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A Perfect Storm for Corporate Inversions: Causes and Responses

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INTRODUCTION

Over the past three years, the pace of inversion transactions announced by large U.S. corporations has increased. Not a day goes by without one or more articles appearing in the tax press about inversions, and news articles aimed at the lay reader appear regularly in major newspapers. Inversions have risen to a level of national prominence. This article puts this public discussion in context by analyzing the tax reasons that corporations seek to invert and the potential tax policy responses to those causes.

Analytically, U.S. multinational corporations (U.S. MNCs) invert in order to reduce taxes on U.S. earnings, reduce taxes on future foreign earnings and gain access to cash associated with historic foreign earnings in a tax-efficient manner. The large number of inversions has attracted the attention of U.S. policymakers,[1] leading to a range of responses that aim either to prevent certain inversions from happening or to curtail perceived advantages of an inversion.

This is not the first time that corporate inversion transactions have risen to the forefront of policy discussions in Washington. In the late 1990s and early 2000s a wave of inversions prompted Congress to pass legislation in 2004 that made it more difficult to complete inversions, namely, §7874.[2] That legislation, together with long-standing regulations under §367, halted inversions for several years.[3] But the tide has risen once again and inversions have been undertaken with greater regularity than before, a trend that raises an important question: why have so many happened recently?

This trend has been the result of a ''perfect storm'' of factors, a unique alignment of domestic and international developments over the past several years. It is often argued that structural aspects of the U.S. tax system — such as high corporate tax rates and a

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[1] On July 15, 2014, Treasury Secretary Jack Lew publicly urged congressional leaders of both parties to take action to stem the flow of inversions. (Letter to House Committee on Ways and Means Chairman Dave Camp, Jack Lew (July 15, 2014)). This letter was soon followed by a public statement by President Obama on July 24 to a similar effect. (Remarks of President Barack Obama, Weekly Address (July 26, 2014)). Several bills have been proposed to limit inversions as well, as discussed below in Part V of this article.

[2] American Jobs Creation Act of 2004, Pub. L. No. 108-357 (Oct. 22, 2004). Unless otherwise stated, all section references are to the Internal Revenue Code (''the Code''), and the regulations thereunder.

[3] Very few inversions were undertaken between 2003 and 2008. *See* Zachary R. Mider, *Tax Inversion: How U.S. Companies Buy Tax Breaks*, Bloomberg (July 18, 2014).

worldwide rather than a territorial system of taxation — are responsible for the trend. This view captures part of the story, while, at the same time, opportunities exist for self-help to drive down the amount of U.S. taxes actually paid relative to a given amount of income.

Another factor is that a growing share of the profits of U.S. MNCs over the past several years has been attributable to foreign subsidiaries. An ever-greater portion of MNC cash is held in foreign subsidiaries and would be taxed if repatriated, creating what is known as the ''lockout effect.'' An inversion introduces the possibility of gaining access to foreign cash without the cost of repatriating either historic foreign earnings or future foreign earnings, although a recent Internal Revenue Service (IRS) Notice has made it more difficult to gain access to foreign cash.

As well, an inversion introduces the opportunity to reduce tax on U.S. earnings going forward through intercompany leverage, a practice known as ''earnings stripping.''

Moreover, the recent high-profile commentary and debate among U.S. legislators regarding measures to limit or stop inversions may serve to encourage U.S. corporations to invert sooner rather than later, so as to avoid losing the opportunity altogether should new legislation actually be passed.

Another factor facilitating inversions is that certain European jurisdictions have become more favorable destinations for inverted companies. Over the past five years, the United Kingdom has become an appealing jurisdiction, with low statutory corporate tax rates, zero-percent withholding on outbound dividends and on inbound dividends from the United States.

While this perfect storm of factors has led to a wave of inversions that has already prompted a number of legislative proposals and regulatory responses, it remains to be seen how sweeping the policy response will ultimately be. It is possible that recently announced regulations in combination with existing law will slow or stem the tide and that such regulations will therefore be the most substantive response, but it is also possible that inversions could serve as the tipping point that leads to broader reform of the tax code. Only time will tell the full extent to which U.S. tax law is changed in response to inversions.

This paper discusses the contribution of each factor mentioned above to the current wave of inversions and analyzes regulatory and legislative proposals in light of these factors.

I. WHY DO U.S. COMPANIES INVERT?

Statutory Corporate Tax Rates in the United States and Abroad

Perhaps the most frequently discussed aspect of the U.S. tax system thought to create an incentive for U.S. companies to expatriate is the corporate income tax rate.[4] Currently, the United States has the highest combined statutory corporate income tax rate of any Organisation for Economic Co-operation and Development (OECD) country,[5] calculated to be 39.1%.[6] As seen in Figure 1, the U.S. rate is well above the combined statutory rates of most OECD countries, and is more than 10 percentage points above the Gross Domestic Product (GDP)-weighted average of the top combined statutory rates of the other OECD countries (28.5%). By comparison, the United Kingdom and Ireland have much lower combined rates at only 21% and 12.5%, respectively.[7]

The United States has not always had the highest combined statutory rate, however. In 1998, the U.S. combined rate (then at 39.4%) was below the OECD GDP-weighted average (at 40.7%).[8] Since then, while the U.S. top combined corporate rate has remained largely unchanged at around 39%, almost all the OECD countries have lowered their rates, and in some

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[4] *See, e.g.,* Paul A. Volcker et al., *President's Economic Recovery Advisory Board, The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation*, at 69 (2010) (''Because the high statutory corporate tax rate in the U.S. causes or exacerbates many distortions in the current tax system, lowering the rate would reduce these inefficiencies.''). *See also* Donald J. Marples & Jane G. Gravelle, *Corporate Expatriation, Inversions, and Mergers: Tax Issues*, Cong. Research Serv., R43568 (May 27, 2014); Jane G. Gravelle, *International Corporate Tax Rate Comparisons and Policy Implications*, Cong. Research Serv., R41743 (Jan. 16, 2014). *Cf.* Kane, M. and Rock, E. (2007). *Corporate Taxation and International Charter Competition*. 106 Mich. L. Rev. 1229 (2008); Heather Campbell, *When Good Law Goes Bad: Stanley Works' Recent Dilemma and How the Internal Revenue Code Disadvantages U.S. Multinational Corporations Forcing Their Flight to Foreign Jurisdictions*, 31 Syr. J. of Int'l L. & Com. 95 (2004).

[5] The OECD calculates the ''combined'' rate by summing (a) ''the basic central government statutory corporate income tax rate (inclusive of surtax (if any)), adjusted (if applicable) to show the net rate where the central government provides a deduction in respect of sub-central income tax,'' plus (b) ''the basic sub-central (combined state/regional and local) statutory corporate income tax rate, inclusive of sub-central surtax (if any).'' *OECD Tax Database*, tbl. II.1, nn. 3–5.

[6] *Id.*

[7] Note that on April 1, 2015, the United Kingdom will reduce its top statutory rate further to 20%. *See* EY, *Worldwide Corporate Tax Guide* 2014, at 1433 (Apr. 2014).

[8] Calculated using data from *OECD Tax Database*, above, n. 5.

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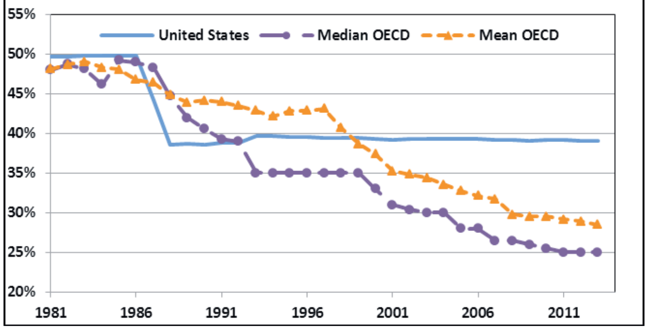
cases significantly.[9] This trend can be seen not only in Figure 1, which compares the top combined statutory rates of OECD countries in 2000 and 2014, but also in Figure 2, which tracks the U.S. top combined statutory rate compared to the mean and median top combined statutory rates of the remaining OECD countries since 1981.

Fig. 2: Corporate Income Tax Rates Since 1980, U.S. vs. OECD Countries
(Weighted avgerage using PPP-adjusted GDP data in 2005 U.S. Dollars)
Source: OECD Tax Database, OECD GDP Data



While the top combined statutory rate is indeed comparatively high in the United States, it does not tell the whole story regarding the recent wave of inversions. First, the completion of an inversion transaction does not change the statutory rate of taxation on U.S. earnings. To the contrary, even after the completion of the inversion, the U.S. subsidiary under the foreign acquirer will face the same corporate income tax regime that it did before the inversion.

Second, the top combined statutory rate taken on its own can overstate the tax burden borne by taxpayers.[10] Studies suggest that despite the U.S. high combined statutory rate, the effective tax rate (i.e., the rate calculated by dividing the amount of taxes actually paid by a corporation over its financial accounting profits) paid by many U.S. corporations is actually much lower. For example, the Government Accountability Office (GAO) recently estimated that an average U.S. corporation pays an effective tax rate of only about 22.9%, much lower than the 39.1% top combined statutory rate.[11] Moreover, the effective tax rate varies from industry to industry, corporation to corporation, and even year to year within the same company.[12]

One could debate whether the statutory rate or the effective rate is more relevant. Tax planning is sometimes intended to save tax on the last dollars of income. One could argue that the last dollars of income are taxed at the statutory rate absent tax planning and that the statutory rate is therefore more relevant to companies considering inverting. But, it is not always the case that last dollars of income are taxed at the statutory rate. Tax planning can drive the effective rate much lower than the statutory rate (e.g., an additional dollar of foreign earnings retained in a foreign subsidiary is generally not taxed at all in the U.S. until or unless repatriated) and thus the effective rate may be a better measure of the tax that companies actually bear.

