Mergers of Equals. Getting Caught in the § 7874 Corporate Inversion Web - Change the Rules or Change the Game.

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INTRODUCTION

Internal Revenue Code § 7874[1] was introduced to discourage U.S. corporations from engaging in certain "inversion" transactions. An inversion transaction, for purposes of § 7874, occurs if the following circumstances occur: a U.S. corporation or partnership becomes a subsidiary of, or transfers substantially all of its assets to, a foreign corporation and the former owners of the U.S. entity own at least 60% of the stock, by vote or value, of the new foreign parent corporation. Inversion transactions include stock inversions, asset inversions, and various permutations of these two types.

Congress intended that this new provision capture transactions in which a U.S. corporation reincorporates in a foreign jurisdiction, but the resulting entity has only "a minimal presence in [the] foreign country of incorporation." In light of this intention, the "substantial business activities" exception was enacted. However, new regulations significantly narrow the substantial business activities exception to the point where it captures transactions that were not intended to be in scope.

The changes in the regulations have limited the ability of U.S. multinational corporations to compete against other corporations established in jurisdictions with lower corporate tax rates. The U.S. has one of the highest corporate tax rates in the developed world. In order to achieve corporate tax neutrality, which will encourage companies to establish and maintain businesses in the U.S., the government will need to more aggressively target tax policies and rules that act as disincentives for companies to maintain their operations in the U.S.

THE CODE

In 2004, § 7874 was enacted by the American Jobs Creation Act of 2004 to address loopholes in the previous tax rules which governed these transactions. When introduced, the section provided that it would override all tax treaties. It states:

> Nothing in … any … provisions of law shall be construed as permitting an exemption, by reason of any treaty obligation of the United States heretofore or hereafter entered into, from the provisions of this section[2]

The rule defines two different types of inversion transactions and increases the U.S. tax costs for these transactions.

§ 7874(a)(1) provides that the taxable income of an expatriated entity for any taxable year cannot be less than the inversion gain of the entity for the taxable year. 7874(a)(2)defines expatriated entity as a domestic corporation, or partnership, with respect to which a *foreign corporation is a surrogate foreign corporation*, and any United States person who is related to a domestic corporation or partnership. A foreign corporation shall be treated as a surrogate foreign corporation if, pursuant to a plan (or a series of related transactions) the entity completes the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation or substantially all of the properties constituting a trade or business of a domestic partnership, and

(i) after the acquisition at least **60 percent of the stock** (by vote or value) of the entity is held, 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 domestic corporation, or in the case of an acquisition with respect to a domestic partnership, by former partners of the domestic partnership by reason of holding a capital or profits interest in the domestic partnership, and

(ii) after the acquisition the expanded affiliated group which includes the entity does not have **substantial business activities** in the foreign country in which, or under the law of which, the entity is created or organized, when compared to the total business activities of such expanded affiliated group.

Accordingly, a domestic corporation or partnership trade or business shall not be treated as a foreign subsidiary if such entity acquired directly or indirectly more than half of the properties held directly or indirectly by such corporation or more than half of the properties constituting such partnership trade or business, as the case may be.

Essentially, there are three key requirements that must be satisfied under this section (i) Ownership Test; (ii) Asset Test, and the (iii) Business Activities Test. Under the Ownership Test , the expatriating US company will be treated as a foreign corporation for U.S. tax purposes if the percentage of new foreign parent company's stock owned by former US company's shareholders after the transaction is 60% or more but less than 80%. However, the relocated US company will lose the ability to use its net operating losses (NOLs) as well as other tax attributes for up to ten years after the inversion.[3] If after the transaction the percentage of ownership is 80% or more, and other requirements are met, the new foreign parent will be treated as a U.S. corporation for U.S. tax purposes. In essence, the inversion is disregarded entirely and, thus, the expatriated U.S company will be treated like a U.S. domestic corporation forever, even if the corporation satisfies the lower ownership thresholds at some future date.[4] If ownership is less than 60% then § 7874 does not apply.[5]

Under the Asset Test, the new foreign parent must acquire directly or indirectly "substantially all" the assets of the expatriated US company to be captured by §7874. This test is particularly relevant where the relocating US company makes a distribution or disposition prior to migration.[6] The regulation does not provide a definition of substantially all.

The Substantial Business Activities Test looks at the level of business activities of the expatriated entity that is conducted in the new foreign parent company's country of incorporation. The test looks at the combined activities of the relocated U.S. company and the new foreign parent.

THE REGULATIONS

2006

The first regulations governing §7874 were introduced in 2006. The regulations primarily provided rules that interpreted the substantial business activities test. It introduced two tests to determine whether an enterprise has substantial business activities in its new location. One test required looking at the general facts-and-circumstances of the transaction and the other was a safe harbor test. When applying the facts-and-circumstances test, the regulations suggested looking at the following factors:

1. The conduct of continuous business activities in the foreign country by members of the expanded affiliated group prior to the acquisition

2. Business activities of the expanded affiliated group in the foreign country occurring in the ordinary course of the active conduct of one or more trades or businesses, involving the following:

a. Property located in the foreign country that was owned by members of the expanded affiliated group

b. The performance of services by individuals in the foreign country who were employed by members of the expanded affiliated group

c. Sales to customers in the foreign country by members of the expanded affiliated group

3. The performance in the foreign country of substantial managerial activities by officers and employees of members of the expanded affiliated group who were based in the foreign country

4. A substantial degree of ownership of the expanded affiliated group by investors resident in the foreign country

5. The existence of business activities in the foreign country that were material to the achievement of the expanded affiliated group's overall business objectives

In order to meet the safe harbor requirements, a company had to provide sufficient support indicating that:

1. After the acquisition the total value of the group assets located in the foreign country was ***at least 10 percent*** (by headcount and compensation) of total group employees.

2. After the acquisition, the total value of the group assets located in the foreign country was ***at least 10 percent*** of the total value of all group assets.

3. During the testing period, the group sales made in the foreign country accounted for ***at least 10 percent*** of total group assets.

In summary, the bright line ten-percent safe harbor test required that the new jurisdiction have at least 10% in number and compensation of employees, and ten percent of the value of tangible assets, and of sales.[7] The safe harbor applied to certain transactions that were inconsistent with the purposes of § 7874.

Under the 2006 regulations companies were not required to satisfy all the factors in order to escape the application of the rules. The weight given to any one factor was

determined on a case by case basis.[8] The 2006 Regulations also included an anti-avoidance rule that would operate to disregard the transfer of any assets, activities or income in order to avoid the application of the rules.[9]

2009

As noted above, the 2006 regulations contained a "Substantial Business Activities" test. This test included both a facts-and-circumstances test as well as a bright-line ten percent safe harbor. In the 2009, however, the regulations Substantial Business Activities test was modified and the safe harbor test was removed.

