CORPORATE INVERSION TRANSACTIONS: TAX PLANNING AS TREASON OR A CASE FOR REFORM?

Authors
Robert Rinninsland
Cheryl Magat

Tags
Corporate Tax
Inversion Transactions

INTRODUCTION

> Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury. There is not even a patriotic duty to increase one's taxes.
>
> – Judge Learned Hand
> *Helvering v. Gregory*, 69 F.2d 809, 810-11 (2d Cir. 1934).

To invert or not to invert: That seems to be the question many U.S. corporations are deliberating today, particularly in the context of acquisitions of non-U.S. businesses. Although the level of the political and public outcry on the "evils" of inversion transactions is a recent phenomenon, inversion transactions are not new to the U.S. business community. This article provides a perspective on the issue of U.S. companies incorporating in other jurisdictions by means of inversion transactions. It will discuss the historical context, the legislative and regulatory responses, and current events including proposed legislative developments as of the date of publication. Finally, we will offer our suggestions for a reasonable approach to the inversion issue designed to balance the governmental and the private sector concerns.

INVERSIONS: DEFINITION AND HISTORY

What is an Inversion?

An inversion transaction is a tax-motivated corporate restructuring of a U.S.-based multinational corporation or partnership in which the U.S. parent corporation or U.S. partnership is replaced by a foreign corporation, partnership, or other entity, thereby converting the U.S. entity into a foreign-based entity. In a "self-inversion," the U.S. entity effects an internal reorganization by re-domiciling in another jurisdiction. In an "acquisition-inversion," a U.S. entity migrates to a foreign jurisdiction in connection with the purchase of a foreign-incorporated M&A target corporation. In this latter type of inversion, the target and the U.S. entity often can be combined under a new holding company in a lower-tax foreign jurisdiction.

Stock Transaction/Asset Transaction

Inversion transactions take the form of stock or asset transactions.

In a stock transaction, shareholders of a publicly held U.S. corporation may exchange their shares for shares of a newly-created foreign subsidiary, incorporated in a tax haven such as Bermuda, in a stock-for-stock B-reorganization under Code §368 (a)(1)(B) or in a reverse subsidiary merger under Code §368 (a)(2)(E), with the U.S. parent surviving as a subsidiary of the foreign corporation. Foreign subsidiaries of the U.S. company would be transferred either before the transaction or as a post-transaction restructuring.

In an asset transaction, the U.S. company would transfer assets to the foreign corporation under Code §361(a) in return for shares of the foreign corporation's stock and the foreign corporation's assumption of the U.S. company's liabilities. The U.S. company would then transfer shares of the foreign corporation's stock to its shareholders in return for the shareholders' U.S. company stock, and the U.S. company's shareholders would exchange their U.S. company stock in return for the foreign corporation stock under Code §354(a).

History of Inversion Transactions

The first well-known inversion transaction was the McDermott International self-inversion to Panama in 1983, which prompted the 1984 enactment of Code §1248(i). Code §1248(i) imposes a §1248 tax, usually associated with sales of C.F.C.'s, to outbound transfers of stock in domestic U.S. companies where these transfers had the same substantive effect. Code §1248(i) creates a deemed distribution by the domestic corporation of the foreign stock received in the self-inversion, by treating the domestic corporation as having received and then distributed the stock of the foreign corporation that is received by the shareholders as part of the exchange. The deemed distribution is considered made in a redemption or liquidation of the domestic corporation, whichever is appropriate.

Changes to the U.S. Subpart F anti-deferral tax regime made by the Tax Reform Act of 1986 both expanded Subpart F and restricted use of foreign tax credits to offset U.S. tax on Subpart F income. As a result, U.S. multinational companies had legitimate concerns regarding double taxation of income resulting from restrictions placed on the foreign tax credit. From a U.S. corporate perspective, increased exposure of non-U.S. operations to the U.S. tax regime became a primary concern of management. U.S. companies analyzed and identified the benefits of an inversion transaction as:

- Removal of foreign subsidiaries from the U.S. Subpart F rules;
- Elimination of international double taxation caused by the interaction of the U.S. interest allocation rules and the U.S. foreign tax credit; and
- Increased flexibility in shifting risks and functions to more tax favorable environments.