The U.S. Worldwide System of Taxation

The second feature of the U.S. tax system often identified as an incentive for inversions is the United States' worldwide system of taxation coupled with a policy of deferral of foreign earnings until such earnings are repatriated. Generally, countries take one of two broad approaches to the taxation of earnings of MNCs. Under a worldwide system, such as that employed in the United States, the determining factor for tax liability is corporate residence. All income earned by companies resident within the country is subject to tax by that country, whether the income is earned domestically or abroad. Under a territorial system, the determining factor is instead the source of the income. Companies are generally subject to tax on income earned within the borders of a country, while income earned abroad is either wholly or partially exempt from taxation.[13] In 2012, 28 of the 34 current OECD member countries had territorial tax systems that exempt at least 95% of certain dividends from certain

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[9] *Id.* Nine OECD countries lowered their top combined statutory corporate tax rates by 10 percentage points or more, with Germany lowering its rate the most of all, by 25.9 percentage points.

[10] *See* Jane G. Gravelle, Cong. Research Serv., R41743, above n. 4. *See also* Gov. Accountability Off., *Effective Tax Rates Can Differ Significantly from the Statutory Rate* (May 2013); Jane G. Gravelle, *Dynamic Scoring for Tax Legislation: A Review of Models*, Cong. Research Serv., R43381 (July 8, 2014).

[11] James A. Wozny, *GAO Official Defends Agency Report Numbers*, Tax Analysts (Nov. 25, 2013).

[12] A 2014 study by the Citizens for Tax Justice, which reviewed the returns of 288 Fortune 500 corporations during the five-year period from 2008 to 2012, found that based upon the deductions and credits available there was a wide range of average effective rates paid. Averages for industries as a whole ranged from 2.9% (utilities) to 29.6% (retail, healthcare, and wholesale). Roughly a third (93) of the corporations surveyed paid zero corporate income tax during at least one of the five years, and 26 corporations paid zero corporate income tax across any of the five years. Robert S. McIntyre et al., *The Sorry State of Corporate Taxes What Fortune 500 Firms Pay (or Don't Pay) in the USA and What They Pay Abroad — 2008 to 2012*, Citizens for Tax Justice (2014).

[13] *See* Thornton Matheson, Victoria Perry & Chandara Veung, *Territorial vs. Worldwide Corporate Taxation: Implications for Developing Countries*, International Monetary Fund, Working Paper No. 13/205 (Oct. 2013).

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foreign subsidiaries.[14] The number of OECD member countries using territorial systems of taxation has doubled since 2000.[15]

A conflict arises where an MNC resident in a country with a worldwide system of taxation also operates abroad. Each country has a claim to tax the company's income. To avoid double taxation, the United States provides a foreign tax credit to U.S. corporations for taxes paid to a foreign country on foreign-source income that is also subject to U.S. tax. The United States also allows U.S. corporations to defer taxes on income earned in foreign subsidiaries until such income is repatriated to the domestic parent. The deferral system encourages U.S. MNCs to leave foreign earnings in foreign subsidiaries to avoid the tax that would be imposed on a dividend of those earnings to the U.S. parent corporation. Moreover, under Subpart F of the Code, U.S. MNCs must pay tax on certain types of income earned by foreign subsidiaries even if such income is not repatriated. Thus, under the U.S. worldwide system of taxation, a U.S. MNC may anticipate that earnings of its foreign subsidiaries will eventually be subject to U.S. tax.

Removing Foreign Earnings from the U.S. Tax Base: Access to Existing Cash in Foreign Subsidiaries and Avoidance of U.S. Tax on Future Foreign Earnings

Inversions may present an opportunity for the new parent and shareholders to gain access to cash in foreign subsidiaries, expand operations abroad without facing tax on repatriation of new earnings to the United States, and avoid the U.S. regime that taxes and regulates controlled foreign corporations (CFCs).

An inversion facilitates gaining access to foreign earnings. For example, if the foreign subsidiaries of the U.S. MNC are transferred out from under the U.S. parent during the course of the inversion, it may be possible subsequently to remove cash in the foreign subsidiaries without U.S. tax. The transfer of the foreign subsidiaries may be taxable but if the U.S. parent has losses or other tax attributes, the U.S. parent may be able to use those attributes to shelter gain on the transfer.[16] As well, until the issuance of Notice 2014-52,[17] the foreign subsidiaries could lend funds directly to the foreign acquirer without incurring a repatriation tax, "hopscotching" around the U.S. parent. Further, until the issuance of Notice 2014-52, opportunities existed for de-controlling the historic foreign subsidiaries after the inversion, thereby limiting the extent to which future earnings would be subject to U.S. tax.

An inversion also facilitates expansion of foreign operations of the MNC under the foreign acquirer. The foreign acquirer can acquire foreign businesses, make strategic investments abroad, or potentially organically expand foreign operations generally without U.S. corporate tax on future earnings of those new foreign operations. Earnings of foreign subsidiaries under the foreign acquirer (and not under the U.S. parent) would generally not be subject to U.S. tax as earned nor when redeployed around the corporate group or distributed to shareholders. By contrast, earnings of foreign subsidiaries that are under a U.S. parent are subject to U.S. tax upon distribution generally and, in the case of Subpart F income, such earnings are subject to U.S. tax as they are earned.[18]

The ability to gain access to historic foreign earnings and to expand foreign operations without U.S. tax on future foreign earnings is advantageous to U.S. MNCs because profits of foreign subsidiaries represent a growing share of the total profits of U.S. MNCs, as shown in Figure 3.[19] PricewaterhouseCoopers calculated that 48% of book earnings of U.S. public corporations before tax in 2012 came from foreign sources.[20]

Further, a substantial portion of the additional foreign earnings of U.S. MNCs remains held abroad in the foreign subsidiaries rather than repatriated to the United States, in large part because it would be taxed by the United States if it were repatriated. As long as the foreign-source income is left in foreign subsidiaries, the U.S. MNC can potentially indefinitely avoid U.S. taxation, but as a result neither the U.S. parent

[14] PwC, *Evolution of Territorial Tax Systems in the OECD* (Apr. 2, 2013).

[15] *Id.*

[16] Section 7874 limits the use of losses and other attributes to offset such gain if the ownership fraction for purposes of §7874, as discussed in Part III, below, is at least 60% but less than 80%.

[17] 2014-42 I.R.B. 712.

[18] §951(a).

[19] Figure 3 reflects annual data reported by the Bureau of Economic Analysis (BEA) on the profits of U.S. corporations before tax. *See* Bureau of Economic Analysis, *National Income and Product Accounts*, Table 6.17D, n. 6.

[20] *Hearing Before the Sen. Fin. Comm.*, 113th Cong. 6–7 (July 22, 2014) (statement of Perer R. Merrill). A recent study of the reported profits of a sample of U.S. MNCs is suggestive of the trend as well. Mindy Herzfeld, *Inversions — Why Now?* Tax Notes 653 (Aug. 11, 2014). Recent data from the BEA also suggest that foreign operations of U.S. MNCs are growing faster than domestic in terms of value added, the number of employees, and research and development expenditures. Kevin B. Barefoot, *Operations of U.S. Parents and Foreign Affiliates in 2011*, *U.S. Multinational Companies*, Bureau of Economic Analysis 37, 38 (Nov. 2011).

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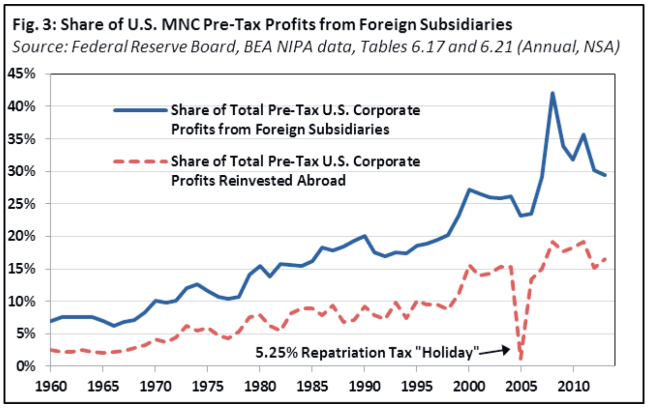

nor its shareholders can use the cash associated with these earnings, a phenomenon known as the ''lockout effect.'' The U.S. MNC may therefore make suboptimal investments abroad or simply hold the cash indefinitely in the foreign subsidiary.[21]

The amount of cash held in foreign subsidiaries of U.S. MNC's is growing.[22] According to a recent study, the total foreign earnings that are indefinitely reinvested abroad by Russell 1000 companies grew 93% between 2008 and 2013, reaching a total of $2.1 trillion and accounting for 8.7% of the total assets of those companies.[23] Another report found that as of the second quarter of 2013 roughly $900 billion was trapped abroad in U.S. nonfinancial companies, having grown about 50% since the fourth quarter of 2010 and representing about 61% of the companies' total cash holdings.[24] Further, in response to the 2004 enactment of §965, which enabled corporations generally to pay 5.25% tax on dividends from CFCs rather than the full statutory rate for a limited period of time,[25] 843 U.S. corporations were reported to have repatriated $362 billion.[26] This deviation in the trend can be seen in Figure 3.[27]

Earnings Stripping

Another opportunity presented by an inversion is the practice of earnings stripping. Earnings stripping refers to the arrangement of debt within an MNC so that a corporation is able to pay deductible interest to a related person in a lower-tax foreign jurisdiction.[28] In the case of earnings stripping by a U.S. corporation, the tax-deductible interest payments shift income out of the United States and erode the U.S. tax base.