The 2009 regulations also added another element to the anti-avoidance rules. Any assets, business activities, or employees that were transferred to the foreign country in which the foreign corporation was organized would be disregarded if the transfer was pursuant to a plan that existed at the time of the acquisition.[10]

2012

The 2012 Regulations provided additional rules to assist taxpayers with interpreting the Substantial Business Activities Test. These regulations significantly modified the facts-and-circumstances test by replacing it with a "bright-line" – not a safe harbor - rule. Under the 2012 Regulations, a foreign corporation has substantial business activities in a relevant foreign country, after an acquisition, if

1. The number of group employees based in the relevant foreign country is ***at least 25 percent*** of the total number of group employees on the applicable date.

   The employee compensation incurred with respect to group employees based in the relevant foreign country is ***at least 25 percent*** of the total employee compensation incurred with respect to all group employees during the testing period

2. The value of the group assets located in the relevant foreign country is ***at least 25 percent*** of the total value of all group assets on the applicable date,
3. The group income derived in the relevant foreign country is ***at least 25 percent*** of the total group income during the testing period.[11]

According to one author, the main impact of the 2012 regulations is that "the bright line test raises the bar in two respects: first, by setting a 25 percent threshold for employees, assets and sales in the relevant jurisdiction, and second, by requiring an inflexible three factor analysis rather than a facts and circumstances" approach. [12]

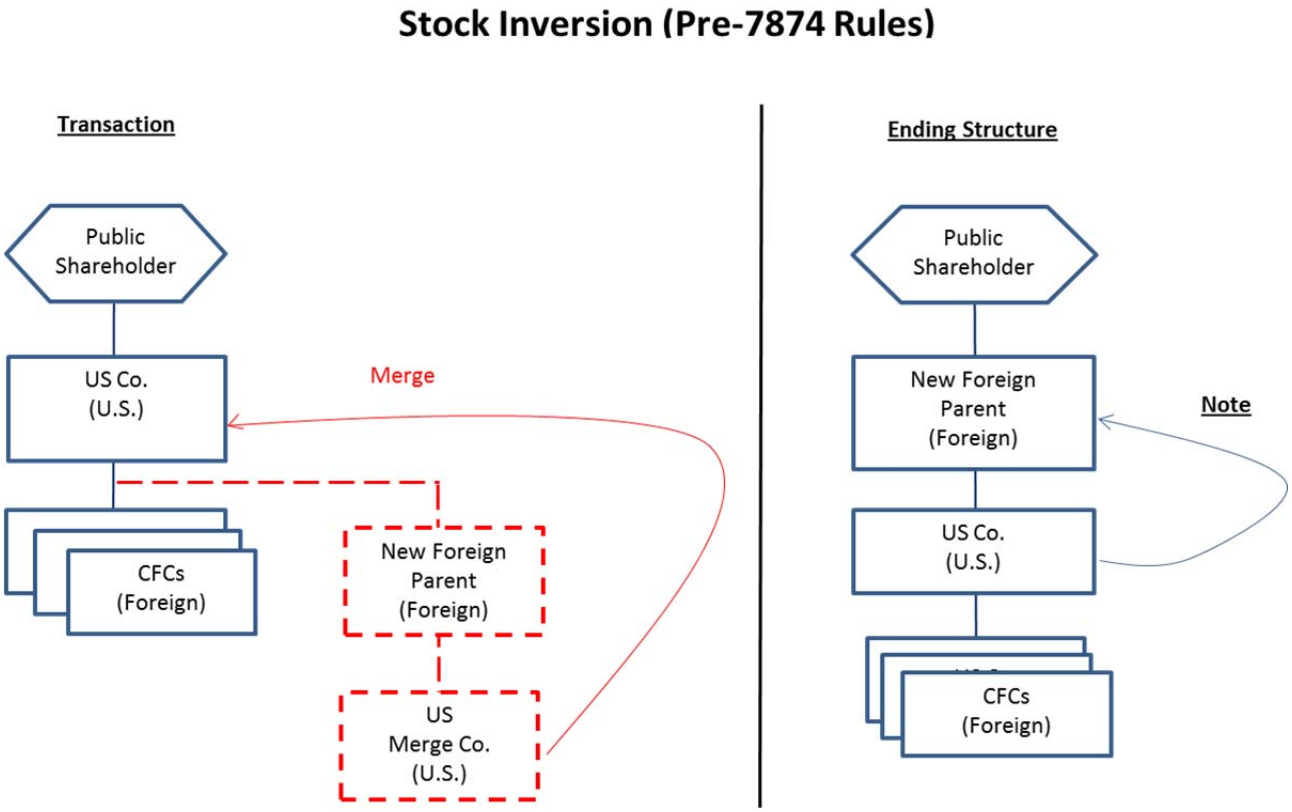
The 2012 regulations are effective for transactions occurring after June 6, 2012. Transactions were grandfathered under the 2009 rules if there was an existing binding contract or the transaction was previously disclosed in a SEC filing before the effective date.[13]

FORM OF INVERSION TRANSACTIONS

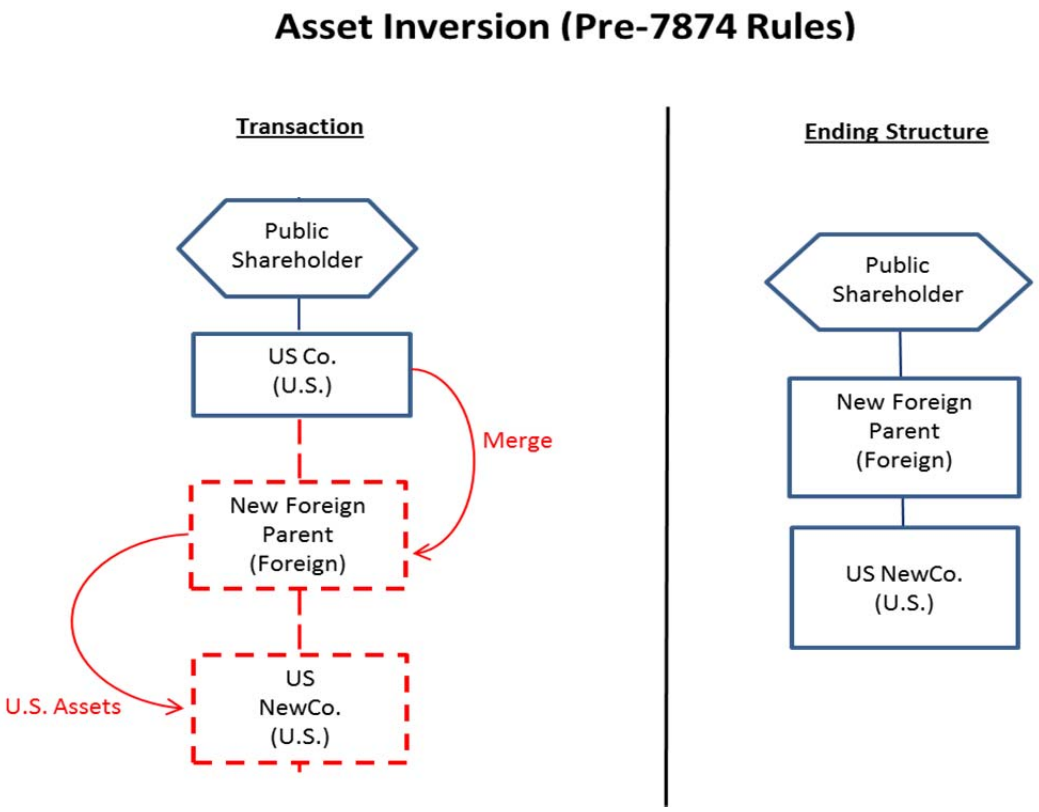
One of the main goals of an inversion transaction is to establish a foreign corporation as the parent corporation. There are three primary ways to achieve this goal: a share inversion, an asset inversion or a hybrid approach.