Accordingly, some publicly held U.S. corporations acted on plans to transform to a subsidiary of an existing foreign subsidiary. Because of its new, *public* ownership, the former foreign subsidiary would not be a controlled foreign corporation.

The first such post 1986 Tax Reform Act stock inversion transaction was consummated in February of 1994 by Helen of Troy. Subsequent inversion transactions involved such companies as Stanley Works, Ingersoll-Rand, Tyco International, and Cooper Industries.

These transactions were primarily tax-driven and were publicized as such. The normal profile for an inversion company was a company with:

- Intellectual property that was under current or continuous development;

- Substantial foreign operations or with plans to effect substantial foreign acquisitions;

- Low-taxed foreign source earnings; and

- U.S.-sourced taxable income that could offset interest expense.

A company fitting this profile could see a dramatic decrease in its worldwide effective tax rate as a result of avoiding U.S. tax on low-tax foreign earnings and a reduction in U.S. tax from non-U.S. based financing of U.S. operations.

The post-inversion tax savings from an inversion transaction would generally be subjects to an upfront tax cost. The I.R.S. applied outbound taxation principles to the stock inversion transactions under Code §367(a). Under Code §367(a), gain, but not loss, is recognized on an outbound transfer of stock or assets except to the extent provided in regulations. However, corporations with sufficient tax attributes, such as net operating losses, could undertake inversion transactions without incremental U.S. tax cost. Alternatively, inversions could be structured to trigger shareholder level gain recognition in periods when the stock price was depressed, thereby minimizing the tax cost. Finally, "tax neutral" shareholders of U.S. companies, such as pension funds and tax-exempt entities, were ambivalent to any potential application of Code §367(a) outbound provisions.

The Treasury issued a special report on inversion transactions in May of 2002, ("the Report").[60] The Report was issued within the backdrop of an increase in inversion transactions subsequent to the fall in the stock market in 2001. The Report noted the increase in inversion transactions resulted in part from depressed market conditions that reduced exposure to upfront gain. The Report stated that the ability to realize substantial reduction in tax through a transaction that is complicated technically but virtually transparent operationally is cause for concern as a matter of tax policy.[61]

Pamela Olsen, the Acting Secretary of Treasury for Tax Policy at the time, testified before the House Ways and Means Committee on Inversions in June of 2002. She referenced the U.S. Treasury Report and made several proposals for tax legislation designed to address not only inversion transactions themselves, but the underlying defects in the U.S. international tax system that may have resulted in this form of

---

[60] *Corporate Inversion Transactions-Tax Policy Implications*, Office of Tax Policy, Department of Treasury.

[61] The Report, p. 3.

corporate self-help. Most importantly, she cautioned against a "knee jerk" response to the inversion issue. She stated that:

> A narrow policy response to the inversion phenomenon may inadvertently result in a tax code favoring the acquisition of US operations by foreign corporations and the expansion of foreign controlled operations in the United States at the expense of domestically managed corporations. In turn, other decisions affecting the location of new investment, choice of suppliers, and employment opportunities may be adversely affected. While the openness of the US economy has always made – and will continue to make – the United States one of the most attractive and hospitable locations for foreign investment in the world, there is no merit in policies biased against domestic control and domestic management of US operations.[62]

Code §7874, effective for taxable years ending after March 4, 2003, was added by Section 801 of the American Jobs Creation Act of 2004. The legislative history of Code §7874 indicates that its basic thrust was inversion transactions in which a U.S. parent corporation of a multinational corporate group is replaced by a foreign entity while the existing shareholder group remains in control.[63]

In that regard, Congress specifically identified certain transactions that were to be subject to an ant-abuse rule. Thus, for example, a special rule was included for public offerings. Under the rule, the shares held by the public after the offering are disregarded in determining whether the ownership thresholds are met so that the anti-inversion rules apply. The Senate Finance Committee proposed a similar treatment for shareholders that invest in the foreign corporation as part of a private placement in which cash is invested.[64] However, this view was not incorporated in the final bill.[65] That position was rejected in conference when the legislation was adopted. It was not part of the House bill, and was not part of the bill that was adopted in the Senate-House Conference. The Statement of Managers to the Conference Report stated that the difference in the two bills was resolved when the House version prevailed. Although no reason was given for that result, there is no doubt that Congress rejected the Senate approach that all or most new cash investors had to be disregarded in determining the ownership thresholds for application of Code §7874.

