Revisiting the Law of Moses’ Rod: The Case of Inversions

By Adam H. Rosenzweig

Adam H. Rosenzweig is a professor at Washington University in St. Louis.

In 1984 Martin D. Ginsburg wrote, “Reliable maxims do not abound in the tax field, but there are a few. One relates to Moses’ rod. It reminds us that every stick crafted to beat on the head of a taxpayer will metamorphose sooner or later into a large green snake and bite the commissioner on the hind part.”1 In 1985 he added:

When you grab a technical nicety and sharpen it to spear a legitimate transaction, and no impelling tax policy or unavoidable statutory mandate requires that result, you court disaster. You have assumed the risk of Moses — nee Aaron’s — Rod, the Murphy’s Law of the tax field. As I never tire of repeating,2 it reminds us that every stick crafted to beat on the head of a taxpayer will, sooner or later, metamorphose into a large green snake and bite the Commissioner on the hind part.3

In this article, I revisit the law of Moses’ rod4 in the context of inversions. I explore how proposed revisions to the anti-inversion rules, including those in Notice 2014-52, 2014-42 IRB 712, could be used to justify new, and even more aggressive, expatriation strategies.5 Several strategies just short of technical inversions already exist in the literature, and the ones described in this article build on their lessons. As far as I know, however, the specific proposals described in this article have not been published elsewhere; but I am not necessarily claiming that I am the only one to come up with them. I am sure that practitioners have already started developing other strategies, and may well have devised similar (or likely more superior) structures. Since I have been out of law firm practice since 2005, any similarities between the proposals in this article and those developed in the real world would be purely coincidental.

These structures are not equal in terms of resistance to attack administratively or by regulation, nor would they necessarily be attractive to any particular company. Just as important, I am not advocating that any taxpayer, law firm, accounting firm, investment bank, or other party pursue any of these strategies, or that they are “good” from a tax policy standpoint. Rather, my goal is to follow in

1Ginsburg, “Making Tax Law Through the Judicial Process,” 70 ABA J. 74, 76 (1984). See also Victor Fleischer, “Regulatory Arbitrage,” 89 Tex. L. Rev. 227, 283, n.319 (2010) (“Professor Ginsburg was no regulatory nihilist. His point was that, when the government stretches tax policy to achieve a pro-government result, astute taxpayers will convert the rule into a pro-taxpayer strategy.”).

2While I don’t know if this is true as a general matter, I can attest that I first learned of this adage from Ginsburg when I was a student at Georgetown.


4While reference was made to both Moses and Aaron, this has come to be known as the “law of Moses’s rod.” See Lawrence Zelenak, “Thinking About Nonliteral Interpretations of the Internal Revenue Code,” 64 N.C. L. Rev. 623, 670, n.281 (1986).

5See Erick M. Jensen, “Legislative and Regulatory Responses to Tax Avoidance: Explicating and Evaluating the Alternatives,” 57 St. Louis U. L.J. 1, 16-17 (2012) (“Finally, new statutory or regulatory language is, well, new language, something that energizes tax professionals. Give us new words to interpret, and we will interpret them as favorably to our clients as possible. . . . No matter how well intentioned, changing statutory and regulatory language can breed, rather than deter, tax avoidance.”) (internal quotation omitted).
Ginsburg’s footsteps when he wrote that examples “work more forcibly on the mind than precepts.”

The remainder of this article will assume the following: (1) that the regulations announced in Notice 2014-52 have been finalized; (2) that the threshold for section 7874 has been raised from 20 percent to 50 percent; (3) that debt issued from a U.S. company to its inverted parent (or related party) is treated as equity under section 385; and (4) that deductions for interest paid from a controlled foreign corporation of an inverted company to a related party are capped at a 1.5-1 debt/equity ratio. Of course, there are other rules that could be adopted, but these appear to be the primary ones now being proposed.