The example below outlines the basic structure for a share inversion. The publicly traded U.S. corporation, US Co, owns a controlled foreign corporations (CFCs). The publicly traded company forms a new foreign corporation, New Foreign Parent. The New Foreign Parent then forms a wholly owned U.S. corporation, US MergeCo. After the formation of these new entities, US Co merges into US MergeCo, with US Co

surviving. US Co becomes a wholly owned subsidiary of New Foreign Parent, and the former shareholders of US Co receive shares of New Foreign Parent in the transaction.



The example below provides an outline of a standard asset inversion. In this type of transaction, US Co first forms New Foreign Parent. US Co then transfers all its assets to New Foreign Parent in an asset reorganization. New Foreign Parent then transfers all assets received from US Co to a newly formed U.S. corporation, US NewCo. The former shareholders of US Co receive shares in New Foreign Parent. In the next phase of the transaction US Co is dissolved.



Both structures show how a simple change in ownership could have a long-term positive impact on a company's total tax expense. The government hopes that the new 2012 Regulations will have a drastic impact on whether corporations decide to enter into an expatriation or inversion transaction if they can legislate away any of the potential benefits.

ADVANTAGES AND DISADVANTAGES

The primary shareholder level issue is whether the stock transfer, which would be non-taxable – will be respected as a tax-free exchange under § 367. The primary corporate level issue is whether New Foreign Parent will be respected, for U.S. tax purposes, as a foreign corporation.

Stock inversion transactions will generally result in taxable gain for U.S. shareholders. However, if any of the shareholders are tax exempt (ie. pension funds) no taxable gain will result. In addition, withholding taxes may apply to subsequent payments to New Foreign Parent Co. Asset inversion transactions will generally result in a taxable gain to US Co if any of the assets were still held by New Foreign Parent.

When §7874 applies to an inversion transaction there are two main tax consequences that may result. First the rule can be used to limit former US Co's use of tax attributes as a subsidiary of New Foreign Co. Second, New Foreign Co. may be treated as a U.S. corporation for U.S. tax purposes.[14]

One of the main post-inversion benefits is US Co's ability to reduce its U.S. tax through "base erosion"[15] techniques, such as interest stripping. For example, US Co can enter into a debt arrangement, or other deductible payment plans, with New Foreign Parent. In this scenario, the new Foreign Parent company's ownership will be financed by its U.S. subsidiary largely with debt. This will create the opportunity to deduct the interest expense against U.S. taxable income. The interest income will likely be untaxed or taxed a very low rate in the New Foreign Parent's jurisdiction. The income will also not be taxed by the United States under Subpart F, because the recipient of the interest payment is no longer owned by a US company.[16]

In situations where after an inversion transaction the US Co subsidiary of the New Foreign Parent is subject to §7874 then US Co will be treated as a US corporation and U.S. tax will be levied on its worldwide income. However, there are still tax benefits that

may be realized by the group in the future. For example, US companies that expatriate can achieve the following benefits:

(i) No longer subject to tax arising from the U.S. treatment of future foreign source income,

(ii) Will no longer trigger capital gains at the firm level or shareholder level,

(iii) Will have enhanced opportunities to relocate profits worldwide at a reduced tax rate,

(iv) Avoid taxes related to repatriation of foreign source income and the complicated Subpart F regime,

(v) Achieve a benefit from expense allocation rules. US Co may benefit from tax shields associated with interest expenses that might not be as valuable currently due to a firm's excess foreign tax credit status,

(vi) Ability to become more aggressive in structuring their worldwide operations, including relocating U.S. income to low tax jurisdictions.[17]

Not all expatriations are tax motivated. There are many non-tax benefits as well. In fact, according to one author, some of the reasons firms have expressed an interest expatriation included "greater operational flexibility, improved cash management, and an enhanced ability to access international capital markets."[18] However, there is no doubt that significant tax benefits can be achieved if executed correctly.

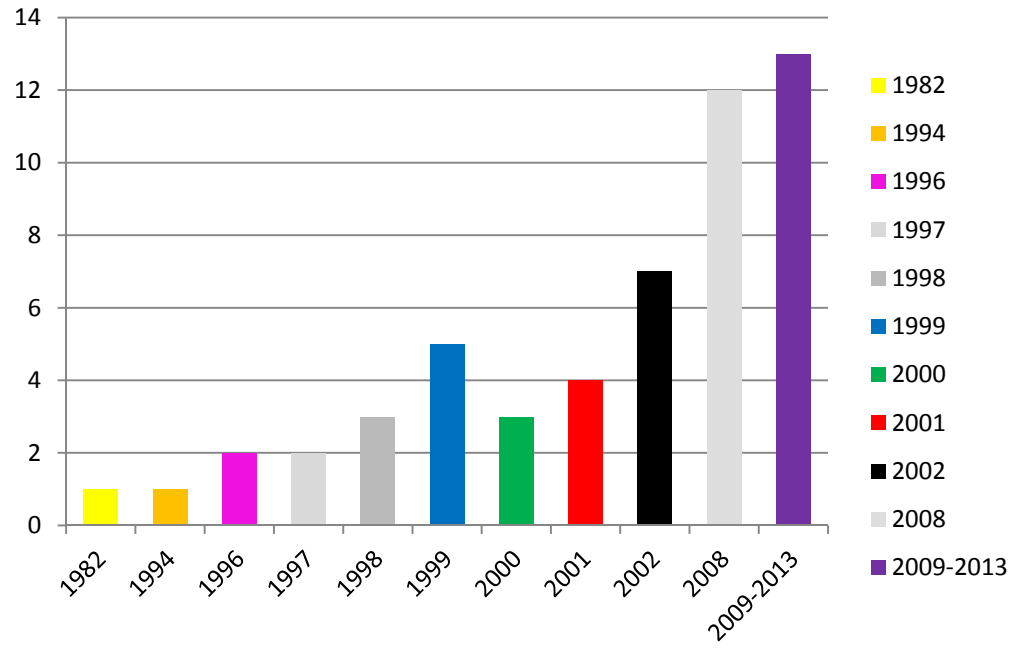
Regardless of the motivations, the U.S. has seen a steady growth in these types of transaction over the past few years. One author notes:

