CORPORATE INVERSION TRANSACTIONS: TAX POLICY IMPLICATIONS

OFFICE OF TAX POLICY
DEPARTMENT OF THE TREASURY

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I. EXECUTIVE SUMMARY

In recent months, several high-profile U.S. companies have announced plans to reincorporate outside the United States. The documents prepared for shareholder approval and filed with the Securities and Exchange Commission cite substantial reductions in overall corporate taxes as a key reason for the transactions.

While the so-called corporate inversion transactions are not new, there has been a marked increase recently in the frequency, size, and profile of the transactions. The Treasury Department is undertaking a study of the issues arising in connection with this corporate inversion activity and the implications for the U.S. tax system and the U.S. economy. The Treasury Department concluded it was important to provide this preliminary report describing the current tax treatment of the transactions, the current tax treatment of the companies post-inversion, the features of our tax laws that facilitate the transactions or that may be exploited through such transactions, and the features of our tax laws that drive companies to consider these transactions. In considering modifications to our tax laws to address these transactions, it is important to ensure that the longer-term implications for the U.S. economy also are addressed.

An inversion is a transaction through which the corporate structure of a U.S.-based multinational group is altered so that a new foreign corporation, typically located in a low- or no-tax country, replaces the existing U.S. parent corporation as the parent of the corporate group. The transactional forms through which this reincorporation outside the United States can be accomplished vary as a technical matter, but all involve little or no immediate operational change and all are transactions in which either the shareholders of the company or the company itself will be subject to tax. This reincorporation step may be accompanied by other restructuring steps designed to shift the ownership of the group's foreign operations outside the United States. The restructuring steps involving movement of foreign subsidiaries are complex and varied, but, like the reincorporation itself, are transactions that will be subject to tax. When all the transactions are complete, the foreign operations of the company will be outside of the U.S. taxing jurisdiction and the corporate structure also may provide opportunities to reduce the U.S. tax on U.S. operations.

Market conditions have been a factor in the recent increase in inversion activity. Although the reincorporation step triggers potential tax at the shareholder level or the corporate level, depending on the transactional form, that tax liability may be less significant because of current economic and market factors. The company's shareholders may have little or no gain inherent in their stock and the company may have net operating losses to offset any gain at the company level. While these market conditions may help facilitate the transactions, they are not what motivates a company to undertake an inversion. U.S.-based companies and their shareholders are making the decision to reincorporate outside the United States largely because of the tax savings available.

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. 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. A U.S.-based start-up venture may incorporate overseas at the outset. An existing U.S. group may be the subject of a takeover bid, either friendly or hostile, from a foreign-based company. In either case, the structure that results provides tax-savings opportunities that are similar to those provided by an inversion transaction. Moreover, these transactions can have significant adverse effects on the U.S. economy in the long term, as decisions affecting the future location of new investment, operations and facilities, and employment opportunities are made by what is a foreign-based company rather than a U.S.-based company. Thus, the policy response to the recent corporate inversion activity should be broad enough to address the underlying differences in the U.S. tax treatment of U.S.-based companies and foreign-based companies, without regard to how foreign-based status is achieved. Measures designed simply to halt inversion activity may address these transactions in the short run, but there is a serious risk that measures targeted too narrowly would have the unintended effect of encouraging a shift to other forms of transactions to the detriment of the U.S. economy in the long run.

A prompt and thoroughly-reasoned response is needed to address the U.S. tax advantages that are available to foreign-based companies through the ability to reduce the U.S. corporate-level tax on income from U.S. operations. Inappropriate shifting of income from the U.S. companies in the corporate group to the foreign parent or its foreign subsidiaries represents an erosion of the U.S. corporate tax base. It provides a competitive advantage to companies that have undergone an inversion or otherwise operate in a foreign-based group. It creates a corresponding disadvantage for their U.S. competitors that operate in a U.S.-based group. Moreover, exploitation of inappropriate income-shifting opportunities erodes confidence in the fairness of the tax system. Changes to the applicable statutory and regulatory rules are needed to ensure that any transaction that results in a new foreign parent of a corporate group with U.S. operations does not serve to facilitate an inappropriate decrease in tax on the U.S. income of the U.S. operations. As discussed in this report, areas that need particular focus include the rules limiting deductions for interest paid on foreign related party debt, the rules requiring arm's length pricing and valuations on transfers of assets, including intangible assets, to foreign related parties, and the rules regarding cross-border corporate reorganizations.

We also must work to address the U.S. tax disadvantages that are caused for U.S.-based companies that do business abroad relative to their counterparts in our major trading partners. The U.S. international tax rules can operate to impose a burden on U.S.-based companies with foreign operations that is disproportionate to the tax burden imposed by our trading partners on the foreign operations of their companies. The U.S. rules for the taxation of foreign-source income are unique in their breadth of reach and degree of complexity. Both the recent inversion activity and the increase in foreign acquisitions of U.S. multinationals are evidence that the competitive disadvantage caused by our international tax rules is a serious issue with significant consequences for U.S. businesses and the U.S. economy. A comprehensive reexamination of the

U.S. international tax rules and the economic assumptions underlying them is needed. As we consider appropriate reformulation of these rules we should not underestimate the benefits to be gained from reducing the complexity of the current rules. Our system of international tax rules should not be allowed to disadvantage U.S.-based companies competing in the global marketplace.

As we continue to work to address these issues, we must keep our focus on the overarching goal of maintaining the position of the United States as the most desirable location in the world for place of incorporation, location of headquarters, and transaction of business.

II. INTRODUCTION

Since the late 1990s, an increasing number of U.S.-based multinational corporations have engaged in so-called "corporate inversions" or "corporate reincorporations".[1] A corporate inversion is a transaction or series of transactions through which a U.S.-based multinational restructures its corporate group so that the ultimate parent corporation of the group becomes a foreign entity. If accompanied by the movement of the multinational's ownership of its foreign operations to the foreign entity, the effect is the removal from the U.S. tax base of the income of the foreign operations that is or may be included in U.S. taxable income in the future. If accompanied by an increase in the leveraging of U.S. operations through intercompany debt or by a transfer of intangibles to the foreign entity, the effect is the reduction of the U.S. taxable income of U.S. operations. As discussed below, an inversion may be accomplished through one of several alternative transaction forms.

In response to the recent marked increase in the frequency and size of inversions of U.S.-based multinational corporations, the Treasury Department announced on February 28, 2002, that it was studying the issues arising in connection with inversions and the implications of these transactions for the U.S. tax system and the U.S. economy. Since that announcement, several bills have been introduced in Congress to address inversion transactions.[2] In the interest of providing technical and analytical input to the ongoing consideration of an appropriate response to this inversion activity, the Treasury Department is releasing this preliminary report.

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[1] Although the recent series of inversion transactions began in the late 1990s, inversion transactions have occurred sporadically since the early 1980s. For a discussion of the history of inversion transactions, see Willard B. Taylor, "Corporate Expatriations—Why Not?", 78 TAXES 146, 146-152 (March 2000).

[2] H.R. 3884, Corporate Patriot Enforcement Act of 2002 (introduced by Rep. Neal on March 6, 2002); H.R. 3857 (introduced by Rep. McInnis on March 6, 2002); H.R. 3922, Save America's Jobs Act of 2002 (introduced by Rep. Maloney on March 11, 2002); S. 2050 (introduced by Sen. Wellstone and Sen. Dayton on March 21, 2002); S. 2119, Reversing the Expatriation of Profits Offshore Act (introduced by Sen. Baucus and Sen. Grassley on April 11, 2002); H.R. 4756, Uncle Sam Wants You Act of 2002 (introduced by Rep. N. Johnson on May 16, 2002).

The description of inversion transactions contained in this report is based on public documents filed with the Securities and Exchange Commission ("SEC filings") by the companies engaging in these transactions, as well as press releases and other information. A technical discussion of the structure and forms of inversion transactions and the potential tax treatment of the various elements of the transactions is included in this report to provide context for the discussion of policy issues that arise. The technical discussion contained in this report is based on current law and does not address the potential impact on these transactions of any of the bills pending before Congress. Moreover, it is intended as a general discussion and does not constitute an analysis of any specific transaction.

III. TECHNICAL STRUCTURE OF INVERSION TRANSACTIONS

A. In General

The term "inversion" is used to describe a broad category of transactions through which the corporate structure of a group of corporations with a U.S. parent (a "U.S.-based group") is altered so that after the transaction, the ultimate parent of the corporate group is a foreign corporation. Typically, that foreign parent corporation is incorporated in a jurisdiction that imposes little or no income tax. This basic reincorporation outside the United States often is accompanied by a series of other restructuring steps. Most commonly, the associated restructuring involves a shift outside the United States of the ownership of the group's existing foreign operations, accomplished through the transfer of existing foreign subsidiaries to the new foreign parent corporation or a foreign subsidiary thereof.

The following general description of inversions and related transactions focuses on the most common forms. This description is not an exhaustive analysis of all the various permutations and specific details with respect to these transactions or of the tax issues that may arise in carrying out the transactions.

B. Foreign Reincorporation

There are several different ways to accomplish the foreign reincorporation of a U.S. parent corporation and the specific tax consequences differ, although all are transactions on which either the shareholders or the company itself will be subject to tax. While the details vary, the reincorporation step of an inversion transaction generally is accomplished through one of three broad categories of transactions.

