Cant and the Inconvenient Truth About Corporate Inversions

By Bret Wells

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Wells writes that inversion transactions and inversion benefits are still available and are being pursued even with the enactment of section 7874. That section obscures the fundamental design flaws of the tax system without solving the underlying defects. The inversion transactions that have occurred since the enactment of section 7874 prove that Congress should reform the U.S. international tax regime.

Inversion problem solved — or is it?

Before the enactment of section 7874, Congress recognized that inversion transactions permit a company to capture enormous U.S. tax savings even though its business operations continue to be conducted in much the same manner as before the inversion.[1] Further, Treasury found that inverted companies had a competitive tax advantage in terms of operating within the territory of the United States.[2] In an earlier article that examined several historic transactions with uncontroverted facts, I asserted that the inversion phenomenon is useful to policymakers because it provides a clear picture of cause-effect dynamics and offers unmistakable proof that foreign-owned multinational corporations (MNCs) are able to significantly reduce their U.S. tax liability on U.S. operations compared with their U.S. MNC competitors.[3] From a foreign MNC perspective, the U.S. international tax regime is a de facto territorial tax regime. The tax benefits of an inversion transaction should have caused policymakers to ask why this de facto territorial tax regime is advantageous and what measures are needed to adequately protect the U.S. tax base from inbound multinational tax planning. Congress should have then questioned whether the existing outbound tax regime with its subpart F and foreign tax credit components in practice causes U.S. MNCs to receive discriminatory tax treatment and whether that result is defensible in the current environment.[4]

However, instead of addressing those questions, Congress treated the inversion phenomenon as an outlier that needed a stand-alone legislative fix. The adoption of section 7874 was akin to a ''kill the inversion messenger'' response. Congress wanted to stop so-called naked inversion transactions[5] in

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[1]*See* S. Rep. No. 108-192, at 142 (2003), *Doc 2003-24258*, *2003 TNT 217-31*; *see also* Joint Committee on Taxation, ''General Explanation of Tax Legislation Enacted in the 108th Congress,'' JCS-5-05, at 343 (May 31, 2005), *Doc 2005-11832*, *2005 TNT 108-16*.

[2]Treasury, ''Report to Congress on Earnings Stripping, Transfer Pricing, and U.S. Tax Treaties,'' at 8 (Nov. 2007), *Doc 2007-26269*, *2007 TNT 230-17*.

[3]Bret Wells, ''What Corporate Inversions Teach About International Tax Reform,'' *Tax Notes*, June 21, 2010, p. 1345, *Doc 2010-11447*, *2010 TNT 119-5*.

[4]Admittedly, statements in the legislative history and from the prior administration indicate some recognition that fundamental international tax reform is the clear lesson from the inversion phenomenon. But those observations and statements did not lead to comprehensive international tax reform. *See, e.g.*, H.R. Rep. No. 108-548, at 244 (2004), *Doc 2004-12632*, *2004 TNT 119-71* (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 7-8, 98-99 (May 2002), *Doc 2002-12218*, *2002 TNT 98-49* (stating that ''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 disadvantage U.S.-based companies competing in the global marketplace.''

. . .

''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'').

[5]As used in this article, the term ''naked inversion transaction'' refers to an inversion transaction in which the underlying business is not changed and the legacy shareholders retain their ownership in the new inverted parent. Except for Case 1

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which the sole reason for the stand-alone inversion transaction is to capture U.S. tax savings, but it did not try to resolve the underlying defects of current law that make inversion transactions beneficial.[6] To that extent, section 7874 largely achieves its objective: Self-help naked inversion transactions are quarantined.

So again, inversion problem solved, right? Well, maybe not.

In fact, inversion planning has remained vibrant for those in the practice and for those who care to see. With the notable exception of Case 1 inversions, which Treasury has attempted to quash recently with new temporary regulations, the current inversion planning strategies are largely event-driven exercises. However, for U.S. MNCs with a growing international business, the events that must concurrently occur with the inversion transaction are foreseeable events. Those events may not be routine, but they also are not uncommon. By clothing an inversion transaction within the context of an extraneous and concurrent event, policymakers can plausibly deny the existence of inversion transactions after the enactment of section 7874. But make no mistake: The tax benefits from inversions are there to be had under current law, and the post-section 7874 inversion planning techniques are broadly understood. In Part A, four case studies are reviewed to illustrate several important contours of inversion planning in the post-section 7874 world. Part B identifies several implications of the efficacy of those transactions.

A. Inversion Techniques Post-Section 7874

Case 1: Inversions When a 'Substantial Business Presence' Exists.

> Case 1: A U.S. MNC has most of its operations, assets, and employees in the United States but has a substantial business presence in the United Kingdom. The new foreign parent is formed in the United Kingdom and exchanges one share of its stock for each share of U.S. MNC stock.

Section 7874 allows a U.S. MNC to invert in a solely tax-motivated transaction if it has a substantial business presence in the ultimate parent company's country of incorporation.[7] In the 2006 temporary regulations, Treasury provided a safe harbor under which a substantial business presence was considered to exist in a particular foreign jurisdiction if more than 10 percent of the employees (by head count and compensation) and more than 10 percent of the total value of all group assets were located in that jurisdiction.[8] But those regulations were withdrawn in 2009,[9] and the 2009 temporary regulations provided for only a general facts and circumstance test.[10]

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inversions, section 7874 generally causes a surrogate foreign parent to be taxed as a U.S. domestic corporation, thus preventing the new foreign parent from obtaining inversion benefits in a naked inversion transaction. *See* section 7874(b). But a surrogate foreign corporation is said to exist only if three criteria are satisfied: (1) an acquisition test is met under which a foreign corporation makes a direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation (*see* section 7874(a)(2)(B)(i)); (2) a stock ownership test is met under which former shareholders of the domestic corporation own at least 80 percent of the aggregate vote or value in the transferee foreign corporation's stock and have acquired their interest "by reason of holding stock in the domestic corporation" (*see* section 7874(a)(2)(B)(ii)); and (3) a business activities test is met under which the expanded affiliated group that includes the transferee foreign corporation must not have substantial business activities in the jurisdiction where the transferee foreign corporation is created or organized as compared with the expanded affiliated group's worldwide business activities (*see* section 7874(a)(2)(B)(iii)).