Earnings stripping is often part of an inversion strategy. The U.S. corporation may either issue a note to the foreign acquirer at the time of the inversion or distribute the note to the foreign acquirer at some point after completion of the inversion.[29] Often the foreign acquirer (or a foreign subsidiary of the foreign acquirer) is resident in a jurisdiction with a territorial system of taxation (so that the foreign acquirer (or its subsidiary) is not taxed on the foreign-source interest income from the U.S. subsidiary) and has a comprehensive income tax treaty with the United States that provides for little or no U.S. withholding tax on the interest paid.[30] According to a study conducted in 2004, the effective tax rate of an average post-inversion corporation was about 12 percentage points lower than the pre-inversion effective rate, with most of the reduction attributable to earnings stripping.[31] A 2007 report on earnings stripping by the U.S. Treasury Department found that earnings stripping was widely employed by corporations that had completed inversions.[32]

II. TO WHERE DO U.S. COMPANIES INVERT, AND WHAT HAS CHANGED?

Domestic factors represent only one side of the equation in respect of corporate inversions. Recent developments abroad have facilitated inversions of U.S. MNCs, most notably tax law changes in the United Kingdom over the past five years.

During the first wave of inversions, U.S. MNCs tended to invert to Bermuda and the Cayman Islands. Between 1996 and 2002, 19 U.S. corporations inverted to those two jurisdictions.[33] Bermuda and the Cayman Islands each had the advantage of a zero-percent corporate income tax rate but, given the small size of the two economies and the fact that each coun-

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[21] *See* Eric Drabkin, Kenneth Serwin & Laura D'Andrea Tyson, *Implications of a Switch to a Territorial Tax System in the United States: A Critical Comparison to the Current System*, Berkeley Research Group (Nov. 2013) [hereinafter *Berkeley Report*].

[22] *See* Bureau of Economic Analysis, *National Income and Product Accounts*, Table 6.21. *See also* Figure 3.

[23] Audit Analytics, *Overseas Earnings of Russell 1000 Tops $2 Trillion in 2013* (Apr. 1, 2014), available at http://www.auditanalytics.com/blog/overseas-earnings-of-russell-1000-tops-2-trillion-in-2013/.

[24] Citi, *Corporate Finance Outlook for 2014*, at 10 (2013).

[25] American Jobs Creation Act of 2004, above, n. 2.

[26] Lynnley Browning, *A One-Time Tax Break Saved 843 U.S. Corporations $265 Billion*, N.Y. Times (June 24, 2008).

[27] *See also* Jan Hatzius et al., *Corporate Tax Reform: Has the Time Finally Come?* Goldman Sachs (July 19, 2014).

[28] U.S. Department of the Treasury, *Report to Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties 7* (Nov. 2007) [hereinafter Report to Congress].

[29] *Id.*, at 9–10.

[30] *Id.*

[31] Jim A. Seida and William F. Wempe, *Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion*, 57 Nat'l Tax J. 805, 825 (Dec. 2004).

[32] *Report to Congress*, above, n. 28, at 4.

[33] Mihir A. Desai and James R. Hines, *Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions*, NBER Working Paper No. 9057 tbl. 1 (Sept. 2002).

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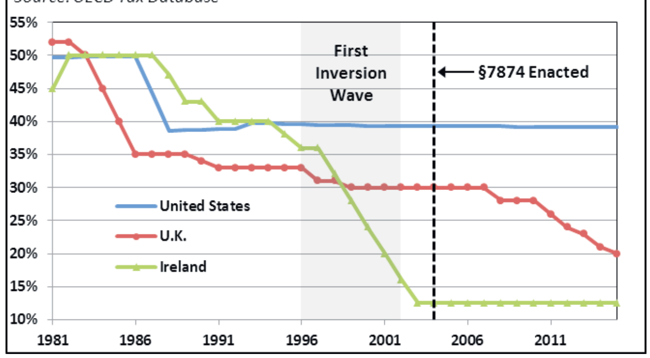
try had long been regarded as a tax haven, it was conspicuous that a relocation to either country was being undertaken for tax purposes.[34] Further, neither country had a tax treaty with the United States, meaning that any dividend or interest payment from the U.S. corporation to the new foreign parent would be subject to the full U.S. withholding tax of 30%.[35] Moreover, the absence of a treaty with the United States also made MNCs located in Bermuda and the Cayman Islands vulnerable to the passage of anti-avoidance legislation by Congress. These drawbacks, in combination with the increasing appeal of European jurisdictions a decade later, led some previously inverted MNCs to move once again, this time to Europe.[36]

Unlike Bermuda and the Cayman Islands, most European countries have tax treaties with the United States that reduce withholding tax rates on dividends and interest payments, making them more attractive in this regard as a destination for inversions.[37] The treaty with Ireland, for example, allows inbound dividends from the United States to be taxed at a U.S. withholding tax rate of 5%.[38] Under the treaty with the United Kingdom, inbound dividends from the United States are exempt from U.S. withholding tax as long as the U.K. parent is publicly traded.[39] The Netherlands is sometimes also considered as an inversion destination, but unlike the treaty with the United Kingdom, the conditions imposed by the U.S.-Netherlands treaty make it hard to take advantage of the zero percent withholding tax rate on dividends paid from the United States provided in the treaty.[40]

Given the treaty advantages of many European countries, it might seem surprising that they were not the target destinations of the first wave of inversions during the late 1990s. However, at that time the corporate income tax rates for many European countries were still relatively high. As shown above in Figure 1, the median combined statutory corporate income tax rate of OECD countries excluding the United States was 35% until the year 2000. Figure 4 shows the trend in more detail for Ireland and the United Kingdom, revealing that much of the decrease in those jurisdictions' rates occurred after the first wave of inversions had begun. Additionally, since that time, Ireland and the United Kingdom have each undertaken substantial reform of their tax laws, as discussed below.

Fig. 4: Corporate Income Tax Rates Since 1980, Ireland and the U.K.
Source: OECD Tax Database



Ireland began its reform effort earlier than the United Kingdom, and as a result had a head start as a destination in this second, more recent wave of inversions. The most well-known Irish reform measure is the reduction of Ireland's corporate income tax rate in a period of only six years from a rate commensurate with that of the United States to the lowest in the OECD at 12.5%, as seen in Figure 4.[41] As well, the Finance Act 2004 introduced a participation exemption for capital gains,[42] thus permitting the tax-free sale of shares by an Irish company if certain circum-

[34] *See, e.g.,* Ritsuko Ando and Susan Zeidler, *Accenture to Shift Incorporation to Ireland*, Reuters (May 27, 2009).

[35] §881(a).

[36] *See* Ben Casselman and Jesse Drucker, *Swiss Gain as Tax Plan Dims Bermuda's Allure*, Wall St. J. (Dec. 12, 2008); Jesse Drucker, *Accenture Is Seeking to Change Tax Locales*, Wall St. J. (May 27, 2009).

[37] *Worldwide Corporate Tax Guide* 2014, above, n. 7, at 1501–2.

[38] *Id.*, at 1502. To achieve the 5% rate in Ireland, the Irish parent must own at least 10% of the voting stock of the U.S. subsidiary. (Convention Between the Government of the United States of America and the Government of Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, art. X, U.S.-Ire., July 28, 1997.) Certain limitations-on-benefits provisions must be satisfied.

[39] To achieve the zero-percent rate in the United Kingdom, the U.K. parent must, among other things, own 80% or more of the voting power of the U.S. subsidiary for a 12-month period preceding the declaration of the dividend. (Convention Between the Government of the United States of America and the Government of United Kingdom for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, art. X, U.S.-U.K., July 24, 2001.) Certain limitations-on-benefits provisions must be satisfied.

[40] As a general matter, in order to achieve a zero-percent rate on withholding after inverting to the Netherlands, a publicly traded parent corporation must have ''substantial presence'' in the Netherlands, a difficult standard to meet. (*See* Protocol Amending the Convention Between the Government of the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, art. X, U.S.-Neth., Mar. 8, 2004.)

[41] *See Ireland's Corporation Tax Strategy, Ireland Department of Finance* (2013); Thomas Conefrey and John D. FitzGerald, *The Macro-Economic Impact of Changing the Rate of Corporation Tax*, ESRI Working Paper No. 273, at 4–5 (2009).

[42] Russell Brennan Keane, *Doing Business in Ireland: Tax Con-*

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stances are met,[43] making it easier for MNCs to carry out tax-efficient reorganizations and sales of subsidiary corporations after the completion of an inversion. The Finance Act 2004 also abolished stamp duties on intellectual property[44] and introduced a research and development tax credit (now set at 25%) applicable to a broad range of activities.[45] More recently, Ireland extended the acceptance of U.S. Generally Accepted Accounting Principles (GAAP) for the preparation of financial disclosures and other statements of U.S. entities migrating to Ireland.[46] Ireland is also perceived to be hospitable from a legal and regulatory perspective, with access to efficient commercial courts,[47] similarities to Delaware corporate law,[48] and reliable English-speaking governmental institutions. The combination of these advantages and reform efforts along with a favorable tax treaty and EU access made Ireland a more appealing jurisdiction than either Bermuda or the Cayman Islands to lead off this recent wave of inversions.

