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Turning the Corporate Inversion Transaction Right Side Up: Proposed Legislation in the 108th Congress Aims to Stamp Out Any Economic Vitality of the Corporate Inversion Transaction

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TURNING THE CORPORATE INVERSION TRANSACTION RIGHT SIDE UP: PROPOSED LEGISLATION IN THE 108TH CONGRESS AIMS TO STAMP OUT ANY ECONOMIC VITALITY OF THE CORPORATE INVERSION TRANSACTION

Derek E. Anderson[*]

I. INTRODUCTION . . . 268

II. TAX PLANNING — BIG BUSINESS . . . 270
A. *U.S. Competition* . . . 271
B. *Global Competition* . . . 272
C. *Treaties* . . . 272

III. EXPATRIATION . . . 273
A. *Individual Expatriation* . . . 273
B. *Corporate Expatriation* . . . 274

IV. THE CORPORATE INVERSION TRANSACTION . . . 274
A. *The Beginnings* . . . 275
B. *The Recent Past* . . . 276

V. ACHIEVING THE CORPORATE INVERSION TRANSACTION . . . 277
A. *The Stock Exchange Transaction* . . . 278
B. *The Asset Transaction* . . . 279
C. *The Drop Down Transaction* . . . 279
D. *Summary* . . . 280

VI. TAX INCENTIVES OF THE CORPORATE INVERSION TRANSACTION . . . 280
A. *The Battle Between Worldwide and Territorial Tax Regimes* . . . 280
B. *Reducing Taxable Income* . . . 281
C. *Summary* . . . 282

VII. EXISTING IRC DETERRENTS . . . 282
A. *Section 367(a)* . . . 283
B. *Section 482* . . . 283
C. *Section 163(j)* . . . 284

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D. *Section 269 — The Business Purpose Doctrine* 285
E. *Section 368 — Reorganizations and Business Exigencies* 285
F. *Conclusion* 286

VIII. PUBLIC POLICY CONCERNS 286
A. *"U.S. Corporation" — Definition Modified* 288
B. *The Three-Part Test* 289
C. *Other Proposed Restrictions* 292
1. Tax Offset Limits 292
2. Related Party Transactions 292
3. Modifications of Limitations on Interest Deductions 293
4. Treaty Overrides 295

IX. FORECASTING THE FUTURE — CHALLENGES AND EFFECTS FACING PROPOSED LEGISLATION 296
A. *Predictions* 296
B. *Administration of Proposed Legislation* 296
C. *Intended Tax Consequences — Effect and Analysis* 297
1. "U.S. Corporation" — Section 7701 Modified 297
2. The Three-Part Test 298
3. Tax Offset Limits 299
4. Reporting Related Party Transactions 299
5. Interest Deduction Limitations — 163(j) 299
D. *Treaty Override* 300

X. CONCLUSION 300

I. INTRODUCTION

The flurry of corporate inversion transactions over the last decade or so, combined with recent wars and recession, has resulted in a dramatic increase in the scrutiny of and attention paid to this transaction by government officials, individual citizens, and media outlets over the last few years. Congress has reacted recently with the introduction of a slew of proposed legislative bills that intend to stamp out the economic vitality of the corporate inversion transaction. The effectiveness of such legislation is debatable as it relates to U.S. tax policy and the allocation of enforcement resources.

The corporate inversion transaction essentially changes a U.S. corporation's residence to a foreign country.[1] This occurs through the process of incorporation in that country, which essentially requires the drafting and processing of new corporate governing documents. By executing this transaction, U.S. corporations have more flexibility to shift the generation of income from the United States to foreign sources, which reduces their taxable income in the United States. In addition, the U.S. corporation creates opportunities to employ "earnings-stripping" techniques, including the shifting of inter-company debt from the foreign to U.S. corporation in order to increase interest deductions.

With stiff domestic and global competition, the corporate inversion transaction has helped certain U.S. corporations excel, maintain or even simply survive in their respective markets. Many times, U.S. corporations use this transaction in order to take advantage of treaties, whose underlying purpose is arguably abused by this transaction. Moreover, while U.S. corporations essentially renounce their U.S. citizenship by executing this transaction, as individual taxpayers have been doing for years, they are not required to relocate business operations. Instead, their business operations remain in the United States while they take advantage of more friendly foreign tax regimes.

Notwithstanding its many years of existence, the corporate inversion transaction has only recently received unprecedented attention. For example, its existence and method has been explained and exposed in great detail in many national magazines, television programs and newspapers.[2] One possibility is that the frustration of recent wars and recession have spilled over to this transaction.

The most common methods used to execute the corporate inversion transaction include exchanging stock for stock, assets for stock, or through the "drop down" transaction, which occurs when the new foreign parent corporation creates a U.S. subsidiary and "drops down" some exchanged assets. Each method varies the U.S. corporation's tax consequences with regard to its shareholders, but all result in an inverted corporate structure.

The U.S. taxes the worldwide income of its citizens. In contrast, its foreign competitors are often subject to a "territorial" tax regime, which imposes tax on income derived only in that country. This puts U.S. corporations at a competitive disadvantage as it relates to the comparative tax burdens. Therefore, U.S. corporations have looked to the corporate inversion

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1. U.S. corporations are defined in the IRC section 7701 under the terms "domestic" and "corporation"; the term "[c]orporation includes associations, joint-stock companies, and insurance companies" and "domestic" is applied to any "corporation" that is created or organized in the United States under the law of the United States or any State. I.R.C. § 7701 (2000).

2. *See, e.g.*, *infra* notes 14-20.

transaction as a way to escape the grasp of the U.S. worldwide tax regime and enter into more friendly territorial regimes.

There are many existing tax code provisions that deter corporate inversion transactions to some degree. However, none of those sections, individually or collectively, have had the necessary impact to prevent big companies from completing the corporate inversion transaction anyway. As a result, much legislation has been introduced that will deter corporations from executing this transaction. The effect such proposals will have is still up for debate.

This Article will more fully discuss the foregoing issues regarding the corporate inversion transaction. Part II will discuss some of the reasons related to competition and treaty benefits that have motivated U.S. corporations to pursue the corporate inversion transaction. Part III will introduce the concept of "expatriation" and some reasons individuals and corporations choose to do it. Parts IV, V, & VI will discuss a brief history, mechanical explanation, tax consequences, and some incentives of the corporate inversion transaction. Part VII will discuss existing statutes that economically penalize and deter U.S. corporations that engage in the corporate inversion transaction. Part VIII will discuss the reaction by the public and government officials, and the newly proposed legislation that aims to deal with preventing illegitimate corporate inversion transactions. Finally, Part X will discuss the potential effects of the proposed legislation and the challenges it faces.

II. TAX PLANNING — BIG BUSINESS

Individuals and corporations alike share the desire to lower taxes and increase earnings, at least as applied to them. Perhaps Judge Learned Hand's often-overused statement, "there is nothing so sinister in so arranging one's affairs as to keep taxes as low as possible," is a good description of that philosophy.[3] U.S. corporations in particular have demonstrated their desire to pursue tax savings by utilizing the most sophisticated tax planning strategies possible.

Some techniques used by tax planners are those that are generally accepted by virtue of explicit legislative, judicial or administrative statement or rule. Other "cutting edge" techniques are too new to have received a governmental response. With the latter, the Internal Revenue Service (IRS) may ultimately approve those techniques. On the other hand, if reviewing a method that appears to be a tax avoidance vehicle in violation of judicial

3. Jay A. Soled, *Use of Judicial Doctrines in Resolving Transfer Tax Controversies*, 42 B.C. L. REV. 587, 597 n.61 (2001) (quoting Comm'r v. Newman, 159 F.2d 848, 850-51 (2d Cir. 1947) (Hand, J., dissenting)).

doctrines or Internal Revenue Code (IRC) sections,[4] the IRS may not approve. Despite this uncertainty, many U.S. corporations have nonetheless ventured into uncharted territory, risking IRS scrutiny, in hopes of saving millions of dollars.[5]

A. *U.S. Competition*

Profitability is presumably one of the primary objectives of a U.S. corporation. This objective is made difficult by direct competitive elements as well as those of an indirect nature existing in the U.S. marketplace.[6] Both types of elements necessarily compel these corporations to look for ways to increase efficiency and reduce costs. To accomplish this objective, corporations have used sophisticated marketing, financial, budgeting, and most importantly tax saving techniques.

To this end, savvy tax planners have saved U.S. corporations millions of dollars in taxes through sophisticated tax vehicles. The U.S. tax laws provide thousands of tax saving deductions and credits. Accordingly, some U.S. corporations which have utilized these tax saving provisions have benefitted with huge profits or even basic survival. Regardless of the profit margin, tax planning can achieve significant savings for businesses and those who do not think that they can afford such advice may not survive at all.[7]

4. Whether a tax planning technique falls inside or outside of the intended scope of the IRC can depend upon many different factors at any period of time; for example, the economic climate of the time, media coverage, whether our country is at war, interest by lobbyists and/or special interest groups, or whether the IRS takes notice. For example, as discussed below, the corporate inversion transaction occurred many times in the 1980s and early 1990s without much scrutiny by the IRS or media. However, in recent years, which happen to coincide with an economic recession and time of war, media attention has increased, and as a result of this attention the IRS and Congress have taken notice and begun formulating and proposing means to prevent the occurrence of such a transaction.

5. *See infra* note 78 (discussing U.S. corporations Tyco, Ingersoll, Cooper Industries, and Stanley Works who saved hundreds of millions of dollars by and through the corporate inversion transaction. Tyco reportedly saved more than 400 million dollars in 2001 through tax savings).