[6]*See* H.R. Rep. No. 108-755, at 344-349 (2004).

[7]*See* section 7874(a)(2)(B)(iii) and (b). In applying this test, the 2009 temporary regulations provided an anti-stuffing rule to prevent manipulation of the substantial business activities test. The regulations indicated that the section 7874(c)(4) anti-stuffing rule would apply to eliminate from consideration any assets temporarily located in the foreign country as part of a plan whose principal purpose was to avoid section 7874, assets and employees located in a foreign jurisdiction with a principal purpose of avoiding section 7874's application, and assets and activities of employees who are transferred as part of a plan existing at the time of the inversion transaction. *See* reg. section 1.7874-2T(g)(5).

[8]T.D. 9265, *Doc 2006-10734*, *2006 TNT 108-10*.

[9]*See* T.D. 9453, *Doc 2009-13086*, *2009 TNT 109-10*. 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.

[10]*See* reg. section 1.7874-2T(g)(1). Reg. section 1.7874-2T(g)(3) lists the following as factors to be considered in determining whether a substantial business presence exists in a foreign jurisdiction, but it does not indicate how to weigh or assess those factors:

i. the historical conduct of continuous business activities in the foreign country by the expanded affiliated group;
ii. the conduct of continuous business activities in the foreign country by the expanded affiliated group in the ordinary course of one or more active trades or businesses, involving:
  A. property located in the foreign country that is owned by members of the expanded affiliated group,
  B. the performance of services in the foreign country by employees of the expanded affiliated group, and

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The lack of clarity on how to apply the general facts and circumstances test may have led some to believe that without further guidance, taxpayers would not risk transactions premised on such a nebulous test.[11] However, despite the lack of a regulatory safe harbor and interpretive guidance on the general facts and circumstance test, the marketplace got comfortable with how the substantial business presence inquiry should be applied under the 2009 temporary regulations.

For example, in a proxy statement issued to shareholders on August 18, 2009, Tim Horton's Inc. requested that its shareholders approve a corporate inversion transaction to change the publicly traded parent company from a U.S. company to a newly formed Canadian company. The proxy statement said the company expected that the reorganization would enable it "to continue to take advantage of lower Canadian tax rates in the years after the year of implementation to a greater extent than would likely have been available if the reorganization was not completed."[12] Tim Horton's estimated that the cost to execute this naked inversion transaction would be in the range of an additional $6 million to $7 million.[13] The proxy statement also said that the company believed the resulting post-inversion corporate structure would not change its future operational plans to grow its business, including its focus on its U.S. business. Even so, the company asserted: "A Canadian parent is expected to permit us to expand in Canada and internationally with greater efficiency than we could achieve under our existing corporate structure."[14] The company also said that a substantial amount of its business activities occurred in Canada.[15] After noting that section 7874 may cause the new foreign parent in an inversion transaction to be considered a surrogate foreign parent, tax counsel concluded that the naked inversion transaction would qualify under the substantial business activities exception because "a very substantial majority" of Tim Horton's business operations are in Canada, where the new foreign parent would be incorporated.[16] On September 22, 2009, Tim Horton's announced that its shareholders had overwhelmingly approved the naked inversion transaction and that the company would engage in the merger on September 28, 2009.[17]

On November 23, 2009, the board of directors of Ensco International recommended that the company engage in a corporate inversion transaction to change the publicly traded parent company from a U.S. company to a newly formed parent company incorporated in the United Kingdom. Ensco said that it was no longer advisable for it to remain a U.S. MNC and that the execution of a naked inversion transaction would allow the company to achieve a global effective tax rate comparable to that of its global competitors because the United Kingdom had a favorable tax regime.[18] Because Ensco's executives would be required to move to the United Kingdom, the company announced in a later filing on December 1, 2009, that it was increasing the compensation of its senior executives by 15 percent and providing them a significant relocation package (for example, schooling for dependents, a family travel allowance, and individual tax protection for the extra U.K. taxes that those executives would bear).[19] Thus Ensco would be incurring additional executive compensation costs to effectuate the naked inversion transaction. Despite those extra costs, the Ensco board of directors believed the relocation of those high-paying jobs to overseas locations was in the company's best interest. On December 22, 2009, Ensco announced that its shareholders overwhelmingly approved the proposed inversion transaction.[20] The shareholders did so presumably because they agreed with the Ensco board that the inversion benefits were more than sufficient to offset the company's higher operating costs. But consummation of this naked inversion transaction was contingent on Ensco receiving an

C. sales of goods to customers;

iii. the performance in the foreign country of substantial managerial activities by officers and employees of the expanded affiliated group who are based in the foreign country;

iv. a substantial degree of ownership of the expanded affiliated group by investors resident in the foreign country; and

v. business activities in the foreign country that are material to the achievement of the overall business objectives of the expanded affiliated group.

[11]*See* Philip Tretiak and Patrick Jackman, "Code Section 7874: Hotel California for U.S. Companies," 35 *Int'l Tax J.* 5, 9 (Nov. 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).

[12]Tim Horton's Inc., Form DEFM 14A, "Proxy Statement," at 22 (Aug. 18, 2009).

[13]*Id.* at 23.

[14]*Id.* at 26.

[15]*Id.*

[16]*Id.* at 34.

[17]Tim Horton's Inc., Form 8-K, "Current Report" (Sept. 22, 2009).

[18]Ensco, Form DEFM 14A, "Proxy Statement," at 15 (Nov. 20, 2009), *available at* http://ensco.q4cdn.com/a1121bd1-dec1-496a-b414-d65e07a1798a.pdf?noexit=true.

[19]Ensco, Form 8-K, "Current Report" (Dec. 1, 2009), *available at* http://ensco.q4cdn.com/710a9502-e67e-4d8d-b697-53d68d921dbc.pdf?noexit=true.