Stock Transaction. The reincorporation step in many of the transactions that have occurred to date involves interposing a newly-formed holding company located in Bermuda or another low-tax jurisdiction (the "foreign parent") between the current U.S. parent corporation (the "U.S. parent") and that corporation's shareholders. The newly-formed foreign parent acquires the outstanding stock of the U.S. parent either directly or through a reverse subsidiary merger (a merger of a transitory U.S. subsidiary of the new foreign parent into the U.S. parent), with the U.S. parent surviving as a subsidiary of the new foreign parent and the shareholders of the U.S. parent exchanging their U.S. parent stock for stock in the new foreign parent.[3] After the transaction is complete, the U.S. corporate group generally is unchanged except that the stock of the former U.S. parent is held by the new foreign parent. The shareholders hold stock of the new foreign parent instead of the former U.S. parent. This type of transaction is referred to herein as a "Stock Transaction".[4]

Asset Transaction. The second category of transaction that has been used to implement the reincorporation step in several, generally smaller, transactions is the direct reincorporation of the U.S. parent in a foreign jurisdiction. As a corporate law matter, that may be accomplished either through a merger of the U.S. parent into a newly-formed foreign corporation, with the existing shareholders of the U.S. parent receiving stock of the new foreign corporation, or pursuant to conversion and continuation procedures under state corporate law. After this transaction, the new foreign parent holds the corporate group previously held by the former U.S. parent, and the shareholders hold stock of the new foreign parent instead of stock of the former U.S. parent. This type of transaction is referred to herein as an "Asset Transaction".

Drop Down Transaction. The third category of transaction that has been used to implement the reincorporation step involves elements of both stock and asset transfers. In this type of transaction, the U.S. parent transfers its assets to a new foreign corporation, and then a portion of those assets is contributed immediately to a U.S. subsidiary of the new foreign parent. To the extent that assets are contributed to a U.S. corporation, and therefore effectively remain in U.S. corporate solution, the result generally is the same as in a Stock Transaction (*i.e.*, the interposition of a foreign corporation between the existing U.S. group and the current shareholders). To the extent the foreign corporation directly holds some of the assets of the former U.S. parent, the result generally is the same as in an Asset Transaction. This type of transaction is referred to herein as a "Drop Down Transaction".

The reincorporation step, in whichever form accomplished, has no real effect on the operation of the company. The transaction is taxable to the U.S. shareholders of the company or to the company itself. The reincorporation alone will have no effect on the ongoing U.S. tax treatment of the company, unless it is accompanied by other restructuring steps or other changes in future business operations or growth.

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3 Some of the transactions use a transitory subsidiary that is indirectly owned by the foreign parent through an intermediate holding company that may be either U.S. or foreign.

4 Some of the earlier inversion transactions also included an option under which some portion of the shareholders could retain an equity interest in the existing U.S. parent, which interest could be convertible into, or possibly coupled with, an equity interest in the foreign parent.

C. Other Restructuring

1. Transfer of Foreign Subsidiaries

Several inversion transactions have involved the transfer of ownership in existing foreign subsidiaries of the former U.S. corporate group either to the new foreign parent corporation or to a foreign affiliate thereof. In a corporate inversion that is accomplished as a Stock Transaction, the foreign subsidiaries may be transferred to the new foreign parent immediately before the reincorporation transaction, through the exchange of the stock of the foreign subsidiaries for a second class of common stock of the acquiring foreign corporation. This second class of stock typically is non-voting stock, but carries rights similar to the other common stock of the foreign corporation issued to the shareholders as part of the foreign reincorporation (including dividend rights). This use of foreign parent stock results in cross-ownership, with the former U.S. parent or its U.S. subsidiaries holding stock (often referred to as "hook stock") in the foreign parent corporation.

In an Asset Transaction, the transfer of existing foreign subsidiaries may occur as part of the reincorporation, which involves the outbound transfer of all of the U.S. parent corporation's assets, including any stock in foreign subsidiaries held directly by the U.S. parent corporation at the time of the transaction, and not as a step separate from the reincorporation. In the case of a Drop Down transaction, the stock of foreign subsidiaries simply would not be part of the assets that are subsequently recontributed to a U.S. corporation following the reincorporation.

Finally, in all three forms of inversion transactions, the transfer of ownership of existing foreign subsidiaries instead may occur after the initial reincorporation transaction. The stock of the foreign subsidiaries may be distributed up to the new foreign parent as a dividend. Alternatively, the stock of the existing foreign subsidiaries may be transferred to the new foreign parent or a foreign affiliate thereof through a sale or exchange transaction.

The effect of the transfer of foreign subsidiaries will be to move their foreign operations outside the U.S. taxing jurisdiction. Even where existing subsidiaries are not transferred, future business opportunities may be directed to the new foreign parent and its foreign affiliates instead of to the foreign subsidiaries of the U.S. group.

2. Intercompany Indebtedness

Many inversion transactions also involve the creation of intercompany indebtedness between the remaining U.S. members of the corporate group and the foreign parent corporation or a foreign affiliate thereof. This intercompany indebtedness may be created immediately prior to the reincorporation transaction by having the U.S. parent issue debt to the foreign parent in exchange for a second class of the foreign parent's common stock (as in the case of the transfer of the existing foreign subsidiaries to the foreign parent in exchange for a second class of the foreign parent's common stock, this class of stock typically will have rights similar to those of the other foreign parent stock used in the reincorporation, but may have restrictions on voting power). Alternatively, the intercompany debt can be established following the inversion transaction through a dividend of the debt or in exchange for property of equivalent value.

The creation of intercompany debt may have no real effect on the location of assets within the group. However, it will generate interest expense that generally will be deductible for U.S. tax purposes.

3. Other Related Transactions

Inversion transactions also may be accompanied by other associated transactions involving the new foreign parent and the former U.S. group. For example, some inversion transactions have been accompanied by a sale or other transfer of the ownership of intangible assets of the U.S. parent to the foreign parent or a foreign affiliate thereof. Several inversion transactions have involved insurance or reinsurance companies. In these transactions, the U.S. members of the corporate group may reinsure a portion of their existing or future business with a foreign affiliate of the new foreign parent.

The effect of a transfer of intangible assets or the establishment of a reinsurance relationship will be to shift income outside the U.S. taxing jurisdiction.

IV. POTENTIAL TAX CONSEQUENCES OF INVERSION TRANSACTIONS

A. Tax Treatment of the Inversion Transaction

1. Reincorporation

The tax consequences arising from an inversion transaction depend on the precise structure of the transaction and the particular facts of the inverting corporation and its shareholders.[5] In all cases, however, the reincorporation step of the inversion results in potential tax, either at the shareholder level or at the corporate level, reflecting the amount of built-in gain at the shareholder or corporate level.

Stock Transaction. A Stock Transaction typically is structured to qualify as a reorganization within the meaning of section 368.[6] Because the transaction involves the transfer of property to a foreign corporation, section 367 also applies. Regulations under section 367(a) treat the outbound transfer of stock of a U.S. corporation as a taxable event, except where certain

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[5] This section provides a general overview of the potential tax consequences arising from an inversion transaction sufficient to inform the policy discussion that follows. It is not intended to be comprehensive. Several recent articles contain more detailed examinations of the tax consequences of inversion transactions and the issues that arise therefrom. See, e.g., Gregg D. LeMein and John D. McDonald, "Taxable Inversion Transactions", 80 TAXES 7 (March 2002); Carol P. Tello, "The Upside Down World of Corporate Inversions", Tax Management International Journal 161 (2001); Taylor, supra note 1.

[6] Section references herein are to the Internal Revenue Code of 1986, as amended, and to the Treasury regulations promulgated thereunder.

conditions are satisfied.[7] In a Stock Transaction, where the foreign acquiring corporation typically is a newly-formed entity without significant assets, the section 367 regulations require the shareholders to recognize gain on the exchange for tax purposes.[8] The amount of taxable gain recognized is equal to the excess, if any, of the fair market value of the stock over the shareholder's adjusted tax basis therein. Shareholders with a loss on the exchange do not recognize this loss for tax purposes, and instead such loss is preserved in the tax basis of the stock of the foreign parent received in the transaction. Although the company's shareholders are required to recognize gain in a Stock Transaction, there are no reporting requirements such as apply in the case of other dispositions of stock.[9] In a Stock Transaction, the former U.S. parent

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[7] The section 367 regulations permit tax-free treatment of the outbound transfer of stock of a U.S. corporation only if: (i) U.S. shareholders of the U.S. corporation receive 50% or less of the total voting power and total value of stock of the transferee foreign corporation; (ii) 50% or less of the total voting power and total value of stock of the transferee foreign corporation is owned by former officers, directors and 5% shareholders of the U.S. corporation immediately after the transaction; (iii) each 5% shareholder of the U.S. corporation enters into a "gain recognition agreement"; (iv) the transferee foreign corporation satisfies an active trade or business requirement; and (v) certain reporting requirements are satisfied. Treas. Reg. § 1.367(a)-3(c)(1). In general, a gain recognition agreement provides that if the stock or substantially all of the assets of the transferred corporation is subsequently disposed of during the five-year period following the initial transfer, the taxpayer must include the realized gain that was not recognized in the original transaction, plus interest. See Treas. Reg. § 1.367(a)-8. The active trade or business requirement generally requires that: (i) the transferee foreign corporation must have been engaged in an active trade or business outside the United States for a 36-month period prior to the transaction; (ii) at the time of the transaction, there is no intention to dispose of or discontinue such trade or business; and (iii) the fair market value of the transferee foreign corporation must be equal to or greater than the fair market value of the U.S. corporation. Treas. Reg. § 1.367(a)-3(c)(3).