However, Congress specifically included a broad grant of authority for the Treasury Department to issue regulations to attack avoidance schemes designed to circumvent the general rule Code §7874. These regulations were authorized to:

---

[62] Pamela Olsen, Acting Assistant Secretary to the Treasury (Tax Policy)- Statement before the House Ways and Means Committee on Inversions, June 6, 2002.

[63] See H.R. Conf. Rep. No. 108755, 108th Cong., 2d Sess., at 568 (Oct. 7, 2004). These transactions were in effect those which were publicized and highlighted in the Treasury report and Ms. Olsen's testimony.

[64] *Id*., at 571.

[65] *Id*., at 573 et seq. The Conference committed followed the House version with Senate amendment with modifications.

> * * * prevent the avoidance of the purposes of the provision, including avoidance through the use of related persons, pass-through or other non-corporate entities, or other intermediaries, and through transactions designed to qualify or disqualify a person as a related person or a member of an expanded affiliated group. Similarly, the Treasury Secretary is granted authority to treat certain non-stock instruments as stock, and certain stock as not stock, where necessary to carry out the purposes of the provision.[66]

Congress also intended to address partnership transactions in addition to stock transaction. To that end Code §7874 was to apply to:

> * * * transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership, if after the acquisition at least 60 percent of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), provided that the other terms of the basic definition are met.[67]

Congress clarified that:

> For purposes of applying this test, all partnerships that are under common control within the meaning of Code § 482 are treated as one partnership, except as provided otherwise in regulations. In addition, the modified ‘‘toll charge’’ provisions apply at the partner level.[68]

LEGISLATIVE AND REGULATORY SCHEME

In General

The resulting legislative and regulatory scheme in the anti-inversion provisions of U.S. tax law, are meant to address perceived tax abuses resulting from the transfer the stock or assets of a U.S. business to an entity outside U.S. tax jurisdiction primarily for the benefit of shareholders or members. Where a transaction falls within the scope of these provisions, either the inverted U.S. entity will have to report the amount of inversion gain or the foreign entity will be characterized as a surrogate U.S. corporation.[69] A surrogate U.S. corporation is treated as if it were a U.S. domestic corporation and is taxed as such by the U.S. As an offset, the

---

66 *Id.*, at 570.

67 *Id.*

68 *Id.*

69 Code §7874(d)(2) defines inversion gain in terms of income or gain resulting from the transfer of stock or assets abroad and related licensing income for a period of ten years after the transfer. This would essentially attribute all such licensing income from overseas business operations back to the U.S. regardless of how earned. Inversion gain of partnerships is reported at the partner level.

inversion gain is not taxed in the U.S. when the business or shares are transferred to a surrogate U.S. corporation.

The law provides that a foreign corporation is a surrogate U.S. corporation if the shareholders of the transferor U.S. corporation end up owning more than 80% of the stock of the foreign corporation by reason of their stock ownership of the domestic corporation whose stock or assets are acquired directly or indirectly by the foreign corporation at issue. Alternatively, it applies if substantially all of the business assets of a U.S. corporation are transferred to a foreign corporation and as a result, the 80% test is met. With respect to partnerships, the same result will apply if substantially all of the partnership's U.S. trade or business assets have been transferred to a foreign corporation and the U.S. partners hold 80% of the stock of the foreign corporation by reason of their partnership interests.

