Corporate Inversions and Whack-a-Mole Tax Policy

By Bret Wells

Corporate inversions provide an insight that we prefer to not face. We see corporate inversions, we hate them, and we want them to go away. We enact laws and change regulations to whack the inversion mole in the middle of its head. But soon after, another inversion mole pops up in a slightly different place. We then whack that mole, too. And the game continues — again and again, without resolution. We do not see the futility in this game because we cannot accept that our responses to the corporate inversion phenomenon are wrong.1 Although targeted legislation and regulations are well meaning and an attempt to accurately capture the observed characteristics of corporate inversions, reactive tax planning soon creates a new inversion mole, which pops up in an unreached place, thus challenging policymakers to develop another whack. We have been playing this whack-a-mole game for 30 years, and by now its contours are undeniable to all but the most willfully blind. Yet, we keep playing the same tired game instead of fixing the fundamental tax disparity that fuels its continuation.

In 1981 McDermott Inc. engaged in an inversion by having one of its subsidiaries, a controlled foreign corporation of the U.S. parent company, exchange newly issued stock for all the stock owned by the public shareholders of the historic U.S. parent, thus allowing the entities to flip positions.2 Section 1248(i) was enacted in 1984 with McDermott in mind. Its effect was to require the U.S. parent to include dividend income to the extent of its CFC’s earnings and profits, thus whacking that inversion mole. Treasury later followed up with Notice 94-93, 1994-2 C.B. 563, which required the U.S. parent to recognize gain on its foreign subsidiary stock as if it had distributed that stock to its public shareholders in exchange for its own stock. Inversion mole whacked.

In 1994 public shareholders of Helen of Troy Ltd. exchanged their stock for stock of a new foreign parent company, thus creating a corporate inversion that sidestepped section 1248(i).3 In response, Treasury issued Notice 94-46, 1994-1 C.B. 356, and eventually promulgated reg. section 1.367(a)-3(c), causing the U.S. shareholders to be taxable on their disadvantage U.S.-based companies competing in the global marketplace4; and id. at 30 ("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.").

3The nuances of how this form of expatriation transaction was accomplished under the old section 367 regulations have been adequately addressed by other commentators. See generally David R. Tillinghast, "Recent Developments in International Mergers, Acquisitions, and Restructurings," 72 Taxes 1061, 1063-1068 (1994); see also Benjamin G. Wells, "Section 367(a) Revisited," Tax Notes, June 10, 1996, p. 1511.
4T.D. 8702.

1Admittedly, statements in the legislative history and from the prior administration indicate some recognition that a need for fundamental international tax reform is the clear lesson from the inversion phenomenon. But those observations and statements did not lead to comprehensive reform. See, e.g., H.R. Rep. No. 108-548, at 244 (2004) (the “Committee believes that corporate inversion transactions are a symptom of larger problems with our current uncompetitive system for taxing U.S.-based global businesses and are also indicative of the unfair advantages that our tax laws convey to foreign ownership”). See also Treasury, “Corporate Inversion Transactions: Tax Policy Implications,” at 2-3 (May 2002) (“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... Our system of international tax rules should not be allowed to (Footnote continued in next column.)
built-in gain if the legacy shareholders of the U.S. parent owned more than 50 percent of the inverted foreign parent company. Inversion mole whacked again.

But two new varieties of inversion moles popped up. In 2010 Valeant Pharmaceuticals engaged in a corporate inversion in which its shareholders received a special dividend immediately before being acquired by Biovail, a Canadian corporation. The pre-merger special dividend decreased the value of Valeant, thus allowing the Valeant shareholders to own slightly less than 50 percent of the post-acquisition combined company.

In response, Congress enacted section 7874, which would treat the new foreign parent as a U.S. corporation for U.S. tax purposes unless either the legacy shareholders of the U.S. corporation owned less than 80 percent of the combined entity, or the new foreign parent had a substantial business presence in the new foreign parent’s jurisdiction of incorporation. Treasury issued regulations in June 2006 that defined the substantial business activities standard, providing a facts-and-circumstances test and a 10 percent safe harbor. And Treasury negotiated a protocol to the Barbados treaty to attack a common inbound treaty structure used by recently inverted companies. That protocol was ratified by the Senate and eventually signed.