This article will consider two potential inversion alternatives: the “subversion” and the “virtual sp-inversion.” This is not to say that these structures are the only ones possible — just two that an academic increasingly far removed from practice could come up with. For example, a variation of a privatizing structure reportedly considered by some bidders in the takeover of Dell Inc., as well as contemplated in T.D. 9265 but not addressed in reg. section 1.7874-2(g), could be pursued. Regardless, the next sections will discuss these two proposals in terms of the assumed anti-inversion rules.

Proposal 1 — The ‘Subversion’

This is a structure with lots of moving parts that is likely completely impractical in the real world, which, of course, means it is perhaps my favorite. This structure is inspired by a rogues’ gallery of existing structures in other areas, including the leveraged partnership, the family limited partnership estate freeze, the Blackstone initial public offering structure, and an umbrella partnership real estate investment trust (UPREIT). Having not seen this particular proposal before, and because nothing seems to exist in the tax world absent a fancy name, I am calling this a “subversion.”

The initial structure is relatively straightforward. US Parent finds a strategic merger partner in a foreign jurisdiction called Foreign Parent. US Parent causes its CFCs to contribute assets to a foreign eligible entity treated as a partnership for U.S. tax purposes called Foreign JV, with Foreign Parent being the other member. For simplicity, I will assume a single CFC, but presumably in the real world, there would need to be several parallel Foreign JV structures to maintain each CFC’s subpart F exemption. CFC contributes substantially all of its assets to Foreign JV in exchange for a preferred interest, which entitles CFC to a preference on liquidation equal to the fair market value of the contributed assets and a coupon equal to the applicable federal rate. Foreign Parent contributes complimentary assets to Foreign JV. Foreign JV then borrows against them, and CFC issues a bottom-tier guarantee for the debt. Because of the guarantee and the preference, Foreign JV could allocate all gross items of deduction related to the debt to CFC, if desired.

The preferred shares of CFC would either be no vote or low vote, and the common shares of Foreign Parent would control Foreign JV. Foreign Parent would be entitled to a guaranteed payment for management services rendered to Foreign JV equal to some reasonable amount, perhaps 2 percent of assets under management. Foreign Parent would then retain a special purpose Delaware corporation called US MgtCo, that was formed by the management of US Parent as an independent company to manage the affairs of Foreign JV, in exchange for a fee equal to some percentage of the guaranteed payment. In this manner, CFC performs no active business other than through its ownership of Foreign JV, which should minimize concerns regarding the potential application of the post-Brown Group regulations (assuming the income of CFC was not subpart F income to begin with), although at the cost of keeping some income within the U.S. tax net at US MgtCo. A more aggressive version of the structure could have Foreign Parent funding US MgtCo with debt to strip out some of the earnings from the United States. Because Foreign Parent and US MgtCo are not related by equity ownership, neither section 385 nor section 163(j) should apply.

The preferred shares would be nontransferable without the consent of Foreign JV but would contain an exchange right that permits CFC to put the shares against Foreign JV in exchange for Foreign Parent stock after two years if a restructuring has not occurred. The exchange right should be enforceable only against Foreign JV and not against Foreign Parent, and be non-severable from the preferred shares to avoid the risk of it being treated.

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6Ginsburg, “The Taxpayer Relief Act of 1997: Worse Than You Think,” Tax Notes, Sept. 29, 1997, p. 1790. That Tax Notes article was one of the first readings I was assigned (outside “the big red book”) as a student in Ginsburg’s course on structuring venture capital and private equity transactions.


8Perhaps another alternative could involve a U.S. company issuing mandatory exchangeable stock (or DECS) with respect to a foreign subsidiary, ultimately followed by a taxable split-off. See, e.g., Michael S. Farber, “Equity, Debt, Not — The Tax Treatment of Non-Debt Open Transactions,” 60 Tax Law. 635, 641-643 (2007). I like this proposal in part because the coupon on the DECS would presumably be capitalized into the stock of the CFC, leading to lower gain on distribution.