The anti-inversion rules apply if three basic conditions are satisfied:

- After March 4, 2003, the foreign corporation completes the direct or indirect acquisition of substantially all of the properties held by a domestic corporation;[70]
- After the acquisition, at least 60% of the stock by vote or value of the entity is held by former shareholders, partners or members of the domestic corporation by reason of holding stock or interests in the domestic corporation;[71] and
- After the acquisition the expanded affiliate group that includes the foreign corporation does not have substantial business activities in the foreign country in which, or under the law of which, the foreign corporation is created or organized, when compared to the total business activities of the expanded affiliated group.[72]

Stock of the foreign corporation held by members of the expanded affiliated group including the foreign corporation is disregarded in determining whether the vote and value condition is satisfied.[73] In addition, stock of the foreign corporation sold in a public offering related to the acquisition is disregarded for purposes of the ownership test.[74] Finally, the I.R.S. is granted broad authority to address abusive situations structured to avoid application of Code §7874.

An expatriated entity is a domestic corporation or partnership with respect to which a foreign corporation is a surrogate U.S. corporation. Also covered is any U.S. person related (within the meaning of Code §§267(b) or 707(b)(1)) to such domestic corporation or partnership.[75]

---

70 Code §7874(a)(2)(B)(i)'s "acquisition condition."
71 Code §7874(a)(2)(B)(ii)(I)'s "vote and value condition."
72 Code §7874(a)(2)(B)(iii) "active trade or business condition."
73 Code §7874(c)(2)(A).
74 Code §7874(c)(2)(B).
75 Code §7874(a)(2)(A).

When the three conditions described above are met, a foreign corporation is treated as a surrogate U.S. corporation. Note that in applying the test related to business activities, the test is applied by reference to activities of the expanded affiliated group ("E.A.G.").[76] The E.A.G. is an affiliated group defined in Code §1504(a), but without regard to the exclusion of foreign corporations[77] and with a reduction of the 80% ownership threshold of Code §1504(a) to a more-than-50% ownership threshold.[78]

If only a 60% threshold of common ownership is achieved, the foreign corporation is referred to as a surrogate foreign corporation. The transfer of assets to the surrogate foreign corporation triggers gain, and subsequent fees for the license of intangible property by the surrogate foreign corporation are subject to U.S. tax. Neither the gain nor the licensing income can be reduced by net operating loss carryovers or foreign tax credits. This treatment applies from the first date properties are acquired pursuant to the plan through the end of the ten-year period following the completion of the acquisition.

<u>Notice 2009-78</u>

In Notice 2009-78, the I.R.S. expressed concern about transactions that escaped characterization as an inversion because of shares of stock issued to moneyed investors for cash or marketable securities. The I.R.S. became aware that investment banks and private equity firms could create a financial product by having clients join in an inversion transaction, contributing cash or marketable securities to the foreign entity and preventing the 80% threshold from being met. The securities or cash might be segregated to be available for redemption at an agreed upon time. Fees would be paid. To prevent that result, the I.R.S. announced that in regulations to be drafted which would be effective for transactions completed as of September 17, 2009 or later, shares of stock in a foreign corporation issued for cash or marketable securities would, subject to certain unnamed exceptions, be removed from consideration in determining whether the shareholders or members of the domestic entity own more than 80% of the foreign corporation to which substantially all of the assets are transferred.

On January 16, 2014, temporary regulations were issued as a follow up to Notice 2009-78. These regulations offer a new *de minimis* exception to allow some continued participation by former shareholders (or partners) of the U.S entity. For those who can qualify, the *de minimis* exception offers a previously unavailable option to allow some continuing involvement (up to 5%) by the former shareholders without triggering the inversion rules. This will allow a foreign corporate acquiror to acquire a U.S. corporation or U.S. partnership for cash consideration while allowing management or other shareholders to roll-over into an equity interest in the foreign corporate acquiror without having it deemed a U.S. corporation. The *de minimis* exclusion applies where:

---

[76] Code §7874(a)(2)(B).
[77] Code §1504(b)(3)
[78] Code §7874(c)(1) .

- The ownership fraction determined without regard to the Exclusion Rule is less than 5% (by vote and value);

- After the acquisition and all transactions related to the acquisition, former shareholders of the U.S. corporation, in the aggregate, own directly or indirectly less than 5% (by vote and value) of the stock of any member of the expanded affiliated group that includes the foreign corporation; and

- Stock of the foreign corporation that would otherwise be excluded from the denominator of the ownership fraction was not transferred in a transaction related to the acquisition with a principal purpose of avoiding the purposes of Code §7874.