[20]Ensco, Form 8-K12B, "Current Report" (Dec. 23, 2009), *available at* http://ensco.q4cdn.com/612162ad-d981-4774-91bb-0af330deb4b9.pdf?noexit=true.

opinion that the substantial business presence test was satisfied. It did. After noting that no safe harbor or other clear guidance existed, tax counsel concluded that the new publicly traded parent company nevertheless should be viewed as having a substantial business presence in the United Kingdom and consequently that the company should not be considered a surrogate parent.[21]

In a proxy statement dated February 10, 2012, Aon Corp. announced a special shareholders meeting to approve a naked inversion transaction that would result in its parent company being incorporated in the United Kingdom. Again, the proxy statement indicated that tax counsel recognized there is no clear safe harbor or other direct guidance on the substantial business presence test.[22] Despite that uncertainty, tax counsel was still able to conclude that Aon should satisfy the substantial business presence standard with the consequence that the anti-inversion "surrogate parent" provisions of section 7874 should not apply to the merger.[23] In a filing on April 2, 2012, Aon announced that it had completed its naked inversion transaction.[24]

In a proxy statement dated March 8, 2012, Rowan Companies Inc. announced a special shareholders meeting to approve a naked inversion transaction that would allow Rowan to re-domicile its parent company from the United States to the United Kingdom.[25] The proxy statement indicated that completion of the restructuring would result in more ongoing nontax operating expenses than if Rowan did not engage in the naked inversion transaction.[26] Despite those higher operating costs, the proxy statement said that the company believed the naked inversion transaction would be a significant benefit to Rowan because it would allow the company's effective tax rate to remain competitive with the rates of its global competitors.[27] The proxy statement also indicated that if U.S. legislative proposals to tighten the international tax provisions were enacted, they would have an adverse effect on Rowan's worldwide effective corporate tax rate and that without the naked inversion transaction, it would be difficult for the company to predict its worldwide effective corporate tax rate.[28] In considering whether the naked inversion transaction would withstand attack under section 7874, the proxy statement said that tax counsel recognized that no clear safe harbor or other direct guidance existed regarding the substantial business presence test.[29] Despite that uncertainty, tax counsel was still able to conclude that Rowan should satisfy the substantial business presence standard with the consequence that the anti-inversion surrogate parent provisions of section 7874 should not apply to the merger.[30] In a May 4, 2012, filing with the SEC, Rowan indicated that it had completed its naked inversion transaction.[31]

Given that the tax practitioner community had gotten comfortable providing "should" (or higher) level opinions on the substantial business presence inquiry under the nebulous 2009 temporary regulations,[32] the expectation was that this particular form of naked inversion transaction would gain greater prominence. As multinationals expand internationally, it is not uncommon for a few key countries of operation to become a significant part of the MNC's global business. And as more and more of the U.S. trading partners adopt territorial tax regimes, the number of favorable jurisdictions for incorporating a new parent company is expanding.[33] Moreover, section 7874(c)(3) only requires that the parent remain incorporated in that particular jurisdiction for two years. Thus, after the inversion transaction is "old and cold," the parent company can reincorporate into the optimum tax jurisdiction.

Again, naked inversion transactions present an inconvenient truth because they occur solely for tax reasons. As such, their existence is a clear indictment of the discriminatory and disparate treatment

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[21]Ensco, Form DEFM 14A, "Proxy Statement," at 44 (Nov. 20, 2009), *available at* http://ensco.q4cdn.com/a1121bd1-dec1-496a-b414-d65e07a1798a.pdf?noexit=true.

[22]Aon Prospectus for Special Shareholder Meeting of March 18, 2012, at 24 (Feb. 6, 2012).

[23]*Id.* at 61-62.

[24]Aon, Form 8-K12B, "Current Report" (filed Apr. 2, 2012).

[25]Rowan Prospectus for Special Shareholder Meeting on April 16, 2012 (Mar. 8, 2012).

[26]*Id.* at 33.

[27]*Id.* at 37.

[28]*Id.* at 37-38.

[29]*Id.* at 54-55.

[30]*Id.* at 55.

[31]Rowan, Form 8-K12B, "Current Report" (filed May 4, 2012).

[32]Even though the marketplace was willing to opine in this area, practitioners continued to call for a reinstatement of a regulatory safe harbor. For contrasting suggestions on how a revised safe harbor might be constructed, *compare* New York State Bar Association Tax Section, "Report on Certain Issues Under Section 7874" (May 3, 2010), *Doc 2010-9861*, *2010 TNT 85-17*, *with* Stewart R. Lipeles et al., "Substantial Business Activities Inverted," 88 *Taxes* 5 (Nov. 2010).

[33]*See* JCT, "Background and Selected Issues Related to the U.S. International Tax System and Systems That Exempt Foreign Business Income," JCX-33-11 (May 20, 2011), *Doc 2011-11045*, *2011 TNT 99-76* (analyzing nine major U.S. trading partners that provide for an exemption system); *see also* JCT, "Present Law and Issues in U.S. Taxation of Cross-Border Income," JCX-42-11 (Sept. 6, 2011), *Doc 2011-18856*, *2011 TNT 173-27* (reviewing policy considerations between a territorial and worldwide tax system).

that U.S. MNCs receive under the current U.S. international tax regime. But instead of facing that truth, Treasury has sought to banish the Case 1 form of naked inversion transaction using its regulatory authority. In T.D. 9592, the IRS and Treasury said they now believe that the facts and circumstances test of the 2009 temporary regulations should be replaced with a bright-line rule describing the threshold of activities required for an expanded affiliated group to have substantial business activities in the relevant foreign country because "such a rule will provide more certainty in applying section 7874 to particular transactions than the 2009 temporary regulations and will improve the administrability of this provision."[34] The 2012 temporary regulations provide that an expanded affiliated group will have substantial business activities in a particular foreign country only if at least 25 percent of the group employees, group assets, and group income are located or derived in that country.[35] Also, whereas section 7874(b)(2)(B)(iii) indicates that the substantial business activities test is to be applied after the inversion acquisition, the new 2012 temporary regulations require that the employee compensation and group income be tested a year before the inversion date, presumably to prevent a favorable benefit from the movement of personnel and business activities to the foreign jurisdiction shortly before the naked inversion transaction.[36] In public comments, Treasury officials claimed that more U.S. MNCs have completed naked inversion transactions or have announced their intentions to invert, and that as a result, Treasury had come to believe that a general facts and circumstances test was inconsistent with the congressional intent underlying section 7874.[37] Respected practitioners have pointed out that the absolute 25 percent standard in the new 2012 temporary regulations will make it extremely difficult for any diversified global company to meet this test even if substantially all of its activities occur outside the United States.[38] Thus, instead of addressing the problem that naked inversion transactions make obvious, the new 2012 temporary regulations' seek to quash naked inversion transactions without addressing the underlying design defects that make those transactions beneficial.