In combination, the proscriptions in new legislation, the tightening (and the threat of further tightening) of the limitation on treaty benefits, and the promulgation of new regulations to implement section 7874 failed to stop corporate inversions despite the multifaceted nature of this whack. As

Footnote continued in next column.

See Valeant and Biovail, DEF-14A, “Joint Proxy Statement,” at 2, 102-104 (Aug. 20, 2010) (stating that historic Biovail shareholders are expected to own 50.5 percent post-merger and describing how the reorganization is expected to be tax free under section 367(a); Biovail, Form 8-K, “Current Report” (Sept. 28, 2010) (stating that shareholders approved the merger of Valeant on Sept. 27, 2010, and describing the completion of the merger and special dividend).

See Biovail, DEF-14A, “Proxy Statement,” at 2 (Aug. 23, 2010) (stating that historic Biovail shareholders are expected to own 50.5 percent post-merger).

See reg. section 1.367(a)-3(c)(3)(iii)(B)(1).

Use the then-existing provisions of the Barbados-U.S. treaty.

for the efforts to tighten U.S. tax treaties, potentially affected companies migrated out of the Cayman Islands and Bermuda in 2008 and 2009 to re-domicile in Switzerland (Covidien Ltd., Tyco International Ltd., Foster Wheeler AG, Transocean Ltd., Weatherford International, ACE Ltd., and Noble Corp.) or to Ireland (Accenture PLC, Seagate, Cooper Industries, and Ingersoll Rand). Thus, significant treaty benefits for those inverted companies remain despite Treasury’s efforts to incorporate stricter limitations on treaty benefits. As for section 7874’s effect, several companies proposed to engage in naked inversions, claiming that they met the 10 percent safe harbor provided in the existing regulations. Angered by proposed inversions that would safely navigate the 10 percent safe harbor, Treasury removed it from the regulations, thus taking another whack at inversions.

But the capital markets understand financial incentives, and there are significant financial incentives to be a foreign-owned multinational enterprise. Tim Horton’s Inc., Ensco Inc., Aon PLC, and Rowan Cos. Inc. all engaged in naked inversion transactions based on the advice of tax counsel, claiming that they had a substantial business presence in the country of incorporation of the inverted parent company based on all the facts and circumstances. In response, Treasury amended the definition of substantial business presence in the regulations to prospectively require that 25 percent of the employees, sales, and assets of the combined company be located in the jurisdiction of incorporation of the ultimate parent entity. But as the recently announced inversion of Liberty Global Inc. demonstrates, even this elevated standard can be met in appropriate business combinations.

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18Covidien, Form 8-K, “Current Report” (May 28, 2009) (announcing the migration of its parent company from Bermuda to Switzerland).
20Tyco Electronics, Form 8-K, “Current Report” (June 23, 2009) (announcing the re-domestication of its parent company from Bermuda to Switzerland).
21Foster Wheeler, Form 8-K, “Current Report” (Sept. 1, 2009) (announcing shareholder approval to re-domesticate the corporate parent from Bermuda to Switzerland).
22Transocean Inc., Form 8-K, “Current Report” (Oct. 31, 2009) (announcing the re-domestication of its parent company from the Cayman Islands to Switzerland).
23Weatherford International, Form 8-K, “Current Report” (Feb. 28, 2009) (announcing the re-domestication of its parent corporation from Bermuda to Switzerland).
24ACE Ltd., Form 8-K, “Current Report” (July 10, 2008) (announcing shareholder approval to re-domesticate the parent company from the Cayman Islands to Switzerland).
26Accenture, Form 8-K, “Current Report” (Sept. 1, 2009) (announcing the completion of the re-domestication of the parent company from Bermuda to Ireland).
27Seagate, Form 8-K, “Current Report” (Apr. 14, 2009) (announcing the re-domestication of the parent company from the Cayman Islands to Ireland).
28Cooper Industries, Form 8-K, “Current Report” (June 18, 2009) (announcing the re-domestication of the parent company from Bermuda to Ireland).
29Ingersoll Rand, Form 8-K, “Current Report” (June 12, 2009) (announcing that final approvals were received to effectuate the migration of the corporate parent from Bermuda to Ireland).