However, these regulations also expanded the scope of Notice 2009-78 by describing all situations in which stock will be excluded from the denominator of the ownership fraction and expanded the definition of nonqualified property for purposes of the exclusion rule to include certain obligations. To the extent such transfers increase the fair market value of the assets or decrease the amount of liabilities of the foreign corporation, regulations exclude the following from the ownership fraction:

- Stock of the foreign acquiror transferred to any person (including the U.S. corporation) in exchange for property to the extent, pursuant to the same plan (or series of related transactions), the stock is subsequently transferred in exchange for the satisfaction or the assumption of an obligation associated with the property exchanged; and

- Any stock of the foreign acquiror transferred in exchange for nonqualified property by any person (including an unrelated person) in connection with the potential inversion transaction.

These regulations are generally effective for transactions occurring on or after September 17, 2009 for matters addressed in Notice 2009-78, and on or after January 16, 2014 for matters not covered in Notice 2009-78 unless the taxpayer elects otherwise.

Temporary Regulations

On June 7, 2012, the I.R.S. issued temporary regulations[79] establishing a bright-line rule for the substantial business activities exception. An entity's expanded affiliated group will have substantial business activities in the foreign country of incorporation if the following tests are met regarding activities in the foreign country:

- 25% of the group's employees (by headcount and compensation during the twelve-month period preceding the inversion);

---

[79] Reg. §1.7874-3T.

- 25% of the group's active assets (tangible personal property and real property used or held in the active conduct of a trade or business; property the group rents is assigned a value equal to eight times its annual rent); and

- 25% of the group's gross income from unrelated customers and received in the ordinary course of business.

Under the temporary regulations, if one or more members of the expanded affiliated group hold, in the aggregate, more than 50% (by value) of the interests in a partnership, that partnership's items shall be taken into account in these calculations. Other U.S. tax rules, such as Code §367, net operating loss, and foreign tax credit carryover suspensions, continue to apply.

CURRENT EVENTS

Political and business news regarding inversion transactions is almost a daily occurrence. The more significant recent developments are summarized below.

Congressional Action

There is a growing Congressional frustration with large U.S. companies partaking in inversion transactions, but it remains unclear when lawmakers will act to prevent these deals or diminish their tax benefits.

Six House and Senate Democrats called on the Obama administration to deny federal contracts to companies that have moved their headquarters offshore for tax purposes. A letter to President Obama, signed by Reps. Rosa DeLauro (D-Conn.), Lloyd Doggett (D-Texas), and Sander Levin (D-Mich.), and Sens. Carl Levin (D-Mich.), Dick Durbin (D-Ill.) and Jack Reed (D-R.I.), said that companies enjoy the infrastructure provided by U.S. taxes, but manage to avoid contributing their share toward paying for them. They say, "When the tax bill comes due, they renounce their citizenship. But, perhaps even more outrageously, they also seek, and win, taxpayer-funded federal contracts from the same country they renounced." The lawmakers expressed support for the No Federal Contracts for Corporate Deserters Act (H.R. 5278, S. 2704), legislation that was introduced on July 30, that would tighten restrictions on corporate inversions. Those bills remain in committee.

On August 14, Senator Charles E. Schumer (D-N.Y.) offered a proposal to curb earnings stripping. Schumer said in a news release, "We cannot stand idly by while corporate deserters abuse and avoid the U.S. tax system." The Schumer proposal was introduced formally as an anti-inversion bill on September 10, 2014. The proposal includes:

- Repealing the debt-to-equity safe harbor such that limitations on the interest deduction apply to all inverted corporations, regardless of financial leverage;

- Reducing the allowed net interest expense from 50% to no more than 25% of the subsidiary's adjusted income;

- Repealing the interest expense deduction carry-forward and excess limitation carry-forward such that inverters would be unable to take advantage of the deduction in the future; and

- Requiring the U.S. subsidiary to obtain yearly preapproval from the I.R.S. on the terms of its related-party transactions for ten years immediately following an inversion.