[34]*See* Preamble to T.D. 9592, *Doc 2012-12351*, *2012 TNT 111-13*.
[35]*See* reg. section 1.7874-3T(b)(1) through (3).
[36]Reg. section 1.7874-3T(b)(1)(ii); reg. section 1.7874-3T(b)(3); reg. section 1.7874-3T(d)(11).
[37]*See* Jeremiah Coder, "New Substantial Business Activity Test Criticized as Excessive," *Tax Notes*, June 18, 2012, p. 1439, *Doc 2012-12406*, or *2012 TNT 112-4*.
[38]*Id.*

Case 2: Acquisition of U.S. MNC by Larger Foreign-Owned MNC.

> Case 2: A U.S. MNC has a successful business but would benefit from the international platform of its larger competitor (Foreign Acquirer). Foreign Acquirer acquires all the stock of the U.S. MNC in exchange for a minority of shares in Foreign Acquirer.

An instructive example of a Case 2 inversion is seen in Ensco's acquisition of Pride International. Again, Ensco had successfully engaged in a naked inversion transaction in 2009 similar to the one posited in Case 1 based on the contention that Ensco had a substantial business presence in the United Kingdom. In 2011 Ensco acquired Pride, a U.S. MNC. In exchange for each share of Pride common stock, Ensco agreed to provide the Pride shareholder the right to receive a 0.4778 Ensco share and $15.60 in cash.[39] The Ensco-Pride joint proxy statement estimated the aggregate value of the merger consideration to be received by Pride shareholders as approximately $8 billion, consisting of approximately $2.9 billion in cash and approximately $5.1 billion in Ensco stock.[40] The joint proxy statement estimated that the legacy Ensco shareholders would hold approximately 62 percent of the stock of the combined company while the legacy Pride shareholders would own approximately 38 percent of the combined company.[41]

In evaluating the merger, the prospectus said that the Pride board of directors favorably considered "the fact that Ensco was headquartered in a jurisdiction that has a favorable tax regime and an extensive network of tax treaties, which can allow the combined company to achieve a global effective tax rate comparable to Pride's competitors,"[42] many of which had already inverted. The shareholders overwhelmingly approved the transaction, and Ensco announced its successful acquisition of Pride on May 31, 2011.[43] Thus, although it was not described explicitly as an inversion transaction, Ensco was able to parlay its inversion advantage to the Pride business by acquiring Pride outright, and the Pride board of directors documented for its shareholders

[39]Ensco-Pride International Inc. Joint Proxy Statement, at 1 (Apr. 25, 2011), *available at* http://www.enscoplc.com/Theme/Ensco/files/docs_financial/May%2031,%202011%20Special%20Meeting%20Proxy%20Statement_v001_q0696k.pdf.
[40]*Id.* at 10.
[41]*Id.*
[42]*Id.* at 68.
[43]*See* Ensco release (May 31, 2011), *available at* http://www.enscoplc.com/Newsroom/Press-Releases/Press-Release-Details/2011/Ensco-plc-Completes-Acquisition-of-Pride-International1125471/default.aspx.

that the foreign MNC tax advantage was an important consideration (albeit not the only consideration) taken into account in its decision to sell the company.

It is important to note that the Case 2 inversion provides the same opportunity for inversion tax savings as the Case 1 inversion, but the 2012 temporary regulations do not forestall the ability to access the inversion benefits in the Case 2 scenario. Again, section 7874 was not designed to prevent inversion benefits from being available. Its principal intention was to provide plausible deniability that inversion benefits are motivating market transactions and that significant inversion savings are not being achieved. Thus the Case 1 inversion is unacceptable because it is a naked inversion transaction whose only purpose is clearly to obtain substantial inversion tax savings. The Case 2 inversion is acceptable because the inversion benefit is being accessed as part of a larger transaction that obscures the substantial tax savings provided under the inversion aspect of the acquisition.

Case 3: Bootstrap of Inversion Benefits Onto Minnow Acquisitions.

> Case 3: A U.S. MNC will acquire a smaller foreign target corporation because doing so will help its growth in foreign markets. Even though this acquisition makes strategic sense in its own right, the U.S. MNC wants to use the acquisition to engage in an inversion transaction. Thus the new foreign parent is formed and issues stock to the shareholders of the U.S. MNC in exchange for all their U.S. MNC stock. It simultaneously issues the new foreign parent shares in exchange for all the shares in the foreign target corporation. After that transaction, the legacy U.S. MNC shareholders hold 75 percent of the stock of the new foreign parent while the legacy foreign target corporation shareholders receive 25 percent of the new foreign parent stock.