The United Kingdom has enacted reforms recently as well. In 2008, many U.K. companies were themselves expatriating to lower-tax jurisdictions, causing business leaders to argue that the ''U.K.'s uncompetitive corporate tax system [was] driving firms overseas.''[49] U.K. tax professionals considered their country to place far behind Ireland, the Netherlands, Switzerland, and Luxembourg in terms of tax competitiveness, and many U.K. businesses admitted that they were considering relocating to a lower-tax jurisdiction.[50] Since then, however, the government has made a concerted effort to become ''the most competitive corporate tax regime in the G20,''[51] and by 2012 the United Kingdom had reversed its reputation and was perceived by tax professionals as the most attractive country for tax competitiveness.[52]

The most notable change in the United Kingdom was the significant reduction of the top corporate tax rate. As seen in Figure 4, the top rate as recently as 2007 was 30%, placing it among the 10 highest in the OECD.[53] But since that time the rate has steadily been brought down.[54] Currently at 21%, the rate will be reduced to 20% on April 1, 2015, making it the fourth lowest rate in the OECD.[55]

The United Kingdom also transitioned from a wholly worldwide system of taxation similar to the United States to a more territorial system, fundamentally changing the way foreign profits are taxed. Although the system is still technically a residence-based one with a foreign-tax credit regime,[56] the recent legislative changes cause it to operate effectively as a territorial system. First, the Finance Act 2009 generally exempted dividends received by U.K.-resident companies from controlled companies, including non-resident controlled companies, as long as certain conditions are satisfied.[57] Two years later, the Finance Act 2011 introduced a new branch profits exemption regime that exempted U.K. resident companies from corporate tax on profits attributable to their foreign permanent establishments.[58] Companies are permitted to make an irrevocable election to exempt all branch profits and losses from U.K. taxation on a company-by-company basis.[59]

The following year, the Finance Act 2012 introduced a new regime for the tax treatment of CFCs (i.e., non-U.K. corporations controlled by persons in the United Kingdom) in an effort to make the incidence of the tax more narrow and targeted. The old regime was arguably in conflict with European Union (EU) law by assuming that all profits of a CFC could

sideration for Companies, at 8 (Apr. 2008).

43 *Worldwide Corporate Tax Guide* 2014, above, n. 7, at 614. The Irish company will be exempt from capital gain taxation if: (a) the investee company is resident of Ireland, an EU country, or a treaty country; (b) the Irish company has held at least 5% of the shares of the investee company for at least 12 months; and (c) the investee company (or the investee company along with certain other entities) is a trading company.

44 Ireland Dept. of Revenue, *Notes for Guidance: Finance Act 2004* (2004).

45 EY, *Worldwide R&D Incentives Reference Guide* 2013–2014, at 94 (2013).

46 A&L Goodbody, *Companies (Amendment) Act 2012 Becomes Law* (July 10, 2012).

47 Mason Hayes & Curran, *Ireland as a Business Location* 3 (2013).

48 Arthur Cox, *Inversions to Ireland* 78 (Apr. 2014).

49 Julia Werdigier, *British Companies Emigrating Overseas*, N.Y. Times (Sept. 4, 2008).

50 KPMG, *Annual Survey of Tax Competitiveness 2012* (2012). Also, roughly one in six companies surveyed admitted that they were actively pursuing relocation.

51 H.M. Government, *The Coalition: Our Program for Government* 10 (May 2010).

52 KPMG, *Annual Survey of Tax Competitiveness 2013*, at 2 (2013).

53 Calculated using data from *OECD Tax Database*, above, n. 5.

54 *Id.*

55 *Worldwide Corporate Tax Guide* 2014, above, n. 7, at 1433; Grant Thornton, *Key Dates for Tax April 2014–April 2015*, at 17 (2014).

56 *Worldwide Corporate Tax Guide* 2014, above, n. 7, at 1433, 1436.

57 Under prior law, shareholders in receipt of such dividends were able to claim a foreign tax credit. Slaughter and May, *UK Corporation Tax on Dividends* (Oct. 2009).

58 PwC, *Key Tax Accounting Considerations of the United Kingdom's Finance Act 2012*, at 3 (July 23, 2012) [hereinafter *PwC Finance Act 2012 Tax Report*].

59 Buzzacott, *The UK Tax Exemption for the Profits and Losses of Foreign Branches* (Mar. 2012).

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be attributed to the U.K. parent.[60] The new regime instead imposes a ''gateway'' test that attempts to catch only profits that are artificially diverted from the U.K.[61] The change adds complexity and a degree of uncertainty, as part of the gateway test involves an analysis of whether the purpose of the CFC is to achieve a tax advantage,[62] but overall it tends to reduce tax and administrative burdens by carving many U.K. companies out from the application of the CFC tax regime.[63]

The Finance Act 2012 also introduced a new ''patent box'' regime to further encourage research and development. The new law provides additional deductions so that qualifying income that arises from patents and certain intellectual property (such as royalty income or income from the sale of a patent) is taxed at a rate of 10% rather than at the full corporate rate, a rate that is being phased in over the course of a five-year period.[64] In addition to income from patents, the new rules also apply to income from protection certificates, market authorizations, and many other types of intellectual property.[65]

One could question whether these changes are likely to remain in place or whether future changes in law are likely to curtail them. While nobody can predict what may ensue, the changes apparently took place over several U.K. governments, a fact that may speak in favor of their stability.

In addition to the policy reforms over the last several years, the United Kingdom has for some time offered other beneficial rules, such as the ''substantial shareholdings exemption'' regime that broadly exempts capital gain on certain large stock dispositions,[66] the zero-percent withholding tax rate on outbound dividends,[67] and the zero-percent rate of dividend withholding tax with the United States under the treaty, discussed above. Moreover, the U.K. offers many cultural and institutional advantages to U.S. MNCs, including similar language, culture, regulation, and day-to-day government operation in the context of a large and diverse economy with well-functioning institutions, and all without designation as a ''tax haven.'' Whereas Ireland has recently been perceived as associated with tax avoidance,[68] the United Kingdom has not developed such a reputation. These long-standing advantageous features, in combination with the recent reform measures, have in a short time made the United Kingdom a desirable jurisdiction for an inversion.

III. WHY DON'T MORE U.S. COMPANIES INVERT?

Section 7874 and the Need for a Merger Partner

Given the framework discussed above, it might seem surprising that there have not been more inversions over the past several years. A deterrent can be found in U.S. legislation enacted specifically to limit inversions. Section 7874, enacted in 2004[69] following a wave of highly publicized inversion transactions, made it more difficult for a U.S. corporation to invert by requiring that the foreign merger partner be more substantial than a foreign shell corporation. Since the enactment of §7874, the U.S. corporation has been required to find a foreign merger partner large enough such that the shareholders of the U.S. corporation end up receiving less than 80% of the foreign acquirer.

Section 7874 treats a foreign corporation as a ''surrogate foreign corporation'' if, pursuant to a plan or a series of related transactions:[70]

- the foreign corporation completes the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation (or substantially all of the properties constituting a trade or business of a domestic partnership);
- after the acquisition, at least 60% of the stock (by vote or value) of the foreign corporation is held by former shareholders of the domestic corporation (or partners in the domestic partnership) by reason of holding stock in the domestic corporation (or partnership interests in the domestic partnership); and
- after the acquisition, the expanded affiliated group (EAG) that includes the foreign corporation does not have ''substantial business activities'' in the

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[60] Slaughter and May, *CFC Reform — Has the UK Got It Right?* 1 (Dec. 2011) [hereinafter *CFC Reform*].

[61] *Id.*; *Worldwide Corporate Tax Guide 2014*, above, n. 7, at 1442; *PwC Finance Act 2012 Tax Report*, above, n. 58, at 3.

[62] *Worldwide Corporate Tax Guide 2014*, above, n. 7, at 1442–43; *CFC Reform*, above, n. 60, at 3.

[63] *See CFC Reform*, above, n. 60, at 3.

[64] *Worldwide Corporate Tax Guide 2014*, above, n. 7, at 1443.

[65] Slaughter and May, *UK Patent Box* 1 (May 2012).

[66] *Worldwide Corporate Tax Guide 2014*, above, n. 7, at 1434–35; HM Revenue and Customs, *Capital Gains Manual*, available at http://www.hmrc.gov.uk/manuals/cgmanual/cg53000.htm.

[67] *Worldwide Corporate Tax Guide 2014*, above, n. 7, at 1433.

[68] *See, e.g.,* Martin Sullivan, *If Ireland Is Not a Tax Haven, What Is It?* Forbes (Nov. 6, 2013); Nelson D. Schwartz and Charles Duhigg, *Apple's Web of Tax Shelters Saved It Billions, Panel Finds*, N.Y. Times (May 20, 2013).

[69] American Jobs Creation Act of 2004, above, n. 2.

[70] §7874(a)(2).

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foreign country in which, or under the law of which, the foreign corporation is created or organized.

The percentage of the stock of the foreign corporation that is held by former shareholders of (or partners in) the domestic corporation (or domestic partnership) after the completion of the transaction by reason of holding stock in the domestic corporation (or partnership interests in the domestic partnership) is referred to as the ''ownership fraction.'' If the ownership fraction is at least 60% (but less than 80%) and the other requirements of §7874 are met, the domestic corporation and certain of its affiliates are prevented from using tax attributes (notably foreign tax credits or net operating losses) to offset any U.S. federal tax otherwise due with respect to any income or gain recognized by reason of any transfer of stock or other properties during the 10-year period following the acquisition.

The most substantive penalty occurs, however, when the ownership fraction is at least 80%. If that threshold is met and the other requirements of §7874 are met, then the foreign status of the acquirer is disregarded, and for U.S. tax purposes the foreign acquirer is treated as a domestic corporation, notwithstanding any other provision of U.S. law or treaty obligation.[71] While the penalty for surpassing the 60% threshold may be costly, surpassing the 80% threshold would defeat the inversion altogether. As a result, it is often the case that corporations undertaking an inversion will end up with former U.S. target owners coming in between the 60% and 80% thresholds.