Similar proposals have been introduced by other members of the House and Senate, including tightening the existing anti-inversion regime under Code §7874 (the earnings-stripping rules) and tightening exceptions to Subpart F rules

Executive Branch Considerations

"While most of the discussion on executive action has focused on earnings stripping, other possible avenues have been considered, including the possibility of attacking fact patterns where 'substantial business operations' do not exist in the country of tax residence."

While most of the discussion on executive action has focused on earnings stripping, other possible avenues have been considered, including the possibility of attacking fact patterns where "substantial business operations" do not exist in the country of tax residence. This approach will not address an inversion that is part of an M&A transaction, which covers the majority of the most recent inversion transactions. These inversions typically have less than 60% of the former U.S. parent's shareholders as owners of the new company and also have substantial activities in the country of tax residence.

President Obama has announced consideration of a plan to bypass Congress and act on corporate inversions unilaterally. Stephen Shay, currently a professor of tax law at Harvard Law School and previously a Treasury Department official, has stated that the Administration could use Code §385 as a way to curb the earnings stripping that often accompanies corporate inversions. Code §385 gives the Treasury the power to designate an instrument issued by a corporation as debt or equity. Other tax experts are skeptical of this approach, believing that Code §385. Originally, the long-standing law was passed to deal with tax issues arising from domestic corporate mergers and has never been viewed as a means to fight base erosion. Still, others have suggested that the Administration could rely on older law to enact restrictions that are harsher than the earnings stripping rules.

The Business Community

Beginning in 2012, 21 U.S. companies have announced or completed inversion transactions of one kind or another, representing almost half of the 51 total such transactions in the last three decades.

One embarrassing episode for the Administration is that in 2009, when the Treasury Department bailed out the auto industry, Delphi Corp. emerge from bankruptcy as a U.K. company rather than a U.S. company. The Administration and Delphi are at odds as to whether that was intended.

On July 24, President Obama referred to companies looking to shift domicile to other countries as corporate deserters. Since then, Burger King Worldwide Inc. announced the acquisition of Tim Horton's Inc., a Canadian corporation, and a plan to establish its headquarters in Canada, where taxes are generally lower than in the U.S. on direct investment dividends.

Some announced inversion plans contain an escape provision that allows cancellation of the deal if a law is implemented that would mean the new company would be treated as a U.S. domestic corporation for tax purposes. An example is Medtronic's agreement to buy Covidien Plc, an Irish domiciled company. Medtronic has maintained that the main purpose for the deal is strategic. It will combine the two companies' complementary product lines and will free up cash generated overseas for reinvestment in the United States. Medtronic announced its expectation to invest more aggressively in the United States after the deal closes.

Other rumored potential inversions have seemingly been put on hold to see what emerges from the political debate. This most notably includes Walgreens Co., the largest U.S. drugstore, which passed on an opportunity to move its domicile to Switzerland when it bought Alliance Boots GmbH.

Avoiding Inversions

Although lawmakers are trying to determine ways to stop the inversions, there are other ways to avoid taxes by claiming a foreign address. Private equity buyout deals would be much tougher to regulate due to the fact that they involve U.S. companies that are technically sold to a foreign buyer.

At least 14 companies have left the U.S. tax system through a sale to an investment fund. In these transactions, top executives remain based in the U.S., but the companies are incorporated offshore. Companies that have used this strategy include Michael Kors Holdings, Ltd., which is now incorporated in the British Virgin Islands, and Herbalife Ltd, which operates from Los Angeles but is incorporated in the Cayman Islands. Dell Inc. considered the idea of incorporating in a foreign country, but in the end opted to remain registered in the U.S.

Rep. Sander Levin (D-Mich.) has proposed a rule that would treat certain companies as domestic after a sale to a foreign buyer if the combined company's "management and control" remain in the U.S. This rule may affect companies that undergo future buyouts. This, however, may create a different problem. Companies may move their top executives abroad as part of a leveraged buyout, taking high paying jobs as well as tax revenue out of the county.