Synergistic acquisitions of smaller competitors are a reasonably foreseeable part of the international growth of an MNC. Although strategic acquisitions are not a routine occurrence, they are not uncommon. A U.S. MNC can use the strategic acquisition of a smaller foreign company as a mechanism for executing an inversion transaction by bootstrapping that transaction onto the acquisition.[44]

For example, on May 21, 2012, Eaton Corp. (a U.S. MNC) announced its acquisition of Cooper Industries. In the press release, Eaton said that its acquisition of Cooper would significantly increase the capabilities and geographic breadth of the combined company.[45] Eaton said that the combination of the two companies would create ''a game changer to serve the electrical industry.''[46] Under the terms of the merger agreement, Cooper shareholders will receive $39.15 in cash and a 0.77479 share of new Eaton stock for each Cooper share. Based on the closing price for Eaton common stock on May 18, 2012, the Eaton legacy shareholders are expected to own approximately 73 percent of the combined company, and legacy Cooper shareholders are expected to own approximately 27 percent. Even though Eaton is the acquiring company in the transaction and Cooper is the much smaller target, Eaton will use the acquisition of its smaller competitor to bootstrap itself into an inversion transaction. Eaton announced that it intends to form Eaton Global Corp. PLC, an Irish company, as the new parent company for the Eaton multinational group. Shares of new Eaton will be registered with the U.S. SEC and are expected to trade on the New York Stock Exchange under the ticker symbol ETN, the same ticker symbol as old Eaton. Thus the self-help inversion benefits that Cooper obtained for itself in 2002 in its own naked inversion transaction are now being used to provide those inversion benefits to its larger U.S. MNC competitor, Eaton, in a post-section 7874 context.

In the analyst presentation the day after the announcement, Eaton executives touted the synergy savings from the combination of the two companies and did not mention the benefits of having its new parent company incorporated in Ireland. Well done! Wall Street by now fully understands the inversion benefits that this transaction creates and does not need a further public explanation.[47] One would expect that the Eaton-Cooper joint proxy statement (once issued) will simply make an innocuous statement such as ''the Irish parent company better positions the combined company for global growth.'' Once the Cooper acquisition is completed, Eaton can be left alone to engage in the needful work of capturing the inversion benefits for its own historic U.S. business.

[44]Two important caveats are in order. First, the target company must be a foreign company, not a U.S. company. *See* reg. section 1.7874-2T(e). Second, the legacy foreign target company shareholders must own at least 20 percent of the combined company after the transaction. *See* section 7874(b).

[45]*See* Eaton release (May 21, 2012).

[46]*Id.*

[47]*See* Martin A. Sullivan, ''Eaton Migrates to Ireland: Will the U.S. Now Go Territorial?'' *Tax Notes*, June 11, 2012, p. 1302, *Doc 2012-12279*, or *2012 TNT 112-2* (stating that Eaton's acquisition of Cooper is in fact an inversion transaction designed to provide self-help territorial taxation to the combined group).

It is important to note that the Case 3 inversion provides the same opportunity for inversion tax savings as the Case 1 and Case 2 inversions, yet the 2012 temporary regulations do not prevent access to the inversion benefits in the Case 3 scenario. Again, section 7874 was not designed to prevent inversion benefits from being available. Its principal purpose was to provide plausible deniability that inversion benefits are motivating market transactions. Plausible deniability of the existence of an inversion transaction is available in the Case 3 scenario.

Case 4: Will Sovereign Wealth Funds Join the Act? To my knowledge, a sovereign wealth fund has not yet stepped into an inversion transaction as an accommodation party, but financial incentives exist for doing so, so one can envision such a transaction.[48] The following hypothetical Case 4 is provided to demonstrate a possible scenario.

> Case 4: A U.S. multinational with a market capitalization of $30 billion wants to obtain the tax savings of an inversion transaction but has no readily available foreign acquisitions, nor does it have a substantial business presence in any particular foreign jurisdiction. So an accommodating sovereign wealth fund that has grown weary of investing in U.S. Treasury bonds is approached to help the U.S. MNC achieve an inversion. In the transaction, a new foreign parent company will be created. The legacy U.S. MNC shareholders will transfer all their U.S. MNC stock to the new foreign parent in exchange for all the new foreign parent stock, and they will have a binding commitment to sell 25 percent of the new foreign parent stock to the sovereign wealth fund for cash equal to 25 percent of the value of the U.S. MNC. After that transaction, the legacy U.S. MNC shareholders will receive 0.25x of cash and a 0.75 share of the new foreign parent stock for each share of the U.S. MNC stock. They will own 75 percent of the resulting new foreign parent, and the sovereign wealth fund will own 25 percent of the stock of the new foreign parent.

Because the legacy U.S. MNC shareholders have a binding obligation to sell 25 percent of their new foreign parent stock, they would not be considered to have control of the new foreign parent immediately after the exchange; instead, the sovereign wealth fund would be considered to own 25 percent of the new foreign parent stock immediately after the exchange.[49] Because the legacy U.S. MNC shareholders own less than 80 percent of the new foreign parent's stock post-inversion, the new foreign parent does not appear to be a surrogate parent under section 7874 as long as the sovereign wealth fund's 25 percent ownership of the new foreign parent is not disregarded for purposes of that test. If the new ownership interest of the sovereign wealth fund is disregarded, section 7874 will categorize the new foreign parent in Case 4 as a surrogate foreign parent within the meaning of section 7874(b).

The starting point for analyzing whether the sovereign wealth fund's ownership is to be disregarded from the ownership test of section 7874(a)(2)(B)(ii) is section 7874(c)(2)(B), which provides that stock sold in a public offering that is ''related to''[50] an inversion transaction must be disregarded for purposes of determining the continuity of the legacy U.S. MNC shareholders in the new foreign parent. The statute does not define the term ''public offering,'' nor does it provide any basis for determining when an issuance of stock will be viewed as related to an inversion transaction.[51] At a minimum this prohibition means that a U.S. MNC cannot use an initial public offering of 21 percent of its stock as a way to effectuate an inversion transaction.[52] But Congress did not explain why it chose to distinguish between new capital raised in a public offering and new capital

[48]For a more detailed list of potential techniques to use a financial buyer to obtain inversion benefits, see NYSBA tax section, *supra* note 32.

[49]*See Intermountain Lumber Co. v. Commissioner*, 65 T.C. 1025 (1976) (binding obligation by incorporator to sell 50 percent of stock broke control); Rev. Rul. 70-140, 1970-1 C.B. 73 (incorporation followed by planned exchange of stock for stock of public company broke control); Rev. Rul. 70-522, 1970-2 C.B. 81 (reciprocal agreement to exchange 49 percent of stock of newly organized subsidiaries broke control for both transferors).