> *American multinational companies are reincorporating as foreign companies at an accelerating rate. This development is clearly a reaction to the incentives created by the U.S. system of taxing worldwide income, as it contrasts with foreign tax systems.*[19]

There is also a growing fear, which some believe is unfounded in a truly competitive market, that the U.S. market is set to lose significant future tax revenues due to the large amount of expatriations leading up to the recent change in legislation. One commentator speculated, "the impact in one year may not be material, but the cumulative impact over time adds up". [20] A review of some recent transactions provides a better context for these arguments.

REVIEW OF TRANSACTIONS

Corporate inversions became very popular in the 1990s. However, according to a New York Times article, the vast majority of inversions have occurred in the last few years. The article reports that there have been about fifty U.S inversion transactions in total with at least 20 of them occurring after 2008.[21] The majority of recent expatriations have been concentrated in the pharmaceuticals, insurance and oil field services.[22] The chart below shows the number of migrations starting since 1982. Also see Appendix A for a list of expatriation transactions.



Source: The author, Marsha Henry, compiled data from her research and generated this chart.

Although, main stream media interest in corporate inversions did not begin until the 1990's, the first corporate inversion on record was actually as early as 1982. In 1982 McDermott Inc., an oil company relocated to Panama.[23] One author describes the transaction and benefits as follows:

The purpose and form of the McDermott transaction were very different from inversions as known today. Shareholders of McDermott exchanged their shares for stock of McDermott International, an existing Panamanian subsidiary with substantial earnings and profits, and ended up owning 90% of the latter corporation. The transaction apparently was deliberately structured to be taxable to allow exchanging shareholders to recognize loss on the exchange. The inversion had the further benefit of removing from U.S. taxing jurisdiction the earnings that had been accumulated in McDermott International while it was a controlled foreign corporation (CFC). Absent the inversion, the accumulated earnings would have been taxed to McDermott as a

dividend under § 1248 upon the sale of the stock or the liquidation of McDermott International.6 Since, in form, McDermott made no disposition of stock to which § 1248 could apply, those accumulated earnings had by this transaction been effectively removed from U.S. taxing jurisdiction.8 In response to the transaction Congress adopted §1248(i) of the Code, which applies when a domestic corporation owns CFC stock and a shareholder exchanges stock of the domestic corporation for stock of the controlled foreign corporation.9 The stock received in the exchange is treated as being issued to the domestic corporation and then transferred to its shareholders in a distribution in redemption or liquidation. The domestic corporation thus recognizes gain on the constructive distribution, resulting in a tax cost that neutralizes the benefits from a McDermott type transaction.[24]

In 1994, highly publicized inversion was Helen of Troy's reincorporation to Bermuda.

The Helen of Troy transaction was described as follows:

The 1994 Helen of Troy transaction was the first of the modern wave of outbound inversions and has come to be regarded as the prototypical pure inversion transaction." The transaction involved the tax-free exchange by Helen of Troy - U.S. shareholders of their shares for the shares of a newly established Bermuda corporation, Helen of Troy – Bermuda, in accordance with Code § 368(a)(1)(B). Under the rules then in effect § 367(a) did not apply to require recognition of gain on the exchange by the shareholders. Subsequent to the inversion Helen of Troy - Bermuda contributed its stock in the U.S. corporation to a Barbados corporation to obtain the benefit of the U.S.-Barbados income tax treaty for payments of interest or dividends originating from the U.S. corporation. At this point, however, Helen of Troy - U.S. and its shareholders had not yet removed themselves from the reach of the CFC rules. Subsequently, therefore, through a number of intra-group sales, the assets (operating assets/stock) of

> *the U.S. corporation were transferred to affiliated corporations, including newly created Cayman Island and Hong Kong affiliates. The income generated by these assets and operations ceased to be subject to the current inclusion rules of Subpart F. Similarly all future acquisitions could be structured through foreign (non CFC) affiliates to avoid the application of the Subpart F rules.*[25]

As a result of the Helen of Troy transaction the IRS introduced §367(a) in 1996.[26] This provision allowed the IRS to tax gains on all transfers by U.S. persons of stock or securities of a domestic corporation to a foreign corporation".[27] §367 and regulations are considered to be the first comprehensive set of US anti-inversion rules. These rules permit the US shareholders of the US target corporation to receive up to 50% of the foreign acquiring corporation's equity (measured by voting power and value) in the exchange, provided certain other requirements are also satisfied. If this ownership limitation is satisfied, then except as provided in §367 (a)(5), the US transferors are not subject to taxation under §367(a)(1) if the domestic corporation complies with certain reporting requirements and the following additional conditions are satisfied:

> 50% or less of the total voting power and value of the stock of the foreign acquiring corporation is owned after the transfer by US persons that are either officers, directors or 5% shareholders of the US target corporation.
>
> Either,
>
> (a) the US transferor is not a 5% shareholder of the foreign corporation or
>
> (b) the US transferor enters into a five-year gain recognition agreement regarding the US target corporation stock it exchanged.[28]

Where the active trade or business test is satisfied there is no resulting tax to the U.S. shareholder.