CONCLUSION AND RECOMMEDATIONS

Inversions have been a significant catalyst in cross-border M&A activity in recent years. Consistent with the original profile of stock inversion transactions noted above, many transactions have been concentrated in industries having business models that involve offshore transfers of I.P. tailored for non-U.S. commercial markets and where gross revenues from outside the U.S. are material. The pharmaceutical industry is currently a source of many of the inversion transactions based on this profile (*e.g.*, Actavis/Warner Chilcott, Endo/Paladin, and Perrigo/Elan).

In addition, already-completed inversions can be drivers of further M&A opportunities – either by positioning the inverted company as an advantaged potential acquirer of future targets (*e.g.*, Actavis/Forest Labs) or perhaps by making the now-enlarged inverted company a target for an even larger U.S. company seeking yet another inversion.

Inversion transactions have positioned themselves at the heart of the debate on how the U.S. can tax foreign profits. Republicans advocate a new tax holiday, while the Obama administration fiercely opposes the concept, proposing instead to tax foreign profits even when not repatriated. As of the writing of this article, some type of anti-inversion legislation seems to be gaining traction in the current Congress. Whether such legislation can avoid any long-term negative economic effects, however, remains to be seen. The fact of the matter is that many U.S. companies' growth is increasingly generated abroad.

Accordingly, if enacted solely as a punitive measure, U.S. tax policy with respect to inversion transactions would only incentivize investment abroad or hoarding foreign earnings in low-tax countries. This would exacerbate the problems caused by the existing U.S. tax Code's complexity and, as argued by many, create bias against international businesses. The authors recommend consideration of one of the following approaches to the inversion issue:

1. *Reprise Code §965 with some safeguards to guarantee proper U.S.-based investment.*

Code §965 provided for a one-year dividend repatriation tax holiday. It allowed a U.S. corporate shareholder ("U.S.S.") to elect, for one tax year, to receive an 85% dividends received deduction ("D.R.D.") on qualifying dividends received from its C.F.C.'s. That allowance would generally reduce the effective tax rate on repatriated earnings to 5.25%. Qualifying dividends, as described in Code §965, were initially subject to four principal limitations (later clarified in three notices from the I.R.S.):

- Code §965(b)(1) capped the amount of the dividends eligible to the greater of $500 million or "the amount shown on the applicable financial statements as permanently invested outside the U.S."

- Code §965(b)(2) limited the D.R.D. to "extraordinary" cash dividends: those demonstrated to be in excess of the average dividends paid to the U.S. corporation by the C.F.C. Thus, only dividends that exceeded a base period amount found by taking the average of dividends and other distributions during the five years ending on June 30, 2003 could qualify. Of course, if the base amount were zero because all earning were permanently invested overseas, the base would be meaningless.

- Code §965(b)(3) reduced the amount of the eligible dividends by any increase in related-party debt. In effect, the C.F.C. was required to borrow from unrelated parties, liquidate cash equivalent securities, or use cash on hand to pay the extraordinary dividend. The U.S.S. could not borrow to fund the dividend of its foreign subsidiaries.

- Code §965(b)(4) created the most controversial and flexible limitation in the dividends qualifying for the D.R.D. This stipulation required that the U.S.S. claiming the D.R.D. invest the full amount of the dividend in the United States, in accordance with a domestic reinvestment plan ("D.R.I.P.") adopted before the payment or the dividend. The D.R.I.P. was required to be approved by the management of the U.S.S., including the C.E.O. and the board of directors, making it subject to Sarbanes-Oxley requirements. However, as a practical matter, no incremental investment requirement was imposed under the limitation. Specifically, the U.S.S. could use the funds for any qualifying investment without having to demonstrate that the amount spent on that investment exceeded either: (i) the average amount spent in previous years or (ii) the amount of spending budgeted before receiving the dividend.

Of the roughly 9,700 companies that had C.F.C.'s in 2004, 843 corporations took advantage of Code §965, repatriating $362 billion, of which $312 billion was eligible for deduction. The stated goal of Code §965 was to provide economic stimulus in the United States and to promote the creation of new jobs. Congressional representatives from both parties made the case for the bill based on the jobs that would be created with new cash investments by domestic companies.