[50]Because the stock ownership test requires that former shareholders own the requisite amount of stock in the transferee foreign corporation ''by reason of'' holding stock in the domestic corporation, practitioners may have presumed that shareholders must give up their shares to implicate section 7874. The existing temporary regulations clarify that the former shareholders must own stock by reason of holding their stock in the domestic corporation and that this by reason of condition is satisfied if stock of a foreign corporation is received in exchange for or ''with respect to'' stock in a foreign corporation (or an interest in a domestic partnership), and that this by reason of condition also may be satisfied other than through exchanges or distributions. *See* reg. section 1.7874-2T(f); Tretiak and Jackman, *supra* note 11.

[51]*See* NYSBA tax section, *supra* note 32; Carl Dubert, ''Section 7874 Temporary Regulations: Treasury and IRS Wave Taxpayers Through the Stoplight,'' 17 *J. Int'l Tax'n* 12, 23-25 (July 2006).

[52]*See* section 7874(a)(2)(B)(i) and (c).

raised privately.[53] In Notice 2009-78,[54] Treasury and the IRS announced their intention to expand the scope of stock to be excluded from the ownership test of section 7874(a)(2)(B)(ii) to include some stock issued in a private offering when that stock is exchanged for non-qualified property (cash, cash equivalents, marketable securities, or any other property acquired with a principal purpose of avoiding section 7874(c)(2)(B)). Because the sovereign wealth fund's purchase of shares was related to the inversion transaction, Notice 2009-78 holds open the possibility that the stock ownership of the sovereign wealth fund would be disregarded in determining whether the legacy U.S. MNC shareholders own more than 80 percent of the new foreign parent after the inversion transaction if the sovereign wealth fund's ownership has a principal purpose of avoiding section 7874(c)(2)(B). The difficult conceptual problem raised by Case 4 is that the legacy U.S. MNC shareholders have been cashed out of a significant part of their investment, so the transaction has a significant nontax purpose.

Suppose the facts in Case 4 are modified so that the sovereign wealth fund purchased 95 percent of the stock of the new foreign parent, not 25 percent. Again, the acquisition is related to the inversion transaction, so arguably Notice 2009-78 could apply and the 95 percent stock ownership of the sovereign wealth fund would be disregarded. The New York State Bar Association Tax Section posited a similar hypothetical and argued that Treasury should create a carveout from this stock exclusionary rule for stock acquired in transactions whose predominant nature is that of a sale rather than an inversion.[55] The contours of the exclusionary rule of section 7874(c)(2)(B) were not addressed in the regulations issued under T.D. 9591 or T.D. 9592, but the preamble to T.D. 9591 says that Treasury continues to study how to apply the post-transaction ownership test of section 7874(a)(2)(B)(ii) when stock is issued in exchange for some types of property.[56] Further, Treasury officials have said that further regulatory guidance on these issues can be expected this summer.[57]

In any event, subject to further regulatory guidance on the efficacy of this technique, the ability to sidestep section 7874 through a strategic foreign investor at some ownership level gives a U.S. MNC the potential to capture significant tax savings for all the shareholders of the new foreign parent, including the sovereign wealth fund. The sovereign wealth fund may represent that it would hold its investment long enough for the transaction to be considered old and cold, and in return the sovereign wealth fund may be given a special class of common stock that entitles it to a preferential dividend as further compensation for entering into the transaction. The premium that would exist in this structure would be entirely funded by the U.S. tax savings, which could be shared with the sovereign wealth fund for making these U.S. tax savings available to the multinational. Again, the fundamental question raised by the Case 4 inversion is whether it is desirable for the U.S. tax system to condition access to the substantial inversion tax benefits on a foreign investor's willingness to participate in the transaction. If the answer is no, one must confront the obvious line-drawing problem of how to differentiate an equity participation by a new financial owner that represents a ''tainted ownership'' under the exclusionary rule of section 7874(c)(2)(B) from an equity participation that does not.

B. Implications of the Case Studies

The above case studies indicate that corporate inversions have continued to be a fruitful area of tax planning.[58] Some U.S. MNCs may be too big to invert at this point and thus unable to fit within a Case 2 or Case 3 fact pattern. Other U.S. MNCs may not have a substantial business presence in any particular foreign jurisdiction, so they may be unable to avail themselves of the Case 1 fact pattern, particularly after the promulgation of the bright-line requirements for the substantial business presence test in the 2012 temporary regulations. But for many U.S. MNCs that are expanding globally in foreign markets, the occurrence of the necessary ''extraneous event'' that would put them in a Case 2 or Case 3 fact pattern is foreseeable in their life cycle, but patience may be needed. The extent to

[53]But as has been pointed out by others, the legislative history indicates that Congress meant to make this distinction. The Senate version of section 7874 would have disregarded stock issued in private placements, and the House version would have disregarded stock issued only in public offerings. The conference committee followed the House bill in this respect without explanation. *See* H.R. Rep. No. 108-548, *supra* note 4, at 242-245; *see* S. Rep. No. 108-192, *supra* note 1, at 139-145; H.R. Conf. Rep. No. 108-755, *supra* note 6, at 554-562; *see also* NYSBA tax section, *supra* note 32.

[54]2009-40 IRB 452, *Doc 2009-20692*, *2009 TNT 179-8*.

[55]*See* NYSBA tax section, *supra* note 32, at 43.

[56]*See* Preamble to T.D. 9591, *Doc 2012-12347*, *2012 TNT 111-12*.

[57]*See* Coder, *supra* note 37.

[58]IRS officials appear to concur that inversion planning is alive and well. *See* Amy S. Elliott, ''Aggressive Corporate Inversions Remain a Problem, IRS Official Says,'' *Tax Notes*, Nov. 7, 2011, p. 662, *Doc 2011-22814*, or *2011 TNT 210-6*.

which a financial investor may provide the mechanism for a U.S. MNC to access the inversion tax benefits as illustrated in the Case 4 example has been unclear since the issuance of Notice 2009-78, but presumably Treasury will clarify the prescriptive scope of section 7874(c)(2)(B) in forthcoming regulations. Thus, seen in its historical record, section 7874 has not thwarted U.S. MNCs from accessing inversion tax benefits. Rather, its most important contribution has been to ensure that those inversion tax savings are accessed in transactions other than naked inversion transactions. That has allowed policymakers to plausibly deny that fundamental international tax reform is needed. Thus section 7874 requires U.S. MNCs to cloak their inversion transactions within the event-driven veneer needed to allow policymakers to blissfully believe there is no need for fundamental reform.

