) and the crime (inversion). If Congress believes that inversions are

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28 See Treasury Inversions Report, at L-4.

29 In a few cases, inversion transactions have offered some shareholders the ability to defer their Section 367(a) tax through the use of exchangeable shares (see, e.g., Triton Energy Corporation, Proxy Statement/Prospectus, February 23, 1996; Fruit of the Loom, Inc., Proxy Statement/Prospectus for Special Meeting of Shareholders, October 15, 1998), although this does not appear to be a common feature of the most recent transactions.

inappropriate, then a more effective deterrent (or a more targeted response) may be appropriate.[30]

3. Greater market acceptance of offshore holding companies

It also appears that the non-tax environment for inversion transactions has improved. In particular, offshore holding companies, even those incorporated in tax havens, appear not to be regarded by capital markets with suspicion as they once were. Instead, investment bankers who once may have advised their clients that it is difficult to sell stock of a non-U.S. corporation may now be leading the inversion charge. Moreover, it seems to have become clear that an inversion transaction will not cause a corporation to become ineligible for the S&P 500.[31]

B. What Are Inverters Doing?

The inversion transactions that have been announced to date fall into five basic categories, the last of which may not be considered an inversion at all as the term is generally used.

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30 We made a similar point in the NYSBA Report on Notice 94-46, supra. Note 20 at 915, which stated that we would "prefer action that was more closely tailored to the specific policies to be furthered and types of tax avoidance targeted" by the IRS in Notice 94-46.

31 See generally, Roger J. Bos, Michele Ruotolo, "General Criteria for S&P U.S. Index Membership," (September, 2000), available at http://www.spglobal.com/GeneralCriteria.pdf. For instance, in connection with the addition of Global Crossing to the S&P 500 in September 1999, this document indicates that Standard & Poor's relied on the facts that Global Crossing followed GAAP and reported in U.S. dollars, the majority of its trading volume was in the U.S., the majority of its operations were within the U.S. and that it had registered offshore for tax purposes. In addition, many other companies that have engaged in or announced the intention to engage in an inversion transaction are currently listed on the S&P 500, including: Cooper Industries, Ltd.; Ingersoll-Rand Co. Ltd.; Nabors Industries; The Stanley Works; Transocean Inc.; and Tyco International.

1. Taxable stock transfers

In this type of transaction, public shareholders of the U.S. corporation exchange their stock for stock in a newly formed foreign holding corporation incorporated in a tax haven jurisdiction such as Bermuda.[32] In some of these transactions, the corporation has allowed U.S. shareholders to elect to exchange their stock in the U.S. corporation for units, each consisting of one share of stock in the foreign corporation and one share of stock in the U.S. corporation.[33] Following the exchange, the U.S. corporation may transfer its existing foreign business operations (stock of CFCs, assets, or both), or a portion thereof, to the new foreign parent corporation or new foreign "sister companies."[34] Presumably, in all cases, the group intends to make future non-U.S. acquisitions and investments through the new Bermuda parent. Certain of these transactions have utilized a holding company or finance subsidiary resident in Barbados for purposes of qualifying for benefits under the U.S.-Barbados tax treaty.[35]

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32 Examples of this type of transaction include Helen of Troy Limited, Prospectus/Proxy Statement, January 5, 1994; Triton Energy Corporation, Proxy Statement/Prospectus, February 23, 1996; ADT Ltd., Registration Statement, April 2, 1997; Fruit of The Loom, Inc., Proxy Statement/Prospectus for Special Meeting of Shareholders, October 15, 1998; Gold Reserve Corporation, Inc., Proxy Statement/Prospectus, November 30, 1998; PXRE Corporation, Registration Statement, August 18, 1999; Everest Group Re. Ltd., Proxy Statement/Prospectus, January 2000; The Stanley Works, Proxy Statement/Prospectus, April 2, 2002; Nabors Industries, Proxy Statement/Prospectus, March 22, 2002; and Weatherford Industries, Inc., Proxy Statement/Prospectus, April 5, 2002.

33 Transactions in which the company offered its U.S. shareholders such an election include Triton Energy, Fruit of the Loom and Gold Reserve. Note that in Fruit of the Loom, the company made this opportunity available only to the CEO. Further, note that in Triton, no units ultimately were issued because the number of U.S. shareholders electing to receive them did not satisfy a minimum requirement (15% of the total shareholders) established by the company.

34 Alternatively, a post-inversion "freeze" strategy might be employed, pursuant to which the former U.S. parent exchanges its stock in a CFC for new limited and preferred stock in the CFC and the CFC issues common stock to the new foreign parent.

35 Barbados uses the management and control test for determining residency, contained in Article 4(1)(a)(ii) of the Barbados Treaty. Treaty benefits include a 5% withholding rate on dividends and interest. Additionally, Barbados imposes tax on a resident corporation's non-Barbados-source income at a maximum rate of 2.5%, which is gradually reduced to a minimum of 1% as the income increases.

The U.S. shareholders recognize gain upon the exchange of their stock under Section 367(a) except to the extent that they receive shares in the U.S. corporation. In the transactions that have included the option for U.S. shareholders to elect to receive units, the transaction structure may allocate most of the value of the units to the stock of the domestic corporation, potentially enabling electing shareholders to receive mostly tax-free treatment. The transfer of the U.S. corporation's foreign subsidiaries to the new foreign parent corporation (and effecting future non-U.S. acquisitions through the parent or a new subsidiary not in the U.S. "chain") is intended to allow the subsidiaries to avoid CFC status and U.S. repatriation tax issues going forward. Sometimes, the foreign parent corporation's by-laws contain transfer restrictions designed to ensure that no U.S. person holds 10% or more of the voting power of that corporation.

The transfer of stock of foreign subsidiaries and/or assets by the U.S. corporation to the new foreign parent is generally analyzed in the relevant proxy statements. These transactions may be taxable, or, perhaps partly or wholly tax-deferred under Section 351 (or possibly Section 354), subject to a Section 367 gain recognition agreement. The public disclosure in several of these transactions has contained a statement to the effect that the U.S. corporation is not expected to incur a material amount of U.S. federal income or withholding tax as a result of the reorganization, perhaps based on a gain recognition agreement, the relative basis and the value of the assets transferred, the availability of favorable tax attributes such as NOLs and credits or a combination of the foregoing.

2. **Taxable stock transfers with “tail” or “hook” stock**

In this type of transaction, in which shareholders of the U.S. corporation exchange their shares for stock in the new foreign parent corporation, the U.S. corporation contributes stock of foreign subsidiaries and/or assets to the foreign parent pursuant to Section 351 in exchange for non-voting stock of the foreign corporation ("tail" or "hook" stock).[36] The foreign parent's by-laws provide that holders of the hook stock may convert it into voting stock of the foreign parent in certain circumstances, such as to compensate employees and make acquisitions. The by-laws also typically contain transfer restrictions governing the non-voting stock.

The U.S. shareholders recognize gain under Section 367(a) upon the exchange of their shares for stock of the foreign parent. Assuming that the transfer of assets or stock would otherwise qualify under Section 351, the tax consequences of this transfer of assets themselves depend on a variety of factors, including the type of asset being transferred and whether the fair market value of the asset transferred exceeds its tax basis. Assets qualifying for the non-U.S. active trade or business exception can be transferred free of tax to the extent provided in the regulations under Section 367(a)(3). Where shares of foreign subsidiaries are transferred, the transferring U.S. corporation looks to the regulations under Sections 367(a) and 367(b) for guidance. The transfer is free from current tax under Section 367(a) as long as the U.S. transferor enters into a gain recognition agreement, while a toll charge is imposed under Section 367(b) to the extent

[36] Examples of this type of transaction include Ingersoll-Rand Company, Ltd., Proxy Statement/Prospectus, December 2001; and Cooper Industries, Inc., Registration Statement, March 8, 2002. The label “hook” or “tail” shares presumably refers to the fact that the new corporate chart will contain a “tail”/“hook” because the former U.S. parent both is a subsidiary <u>and</u> a shareholder of the new foreign parent.

of the Section 1248 amount (which may be sheltered to some extent, by accompanying foreign tax credit).[37] The public disclosure in these transactions generally takes the position that the U.S. corporation will not incur a material amount of U.S. federal income or withholding tax, and generally does not provide further explanation.

3. Reincorporation transactions

In this type of transaction, the U.S. corporation may reincorporate into a state that does not require 100% shareholder approval for domestic-to-foreign reincorporations (such as Arizona or Texas) and then "continue" or reincorporate into a tax-haven jurisdiction such as Bermuda.[38] See Bermuda The Companies Act 1981, Section 132C(2). The U.S. corporation recognizes gain upon the deemed transfer of its assets to the foreign corporation under Section 367(a).[39] The public disclosure in these transactions takes the position that the U.S. shareholders recognize no gain or loss in the transaction because it constitutes an F-reorganization and does not involve any transfer of assets or stock, either directly or indirectly, by the U.S. shareholders to the foreign corporation under Section 367(a).[40]

4. F- or C-Reorganization followed by drop-down to a U.S. holding corporation

In this type of transaction, the U.S. corporation reincorporates in a state whose corporate law requires less than 100% shareholder approval and then reincorporates in a tax-haven jurisdiction in a transaction intended to qualify as an F-

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[37] Treas. Reg. §1.367(a)-3(b) and Treas. Reg. §1.367(b)-4(b).

[38] Examples of this type of transaction include Xoma Corporation, Proxy Statement, November 30, 1998; and White Mountain Insurance Group, Prospectus/Proxy Statement, September 23, 1999.

[39] Treas. Reg. § 1.367(a)-1T(f).

[40] Treas. Reg. § 1.367(a)-3(a) and Treas. Reg. §1.367(a)-3(d)(3), Ex. 12.

reorganization, or the U.S. corporation transfers its assets to a newly formed foreign subsidiary of a newly formed foreign parent corporation in a transaction intended to qualify as a triangular reorganization under Section 368(a)(1)(C), with the result that the shareholders exchange their stock for stock in the foreign parent corporation. The foreign parent corporation then drops down certain of its assets to a newly-formed U.S. subsidiary.[41]

The U.S. shareholders recognize gain under the indirect stock transfer rules of Treasury Regulation § 1.367(a)-3(d)(1)(v) to the extent of the assets transferred to the new U.S. corporation. The U.S. corporation recognizes gain on the foreign assets retained by the reincorporated foreign corporation under Section 367(a) but takes the position that it does not recognize gain on the assets recontributed to the new U.S. subsidiary under the indirect stock transfer coordination provision set forth in Treasury Regulation § 1.367(a)-3(d)(3)(vi).