As mentioned above, even if the §7874 thresholds are surpassed, §7874 does not apply if the substantial business activities test is met. That is, the section does not apply if the EAG that includes the foreign corporation has substantial business activities in the foreign acquirer's jurisdiction. However, the regulations provide a strict bright-line standard defining substantial business activities that many corporations undertaking an inversion cannot meet.[72] The EAG is treated as having substantial business activities in the relevant foreign country only if at least 25% of the EAG's (a) employees (both by number and compensation), (b) tangible or real property, and (c) income from unrelated persons are located in or derived from such foreign country.[73] As a result of these high bars, U.S. corporations interested in inverting to a foreign jurisdiction rely almost exclusively on the ownership fraction test and seek a merger partner large enough to ensure that the 80% threshold is not surpassed.

[71] §7874(b).

[72] §7874(a)(2)(B)(iii).

[73] Reg. §1.7874-3T.

A corporation could potentially spin off one of its own businesses and then have the spun-off company combine with a foreign corporation if there is no foreign merger partner to combine with the whole domestic corporation. This approach — sometimes called a ''spin-to-inversion'' or ''spinversion'' — is complex as it requires disaggregating the domestic corporation into distinct business lines and corporations. As well, the spin-off rules under §355 require that the combination between the spun-off company and the foreign merger partner results in the former shareholders of the domestic corporation owning more than 50% of the combined company.[74] While not impossible, a spin-to-inversion is difficult to pull off.

Section 367 and §4985: Shareholder and Insider Tax

The regulations under §367 also provide a dampener by causing shareholders of the U.S. corporation to recognize gain on certain inversion transactions. Prompted by the inversion of Helen of Troy Corp. in 1994 into a Bermuda corporation — a transaction that was tax-free to Helen of Troy Corp.'s shareholders under the rules that applied at the time[75] — the IRS issued regulations under §367(a) to discourage such transactions.[76]

The §367(a) regulations generally require the recognition of gain (but not loss) on the transfer of stock or securities of a domestic corporation by a U.S. person to a foreign corporation if:[77]

- all U.S. transferors receive in the aggregate more than 50% of either the total voting power or the total value of the stock of the transferee foreign corporation in the transaction;
- U.S. persons that are either officers or directors of the U.S. target company or are 5% target shareholders, own in the aggregate more than 50% of the total voting power or the total value of the stock of the transferee foreign corporation immediately after the transfer; or
- the transferee foreign corporation fails an ''active trade or business test.'' This test is failed, for example, if, at the time of the acquisition, the value of the transferee foreign corporation is less than the value of the U.S. target company.

[74] §355(e)(2).

[75] *See* Helen of Troy Limited, *Prospectus/Proxy Statement*, at 31–37 (Jan. 5, 1994).

[76] T.D. 8638, 60 Fed. Reg. 66,739 (Dec. 26, 1995).

[77] Reg. §1.367(a)-3.

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Section 4985, enacted alongside §7874 in the American Jobs Creation Act of 2004,[78] works in conjunction with the §367(a) regulations, adding an excise tax on corporate insiders to discourage inversions. The provision imposes a tax upon ''disqualified individuals'' (generally a corporate insider subject to disclosure requirements of §16(a) of the Securities Exchange Act of 1934)[79] with respect to an ''expatriated corporation'' (generally a domestic corporation (or partnership) with respect to which a foreign corporation is a ''surrogate foreign corporation'' under §7874, as described above)[80] on the value of ''specified stock compensation'' (generally stock-based compensation for that individual's services granted by the expatriated corporation)[81] if gain is recognized on the stock of such corporation by any shareholder by reason of the expatriating acquisition. Therefore, if a transaction were to trigger both gain recognition under the §367(a) regulations and the application of §7874, the transaction would also implicate the §4985 tax on the stock compensation of corporate insiders, creating yet another disincentive to invert.

Section 4985 and the regulations under §367(a) discourage inversions, but they have not stopped inversions from occurring. As to the §367 regulations, those rules only matter if the shareholders are in fact subject to U.S. tax, have enough gain that the tax on that gain is a meaningful cost and are in a position to affect the decision to invert.

Political Response and Publicity

In addition to overcoming the hurdles imposed by §367, §4985 and §7874, a U.S. corporation undertaking an inversion must consider the publicity and political response that may result from the announcement of the relocation to a lower-tax jurisdiction. Indeed, the political attention arising from the wave of corporate inversions in the late 1990s and early 2000s led to bipartisan support for the enactment of §7874[82] and led state legislatures to take action as well. When anti-inversion legislation was first proposed in Congress in 2002, both the Democratic Chairman and the Ranking Republican Member of the Senate Finance Committee, Sens. Max Baucus (D-Mont.) and Charles Grassley (R-Iowa), respectively, were advocates of the bill.[83] Between 2002 and 2004, during the apex of the inversion wave, more than 30 bills were introduced in Congress to limit or stop such transactions.[84] Among them was Baucus's and Grassley's proposed bill, the Reversing the Expatriation of Profits Offshore (REPO) Act, which set the structure for what eventually became §7874.[85] As to state legislatures, in 2003, California enacted a law providing that ''a state agency may not enter into any contract with an expatriate corporation or its subsidiaries.''[86] North Carolina also enacted legislation prohibiting state contracts for goods or services with corporations that incorporated in certain tax havens if the corporation's stock was principally traded in the United States.[87] Many other states proposed similar legislation.[88]

IV. WHAT ARE THE POLICY RESPONSES?

While there has not yet been any new legislative enactment — whether in the form of an update to §163(j), §367 or §7874, or in the form of more comprehensive tax reform — the IRS has promulgated two targeted revisions to regulations under §367 and §7874 as well as a broader effort to do what it can to rein in inversions through regulations under a host of provisions. Each of these regulatory responses seeks to limit inversions in one of two ways: either by making inversions more difficult to undertake without triggering the penalties under §367 or §7874, as discussed in Part III; or by curtailing the potential tax benefits available to companies after the completion of an inversion, as discussed in Part I.

IRS Notice 2014-32

In Notice 2014-32, issued on April 25, 2014,[89] the IRS announced its intent to update the regulations under §367 to close off an approach that taxpayers had

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[78] American Jobs Creation Act of 2004, above, n. 2.

[79] §4985(e)(1).

[80] §4985(e)(2).

[81] §4985(e)(3).

[82] *Cf.* Scott L. Butterfield and Lou X. Orchard, *Corporate Inversions and Fair Play*, 29 J. Applied Bus. Res. 3 (May/June 2013).

[83] Sen. Baucus decried that U.S. companies were ''in effect, renouncing their U.S. citizenship to cut their tax bill'' (Press Release, *Baucus Statement upon Introduction of Inversion Legislation* (Apr. 11, 2002)), while Sen. Grassley called the inversions ''immoral'' transactions (Press Release, *Grassley Announces Bill to Rein in Corporate Expatriation* (Apr. 11, 2002)).

[84] Michael Kirsch, *The Congressional Response to Corporate Expatriations: The Tension Between Symbols and Substance in the Taxation of Multinational Corporations*, 24 Va. Tax Rev. 475, 496 (2005).

[85] *Grassley Announces Bill to Rein in Corporate Expatriation*, above, n. 83.

[86] California Taxpayer and Shareholder Protection Act of 2003, *Cal. Pub. Cont. Code* §10286.1(a) (West 2004).

[87] Michael Kirsch, above, n. 84, at 499.

[88] *Id.*, at 499 n. 81.

[89] Notice 2014-32, 2014-20 I.R.B. 1006.

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been taking to complete inversion transactions without triggering gain to shareholders under §367(a). The notice also has the effect of limiting opportunities to engage in earnings stripping (see Part I) in certain contexts.

The notice relates to Reg. §1.367(b)-10, issued in 2011 (the ''Killer B Regulations''), imposing potential taxation in certain cross-border reorganizations.[90] The Killer B Regulations apply to triangular reorganizations where P or S (or both) is a foreign corporation and, in connection with the reorganization, S acquires in exchange for property all or a portion of the P stock or P securities (the ''P acquisition'') that are ultimately used to acquire the stock, securities or property of a U.S. corporation (UST) in the triangular reorganization.[91]

If the regulation applies, it creates a ''deemed distribution'' from S to P in an amount equal to the sum of any money transferred by S, liabilities that are assumed by S, and the fair market value of other property transferred by S in the P acquisition in exchange for the P stock or P securities.[92] The regulation also makes clear that the distribution is treated as if it had actually occurred for all purposes of the Code.[93]

Similarly, the regulation creates a ''deemed contribution'' of property (with no built-in gain or loss) by P to S in an amount equal to the amount of the deemed distribution from S to P.[94] As in the case of the deemed distribution, the regulation states that the contribution is treated as if it had actually occurred for all purposes of the Code.[95]

To prevent taxpayers from facing taxation on both shareholder gain and on the deemed distribution from S to P, a priority rule in Reg. §1.367(b)-10(a)(2)(iii) compares (a) the total shareholder gain that would be recognized by U.S. persons holding UST stock under §367(a)(1) (the ''367(a)(1) gain'') to (b) the sum of (x) the amount of the deemed distribution that would be treated as a dividend under §301(c)(1) and (y) the amount of such deemed distribution that would be treated as gain from the sale or exchange of property under §301(c)(3) if the section applies (together the ''367(b) income''). If the 367(a)(1) gain is equal to or greater than the 367(b) income, then the 367(a)(1) gain will be recognized, but the Killer B Regulations will not apply and hence the 367(b) income will not be triggered. On the other hand, if the 367(a)(1) gain is less than the 367(b) income, then the Killer B Regulations will apply, and Reg. §1.367(a)-3(a)(2)(iv) provides that the 367(a)(1) gain will not be recognized. Thus, USTs wishing to avoid shareholder tax on the inversion had an opportunity to avoid §367(a)(1) taxation in exchange for structuring the transaction in a way that would give rise to 367(b) income greater than the gain built into the shares held by the U.S. persons holding UST stock.