The knee-jerk reaction to all these case studies may be to simply wish that the transactions would go away. In fact, Treasury's issuance of the 2012 temporary regulations to quash the remaining form of naked inversion transactions illustrated by the Case 1 inversion is akin to a plea for inversion transactions to "leave us alone" without addressing the underlying tax disparities that create the incentives for an inversion transaction in the first place. But saying that taxpayers should simply refrain from accessing inversion tax savings is "mere cant" and fails to recognize that reactive tax planning must be done by corporate officers charged with a fiduciary duty to maximize shareholder value.[59] Thus, although the post-section 7874 record is debatable and more nuanced, the reality is that significant and respected companies continue to execute bootstrap inversion transactions with the objective of becoming a foreign MNC and that the tax benefits of foreign ownership are cited as support for companies changing hands. The actual transactions set forth above demonstrate an inconvenient truth about the current U.S. international tax regime even though there is room for reasonable minds to disagree. And for those who desire plausible deniability, there is room to continue viewing cross-border issues in terms of rigid "inbound" and "outbound" paradigms that allow them to discount the notion that multinational business activities can and do migrate between those historical conceptual frameworks.

But for those who recognize this problem and want to correct it, what must be done? In my opinion, at least three things need to be done as soon as possible.

Reform Proposal 1: Base-Protecting Surtax. A significant portion of the inversion tax benefits is attributable to the United States' inadequate protection of its territorial tax base from base erosion payments. Earnings stripping techniques are available in the multinational context that allow erosion of the U.S. tax base. In another work, a coauthor and I proposed that the United States adopt an upfront surtax on all related-party base erosion payments to protect the U.S. tax jurisdiction's right to tax residual profits, and we recommended that a refund of that surtax be given only if the refund was justified by a residual profit-split analysis.[60] The upfront surtax on related-party base erosion payments, coupled with the compulsory use of a residual profit-split analysis, would better ensure that the United States retains the right to tax residual profits that are created in the United States but stripped away through related-party base erosion payments. Others have proposed that the United States adopt a formulary apportionment method for multinationals.[61] Regardless of the specific recommendation, it is time for Congress to squarely address how to comprehensively protect the U.S. tax base against earnings stripping techniques that exist within the related-party multinational context — if only for the fact that unless similarly situated MNCs are taxed similarly on their U.S. territorial profits, financial markets will have an incentive to repackage the disfavored U.S. MNCs into the more favorable foreign MNC format.

Reform Proposal 2: Territorial Tax Regime. I accept that a worldwide tax regime without deferral might be the theoretically optimum tax regime under the assumption that all the major U.S. trading partners

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[59] *Gregory v. Helvering*, 293 U.S. 465 (1935); *see also Commissioner v. Newman*, 159 F.2d 848, 850-851 (2d Cir. 1947) (L. Hand, J., dissenting) ("Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.").

[60] A detailed discussion of this proposal is beyond the scope of this article but is comprehensively addressed elsewhere. *See* Bret Wells and Cym Lowell, "Homeless Income and Tax Base Erosion: Source Is the Linchpin," 65 *Tax L. Rev*. ___ (forthcoming 2012).

[61] *See generally* Rosanne Altshuler and Harry Grubert, "Formula Apportionment: Is It Better Than the Current System and Are There Better Alternatives?" 63 *Nat'l Tax J*. 1145 (2010); Jane G. Gravelle, "Reform of U.S. International Taxation: Alternatives," Congressional Research Service, RL34115, at 13 (2010), *Doc 2010-27084*, *2010 TNT 244-20* (transfer pricing rules would become more important in a territorial system); Ways and Means Committee hearing on transfer pricing (July 22, 2010) (testimony of professor Reuven S. Avi-Yonah), *Doc 2010-16349*, *2010 TNT 141-41*.

have a similar worldwide tax regime. In the formative League of Nations debates, tax scholars predicted that all nations would adopt worldwide tax regimes as they moved from semi-developed status to developed nation status.[62] The arm's-length standard and the current model treaties were forged with that foundational premise in mind.[63] But in fact, the world has moved in the opposite direction, with most of the U.S. treaty partners adopting territorial tax regimes.[64] In a world where most other nations use a territorial tax regime, the United States is increasingly out of step with international norms. It is becoming more difficult for the United States to stand alone in its tax policy paradigm given the growth of multinational activities.

It is important to understand that an inversion transaction attempts to create a de facto territorial U.S. tax regime. That is achievable because the United States generally limits its net basis taxation of foreign direct investors to income that is effectively connected with the conduct of a U.S. trade or business.[65] Thus, by converting a U.S. MNC into a foreign MNC and by having the foreign MNC invest in non-U.S. jurisdictions outside the U.S. affiliate ownership chain, a foreign MNC can limit the scope of U.S. taxation to only the activities that occur within the territory of the United States. As multinationals expand their operations overseas, the risk that an additional U.S. tax obligation would be due on extraterritorial profits represents an additional potential tax cost that structurally can be avoided if the U.S. MNC were an inverted company. That potential extraterritorial U.S. tax cost may not be material to a U.S. MNC that does not have significant foreign activities, but as the multinational's international activities grow in importance, that disadvantage becomes more pronounced and an inversion transaction therefore becomes financially more appealing. So in one sense, inaction by Congress allows many U.S. MNCs to avail themselves of self-help techniques to create a de facto territorial tax regime through inversion transactions that are brushed with the veneer needed to pass muster in a post-section 7874 world. The financial incentives under current law will provide the impetus for reactive tax planning on the part of the taxpayer community to cause multinationals to increasingly become foreign MNCs, not U.S. MNCs, as U.S. MNCs reach reasonably foreseeable events in their life cycles.