6. By direct elements, I am referring generally to businesses which produce and/or sell the same or similar products and that compete for the business of the same individuals who seek these products. By indirect elements, I am referring specifically to costs not directly related to the product, like taxes.

7. Even small businesses should employ some small-scale tax planning in order to survive. Small business owners obviously cannot employ large accounting firms or tax lawyers to help them with their strategic planning but instead, have to rely on less expensive, but not necessarily less skilled tax practitioners, who may nonetheless provide sufficient and effective tax planning advice. Having said this, in most of this Article, when tax planning is mentioned, it is done so with larger U.S. corporations in mind.

B. *Global Competition*

The dynamics of competition have changed for U.S. corporations over the last century. Instead of domestic dominated battles in the United States, foreign corporations have entered the competitive fray for U.S. and foreign dollars more fiercely than ever before.[8] Accordingly, U.S. corporations now account for foreign competitors as well as they pursue survival and success.

Currently, even though U.S. corporations may dominate certain industries domestically or globally, some foreign tax regimes are significantly more tax friendly than that of the United States. In these situations, foreign corporations have a substantial advantage over their U.S. counterparts.

For example, Barbados and Bermuda are widely recognized as tax-haven jurisdictions for foreign corporations because of their favorable corporate tax regimes and existing U.S. income tax treaties. Some foreign corporations that are subject to a "territorial" tax regime and that generate income in these countries may not have to pay tax to their home country on foreign derived income. If they do not, the foreign corporations can then bring earned profits back to their home countries tax-free. On the other hand, U.S. corporations are subject to "worldwide" tax rules, which require tax to be paid on any income generated in foreign jurisdictions, otherwise referred to as "foreign source" income.[9] This differing treatment is a significant advantage for foreign corporations.

C. *Treaties*

Unlike other areas of international law where uniform laws and institutional bodies exist to resolve disputes, such as the United Nations and the International Court of Justice in The Hague, there is not an international institution nor a set of laws that apply uniformly to international tax disputes. Instead, a collection of unilateral, bilateral, and multilateral income tax treaties exist between various nations. The United States itself has entered into more than fifty bilateral income tax treaties. Each of these treaties affects

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8. Foreign corporations are defined in the IRC section 7701 as not "domestic." I.R.C. § 7701 (2000).

9. Countries such as Germany, Netherlands, Switzerland, France, and recently the United Kingdom, can in some circumstances allow corporations incorporated in their countries to invest foreign subsidiaries and pay tax on their gain in that country and according to their tax structure, and then pay no or very little tax when they bring those profits home. The term "territorial" refers to the fact that in some countries such as these, worldwide income is not collected, but tax is instead primarily levied on their U.S. corporations (not to be confused with domestic U.S. corporations). The degree with which each country administers and modifies these rules varies depending on a number of factors including the character of the investment (i.e., passive).

the taxation of U.S. individuals and corporations according to negotiated terms.[10]

U.S. corporations have chosen to incorporate in countries where the most favorable U.S. income tax treaty benefits exist. The U.S.-Barbados treaty is one such example.[11] Many in Congress believe that U.S. corporations are abusing these treaty benefits and have accordingly proposed legislation that would modify, renegotiate or trump all or part of such treaties that are being abused by U.S. corporations.

III. EXPATRIATION

Expatriation is the process of renouncing one's citizenship and is a concept that is employed by both individuals and corporations alike. It may also be the most extreme tax avoidance technique available.[12] In recent years, U.S. corporations have found multiple ways to implement this technique for their benefit.

A. *Individual Expatriation*

Although this Article focuses specifically on issues of a corporate nature, a brief discussion of individual expatriation is helpful for the purpose of analogy and comparison.[13] Expatriation is defined as "to give up residence

10. *See* BORIS I. BITTKER & LAWRENCE LOKKEN, FUNDAMENTALS OF INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN INCOME AND FOREIGN TAXPAYERS (2003).

11. Income and Capital Tax Convention, Dec. 31, 1984, U.S.-Barb., *available at* http://www.irs.gov/pub/irs-trty/barbados.pdf (last visited June 29, 2004).

12. Expatriation is the most extreme tax avoidance technique available because the person seeking this method will ultimately lose their U.S. citizenship and all of the benefits that come along with it. It is ironic that persons, especially individuals, would undertake such an endeavor when millions of others would pay a huge price to become a U.S. citizen. This point, however, should be saved for another discussion. Regardless, the theory for use of this method must be that persons with huge quantities of cash can purchase freedoms and comforts not necessarily available to fellow citizens in their new-found country or in the United States and that it can simulate the same or greater freedoms that are available to U.S. citizens.

13. Not only is it useful by way of analogy, but it also gives perspective in regards to where the birth of corporate expatriation ideas occurred — with the individual. And, just like the individual, U.S. corporations have embraced the idea of expatriation and have done so through the corporate inversion transaction technique with similar or greater tax benefits and without all of the problems of actually moving outside of the country. After all, corporations are entities, and when their citizenship changes, at least in the corporate inversion transaction, it is all done on paper. This means that all of the corporate executives, who make enormous sums of money and big bonuses, can still live in the United States and enjoy the benefits of citizenship here, as can the U.S. corporations that they run.

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in one's native land" or "to renounce allegiance to one's native land."[14] In other words, a U.S. citizen may choose to disown or revoke his own U.S. citizenship. The purpose for this revocation most of the time is tax related. When someone has millions of dollars, he or she may save millions in taxes by leaving the country. Such a scenario is, of course, not quite that easy, but for our purposes, this short discussion should suffice.

B. *Corporate Expatriation*

Like individuals, many U.S. corporations have chosen to revoke U.S. citizenship to escape U.S. tax burdens. The corporate inversion transaction is one way to achieve that goal. The effects of corporate expatriation are similar to that of individuals in that, once a corporation becomes foreign, its income is no longer subject to the U.S. worldwide tax regime. In addition, like the U.S. individual, U.S. corporations have commonly chosen to expatriate to countries such as Barbados or Bermuda.[15]

IV. THE CORPORATE INVERSION TRANSACTION

Notwithstanding America's general aversion to ideas of tax, the corporate inversion transaction has been big news the last few years within and without the tax profession. Clearly, it has provided members of Congress with great and compelling material for dramatic and patriotic debates on their respective legislative floors. These legislative bodies have angrily accused those U.S. corporations who utilize the corporate inversion transaction of being unpatriotic, lacking business purpose, unnecessary, an erosion of the corporate base, and immoral.[16]

Several articles have been written and published in prominent national magazines and newspapers addressing the corporate inversion transaction,

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14. It should be noted that the definition of expatriation, "to renounce allegiance to one's native land," is the reason why many in the government and public have expressed distasteful feelings toward the corporate expatriation transactions. WEBSTER'S II NEW COLLEGE DICTIONARY 394 (1995). These transactions are seen as unpatriotic in a similar way to those individuals who have "shirked" their civic duties as Americans, especially during this time of war and recession. This treasonous perspective has provoked lawmakers to propose means to make it difficult or impossible for an individual, and now U.S. corporations, to engage in such behavior.

15. These countries happen to be the most commonly mentioned ones; they are considered to be "tax-havens" by some in the U.S. government because of their corporate-friendly tax regimes and because of current income tax treaties between the United States which have been utilized or, to some, manipulated to help U.S. corporations achieve tax avoidance.

16. Notwithstanding the substantive requirement that an "exigent business purpose" must exist for a corporate reorganization to achieve tax-free status, in the recent past, U.S. corporations have openly admitted in their literature that the primary purpose for such a corporate change is to achieve tax savings, or in the thoughts of some, tax avoidance.

including the *New York Times*,[17] the *Wall Street Journal*,[18] the *New York Post*,[19] and *U.S. News and World Report*.[20] It is easily understood why the corporate inversion transaction is under scrutiny and why some in Congress might wonder as to the business purpose (or lack thereof) that underlie these transactions. However, it is curious that recent debate and criticism on this subject has only emerged within the last few years. After all, the corporate inversion technique has been around for over twenty years.

A. *The Beginnings*

Although it is not certain when the first corporate inversion transaction actually occurred, it is certain that the McDermott, Inc. corporate inversion transaction was one of the first to gain the full attention of the IRS.[21] This corporate inversion transaction was achieved through a stock exchange, where McDermott shareholders exchanged their shares for shares in McDermott International, an existing Panamanian corporation. This exchange resulted in McDermott, Inc. effectively being relocated to Panama, but only on paper. Under then-existing rules, the shareholders did not recognize gain on the stock exchange.

The IRS argued that nonrecognition under these circumstances was unfair and they quickly responded in the courts by arguing that notwithstanding then-existing IRC section 304(a),[22] the gain realization of the stock exchange should be recognized. Their arguments were unsuccessful in that case. Congress responded by passing IRC section 1248(i), which requires shareholders who exchange their stock for foreign stock to recognize gain, to the extent of the corporation's earnings and profits.[23] In other words, the shareholder is treated as if he had liquidated the stock after he had received it from the foreign corporation.[24] In the McDermott situation, the Panamanian

17. *See* David Cay Johnston, *U.S. Corporations Are Using Bermuda To Slash Tax Bills*, N.Y. TIMES, Feb. 18, 2002, at A1.

18. *See* John D. McKinnon, *New Penalties, Constraints Seen For Tax Dodgers*, WALL ST. J., Mar. 14, 2002, at A-2.

19. *See* Paul Tharp, *Corporations Heading South—Looking for the Great Tax Dodge*, N.Y. POST, Feb. 12, 2002, at 32.