If Code §965 were reinstated on a permanent basis and tighter rules and controls were implemented with respect to U.S. investment, the resulting stimulation of growth and investment among participating companies and job creation could well provide an appropriate measure of success.

Several caveats should be considered in connection with this proposal.

- The rules should be drafted to encourage U.S. companies of all sizes to participate, not just the large multinationals who participated in 2004.

- Attractive U.S. investment opportunities must be identified and nurtured. These opportunities must be over and above the dividend received tax break itself, and be attractive to industries whose business models (as noted above) are international in nature. These opportunities could take the form of research and development, investment tax credits, industry-related tax benefits incentives for domestic acquisition, or M&A transactions, among others. In this regard, it is noted that most of the repatriated funds in 2004 were in fact used for share repurchase programs by the participating companies.

- Avoid early (or any) sun-setting of the provision. It was shown in 2004 that the one-year period encouraged "one off" repatriations, as opposed to repatriations which would be integrated in a U.S. company's ongoing strategic financial or business plan.

- Don't get trapped in accounting rules. The 2004 statute keyed into "permanently reinvested earnings." Any new legislation should provide for whatever cash can be repatriated on the assumption that the cash infusion to the U.S. will have the intended growth and economic stimulation effects.

2. Revision of U.S. Taxation of Foreign Earnings on a Permanent Basis

As an alternative or complement to a Code §965 approach, enacting a near-term cash tax repatriation strategy as a precursor to longer-term reforms should be considered. This regime would create a separate, internationally competitive tax rate on foreign earnings, with a view to leading to greater value creation for shareholders, smarter investment by firms, and a new source of revenue for the federal government.

The worldwide U.S. tax regime with foreign tax credit offset along with the Subpart F regime could be replaced. Under this current regime, contrary to the arguments that the playing field is not level for “domestic” versus “international” companies, it is the international companies that are more likely to be subject to the higher tax burden. The fact that the U.S. has the highest corporate statutory rate in the world only adds insult to injury.

For example, if the shareholder of a U.S. entity is a corporation, Code §243 states that some form of dividend received deduction could be taken if the dividend recipient owns at least 10% of the distributing entity. The deduction could be up to 100% of the dividend received if the corporation owns at least 80% of the subsidiary's stock.

Contrast this with dividends received from a foreign subsidiary. In the latter situation, Code §902 states that the U.S. parent reports the entire pre-tax distributed amount and pays U.S. corporate income taxes on that amount, offset by whatever taxes were already paid to the foreign government. If Subpart F applies, U.S. tax is imposed without cash flow to the shareholder.

Imposing a dividends received deduction for dividends from abroad would in fact level the playing field for international and domestic based U.S. Companies. The dividends received deduction could be tied to a double tiered tax credit system. Code §243 et seq. rules could apply to foreign-sourced dividend income, with the added possibility of tax credits for dividend taxes paid on funds designed for U.S. reinvestment.

Given the current skepticism of U.S. multinational company tax affairs, any plan designed and implemented must be closely monitored. This would be done with a view towards quantifying whether the lower effective tax rate on foreign-sourced earnings repatriated and reinvested is enough to close the gap between the advantages that foreign investments enjoy relative to those in the United States. This analysis could provide source data for or against further U.S. tax reform, such as a territorial system. Increased cash flow to the U.S. would in fact present itself in other business transactions which themselves generate tax revenue. Examples include increased taxable wages, goods and services transactions subject to sales taxes, paying taxable dividends to shareholders, and increasing the value of corporate shares owned by taxable U.S. investors. Note, in this regard, that corporate tax revenues per se have never been a major component of the U.S. Treasury tax revenue stream.

Inversion transactions may slow down in light of proposed legislation, but the factors that motivate these transactions remain. Dealing with these issues is like the old time health remedy, castor oil. The taste may not be great, but one was a better person for having swallowed the medicine. It is time for the stakeholders, government, public, and business communities of the U.S. to ready the teaspoon.