If §367 had been in effect at the time of the Helen of Troy inversion transaction it is argued that it would likely have caused the transaction to be fully taxable to its US shareholders.[29] It was hoped that requiring the recognition of the built in gain on the stock would act as a deterrent against inversions. However, these rules proved to be ineffective at deterring inversion transactions.[30] First, it did not capture transactions where prior to the transaction the US Corporation reduced its value to less than 50% of the aggregate value.[31] Second, since taxable US persons may comprise a minority of the shareholders of a publicly traded expatriated US Co, or such shareholders may otherwise have little gain in their shares of the expatriated US Co, there were not real capital gain tax consequences in many situations. Finally, the § 367 rules did not address the movement of intangibles and foreign subsidiaries from a US parent to a foreign parent.[32]

After Helen of Troy and the despite the introduction of the §367 rules, a number other US multinational companies decided to expatriate. In 1997, Tyco International relocated to Bermuda. In 1998 Fruit of the Loom moved to the Cayman Islands, Ingersoll-Rand relocated to Bermuda in 2001 and Cooper expatriated in 2002. This string of transactions, along with a few others, lead to the introduction of §7874 in 2004.[33]

After the introduction of § 7874 it wasn't until 2008 that a new wave of expatriations started to occur. This in included transactions by Foster Wheeler, Transocean Offshore and Ensco which made the move to the United Kingdom in 2009.

A few of the more notable recent inversion transactions include the September 2013 announcement by Applied Materials agreement to purchase a smaller rival, Tokyo Electron, in an all-stock deal that is expected to create a new entity responsible for operating the new semiconductor and display manufacturing equipment business. [34] The new company will be incorporated in the Netherlands, and "will save millions of dollars a year" as a result of this decision.[35] The company announced that its effective tax rate would be reduced by 5% because of the move, equivalent to about 100 million dollars per year. [36]

In November 2012, Eaton Corporation acquired Cooper Industries for $13 billion. Cooper, a global electrical equipment company was incorporated in Ireland. According to an article written in the local newspaper, as a requirement of the purchase, Eaton had to incorporate a new company in Ireland which would be the parent company of the U.S. Eaton Corporation. Cooper Industries also became a subsidiary of the newly incorporated entity. The article also states that Eaton's headquarters will remain in Cleveland.[37] Ireland has a 12.5% corporate tax rate. The newly merged company anticipates that this move will reduce its tax bill by at least $160 million per year.[38]

In July 2013, Publicis Groupe SA and Omnicom Group Inc. announced an all stock merger with the new holding company based in the Netherlands. The new company's operations will remain in NY and Paris. The article reports that Publicis shareholders will receive one share in the new merged company for each stock they currently hold, as well as a one-time dividend of one euro per share. Omnicom investors will get 0.813 for each share they currently hold.[39] The potential reduction in tax expense of the combined unit will be somewhere in the $80 million range.[40]

Perrigo, a Michigan incorporated pharmaceutical company, announced its merger with and Elan, an Irish drug company, in July 2013. The new company is expected to incorporate in Ireland "bringing its effective tax rate to seventeen percent from thirty percent.[41] That amounts to almost fifty-percent in savings. In addition, also in 2013, Actavis, based in New Jersey, purchased and merged with Irish based drug maker Warner Chilcott. The new company plans to reincorporate in Ireland and saving an average of approximately $75 million in taxes each year for the next two years.[42]

It can be argued that the common theme in each one of these transactions is the large tax savings that results. While that may be the case, an environment that doesn't facilitate the development of business by eliminating the opportunity to be strategic in structuring one's affairs may actually be stifling competition.

ANALYSIS: WHAT'S THE REAL IMPACT?

US domestic corporations are taxed on their worldwide income which includes both domestic and foreign income. However, foreign corporations are taxed only on their foreign source income. There are various deferral mechanisms in place to allow US corporations to delay payment of tax on certain income items earned by a foreign subsidiary until it is repatriated to the US. The U.S. also has one of the highest corporate tax rates.[43] Under a worldwide income taxing regime, this, it is argued, is a major disincentive for U.S. multi-national corporations operating in a larger global environment. Stuart Webber, in his article entitled, "*Escaping the U.S. Tax System: From Corporate Inversions to Re-Domiciling*" states:

> *… the U.S. corporate income tax rates are the highest in the world. While many countries have lowered their income tax rates recently, the United States has maintained relatively high income taxes. Also, U.S. headquartered businesses are penalized by complex international rules that tax the firm's worldwide income and substantially complicate the process for determining tax obligations. These tax policies increase a U.S.-Based MNE's cost of doing business. In contrast, most other countries impose lower income tax rates and do not tax overseas profits. U.S.-headquartered firms bear substantial tax costs and must wonder whether there are significant offsetting benefits. So companies might ask: Is there a ways to escape the burden of high U.S. income tax rates and complex tax rules?*[44]

In the past few years the US government has made a valiant effort to curb expatriations of US companies as one form of eliminating payment of tax on foreign source income. Clearly there are many tax advantages associated with these types of transactions. However, these rules appear to give insufficient value to how much the lack of a competitive taxation system relative to other nations impacts a U.S. multinational corporation's decision to expatriate.[45]

In the Department of the Treasury's May 2002 report entitled, "Corporate Inversion Transactions: Tax Policy Implications", the Treasury Department makes clearly acknowledges that the §7874 rules my achieve results that would make the U.S. un-competitive in a global marketplace. The Treasury Department reports:

> *Both the recent inversion activity and the increase in foreign acquisitions of U.S. multinationals are evidence that the competitive disadvantage caused by our international tax rules is a serious issue with significant consequences for U.S. businesses*

> *and the U.S. economy. A comprehensive re-examination of the U.S. international tax rules is needed…. Consideration …should be given to significant reforms within the context of our current system*[46]

As a solution to this issue, The Treasury Department recommended a more comprehensive review of the U.S. worldwide tax system. This, according to the Treasury's report was a better alternative to fostering a competitive environment for U.S. multinational corporations rather than simply focusing legislative developments on the prevention of expatriations and inversions. The report concluded that U.S. tax system for taxing foreign source income should be reformed to be more competitive:

> *We must work to ensure that our tax system does not operate to place U.S.-based companies at a competitive disadvantage in the global marketplace. The tax policy issues raised by the recent inversion activity are serious issues. Further work is needed to develop and implement an appropriate and effective long-term response. As an immediate matter, careful attention should be focused on ensuring that an inversion transaction, or any other transaction resulting in a new foreign parent, cannot be used to reduce inappropriately the U.S. tax on income from U.S. operations. A comprehensive review of the U.S. tax system… is both appropriate and timely. Our overarching goal must be to maintain the position of the United States as the most desirable location in the world for place of incorporation, location of headquarters, and transaction of business.*[47]

According to another commentator, the 2012 amendments have a particularly disabling effect on U.S. enterprises in cases where the §7874 regulations prevent "genuine and legitimate business transactions". This, according to the authors, is one of the main reasons why they argue that "this was not the intent of §7874 when enacted by

Congress in 2004."[48] The authors argue that Congress wanted to prevent only abusive transactions, which is why a safe harbor was initially included in the original 2006 regulations.