20. *See* Randall E. Stross, *Oh, For Haven's Sake*, U.S. NEWS & WORLD REP., May 13, 2002, at 41.

21. *See* New York State Association Tax Section Report on Outbound Corporate Inversion Transactions, Doc. 2002-13085 (74 original pages), 2002 TNT 105-34 (May 24, 2002) [hereinafter NYSBA Report].

22. Bhada v. Comm'r, 89 T.C. 959 (1987), *aff'd*, 892 F.2d 39 (6th Cir. 1989).

23. I.R.C. § 1248 (2000).

24. This IRC section affects transactions that are structured similarly to the McDermott transaction in that McDermott International was not newly formed and had earnings and profits. Section 1248 provides that the "gain recognized on the sale or exchange of such stock shall be

company had earnings and profits. If this IRC section had existed at that time, shareholders would have recognized gain to the extent of earnings and profits.

Occurrences of the corporate inversion transaction were few in the subsequent years. Therefore, IRC section 1248(i) was perceived as an effective deterrent to the corporate inversion transaction. This relatively quiet period did not last long, however, as many more corporate inversion transactions were set to occur.[25]

B. *The Recent Past*

The Helen of Troy Corporation executed an inversion transaction in 1994 and is said to have been "the first of the modern wave of outbound inversions" and has come to be regarded as the prototypical "pure" corporate inversion transaction.[26] This was referred to as a "pure" transaction because it involved a newly-formed foreign corporation, which distinguished it from McDermott, where the Panamanian corporation already existed.[27] By forming a new corporation, no earnings and profits would exist, and newly-passed IRC section 1248(i) would have no effect.

Instead, the Helen of Troy corporate inversion transaction took advantage of the tax-free reorganization provisions of section 368(a)(1)(B) and the existing rules of 367(a).[28] Under the then-existing regulations promulgated under section 367(a), U.S. shareholders would not have to recognize any gain for their transfer of shares to a foreign corporation.[29] Later, the new

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included in the gross income of such person as a dividend, to the extent of the earnings and profits of the foreign corporation." *Id.*

25. It should be pointed out that, notwithstanding the similarities of the McDermott and Helen of Troy transaction, *infra*, the tax consequences were different because section 1248, as discussed above, was born directly out of the McDermott transaction, which required the recognition of gain in certain stock exchange transactions only "to the extent of earnings and profits." *Id.* Therefore, transactions that involved newly formed corporate entities, with no earnings and profits, were not affected by section 1248. Because the Helen of Troy foreign corporation was newly formed, the Helen of Troy corporate inversion transaction was not affected by the IRC section 1248.

26. NYSBA Report, *supra* note 21, at 4-6.

27. *Id.* at 6.

28. Under section 368(a)(1)(B), one definition of a reorganization given states, "the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition)." I.R.C. § 368(a)(1)(B) (2000). This is the type of reorganization that Helen of Troy attempted to complete.

29. *See* NYSBA Report, *supra* note 21, at 6. At the time, U.S. stock transferors did not have to recognize gain on their transfers to a foreign entity.

shareholders in the Helen of Troy foreign parent corporation exchanged their new shares for shares in a Barbados corporation. The existing U.S.-Barbados income tax treaty removed the withholding tax on all U.S. source income that was expatriated to Barbados. Helen of Troy was able to take advantage of this treaty through this second transaction.

Like McDermott, the Helen of Troy transaction caught the attention of the IRS, who responded by announcing that the regulations enacted under IRC section 367(a) would be modified so that all stock and/or security transfers of U.S. corporations to foreign corporations by U.S. persons would require gain recognition if the U.S. shareholders owned fifty percent or more of the value or voting rights of the foreign corporation immediately after the exchange.[30] This published notice was later adopted permanently.[31] As discussed below, this regulation has been almost entirely ineffective as a deterrent against the corporate inversion transaction.

V. Achieving the Corporate Inversion Transaction

Inversion can occur through a few different structuring techniques. The most commonly mentioned techniques include (1) the "stock exchange transaction," (2) the "asset transaction," and (3) the "drop down transaction."[32] Each technique effectively achieves the inversion, but each has different tax implications.

30. Notice 94-46, 1994-1 C.B. 356. The transaction will not be taxable if less than 50% of the total voting power and value of the stock at the end of the transfer remains with the U.S. shareholders as provided by section 367(a), 50% or less of the total voting power and 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, each 5% shareholder of the U.S. corporation enters into a "gain recognition agreement," the transferee foreign corporation satisfies an active trade or business requirement and certain reporting requirements are met. *See* Treas. Reg. § 1.367(a)-3(c)(1) (1997).

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

32. There are other vehicles that can achieve the same result as those three methods discussed above. For example, a U.S. corporation may incorporate in a foreign country at the outset. Strategically, this may allow, on the one hand, a greater opportunity for growth without the burden of U.S. income tax, but on the other hand, if significant business is conducted in the United States, this same entity may be subject to U.S. source rules and marketing and advertising hurdles that effect foreign corporations in the United States. *See* U.S. Source Rules explained in I.R.C. §§ 871 & 881 (2000). Secondly, an already existing U.S. corporation may be subject to a friendly or hostile bid from a foreign corporation. *See* U.S. Treasury, Office of Tax Policy, Corporate Inversion Transactions: Tax Policy Implications, Doc. 2002-12218 (31 original pages), 2002 TNT 98-49 (May 21, 2002) [hereinafter Treasury Report].

A. *The Stock Exchange Transaction*

Many of the U.S. corporations engaging in corporate inversion transactions have used the stock-for-stock exchange method to invert themselves in a foreign jurisdiction. This transaction is governed by the rules specified in IRC section 368(a)(1)(B).[33] This transaction typically occurs when a newly-formed holding company located in some low or no-tax jurisdiction, like Bermuda, and the shareholders of the U.S. parent exchange stock, either directly or through a reverse subsidiary merger. Although this transaction is theoretically complex and requires specific expertise, the effects of the transaction in reality occur almost strictly on paper. In other words, instead of the business operations relocating to a foreign jurisdiction, the only change that occurs is in the corporate structure of the former U.S. parent, in that the U.S. shareholders will now own stock in the new foreign parent instead of the newly-relegated U.S. subsidiary.[34]

A stock exchange transaction is typically structured to take advantage of tax-free reorganizational status as provided by IRC section 368.[35] However, because this transaction involves the transfer of property to a foreign corporation, gain is recognized as required by IRC section 367(a).[36] The gain amount is the difference between adjusted basis and fair market value.[37] Shareholders who suffer a loss in the transaction cannot recognize the loss until future disposition of their new foreign stock.[38] In addition, it should be noted that there is no corporate-level tax in the stock exchange transaction.[39]

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33. I.R.C. § 368(a)(1)(B). To satisfy this IRC section the newly formed foreign corporation must acquire stock *solely* in exchange for the U.S. corporation's voting stock AND *control* ownership of at least 80% of voting power and the total shares of each class of the U.S. corporation's nonvoting stock. This results in the inversion of the corporation because the U.S. corporation or previous parent now becomes the U.S. subsidiary, with the newly formed foreign corporation becoming parent.

34. This non-change is precisely the seed of the outrage and reason for the vehement accusations of being "unpatriotic," as will be discussed more fully below. U.S. corporations are doing little in terms of changing the management or operation of their corporations. Instead, they are completing a transaction that is entirely paper-based and causing the U.S. corporation to acquire a windfall of tax savings without any operational and/or moving costs.

35. *See supra* note 33 (explaining the specific rules provided in section 368(a)(1)(B) that allow tax-free reorganization status).

36. I.R.C. § 367(a) (2000). See discussion above of the Helen of Troy corporation corporate inversion transaction and the reaction of the IRS embodied in Published Notice 94-46 and Treasury Regulation section 1.367(a)-3(c), T.D. 8702, 1997-8 I.R.B. 4.

37. *See* Treas. Reg. § 1.367(a)-3(a), (c).

38. *Id.*

39. Treasury Report, *supra* note 32, § IV-A.

B. *The Asset Transaction*

Another method used by U.S. corporations to achieve inversion is the asset transaction, whereby assets are exchanged for stock. There are two different ways to accomplish this asset transaction: first, by simple merger of the U.S. corporation into a newly-formed foreign corporation, with shareholders of the original U.S. corporation receiving stock from the foreign corporation; and second, by a conversion of the two companies.[40]

The tax consequences of the asset transaction are different from the stock exchange transaction to the extent that, in the stock exchange transaction, the shareholders recognize gain on the transfers of the shares to the foreign corporation, but in the asset transaction, the corporation recognizes gain on the assets transferred to the new corporation.[41] Put differently, the U.S. corporation must recognize gain on the assets transferred as if they had sold all of their assets at fair market value at the time of the transaction, while the shareholders will not recognize gain. Instead, the shareholders will take a transferred basis from the U.S. stock to the foreign stock.[42]

C. *The Drop Down Transaction*

The third transaction, referred to as the "drop down transaction," involves both the first and second techniques by combining both stock and asset transfers. For example, the original U.S. corporation may transfer its assets to the new foreign corporation which then transfers a portion of those assets to a new U.S. subsidiary. This transaction is similar to the stock exchange transaction to the extent that the shareholders receive foreign stock in exchange for their stock in the new U.S. subsidiary.[43] In addition, this transaction is similar to the asset transaction to the extent that the foreign parent owns assets of the U.S. subsidiary. Like the other two techniques, this transaction has almost no effect at all on the location of the corporate assets or operations.[44] Instead, it takes place mostly on paper.