5. "Ab Initio" foreign incorporations of U.S. operations

This type of transaction involves the ab initio incorporation of a business, which may previously have been conducted by a U.S. entity, in a tax-haven jurisdiction.[42] In the Accenture transaction, for example, the consulting arm of Arthur Andersen previously conducted through a series of related partnerships and corporations under the control of the partners, was rolled into a corporate structure with a newly formed Bermuda holding corporation as the parent in connection with an initial public offering of

[41] Examples of this type of transaction include TransOcean Offshore, Inc., Prospectus/Proxy Statement, April 12, 1999; and Foster Wheeler Corporation, Prospectus/Proxy Statement, March 9, 2001.

[42] Examples of this type of transaction include Accenture, Ltd., Prospectus/Registration Statement, July 19, 2001; and Seagate Technology, Inc., Prospectus/Registration Statement, April 20, 2002.

approximately 12% of the stock of Accenture Bermuda. The structure utilized a Luxembourg intermediate entity, presumably in order to qualify for benefits under the U.S.-Luxembourg tax treaty. In the Seagate transaction, a series of steps in an LBO-type transaction resulted in a newly formed Cayman Islands limited liability company (owned 79% by new private equity investors and 21% by existing management) acquiring substantially all of the operating assets of Seagate Technology, Inc., a U.S. corporation.

C. What Policy Issues Do Outbound Inversions Implicate?

1. Tax policy issues

At a technical level, inversion transactions are designed to avoid U.S. corporate income tax on some or all of the group's non-U.S. income and to reduce U.S. corporate income tax on its U.S. source income. Both of these objectives raise serious policy concerns because they are outside of the system Congress has established for taxation of U.S. corporations.

(a) Foreign income

As discussed above, earlier generations of inversion transactions generally focused on the first benefit – avoidance of U.S. tax on foreign income. Notice 94-46 appeared to focus on a domestic corporation's removal of its foreign earnings from application of the anti-deferral rules governing CFCs (i.e., Subpart F),[43] and the NYSBA Report on Notice 94-46 focused on tax avoidance relating to "outbound" investment.[44]

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[43] For example, the typical transaction targeted by the Notice is one where the parent foreign corporation is not a CFC post-inversion. In fact, the Notice suggested an exception to the general Section 367(a) rule where the transferee corporation would be a CFC post-inversion. However, after consideration of comments received, the regulations did not include such an exception. See TD 8638, 60 FR 66739, Dec. 26, 1995.

[44] NYSBA Report on Notice 94-46, supra. Note 20.

As noted by the report, the policy underlying Notice 94-46 appeared to be that companies that are U.S.-based in an "economic" and "political" sense should not be allowed to become foreign-owned without U.S. tax cost.[45] The report concluded that outbound inversion transactions implicated two key tax avoidance issues that needed to be addressed: (i) the loss of U.S. tax on the built-in gain of, and future earnings generated by, the pre-existing foreign subsidiary or assets transferred to the new parent foreign corporation; and (ii) the "exploitation" by the new parent foreign corporation, without consideration, of any new foreign business in effect generated by the pre-existing foreign subsidiaries.[46]

Inversion transactions are also intended to avoid U.S. income tax on foreign business operations outside of the Subpart F context. Prior to an inversion transaction, even without regard to application of Subpart F rules, a domestic corporation would ultimately pay U.S. tax on foreign earnings (net of any available foreign tax credit) either upon receipt of dividends from foreign subsidiaries or sale of foreign subsidiary stock. After an inversion transaction, however, foreign source income earned in the new foreign parent or its foreign subsidiaries is not subject to U.S. tax at the corporate level when distributed to the new foreign parent or its shareholders (for that matter, it can even be "repatriated" to the former U.S. parent through a loan or capital contribution). Where the U.S. may still serve, in effect, as the headquarters and principal place of business of the corporate group, if the inversion transaction fully achieves its objectives the "U.S. company" is only taxed on its domestic source income.

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[45] Id. at 914.

[46] Id.

Some have described these aspects of inversion transactions as permitting U.S. corporate taxpayers to be taxed on a de facto "territorial" basis. This aspect of inversions has many defenders, who point out that many other jurisdictions have territorial systems that eliminate home country tax on much (or even all) foreign source income. By contrast, as discussed above, the U.S. has a credit system, which taxes foreign source income and seeks to avoid double taxation by providing an appropriate foreign tax credit. The U.S. system is less favorable in a number of situations than an exclusion/territorial system (e.g., where the foreign income is low-taxed, or where between basketing, interest allocation and other complexities, the foreign tax credit system is burdensome and provides limited relief). Many commentators believe that this aspect of the U.S. tax system is outmoded and uncompetitive in the international setting and needs to be overhauled because it taxes foreign income too heavily. Some even assert that inversions may be a salutary escape value. One response to this argument might be that it is Congress's job to overhaul the system, and, if it does not choose to do so, it is not appropriate for taxpayers to have an easy "end run" around the system Congress has enacted. Moreover, as many have pointed out, most so-called territorial systems do not provide a blanket exemption that is as favorable as the intended tax treatment of the inverted company.[47]

[47] For example, many territorial systems provide for home country taxation of passive income (see, e.g., Release and Briefing Memo on REPO Introduced by Sen. Charles Grassley (R – Iowa) and Max Baucus (D – Mont.), April 11, 2002, reprinted in Daily Tax Report, April 12, 2002, at L-11 (hereinafter the "Press Briefing Memo")). This constraint would not apply to an inverted company (except, perhaps, if the passive income and assets were so substantial as to make the PFIC rules applicable).

(b) **Earnings stripping**

Published news reports have also noted that today's inversions are typically accompanied by "earnings stripping" transactions designed to reduce the inverted corporation's U.S. source income.[48] In fact, according to Treasury, "notwithstanding the longer-term competitive benefits related to the tax treatment of future foreign operations or foreign acquisitions, the decision to enter into the inversion may be dependent in many cases upon the immediate expected reduction in U.S. tax on income from U.S. operations.[49] This earnings stripping is achieved post-inversion when the domestic corporation, now a subsidiary of the new parent foreign corporation, makes deductible payments to the new parent corporation or a non-U.S. incorporated subsidiary of the new foreign parent.[50] One significant source of these payments may be intercompany debt, which it appears that many inversion transactions create between the new parent and its new U.S. subsidiary.[51] Receipt of these payments is not generally subject to foreign tax in the hands of the new parent corporation because it is organized in a tax-haven jurisdiction. In addition, the payments are subject to reduced or no U.S. withholding tax because the new parent corporation takes advantage of special U.S. tax treaty provisions by becoming "resident" in a country like Barbados or Luxembourg. In

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48 See, e.g., David Cay Johnston, "Tax Treaties with Small Nations Turn Into a New Shield for Profits," N.Y. Times, April 16, 2002; See, also, Press Briefing Memo, Id.

49 Treasury Inversions Report, at L-13.

50 These payments may take the form of interest payments, management fees or royalties. Although the subject of less focus in the literature, earnings stripping may also occur where the U.S. corporation incurs expenses such as general and administrative expense, for the benefit of its non-U.S. affiliates and fails to charge the foreign corporation for services and assets it provides or where profitable opportunities are shifted outside the U.S. or profit is shifted by transfer pricing and other intercompany arrangements.

51 See Treasury Inversions Report, at L-6, L-13.

this way, the inverted corporation not only avoids U.S. tax on its foreign source income, but also reduces U.S. tax on its U.S. domestic source income, all while retaining its headquarters and principal place of business in the U.S. The earnings stripping aspect of inversions has few defenders from a policy perspective. An argument can be made that the existing earnings stripping rules of Section 163(j), Section 482 and similar rules are theoretically available to address these concerns, but, at least in the case of Section 482, enforcement is cumbersome and in the case of Section 163(j), the rules permit a substantial amount of base erosion before they kick in.

Moreover, some of the so-called earnings stripping may not violate Section 482, as it may consist of transactions on arm's-length terms. The inversion structure creates the ability to move functions (and perhaps, financial assets) to an offshore parent or sister, and to charge an arm's-length deductible amount for them that includes a profit element that will never be subject to U.S. tax. A non-U.S. multinational has the same opportunity. In both cases, the intra-group charge will not show up as an expense on the group's GAAP financials, and thus it will reduce the group's taxes and effective tax rate without reducing GAAP income. Whether the inverted group or "true" non-U.S. multinational will be so restrained as to limit its charges to an arm's-length amount is a separate issue. A pre-inversion U.S. corporation cannot accomplish even the minimum amount of U.S. tax reduction without this unless the income in question (1) is not Subpart F income (intercompany interest clearly is) and (2) never needs to be repatriated.

2. **Are inversions "shams"?**

At a far less technical level, many argue that today's inversion transactions are "shams." Inversions appear to achieve a dramatic reduction in a U.S. company's U.S. tax liability without in substance affecting its ownership, headquarters, operations or business practices. As noted by Treasury, "The ability to achieve a substantial reduction in taxes through a transaction that is complicated technically but virtually transparent operationally is a cause for concern as a policy matter."[52] The inverted corporation typically is a "shell" corporation, which inverted corporation, although in substance operationally headquartered in the U.S., achieves foreign status merely by filing organizing papers in a tax haven and then typically claims "residency" in a separate U.S. tax treaty jurisdiction through what can be seen as minimal contacts with that jurisdiction. Yet, inverting companies claim radically different tax results pre- and post- inversion with the utter lack of substantive business change. Even though this aspect of the inversion may be consistent with the letter of the law, it may undermine public confidence in the integrity of the U.S. tax system.

3. **Political and other issues**

Some critics have labeled inversion transactions as unpatriotic. Essentially, after September 11th, there has been an increasing perception that payment of U.S. income tax is a patriotic duty. Thus, the attack on inversion transactions may be based in part on "moral" grounds rather than pure tax policy.[53] In a press release

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52 Treasury Inversions Report, at L-4.