Another commentator states that, "the 2012 Regulations will make it very difficult, if not impossible, for many companies, and in some cases large portions of entire industries, to satisfy the substantial business activities test". The commentator further states that the new regulations will "penalize successful companies with a broad, worldwide customer base".[49]

In another article written by Michael DiFronzo et al., entitled "*We Ordered Pancakes, No Waffles – How §7874 Guidance Has Delivered Something Other Than What Congress Ordered*", the author's critique of the 2012 amendments to §7874 similarly stems from the fact few, if any, US multinational corporations will be in a position to satisfy the onerous bright line test . The author states:

> *While a bright-line rule provides more certainty than a facts-and-circumstances test, the real reason that the IRS and Treasury believe that the new bright-line test may improve the administrability of §7874 may be because it will be nearly impossible for any multinational group to have sufficient business activities in the relevant country to avoid being considered to expatriate under §7874. It is extremely unlikely that any multinational group of companies will have 25% of its business activities in any one country, including the United States. In other words, the 25% bright-line test may effectively read the Substantial Business Activities Test out of §7874.*[50]

The author provides further analysis on the various requirements needed to satisfy the §7874 test and why the thresholds are too onerous for most multi-national corporations. He argues:

> *To satisfy the portion of the bright-line test related to employees, the [expatriated entity] must take into account both the number of employees ("Headcount Test") and the total compensation paid to its employees ("Compensation Test"). Under the Headcount Test, the number of group employees based in the foreign jurisdiction must be at least 25% of the total number of group employees as of the "applicable date," which is generally the acquisition's completion date or the last day of the month preceding the acquisition's completion date. Under the Compensation Test, employee compensation incurred with regard to group employees based in the foreign jurisdiction must be at least 25% of total compensation paid to all group employees during the "testing period." The testing period corresponds with the one-year period ending on the applicable date. For purposes of the Headcount Test and the Compensation Test, a group employee is considered to be based in the foreign jurisdiction only if s/he spends more time providing services in the relevant foreign country than in any other single country during the testing period.*[51]

The author argues that in the current global environment, which often requires employees work in multiple jurisdictions in order to engage, meet and manage client relationships, and distribute their product to a wider global market, would make it particularly difficult to satisfy the requirements of this test. With respect to the income test portion of §7874 the author also notes a similar struggle by most multinational corporations to satisfy this test. He states:

> *Finally, to meet the income portion of the test, at least 25% of the group's income for the testing period must be derived from transactions occurring in the ordinary course of business with unrelated customers located in the foreign jurisdiction (the "Group Income Test"). Intercompany transactions are not taken into account. Perhaps more startling, however, is that export sales are not taken into account either. Therefore, a foreign corporation (with a nominal U.S. parent) that has all of its assets and employees located in one country may not be treated as having substantial business activities in such foreign jurisdiction simply because more than 75% of its income is generated from export sales. Despite the corporation's valid business presence in the foreign jurisdiction, it may still be considered an expatriated corporation under §7874.*[52]

The author concludes that the current regulations as amended in 2012, essentially eliminates the Substantial Business Activities test. He suggests that:

> *[c]onsidering that most multinational companies, if truly operating on a global scale, will rarely have 25% of sales generated in one jurisdiction, the Substantial Business Activities Test is generally a moot point and provides no meaningful relief from the application of §7874.*[53]

In David Gelles' article, entitled "*New Corporate Tax Shelter: A Merger Abroad*", the author provides a lengthy description of recent inversion activity and the resulting tax savings that each transaction saved the company and its shareholders. After discussing the short term and long term advantages and disadvantages associated with expatriations he noted that the House Ways and Means Committee and the Senate Finance Committee were in the process of drafting tighter rules to govern expatriations while still "trying to make the United States a more competitive place for multinationals

to call home".[54] However, one commenter in the article points out that the impetus to engage in these types of activities is unlikely to change until the U.S. foreign source income laws changes.[55] Nonetheless, despite the critical feedback the IRS received, the government has no immediate plans to revise the regulations. According to John Merrick, special counsel to the IRS associate chief counsel (International) the government position is that the:

> *… substantial business activity should really apply based on where the economic heart and soul of the company is located, where its footprint is … If you are in the U.S., if you are a U.S. company then you must show that it makes sense that you have a greater center of gravity, for example in another country.*[56]

And although Merrick acknowledged that the "bright line tests are less flexible than the facts-and circumstances test"[57], he emphasized that the government believes that "the new approach provides taxpayers with a strong degree of clarity … and provides the government with a consistent tool for identifying truly abusive transactions".[58]

The more questionable part of Merrick's statement is his assertion that Congress did not intend that "every U.S. – based company should be able to go to another jurisdiction under this rule".[59] Given the difficulty of any U.S. multinational corporation meeting the requirements under the §7874 rules, as outlined above, it is likely that Congress did not want to stop legitimated transactions from moving forward. Merrick's comments do not seem to account for situations where a U.S. corporation truly operates as a global corporation and does not have any of its assets or employees concentrated in any

particular jurisdiction. This example taken from Stewart Lipeles' article entitled "*Code Sec. 7874 Regulations: Third Time's the Charm?"*, outlines such a scenario:

S is a Swiss corporation that provides certain services to customers exclusively in Europe. All of S's management personnel and direct employees are located in Switzerland, though S's affiliates have some sales personnel in other European jurisdictions. S's customers are located throughout Europe, with less than five percent of the customers in Switzerland itself. Switzerland was selected as the headquarters because of its infrastructure and geographical proximity to customers, both of which it views as essential to its business. D3 a domestic holding company, holds all the stock of S and its affiliates. The original owners of S formed D3 to make the company more attractive to potential U.S. investors and to facilitate possible expansion to other markets in the future. However, the company has decided to remain focused on the European market and would like to eliminate the U.S. holding company structure by inverting. D3 has no tangible assets, employees or sales in the Unites States.

In this case, D3 is caught in the U.S. tax net even though it has no business activity in the United States at all. From a business perspective, it makes no sense for D3 to be a U.S. company. The group's activities are solely focused on overseas markets, and one of the primary reasons for locating the group's headquarters in Switzerland is that country's geographical proximity to customers. The most natural corporate structure for the group would be a Swiss corporate parent. D3 cannot invert to Switzerland, however, because D3 cannot satisfy the sales test under the 2012 Regulations.[60]

This is only one example, but one that is indicative of how restrictive the §7874 rules can be when implemented without any discretion to consider unique facts and circumstances of each U.S. multinational's business.

Ultimately, the real impact will be in the development of more sophisticated tax planning strategies, or the loss of entire U.S. business who succumb to competition or are subject of foreign takeovers.