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30See T.D. 9453. In the preamble to T.D. 9453, the IRS and Treasury said they had concluded that the safe harbor provided by the 2006 temporary regulations may apply to some transactions that are inconsistent with the purposes of section 7874 and that the 2009 temporary regulations therefore did not retain the safe harbor provided by the 2006 temporary regulations. The 2009 temporary regulations also do not retain the examples illustrating the general rule in the 2006 temporary regulations. Thus, after the issuance of the 2009 temporary regulations, taxpayers could no longer rely on the safe harbor or on the examples illustrating the general rule provided by the 2006 temporary regulations.
31See Philip Tretiak and Patrick Jackman, “Code Section 7874: Hotel California for U.S. Companies,” 15 Int’l Tax J. 5, 9 (2009) (hypothesizing that the removal of the safe harbor coupled with the statement in the preamble to T.D. 9453 that the substantial business presence test was a no-rule area represents an effort by the IRS to up the ante for outside counsel to opine on this area of law).
36See proxy statement of Liberty Global Inc., filed on Schedule 14A, at 168 (May 1, 2013).
COMMENTARY / VIEWPOINTS

Another common way to achieve corporate inversions is through foreign mergers and acquisitions in which the legacy shareholders of the U.S. MNE own less than 80 percent of the combined company. A wave of recent business combinations, including Eaton/Cooper, Chiquita/Fyffes, and Argonaut/PXRE used this technique. For tax purposes, the smaller foreign company is the tax acquirer of the larger U.S. company, and the management team that survives the business combination (or at least the location of the key corporate officers) often remains in the United States. Congress recently reawakened to this type of corporate inversion when Pfizer Inc., a behemoth company, made a failed attempt to acquire a smaller competitor, AstraZeneca PLC. In response to this corporate inversion technique, a bill has been introduced that would treat a foreign parent entity as a U.S. corporation (thus denying inversion benefits) for a new parent entity if more than 50 percent of its shareholders are legacy shareholders of the U.S. target company or if management and control of the inverted parent company is located in the United States. But because the AstraZeneca shareholders rejected Pfizer’s takeover attempt, momentum for this legislation may have been lost, at least for now.

History should be our guide. It is undeniable that substantial tax benefits (often more than $150 million annually for the inverted companies) are available for a foreign-owned MNE. A recent report indicates that an inversion of Walgreens could reduce its U.S. taxes by $4 billion over a five-year period. Potential tax savings of these magnitudes make reactive tax planning inevitable. Whacking the current form of the corporate inversion mole is not an effective response to the inversion phenomenon (as good as it may feel to whack that mole really hard) because it fails to address the enormous tax disparity between U.S.-owned MNEs and foreign-owned MNEs, which is what compels companies to search for the next generation of inversion structures. Corporate inversions represent “voting with one’s feet.” The United States cannot have a tax system that treats similarly situated competitors in the U.S. marketplace differently and not expect the disfavored competitor, the U.S.-owned MNE, to try to transform itself into the more favorable foreign-owned MNE.

Wall Street is very good at reinventing companies, and it is telling Congress a simple truth: current U.S. tax law provides a broader array of opportunities to strip U.S. territorial profits out of the U.S. tax base if the global business is structured as a foreign-owned MNE. Corporate inversions are the way for historically U.S.-owned MNEs to gain access to the profit-shifting and earning-stripping techniques available to inbound foreign-owned MNE competitors. The U.S. tax treaty policy and transfer pricing rules have been designed to minimize source country taxation and to maximize the potential for eventual residency-based taxation.