53 In that regard, we note that when the individual "expatriation" provisions were debated and ultimately enacted a few years ago, there was a similar debate on the "morality" of a U.S. citizen (or permanent U.S. resident) relinquishing his or her U.S. citizenship (or residence) primarily for U.S. tax avoidance purposes. This led to a limited tightening of the special tax rules relating to individual expatriation (see, P.L. 104-191, "Health Insurance Portability and Accountability Act of 1996," §§ 511-513,

accompanying the announcement of proposed remedial legislation, Senator Charles E. Grassley said "These expatriations aren't illegal, but they're sure immoral. During a war on terrorism, coming out of a recession, everyone ought to be pulling together. If companies don't have their hearts in America, they ought to get out."[54] Representative Richard E. Neal's anti-inversion Bill, introduced on March 6, 2002, was proposed to be effective immediately for those corporations that expatriate after an effective date clearly chosen for political reasons – September 11, 2001.[55] Similarly, a recently proposed Bill to combat inversions was introduced as the "Uncle Sam Wants You Act of 2002."[56] The controversy over inversions may also become an issue in upcoming Congressional elections.[57]

It appears that the U.S. fisc's loss of corporate tax revenues as a result of inversion transactions may be significant. For example, it has been reported that Tyco saved more than $400 million last year by reason of its inversion transaction.[58] Ingersoll-Rand Ltd. stated that after its inversion it expects to achieve an annual incremental increase in net earnings of $40 million.[59] In addition, Cooper Industries Ltd. and Stanley Works Ltd. stated that after their inversion transactions they expect to reduce their annual

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enacted August 21, 1996). Many believe, however, that the more effective deterrent was the accompanying change in the visa rules, which make it difficult for a tax-motivated expatriate to even visit the United States (see, P.L. 104-208, "Illegal Immigration Reform and Immigrant Responsibility Act of 1996," § 352).

54 Press Briefing Memo, supra. Note 47 at L-11.

55 H.R. 3884, The "Corporate Patriot Enforcement Act of 2002", introduced March 6, 2002 by Representative Richard E. Neal.

56 H.R. 4756, introduced May 16, 2002 by Representative Nancy L. Johnson.

57 See David E. Rosenbaum, "Taking On Offshore Tax Havens," N.Y. Times, May 6, 2002.

58 David Cay Johnston, "U.S. Corporations Are Using Bermuda to Slash Tax Bills," N.Y. Times, Feb. 18, 2002.

59 Ingersoll-Rand Company, Ltd., Proxy Statement/Prospectus, April 5, 2002.

effective tax rates by 12%-17% in the case of Cooper Industries, and 7%-9% in the case of Stanley Works.[60]

D. Other Transactions That Raise Similar Issues

1. Bermuda insurance company transactions

Many of the policy concerns outlined above have already been aired in connection with recent developments in the insurance industry, which have also involved the use of Bermuda entities to reduce U.S. tax liability. While many Bermuda-based (or incorporated) insurance companies are involved in the insurance of non-U.S. risks, the Bermuda insurance inversion differs from its non-insurance cousin in that its tax objectives include shifting gross income (investment earnings) attributable (in an economic sense) to the U.S. insurance business offshore to a tax haven where it is free of direct or indirect U.S. corporate taxation.

Several domestic property and casualty ("P&C") insurance companies have complained that they suffer a significant tax disadvantage in relation to their competitors that are based in Bermuda.[61] Generally, they have asserted that the disadvantage initially arose when Bermuda-based insurance companies began acquiring U.S. affiliates that were engaged in the business of insuring against U.S. risks. By causing the U.S. affiliate to reinsure most of third party risks to a Bermuda subsidiary of its Bermuda parent, the group is effectively able to transfer substantial amounts of the gross premiums earned in its U.S. business to Bermuda (for which the U.S. affiliate

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[60] See Cooper Industries, Ltd., Proxy Statement/Prospectus, July 27, 2001; and Stanley Works, Proxy Statement/Prospectus, April 2, 2002.

[61] See generally, Lee A. Sheppard, "Would Imputed Income Prevent Escape to Bermuda?," 2000 TNT 54-4 (March 20, 2000).

claims a deduction for reinsurance premiums paid), although the U.S. insurer will often receive a taxable "ceding commission" from its Bermuda reinsurance affiliate. Because insurance companies make a substantial portion (if not all) of their profits through the investment of these premiums (and their capital), a Bermuda-based company that is able to earn investment income on a tax-free basis will (to the extent it does not rebate the benefit to its U.S. affiliate through a ceding commission) enjoy a substantial advantage over its U.S.-based competitors that are required to pay U.S. tax on their investment income.

Some U.S.-based P&C insurance companies have responded to this competitive pressure by engaging in outbound inversion transactions in order to convert the U.S. corporation into a subsidiary of a shell Bermuda corporation. Once the organizational structure has been inverted, the U.S. corporation reinsures many of the U.S. risks it has insured to a Bermuda insurance company subsidiary of its Bermuda parent, thereby replicating the tax advantaged structure enjoyed by "true" non-U.S. insurance companies in Bermuda and other jurisdictions. (As in other inversion transactions, the Bermuda group will presumably also conduct its future non-U.S. business outside of its U.S. group). Although these inversion transactions may have been subject to tax pursuant to Section 367(a), depressed stock prices that have prevailed in recent years in the insurance industry have meant that there is often an insubstantial amount of gain, if any, that is subject to taxation.

Some U.S. P&C companies that have not engaged in an inversion transaction have lobbied for changes to U.S. tax law that would eliminate the tax benefits obtained through the use of Bermuda-based structures. They argue that existing provisions of the Code, such as Section 482, and the 1% excise tax under Section 4371, have been ineffectual in terms of reducing the tax advantages enjoyed by foreign corporations and inverted U.S. corporations.[62] Additionally, they argue that the case law that has developed under Section 845(a) which authorizes the IRS to reallocate income or deductions to reflect the proper source and character of income among related parties to a reinsurance agreement, does not adequately address the issue of investment income.[63] For these reasons, these domestic P&C companies have lobbied for expanded income imputation provisions under Section 845 which would effectively pull investment income earned offshore that is attributable to ceded insurance premiums back into the U.S. tax net.[64] More recently, there have been proposals that would amend Section 832 to defer the deduction for reinsurance premiums paid to a related party in a tax haven until the time of loss recovery unless the foreign related reinsurer elects to treat the investment income attributable to the reinsurance premium as effectively connected with the conduct of a U.S. trade or business of such reinsurer.[65]

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[62] See, Treasury Department, "Effect on U.S. Reinsurance Corporations of the Waiver by Treaty of the Excise Tax on certain Reinsurance Premiums," April 2, 1990, 90 TNT 71-31. See also, D. Crane & L. Workman, "Bermuda Triangle: Tax Havens, Treaties & U.S. P&C Insurance Competitiveness," 2002 TNT 5-24 (January 4, 2002).

[63] Sheppard, supra. Note 61.

[64] Id. See the Johnson/Neal bill H.R. 4192, introduced in April, 2000. A variation of this proposal appears in the REPO Bill described in Part IV, below.

[65] See the Johnson/Neal bill, H.R. 1755; Reinsurance Tax Equity Act of 2001 (May 8, 2001). Some industry observers have expressed concern, however, that this proposal may override existing treaty obligations of the U.S. as well as impose unworkable compliance burdens in practice.

2. Startups, acquisition vehicles and long-standing foreign multinationals

As discussed above, it seems that U.S. corporations have engaged (or propose to engage) in inversion transactions principally because they reduce U.S. taxation of future foreign income (i.e., non-effectively connected income earned through foreign affiliates) and provide enhanced opportunities for the inverted companies to reduce U.S. taxation of U.S. connected income through base erosion techniques. In analyzing the inversion phenomenon from a policy perspective, and considering what legislative or regulatory response may be appropriate, it is important to note that other transactions (which may be indistinguishable from certain tax policy perspectives) may offer the same tax savings opportunities.[66] For example, U.S. taxation of foreign income generally can be avoided where U.S. business that will have predominant (but dispersed) U.S. ownership is incorporated de novo as a subsidiary of a foreign corporation.[67] U.S. taxation of foreign income can be avoided in a similar manner in the context of mergers and acquisitions by structuring the merger or acquisition so that the U.S. participant becomes a subsidiary of a foreign corporation.[68] This may occur in a "true" cross-border transaction where the foreign participant is an existing non-U.S. operating business or when the foreign entity is a shell corporation with no other assets that is set up for purposes of the transaction.

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[66] See, Treasury Inversions Report, at L-4 ("As we formulate a response, however, we must not lose sight of the fact that an inversion is not the only route to accomplishing this type of reduction in taxes.")

[67] The appeal of such an arrangement is demonstrated by the testimony of Bob Pearlman, former Vice President of Tax, Licensing and Customs at Intel Corporation, at a March 1999 Senate hearing: "if Intel were to be founded today, I would strongly advise that the parent company be incorporated outside the United States. Our tax code competitively disadvantages multinationals simply because the parent company is incorporated in the United States." "Unofficial Transcript of Finance Hearing on International Tax Laws," 1999 TNT 50-54 (Mar. 16, 1999).

[68] For a discussion of this phenomenon, see Ken Brewer, "Treason? Or Survival of the Fittest? Dealing with Corporate Expatriation," 95 Tax Notes 603 (Apr. 23, 2002).

One possible rationale for distinguishing between inversions and other similar transactions that facilitate avoidance of U.S. taxation of foreign income is that traditional inversions are clearly tax-motivated. It should be noted, however, that many U.S. corporations are established as subsidiaries of foreign holding companies with the same tax avoidance motives as inversion transactions. In addition, many cross-border mergers and acquisitions are similarly structured in order to minimize the impact of U.S. tax rules on the ultimate U.S. shareholders. (Indeed, in some cases, the only significant "cross border" aspect of the acquisition transaction may be the selection of a tax haven Newco as the acquisition vehicle). Accordingly, tax motivation does not seem to provide a solid basis to discriminate against inversion transactions in favor of other transactions that provide similar tax reduction potential. A legislative solution that effectively prevents inversions altogether by established companies but has no effect on the other structures described above may lead to an even greater advantage for "new" companies and thus an unfair and inefficient tax distinction between similarly situated U.S. businesses. On the other hand, it may be considered more abusive to invert an existing U.S. enterprise since the result may be to facilitate escape from U.S. taxation for the fruits of the goodwill of the enterprise accumulated during the period it was a U.S. taxpayer.

The relevant universe of comparison expands if one focuses on the "base erosion" aspect of inversions (which many believe is the more important and troubling aspect). If the base erosion facilitated by inversion transactions is in fact the core issue, the entire "inversion" debate, which seems to have been focused on companies predominantly owned by U.S. persons, may be inappropriately limited. The base erosion techniques available to inverted companies, including earnings stripping, transfer pricing, and tax treaty abuse (including treaty shopping and the use of hybrid instruments) are equally available to U.S. enterprises beneficially owned by U.S.-owned foreign holding companies and to foreign-owned multinationals. Many commentators have argued for some time that foreign-owned U.S. companies as a group tend to avail themselves of various base-eroding techniques to avoid paying their fair share of U.S. taxes and that such enterprises thus enjoy a significant competitive advantage over comparable U.S.-owned companies.[69] If true, and anti-inversion legislation is enacted, that arguably unfair competitive advantage will be solidified unless other measures are taken.