CONSEQUENCES OF LEAVING THE RULES UNCHANGED

The Office of Tax Policy, Department of Treasury Report of May 2002 reports that, "in the last few years, foreign acquisitions of U.S. companies have grown substantially. Foreign acquisitions of U.S. businesses were $90.9 billion in 1997, $234 billion in 1998, $266.5 billion in 1999, and $340 billion in 2000".[61] After the introduction of §7874, there was an immediate decrease in cross-border merger activities before an upswing in more recent years.[62] One of the main reasons stated for these foreign acquisitions of U.S. companies is the "disparity in tax treatment between multinational companies based in the United States and those based in major [foreign] trading" centers.[63]

Steven Surdell, a principal at EY LLP and chief of the firm's international mergers and acquisitions practices notes in a recent article that:

> *… large U.S. multinational companies are competing with foreign multinationals for productive business assets around the globe. Due to the substantial differences in tax codes in different jurisdictions … the value of those assets could be substantially different in the hands of different bidders. In this climate … bidders are being forced to consider reincorporating in jurisdictions hosting tax rules that allow them to efficiently hold the productive assets. U.S. policymakers should consider whether the tax code is punishing U.S.-based corporations in these*

> *competitions. To the extent you have U.S. and non-U.S. multinationals bidding for assets, the same group of assets, the international tax regime that applies to these prospective bidders is going to—perhaps dramatically in some instances—affect the ability to bid on those assets because it is going to affect the after-tax cash flows … Now that may or may not be something that people like, but it happens to be true.*[64]

The question of what the real impact §7874 will have on future investments in the U.S. was addressed by David Brumbaugh, in his article entitled, "*Firms That Incorporate Abroad for Tax Purposes: Corporate 'Inversions' and 'Expatriation*'". The author asks:

> *What are the implications of this possible impact on investment flows? In assessing the impact of taxes on investment, economic analysis focuses on economic efficiency and, ultimately, on economic welfare. According to traditional economic theory, taxes best promote economic efficiency when they are least distorting of investment decisions; when taxes do not distort investment decisions, investment is generally employed in its most productive location. As a consequence, economic welfare is maximized. Economic theory also holds that taxes are least distorting of the location of investment when the tax burden on investment is the same in every location. In the international context, taxes do not distort investment location when the tax burden on foreign source income is the same as that on domestic income. (In tax parlance, a tax policy that promotes equal taxation of foreign and domestic investment is a policy of "capital export neutrality.") Since inversions reduce the tax burden on foreign income compared to domestic income, their availability likely nudges the U.S. tax system away from capital export neutrality with a corresponding loss in economic efficiency and economic welfare.*

The author goes on to discuss the capital import neutrality policy and how having this as a goal would better serve the U.S. government when making decisions about what the most effective international tax rules should be. The author states:

While capital export neutrality is thought by economists to maximize world economic welfare, business leaders and others have emphasized the importance of taxes' impact on U.S. competitiveness and the ability of U.S. firms to compete in world markets. This analysis recommends a policy sometimes called "capital import neutrality" under which the United States would not tax income from foreign business operations, and would limit its tax jurisdiction to U.S.-source income. For example, several European countries operate "territorial" tax systems that do not apply home-country taxes to foreign income; it is argued that the United States should likewise adopt a territorial system to place its firms on the same tax footing as firms from territorial countries.

The availability of corporate inversions introduces an element of capital import neutrality into the U.S. system. Supporters of capital import neutrality are likely to view inversions in a more positive light than supporters of capital export neutrality; capital import neutrality recommends an exemption for foreign income and inversions accomplish that for inverted firms. And as noted above, some policymakers have suggested that inversions may signal a need for tax changes that would make the U.S. tax system more "competitive."[65]

The author's argument in favor of adopting the capital neutrality tax policy approach has garnered a lot of support from the tax professional community and many large multinational corporations. However, where this policy would have the most impact would be in the legislative offices of the U.S. government. This would probably prove to be a better long-term competitive strategy for the nation rather than a policy that

promotes imposing stringent and restriction tax rules aimed at preventing multinational corporations from engaging in transactions in order to remain competitive in a global market.

IMPACT OF INTERNATIONAL TAX REFORM PROPOSALS

On October 26, 2011, Senator Dave Camp, Chairman of the Committee on Ways and Means, released an international tax reform discussion draft. The proposal, ultimately, is intended to lower to tax rates for both individuals and employers to 25%. In addition, according the Ways and Means Committee's press release, Camp's proposal will "transition the United States from a worldwide system of taxation to a territorial system.[66] Camp's plan would:

Exempt 95% of overseas earnings from U.S. taxation when profits are brought back to the United States from a foreign subsidiary

Include anti-abuse rules to ensure companies do not avoid paying their fair share of U.S. taxes

Free up existing overseas earnings to be reinvested in America after they are taxed at a lower rate in line with current repatriation proposals

Make American companies more competitive on the global stage with little or no impact on the federal deficit[67]

In November 2013, U.S. Senator Baucus, the Finance Committee Chairman, released a proposal intended to reform the U.S. rules governing U.S. multinational corporations and the taxation of their foreign source income. Under Senator Baucus' International

Business Tax Reform Discussion Draft, there are a number of significant changes. It will:

- Establish a minimum tax on worldwide income
- Change the definition of controlled foreign corporation ("CFC") to exclude foreign branches, or 10/50 companies
- Disallow a portion of US shareholder interest expense
- Exempt a portion of gains and losses on the stock of a CFC
- Provide partial exemption from tax for "active foreign market income" defined as amounts that are attributable to economically significant activities of a qualified trade or business.[68]

There are a few common themes to note in the discussion of international tax reform that are addressed both directly (Baucus proposal) and indirectly (Camp proposal). The proposals generally address the use of Foreign Tax Credits, in particular carryforward allowances, taxation of branch income and the use §960 Credits from Subpart F. They also address the appropriate scope of Subpart F rules, or eliminate the need for these rules. On the agenda is also a proposal to govern and restrict the use of intellectual property rights between entities within a corporate group. Another important issue that is on the table is the treatment of repatriated earnings. These topics, along with the government's focus on limiting base erosion and reducing or eliminating interest deductions in certain circumstances, are among the hot button issues that garner a lot of media attention. In addition, a focus on achieving revenue neutrality by reducing the U.S. corporate income tax rates is a primary tax policy concern that grabs the attention of many tax professionals and C-Suite executives.[69]

Clearly, Washington is listening and understands the need for tax reform. Should any one of these two proposals become law, it will dramatically impact the way U.S. multinationals do business. If the Camp proposal is successfully adopted, it is arguable that impetus to expatriating will be gone. A 25 percent tax rate, considered an average rate by the Organisation for Economic Co-operation and Development (OECD)[70], would make it more attractive to remain in the U.S. Further, a territorial system of taxation, which only taxes domestic source income, would eliminate taxation of income earned by foreign subsidiaries or foreign branches. This would be the case regardless if the income is repatriated.