Like the stock exchange transaction, shareholders will recognize gain in the drop down transaction and, if there is a loss, it cannot be recognized until the stock is subsequently sold.[45] In the drop down transaction, the U.S. corporation will not be required to recognize gain on the assets that it

40. *Id.*

41. This is of course assuming that such a transaction qualifies under section 368 as a reorganization. *See* I.R.C. § 368 (2000).

42. *See supra* note 33; *see also* Treas. Reg. § 1.367(a)-3(a), (d)(3)(example 12) (1997). Further, this is also assuming that the reorganization qualifies under the IRC section 368, which also has a "continuance of business" requirement that must be met. *See* I.R.C. § 368.

43. *See* Treasury Report, *supra* note 32, § IV-A.

44. *Id.*

45. *See* Treas. Reg. § 1.367(a)-3(a), (d)(3) (1997).

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contributes to the U.S. subsidiary. However, it will be required to recognize gain, but not loss, on assets retained by the foreign corporation.[46] There is generally no shareholder recognition for the portion of assets transferred to the foreign corporation.[47]

D. *Summary*

While a U.S. corporation may choose to employ either the stock, asset, or drop down transaction for different tax reasons, the ultimate objective is achieved when the corporation is restructured in such a fashion that, in the end, a new foreign parent of the U.S. corporation is created in a foreign jurisdiction, and is now subjected to a foreign instead of the U.S. worldwide tax regime.

VI. TAX INCENTIVES OF THE CORPORATE INVERSION TRANSACTION

The various methods discussed above are all designed to achieve an inverted corporate structure where shareholders of a U.S. corporation ultimately become owners of stock in a foreign corporation. This transaction is expensive in terms of legal, accounting, and banking fees.[48] But in the grand scheme, U.S. corporations can achieve significant tax savings despite the fees and without the costs of operational business changes.[49] The savings occur because any income derived in a foreign country by the new foreign corporation is taxed according to that country's tax laws rather than the U.S. worldwide tax regime. Furthermore, if a U.S. income tax treaty exists between that foreign country and the United States, any U.S. source income is taxed at a lower rate.

A. *The Battle Between Worldwide and Territorial Tax Regimes*

The taxation of worldwide income, for U.S. purposes, means that any income generated by an individual U.S. citizen or corporation, anywhere in the world, is included in gross income. In contrast, corporations that have established residency in Germany, the Netherlands, Switzerland or France, are subject to a "territorial" tax regime, which, in many situations, will require very little or no tax reported as gross income or is paid/reported on

46. *Id.*

47. *Id.*

48. With the accumulation of attorney's fees, proxy statements, voter approval, SEC compliance, and the like, expenses related to the completion of the corporate inversion transaction can extend into the millions of dollars.

49. *See infra* note 78 (discussing the hundreds of millions of post-inversion tax savings by Tyco, Ingersoll and Stanley).

foreign source income.[50] For example, if a corporation formed in a "territorial" country generates foreign source income in a country such as Bermuda or Barbados, it may pay little or no tax on its earnings. Those earnings can be brought back to their country of incorporation tax-free. Under the worldwide tax regime, U.S. corporations are unable to bring their foreign source income back to the United States tax-free. This puts them at a major competitive disadvantage.[51]

Foreign credits are one way that the U.S. government has chosen to deal with this competitive disadvantage. For example, when U.S. corporations pay tax in a foreign country, they may receive credit to offset U.S. tax liability.[52] Notwithstanding the receipt of these credits, U.S. corporations may still pay higher overall tax on their foreign investments than their competitors from "territorial jurisdictions,"[53] because the credits aim to eliminate double tax, not U.S. tax. In other words, the U.S. corporations are still paying a full amount of tax on their foreign investments, and foreign corporations are not. Accordingly, the U.S. worldwide tax regime is perceived as less favorable than some of the foreign "territorial" regimes. The corporate inversion has been viewed as one tool that has helped U.S. corporations diminish the impact of this competitive disadvantage.

B. *Reducing Taxable Income*

Aside from the shifting of foreign source income outside the United States to escape U.S. tax, the other primary objective of U.S. corporations is to engage in various earnings-stripping techniques in order to reduce taxable income. With a reduction of taxable income, corporations can achieve greater profits, higher stock prices, and become more competitive.

Earnings-stripping techniques include making deductible payments to another affiliated or related corporation. For example, a U.S. corporation could make payment on a loan created by its foreign parent, with the interest portion being fully deductible as a business interest expense under section 163.[54] Other deductible payments between U.S. and foreign entities could include royalties and management and administrative expenses incurred by

50. NYSBA Report, *supra* note 21, at 9.

51. This is the theory and may be generally true. However, there are other intangible elements that weigh into a U.S. corporation's success that perhaps are not as quantifiable, including goodwill. U.S.-conscious Americans (e.g., "Michiganders") who prefer, for example, American auto companies may hurt corporations that are generally known to be foreign-based.

52. *See* I.R.C. § 862 (2000) (describing U.S. source income and what foreign income is to be included in gross income and what deductible expenses exist to offset such gross income).

53. *See* NYSBA Report, *supra* note 21, at 10 (explaining that some U.S. corporations argue that their tax on foreign investment is greater than that paid by foreign corporation competitors).

54. I.R.C. § 163 (2000).

the U.S. subsidiary on behalf of the foreign parent who compensates for those services.[55]

The creation of inter-company debt between a U.S. subsidiary and new foreign parent is the most common and favored earnings-stripping technique, for two reasons. First, loans are not included in gross income. Therefore, a transfer of income disguised as a loan is tax-free to the U.S. and foreign corporation. Second, interest payments made on a loan by a U.S. corporation are fully deductible against its other income. Even though payments made from a U.S. corporation to a foreign corporation are typically subject to a thirty percent withholding tax,[56] taxes may be reduced if they originate from a corporation incorporated in a U.S. treaty country, such as Barbados or Bermuda.[57]

C. *Summary*

In conclusion, the steps of earnings-stripping are as follows: a loan is made to a U.S. subsidiary by a foreign parent; no tax is paid on the loan proceeds; deductions are available to the U.S. corporation for interest payments made on the loan under IRC section 163;[58] and payments to the corporation can and may be reduced by an income tax treaty. The foregoing reasons clearly indicate why many U.S. corporations have chosen to invert.

VII. EXISTING IRC DETERRENTS

The IRC sections most commonly mentioned as corporate inversion deterrents are discussed below. All of these sections have some impact either in reality or in theory. However, none of them is significant enough to deter some U.S. corporations from taking advantage of the corporate inversion. Many believe that such transactions are achieved in form over substance.[59]

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55. NYSBA Report, *supra* note 21, at 23.

56. *See* I.R.C. §§ 862, 871 & 881 (requiring foreign individuals to be subject to 30% withholding tax on all U.S. source income).

57. IRC section 871 provides that nonresident income "not connected" with the United States may be subject to 30% withholding but can be reduced by existing treaties. I.R.C. § 871. Section 881 is identical except it applies to corporations. I.R.C. § 881.

58. The IRC section 163(a) provides that, "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." I.R.C. § 163(a). However, subsection (j) of this same IRC section limits some of the interest deductions if, first, the corporation exceeds the 1.5-1 debt-equity ratio, and second, the interest deductions exceed a certain percentage of gross income. I.R.C. § 163(j).

59. By the phrase "form over substance," it is meant that the spirit or purpose of the law has been circumvented or violated notwithstanding technical IRC compliance. In other words, it complies with the current code, but even so, the transaction does not smell right. For example, there are laws in place that allow companies to take certain interest deductions to reduce taxable income,

In other words, technical compliance is violating substantive compliance. Nevertheless, the corporate inversion transaction has endured the increasing scrutiny aimed at defeating its existence.[60]

A. *Section 367(a)*

As mentioned above, the IRS responded to the Helen of Troy corporate inversion transaction by modifying section 367(a) of the IRC so that all similar transfers of U.S. stock by U.S. persons to foreign corporations would result in taxable gain to the extent of earnings and profits.[61] After this modification became final, very few corporate inversion transactions transpired and the modification appeared successful in deterring future corporate inversion transactions. Of course, that was an incorrect assumption, as evidenced by the flurry of corporate inversions that took place over the next decade or so.

The overall ineffectiveness of 367(a) as a deterrent against inversions has been explained in two ways. First, because of the economic recession, stock prices have been depressed. An exchange of depressed stock triggers very little or no gain. Therefore, the effect of 367(a) is nullified.[62] Second, the holding of U.S. shares by tax-exempt institutions and foreign investors lessened its impact because less gain would have to be recognized on a transfer to a foreign entity.

B. *Section 482*

IRC section 482 gives the Treasury Secretary discretionary power to reallocate income and deductions when it is determined that such adjustments are necessary to "clearly reflect income."[63] This discretionary power is

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as discussed above. But this provision is arguably abused in the context of a corporate inversion transaction when earnings-stripping techniques are employed between related corporations in order to avoid U.S. tax liability on income that is for all intents and purposes generated in the United States.

60. It is a bit ironic that corporate inversion transactions have been around for about 20 years when suddenly, in the midst of economic recession and war, heavy scrutiny is placed on the transaction, especially in the wake of "9/11" when U.S. citizens viewed corporate inversion transactions as "unpatriotic." To illustrate the "9/11" effect, many of the bills discussed below propose retroactive consequences on corporate inversion transactions that took place on or post-9/11.

61. *See supra* note 30. This is of course assuming that the U.S. transferors owned more than 50% of the value or voting rights of the foreign corporation immediately after the exchange. *See* Treas. Reg. § 1.367(a)-3(c), T.D. 8702, 1997-8 I.R.B. 4, at 94-46.