[8] Treas. Reg. § 1.367(a)-3(a), (c). As discussed above in note 4, an inversion transaction may be structured in a manner that allows some shareholders to retain an equity interest in the U.S. parent corporation. Such a structure would mean that those shareholders would not have a taxable exchange in the transaction. The IRS and the Treasury announced in the preamble to the section 367 regulations issued in 1998 that these transactions would be scrutinized on a case-by-case basis using substance over form (or other) principles. T.D. 8770, 1998-27 I.R.B. 4. None of the most recent transactions has used this structure.

[9] Section 6045 requires information reporting to the IRS on transactions involving brokers as provided in regulations. Regulations promulgated under section 6045 generally require Form 1099 reporting of the gross proceeds from any sale effected by a broker in the ordinary course of its business. See Treas. Reg. § 1.6045-1(c)(2). For these purposes, a sale is defined as a disposition for cash, and therefore would not cover the shareholder's taxable exchange in a Stock Transaction. Other reporting obligations may apply with respect to the transaction. See, e.g., Treas. Reg. § 1.368-3.

itself is not subject to tax on the reincorporation transaction; however, associated transfers of assets by the U.S. parent or its subsidiaries may be taxable.

Asset Transactions. Because an Asset Transaction involves an outbound transfer of assets by the U.S. parent to the newly-formed foreign parent, the U.S. parent must recognize gain (but not loss) for U.S. tax purposes, calculated as if all of its assets had been sold at the time of the transaction for their fair market value.[10] The shareholders of the corporation are not subject to a second level of tax, provided that the transaction qualifies as a reorganization under section 368.[11] If the transaction qualifies as a reorganization, the shareholders will hold the shares of the new foreign parent with the same tax basis and holding period for tax purposes that they had in their stock of the former U.S. parent.[12]

Drop Down Transactions. A Drop Down Transaction is analyzed under both sets of section 367 rules discussed above.[13] To the extent of the assets transferred to the new foreign parent and then contributed to a new U.S. subsidiary of the foreign parent, the transaction is treated generally as a Stock Transaction, with the shareholders of the U.S. parent required to recognize gain (but not loss) for tax purposes on the exchange. Similarly, the U.S. parent is not required to recognize gain for tax purposes with respect to those assets that have been contributed to the U.S. corporation. To the extent assets transferred to the new foreign parent are retained by that corporation, the transaction is treated generally as an Asset Transaction and there is a recognition of gain (but not loss) for tax purposes at the corporate level on the assets transferred to the foreign corporation. There generally is no shareholder-level recognition of gain for tax purposes on this portion of the transaction.

2. Tax Treatment of Transfers of Stock of Foreign Subsidiaries

A restructuring of the foreign operations of the U.S. group as part of an inversion transaction presents various U.S. tax issues, many of which depend upon the precise mechanism

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[10] Section 367 provides limited exceptions to this rule requiring gain recognition for tax purposes. These exceptions apply to the outbound transfer of certain assets for use in the active conduct of a trade or business outside the United States, or the outbound transfer of certain stock or securities of foreign corporations. Section 367(a)(2), (3). These exceptions are not available unless the foreign transferee corporation is controlled by five or fewer U.S. corporations, which would not be the case in the inversion of a public company. Section 367(a)(5).

[11] See Treas. Reg. § 1.367(a)-3(a), (d)(3) (Example 12). In order for a transaction to qualify as a reorganization under section 368(a), the transaction must be undertaken for reasons germane to the continuance of the business of a corporation that is a party to the reorganization. See Treas. Reg. § 1.368-2(g).

[12] Sections 358(a), 1223(1).

[13] Treas. Reg. § 1.367(a)-3(d)(2)(vi).

used to effectuate the restructuring.[14] The U.S. parent (or another U.S. member of the corporate group) may transfer the stock of a foreign subsidiary to the foreign parent or foreign affiliate in a transaction that otherwise would qualify for nonrecognition treatment. However, the regulations under section 367 generally require the U.S. parent (or other transferor) of the foreign subsidiary to recognize for tax purposes the gain, if any, on the foreign subsidiary stock transferred to a foreign corporation, to the extent of the accumulated earnings and profits of the foreign subsidiary attributable to the stock transferred.[15] Any loss on the foreign subsidiary stock would not be recognized for tax purposes. Any required inclusion would be treated as a dividend for U.S. tax purposes; accordingly, the U.S. parent (or other transferor) would be entitled to indirect foreign tax credits under section 902 for the foreign taxes paid by the foreign subsidiary with respect to the earnings deemed distributed.[16]

Alternatively, the U.S. parent (or other transferor) may transfer the stock of a foreign subsidiary to the foreign parent or a foreign affiliate in a taxable exchange. In such a case, the full amount of any gain on the stock of the foreign subsidiary would be recognized for tax purposes. To the extent of any accumulated earnings and profits attributable to the stock, this gain would be treated for tax purposes as a dividend under section 1248, with indirect foreign tax credits under section 902 for the foreign taxes paid by the foreign subsidiary with respect to such earnings. Under section 267 (which denies losses on transfers between related parties), any loss on the foreign subsidiary stock would not be recognized for tax purposes. This type of transaction may be recharaterized under section 304, depending on the relationship of the parties that participate in the transfer of the foreign subsidiary stock and the type of consideration exchanged.[17]

However the transfer of the foreign subsidiary's stock is accomplished, the transfer must be conducted at arm's length. If the members of the U.S. corporate group that previously owned the foreign subsidiary's stock receive property in exchange that has less value than the stock

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[14] There also may be non-U.S. tax consequences arising from the restructuring transaction.

[15] Treas. Reg. §§ 1.367(a)-3(b)(2), 1.367(b)-4(b). The section 367 regulations also require the transferring U.S. members of the corporate group to enter into a five-year gain recognition agreement. Treas. Reg. § 1.367(a)-3(b)(1)(ii).

[16] Treas. Reg. § 1.367(b)-4(b). In general, the foreign taxes that are associated with a dividend are the ratable portion of the overall foreign taxes paid by the foreign corporation as compared to the overall earnings and profits. The relationship between earnings and foreign taxes paid is done on an annual basis for taxable years prior to 1987, and generally across all taxable years after 1986.

[17] Section 304 applies to certain transactions involving two corporations that are commonly controlled in which one corporation acquires the stock of the other corporation directly or indirectly from the person (or persons) so in control. If section 304 applies, the transaction generally is recharacterized as a dividend to the extent of the earnings and profits of both corporations involved.

transferred, the shortfall may be characterized as a deemed dividend to the foreign parent, which would be subject to a U.S. withholding tax (although possibly at a reduced rate if the recipient foreign parent qualifies for benefits under a U.S. income tax treaty).

3. Tax Treatment of Creating Intercompany Indebtedness and Other Restructuring

The tax consequences of establishing intercompany indebtedness depend on the particular facts of the transaction. The indebtedness may be distributed by a U.S. corporation to the foreign parent. This distribution should constitute a dividend to the extent of any earnings and profits of the distributing corporation, and therefore should be subject to a U.S. withholding tax, which may be reduced under an applicable U.S. income tax treaty. Alternatively, the debt could be issued by a U.S. corporation in exchange for property of the foreign parent of equivalent value, which generally should not produce any immediate U.S. tax consequences.

The outbound transfer of intangible assets generally is treated as a taxable transaction under general tax principles or, if structured as part of a transaction that otherwise would be a nonrecognition transaction, under section 367(d).[18] The applicable transfer pricing rules under section 482 require that the transaction be conducted in accordance with the arm's length standard and that the income with respect to the transaction be commensurate with the income attributable to the intangible assets transferred.[19]

B. Tax Treatment of the Corporate Group

1. Brief Overview of U.S. Income Tax Rules

The United States generally taxes a U.S. corporation on its worldwide income. The income of a foreign subsidiary from business operations outside the United States generally is subject to U.S. taxation only when the foreign subsidiary's earnings are repatriated to the United States in the form of dividends. However, under subpart F of the Code,[20] a U.S. parent

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[18] An outbound transfer of an intangible asset to which section 367(d) applies is treated as a sale of the intangible asset in exchange for deemed annual payments based on the productivity of the asset. Such deemed payments are treated as ordinary income to the transferor. Section 367(d)(2)(C).

[19] Section 482 authorizes the Secretary to allocate income, deductions, credits, or allowances between persons under common control if necessary to prevent evasion of taxes or clearly to reflect the income of any such person. The section 482 regulations provide that in determining the taxable income of a controlled person, the standard to be applied is that of a person dealing at arm's length with an uncontrolled person. Treas. Reg. § 1.482-1(b)(1). Section 482 also provides that in the case of any transfer of intangible property, the income with respect to such transfer shall be commensurate with the income attributable to the property.

[20] Sections 951-964.

corporation is subject to current U.S. tax on certain income earned by a foreign subsidiary, without regard to whether such income is distributed to the U.S corporation.