If the United States' major trading partners largely endorse a territorial tax paradigm and if current U.S. tax law provides a financial incentive for U.S. MNCs to engage in post-section 7874 inversion planning so that the U.S. tax system becomes a de facto territorial tax regime, the question becomes whether the United States has any other choice but to adopt a territorial tax system. Said differently, if it is reasonably foreseeable that many U.S. MNCs over their life cycle will be able to position themselves into a de facto territorial tax regime because the acquisition events posited in the Case 2 and the Case 3 inversions are not uncommon, it would be preferable to implement a thoughtful territorial tax regime that protects the U.S. fiscal interest now instead of waiting for those inversion events to occur. On October 26, 2011, House Ways and Means Committee Chair Dave Camp, R-Mich., released the Tax Reform Act of 2011.[66] That draft legislation for the first time introduced statutory language for implementing a territorial tax regime for the United States. If for no other reason, TRA 2011 is an important milestone because it provides the opportunity to consider how a territorial tax regime might coordinate with existing rules.[67] A thoughtful commentator has pointed out that a move to a territorial tax regime is probably not politically viable because Congress is unlikely to want to raise tax revenues elsewhere to pay for international tax reform that is perceived to benefit large MNCs.[68] That pragmatic prediction is certainly supported by the historical experience with the entire section 7874 experiment, but the fundamental reality is that the U.S. corporate tax base as it applies to multinationals will probably become a de facto territorial tax regime for a broad array of MNCs over their life cycles regardless of whether Congress acts. Consequently, if a de facto territorial tax regime is bound to happen for multinational business activity, Congress should affirmatively design a territorial tax regime that better protects its U.S. fiscal interests and eliminates the disparate treatment U.S. MNCs receive under existing law.

Reform Proposal 3: Eliminate Most of the Subpart F Tax Rules. The subpart F rules evolved over

[62]League of Nations, ''Report on Double Taxation to the Financial Committee of the League of Nations,'' Doc. E.F.S. 73 F 19 at 51 (Apr. 5, 1923).

[63]*See* Wells and Lowell, *supra* note 60.

[64]JCT, *supra* note 33 (analyzing nine major U.S. trading partners that provide for an exemption system); *see also* JCX-42-11, *supra* note 33 (reviewing policy considerations between a territorial and worldwide tax system).

[65]Section 864(b) and (c).

[66]H.R. ___, Tax Reform Act of 2011 (Oct. 26, 2011), *Doc 2011-22576*, *2011 TNT 208-27*.

[67]A technical discussion of TRA 2011 is beyond the scope of this article but is discussed elsewhere. *See* Wells, ''Territorial Tax Reform: Homeless Income Is the Achilles Heel,'' 12 *Hous. Bus. & Tax. L.J.* 1 (2012).

[68]*See* Sullivan, *supra* note 47.

multiple decades as a way to protect the tax base from the migration of U.S.-origin profits to foreign affiliates,[69] but the basic tools for that profit migration were left in place. If the United States adopted a surtax to protect the U.S. tax base from erosion, the subpart F rules (except for sections 954(c) and 953) should no longer be needed. Their elimination would reduce a tax handicap borne by U.S. MNCs versus their foreign-owned MNC competitors while meeting the original policy challenge that led to the enactment of the subpart F regime in the first place.[70] The experience since the enactment of the subpart F regime provides strong evidence that migration of U.S.-origin profits will not be thwarted by an ad hoc subpart F classification paradigm that applies only to U.S. MNCs.[71] The solution to the migration of U.S.-origin profits is found only by targeting reform at the transfer pricing method mistakes that allow the migration of residual profits. A commentator could fairly ask, ''Why are you so confident that the adoption of the proposed surtax displaces the need for an expansive subpart F regime?'' The answer is that the upfront surtax is the backstop regime. It is sufficient because tax is collected upfront on the estimated residual profit that is being transferred via the base erosion payment, and the upfront surtax is not refunded unless a residual profit-split analysis is performed in which both parties are treated as ''tested parties.''[72] By collecting what is expected to be the correct amount of tax on the residual profits upfront, and by requiring a residual profit-split analysis to determine the correct attribution of the profits based on a functional analysis of the true origins of the profits with all parties treated as tested parties, the migration of residual profits away from the U.S. taxing jurisdiction is quashed before it arises and is handled as a transfer pricing matter. Unless appropriate transfer pricing collection and compliance procedures are put in place to forestall the migration of residual profits via base erosion payments, U.S. tax base erosion will persist.

Unfortunately, at least for the moment, the United States seems to be stuck in neutral with no clear consensus on the way forward. Inversion transactions and inversion benefits are still available and are hotly pursued, but Congress and the public can plausibly deny that this is the case since naked inversion transactions are no longer clearly seen. But the Case 2 and Case 3 inversions are being done, and Case 4 inversions remain potentially available in the future. In this context, section 7874 is harmful because it obscures the fundamental design flaws of current law without solving the underlying defects. By providing plausible deniability regarding the design defects of current law, section 7874 allows policymakers to avoid facing an inconvenient truth about the existing U.S. international tax regime while allowing the inversion planning to continue under the radar. Valuable time has been wasted. It is now time for Congress to address the underlying policy flaws that provide significant savings for multinationals that are nominally classified as foreign-status corporations. The post-section 7874 inversion record continues to provide the evidence for this needed reform whether or not policymakers want to see it.

[69]*See* Michael C. Durst, ''The Two Worlds of Transfer Pricing Policymaking,'' *Tax Notes*, Jan. 24, 2011, p. 443, *Doc 2011-93*, or *2011 TNT 16-22* (suggesting that backstop provisions of the subpart F regime are the critical elements of combating U.S. tax base erosion); *see* Wells, *supra* note 67.

[70]*See* Wells, *supra* note 67.

[71]*Id.*

[72]For an analysis of why the United States had historically endorsed transactional transfer pricing methods that tested only one party in the MNC context, see Wells and Lowell, *supra* note 60.