62. *See* NYSBA Report, *supra* note 21, at 12. This explains that depressed stock prices reduce recognizable gain and that limited recognition may be a small price to pay as compared with millions of dollars of tax savings in the wake of a corporate inversion transaction.

63. This IRC section provides that:

granted to the Treasury Secretary to deal with "transfer-pricing" issues or the shifting of income between related entities. This section implicitly demands that transactions between related corporations occur at "arm's length," and that the income with respect to the transaction be commensurate with the income attributable to the assets transferred.[64] If this "arms-length" posture does not exist in transactions between related corporations, this discretionary power allows the Treasury Secretary to re-allocate these items to "clearly reflect income." Nevertheless, occurrences of "transfer-pricing" are difficult to police and the discretionary power is therefore rarely used.

C. *Section 163(j)*

IRC section 163 allows tax deductions for interest paid on business debt, and has been the predominant motivator for U.S. corporations to engage in corporate inversion transactions.[65] However, IRC section 163(j) was enacted in 1989 by the IRS to prevent corporate abuses of disproportionate interest deductions. This IRC section is triggered when a U.S. corporation's debt to equity ratio exceeds 1.5 to 1.[66] When triggered, all interest amounts in excess of fifty percent of gross income of the U.S. corporations are denied.[67] This limits U.S. corporations from abusing the interest deduction by severely leveraging a corporation in order to reduce taxable income. But like the other existing IRC sections, this provision has not been sufficient to deter U.S. corporations from inverting anyway.

> [I]n any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

I.R.C. § 482 (2000).

64. Transfer pricing abuse, as it has been called, can potentially run rampant between related corporations in their pursuit to put their finances and tax liability in the most advantageous position possible. One such example, among many that exist, is selling property between corporations at artificially high or low prices and then reselling such property with different tax consequences.

65. I.R.C. § 163 (2000). Keep in mind the main reason that U.S. corporations are going to all this trouble to invert their corporations — tax savings. One of the greatest tax-saving tools is to reduce income by earnings-stripping techniques such as the shifting of inter-company debt to take advantage of tax-free shifting of funds, and the interest deductions allowed by section 163 that derive from the creation of debt. That is the reason why this section is in large part the motivation or the "juice" behind these corporate inversion transactions.

66. § 163(j).

67. *Id.*

D. *Section 269 — The Business Purpose Doctrine*

IRC section 269 explicitly gives the Treasury Secretary discretionary power to analyze a transaction and deny certain deductions when she determines that "the principal purpose for which such acquisition is made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy."[68] However, this discretionary power has not been employed to prevent illegitimate corporate inversion transactions. For example, many corporations, in their literature to shareholders and investors, have clearly indicated that they are pursuing a corporate inversion transaction in order to reduce costs and increase tax savings. This deliberate declaration belies the clear purposes and requirements of the business purpose doctrine.[69] The apparent technical weakness of this IRC section may be, as suggested by some analysts, the requirement of showing that tax avoidance is "the" as opposed to "a" principal purpose of the transaction.[70] Accordingly, the Treasury Secretary would have a very difficult time proving that the singular purpose of any corporate inversion transaction was not business, but tax related.

E. *Section 368 — Reorganizations and Business Exigencies*

IRC section 368 presents the same theoretical problems as section 269 because both give the Treasury Secretary discretionary powers, but neither of them has been used effectively against corporate inversion transactions. For example, in order to qualify as a tax-free reorganization under 368, a

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68. I.R.C. § 269(a) & (b). Section 269(c) provides that

> In any case to which subsection (a) or (b) applies the Secretary is authorized — (1) to allow as a deduction, credit, or allowance any part of any amount disallowed by such subsection, if he determines that such allowance will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or (2) to distribute, apportion, or allocate gross income, and distribute, apportion, or allocate the deductions, credits, or allowances the benefit of which was sought to be secured, between or among the corporations, or properties, or parts thereof, involved, and to allow such deductions, credits, or allowances so distributed, apportioned, or allocated, but to give effect to such allowance only to such extent as he determines will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or (3) to exercise his powers in part under paragraph (1) and in part under paragraph (2).

Id. § 269(c).

69. *See infra* note 78 (discussing the corporate inversion transaction proposals of Ingersoll and their frank admittal in proxy literature that proposes a corporate inversion transaction that would save millions of dollars in taxes).

70. *See* NYSBA Report, *supra* note 21, at 34.

corporate restructuring must be necessitated or "required by business exigencies."[71] So what are the business exigencies of a corporate inversion transaction? Clearly, the reasons are tax avoidance, not "business."[72] Nevertheless, this section has had little deterrent effect on the corporate inversion transaction as evidenced by the bevy of transactions executed in the last decade.[73]

F. *Conclusion*

The IRC provisions intended to reduce corporate inversions have had a limited overall effect against U.S. corporations who wish to invert in foreign countries, and therefore should be modified or replaced.

VIII. PUBLIC POLICY CONCERNS

As discussed, the corporate inversion transaction existed for many years in relative anonymity. Recently, however, the subject has been featured on noted television programs, in magazines and newspapers that have all attempted to expose and discuss the intricacies, benefits, and controversies of this complex and intriguing offshore transaction.[74]

In the wake of media attention, politicians have jumped on the bandwagon of public criticism for what they and others perceive as the inequities of the corporate inversion transaction, especially in the wake of September 11. This criticism has focused on an unpatriotic theme for the most part. For example, Representative Charles Rangel (D-NY) has accused inverting corporations of "choosing profits over patriotism."[75] Senator Charles E. Grassley (R-Iowa), was quoted in the New York Times as saying, "[t]here is no business reason for doing this, other than to escape U.S. taxation. I believe the Finance Committee needs to investigate this activity."[76] Senator Grassley went further by stating that corporate inversion transactions

71. *See* Treas. Reg. § 1.368-1(b) (1997).

72. One can sensibly argue that tax planning decisions fall well within the definition of "business" generally. However, naked tax avoidance, as openly admitted by various companies is clearly contrary to public policy and the spirit of the IRC.

73. Granted, corporate inversion transactions as a whole have diminished substantially the last few years with the slew of proposed legislation that may completely eviscerate any viable and potential corporate inversion transaction opportunities for U.S. corporations.

74. *See supra* notes 17-21.

75. *See* Lee A. Sheppard, *Preventing Corporate Inversion, Part 2*, TAX NOTES (May 6, 2002) (looking at ways of preventing inversion transactions).

76. *See* Johnston, *supra* note 17, at A1.

are "immoral" and that in "a war on terrorism, coming out of a recession, everyone ought to be pulling together."[77]

This transaction has raised the ire of many politicians and individuals mostly because of the hundreds of millions of dollars that are uncollected from these multi-billion dollar companies.[78] Such huge tax savings implicate serious policy issues and have forced the Congress to respond.

The Congress has proposed a slew of bills containing prohibitive and limiting language pertaining to any future occurrences of the corporate inversion transaction.[79] It is clear from the sheer number of bills that politicians are motivated to succeed in passing a bill that will completely eviscerate the economic viability of the corporate inversion transaction. There are a few common provisions in these bills that specifically address the corporate inversion transaction. The different provisions can be broken down categorically.

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77. *See* Release and Briefing Memo on REPO introduced by Sen. Charles Grassley (R-Iowa) & Max Baucus (D-Mont.), Apr. 11, 2002, *reprinted in* DAILY TAX REP., Apr. 12, 2002, at L-11.

78. Tyco reportedly saved more than 400 million dollars in 2001 through tax savings. Ingersoll, in attempts to influence stockholder votes, stated in their proxy statement that they would increase their net earnings by 40 million dollars. Furthermore, Cooper Industries and Stanley Works, in their prospectus documents, stated that they would reduce their effective tax rates; Cooper Industries intended a 12%-17% reduction, and Stanley Works a 7%-9% reduction. *See* COOPER INDUSTRIES, PROXY STATEMENT/PROSPECTUS (2001); STANLEY WORKS, PROXY STATEMENT/PROSPECTUS (2002).

79. *See* Corporate Patriot Enforcement Act of 2003, H.R. 737, 108th Cong. (2003) (introduced by House Representative Richard Neal [MA-2]); Energy Tax Policy Act of 2003, H.R. 1531, 108th Cong. (2003) (introduced by House Representative Jim McCrery [LA-4]); Taxpayer and Fairness Protection Act of 2003, H.R. 1661, 108th Cong. (2003) (introduced by House Representative Charles B. Rangel [NY-15]); Jobs and Growth Reconciliation Tax Act of 2003, H.R. 2046, 108th Cong. (2003) (introduced by House Representative Charles B. Rangel, [NY-15]); Working Families Tax Credit Act of 2003, H.R. 2286, 108th Cong. (2003) (introduced by House Representative Charles B. Rangel [MA-15]); American Jobs Creation Act of 2003, H.R. 2896, 108th Cong. (2003) (introduced by House Representative William M. Thomas [CA-22]); Pension Protection Act of 2003, S. 9, 108th Cong. (2003) (introduced by Senator Thomas A. Daschle [SD]); Reversing the Expatriation of Profits Offshore Act, S. 2119, 107th Cong. (2002) (introduced by Senator Charles E. Grassley [IA]); Corporate Patriot Enforcement Act of 2003, S. 384, 108th Cong. (2003) (introduced by Senator Harry M. Reid [NV]); Corporate Tax Fairness and Shareholder Rights Act of 2003, S. 513, 108th Cong. (2003) (introduced by Senator Evan Bayh [IN]); Jobs and Growth Tax Relief Reconciliation Act of 2003, S. 1054, 108th Cong. (2003) (introduced by Senator Charles E. Grassley [IA]); Energy Tax Incentives Act of 2003, S. 1149, 108th Cong. (2003) (introduced by Senator Charles E. Grassley [IA]); Sales Tax Equity Act of 2003, S. 1136, 108th Cong. (2003) (introduced by Senator Bill Nelson [FL]); Dayton Fair Tax Cut Act, S. 135, 108th Cong. (2003) (introduced by Senator Mark Dayton [MN]).