In order to avoid double taxation of income, the United States permits a taxpayer to credit foreign taxes paid against its U.S. tax liability.[21] The availability of foreign tax credits is limited to the U.S. tax imposed on foreign-source net income.[22] Because the foreign tax credit limitation is determined on the basis of net income, the allocation and apportionment of expenses between U.S. and foreign source income is critical to determining the extent to which foreign taxes are creditable in any given year. Most expenses are allocated to the income to which such expenses relate.[23] In the case of interest expense, the deduction is allocated between U.S. and foreign source income based on the proportion of U.S. and foreign assets.[24]

2. Taxation of U.S. Operations Post-Inversion

After an inversion, the U.S. operations conducted by the corporate group continue to be subject to U.S. tax at the corporate level.[25] Because the inversion transaction interposes a foreign corporation between the former U.S. parent and the shareholders, an additional U.S. withholding tax applies to the distribution of earnings from the U.S. members of the corporate group to the new foreign parent. The U.S. withholding tax rate generally is 30 percent of the gross amount of any dividend; however, that rate may be reduced under an applicable tax treaty.[26] Although most inversion transactions have involved a reincorporation into a foreign jurisdiction that does not have a tax treaty with the United States (or that has a treaty that does not reduce the withholding tax rate for dividends), many of these transactions are structured with the new foreign parent resident in a treaty country (typically Barbados) so that the U.S. withholding tax on dividends from the U.S. corporation to the foreign parent is reduced (typically to 5 percent) under the applicable income tax treaty.[27]

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[21] Section 901.

[22] Section 904.

[23] See generally Treas. Reg. § 1.861-8.

[24] See Section 864(e).

[25] If the U.S. operations are conducted through a U.S. corporation, the corporation remains subject to U.S. tax. If the U.S. operations are conducted through a pass-through entity owned by foreign members of the corporate group, or as a branch of a foreign corporation, the income that is effectively connected with the conduct of a trade or business within the United States is subject to U.S. net basis taxation.

[26] See, e.g., U.S. Treasury Department, U.S. Model Income Tax Convention of September 20, 1996, Article 10 (Dividends).

[27] Taxpayers may attempt to obtain benefits, including reduced withholding tax rates on dividends and other payments, under the U.S.-Barbados income tax treaty by having the

The restructuring that may accompany an inversion makes available several opportunities for increasing the payments that are made by the U.S. members of the group to foreign members of the group. These payments, if deductible for tax purposes, reduce the effective rate of U.S. taxation on U.S. operations by reducing the net income subject to U.S. tax. For example, many inversion transactions have involved the establishment of intercompany indebtedness to the foreign parent or another foreign affiliate from the U.S. members of the corporate group. Interest paid on such indebtedness generally would be deductible in the United States, subject to the limitations of section 163(j) and certain other provisions. The interest income on the debt typically is received in a jurisdiction that subjects that income to little or no taxation. Although the United States imposes a withholding tax of 30 percent on interest payments to a related party, this withholding tax may be substantially reduced or eliminated under an applicable U.S. income tax treaty.

Particular post-inversion opportunities may be available to companies in specific sectors. Insurance companies may shift insurance risks through reinsurance arrangements between the U.S. members of the corporate group and foreign affiliates in low- or no-tax jurisdictions. Premiums paid on the intercompany reinsurance are deductible in the United States, and the premium and other related income of the foreign affiliates on the reinsurance contract generally is not subject to U.S. taxation unless such income is effectively connected with the conduct of a U.S. trade or business. A U.S. excise tax applies to the premiums, unless this excise tax is eliminated pursuant to an applicable income tax treaty.[28] Unlike intercompany debt, which effectively permits a taxpayer to shift a fixed amount of income from a U.S. corporation to the foreign parent or a foreign affiliate in a low-tax country, a reinsurance arrangement shifts both the profit or loss of any given contract, which will not be known at the time of the agreement. Any reinsurance arrangement between related parties must be established and operate in accordance with the arm's length transfer pricing principles of section 482 and also may be subject to challenge under section 845.[29]

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foreign parent company managed and controlled in Barbados (although incorporated elsewhere). Barbados provides a special income tax regime for such corporations that imposes only a nominal income tax, at a rate between 1% and 2.5% depending on the total amount of income subject to tax.

[28] Section 4371 imposes an excise tax of 1% of premiums for reinsurance covering U.S. risks that are not effectively connected with a U.S. trade or business. See sections 4371(3), 4373(1). The Treasury Department generally waives the excise tax pursuant to a tax treaty only if it is satisfied that an insurer operating from the treaty partner and insuring U.S. risks would face a level of taxation that is substantial relative to the level of taxation faced by U.S. insurers. See U.S. Treasury Department, Report to Congress on the Effect on U.S. Reinsurance Corporations of the Waiver by Treaty of the Excise Tax on Certain Reinsurance Premiums (March 1990).

[29] Section 845(a) authorizes the Secretary, in the case of reinsurance between related persons, to make adjustments necessary to reflect the proper source and character of taxable income. Section 845(b) further provides authority to make adjustments to any reinsurance contract that

3. Taxation of Foreign Operations Post-Inversion

To the extent the ownership of foreign subsidiaries has been shifted out of the former U.S. group to the new foreign parent or a foreign subsidiary thereof, an inversion transaction eliminates the U.S. corporate-level taxation of these foreign operations.[30] Accordingly, the significance of the foreign tax credit limitation (and the related rules concerning the allocation of expenses, including interest) to the inverted corporate group is reduced or eliminated, as foreign-source earnings of the corporate group will not be subject to U.S. tax. To the extent foreign operations are not shifted offshore (*i.e.*, the foreign operations are still owned by U.S. members of the post-inversion group), income from such operations will remain subject to U.S. taxation, although it may be possible to reduce the amount of income that ultimately is taxed in the United States (either immediately under subpart F or upon repatriation) by restructuring the foreign operations in a manner similar to the restructuring that may occur with respect to the domestic operations of the company (*e.g.*, increased payments of interest and royalties to the foreign parent or its foreign affiliates) or through other means (*e.g.*, transfers of customers, good will or know-how to the foreign parent or its foreign affiliates). Even without the restructuring of foreign operations or transferring of intangibles, future growth of the multinational's foreign operations may occur through new subsidiaries owned by the new foreign parent, in which case the income would be outside the U.S. tax base.

4. Taxation of Shareholders Post-Inversion[31]

Because shareholders will own stock of a foreign corporation (rather than a U.S. corporation) following the inversion, different tax consequences may apply to dividends and gain from that stock. The changes in the taxation of shareholders of the inverted company depend on the status of the shareholder.

U.S. Shareholders. Noncorporate U.S. shareholders generally are taxed in the same manner after the transaction as before, except that any dividends received generally will be foreign-source income instead of U.S.-source income.[32] Corporate U.S. shareholders will have

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has a significant tax avoidance effect without regard to whether the parties to such reinsurance agreement are related.

[30] Following the inversion, the income from foreign operations will continue to be subject to shareholder-level tax when the earnings of the corporation are distributed to U.S. shareholders.

[31] Because this report is focused on publicly announced transactions involving widely held companies with active business operations, the possible post-inversion application to shareholders of the new foreign parent of the rules relating to controlled foreign corporations, foreign personal holding companies, and passive foreign investment companies is not discussed herein.

[32] But see section 904(g), which re-sources a portion of dividends from a foreign corporation in certain circumstances.

significantly different tax treatment because they generally will no longer be entitled to a dividends received deduction for dividends from the new foreign parent.[33]

Foreign Shareholders. In general, foreign shareholders receive substantially more favorable U.S. tax treatment following an inversion transaction. Prior to the inversion, the foreign shareholders were subject to a U.S. withholding tax on any dividends paid by the U.S. corporation, imposed at a rate of 30 percent but subject to reduction under an applicable U.S. income tax treaty.[34] Following the inversion, dividends should no longer be subject to U.S. withholding tax. Additionally, any stock of the U.S. corporation held directly by a nonresident alien individual was includible in his or her estate; in contrast, stock of the new foreign parent held by a nonresident alien individual is not subject to U.S. estate tax.

V. KEY NON-TAX ISSUES IN INVERSION TRANSACTIONS

A. Business Operations

Although an inversion transaction requires significant restructuring as a corporate law matter, the effect of such a transaction on the actual management and operation of the inverted company generally is limited. While the jurisdiction of incorporation is changed in an inversion transaction, there need not be any change in the location of the corporation's headquarters or its other business operations. In this regard, most of the SEC filings with respect to inversion transactions include a representation that the company's management does not anticipate that the transaction will have any material effect on the company's operations.

B. Access to Capital Markets

Inversion transactions generally do not affect a company's access to U.S. capital markets. Although the parent of the corporate group is a foreign corporation following an inversion, the stock of the foreign parent typically continues to be traded on the U.S. stock exchange where the former U.S. parent's stock was traded before the inversion transaction. Indeed, the ability to continue to use the same ticker symbol often is a condition in the underlying merger agreement.

Similarly, in instances where the corporation is a member of the S&P 500, the SEC filings provide assurances that the corporation will continue to be an S&P 500 member after the inversion. Because of the significant amount of investment made through funds that are structured to replicate the S&P 500 (currently over one trillion dollars is invested in this manner), removal of a company from the S&P 500 can have an immediate and significant impact on the

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[33] But see section 243(e) (permitting a dividends received deduction in the case of dividends from a foreign corporation that are attributable to a period when the corporation was a domestic corporation subject to U.S. income taxation).