III. CAN OUTBOUND INVERSION ISSUES BE ADDRESSED UNDER CURRENT LAW?

There is no apparent reason why an inversion accomplished by creation of a new Bermuda holding company should alter a U.S. company's tax burden at all. The U.S. company should retain all its assets and earnings power and, absent the injection of new capital into Bermuda Co (which has not been the pattern in transactions to date), Bermuda Co should only earn what the public-shareholders formerly earned directly. Obviously, that is not the desired result. Through express or subtle asset transfers and conversion of taxable equity returns (e.g., dividends) into excluded income earned by foreign subsidiaries of Bermuda Co or deductible payments (interest, royalties), the taxed earning power of the U.S. company is to be depleted. However, on the operations side,

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69 See, e.g., "Dorgan: Treasury Loses Trillions in Multinational Tax Loopholes," 1999 TNT 72-4 (Apr. 14, 1999); Leblang, Stuart E., "International Double Nontaxation," 98 TNT 133-61 (Jul. 13, 1998). See also "GAO Reports International Corporations Pay Little U.S. Income Tax," 1999 TNT 72-48 (Apr. 15, 1999); "Many Foreign Corporations Paid Little or No Income Taxes, GAO Finds," 93 TNT 142-22 (Jul. 14, 1993); "Full Text: Unofficial Transcript of Governmental Affairs Hearing on Transfer Pricing," 93 TNT 78-60 (Apr. 8, 1993).

the U.S. company will continue to be run largely as before, principally from the United States, with new foreign activity being limited to occasional board meetings.

In addition to raising significant tax policy issues, the emerging inversions phenomenon also raises a number of interpretive questions under current law. While statutory changes may resolve the tax policy issues, and obviate the interpretational questions, that possibility is not a certainty. Moreover, a new statute may leave open some or all of the aspects of the treatment of past transactions. Even if definitive legislation is adopted which resolves the status of past and future transactions, the application of fundamental current tax law principles to inversions in their various guises and aspects is of great significance in terms of the integrity of the tax law and compliance. For these reasons, we believe an analysis of current law's application to inversions is essential. Such analysis needs to go beyond the basics of the inversion and deal with the refinements which "turbo-charge" the transaction.

In addition to the specific points discussed below, it might be helpful if the IRS were simply to announce that it believes that inversions raise serious questions under current law and that it intends to examine each transaction closely to determine whether additional tax is due. Compliance might also be facilitated by treating inversions as listed tax shelters under Treas. Reg. §1.6011-4T(b)(1), requiring special disclosure and other consequences of such listing under existing and revised tax shelter rules.

A. Application of Section 269 and the Business Purpose Doctrine

An inversion transaction where a foreign corporation acquires a U.S. corporation is within the ambit of Section 269 if "the principal purpose for which such acquisition is made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy." It is evident and practically acknowledged that the principal purpose of creating the foreign holding company is to secure for the inverted company and its shareholders the benefit of income exclusions and deductions relating to income that otherwise would presumably have been earned and taxed to the U.S. company. It is hard to see how these objectives could be achieved without the acquisition of control of the U.S. company by a foreign holding company. Nonetheless, many practitioners believe that Section 269 has insufficient deterrent effect in the real world. Section 269 has been viewed as a weak tool, in part because of its requirement of showing what "the" (as opposed to "a") principal purpose of a transaction is. It can also perhaps be argued that the benefits that arise post-inversion simply take advantage of a permissible statutory framework (analogous to Western Hemisphere Trade Corporation status) or that the transaction indirectly facilitates expansion of the corporate group (by freeing it of the tax shackles that bound it).

The more difficult issue is how Section 269 would be given effect, if applicable: by subjecting the subsidiaries of the foreign holding company to Subpart F? By denying interest and other deductions for payments made by the U.S. corporation to the foreign holding company? It might be helpful if the IRS (perhaps backed by enabling legislation and a special appropriation) would announce a Section 269 initiative that would include new regulations to clarify what the consequences of Section 269 would be for transactions of this type and a dedicated task force to enforce them. Consequences could include directly or indirectly denying any tax benefits that the group would not otherwise enjoy if its new parent were in fact a domestic corporation by, among other things, imposing tax on the acquiring or the acquired company.

Similar issues arise under the requirement of Treas. Reg. §1.368-1(a) that a tax-free reorganization be "required by business exigencies." It may be possible to assert, in the abstract, business purposes for a holding company. Nevertheless, the purpose for creating a foreign holding company in inversion transactions is clearly based on tax rather than business factors. If reorganization status were denied in the simple holding company inversion, there would be little practical consequence (shareholders are taxed under Section 367 in any event and, in form, there is no disposition of U.S. company assets). However, hybrid transactions (in which appreciated assets are dropped by Bermuda Co into a new U.S. subsidiary) would be at risk since the transfer of appreciated assets to the U.S. subsidiary would be rendered taxable.

B. Deemed Transfer of Goodwill

After the inversion, the foreign holding company is in the position of benefiting from the accumulated goodwill and going concern value of the U.S. company, including the corporate name, without compensation. These are the elements which permit the foreign holding company to earn returns beyond those expected by a start-up enterprise and indeed without even the necessity of raising new capital therefor. In practical terms, it would appear arguable that such usage represents a deemed distribution by the U.S. company (taxable to the U.S. company under Section 311 and to the foreign holding company under Sections 881 or 882) or an appropriate subject for reallocation under Section 482 (including possibly the "commensurate with the income" standard).

These results might well be appropriate in the context of an entire transaction, including intended transfers and intercompany arrangements, designed to reduce U.S. taxable income.

The IRS, while recognizing the implicit transfer inherent in a parent's permitting a subsidiary to use its name and associated goodwill, has historically been pragmatic in not seeking to tax it.[70] It is unclear, however, whether such reticence should or would apply to the appropriation of such benefits by a foreign parent superimposed for tax-reduction purposes. Certainly the tax law is more willing to tax distributions of appreciated assets (especially where they are removed from U.S. tax jurisdiction) than contributions (where continuing ownership and Subpart F result in retained tax jurisdiction).

It has been suggested that one means to strip earnings from the U.S. company after the inversion would be for it to pay deductible royalties for use of the company's logo, the rights to which would be owned by the foreign holding company. It is hard to imagine that such deductions would be sustained, given that the U.S. company would be the developer of this intangible.[71] Indeed, attempting to create U.S. deductions in this fashion would be inviting the IRS and the courts to find a taxable distribution of the U.S. company goodwill.

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70 See PLR 8433023 (May 10, 1984); see also Treas. Reg. §1.367(a)-1T(d)(5)(iii), excluding the use of a corporate name and other foreign goodwill from "intangibles" subject to Section 367(d) of the Code.

71 See, DHL Corporation v. Commissioner, 285 F.3d 1210 (9th Cir., 2002); Medieval Attractions N.V. v. Commissioner, 72 TCM 924 (1996). Consider, however, whether these payments may become more supportable over time, as the foreign parent and affiliates spend more time and effort in maintaining and developing the value of the logo.

C. Section 482 Issues in Associated Transactions

Specific follow-on transactions which are part of, or follow, the inversion can raise issues under Section 482. These include sales of corporate assets, including foreign assets, to the foreign holding company or its subsidiaries. It would only be natural for these transactions (especially the valuations used) to be examined with a questioning eye, given the avowed (and frequently advertised) intention to remove assets from the U.S. tax jurisdiction, including by escaping from Subpart F.

Large-scale transactions will obviously be scrutinized closely, raising as they do the goodwill migration issue described above. Issues to be dealt with on audit and in litigation include (i) for taxable transactions the proper valuation of the sold units as going concerns (including the "commensurate with income" standard as to intangibles); and (ii) for purported tax-free (except for Section 1248 toll charges) transfers for the foreign holding company stock, the proper valuation of the stock (which will have no voting rights and often limited or waived dividend rights) under the inversion standard of Notice 94-93.[72] Indeed, inversions may be the appropriate forum for the IRS to reconsider whether the acquisition of Bermuda Co stock by its subsidiary, U.S. Co, is effectively a deemed dividend by U.S. Co.[73]

In addition, normal recurring transactions can be structured to reduce U.S. taxable income. Thus, one tax expert has noted "So, once the expatriation transaction is completed, the acquired domestic corporation can sell property to its erstwhile foreign

[72] 1994-2 C.B. 563.

[73] See, Peter C. Canellos, "Acquisition of Issuer Securities by a Controlled Entity: Peter Pan Seafoods, May Department Stores, and McDermott," 45 Tax Lawyer 1 (1991).

subsidiaries at artificially low prices and the resale profit will not be subject to U.S. tax because the profit is not Subpart F income."[74] Hence, even ordinary course dealings may require special monitoring.

While Section 482 cases are clearly a strain on the IRS and the tax system, it may be that special reporting (under Section 6038A and otherwise) and a special industry audit group for inverted companies would be appropriate. In addition, given the context, special Section 482 presumptions (analogous to other presumptions and safe harbors applicable under Section 482) might be applied; for example presuming non-arm's length dealings when the profitability of the U.S. company and its subsidiaries falls below historical percentages, especially when coupled with higher rates of return earned by the foreign holding company and its subsidiaries.

Section 482 might be a more effective deterrent for inversions if the IRS were to announce that every inverting company will be the subject of a thorough Section 482 audit each year for at least a certain period (say 5-10 years) after its inversion. Again, the announcement would be more credible if backed up by special appropriation of funds to provide staffing for this effort.

D. <u>Hybrid Acquisitions</u>

As noted above, in some inversions, the U.S. company reincorporates as a foreign corporation, followed by a transfer of certain (appreciated) assets to a new U.S. subsidiary of the foreign corporation. The intent is for the transfers to the U.S. subsidiary to qualify as an indirect stock acquisition under Treas. Reg. §1.367(a)-3(d), tax-free if a

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[74] Robert Willens, "Tax Shelters," BNA Daily Tax Report, April 22, 2002.

gain recognition agreement is executed. Assets retained by the foreign holding company would be considered disposed of in a taxable transaction (presumably at little or no gain, or sheltered by NOL's or other attributes). The net effect, if successful, is to remove assets from U.S. taxing jurisdiction without withholding tax.