45See Stuart Webber, “Merging U.S. Firms Select European Headquarters to Reduce Taxes,” Tax Notes Int’l, Mar. 31, 2014, p. 1223 (detailing the significant tax savings garnered by companies that have inverted in the past).
46See Americans for Tax Fairness, Reporting on Offshoring America’s Drugstore (June 11, 2014).
48In the formative League of Nations debates over the model treaty that would become the basis for the modern OECD and UN model treaties, tax scholars predicted that all nations would adopt worldwide tax regimes as they moved from semi-developed status to developed nation status. League of Nations, “Report on Double Taxation to the Financial Committee of the
The U.S. subpart F regime has served as a means to backstop the U.S. tax base when this skewed application of our transfer pricing and treaty rules creates inappropriate profit-shifting opportunities. But the subpart F rules do not apply to foreign-owned MNEs (including inverted foreign-owned MNEs), so reliance on those residency-based taxation principles is an inadequate response to the base erosion phenomenon highlighted by corporate inversions. Yet, Congress has stopped short of concluding that inverted companies are similarly positioned to all other foreign-owned MNEs even though inverted companies use the same earnings-stripping techniques available to foreign-owned MNEs. Although there are now signs that legislators on both sides of the aisle recognize the need for broader tax reform, that recognition has not led to a robust reassessment of the U.S. inbound taxation regime.

Some have claimed that broad international tax reform should include the adoption of a territorial tax regime. Foreign-based MNEs are generally taxed in the United States only on the profits attributable to their U.S. business activity (a territorial tax result). Seen in this context, corporate inversions are a self-help way for U.S.-based MNEs to create a de facto U.S. territorial tax regime for themselves. Moreover, because many major trading partners of the United States have adopted territorial tax regimes, the United States has arguably fallen out of step with those other developed nations. But countries that have adopted territorial tax regimes also typically have a robust VAT regime, and there is no momentum for the adoption of a VAT regime in the United States. So if the United States adopted a stand-alone territorial tax regime, it would represent a unique approach. Further, a territorial tax regime provides equal opportunity for all MNEs to engage in earnings stripping. Thus, even though a territorial tax regime may be competitively neutral, it does not address the tax base erosion opportunities available to inbound activities of MNEs and in fact makes those opportunities available for all MNEs. In the end, the U.S. government needs a tax system that is both competitively neutral and collects significant revenue.

Thus, whether one is motivated by a desire to stop corporate inversion transactions or by a desire to develop a territorial tax regime that collects significant revenue, the conclusion is the same: The United States must comprehensively address the base erosion advantages provided to inbound foreign-based MNEs. The United States should better protect its source country right to tax profits that originate from within its borders. In an earlier work, Cym Lowell and I argued that the United States should impose an upfront collection mechanism on all related-party deductible payments and should test all transfer pricing results for MNEs by using a profit-split method to prevent the artificial assignment of residual profits to an offshore risk-taker entrepreneurial entity. Others have proposed that...
the United States disallow deductions for related-party payments made to tax haven affiliates or impose a final withholding tax on those payments. And others have suggested that the United States adopt a formulary apportionment method for MNEs. Regardless of the specific recommendation, it is time for Congress to devote significant attention to protecting the U.S. tax base against earnings-stripping techniques that exist in the inbound related-party foreign-owned MNE context. Failing to do so creates an unacceptable disparity in how similarly situated MNEs are taxed on their U.S. origin profits under current law. Corporate inversions will not go away until the tax burden on income earned from within the United States is similar in amount whether earned by a foreign-based or U.S.-based MNE.

Instead of continuing our historic responses to corporate inversions, which are akin to the whack-a-mole game, policymakers should instead address the base erosion and profit-shifting advantages afforded to inbound foreign-owned MNEs, since that tax advantage is what fuels these transactions. Thus, policymakers need to adopt reform measures that seek to eliminate the significant tax advantages given to foreign ownership of U.S. business activities in order to equalize the playing field between U.S.-based MNEs and foreign-based MNEs. This is the fundamental lesson we are overdue to learn from the corporate inversion phenomenon.

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62 Treasury has observed that "the ability to reduce overall taxes on U.S. operations through these income shifting techniques provides an immediate and quantifiable benefit....[T]he decision to enter into the inversion may be dependent in many cases upon the immediate expected reduction in U.S. tax on income from U.S. operations." See Treasury, supra note 47, at 8.