Under the Killer B Regulations, taxpayers structured transactions so that Reg. §1.367(a)-3 is ''turned off'' (due to the priority rule) while little or no tax was recognized under Reg. §1.367(b)-10, which is ''left on.'' Specifically, the transaction was structured so that the 367(a)(1) gain is less than the 367(b) income, while at the same time there is little or no tax on the 367(b) income on account of the fact that S had little earnings and profits so that the §301(c)(1) dividend was very small and that P, a foreign corporation, is not subject to U.S. tax on capital gain pursuant to §882. As a result, even though the shareholder gain under Reg. §1.367(a)-3 was turned off by the priority rule and the amount of §301(c)(3) gain was significant, P faced little or no tax on the transaction.

Reg. §1.367(b)-10(a)(2)(ii) was possibly intended to prevent that result by ''turning off'' the Killer B Regulations in cases where the foreign corporation would not be subject to U.S. tax. Specifically, where S is a domestic corporation, P's stock in S is not a United States real property interest (within the meaning of §897(c)), and P would not be subject to U.S. tax on a dividend from S under either §881 (for example, by reason of an applicable treaty) or §882 (the ''no-U.S.-tax'' exception), then the Killer B Regulations will not apply (and hence the priority rule could not apply to prevent recognition of 367(a)(1) gain). However, taxpayers seemed to take the view that the no-U.S.-tax exception did not apply if there were any earnings and profits at S because there would still be the prospect of tax on the dividend income under §301(c)(1), albeit a small amount.

Notice 2014-32 is intended to address this type of transaction, announcing several forthcoming changes to both Reg. §1.367(b)-10 and Reg. §1.367(a)-3. The amendments will be effective retroactively to the time of the notice (with certain exceptions for transactions entered into but not completed prior to the time of the notice).

First, the amount of §301(c)(1) dividend income and §301(c)(3) gain considered for purposes of determining the 367(b) income under the priority rule will be adjusted. The new regulation will provide that the 367(b) income will only include §301(c)(1) dividend income or §301(c)(3) gain to the extent that such dividend income or gain would be subject to U.S. tax or would give rise to an income inclusion under

[90] The final regulations themselves updated temporary regulations (Reg. §1.367(b)-14T) that the IRS had issued in 2006.

[91] Reg. §1.367(b)-10(a)(1).

[92] Reg. §1.367(b)-10(b)(1).

[93] Reg. §1.367(b)-10(c)(1).

[94] Reg. §1.367(b)-10(b)(2).

[95] Reg. §1.367(b)-10(c)(2).

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§951(a)(1)(A) that would be subject to U.S. tax. Likewise, Reg. §1.367(a)-3(a)(2)(iv) will be adjusted to make a conforming change to the priority rule.

Second, the no-U.S.-tax exception is modified. Where P is not a controlled foreign corporation, S is a domestic corporation, and P's stock in S is not a United States real property interest, the new regulation will provide that the no-U.S.-tax exception will apply if the deemed distribution would not be treated as a dividend under §301(c)(1) that would be subject to U.S. tax (for example, by reason of a treaty or by reason of the absence of earnings and profits in S).

Third, the anti-abuse rule in Reg. §1.367(b)-10(d) will be augmented. Currently, the anti-abuse rule is designed to make "appropriate adjustments" when "a transaction is engaged in with a view to avoid the purpose of this section."[96] As an example, if S is "created, organized, or funded" to avoid the application of the Killer B Regulations with respect to the earnings and profits of a related corporation," then the earnings and profits of such related corporation may be taken into account.[97] The rule will be modified to provide that S's acquisition of P stock or securities in exchange for a note may invoke the anti-abuse rule. The anti-abuse rule will also be modified to provide that the earnings and profits of a corporation (or successor corporation) may be taken into account for the purposes of determining such "appropriate adjustments," regardless of whether or not the corporation is related to P or S prior to the triangular reorganization. As such, the earnings and profits of the UST or successor may be considered. Finally, the anti-abuse rule will also be modified to clarify that a funding of S may occur after the triangular reorganization and that a funding of S includes capital contributions, loans, and distributions.

In addition to making it more difficult to avoid triggering shareholder level tax, the notice, through the augmented anti-abuse rule, will also make it more difficult to engage in earnings stripping by making it costly to place debt on the U.S. corporation in the course of the transaction. Under the prior formulation, if the regulation applied and S had little earnings and profits then the deemed distribution would be subject to minimal withholding tax, since the deemed distribution would be characterized almost entirely as §301(c)(3) gain. However, with the new anti-abuse rule explicitly taking into account earnings and profits of UST, a much larger component of the deemed distribution could be categorized as a §301(c)(1) dividend subject to withholding tax if the Killer B Regulations apply. The Notice would not seem to interfere with transactions that are not reorganizations, however, as the Killer B Regulations do not apply in the first place if the acquisition of UST is not a reorganization. Thus, if taxpayers are prepared to forgo reorganization treatment and thereby cause the shareholders of UST to recognize gain, the Notice would not seem to interfere with structures where S acquires P stock for a note. Further, if the parent is resident in a jurisdiction with a zero-percent dividend withholding tax treaty, such as the United Kingdom, then, so long as the note is distributed in a transaction separate from the reorganization and after a time period that satisfies applicable treaty requirements (one year in the case of the U.S.-U.K. treaty), the Notice would not seem to interfere with distribution of a note.

Temporary Regulations Under §7874

In January 2014, the IRS issued Reg. §1.7874-4T providing guidance under §7874.[98] The temporary regulations make it more likely that a transaction is covered by §7874 by excluding certain shares from the denominator in calculating the ownership fraction.

Section 7874, as discussed above, depends on the ownership fraction, or the percentage of the foreign acquirer shares that are received by the owners of the U.S. target corporation by reason of their ownership of the U.S. target corporation. An ownership fraction of at least 60% causes the foreign corporation to be treated as a surrogate foreign corporation subject to §7874, and at least 80% causes the corporation to be treated as a U.S. corporation for tax purposes.

Anticipating that the ownership fraction could be diluted by a public offering in connection with the transaction, Congress enacted §7874(c)(2)(B), which prevents stock issued in a public offering related to the acquisition from being taken into account when calculating the ownership fraction. Notice 2009-78 adopted an expansive interpretation of §7874(c)(2)(B). The new temporary regulations followed suit. As an example, the notice and the new temporary regulations would exclude from the denominator of the ownership fraction shares of a foreign acquirer issued in a private placement for cash in connection with the transaction despite the statutory language regarding "public" offerings. The expansive interpretation of this rule prevents a U.S. MNC from avoiding the application of §7874 by creatively "stuffing" the foreign acquirer corporation in the context of the transaction.

The temporary regulations exclude "disqualified stock" from the denominator of the ownership frac-

[96] Reg. §1.367(b)-10(d).

[97] *Id.*

[98] Reg. §1.7874-4T, T.D. 9654, 79 Fed. Reg. 3094 (Jan. 17, 2014).

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tion. Reg. §1.7874-4T(c) defines disqualified stock as stock of the foreign acquiring corporation, whether publicly traded or not, that is transferred in an exchange that is related to the acquisition for either: (a) ''nonqualified property''; or (b) other property where, pursuant to the same plan or series of related transactions, the transferee of that stock subsequently transfers it in exchange for the satisfaction or the assumption of one or more obligations associated with the property exchanged. Only transfers that result in an increase to the fair market value of the assets of foreign acquirer or a decrease in its liabilities result in disqualified stock, however. That is, only issuances of shares by the foreign acquirer or sales of hook stock (i.e., foreign acquirer stock held by a subsidiary of the foreign acquirer) should result in disqualified stock.

The definition of nonqualified property in the temporary regulations is more expansive than in Notice 2009-78. In addition to nonqualified property including cash and cash equivalents, marketable securities and any property acquired with a principal purpose of avoiding the purposes of §7874, nonqualified property also includes certain obligations.

In a change from the Notice, the temporary regulations provide for a *de minimis* exception. Stock of the foreign acquirer is not disqualified stock if (a) the ownership fraction determined, without regard to the exclusion rule, is less than 5% by vote and value and (b) after the acquisition, former shareholders or partners of the U.S. target in the aggregate own (applying the §318 attribution rules as modified by §304(c)(3)(B)) less than 5% by vote and value of the stock of (or a partnership interest in) any member of the EAG that includes the foreign acquirer, so long as there is not a principal purpose to avoid the purposes of §7874.

IRS Notice 2014-52

Most recently, on September 22, 2014, the Treasury Department and the IRS announced their intention to issue new regulations under §304(b)(5)(B), §956(e), §7701(l) and §7874 in an effort to rein in inversions.[99] Such regulations will be effective and applicable to any inversion transactions completed on or after September 22, 2014. The new regulations contemplated by Notice 2014-52 will either limit the benefits of inversion transactions by making it more difficult or costly to gain access to foreign earnings in CFCs, thereby limiting a tax incentive for completing an inversion as discussed in Part I, or by making it more difficult for U.S. MNCs to complete an inversion without triggering existing penalties under §7874.