This result is, however, not clear under the regulation, which deals with gain recognition on the asset and deemed stock acquisitions but not deemed-dividend issues and which assumes that the acquired and acquiring corporations were unrelated prior to the transaction. In an appropriate case, the new U.S. subsidiary might be viewed as a successor to the former U.S. parent, and the foreign corporation the recipient of a taxable dividend of the assets that have left U.S. corporate solution.[75] Moreover, the regulation applies, by its terms, only to asset transfers constituting Section 368(a)(1)(C) reorganizations. In fact, the hybrid transactions appear to take the form of reincorporations of the U.S. company in the foreign jurisdiction constituting a Section 368(a)(1)(F) reorganizations. The only example in Treas. Reg. §1.367(a)-3(d) dealing with an "F" reorganization (Example 12) finds it to be a fully taxable asset transfer. Moreover, even if a transaction can be both an "F" and a "C" reorganization, the same logic might hold that certain of these transactions (non-triangular transactions, especially those that involve relatively small drop-downs) would then also be Section 368(a)(1)(D) reorganizations, which prevents the "C" rule from applying.[76] Finally, as noted above, these transactions may fail even the relatively low threshold of "business

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75 See generally, Reef Corporation, T.C. Memo. 1965-72, *aff'd on other issues*, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967); Davant v. Com'r, 43 T.C. 540 (1965), *aff'd in part, rev'd in part*, 366 F.2d 874 (5th Cir. 1966) , *cert. denied*, 386 U.S. 1022 (1967).

76 Section 368(a)(2)(A).

purpose" imposed by the Section 368 regulations, in which event the entire transaction would be taxable at the corporate and shareholder level.[77]

E. <u>Debt Incurred to Purchase Bermuda Co Stock</u>

Increasing leverage, often through debt of the U.S. company held by the foreign holding company, is usually described as a principal means to erode the U.S. tax base following the inversion. Leveraging raises a host of technical debt-equity, Section 163(j) and related issues. Increasing leverage is a practical problem because the inversion typically does not raise new capital in the foreign jurisdiction to be on-lent to the U.S. company and the U.S. company does not typically need additional funds. (Indeed, any surplus capital is generally routed to the foreign subsidiaries of the foreign holding company, which are not subject to U.S. tax). Hence, increasing leverage really involves reducing net worth by displacing equity with the foreign holding company held debt.

One technique for attempting such displacement is for the foreign holding company to establish a U.S. subsidiary which borrows to buy the foreign holding company shares and uses them in the acquisition of the U.S. company in the inversion transaction. However, under the "over-the-top" model for analyzing triangular reorganizations set forth in Treas. Reg. §1.367(a)-3(d) and Treas. Reg. §1.358-6(b), the foreign holding company is deemed to be the direct acquirer of the U.S. company followed by a drop-down of the U.S. company to the new U.S. subsidiary. Under that

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[77] Subject, however, to possible disallowance of shareholder losses pursuant to Section 1091.

model, there is a risk that the debt incurrence by the U.S. subsidiary would be considered a dividend to the foreign holding company under common law principles or Section 304.

Other leveraging techniques may be more difficult for the IRS to attack under current law, such as the purchase by the U.S. company of its new parent's stock in exchange for a note, where the U.S. company retains the parent company stock (which often pays no dividends and generates no other income). Even though there may be little or no non-tax business reason for such purchases, existing common law doctrines may not be adequate to reach this transaction. The IRS may wish, however, to scrutinize carefully whether the stock issuance is valid as a corporate matter and the valuation of what is typically (we believe) unregistered non-voting stock that is not freely transferable or convertible.

Finally, of course, the IRS will presumably be vigilant in scrutinizing whether the intercompany debt should be respected as indebtedness for federal income tax purposes.[78] There is also the issue, alluded to earlier, as to whether any such purchase by a subsidiary of its foreign parent's stock is, ipso facto, a deemed dividend.

F. Treaty Issues

As noted above, a common pattern in inversions is for the new holding company to be incorporated in Bermuda but "managed and controlled" in Barbados, in an attempt to secure the benefits of the US-Barbados tax treaty. That treaty importantly reduces withholding rates on dividends, interest and royalties, eliminates "second-tier" dividend withholding, and limits branch profits tax. Under its IBC Act, Barbados

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[78] See generally, Laidlaw Transportation Inc., T.C. Memo 1998-232.

imposes tax on qualifying entities at a rate between 1% and 2.5%. These benefits are available only if a number of uncertain conclusions are reached.

First, Bermuda Co must meet the test of being “managed and controlled” in Barbados. It appears that, under Barbados law, the only substantive required Barbados contact for Bermuda Co is conducting the Board of Directors meetings in Barbados.[79] However, the entity is, in fact, managed and controlled, in all real world respects, at the continuing U.S. offices of the inverting U.S. company, a fact which is openly publicly proclaimed as a selling point for the existence of status quo, apart from taxes. The question of residence under the treaty is a factual question, and a U.S. court might be persuaded to find residency lacking on the presumed facts.[80] It might well be influenced by the scant Barbados contacts, the overwhelming U.S. connection, the tax avoidance motivation, and the lack of true double taxation, given the Barbados IBC regime.

Second, the Bermuda Co must not have a U.S. permanent establishment through which it is engaged in a U.S. trade or business with which the dividends, interest and royalties are effectively connected. Under the Barbados treaty, a permanent establishment includes a “place of management.” For reasons set forth above, the IRS might assert, and a court might find, that Bermuda Co’s place of management is the U.S. office from which the worldwide business of US Co and its affiliates is run. If so, it is at least arguable that Bermuda Co’s extensive activities in the U.S., constituting in effect the running of a worldwide business enterprise, would constitute the conduct of a trade or

79 There is apparently a range of views as to whether a majority of meetings is required, or whether a single annual meeting will suffice.

80 See Compagnie Financière de Suez v. United States, 203 Ct.Cl. 605 (1974); FSA 200117019 (January 24, 2001).

business in the U.S.[81] Finally, in the event Bermuda Co is deemed to conduct a U.S. trade or business through a place of management that is a permanent establishment, its U.S. source, as well as perhaps some of its foreign source, income could be excluded from treaty benefits and thus potentially taxable under Section 864 and 882. If so, branch profits tax could also be imposed. Alternatively if, despite being attributable to a permanent establishment under the relevant treaty, the U.S. source dividends are not "effectively connected income" under the Code, they could conceivably be subject to tax at a 30% rate under Section 881, but would be reduced by allocable deductions as is typically provided in the business profits article of the relevant treaty.

G. <u>Possible Application of CFC Rules</u>

The IRS should be alert to the possibility that certain inversion transactions, either alone or combined with subsequent events, may reintroduce the applicability of the CFC rules. For example, consider a situation where the former U.S. parent transfers the stock of its foreign subsidiaries to its new foreign parent in exchange for 40% of the stock of the foreign parent, in the form of nonvoting stock. It appears that under applicable attribution rules, the U.S. company would be considered to own 40% of the <u>voting</u> stock that the foreign parent owns in its foreign subsidiaries.[82] If, in a variety of transactions, another U.S. person comes to own, actually or constructively, more than

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81 Bermuda Co would argue that its U.S. activities would be considered mere "investing" under the tax common law or qualify for the safe harbor in Section 864(b)(2). <u>See</u> Treas. Reg. §1.864-3(b), Example 2. Whether they would be considered to be so limited is, however, uncertain.

82 <u>See</u> Sections 958(b)(3) and 318(a)(2)(C). Section 318(a)(2)(C) attributes "*the* stock owned" (emphasis added) (presumably including the voting character of such stock) by a corporation to a 50% (by value) shareholder (10% for purposes of Section 958(b)) in proportion to the value of such corporation owned by such shareholder (i.e., through any stock, regardless of voting rights).

10% of the stock of the parent (whether voting or nonvoting) or 10% of the voting stock of the subsidiary, one or more of the subsidiaries may become CFCs and the former U.S. parent will become subject to Subpart F. It does not appear that certain existing charter restrictions limiting the amount of parent voting stock that U.S. shareholders may acquire, even if enforceable as a corporate matter, will prevent the foregoing. It has also been suggested that the nonvoting shares held by the former U.S. parent may be susceptible of recharacterization as voting stock.

IV. PROPOSED LEGISLATION

A. Description of Pending Bills

Members of both the House of Representatives and the Senate thus far have introduced six separate Bills to combat the perceived abuses related to inversion transactions. All of the Bills rely primarily on the technique of treating the new foreign corporate parent as a domestic corporation for United States federal tax purposes,[83] although one of the most recent Bills also uses other measures to combat "limited" inversion transactions. All of the Bills focus on a paradigm transaction where (1) a foreign corporation acquires stock or substantially all of the property of a domestic corporation or partnership, and (2) more than 50% or 80% of the stock of the foreign corporation, determined by vote or value, is held by former shareholders of the domestic corporation or partnership. Four of the Bills were introduced by House Members and two of the Bills were introduced by Senators. They are as follows:

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[83] While this approach may seem radical, it in fact has well established roots in the "stapled stock" provisions contained in Section 269B, which were enacted in 1984. Indeed, the stapled stock rules were enacted in part, to address certain CFC de-control transactions that have some similarities with inversions.

H.R. 3857, introduced by Representative McInnis on March 6, 2002, effective for transactions after December 31, 2001.

H.R. 3884, introduced by Representative Neal and others on March 6, 2002, effective for transactions completed after September 11, 2001, and would also apply after 2003 to transactions completed on or before September 11, 2001. This Bill is known as the "Corporate Patriot Enforcement Act of 2002."

H.R. 3922, introduced by Representative Maloney on March 11, 2002, effective for transactions completed after September 11, 2001 (and certain pre-September 11, 2001, transactions).

H.R. 4756, introduced by Representative Johnson on May 16, 2002, effective for transactions completed after September 11, 2001 and not to apply to transactions beginning after December 31, 2003. This Bill is known as the "Uncle Sam Wants You Act of 2002."

S. 2050, introduced by Senator Wellstone and others on March 21, 2002, effective for taxable years of any "inverted domestic corporation" beginning after December 31, 2002, without regard to whether the corporation became an inverted domestic corporation before, on, or after such date.

S. 2119, introduced by Senators Baucus and Grassley and others on April 11, 2002, effective for transactions occurring on or after March 21, 2002 (and the pre-approval process would be effective for certain transactions occurring before March 21, 2002). This Bill is known as the "Reversing the Expatriation of Profits Offshore Act " (the "REPO Bill").