[34] Sections 871(a), 881(a).

company's stock price.[35] Although the S&P 500 generally does not include companies that are headquartered in foreign countries, offshore companies may be considered to be domestic for these purposes, determined on a case-by-case basis.[36] Several corporations that have undergone or are contemplating an inversion have qualified or expect to qualify for continued inclusion in the S&P 500.

Furthermore, some have indicated that inverting may increase the attractiveness of the corporation's stock to foreign investors. Dividends from the new foreign parent corporation generally would not be subject to U.S. withholding tax and generally would not be reported to the tax authorities. The corporation may believe that, as a result of the inversion, it will be able to raise capital in foreign capital markets more easily and that its stock will be a more desirable currency in foreign acquisitions.

C. Shareholders

Entering into an inversion transaction raises a number of potential non-tax issues with respect to the inverting company's shareholders. First, shareholder approval generally is required for an inversion transaction. Inversion transactions do not dilute the ownership interest of the shareholders because the transactions generally result in the shareholders owning exactly what they owned before, except through a foreign corporation rather than a U.S. corporation.[37] Shareholders generally are not entitled to dissenter's rights under state corporate law, although

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[35] See Roger J. Bos, Event Study: Quantifying the Effect of Being Added to an S&P Index (September 2000), available at http://www.spglobal.com/EventStudy.pdf. The study analyzes the price effects of inclusion on one of three S&P indices: the S&P 500, the S&P MidCap 400 and the S&P SmallCap 600. The study indicates that stock added to the S&P 500 increased in price on average by 8.5% from the time the inclusion was announced to when it became effective (usually one day). Id. at 4. The study does not contain any analysis of the price effects on a company leaving the S&P 500 and not being included in one of the other indices. However, the study does indicate that stock removed from either the S&P 500 or the S&P MidCap 400 on average declined in price more than 8% soon after announcement even though the stock was added to the S&P SmallCap 600. The study found that this decrease persisted for at least a year. Id.

[36] See Roger J. Bos, General Criteria for S&P U.S. Index Membership, at 2 (September 2000), available at http://www.spglobal.com/GeneralCriteria.pdf. This document provides an example of a foreign corporation that was included in the S&P 500 because it followed GAAP and reported results in U.S. dollars for accounting purposes and the majority of its trading volume and operations were in the United States, even though it was incorporated outside the United States.

[37] In transactions where the new foreign parent issues stock to the former U.S. parent to acquire some of the U.S. corporation's assets or for intercompany debt obligations, this stock remains owned by the corporate group and therefore does not have a dilutive effect on the company's shareholders.

this depends on the corporate law of the state in which the U.S. parent is incorporated. However, the rights of the shareholders with respect to the governance of the corporation may change in some respects because the ultimate parent corporation of the inverted group will no longer be subject to the corporate laws of the state of its prior incorporation.[38]

VI. TAX POLICY CONSIDERATIONS

A. Introduction

Inversion transactions are not new. However, until recently they were a relatively isolated phenomenon. Recently there has been a marked increase in the frequency of inversion transactions and the size of the companies involved. At the same time, the range of industries in which these transactions are occurring is broadening. These increases reflect an evolution in the perception of these transactions. As more inversion transactions are consummated, more companies find it acceptable from a public relations standpoint to contemplate such a transaction. Indeed, in those industries in which there have been several inversion transactions, other companies within the industry may feel competitive pressure to consider an inversion.

Stock market conditions likely have been a factor in the recent increase in inversion activity. Most inversion transactions have been structured as Stock Transactions, which are taxable to the company's shareholders. However, as a result of several factors, the resulting shareholder-level tax may be less significant today. In general, stock prices have fallen considerably in the past two years. The three most widely-quoted indices of U.S. corporate share prices, the Dow Jones Industrial Average, the Standard & Poor's 500, and the Nasdaq Composite, have fallen roughly 20 percent, 30 percent, and 70 percent, respectively, from the all-time highs reached in 2000. This is particularly significant in light of the trend in shareholder turnover, which indicates that shareholders are holding stock for a shorter period of time, thereby reducing the potential for built-in gain. For example, the annual percentage turnover rates (*i.e.*, the number of shares traded over the total number of shares outstanding) for the New York Stock

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[38] In some inversion transactions, restrictions have been imposed to limit the voting interest of any single shareholder. In particular, a few of these transactions have involved the imposition of new restrictions to limit the ownership of any shareholder to less than 10% of the vote, either through denial of voting rights to the extent a shareholder owns more than a 9.9% ownership interest or through other provisions including redemption rights of the corporation or refusal to register transfers of stock.

An examination of the changes in shareholders' rights under local corporate law of an inverting company as a result of the change in its jurisdiction of incorporation is beyond the scope of the report.

Exchange have increased from 36 percent in 1980, to 46 percent in 1990, and to 88 percent in 2000.[39]

There also has been a significant increase in shareholdings by persons and entities that are not likely to be sensitive to U.S. capital gains tax, such as tax-exempt investors and certain institutional shareholders. Between 1981 and 2001, foreign persons increased their U.S. stock holdings from 5.4 percent to 12.4 percent.[40] The holdings by mutual funds increased even more significantly, from 2.7 percent in 1981 to 18.7 percent in 2001.[41] Mutual funds have some tax-exempt holders such as IRAs. Moreover, mutual fund managers appear to be less sensitive to tax considerations.[42]

Although these market conditions have facilitated the recent inversion activity, they are not what motivates the transactions. U.S-based multinational companies and their shareholders are making the decision to undertake an inversion transaction in large part because of overall tax savings. Through an inversion transaction, a U.S.-based multinational group can substantially reduce or eliminate the U.S. corporate-level tax on income from its foreign operations. In addition, the inversion transaction may be used to achieve a reduction in the U.S. corporate-level tax on income from U.S. operations. An inversion is complicated as a transactional matter but may be virtually transparent as an operational matter. The fact that our tax law operates so that substantial reductions in U.S. taxes are available through a transaction that is more form than substance is troubling to policy makers and the public alike.

Nevertheless, in considering the appropriate response to the recent inversion activity, it is important not to lose sight of the fact that in many cases the same types of tax reduction may be achieved through other means. A start-up venture that contemplates both U.S. and foreign operations must choose a location for its corporate parent. While the natural choice for a U.S.-based venture may be a U.S. parent corporation, that often will not be the most tax-efficient

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[39] New York Stock Exchange, Fact Book 2000, at 99, available at http://www.nyse.com/factbook.

[40] Federal Reserve Board of Governors, Flow of Funds Accounts of the U.S., table 213 (Corporate Equities), p. 82 (March 7, 2002).

[41] Id. The percentage of ownership by mutual funds is determined with respect to the total of all U.S. stock held by both U.S. and foreign persons and all foreign stock held by U.S. persons.

[42] See Robert D. Arnott, Andrew L. Berkin and Jia Ye, "How Well Have Taxable Investors Been Served in the 1980s and 1990s?", 26 Journal of Portfolio Management, issue 4, at 84 (Summer 2000); Joel M. Dickson and John B. Shoven, "A Stock Index Mutual Fund Without Net Capital Gains Realizations", National Bureau of Economic Research Working Paper No. 4717 (1994); Joel M. Dickson and John B. Shoven, "Taxation and Mutual Funds: An Investor Perspective," 9 Tax Policy and the Economy (ed. James M. Poterba, 1995). Mutual funds may in the future become more responsive to tax consequences at the investor level due to new SEC rules requiring disclosure of after-tax performance. See Disclosure of Mutual Fund After-Tax Returns, available at http://www.sec.gov/rules/final/33-7941.htm.

choice. By forming initially through a foreign parent corporation, the venture can enjoy the same tax savings as would be available through a subsequent inversion transaction.

The U.S. tax reduction achieved through an inversion transaction also is available to a foreign acquiror of a U.S.-based multinational group. Following the acquisition, the group may be restructured to achieve substantial reductions in U.S. tax on the income of both foreign and U.S. operations of the former U.S. group. Short of an acquisition of the entire U.S.-based group, a foreign company may acquire the foreign operations of the U.S. group. The movement of those foreign operations out of the U.S. group to the foreign acquiror also results in a substantial reduction or elimination of U.S. tax on the income from such operations.

In the last few years, foreign acquisitions of U.S. companies have grown substantially. Foreign acquisitions of U.S. businesses were $90.9 billion in 1997, $234 billion in 1998, $266.5 billion in 1999, and $340 billion in 2000.[43] There are many economic factors and business reasons that underlie foreign acquisitions of U.S. companies. Even so, the disparity in tax treatment between multinational companies based in the United States and those based in our major trading partners must be recognized and considered as foreign-based multinationals increase their investment in the United States.

B. Cost Differences and Their Effects

Inversion transactions implicate fundamental issues of tax policy. The U.S. tax system can operate to provide a cost advantage to foreign-based multinational companies over U.S.-based multinational companies. Inversions demonstrate this cost advantage in its purest form. By reorganizing to create an offshore parent corporation in a no-tax jurisdiction, a U.S.-based group can reduce its tax liability significantly without any real changes in its business operations and without negatively affecting its access to capital markets. However, this cost advantage is not limited to corporations that invert. Foresighted planners can obtain this same cost advantage by incorporating offshore from the outset. Moreover, a foreign corporation can gain a cost advantage with respect to the operations of an existing U.S. group through a takeover of that group, which may be either friendly or hostile.