A. *"U.S. Corporation" — Definition Modified*

Many of the proposed bills contain provisions that propose to change the definition of a domestic corporation, as provided by section 7701(a)(4).[80] Some bills explicitly amend the definition of a U.S. corporation to include inverted U.S. corporations.[81] Others merely provide that, notwithstanding the current definition as provided in section 7701(a)(4), that in the case of corporate inversion transaction, foreign corporations may be treated as U.S. corporations for tax purposes.[82] Regardless of which definition is passed, U.S. corporations which invert will be considered U.S. corporations in the end for tax purposes.

For example, House Representative Richard E. Neal introduced the Corporate Patriot Enforcement Act of 2003, which states, in part, that paragraph (4)(B)(i) of section 7701(a) of the IRC of 1986 (defining U.S. corporation) is amended to read as follows: "The acquiring corporation in a corporate expatriation transaction shall be treated as a domestic corporation."[83] A "corporate expatriation" transaction is defined further in the bill by satisfying a three-part test, discussed below.[84]

Another example can be illustrated in the "Reversing the Expatriation of Profits Offshore Act," introduced by Senator Charles E. Grassley. In that bill, it states in part that, "if a foreign incorporated entity is treated as an inverted domestic corporation, then, notwithstanding section 7701(a)(4), such entity shall be treated for purposes of this title as a domestic corporation."[85] Determining whether a corporation is inverted is measured by using a similar three-part test.

As provided by this proposed legislation, U.S. corporations that benefitted from the liberal definition of a domestic corporation in the past will not be able to do so in the future as the proposed legislation's scope broadens to cover corporate inversion transactions. In the wake of this legislation, U.S. corporations will be forced to pursue other creative tax planning vehicles.

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80. I.R.C. § 7701(a)(4) (2000).

81. *See* Corporate Patriot Enforcement Act of 2003, H.R. 737; Taxpayer and Fairness Protection Act of 2003, H.R. 1661; Jobs and Growth Reconciliation Tax Act of 2003, H.R. 2046; Working Families Tax Credit Act of 2003, H.R. 2286; Corporate Patriot Enforcement Act of 2003, S. 384; Corporate Tax Fairness and Shareholder Rights Act of 2003, S. 513; Dayton Fair Tax Cut Act, S. 135.

82. *See* Energy Tax Policy Act of 2003, H.R. 1531; Pension Protection Act of 2003, S. 9; Reversing the Expatriation of Profits Offshore Act, S. 2119; Jobs and Growth Tax Relief Reconciliation Act of 2003, S. 1054; Energy Tax Incentives Act of 2003, S. 1149; Sales Tax Equity Act of 2003, S. 1436.

83. *See* Corporate Patriot Enforcement Act of 2003, H.R. 737, § 2(a)(4)(A)-(B).

84. *See infra* Parts VIII.A, VIII.A.2.

85. *See* Reversing the Expatriation of Profits Offshore Act, S. 2119, 107th Cong., § 7874(a)(1)-(2) (2002).

B. *The Three-Part Test*

Two general labels exist in these bills to describe the corporate inversion transaction: the "inverted domestic corporation"[86] or "corporate expatriation transaction."[87] Nearly all of these bills apply a similar three-part test to determine whether a transaction qualifies as a corporate inversion transaction. For example, Senator Grassley's bill[88] states that an "inverted domestic corporation" exists when a (1) foreign incorporated entity makes an acquisition of *substantially all* of the property held by a U.S. corporation;[89] (2) immediately after the acquisition, eighty percent of the new foreign corporation stock's vote or value is held by former shareholders in the U.S. corporation; and (3), the new foreign corporation and its "expanded affiliates" do not have *substantial business activities* in that foreign country.[90] In addition, the stock ownership requirement in several of these bills is lowered from the current eighty percent level to fifty percent. The lowering of this threshold is triggered when the foreign corporation lacks "substantial business activities . . . in the foreign country [where it is] organized, and the

86. *See* Energy Tax Policy Act of 2003, H.R. 1531; Pension Protection Protection Act of 2003, S. 9; Reversing the Expatriation of Profits Offshore Act, S. 2119; Jobs and Growth Tax Relief Reconciliation Act of 2003, S. 1054; Energy Tax Incentives Act of 2003, S. 1149; Sales Tax Equity Act of 2003, S. 1436; Dayton Fair Tax Cut Act, S. 135.

87. *See* Corporate Patriot Enforcement Act of 2003, H.R. 737; Energy Tax Policy Act of 2003, H.R. 1531; Taxpayer and Fairness Protection Act of 2003, H.B. 1661; Jobs and Growth Reconciliation Tax Act of 2003, H.R. 2046, 108th Cong. (2003); Working Families Tax Credit Act of 2003, H.R. 2286, 108th Cong. (2003); Corporate Patriot Enforcement Act of 2003, S. 384, 108th Cong. (2003); Corporate Tax Fairness and Shareholder Rights Act of 2003, S. 513, 108th Cong. (2003).

88. Reversing the Expatriation of Profits Offshore Act, S. 2119.

89. In House Representative Neal's Bill, it is referred to as a "nominally foreign corporation." A "nominally foreign corporation" is defined as "any corporation that would be treated as a foreign corporation." Corporate Patriot Enforcement Act, H.R. 737, *amending* I.R.C. § 7701(a)(4)(B)(ii)(I) (2000). In other words, this would apply to any corporation that would typically be treated as a foreign corporation under existing law of that foreign country and also that of the United States, because it has been, for example, incorporated in Bermuda or some other foreign country.

90. Reversing the Expatriation of Profits Offshore Act, S. 2119, § 7874(a)(2)(A)-(C). An inverted U.S. corporation occurs when (1) a "nominally foreign corporation" makes "a direct or indirect acquisition of *substantially all* of the properties held directly or indirectly by a U.S. corporation," and (2) "after the acquisition at least 80 percent of the stock (by vote or value) of the entity is held — (i) in the case of an acquisition with respect to a domestic corporation, by former shareholders of the domestic corporation by reason of holding stock in the U.S. corporation," and (3) "the expanded affiliated group which after the acquisition includes the entity does not have *substantial business activities*" in the foreign country in which the entity is created or organized when compared to the total business activities of such expanded affiliated group." Reversing the Expatriation of Profits Offshore Act, S. 2119, § 7874(a)(2)(A)-(C) (emphasis added).

stock is publicly traded and the principal market for the public trading of such stock is located in the U.S."[91]

First, the definition of "substantially all" has been elusive in these bills. Most likely, this was intentional on the part of the lawmakers to allow more flexibility in prosecuting corporate inverters. Perhaps the answer is located in a tiny footnote located in a joint committee tax report stating that, "it is expected that the Treasury Secretary will issue regulations applying the term 'substantially all' in this context and will not be bound in this regard by interpretation of the term in other contexts under the Code."[92] In other words, it appears that the Treasury Secretary wishes to reserve the right to formulate and tailor an effective definition of "substantially all" as applied to these situations.

Second, immediately after the acquisition, the shareholders who previously held stock in a U.S. corporation, now a U.S. subsidiary, must own at least eighty percent of the new foreign corporation stock. It is unclear whether "immediately" as defined in this proposed legislation will be consistent with other sections of the IRC. The courts have used many judicial doctrines, including the step-transaction, substance over form, sham transaction, and the business purpose doctrine in order to allow the inclusion of transactions that aim to circumvent this IRC section and fall outside of "immediately." It would make sense to apply this analysis to the context of corporate inversion transactions, but like the "substantially all" provision, Congress may specifically intend to prevent its adoption in the inversion context. For now, it seems like the analysis will be similar to that of other contexts in the IRC.

Third, if the first two elements of the three-part test have been met and if the new foreign parent and its "expanded affiliates" do not have *substantial business activities,* then the transaction meets the three-part test and the

91. Corporate Tax Fairness and Shareholder Rights Act, S. 513, 108th Cong. § (a)(4)(iii) (2003).

92. *See* Joint Committee Taxation Report, Apr. 2, 2003 (JCX-28-03) on the Senate Energy Tax Incentive Act of 2003 (S. 1149), n.16.

foreign corporation will be treated as an "inverted domestic corporation,"[93] or as participating in a "corporate expatriation transaction,"[94] which in either case will effectively re-characterize the foreign corporation as a U.S. corporation for U.S. tax purposes. Congress hopes that this effect will lessen the appeal and economic viability of the corporate inversion transaction.

Most of the proposed bills reduce the existing eighty percent stock ownership requirement as provided in the three-part test to fifty percent in two major situations. The first situation, represented by Senator Grassley's bill, is time related.[95] The second, represented by Senator Neal's bill, turns on whether there are *substantial business activities* as compared with its expanded affiliate group.[96]

Senator Grassley's bill is more stringent than Senator Neal's bill because a fourth time-related requirement must be met in addition to the stock reduction requirements and *substantial business activities* test, which could be retroactive in some situations. In contrast, Senator Neal's proposed bill is severe to U.S. corporations because the changed provision automatically reduces the stock ownership threshold to fifty percent when the foreign corporation does not have *substantial business activities* as compared to its affiliate group.