The House Bills and the Bill introduced by Senator Wellstone are essentially the same, in that they all seek to prevent a transaction whereby a domestic corporation or partnership expatriates in order to avoid U.S. income tax. Each of these Bills provides that a foreign corporation will be treated as a domestic corporation if (1) a foreign corporation acquires directly or indirectly substantially all of the properties held directly or indirectly by the domestic corporation, and (2) former shareholders of the domestic corporation receive more than 80% of the foreign corporation's stock. The 80% threshold is reduced to 50% if the foreign corporation has no substantial business activities in the country of its organization and is publicly traded and the principal market for the public trading is in the United States. The Bills also cover transactions in which a foreign corporation acquires directly or indirectly substantially all of the properties constituting a trade or business of a domestic partnership and the foregoing requirements are otherwise satisfied.

The REPO Bill introduced by Senators Baucus and Grassley is more comprehensive and appears to build on the concepts used by the others. This Bill targets two types of transactions—"pure" inversion transactions and "limited" inversion transactions. In a "pure" inversion transaction, (1) a foreign incorporated entity acquires, directly or indirectly, substantially all of the properties of a domestic corporation (or a domestic partnership) in a transaction completed after March 20, 2002; (2) after the acquisition, the former shareholders (or partners) of the domestic corporation (or partnership) hold 80% or more of the vote or value of the stock of the foreign corporation; and (3) the foreign corporation, including its "expanded affiliated group," does not have substantial business activities in its country of incorporation. Under the

REPO Bill, in a "pure" inversion transaction, the new foreign parent corporation would be deemed a domestic corporation for U.S. tax purposes.

A "limited" inversion transaction is similar to a "pure" inversion transaction except that the shareholders of the domestic corporation obtain more than 50% and less than 80% of the vote or value of the stock of the foreign corporation. "Limited" inversion transactions also include a "pure" or "limited" inversion transaction completed on or before March 20, 2002. Under the REPO Bill, in a "limited" inversion transaction, the foreign corporation will not be treated as a domestic corporation, but there are a number of other consequences: (1) no offsets such as NOLs or other credits could be applied to reduce tax on gain realized by a domestic corporation on the inversion transaction or on subsequent transfers of stock or property to related foreign persons; (2) for 10 years after the date of the inversion transaction (or, if later, January 1, 2002) the domestic corporation and its U.S. affiliates would be required, at such time as may be specified by the IRS, to enter into annual pre-approval agreements as specified by the IRS to ensure the integrity of the earnings stripping, gain and loss and intercompany pricing rules of Sections 163(j), 267(a)(3), 482, and 845 for each taxable year within that 10-year period; and (3) the earnings stripping rules would be revised in order to eliminate the 1.5 to 1 debt-to-equity threshold and reduce the taxable income offset from 50% to 25%. The REPO Bill would also amend Section 845 to expand the reallocation authority of the IRS over related party reinsurance agreements to include adjustments necessary to reflect the proper "amount," as well as "source and character," of taxable income of each of the parties. The Section 845 amendment would apply whether or not an inversion transaction has occurred, effective for risks reinsured in transactions after April 11, 2002.

B. Technical Comments

We have focused our comments on the REPO Bill because it is the most comprehensive of the proposals[84] and because the other bills are quite similar in a number of respects. We understand that the drafters of the proposed legislation view the REPO Bill as a "work in progress." Accordingly, our comments should be viewed in that context.

1. "Substantial business activities" in jurisdiction of incorporation

The concept of "substantial business activities" in the jurisdiction of incorporation plays a significant role in the REPO Bill. If it is present, the transaction is not treated as a "pure" or "limited" inversion. This reflects the fact that the bill is targeted at inversions where the incorporation or inversion transaction in a particular jurisdiction is not related to tangible business operations, and thus presumably is largely (or entirely) tax-motivated. As noted in the Press Briefing Memo accompanying the release of the REPO Bill, "[o]ften, these foreign parent corporations are nothing more than a sheet of paper in a filing cabinet" which afford the opportunity to achieve territorial tax status "through a purely paper transaction, with no substantive change in the current business operations."[85]

The proposed statutory language of the REPO Bill does not define, however, the concept of "substantial business activities" in the country of incorporation, although the accompanying Press Briefing Memo makes it clear that corporations with no

[84] Others have made technical comments on the other bills. See, e.g., Sally A. Thurston, "Going Offshore: Practical and Policy Considerations," Tax Forum No. 558 (May 6, 2002) at 47-50.

[85] Press Briefing Memo, supra. Note 47.

significant operating assets, few or no permanent employees, or no significant real property in the foreign country do not meet the substantial business activity test. In particular, companies are not considered to be conducting substantial business activity in the country of reincorporation merely by conducting board meetings in the foreign country or by relocating a limited number of executives to the foreign jurisdiction.

The Bill does not elaborate further on the qualitative or quantitative standards by which the substantiality of business activity is to be evaluated for this purpose, nor does it incorporate concepts of "central management and control" or equivalent proxies for corporate "residence" status of the sort that are familiar to U.K. or other European tax systems. Insofar as substantial business activity in the country of reincorporation does serve as a talisman for distinguishing between "good" and "bad" inversions, a related tax policy issue also in need of consideration is whether and to what extent criteria such as "effective management," "central administration," "head office" and "place of management" should be taken into account. Although one of the principal operative rules in all five of the pending Bills is potentially to classify an otherwise "foreign" corporation as "domestic" in a manner that would be a relatively new and unique feature of the U.S. federal income system,[86] the adoption of corporate "residence" rules is as part of this approach (or as an alternative approach) more harmonious with international tax norms.[87] While some of these concepts may be appropriately developed through regulations (or even case law), it would be helpful for the statute or legislative

[86] We note that some precedent for this approach exists under the stapled stock rules of Section 269B, which address certain transactions, some of which bear similarities to inversions.

[87] Crafting an appropriate standard may not be so simple; for example, many "managed and controlled" standards have historically focused on board meetings, a criterion that the REPO Bill appears to reject (and sensibly so).

history to provide some degree of additional guidance to narrow the issues. In particular, some concrete guidance may be helpful in the insurance industry setting, where many companies in fact have operations that may well be viewed as substantial business activities under the limited guidance provided.[88]

2. Other definitional issues

(a) Coverage generally

In addition to the core issue of what constitutes "substantial business operations" in the foreign jurisdiction, the definition of a "pure" inversion raises a number of other technical points.

(i) Stock acquisitions

The definitional approach of covering stock acquisitions under the rubric of acquisitions of substantially all of the assets is awkward and may raise a number of ambiguities. For example, how much stock does one need to acquire to be viewed as having acquired substantially all of a corporation's assets? 90% (the traditional threshold for "substantially all")? 80% (the Section 1504 standard)? More than 50% (the GAAP standard)? In this regard, should there be a special rule to deal with the exchangeable share transactions used in a few inversions in the late 1990s (if not, they will presumably return as a technique to keep stock ownership below the trigger threshold)?

We would suggest an 80% test (as is used in the definition of a "pure" inversion transaction). For this purpose, however, we would suggest that stock of the U.S. corporation be excluded if it is either exchangeable for, or tracks, stock of the new

88 Even if they do, these insurance companies would still be subject to the newly expanded Section 845 rules that REPO Bill would enact.

parent. We would also provide for regulatory authority to treat stock as not stock and interests not otherwise treated as stock as stock for this purpose.[89]

(ii) Stock of new parent held by former shareholders

For similar reasons, we would suggest that the basic definition of a "pure" inversion be expanded to include situations where the shareholders of the former U.S. parent receive other securities that are sufficiently similar to stock of the new parent that they should be so treated, such as convertible debt, tracking stock and exchangeable stock. This might also be supplemented by a grant of regulatory authority to include other instruments to the extent necessary to implement the purposes of the "pure" inversion rules.

(iii) Substantially all

The "substantially all" concept may be flawed in other ways. For example, it is well-established that a corporation which has just engaged in a substantial spin-off cannot then be acquired in a "C" reorganization because the latter transaction would fail the "substantially all" test of Section 368(a)(1)(C).[90] Does this mean that such a corporation is free to invert without REPO Bill consequences?

(iv) Accompanying public offerings

We have a number of concerns with the provisions of the REPO Bill which provide that stock sold in a public offering related to the inversion transaction will be disregarded in determining whether the 80% ownership threshold for treatment as a

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89 See Section 382(K)(6)(A), (B), which provides similar regulatory authority under Section 382.

90 Helvering v. Elkhorn Coal, 95 F.2d 732 (4th Cir. 1937), *rev'g*, 34 B.T.A. 845 (1936), *cert. denied*, 305 U.S. 605 (1938).

"pure" inversion is met. First, we are not sure that a substantial public offering that brings a substantial new amount of capital into the business is the type of transaction that should be disregarded, as it has meaningful independent economic significance, although we can appreciate that a significant loophole might be created if the inversion rules could be avoided simply by a concurrent public offering. Second, if contemporaneous stock acquisitions are problematic, we do not see why the anti-abuse rule should only apply to public offerings (as opposed to, say, issuances of stock for cash in a private placement). Third, should stock issuances in exchange for assets of a non-U.S. business or the stock of a non-U.S. business that owns it be excluded? If so, many bona fide mergers and acquisitions transactions that the bill is not intended to pick up could be classified as "pure" inversions if a holding company acquisition vehicle that is established to acquire both entities happens to be set up in a jurisdiction that actually has a relatively small amount of the combined group's operations. Finally, the legislation should clarify whether it is intended to apply only to issuances of stock or whether secondary sales are also intended to be covered.

(v) Foreign owned U.S. corporations

The "pure" inversion definition may cast a wider net than it intends. For example, the definition may unintentionally pick up a reincorporation of an existing foreign multinational that happens to have a U.S. subsidiary, even a small one.[91] This result seems unintended.

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91 Thurston, supra. Note 84 at 48.

Similarly, and as a more general matter, it may not be appropriate to apply the "pure" inversion rules in other situations where the U.S. corporation in question is already, say, a wholly owned subsidiary of a foreign corporation. For example, if a Netherlands parent corporation transfers its wholly owned U.S. subsidiary to a third-country holding company, it is not clear to some of us that the "pure" inversion rules should apply. Indeed, Congress may wish to consider whether a broader exception for foreign owned corporations should apply.[92]

(b) Application to partnerships

The inversion definitions relating to partnership require further development. For example, given the fact that there is virtually no difference under current U.S. tax law between the treatment of foreign and domestic partnerships, it is not clear why the foreign partnership should be exempt from the potential application of the new inversion rules. Moreover, the "substantially all" concept may cause mischief here too – why should the foreign incorporation of one of a partnership's two historic businesses be exempt from these rules if the incorporation of the entire partnership would not.