The cost advantage accorded by the U.S. tax system to foreign-based multinational companies relative to U.S.-based multinational companies can have significant effects on the way business activity is conducted. Foreign-based multinationals may achieve increased market share by passing the tax savings on to customers in the form of reduced prices. This increased market share translates into reduced business opportunities for U.S.-based multinationals. The differential in U.S. tax treatment also may affect acquisitions of U.S.-based multinational groups, with a foreign-based acquiror able to pay more for the acquisition because of the post-acquisition tax savings unavailable to a U.S acquiror. Therefore, the likelihood is increased that a foreign acquiror will prevail over a U.S. competitor in an acquisition bidding war.

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[43] Mergers & Acquisitions 2001 Almanac, vol. 36, No. 2, at 37 (February 2001).

These changes in business activity can have effects on the U.S. tax system. A shift from U.S.-based multinational structures to foreign-based multinational structures, however accomplished, can erode the U.S. corporate income tax base. More business activity will be conducted in the form that allows enjoyment of a relative reduction in U.S. tax liability. The income from the purely foreign operations of a foreign-based company can escape U.S. corporate-level tax altogether. Moreover, there are techniques available under current law that can result in a reduction in the U.S. corporate-level tax on income from the U.S. operations of a foreign-based company.

In addition, changes in business form can affect the location of business activity. A foreign-headquartered company may make locational decisions that are very different from those a U.S.-headquartered company would make. A foreign-based company that has grown through increases in market share due to cost advantages or through acquisitions may make different supply and investment choices than the U.S.-based company it replaced or acquired. Locational decisions that shift business activity away from the United States have an adverse effect on U.S. jobs, U.S. business, and the U.S. economy overall. Of course, any such shift also affects the U.S. corporate income tax base.

The policy response to corporate inversion transactions should be broad enough to address the underlying differences in the U.S. tax treatment of U.S.-based companies and foreign-based companies, without regard to how foreign-based status is achieved. An approach that addresses only inversion transactions runs the serious risk of simply encouraging the other forms of transaction that can be used to accomplish the same tax results, whether it is original foreign incorporation or foreign acquisition of a U.S. multinational group. The increased inversion activity seen recently is a symptom, and the concerns implicated can be addressed most effectively and most fully by addressing the underlying causes.

An appropriate immediate response should address the U.S. tax advantages that are available to foreign-based companies because of the ability to reduce the U.S. corporate-level tax on income from U.S. operations. It also is necessary to address the U.S. tax disadvantages that are caused for U.S.-based companies because of the U.S. tax treatment of income from their foreign operations. These two areas are discussed further in the following sections. In addition, consideration should be given to the overall U.S. corporate income tax burden. Our tax system should be reviewed and evaluated relative to the tax systems of our major trading partners; fundamental structural issues include the relative share of the tax burden on the corporate sector and the persistent difficulties in properly measuring income and appropriately allocating the tax burden on that basis.

VII. ADDRESSING POTENTIAL TAX ADVANTAGES AVAILABLE FOR FOREIGN-BASED COMPANIES WITH U.S. OPERATIONS

A corporate structure that involves a foreign parent corporation and U.S. operating subsidiaries provides particular opportunities for reducing the U.S. tax on the income earned from U.S. operations. These opportunities are not available in the same way to corporate groups with a U.S. parent corporation. U.S. tax liability can be reduced by shifting income away from the U.S. corporations in the group and to the foreign parent or its foreign subsidiaries. The inappropriate shifting of income out of U.S. taxing jurisdiction represents an erosion of the U.S. corporate tax base. It provides an unfair competitive advantage to these companies relative to their U.S. counterparts that operate in a U.S.-based group. Moreover, it erodes confidence in the fairness of the tax system.

The overall tax savings that may be enjoyed through these techniques that shift income out of the United States is most dramatic in the case of a foreign parent corporation located in a no-tax jurisdiction. This structure is common in the recent inversion activity. If the new foreign parent is located in a jurisdiction that does not impose a corporate income tax, any income that can be shifted from the United States is subject to no corporate-level tax at all. Of course, these same results can be achieved in cases where the corporate group is structured from its inception with the parent located in a no-tax country.

Moreover, while the potential tax savings from income-shifting techniques is greatest where the foreign parent is located in a country that does not impose tax at all, the ability to reduce overall taxes is not limited to those cases. Significant overall tax savings can be achieved with the parent corporation located in a country that provides for low taxation of income from the activities conducted by the parent. There also are savings available, and therefore some incentive to engage in this sort of income shifting exists, whenever the foreign parent corporation is subject to an effective tax rate that is lower than the U.S. tax rate.

In the case of inversion transactions, the ability to reduce overall taxes on U.S. operations through these income-shifting techniques provides an immediate and quantifiable benefit. In contrast, the prospect of a more competitive tax environment for future foreign operations is a longer-term benefit that may be more difficult to quantify with precision. The inversion transaction itself involves significant tax cost in terms of gain recognition at the corporate level, the shareholder level, or both, as well as other significant transaction costs. The decision to undertake an inversion also is difficult for reasons other than these tax and transaction costs. In many cases, the immediate and quantifiable benefit from reducing U.S. tax on U.S. operations is a key component of the cost-benefit analysis with respect to the transaction. In other words, 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. Accordingly, addressing these issues and eliminating the opportunities to reduce inappropriately the U.S. tax on income from U.S. operations can be expected to have a significant effect on inversion transaction activity.

A. Earnings Stripping through Foreign Related-Party Debt

One of the simplest ways for a foreign-based company to reduce the U.S. tax on income from U.S. operations is through deductions for interest payments on intercompany debt. Interest paid by a U.S. subsidiary to its foreign parent may be deductible for U.S. tax purposes. The U.S. subsidiary can be loaded up with a disproportionate amount of debt for earnings stripping purposes through the mere issuance of an intercompany note. Thus, the desired earnings stripping, and U.S. tax reduction, can be accomplished without any real movement of assets or change in operations.

A feature common to many inversions is the presence of substantial indebtedness from the former U.S. group to the new foreign parent or one of its foreign subsidiaries. The indebtedness can arise through the former U.S. parent's contribution of a note to the foreign corporation prior to the consummation of the inversion transaction. Alternatively, it can arise after the inversion transaction through a distribution of a note to the new foreign parent. While the steps through which the debt is put in place vary, the result can be interest payments that effectively strip income out of the U.S. taxing jurisdiction. Where the foreign parent is in a no-tax country and a comprehensive income tax treaty with the United States is applicable, the tax-reduction benefit of this technique is maximized, as there is no offsetting increase in foreign taxes. However, even where the foreign parent is located in a country that imposes tax, the interest income earned may be subject to little foreign tax, if the country specifically reduces taxation on financing structures. Moreover, there is some net tax benefit whenever the foreign tax imposed on the interest income is less than the value of the U.S. tax deduction for the interest expense.

The potential to use foreign related-party debt to strip income out of the United States is not unique to inversion transactions and concern about this technique is not new. Section 163(j) was enacted in 1989 to address these concerns by denying U.S. tax deductions for certain interest expense paid by a corporation to a related party. Section 163(j) applies where the corporation's debt-equity ratio exceeds 1.5 to 1 and its net interest expense exceeds 50 percent of its adjusted taxable income (computed by adding back net interest expense, depreciation, amortization and depletion, and any net operating loss deduction).[44] If the corporation exceeds these thresholds, no deduction is allowed for interest in excess of the 50-percent limit that is paid to a related party and that is not subject to U.S. tax. Special rules apply in the case of interest paid to an unrelated party on debt guaranteed by a related party.[45] Special rules also apply in the case of interest that is subject to a reduced rate of U.S. tax pursuant to an income tax treaty.[46]

The rules of section 163(j) are detailed and complex. The prevalent use of foreign related-party debt in inversion transactions is evidence that these rules should be revisited. Moreover, because the opportunities for earnings stripping are not limited to inversion transactions but are present in cases where a U.S. business is structured from the outset with a foreign parent and in cases where a foreign corporation acquires a U.S. operating group, reconsideration of these rules should not be limited in application to inverted companies.

Consideration of potential reform of the earnings stripping limits of section 163(j) should focus on the key components of the current-law rules. Moreover, the operative elements of the limitation on interest deductions in section 163(j) are interrelated. Accordingly, examination of the interaction of these tests and consideration of modifications to those tests is appropriate.

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[44] Section 163(j)(2).

[45] See section 163(j)(6)(D).

[46] See section 163(j)(5)(B).

The deduction limits of section 163(j) currently apply only if the corporation has a debt-equity ratio that exceeds 1.5 to 1.[47] This threshold effectively operates as a safe harbor for corporations with debt-equity ratios of 1.5 to 1 or lower. This fixed safe harbor obviously has a very different effect on different companies. For industries that typically are very highly leveraged, the earnings stripping rules may apply across the board. For industries that typically are much less leveraged, the ratio may allow significant related party debt to be put in place solely for tax reasons. In evaluating whether related party debt is being used as a mechanism for earnings stripping, the most relevant inquiry may be whether the U.S. corporation in question is disproportionately leveraged relative to the corporate group as a whole. Therefore, it may be more appropriate to compare the debt-equity ratio of the U.S. corporation to the debt-equity ratio of the worldwide corporate group of which it is a part (determined without regard to intercompany indebtedness). Further consideration should be given to whether a workable approach can be developed that substitutes this type of comparison for the fixed debt-equity threshold of current law.