The *substantial business activities* test and the fifty percent stock ownership threshold will likely have more success in deterring corporate inversions than their predecessors and will likely keep U.S. corporations more cautious about making corporate structural changes in the future. The structural changes that have occurred in the past have occurred primarily on

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93. *See supra* note 79. "Expanded Affiliates" is defined in I.R.C. section 1504(a), which states,

> [one] or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if – (B) (i) the common parent owns directly stock meeting the requirements of paragraph (2) in at least 1 of the other includible corporations, and (ii) stock meeting the requirements of paragraph (2) in each of the includible corporations (except the common parent) is owned directly by 1 or more of the other includible corporations.

I.R.C. § 1504(a) (2000).

94. *See supra* note 82.

95. *See supra* note 85. The retroactive nature of some provisions in these corporate inversion transaction bills are potentially very devastating as applied to U.S. corporations that fall within the time-frame provided in these bills. It is as if Congress is sending a message to those perceived as "taking advantage" or "manipulating" the IRC to place themselves in a more favorable tax situation, violating the spirit of the IRC and its implicit restrictions, and engaging in unpatriotic behavior, that the Congress will not stand for those who engage in such transactions and such violators will have to pay huge tax penalties for their actions.

96. *See supra* text accompanying note 93.

paper as opposed to any meaningful operational relocation efforts. In other words, the corporate inversion transaction only changed the structure on paper anyway, and the business activities remained in the United States rather than in the new country of incorporation. This fact is one of the reasons why Congress has chosen to act to prevent the corporate inversion transaction from being legitimately recognized. The *substantial business activities* prong will be effective in preventing disingenuous corporate inversion transactions.

C. *Other Proposed Restrictions*

Senator Charles E. Grassley's proposed bill number 2119 is an appropriate frame of reference for analysis because it contains most of the provisions and issues that are collectively present in the other bills proposed. Accordingly, this bill will be analyzed more fully than the others.

1. Tax Offset Limits

Senator Grassley's bill proposes to limit tax offsets on gains that generally occur in the context of corporate inversion transactions. Under this provision, the taxable income of the acquired entity for any taxable year "which includes any portion of the applicable period shall in no event be less than the inversion gain of the entity for the taxable year."[97] The "inversion gain" is defined as "any income or gain required to be recognized" under various sections of the IRC "by reason of the transfer during the applicable period of stock or other properties by an acquired entity" as part of the acquisition in a corporate expatriation transaction or to a foreign related person.[98]

To understand the idea of tax offsets, it is perhaps beneficial to use the idea of debt shifting by way of analogy. For example, like in a debt shifting scheme where inter-company debt is created in order to generate interest deductions to reduce taxable income, tax offsets in the past have been strategically shifted from entity-to-entity in order to reduce taxable liability, like when a U.S. corporation attempts to use a foreign corporation's tax offsets to reduce its inversion gains. Such shifting of tax offsets would be prohibited under this bill.

2. Related Party Transactions

Most inversion transactions involve "related parties." A related party corporation is typically one that owns 50% or more of another entity.[99]

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97. Reversing the Expatriation of Profits Offshore Act, S. 2119, 108th Cong. § 7874(c)(1) (2002).

98. *Id.* § 7874(c)(4). The various IRC sections include 304, 311(b), 367, 1001, or 1248.

99. A "related party," assuming that the proposed legislation adopts the definition of "relatedness" of other IRC sections, exists when a parent owns at least 50% of another entity's

Senator Grassley's Bill would also require U.S. corporations to report and apprise the IRS of any corporate inversion transactions involving "related parties."[100] This provision contemplates the multiple problems and abuses of related party transactions that exist, including the challenge of the IRS to oversee corporate inverters and their subsequent behavior.[101] For example, transfer pricing and debt shifting are potential and actual abusive tools used by related corporations, and because of the limited resources of the IRS, it is difficult without actual knowledge to oversee and enforce such violations.

As provided in the proposed bill,[102] any corporate inversion transaction between related parties would have to get the approval of the Treasury Secretary. Within ninety days of receipt of the application, the Treasury Secretary would have to reply and notify the U.S. corporation whether their application met the requirements of good faith and substantial compliance. If the U.S. corporation has not complied with these requirements, the proposed bill provides that any "deduction, or addition to basis or cost of goods sold, for amounts paid or incurred, or losses incurred, by reason of a transaction between the acquired entity and a foreign related person," any intangible property will be disregarded; and any "cost-sharing arrangement between the acquired entity and a foreign related person shall be disregarded."[103] These procedures would significantly elevate the prior notice requirements and would likewise aid the IRS to more capably deal with the oversight challenges inherent in the policing of the corporate inversion transaction.

3. Modifications of Limitations on Interest Deductions

As discussed above, one primary reason for U.S. corporations to invert is the benefits and availability of post-inversion earnings-stripping techniques such as interest deductions available under section 163 for indebtedness

stock and more than 50% of the capital or profits interest in a partnership, have certain members of the family involved, or if two of the corporations are members of the same controlled group under 1563(a) and 267(f)(1).

100. *See id.* § 7874(d).

101. Oversight of every such transaction certainly exceeds the capability of the IRS to recognize and punish those inverting U.S. corporations. Senator Grassley's bill would require all U.S. corporations to apply for approval to invert, making the job for the IRS a little easier in terms of oversight. *See id.* § 7874(d)(1)(D). Another related party technique that is often abused is that of transfer pricing, which involves transactions between related entities, for example the selling of goods at major discounts, that can temporarily shift income between the entities and defer a portion of tax liability of one or the other related entity.

102. Reversing the Expatriation of Offshore Profits Act, S. 2119, 108th Cong. § 7874(d); *see also* I.R.C. §§ 267(b), 707(b)(1) (2000).

103. *Id.* § 7874(d)(1)(C).

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created by the foreign parent.[104] This debt is evidenced by a promissory note given by the U.S. corporation to the foreign corporation that may never actually be satisfied. Further, this debt-amount can be passed to the U.S. subsidiary essentially as a tax-free dividend.

As discussed, IRC section 163(j) was passed to restrict disproportionate interest deductions. This section is triggered when the corporate debt to equity ratio exceeds 1.5 to 1. After the triggering, any interest expense for the taxable year that exceeds fifty percent of the corporation's taxable income, computed without regard to its net interest expense or net operating losses, is disallowed. In other words, interest deductions that derive out of debt-shifting between inverted corporations, whether it occurs between parent-subsidiary or brother-sister, is disallowed when the 1.5 to 1 and 50% threshold is met. This excess interest is termed "excess interest expense"; any portion over the threshold amount is considered "disqualified interest."[105]

To illustrate, assume that U.S. corporation Anderson ("A Company") has a debt-equity ratio that exceeds 1.5 to 1 and that at the end of the taxable year, it has earned $100, without taking into account net interest expense or net operating losses. Assume further that this $100 represents A Company's taxable income and that A Company has interest expenses of $60. Because 163(j) currently restricts deductions to 50% of taxable income, only $50 (50% of $100) would be allowed and the "excess" of $10 would be disallowed. This provision obviously has some impact on the inverting corporation that intends to utilize these interest deductions. However, the triggering threshold and the gross income percentage is too high to prevent U.S. corporations from inverting.

Senator Grassley's bill proposes to modify section 163(j) by eliminating the debt-to-equity threshold and by lowering the excess interest threshold. For example, the new 163(j), as provided by Grassley, would be applied "without regard to paragraph 2(A)(iii)" of the existing IRC section 163(j),[106] which deals with the debt to equity ratio threshold, and secondly, "25 percent" would be substituted for "50 percent" wherever it appears in that

104. *See* Parts V, V.C.

105. I.R.C. § 163(j) (2000); *see supra* note 58. Under IRC section 304, a brother-sister corporation is one that is in "control" by one or more persons and yet is not involved in a parent-subsidiary relationship. *See* I.R.C. § 304 (2000).

106. This IRC subsection states that

> [t]his subsection shall apply to any corporation for any taxable year if (i) such corporation has excess interest expense for such taxable year, and (ii) the ratio of debt to equity of such corporation as of the close of such taxable year (or on any other day during the taxable year as the Secretary may by regulations prescribe) exceeds 1.5 to 1.

I.R.C. § 163(j)(2)(A).

IRC section.[107] In other words, U.S. corporations are automatically kicked into the "excess interest" analysis, without being subject to a debt-equity ratio first, and such analysis subjects the U.S. corporation to a twenty-five percent threshold, instead of the more gracious fifty percent one.

Using the example from above, A Company, which has $60 in interest expense and $100 taxable income, could only deduct $25 (25% of taxable income) instead of the previously allowed $50, leaving a disallowed or excess amount of $35 instead of $10 under the current rule. Although these numbers may seem insignificant, when you consider real life numbers that range in the millions of dollars, this will certainly have a huge impact on U.S. corporations and their decision to invert and seek to use earnings-stripping techniques.

4. Treaty Overrides

Senator Grassley must be aware of the potential conflicts that may occur between this legislation and existing treaties. This legislation will most likely trump any treaty provision that enables the undesired abuse that allows U.S. corporations to invert disingenuously in other countries. This "trumping" approach is not new. The passage of other IRC sections such as 269(B), have also had "trumping" effects on existing treaties. Therefore, it is unlikely that this will be an issue, outside of the fact that other countries may disapprove.