(c) "Limited" inversion – effective date

The definition of "limited" inversion raises the foregoing issues and at least one more – its effective date. Is it really intended to cover all such transactions that occurred prior to March 20, 2002? Leave aside the most recent wave of transactions -- what about Tyco (1997)? Helen of Troy (1994)? McDermott (1984)? Or for that matter,

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92 See Section 269B(e). Stapled stock rules do not apply if less than 50% of stock is owned directly or indirectly by United States persons. A higher threshold of foreign ownership than Section 269B provides may, however, be appropriate.

corporations that expatriated back in the early 1960s, when they heard President Kennedy's speech and saw Subpart F coming. Are all of these corporations really supposed to be subject to 10 years of heightened Section 482 pre-approval starting with this year? Any ultimate legislation should clarify this point. It is also unclear how these corporations or even the clearly intended targets of this provision (e.g., corporations that inverted in 2001 and early 2002) would secure pre-approval of transactions they have already completed prior to the date that the legislation is enacted and pre-approval procedures are established.

3. Interaction with treaties

If enacted, the REPO Bill would have certain effects on the tax treaty area that should be considered.

(a) Will the inverted domestic corporation enjoy any treaty benefits?

Although an inverted domestic corporation may be treated as a domestic corporation for purposes of the Code, it may not be so treated for purposes of certain U.S. tax treaties, many of which define a United States corporation potentially eligible for treaty benefits as an entity incorporated under the laws of the United States, a state or the District of Columbia.[93] This loss of treaty qualification may not be a practical problem,

[93] For example, under Article 4(1) of the U.K.-U.S. Income Tax Treaty, the term "resident" is defined differently for each contracting state. With respect to the U.K., a corporation will be treated as a resident of the U.K. if its "business is managed and controlled in the United Kingdom". With respect to the U.S., a corporation is a resident of the U.S. only if it is a "United States corporation." For purposes of this treaty, the term "United States corporation" is defined in Article 3(1)(b)(i) as, "a corporation (or any incorporated entity treated as a corporation for United States tax purposes) which is *created or organized* under the laws of the United States or any state thereof or the District of Columbia . . ." (emphasis added). The Treasury Department Technical Explanation on Article 4 further provides that, "A foreign corporation, regardless of the extent to which its income is effectively connected with the conduct of a United States trade or business, is not a resident of the United States."

as many such corporations will presumably shrug their paper shoulders and reincorporate back to Delaware or Connecticut, but it does seem an unfair result.

(b) Treaty overrides

The REPO Bill is clearly intended to override treaties in at least certain aspects (otherwise, given the Barbados treaty, it would not accomplish much). The imposition of the pre-approval rules for intercompany transactions may also violate the non-discrimination provision of certain treaties. The issue of unilateral treaty overrides needs to be carefully considered as part of overall U.S. tax treaty and tax policy.

In this connection, the history of Section 269B of the Code is illuminating. Like the anti-inversion rules, it was directed at a perceived abusive evasion of U.S. tax jurisdiction. It generally overrode treaties and was generally retroactive (with a delayed effective date and some protection of treaty-qualified entities).

4. Special problems of the pre-approval process

Under the REPO Bill, a corporation subject to the "limited" inversion rules is required to enter into an annual pre-approval agreement with the IRS for the applicable period. A pre-approval agreement means a pre-filing, advance pricing, or other agreement specified by the IRS which is entered into at such time as may be specified by the IRS, and contains such provisions as the IRS determines necessary to ensure that the requirements of Sections 163(j), 267(a)(3), 482, and 845, and any other Code provision applicable to transactions between related persons and specified by the IRS, are met.[94] The ostensible purpose of the procedure is to ensure that there will be no

[94] If the corporation fails to meet the pre-approval agreement requirement for any taxable year, then for such taxable year (1) there shall not be allowed any deduction, or addition to basis or cost of goods sold, for amounts paid or incurred, or losses incurred, by reason of a transaction between the acquired

inappropriate base erosion. We have a number of concerns with how these procedures will operate in practice.

First, we are concerned that the scope and content of the pre-approval agreements will be totally within IRS discretion. We would suggest some more objective standards in connection with the delineation of the form and content of any such agreement. These standards could be set forth in the statute, included in the legislative history or, alternatively, the legislation might mandate the timely issuance of regulations or administrative guidance setting forth appropriate standards.

Second, the REPO Bill contains no guidance in the circumstances where the taxpayer and the IRS cannot reach an agreement or the time period in which the IRS must decide whether to enter into an agreement. Similar to the advance pricing agreement program, we suggest that time frames be established with reference as to when the agreement has to be filed and benchmarks for its completion. In that regard, we would reference the experience with other similar type arrangements involving the ruling requirements under the individual expatriation provisions Notice 97-19, 1997-1 C.B. 394, where the IRS had to make a similar type of determination. Initially, there was the requirement that the IRS decide whether the individual expatriated primarily for U.S. tax avoidance purposes. That proved quite difficult and consideration of the initial rulings under Notice 97-19 remained outstanding for an extended period of time. Thereafter, in Notice 98-34, 1998-2 C.B. 29, the IRS modified its policy to the effect that if the taxpayer filed a complete ruling, then the expatriation presumption was rebutted,

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entity and a foreign related person, (2) any transfer or license of intangibles between the acquired entity and a foreign related person shall be disregarded, and (3) any cost-sharing arrangement between the acquired entity and a foreign related entity shall be disregarded.

although the IRS reserved the right to conduct a future audit of the taxpayer's return.[95] Perhaps the solution to the pre-filing agreement should be similar to that of Notice 98-34; that is, if a taxpayer files a true and complete request, the taxpayer will be deemed to have complied with this requirement. In that case, the IRS still could audit the taxpayer in the future.

Additionally, by reference to experiences in the advance pricing agreement area, we remain concerned about the proposed pre-approval process and who will be in charge and can make decisions.[96] These requests most likely will relate to many more transactions than in a typical APA, will require significant effort to prepare, and may lead to extended negotiations with the relevant IRS participants.

Finally, we are concerned with staffing and funding. The APA Office and Competent Authority recently have expanded their staffs to cope with the increasing workload. We are concerned about whether these offices will be able to process this new workload, particularly if these pre-approval agreements are bilateral rather than unilateral. We do not see how these agreements should or could be unilateral, particularly in the case of related-party transactions with foreign corporations that are

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95 Similarly, when under the Netherlands-U.S. Income Tax Treaty, the Competent Authority was given the authority to rule on limitation on benefits cases where a treaty resident did not otherwise satisfy the objective treaty standards, the initial ruling took a long period of time. As a result of experience, the Competent Authority now has developed an internal checklist of information that it plans to publish soon in the Internal Revenue Manual.

96 With regard to APAs, the Advance Pricing Agreement Office has the authority with respect to APAs that are prospective even though the IRS field office is involved in the process. However, if there is a "rollback" to a prior year, the field office ostensibly has the final approval. If there is a bilateral APA, the initial negotiations are with the APA Office, and that Office prepares a suggested negotiating position for the Competent Authority, which has authority over the bilateral negotiations. The APA Office is situated within Associate Chief Counsel (International) while the Competent Authority is within the Large and Mid-Size Business Division. Query, where this pre-approval process will be situated?

resident in jurisdictions that have entered into bilateral U.S. income tax treaties. We suggest that, if this pre-filing agreement process is incorporated, Congress make additional appropriations to enable the IRS to make the additions to staff necessary to process these agreements.

5. Taxation of inversion transaction itself

The REPO Bill appears to have a very different impact on the transaction taxation of a "pure" inversion, on the one hand, and a "limited" inversion, on the other.

(a) Pure inversion

In a "pure" inversion the foreign acquiring corporation is treated as a domestic corporation for all U.S. tax purposes, including income, gift and estate tax purposes, following the pattern of Section 269B of the Code. Based on the foregoing characterization, it would appear that any tax that might have been imposed by reason of Section 367 and the regulations thereunder at the shareholder or corporate level on the basis of an exchange of shares with a foreign corporation or a disposition of assets to a foreign corporation should not be imposed. We would suggest that the legislation clearly confirm this non-taxation result. Although this result seems relatively clear as a technical matter, an explicit statement to that effect in the Committee reports may be helpful.

(b) Limited inversions

As noted above, in the case of a "limited" inversion the REPO Bill requires that all gains realized in the transaction must be realized and taxed without the benefit of any deductions or credits. Many of us question whether this draconian measure, which has few parallels in the Code,[97] is warranted. The response may be that at least two inversion transactions may have gone forward in structures where full corporate gain was recognized (but presumably substantially sheltered), and that this result is politically intolerable. Even if so, it seems particularly harsh to deny the corporation the use of Section 902 credits generated by a Section 1248 dividend to shelter tax on that very dividend (or at least the portion of that dividend that is attributable to the accompanying Section 78 gross-up).[98]

C. Recommendation

1. "Pure" inversions

As discussed above, we believe that the current wave of inversion transactions should be stopped and that legislation is the way to do so. A majority of us believe that, at least in the short-term, the Baucus/Grassley approach with respect to "pure" inversions, with the changes and corrections discussed above, should be enacted quickly to do this. A significant number of us, however, are unsure whether the Baucus/Grassley approach is the best long-term solution to the problem, and thus a majority of us also feel that this legislation should have a three-year sunset in order to give Congress and the Treasury sufficient time to consider whether there may be a preferable long-term solution.[99]

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97 A similar concept appears in Section 860E of the Code which effectively provides that certain income inclusions by a REMIC cannot be offset by other tax attributes.

98 Of course, the inverting corporation may avoid the Section 78 gross-up by electing to deduct foreign taxes for the taxable year, but this may result in inappropriate double taxation of other transactions during its tax year that are not inversion-related.

99 A similar temporary approach appears in H.R. 4756, introduced on May 16, 2002 by Representative Nancy Johnson.

Many of us feel that the "real" problem of inversions is that they are tax-driven transactions through which nothing changes in a true business sense, and that these companies are still "really" United States companies that should be taxed accordingly. If this is the real problem, it may make sense, as a long-term solution, to change the definition of a domestic corporation, which now looks entirely to the laws under which a corporation is formed, and supplement it by providing that a corporation will also be treated as a domestic corporation based on its substantive business contacts, such as where it is truly headquartered, or its senior management are based, or some other "mind and management/managed and controlled" concept. Many of our trading partners use this concept in their tax systems. However, it would be a sea change in United States corporate taxation, the implications of which should be studied thoroughly before it is enacted.

Others feel that the problems lie in the particular areas of the U.S. tax system on which the inversion transactions appear to be focused, and that the problems should be addressed in the long term by reforming those areas – perhaps by moving closer to a territorial system for foreign source income on the one hand, and tightening the rules on earnings stripping on the other, not just for inverting companies but also for other companies that are similarly situated. Re-examination of certain treaties may also be indicated.