Under the rubric of reducing incentives for inversions by limiting the ability of companies to gain access to the untaxed foreign earnings in foreign subsidiaries, the regulations would bring so-called ''hopscotch'' loans mentioned in Part I within the ambit of §956. Section 956 deters a U.S. shareholder from extracting untaxed earnings of CFCs by requiring a U.S. shareholder to include in income its share of a CFC's investment in U.S. property, up to the shareholder's share of the CFC's earnings. An investment in U.S. property for purposes of §956 would include, for example, a loan to the U.S. shareholder or a guarantee of a third-party borrowing by the U.S. shareholder. Prior to Notice 2014-52, an inversion presented an opportunity to avoid this rule by having the CFC loan funds to the foreign acquirer (or guarantee a third-party borrowing of the foreign acquirer) instead, bypassing the U.S. shareholder — hence the name, a ''hopscotch loan.'' The new regulations to be issued pursuant to §956(e) will treat any such loan or guarantee as U.S. property for purposes of §956 if the CFC is a subsidiary of an expatriated U.S. parent company.[100]

Second, new regulations will deter transactions in which the foreign acquirer acquires the CFC out from under the U.S. target corporation. Prior to Notice 2014-52, it was possible for a foreign acquirer to transfer property or a note to a CFC under the U.S. target in exchange for stock representing more than 50% of the vote and value of the CFC. The aim was to cause the foreign corporation to cease to be a CFC so that its U.S. shareholder, the U.S. target, would no longer be subject to Subpart F with respect to the former CFC. Such a transaction would allow the foreign acquirer subsequently to withdraw the untaxed earnings of the former CFC without triggering an income inclusion under §956, as mentioned above in Part I. Under Notice 2014-52, regulations will be issued pursuant to §7701(l) that will recharacterize these transactions as transactions between the foreign acquirer (or its foreign subsidiary) that acquires stock of the CFC and the U.S. shareholder of the CFC.[101]

Third, new regulations will impede companies from gaining access to untaxed foreign earnings through inter-company sales of U.S. target stock by the foreign acquirer in exchange for CFC property or cash. Such an exchange would be subject to §304(a)(2), which treats the CFC property or cash as having been distributed in redemption of the stock of the U.S. target. Section 304(b)(2) would then generally provide that the amount of such deemed distribution that is a dividend (and the source thereof) is determined as if

[99] Notice 2014-52, 2014-42 I.R.B. 712.

[100] *Id.*, §3.01(b).

[101] *Id.*, §3.02.

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the property were distributed by the CFC to the extent of its earnings and profits, and then by the U.S. target corporation to the extent of its earnings and profits. Insofar as the transaction is a deemed distribution from the CFC to the foreign acquirer out of CFC earnings, it could enable the earnings of the CFC to permanently avoid U.S. taxation. Section 304(b)(5)(B) was intended to avoid this consequence in certain circumstances by preventing any earnings and profits of the CFC from being taken into account in connection with the §304 transaction, notwithstanding the general rule of §304(b)(2). Regulations to be issued pursuant to §304(b)(5)(C) will make it more difficult to avoid the application of §304(b)(5)(B).[102]

Notice 2014-52 also announces new regulations relating to the ownership fraction under §7874, making inversion transactions more difficult to accomplish without triggering §7874. First, new regulations are intended to prevent the use of a ''cash box'' — a foreign corporation with excessive amounts of cash or other passive assets — as a merger partner. The new regulations will exclude a portion of the stock of the foreign acquirer from the denominator of the ownership fraction if generally more than 50% of the gross value of all property held by the EAG (other than property held by the U.S. target) after the acquisition constitutes cash or other types of passive assets.[103]

Further, new regulations will be issued to the effect that certain distributions by the U.S. target will be disregarded for purposes of §7874 (and for purposes of the ''substantiality test'' in Reg. §1.367(a)-3(c)). Specifically, the new regulations will disregard any non-ordinary course distributions made by the U.S. target during the 36-month period preceding the date of the acquisition. For that purpose, non-ordinary course distributions are the excess of all distributions made during a taxable year by the U.S. target with respect to its stock over 110% of the average of such distributions during the 36-month period immediately preceding such taxable year.[104] The IRS has not yet provided guidance as to the mechanics for disregarding such distributions.

While Notice 2014-52 announces several rules aimed at inverted companies' efforts to gain access to trapped cash, it does not announce specific rules addressing earnings stripping. Instead, it states that the Department of the Treasury and the IRS are considering issuing guidance to address earnings stripping. It states that future guidance would apply prospectively, but to the extent that the guidance applies only to inverted groups it would apply to groups that complete inversions on or after September 22, 2014.

V. WHAT ELSE MIGHT BE DONE ABOUT IT?

A number of anti-inversion legislative proposals have been put forward recently. The proposals range from targeted amendments to §7874 and §163(j) to fundamental tax reforms.

Proposed §7874 Legislation

Sen. Carl Levin (D-Mich.)[105] and Rep. Sander Levin (D-Mich.)[106] introduced parallel bills on May 20, 2014, in the Senate and House, respectively. Both titled the Stop Corporate Inversions Act of 2014, the bills would expand the framework of §7874 to cover a wider array of transactions.

First, the bills would reduce the §7874 ownership fraction that would result in a foreign acquirer being treated as a U.S. corporation from 80% to 50%.

Second, the bills would treat certain foreign corporations that are ''managed and controlled'' in the United States as domestic corporations (regardless of the percentage ownership of such foreign corporations owned by former domestic entity owners). Specifically, a foreign acquirer could qualify as an ''inverted domestic corporation'' under the bills when both (a) the management and control of the EAG occurs primarily within the United States (with the definition of management and control to be clarified in regulations, but generally meant to represent the case when substantially all of the executive officers and senior management of the EAG are based or primarily located in the United States) and (b) the EAG has ''significant domestic business activities.'' The EAG would be considered to have significant domestic business activities if at least 25% of (i) the employees of the group are based in the United States; (ii) the employee compensation incurred by the group is incurred with respect to employees based in the United States; (iii) the assets of the group are located in the United States; or (iv) the income of the group is derived in the United States.[107] However, a foreign corporation that would otherwise be considered an inverted domestic corporation is not so considered if the EAG has substantial business activities in the foreign country in which or under the law of which the foreign corporation is created or organized.

In a subtle change from existing §7874, the bill proposes that the acquisition of either (a) substantially

[102] *Id.*, §3.03.
[103] *Id.*, §2.01.
[104] *Id.*, §2.02.
[105] Stop Corporate Inversions Act of 2014, S. 2360, 113th Cong. (2014).
[106] Stop Corporate Inversions Act of 2014, H.R. 4679, 113th Cong. (2014).
[107] The Senate version of the legislation would sunset on May 8, 2016, while the House version has no sunset provision.

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all of the assets of a domestic partnership or (b) substantially all of the properties constituting a trade or business of a domestic partnership would be a candidate for the application of §7874, whereas under the existing statute §7874 is only triggered by the latter condition.

Significantly, both bills are proposed to take effect retroactively to May 8, 2014. The retroactivity provision has received support from Senate Finance Committee Chair, Ron Wyden (D-Ore.).[108]

The Levin bills follow in the footsteps of proposals made to amend §7874 in the Obama Administration's Budget in March 2014. As described therein, the Obama proposals would be effective for transactions completed after December 31, 2014.[109] However, the Administration has recently advocated for retroactivity to May 2014 along the lines of the Levin bills.[110]

A noteworthy aspect of the bills is that the ''managed and controlled'' test appears to catch a transaction in which a foreign company with longstanding management and control in the United States acquires a much smaller U.S. company. This and other aspects of the bills would require careful attention to protect against over-application before being passed.

Tightening the Interest Deduction Rules

Section 163(j) limits the extent to which a U.S. subsidiary of a foreign parent corporation may make deductible interest payments to the foreign parent or a foreign sister corporation, thereby governing the extent to which U.S. MNCs can engage in earnings stripping after the completion of an inversion. Currently, §163(j) is sufficiently permissive as to make earnings stripping an important incentive for completing an inversion, as discussed in Part I.

Section 163(j) limits deductions of ''disqualified interest'' (generally, interest paid to a related party that is foreign) in the case of a corporation if (a) the corporation's debt-to-equity ratio is greater than 1.5 to 1; and (b) the corporation has ''excess interest expense'' for the taxable year. Excess interest expense is the excess of the corporation's ''net interest expense'' (i.e., the excess of the interest paid or accrued during the taxable year over the amount of interest includible in gross income for such taxable year)[111] over 50% of the corporation's ''adjusted taxable income'' (i.e., the taxable income of the taxpayer computed without regard to any deductions for net interest expense, domestic production activities, depreciation, amortization, or depletion, or for any net operating losses).[112] Interest that is disallowed under §163(j) may be carried forward indefinitely to subsequent years.[113] Moreover, any ''excess limitation'' for a given taxable year (i.e., the amount by which 50% of the company's adjusted taxable income exceeds the company's net interest expense in a given taxable year)[114] may be carried forward up to three taxable years.[115] Thus, while §163(j) does provide a limitation on the deductibility of interest payments to foreign related parties, the extent to which §163(j) constrains earnings stripping depends on the numbers in a particular case.