On the other hand, if the Baucus proposal, which establishes a minimum tax on worldwide income, were to become law then the incentives to expatriate might also be eliminated, although there would likely be less of a benefit to U.S. multinationals remaining in the U.S since there is no corresponding reduction in the corporate tax rate.

SUMMARY AND CONCLUSION

§7874 was introduced to govern U.S. multinational firms and their expatriation and inversion activities. There is no debate about whether corporate inversions and expatriations save can reduce a company's total tax liability. It is also not difficult to see how these transactions could impact U.S. tax revenues in the long term. This is a huge problem for the U.S. government. However, the question that immediately needs to be addressed is whether the current rules under §7874 are the solution to the problem.

The Committee on Ways and Means Press Release about Senator Dave Camp's international tax reform proposal notes as a compelling reason for overhauling the entire corporate income tax regime that "America is losing ground. In 1960, U.S.-headquartered companies comprised 17 of the world's largest 20 companies – that's 85 percent. By 2010, just six – or a mere 30 percent …". If drastic changes are not made the percentage of U.S.-headquartered companies ranked in the top 20 worldwide may decrease even further.

Given the climate of the global economy which U.S. multinational corporations must compete in, it seems particular short sighted to prevent these companies from freely competing with their peer groups in lower tax jurisdictions. The past few years have seen a drastic decline in corporate revenues and the demise of many U.S. corporations that were household names. In the effort to rebuild and regain market share after the recent market downturn a few years ago, many U.S. multinationals are starting off at a major disadvantage relative to their foreign counterparts: a higher tax burden.

Although, certain legislative safe-guards must be put in place to prevent abusive transactions, the idea that restricting the free flow of commerce and stifling legitimate business activities is the best way to prevent the erosion of the U.S. tax base, as IRS chief counsel Merrick seems to suggest, is misguided and short-sighted. The reality is that until there is a major overhaul of the U.S. foreign source income tax regime, as well as a decrease in the domestic tax rates to make the U.S. more competitive, U.S. multinational corporations will continue to find opportunities to reduce their tax expenses as a way of reducing their cost of doing business. Unfortunately, this may not spell

good news for the U.S. tax coffers over the long-term. However, these strategies may mean survival for many U.S. companies.

It has been an accepted belief that ordering one's affairs in the most efficient manner to reduce tax exposure in-and-of-itself is not a violation of U.S. tax laws[71] – that was until §7874 was introduced. If this value still remains, then the U.S. would be better positioned for the future if it developed policies to facilitate growth and competition between global multinational enterprises within its own borders instead of policing where these businesses decide to call home. Who knows, they may just decide that there's no place like the home they already know. Or maybe one of either Senator Camp or Baucus' international tax proposals will end up changing the game entirely.

APPENDIX A – LIST OF EXPATRIATED COMPANIES

1982	1	McDermott
1994	1	Helen of Troy
1996	2	Triton Energy
		Chicago Bridge & Iron (CBI)
1997	2	Tyco International
		Santa Fe International
1998	3	Fruit of the Loom
		Gold Reserve
		Playstar
1999	5	White Mountain Ins.
		Transocean Offshore
		Xoma
		PXRE Group
		Trenwick
2000	3	Applied Power
		Everest Reinsurance
		R&B Falcon
2001	4	Foster Wheeler
		GlobalSantaFe
		Accenture
		Global Marine
2002	7	Cooper Industries
		Ingersoll-Rand
		Nabors
		Noble Corporation
		Weatherford Int'l
		Seagate Technology
		Stanley Works (aborted)
2008	12	Tyco International
		Tyco Electric, a Tyco spin-off
		Foster Wheeler
		Transocean Offshore
		Weatherford Int'l
		ACE Limited
		Noble Corporation
		Covidien, a Tyco spin-off

		Ingersoll-Rand
		Cooper Industries
		Accenture
		Seagate Technology
2009-2013	13	Ensco
		Eaton/Cooper
		Aon Corporation
		Jazz Pharmaceuticals/Azur Pharma
		Alkermes/Elan Corp
		Rowan Companies
		DutchCo, a Sara Lee spin off
		Global Indemnity
		Valient/Biovail
		Activis/Warner Chilcott
		Perrigo/Elan
		Publicis Groupe SA/Omnicom Group
		Applied Materials/Tokyo Electron
	53	

Source: Various

This list was compiled by Marsha Henry after reviewing numerous articles on Corporate inversions and expatriations.

APPENDIX B – CHART OF U.S. TAX RATES

Making the United States Less Competitive

To attract business and investment in a fiercely competitive global marketplace, every industrialized country except the United States has lowered its corporate income tax over the past 20 years. The United States has bucked that trend and *increased* its rate, creating a less-hospitable environment for corporations.

Nation	1990	2010	Change
Japan	50.0%	39.5%	–10.4
U.S.	38.7%	39.2%	+0.6
France	42.0%	34.4%	–7.6
Belgium	41.0%	34.0%	–7.0
Germany	54.5%	30.2%	–24.4
Australia	39.0%	30.0%	–9.0
Mexico	36.0%	30.0%	–6.0
Spain	35.0%	30.0%	–5.0
New Zealand	33.0%	30.0%	–3.0
Canada	41.5%	29.5%	–11.9
Luxembourg	n/a	28.6%	–
Norway	50.8%	28.0%	–22.8
United Kingdom	34.0%	28.0%	–6.0
Italy	46.4%	27.5%	–18.9
Portugal	40.2%	26.5%	–13.7
Sweden	53.0%	26.3%	–26.7
Finland	44.5%	26.0%	–18.5
Netherlands	35.0%	25.5%	–9.5
OECD average	**41.2%**	**25.5%**	**–15.7**
Denmark	40.0%	25.0%	–15.0
Austria	30.0%	25.0%	–5.0
Korea	n/a	24.2%	–
Greece	46.0%	24.0%	–22.0
Switzerland	30.6%	21.2%	–9.4
Turkey	n/a	20.0%	–
Hungary	40.0%	19.0%	–21.0
Czech Republic	n/a	19.0%	–
Poland	n/a	19.0%	–
Slovak Republic	n/a	19.0%	–
Chile	n/a	17.0%	–
Iceland	n/a	15.0%	–
Ireland	43.0%	12.5%	–30.5

Source: OECD, "Taxation of Corporate and Capital Income (2010)," Table II.1, "Corporate Income Tax Rate," at *http://www.oecd.org/dataoecd/26/56/33717459.xls* (December 9, 2010).

Chart 1 • B 2502 heritage.org

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