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107. Reversing the Expatriation of Profits Offshore Act, S. 2119, § 7874(d)(2)(A)-(B). This comes into play in subsection (2)(B), which states that

> for purposes of this subsection, the term "excess interest expense" means the excess (if any) of (I) the corporation's net interest expense, over (II) the sum of 50 percent of the adjusted taxable income of the corporation plus any excess limitation carryforward under clause (ii). (ii) . . . If a corporation has an excess limitation for any taxable year, the amount of such excess limitation shall be an excess limitation carry forward to the 1st succeeding taxable year and to the 2nd and 3rd succeeding taxable years to the extent not previously taken into account under this clause. The amount of such a carryforward taken into account for any such succeeding taxable year shall not exceed the excess interest expense for such succeeding taxable year (determined without regard to the carryforward from the taxable year of such excess limitation). (iii) . . . For purposes of clause (ii), the term "excess limitation" means the excess (if any) of — (I) 50 percent of the adjusted taxable income of the corporation, over (II) the corporation's net interest expense.

I.R.C. § 163(j)(2)(B).

IX. FORECASTING THE FUTURE — CHALLENGES AND EFFECTS FACING PROPOSED LEGISLATION

This proposed legislation is not certain to be entirely successful. Some unintended or unknown consequences may occur that could actually undermine the purpose of the bill. On the other hand, this legislation may completely convince all U.S. corporations to look beyond the corporate inversion transaction for their next tax-saving technique. Success may depend in large part on the play of various factors, including the ability of the IRS to administer and enforce the proposed laws.

A. *Predictions*

Any projection or opinion as to the specific effectiveness of any of the proposed legislation, as discussed above, is just that. In other words, it is not entirely certain whether this legislation will be successful in any degree. Questions need to be asked and analyzed. For example, how is or should this legislation be administered, what are the intended and likely effects in terms of limiting U.S. corporations' participation in these corporate inversion transactions, and what recommendations can be made to increase the likelihood of success of this legislation?

B. *Administration of Proposed Legislation*

The first questions to ask are those relating to administration. Who will administer the new legislation and how effective will they be in doing so? The short answer is that the Treasury Department and the IRS will administer the proposed legislation. The IRS has limited resources and with all they are responsible for, it will be difficult to oversee the compliance of U.S. corporations which engage in corporate inversion transactions and employ transfer pricing and debt shifting earnings-stripping techniques.

This new legislation should be successful overall in terms of being able to monitor and respond to corporate inversion transactions. Senator Grassley's bill would impose stricter reporting and approval requirements, such as requiring related parties engaging in a corporate inversion transaction to seek the approval of the Treasury Secretary, under the framework of good faith and business purpose.[108] This alone will give the IRS a significant role in determining which U.S. corporations have legitimate business reasons for inverting and will avoid stretching their resources thinner than in the past. In addition, this may also avert the problem of legislation "casting a net" too broadly in terms of affecting legitimate foreign corporations which really do

108. Reversing the Expatriation of Profits Offshore Act, S. 2119, 108th Cong. § 7874(d)(1)(A) (2002).

have reasons for being inverted. In other words, the intended scope of the legislation is to prevent U.S. corporations from engaging in the illicit practice, not true foreign corporations that have incorporated in country such as Bermuda.

The SEC and corporate bylaws require compliance with certain mechanisms related to shareholder notice and voting on large structural changes such as corporate inversions. For example, literature that apprises shareholders of impending votes on structural proposals, proxy statements, and other news resources will notify other unintended parties such as the IRS of the corporation's intention to invert. These events alone are already sufficient enough to bring widespread attention to the proposed transaction, especially in the case of large corporations.

In conclusion, existing mechanisms coupled with new reporting and approval requirements imposed by the proposed legislation should make the IRS better able to effectively oversee and enforce the provisions in the proposed legislation.

C. *Intended Tax Consequences — Effect and Analysis*

Discussed above are a number of proposed legislative provisions that intend to further restrict the tax benefits of the corporate inversion transaction, including changing the definition of a U.S. corporation, modifying acquisition rules, reducing tax offsets and interest deductions, and overriding existing treaty benefits. Cumulatively, these proposed modifications should pose significant tax obstacles to U.S. corporations in achieving an economically viable corporate inversion transaction.

1. "U.S. Corporation" — Section 7701 Modified

As previously discussed, the proposed legislation will change the current definition of a U.S. corporation when it engages in a corporate inversion transaction.[109] The existing definition has been one of the biggest challenges so far in overcoming the perceived inequities of the corporate inversion transaction. Unlike other countries, such as Great Britain, whose definition of "corporation" is not objectively defined, the United States determines residency by place of incorporation. This objective definition has allowed U.S. corporations that invert to conclusively declare that they are foreign corporations because of their incorporating documents, and that they should not therefore be subject to U.S. tax. The new proposed definition change will see through the corporate inversion transaction and will not allow this objective technicality to shelter U.S. corporations.

109. *See supra* Part VI.A.

In order to remove the definitional obstacle of a "domestic corporation" as it is currently defined, it must be changed. The proposed change will be effective in deterring inverting corporations. The question that remains, however, is whether or not it will be broad enough to prevent other transactions that could achieve the same effect as a corporate inversion. In other words, by limiting the definitional exception to corporate inversions, will other transactions that are currently unheard of be able to avert this provision's grasp? Great Britain uses a more case-by-case analysis in determining whether a corporation is domestic or foreign, and Congress may want to consider adopting such an approach itself.[110] On the one hand, this adoption would give the IRS and/or the courts greater flexibility, discretion and power; on the other, it may give too much power, which may have some stifling effect on international business.

2. The Three-Part Test

The three-part corporate inversion transaction test that treats inverted U.S. corporations and their foreign parents and affiliates as U.S. corporations for tax purposes already exists. However, the proposed legislation, specifically Senator Grassley's bill, would expand its application. For example, immediately after the corporate transaction, shareholders would only have to own fifty percent of the foreign parent stock, instead of the previous threshold amount of eighty percent.[111] This threshold reduction would expand the "net" to include more U.S. corporations that are engaging or have engaged in this transaction. On the other hand, there are some worries that the "net" may be cast so widely as to catch those foreign corporations that are legitimately foreign. This worry would perhaps be alleviated if a more subjective test, such as used in Great Britain, were adopted.

Nevertheless, the intended effects should be somewhat successful in preventing future corporate inversion transactions of U.S. corporations. If that is the policy Congress wants to promulgate, then the adoption of this provision in its current form, which lowers the threshold from eighty percent to fifty percent, would prevent many new inversions.

110. A more subjective test would give the IRS more flexibility and power in determining whether a corporation should qualify as a foreign or domestic corporation.

111. *See supra* Part VI.A. This test states that if a foreign corporation acquires all or substantially all of the assets of a U.S. corporation, and immediately thereafter, the former shareholders of the U.S. corporation own 80% or more of the stock in the foreign corporation, and that the new foreign parent, including all of its foreign affiliates, is not engaged in substantial business activities, then an inverted U.S. corporation exists and it will be treated, notwithstanding its foreign entity status, as a U.S. corporation for tax purposes.

3. Tax Offset Limits

The effects of this proposal — tax offset limits — are difficult to gauge. On the one hand, the proposal, if enforceable, would have a significant impact on inverting U.S. corporations. On the other hand, any type of shifting of income, debts, credits and/or deductions, commonly referred to as transfer pricing, is very difficult to oversee and penalize. Therefore, when such offsets are identified and used, which may be infrequent, such a provision would have some effect.

4. Reporting Related Party Transactions

The new reporting and approval requirements as provided by Senator Grassley's bill would significantly restrain improper corporate inversion transactions because most corporate inversion transactions involve related parties.[112] Each U.S. corporation proposing such a transaction would be required to submit an application to the Treasury Secretary, who would carefully analyze the reasons for such a structural modification under the good faith and business purpose doctrinal framework. Of course, putting this discretionary power in the hands of the Treasury Secretary would prevent many disingenuous U.S. corporations from inverting solely for tax reasons, but would hopefully still allow those foreign corporations which have legitimate needs and reasons to do so. This provision would see some success because it would not pose any significant burdens on the IRS, but would instead make it easier to monitor the existence of the intended corporate inversion transactions.

If U.S. international tax policy is to prevent U.S. corporations from expatriating and simultaneously enjoying the benefits of citizenship, this provision should significantly help.

5. Interest Deduction Limitations — 163(j)

Removing the debt to equity threshold and limiting the allowable interest deductions to twenty-five percent of taxable income, as proposed by Senator Grassley's bill, would significantly deter future corporate inversion transactions. Without the huge interest deductions, the motivation is removed. This provision should be easy to administer, assuming U.S. corporations report their income honestly, because of the new reporting and approval requirements by the Treasury Secretary.

Again, if U.S. international tax policy is to prevent U.S. corporations from expatriating and simultaneously enjoying the benefits of citizenship, this

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112. Although there are other transactions that do not involve related parties, such as mergers and acquisitions by true foreign entities.

provision should be significant enough to prevent U.S. corporations from expatriating.

D. *Treaty Override*

Lastly, this proposed legislation has treaty override implications. This fact may cause international tension with some of our treaty partners. Many of these countries, e.g., Bermuda and Barbados, significantly benefit from the abusive "loop-holes" that currently allow U.S. corporations to take advantage of relaxed corporate residency policies.

As the U.S. Congress sits on the verge of passing this much-awaited legislation, it should also consider restructuring current treaties.

X. CONCLUSION

Congress is poised to pass legislation that will stamp out the economic vitality of the corporate inversion transaction and barring unforeseen circumstances, it appears that such legislation will pass during this legislative session. As a result, the corporate inversion transaction will be significantly impacted because the United States will see through it and not recognize the new foreign corporation. Shifting income will be more difficult and the disproportionate interest deductions will be denied.