Alternatively, it may be appropriate to reduce the current-law threshold of 1.5 to 1, but provide an exception for situations where the taxpayer can demonstrate that the U.S. corporation’s debt-equity ratio is not disproportionate to the overall debt-equity ratio of the corporate group. Another approach would be to eliminate the debt-equity ratio threshold entirely, so that the determination of whether an interest deduction is allowed for related-party interest payments is made based solely on a comparison between taxable income and interest expense. With this approach, however, variations in taxable income, due to business cycle fluctuations, could have a substantial impact on the interest deductions permitted even where the taxpayer is not engaging in any inappropriate tax-driven earnings stripping.

The second applicable threshold under current law is whether the net interest expense of the corporation exceeds 50 percent of the corporation's adjusted taxable income. Interest paid to related parties not subject to U.S. tax is disallowed as a deduction to the extent this threshold is exceeded. Consideration should be given to whether it is appropriate to tighten this 50-percent limitation. Moreover, consideration should be given to whether the denial of deductions should apply to all related party interest payments above the threshold as under current law or whether a deduction should be denied only for interest paid on related party debt that itself exceeds some threshold. In addition, it should be noted that the current-law income threshold is based on taxable income adjusted to reflect the addback of interest expense, depreciation and amortization. To the extent that depreciation and amortization taken into account for tax purposes represent economic costs, this addback may not be appropriate and should be examined further.

Finally, section 163(j) currently provides that interest expense disallowed under these rules may be carried forward indefinitely and deducted in a future year. This carryforward provides relief to those taxpayers whose interest-to-income ratio may be subject to unanticipated

[47] It should be noted that the cross ownership of stock that is created in some inversion transactions, where the former U.S. parent corporation may hold a significant amount of the stock of its new foreign parent, raises issues with respect to the application of the debt-equity test.

fluctuations, due, for example, to downturn in their business. However, this carryforward provides opportunities that mitigate the effect of the deduction denial. Therefore, the implications of this carryforward should be taken into account in considering an appropriate debt-equity ratio threshold and income limit.

The interaction between section 163(j) and our tax treaties in addressing earnings stripping must be considered as well. Stripping income out of the United States through foreign related-party debt is effective only if the receipt of the interest payment attracts less tax than the earnings otherwise would have attracted. In the absence of a reduction pursuant to an income tax treaty, U.S. withholding tax at a rate of 30 percent generally applies to payments of interest from a U.S. corporation to a foreign affiliate. Thus, the cost advantage achieved by stripping income through foreign related-party debt is most effective when the interest is paid to a foreign related party that is eligible for benefits under a comprehensive U.S. income tax treaty and that is not subject itself to significant local tax on the interest income.

U.S. income tax treaties are intended to prevent the double taxation by the United States and its treaty partner of income earned by residents of one country from sources within the other country. Thus, the United States does not enter into income tax treaties that lower the rates of U.S. withholding tax on certain types of U.S.-source income (*e.g.*, U.S.-source interest) with jurisdictions that do not have a comprehensive income tax system. In such a case, there is no need for a reduction or elimination in the U.S. withholding tax because there is no risk of double taxation. If a current or prospective treaty partner does not tax a particular category of U.S.-source income earned by its residents, either because of a general tax exemption or a special tax regime, reduction of U.S. withholding tax on that category of income may not be appropriate.

Our tax treaties should be evaluated to identify any inappropriate reductions in U.S. withholding tax that provide earnings stripping opportunities. In addition, we should make certain that the operation of our treaties is consistent with the expectation of the United States and its treaty partners that treaties should reduce or eliminate double taxation of income, not eliminate all taxation of income. Finally, consideration should be given to approaches under domestic law to prevent inappropriate use of an income tax treaty.[48] Specifically correcting inappropriate results under particular treaty provisions through treaty amendments or targeted domestic law provisions would address the problem of potential abuses without damaging our overall treaty relationship with our trading partners.

In addition, because tax treaties are intended to benefit residents of the two treaty partners, the United States includes detailed limitation on benefits provisions in its treaties to prevent the misuse of treaties by residents of third countries. These limitation on benefits provisions are important to ensuring that a resident of a third country cannot benefit inappropriately from a reduction in U.S. withholding tax by structuring a transaction, including an earnings stripping transaction, through a treaty country. One of Treasury's key tax policy

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[48] See U.S. Treasury Department, U.S. Model Income Tax Convention of September 20, 1996: Technical Explanation, Article 22 (Limitation on Benefits)).

goals in modernizing our network of existing tax treaties is to bring the limitations on benefits provisions in all our treaties up to standards so as to prevent the opportunity for such misuse.

B. Income Shifting through Related-Party Transactions

Many inversion transactions involve the movement of foreign subsidiaries out of the U.S. group so that they are held directly by the new foreign parent. This can occur through a contribution of the subsidiaries to the foreign corporation prior to the inversion itself. Alternatively, it can occur through a dividend or sale of the foreign subsidiary stock after the inversion is consummated. In addition to transfers of the U.S. group's foreign subsidiaries, some inversion transactions involve transfers of intangible and other assets to the foreign parent or its foreign subsidiaries. Moreover, in some cases, the existing foreign subsidiaries of the U.S. group are allowed to "wither away," with new business and growth opportunities directed to the foreign subsidiaries of the new foreign parent.

This type of movement of foreign subsidiaries, assets, and opportunities is not unique to inversion transactions. The same sort of restructuring steps are common whenever a foreign-based group acquires a U.S.-based multinational group. Although the potential overall tax savings from income shifting are greatest when the foreign parent corporation is in a no-tax country, significant tax savings are available even without resort to a no-tax country.

These cross-border transfers of subsidiaries and assets give rise to significant valuation issues. In addition, the ongoing transactions – both explicit and implicit – between the various entities give rise to significant income allocation issues. The magnitude of the potential tax savings at stake puts significant pressure on the application of the section 482 income allocation rules. The transfer of foreign operations or other assets to the foreign parent or a foreign subsidiary thereof puts significant pressure on the implementation and enforcement of the arm's length standard under the transfer pricing rules. Where the arm's length standard is not properly applied or enforced, the inappropriate income shifting that results can significantly erode the U.S. tax base.

The application of the arm's length standard to the outbound transfer of intangible assets is particularly difficult for several reasons. As an initial matter, it may be difficult to determine whether a transfer of a non-legally protected intangible asset, such as know-how or business opportunities, has taken place. Where a transaction is identified, a transfer of know-how or business opportunities could be structured or characterized either as the transfer of an intangible asset or as the provision of a service, leading potentially to different transfer pricing results. Where a transaction is identified as the transfer of intangible assets, determination of the appropriate transfer price requires the valuation of the intangible assets, which can be very difficult. The determination of the appropriate transfer price is further complicated when less than all of the rights to an intangible asset are transferred. For example, the right to limited use of an intangible asset may be transferred from a U.S. corporation to its foreign parent or a foreign affiliate thereof in a cost sharing arrangement for the purpose of facilitating the development of future intangible assets that will be owned outside the United States.

Legislative and regulatory developments have helped to facilitate the appropriate application of the arm's length standard to the transfer of intangible assets.[49] This arm's length standard, as supplemented by the commensurate with income standard, provides the appropriate analytical framework for analyzing transfer pricing issues related to the transfer of intangible (and other) assets. However, the complex factual nature of the issues raised in the area of intangible asset transfers should not be underestimated.

Further work is needed to ensure that current enforcement practices and regulatory rules are adequate in the context of outbound transfers of intangible assets. Ongoing work in this area includes a thorough examination of the rules applicable to the transfer of intangible assets, which were put in place in 1994 and 1995, to determine whether they are adequate to ensure an appropriate application of the arm's length standard. In addition, in the context of the ongoing project to revise and update rules applicable to the provision of services, one area of particular focus is the need to address and mitigate the extent to which the structuring or characterization of a transfer of intangible assets as the provision of services can lead to inappropriate transfer pricing results. Further consideration also should be given to the adequacy of the current reporting and penalty rules as they apply in the context of intangible transfers.

Special income-shifting issues arise in the context of the several inversion transactions that have involved insurance and reinsurance companies. The initial reincorporation outside the United States typically has been accompanied by a shift of some portion of the existing U.S. insurance business through reinsurance with a related foreign affiliate. Consideration should be given to whether the use of related party reinsurance permits inappropriate shifting of income from the U.S. members of a corporate group to the new foreign parent and its foreign affiliates, and whether existing mechanisms for dealing with such related party transactions are sufficient to address these opportunities. In this regard, further analysis may be appropriate to consider and evaluate the approaches used by our trading partners in taxing insurance companies, including, for example, the use by some countries of a premium-based tax that captures within the country's tax base all business written on risks within the country.