Another view might be that the barrier/toll charge should be more of an impediment, but that at some cost a corporation should be permitted to exit the U.S. tax system. One possibility would be full corporate and shareholder gain recognition (e.g., a "clean slate" approach). And, of course, after study, it may turn out that Congress concludes Baucus/Grassley is the best available alternative not only for the short term, but also for the long term.

2. **"<u>Limited" inversions</u>**

We are far more concerned about the "limited" inversion branch of the Baucus/Grassley bill. Most of us question whether the advance approval procedures could ever be administrable (even though we would support a well-publicized and financed audit initiative by the IRS of the transfer pricing practices of these companies). We are also concerned that imposing extraordinary remedies at the lower end of the 50%-80% scale frequently will not be appropriate and that considerations should be given to raising the minimum threshold from 50% to 60% to reduce the number of legitimate mergers and acquisition transactions caught in their grasp. Finally, with that change, a different approach altogether may be preferable. One proposal might be to provide that a "limited" inversion transaction be faced with an election to be treated as a "pure" inversion (i.e., as a domestic corporation) or otherwise be subject to a significant toll charge (e.g., full recognition of corporate and shareholder gain, although we would propose in this case to allow the corporation to utilize all available tax attributes). It might also be advisable to grant the IRS authority to issue rulings exempting transactions from the "limited" inversion rules if it finds that the transactions are not tax motivated.[100] We believe that this area requires further study and that, perhaps, it should be severed from the "pure" inversion portion of the bill, which we believe should be on a fast track.

[100] A similar ruling procedure is currently provided for in Treas. Reg. § 1.367(a)-3(c)(9).

V. BROADER REFORMS

If Congress decides to enact the REPO Bill or similar legislation with the intention of stopping the current wave of inversion transactions in its tracks (and seeking to ensure that companies that beat the effective date (currently March 20, 2002) do not benefit very much because of the various burdens added by the "limited" inversion rules), we do not believe that this should be the end of the story. Rather, we believe that it is critical that Congress examine the broader issues that the inversion phenomenon raises, including whether our system of taxation of inbound and outbound investment makes sense in today's global economy or whether the United States should move to some type of territorial system, and whether the existing protections on base erosion generally are adequate. Indeed, Treasury has called for a "comprehensive reexamination of the U.S. international tax rules," adding that it is "appropriate to question the fundamental assumptions underlying the current system."[101]

A. Re-Examine Taxation of Outbound Investment

There are serious questions whether our existing Subpart F rules and our existing foreign tax credit system are providing desirable results.[102] Both are complex (more so, we believe, than that of any other country) and the intricacies of the basketing, interest and expense allocation and other rules sometimes may seem as if they had been designed to make sure that taxpayers do not get a credit that provides sufficient relief against double taxation. More complex issues of economic policy arise on the issue of

[101] Treasury Inversions Report, at L-17.

[102] Our current system of worldwide taxation leavened by some measure of deferral does, however, have its defenders.

whether a credit (as opposed to an exclusion) system is the right policy when applied to operating earnings earned in a jurisdiction whose effective tax rates are simply lower than our own, with the result that repatriation under any credit system would result in a home country repatriation tax. At the other end of the spectrum, few of us would vigorously advocate a pure territorial system that provides exclusion for passive income earned by an entity appropriately viewed as a U.S. taxpayer. Some middle ground (limited territoriality or an improved credit system) may be appropriate.

Any such proposal, of course, raises the question of what entities should be viewed as U.S. taxpayers. The point has been made over and over again that the Bermuda corporation created in many inversion transactions is just a piece of paper in a file cabinet that involves the payment of relatively incidental sums to the jurisdiction of incorporation. This argument proves a bit too much – the same point can be made about the relationship of many Delaware corporations to the state of Delaware. We ought to examine whether corporate residence for U.S. tax purposes should be based solely on place of incorporation, or whether U.S. residency should also be found under a more facts and circumstances test such as applies under the laws of many of our trading partners. One problem with this approach is that if tax incidence turns on something that is easy to measure (e.g., location of board meetings), it is easy to plan around, and if it depends on a larger constellation of facts and circumstances, it is difficult to apply.

B. Restrict Base Erosion for All Taxpayers

Congress has repeatedly enacted legislation specifically targeted at various base-eroding techniques utilized in the inbound investment context, including rules intended to prevent abuse in the areas of transfer pricing,[103] earnings stripping,[104] dual consolidated losses,[105] conduit financing transactions,[106] certain outbound transfers of property,[107] timing of deductions for certain payments to related foreign persons,[108] and foreign-owned hybrid entities.[109] Furthermore, U.S. tax treaty policy has evolved to focus significantly on efforts designed to prevent the use of U.S. tax treaties to facilitate transactions that erode the U.S. tax base, including efforts to negotiate comprehensive limitation on benefits provisions in all U.S. tax treaties. Despite these efforts, some remain concerned that foreign-owned U.S. companies, by exploiting weaknesses in the existing rules designed to curb base erosion, are able to reduce significantly their U.S. tax liabilities relative to their U.S.-owned counterparts.

The REPO Bill would, in certain cases, impose stricter earnings stripping rules on corporations within its scope than on other corporations. It is difficult to see why this should be the case. If, for example, the tightening of section 163(j) proposed for "limited" inversion transactions is appropriate in that setting, maybe it is appropriate across the board.[110] We believe that this should receive serious consideration.[111]

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[103] See Section 482.

[104] See Section 163(j).

[105] See Section 1503(d)(c) .

[106] See Section 7701(l).

[107] See Sections 367(a) and 367(d).

[108] See Sections 163(e)(3) and 267(a)(3).

[109] See Section 894.

[110] In this regard, see Treasury Inversions Report suggesting potential reforms to section 163(j), at L-13, L-14.

[111] At the same time, we caution that tighter earnings stripping rules may not be appropriate where taxes paid in the home country are significant. We also question whether the tightened earnings stripping rules would be appropriate where Section 163(j) applies by reason of a parent guaranty.

Section 482 raises more difficult and complex questions. So long as we and our trading partners seek to apply an arms-length standard, enforcement is inherently complex and cumbersome. We suspect that the across the board pre-approval rules that would apply to "limited" inversions are intended in large part as deterrents to future "limited" inversions and punishments for those whose inversions are classified as "limited" based solely on effective date grounds. We do not believe that it is practical to expand this regime to all taxpayers that are part of larger groups that include non-U.S., non-CFC members. Perhaps a more limited pre-approval process could apply to certain major items (perhaps with the escape valve of certain formulary safe harbors), but this raises a myriad of issues of equity and administrability. A more radical system of formulary apportionment would be more administrable, but cannot realistically be adopted by the United States unilaterally. A detailed review of worldwide transfer pricing issues is, obviously, beyond the scope of this report.

C. Residency Determined By "Mind and Management"

The complaints about inverted corporations remaining in effect "U.S. companies" in an operational and business sense post-inversion suggest that there may be a problem with the current definition of a domestic corporation under Section 7701(a)(3). Only domestic corporations are subject to U.S. tax on a worldwide income basis. Section 7701(a) currently defines domestic corporations by reference to place of incorporation. Other jurisdictions, such as the U.K., determine corporate residency by reference to place of management and control regardless of organizing jurisdiction. It has been suggested that adoption of a similar standard for U.S. Federal tax purposes may be appropriate to combat abusive inversions.[112] Under this approach, in order for an inverting corporation to escape U.S. tax jurisdiction post-inversion, it would be required to transfer substantive control and management offshore. Such an inversion appears to be much less like a classic "sham" transaction than the typical current inversion where there is only the most formal alteration of the inverting corporation's business.

We believe that this alternative merits serious consideration and study, and we would not limit the scope of that study to the confines of the inversions area. We note, however that adopting a "mind and management" regime for residency raises a number of issues. First, as noted above, the relevant criteria need to be carefully thought through. If too simple and administrable (e.g., location of board meetings) they may not provide an appropriate filter. If more broadly based on facts and circumstances analysis, such a regime may introduce a large element of uncertainty to residency determinations. Such uncertainty may unintentionally deter legitimate cross-border business transactions. Second, it is unclear whether such a "mind and management" regime should apply only in the case of inverting corporations or as a general rule of corporate residency. As discussed above, it may be difficult to justify distinctions based on tax policy between inverted corporations, start-ups, corporations involved in acquisitions and long-standing foreign multinationals.[113] If the problem is inversions and the similar transactions described in the preceding sentence, it may be sufficient to apply the test to the "top" corporation in a corporate group. Last, adopting a "mind and management" regime

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[112] See Brewer, supra. Note 68; Lee A. Sheppard, "News Analysis – Preventing Corporate Inversions," Tax Notes, Apr. 1, 2002, p. 29.

[113] See Part II(D)(2), supra.

would be a radical departure from long-standing U.S. tax principles of corporate residency and should be undertaken only after careful study.

D. <u>Renegotiate Treaties</u>

Recent inversion transactions appear to have made significant use of a relatively small number of treaties for a variety of purposes, including the implementation of "earnings stripping" transactions. Treasury may wish to consider whether to seek to renegotiate these treaties to eliminate benefits that may seem inappropriate in light of the recent experience in the inversions area. Indeed, Treasury has already said that, "Our tax treaties should be evaluated to identify any inappropriate reduction in U.S. withholding tax that provide earnings stripping opportunities."[114] In addition to considering particular benefits (e.g., the significant reduction or elimination of U.S. tax on U.S. source income that is not subject to significant "home country" taxation), Treasury may wish to consider whether it is truly appropriate for the limitation of benefits articles of those treaties to include (as is typical) an exception for corporations whose stock is publicly traded in the United States (as opposed to, say, corporations that are residents of the United States for United States Federal income tax purposes *and* are publicly traded in the United States).

E. <u>Taxation of "Tail"/ "Hook" Stock</u>

Finally, a number of recent inversion transactions involve the use of "tail" or "hook" shares, which we understand are generally used to effect "stripping" transactions. For example, these shares of typically nonvoting stock of the new parent

[114] Treasury Inversions Report, at L-14.

stock may be issued in exchange for an intercompany note of the U.S. corporation or shares of stock of its former non-U.S. subsidiaries. As noted above, some commentators have suggested that the issuance of parent stock to a subsidiary that the subsidiary retains may be properly viewed as giving rise to a deemed dividend, and in the outbound context it is sometimes so treated by statute.[115] Congress may wish to consider similar legislation in the inversion or broader inbound context.

[115] Section 956.

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