Several proposals have been put forward that would limit interest deductibility in the context of inversions, thereby reining in the ability of companies to engage in earnings stripping. One approach makes simple changes to §163(j) and is represented by a proposal by Rep. Dave Camp (R-Mich.), Chairman of the House Ways and Means Committee, in his discussion draft of a comprehensive tax reform bill, the Tax Reform Act of 2014.[116] That proposal would change the 50% of adjusted taxable income limit to 40% and would preclude any carryforward of excess limitation.[117] These changes are proposed to be effective for taxable years beginning after December 31, 2014.[118]

Rep. Levin has proposed the Stop Corporate Earnings Stripping Act of 2014 largely consistent in approach with the Camp proposal.[119] The Levin proposal would eliminate the debt-equity test in §163(j), making §163(j) apply regardless of a corporation's debt-to-equity ratio.[120] The Levin proposal would also reduce the cap on deductible net interest expense

[108] Ron Wyden, *We Must Stop Driving Businesses Out of the Country*, Wall St. J. (May 8, 2014). It is worth noting that §7874 was enacted retroactively as it was signed into law by President Bush on October 22, 2004, as part of the American Jobs Creation Act of 2004 but took effect retroactively to March 4, 2003.

[109] *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals*, Dept. of the Treasury (Mar. 2014) [hereinafter *General Explanations*].

[110] *See* Letter to House Committee on Ways and Means Chairman Dave Camp, above, n. 1.

[111] §163(j)(6)(B).

[112] §163(j)(6)(A).

[113] §163(j)(1).

[114] §163(j)(2)(B)(iii).

[115] §163(j)(2)(B)(ii).

[116] Tax Reform Act of 2014, Discussion Draft, introduced by Rep. Dave Camp, 113th Cong. (Feb. 21, 2014). *See also* Majority Tax Staff of H. Comm. on Ways and Means, 113th Cong., *Tax Reform Act of 2014 Discussion Draft Section-by-Section Summary* 134 (2014).

[117] Tax Reform Act of 2014, above, n. 116, at §3704(a) and §3704(b).

[118] *Id.* at §3704(c).

[119] Stop Corporate Earnings Stripping Act of 2014, Discussion Draft, introduced by Rep. Sander Levin, 113th Cong. (2014). *See also* Tax Analysts, *Ways and Means Democrats Summarize Anti-Inversion Proposal* (July 31, 2014).

[120] Stop Corporate Earnings Stripping Act of 2014, above, n.

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to 25% of the corporation's adjusted taxable income down from 50% under current law.[121] Further, it would limit the carryforward of disallowed interest expense to five years rather than indefinitely under current law.[122]

The Levin draft also seeks to deter earnings stripping by proposing to expand the scope of taxation of U.S. shareholders of CFCs under §956. It would statutorily attack hopscotch loans by providing that §956 covers not only United States property but also ''foreign group property.'' Foreign group property means any stock or obligation of a non-CFC foreign person of which at least 25% of the voting power is owned by a common foreign parent.

Sens. Charles Schumer (D-N.Y.) and Richard Durbin (D-Ill.) also released proposed amendments to the interest deduction rules of §163(j) that would apply to inverted U.S. corporations (measured using a 50% threshold, rather than the 60% threshold under current law in §7874, and regardless of when the corporation inverted) in order to limit earnings stripping.[123] The legislation would (a) prevent any such inverted U.S. corporation from carrying forward any disallowed interest expense; (b) reduce the cap on deductible net interest expense for any inverted U.S. corporation to 25% of the corporation's adjusted taxable income; and (c) disregard the debt-to-equity ratio safe harbor for an inverted U.S. corporation.

The Obama Administration has offered a different type of proposal for tightening interest deductions.[124] Under the Administration's proposal, interest deductions are limited based on the overall leverage of the consolidated financial reporting group. Interest deductions would be permitted up to the sum of (a) the corporation's interest income plus (b) the corporation's proportionate share of the financial reporting group's net interest expense computed under U.S. income tax principles (which would be based on the corporation's proportionate share of the group's financial accounting earnings, computed by adding back net interest expense, taxes, depreciation and amortization). If the corporation fails to substantiate the above calculation, or if the corporation so elects, the corporation may instead deduct up to 10% of its adjusted taxable income. Under either calculation, disallowed interest may be carried forward indefinitely and any excess limitation for a taxable year may be carried forward to the three subsequent tax years. The Administration's proposal would not apply to financial service entities nor to financial reporting groups that would otherwise report less than $5 million of net interest expense, in the aggregate, on one or more U.S. income tax returns for a taxable year. Entities exempt from the Administration's proposals would remain subject to §163(j).

Taxing Unrepatriated Foreign Earnings

Another bill, the Pay What You Owe Before You Go Act of 2014, introduced in September by Sens. Durbin and Sherrod Brown (D-Ohio), would tax the undistributed foreign earnings of the foreign subsidiaries of U.S. MNCs that invert by including such earnings in subpart F income. The bill would eliminate a major benefit of inversions, namely being able to access the untaxed foreign earnings of foreign subsidiaries on a tax-efficient basis, as discussed in Part I.[125]

Comprehensive Tax Reform

Another approach to discouraging inversions — rather than pursuing targeted reform focused on stemming the flow of inversions by either limiting the benefits or expanding the scope of transactions that trigger existing penalties — is comprehensive tax reform addressing a number of the issues discussed in Part I all together, namely the comparatively high statutory corporate tax rates and the worldwide rather than territorial system of taxation.[126] Republican congressional leaders prefer such a course, which is perhaps not dissimilar to the path taken by the United Kingdom in recent years, with the goal of inducing more U.S. corporations to remain in the United States. As a result, the Republican proposals emphasize lowering statutory corporate income tax rates.[127] Several proposals along these lines have been put forward in the past several years, including the Bipartisan Tax Fairness and Simplification Act of 2011 (Sen. Wyden)[128] and more recently the Tax Reform Act of 2014 (Rep. Camp).[129]

The approach of predominantly lowering statutory corporate tax rates, however, may be too blunt a mea-

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119, at §4(a).

[121] *Id.*, at §4(b).

[122] *Id.*, at §4(c).

[123] S. 2786, 113th Cong. (2014).

[124] *General Explanations*, above, n. 109, at 49 (Mar. 2014).

[125] Pay What You Owe Before You Go Act of 2014, S. 2985, 113th Cong. (2014).

[126] *Cf.* Tax Analysts, *Lobbyist Sees Hope for Tax Reform in Inversions* (June 2, 2014); Martin A. Sullivan, *Economic Analysis: Lessons from the Last War on Inversions*, Tax Analysts (May 27, 2014).

[127] Sen. Tom Coburn, *Tom Coburn: The Case for Corporate Tax Reform*, Forbes (June 26, 2014).

[128] Bipartisan Tax Fairness and Simplification Act of 2011, S. 727, 112th Cong. (2011). *See also* James M. Bickley, *Tax Reform: An Overview of Proposals in the 112th Congress*, Cong. Research Serv., R41591 (Oct. 26, 2012).

[129] Tax Reform Act of 2014, above, n. 116.

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sure to curtail inversions. As discussed in Part I, there is a great deal of variation among corporations in the effective tax rates that they pay.[130] If the goal is to stop inversions, then broad reforms may not be able to bring down the statutory rates low enough to stop all companies from inverting, at least without massive reductions in corporate tax revenue.[131] And, given the industry-specific incentives abroad (such as the R&D deduction and credits in Ireland or the ''patent box'' deduction regime in the United Kingdom), it may be difficult to stop inversions with a broad rate reduction alone.

Moreover, compared with targeted reform, comprehensive tax reform involves many more stakeholders with strong interests, and as a result would likely take a great deal of time and discussion for a consensus to be reached. While retroactive legislation remains a possible tool to address such a delay, the longer the delay the less politically palatable such an extended period of retroactivity would be. Also, comprehensive reform will create many winners and losers, particularly if there is a transition from a worldwide to a territorial tax system or a lowering of the statutory corporate tax rates. By switching to a territorial tax system, companies that have substantial operations abroad and are looking to repatriate earnings or are unable to easily defer foreign-source earnings will be winners,[132] but this also raises the question from where additional revenue will come. Similarly, in the case of a corporate tax rate reduction, any decline in corporate tax revenue would need to be made up somewhere. If the shortfall is made up by broadening the corporate tax base and scaling back deductions or credits, then it is inevitable that some corporations will end up better off and others worse off.[133] Given the partisanship in Congress, a substantial redistribution of the burden of corporate taxation would not be an easy task.

CONCLUSION

A perfect storm of factors conducive to corporate inversions has indeed arrived, and the question that remains is ''What will happen next?'' While legislation as simple as tightening §163(j) to limit the benefits of inversions or amending the ownership fraction under §7874 would likely curtail inversion transactions, the partisanship of Congress appears to have made compromise on the issue particularly difficult. Moreover, each of the legislative proposals as currently drafted raises important questions about its ultimate impact — whether risking overbreadth on the one side, or limited efficacy on the other. The most potent law addressing inversions today, §7874, was itself the product of bipartisan compromise after the wave of inversions in the early 2000s. But without even a basic consensus as to a course of action among congressional leaders as there was in 2002, one cannot help but wonder whether the current accelerated pace of inversions will provide enough political incentive to forge a compromise and, if so, whether it will be any time soon. Further, it remains to be seen whether regulatory action on its own will be sufficient to stem the flow. Given the recent alignment of factors conducive for inversion transactions, in addition to the fact that there exists a palpable political risk that the door on inversions may one day close, U.S. MNCs might continue to seek to undertake inversions in the immediate future.

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[130] *See* Robert S. McIntyre et al., above, n. 12.

[131] *See* Donald J. Marples and Jane G. Gravelle, Cong. Research Serv., R43568, above, n. 4, at 8–9.

[132] *See Berkeley Report*, above, n. 21.

[133] *See* Martin A. Sullivan, *Winners and Losers in Corporate Tax Reform*, Tax Analysts (Feb. 16, 2011) (discussing the implications of lower statutory corporate tax rates with a broadening of the tax base).

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