C. Treatment of Cross-Border Reorganizations

The complexity of the transactions involved in an inversion is striking. The restructuring involves not only the creation of a new corporate parent for the multinational group but also the movement of subsidiaries and assets within the group. These transactions implicate all of the

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[49] Significant legislative changes were made by the Tax Reform Act of 1986, which amended section 482 to require that consideration for intangible property transferred to a related party be commensurate with the income attributable to the intangible property, and the Omnibus Budget Reconciliation Acts of 1990 and 1993, which amended section 6662 to provide for a comprehensive penalty and reporting regime in order to encourage the preparation by taxpayers of contemporaneous documentation supporting related party transfer prices. Significant regulatory developments include a comprehensive update of the transfer pricing regulations, finalized in 1994, and regulations regarding cost sharing arrangements for the development of intangible assets, finalized in 1995.

corporate rules involving creation and reorganization of corporate entities. In addition, because the transactions involve transfers of assets between the United States and one or more foreign countries, the section 367 rules also are applicable. Furthermore, there will be implications under other regimes, including, for example, the consolidated return rules, the section 304 rules, and the foreign tax credit rules. The cross ownership of stock that is created in some inversion transactions, where the former U.S. parent corporation may hold a significant amount of the stock of its new foreign parent, raises particular issues under a variety of corporate provisions. Finally, the laws of one or more foreign jurisdictions will be implicated by these transactions.

The corporate organization and reorganization rules, as well as the other related rules of subchapter C such as section 304, were written largely for purely domestic transactions. Section 367, and the lengthy regulations thereunder, modify those rules for application in the case of cross-border transactions. With the increasing globalization of both U.S. companies and foreign companies, these rules are being applied more frequently and to larger and more complicated cross-border transactions. The inversion transactions represent one particular source of increasing pressure on these rules. Pressure also comes from the restructuring needed to accomplish any combination of foreign and U.S. companies, whether by merger or acquisition.

It is critical that the rules governing cross-border reorganizations keep up with these developments. The current cross-border reorganization rules are something of a patchwork, developed and revised over the last twenty years. A comprehensive review of these rules would be appropriate in light of the increasing pressure put on these rules through the larger and more complicated international restructuring transactions that are becoming commonplace. One focus in this reconsideration of the current-law rules should be on achieving greater consistency in treatment across similar transactions, in order to avoid both traps for the unwary and opportunities for taxpayers to exploit the rules to reach results that are not intended. Moreover, more detailed guidance and clearer rules would help provide greater certainty to taxpayers and the government in this complex area.

As an immediate matter, the information reporting rules in this area must be revisited. In this regard, many inversion transactions are taxable events at the shareholder level, with the company's U.S. shareholders required to recognize gain and pay tax thereon. However, unlike in the case of a typical disposition of stock for cash, there is no current obligation for Form 1099 reporting of the transaction to the IRS. Requiring reporting of these transactions through Form 1099 would increase the IRS's access to information about these transactions and also would serve to remind shareholders of the tax consequences to them from the transaction the company undertook during the year and insure the income is reported.

VIII. ADDRESSING POTENTIAL TAX DISADVANTAGES FOR U.S.-BASED COMPANIES WITH FOREIGN OPERATIONS

The foreign operations of a U.S.-based multinational are subject to the tax laws of the countries in which those operations are located and also to the U.S. international tax rules. The foreign operations of a foreign-based multinational are subject to the tax laws of the countries in which those operations are located, potentially to the tax laws of the country where the foreign parent is located, but not to the tax laws of the United States. The foreign operations of a U.S.-

based company thus are subject to a burden not borne by local competitors. The broad reach of the U.S. international tax rules and the complexity of those rules therefore raise issues with respect to a level playing field for U.S. companies operating abroad.

The development of our international tax system began at a time when the global economy was very different from today. The basic structure of the U.S. international tax regime dates from the early 1960s, a time when the U.S. economy was dominant, accounting for over half of all multinational investment in the world. The global economy, and the U.S. place in it, has changed dramatically in the last 40 years. The globalization of the U.S. economy puts ever more pressure on our international tax rules. When the rules first were developed, they affected relatively few taxpayers and relatively few transactions. Today, there is hardly a U.S.-based company of any significant size that is not faced with applying the international tax rules to some aspect of its business.

The United States operates a worldwide system of income taxation under which domestic residents are taxed on income regardless of where it is earned. Therefore, a U.S. corporation with foreign operations is subject to U.S. tax on the income from those foreign operations in addition to the tax imposed by the country where the operations are located. Under a foreign tax credit system, the U.S. tax on foreign-source income is reduced to reflect foreign income and withholding taxes paid. However, complex rules apply to limit the availability of foreign tax credits by requiring the categorization of income into baskets to which the foreign tax credit rules are applied separately and by requiring the reduction of income for which foreign tax credits may be claimed to reflect a broad allocation of U.S.-incurred expenses. Income earned through a foreign subsidiary is subject to U.S. tax at the U.S. parent corporation level generally when it is distributed by the foreign subsidiary to the U.S. parent. However, under the rules of subpart F, the U.S. parent is subject to current U.S. tax on certain income of its foreign subsidiaries, without regard to whether the income is actually distributed to the U.S. parent. While the focus of the subpart F rules is on passive, investment-type income earned abroad, the income subject to this current taxation can include income from active foreign business operations.

In contrast, many of our trading partners operate tax systems under which active income earned by foreign subsidiaries and profits earned by foreign branches are exempt from domestic taxation. Under these systems, income from a company's operations is taxed only by the country where the operations are located. Other countries among our key trading partners have tax systems that are more similar to the U.S. international tax rules in that they also start from the worldwide taxation approach. However, no country has rules for the immediate taxation of foreign-source income that are comparable to the U.S. rules in terms of breadth and complexity.

For example, the U.S. tax system imposes current tax on the income earned by a U.S.-owned foreign subsidiary from its shipping operations, while that company's foreign-owned competitors are not subject to tax on their shipping income. Consequently, the U.S.-based company's margin on such operations is reduced by the amount of the tax, putting it at a disadvantage relative to the foreign competitor that does not bear such a tax. The U.S.-based company has less income to reinvest in its business, which can mean less growth and reduced future opportunities for that company.

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. The impact of this competitive disadvantage is seen most starkly with the recent inversion activity, where U.S. companies are undergoing a complex restructuring to create a new foreign parent company so that their foreign operations will no longer be subject to the U.S. international tax rules. At the same time, we also are seeing start-up companies that envision significant foreign operations making the decision to incorporate outside the United States for the same reason. Moreover, the U.S. international tax rules can make a difference in the choice of how to structure a merger between a foreign-based multinational and a U.S.-based multinational. If the foreign-based multinational becomes the parent of the new combined group, internal restructuring can eliminate the application of the U.S. international tax rules to the foreign operations of the former U.S. group. If instead the U.S.-based multinational were to become the parent of the new combined group, the foreign operations of the former U.S. group would remain subject to the U.S. international tax rules and the all of the foreign group's worldwide operations would become subject to those rules for the first time.

A U.S.-based multinational that restructures its foreign operations so that they are held by a new foreign parent will avoid the reach of the U.S. tax rules with respect to those operations. The foreign operations continue to be subject to the tax rules of the country where they are located and will be subject to the tax rules of the country where the new foreign parent is located. Where the new foreign parent is in a country that has no income tax, which is the case in most of the recent inversion transactions, the foreign operations will be subject to tax only where they are located. This is similar to the treatment that would result where the foreign parent is located in a country with a territorial tax system. For this reason, the recent inversion activity has been referred to sometimes as "self-help territoriality."[50]

Both the recent inversion activity and the increase in foreign acquisitions of U.S. multinationals are evidence that the competitive disadvantage caused by our international tax rules is a serious issue with significant consequences for U.S. businesses and the U.S. economy. A comprehensive reexamination of the U.S. international tax rules is needed. It is appropriate to question the fundamental assumptions underlying the current system. We should look to the experiences of other countries and the choices that they have been made in designing their international tax systems. Consideration should be given to fundamental reform of the U.S. international tax rules, including the merits of the exemption-based tax systems of some of our major trading partners. Consideration also should be given to significant reforms within the context of our current system. The reach of the various anti-deferral regimes, which can operate to impose current U.S. tax on active business income earned abroad, should be reevaluated. The restrictions on the use of the foreign tax credit, which can operate to defeat the underlying

[50] One difference is in the treatment of any passive income earned abroad. The territorial tax systems of most of our trading partners include rules imposing tax on passive income earned from foreign sources. Where the foreign parent of an inverted company is located in a no-tax country, passive income earned abroad may not be subject to tax anywhere. Further consideration must be given to this issue.

purpose of the credit and can result in double taxation of business income earned abroad, also should be reevaluated. The many layers of rules in our current system arise in large measure because of the difficulties inherent in satisfactorily defining and capturing income for tax purposes, particularly in the case of activities and investments that cross jurisdictional boundaries. However, the complexity of our tax law itself imposes a significant burden on U.S. companies. Therefore, we also must work to simplify our international tax rules.

IX. CONCLUSION

We must work to ensure that our tax system does not operate to place U.S.-based companies at a competitive disadvantage in the global marketplace. The tax policy issues raised by the recent inversion activity are serious issues. Further work is needed to develop and implement an appropriate and effective long-term response. As an immediate matter, careful attention should be focused on ensuring that an inversion transaction, or any other transaction resulting in a new foreign parent, cannot be used to reduce inappropriately the U.S. tax on income from U.S. operations. A comprehensive review of the U.S. tax system, particularly the international tax rules, is both appropriate and timely. Our overarching goal must be to maintain the position of the United States as the most desirable location in the world for place of incorporation, location of headquarters, and transaction of business.