9T.D. 9008.
as boot in the section 721 transaction. This part of the structure would be intended to comply with reg. section 1.701-2(d), Example 4, regarding the use of partnerships in an UPREIT-type structure.10

Because of the flip right, the preferred shares could be treated as stock of Foreign Parent for purposes of section 7874 under reg. section 1.7874-2(h), although it would be possible to argue that the chance of exercise of the flip would be "remote" within the meaning of reg. section 1.7874-2(h)(4). Regardless, the flip right would not be treated as an indirect acquisition of US Parent stock under reg. section 1.7874-2(k), Example 2. Even if it were considered stock of Foreign Parent, the stock should not be treated as disqualified because the contributed assets were the active trade or business assets of CFC under reg. section 1.7874-4T. Thus, the flip right should be irrelevant to any section 7874 fraction calculation.

A restructuring would involve forming a new foreign holding company, Foreign HoldCo, to hold both Foreign Parent and US Parent. Foreign HoldCo would be formed through a horizontal double-dummy transaction in which Foreign HoldCo forms US Merger Sub and Foreign Merger Sub (for stock of Foreign HoldCo), with each merging into US Parent and Foreign Parent respectively, and with shareholders of those companies receiving stock of Foreign HoldCo. The restructuring itself would then be subject to section 7874. This is when the valuation issue becomes crucial. Under the structure, CFC holds a preferred interest with little participation in growth, little to no voting rights, and significant restrictions on transfer. Under FLP guidance, this should entitle the preferred shares to a significant valuation discount from the individual value of the contributed assets.11 This discount is furthered by the presence of the debt, which is guaranteed by CFC. While the guaranteed debt increased the basis of the preferred shares in the hands of CFC, it reduced the net value of the equity of Foreign JV post-contribution.

Further, this structure works best when CFC owns high-growth foreign assets and US Parent owns primarily mature, low-growth U.S. assets. Over time, the residual equity value of the common shares of Foreign JV grows, while the value of the preferred shares remains low. Taken together, a significant amount of the value of the foreign assets can be shifted from US Parent to Foreign Parent through the valuation discount and freeze technique.

Assuming all of this is correct, the value of Foreign Parent could well exceed 50 percent of the value of US Parent by the time of the restructuring. If so, the formation of Foreign HoldCo through a double-dummy structure would clearly seem to fit within reg. section 1.7874-4T(j), Example 3 and thus not be an inversion.12 US Parent would become a wholly owned subsidiary of Foreign HoldCo, and all U.S. business would be run through US Parent. CFC would remain in place, owning a plain vanilla preferred interest in Foreign JV because the flip right would have expired, and would continue to be owned 100 percent by US Parent. Thus, the bulk of the future income generated by the legacy assets of CFC would now be allocated to Foreign Parent. Since there would be no inversion, there would be no foreign expatriated entity and no specified related person, and Notice 2014-52 therefore would not apply. Even if it did, section 3.02 of the notice presumably would not apply because no CFC stock has been purchased or transferred. For the same reason—that Foreign HoldCo is not a foreign expatriated entity, and thus, CFC is not a foreign related person for purposes of section 7874(d)(3) — CFC could take a distribution of cash from Foreign JV because of the guarantee of the debt and lend that cash to Foreign HoldCo without triggering section 956 or section 3.01 of Notice 2014-52 to US Parent.

The resulting structure would look as follows:

10This is distinct from the UPREIT-style structure adopted in the Burger King/Tim Hortons transaction that was intended to avoid the application of the "Helen of Troy" regulations for U.S. shareholders in the transaction. In that case, the sole purpose of the partnership was to defer tax under section 721 in the share exchange, and the partnership served solely as a holding company. Under the subversion, the partnership would have operating assets and would in substance combine the operating assets of two unrelated parties under section 707. This fits much more closely within the confines of reg. section 1.701-2(e) than the Burger King transaction. See, e.g., Samuel C. Thompson Jr., "The Cat-and-Mouse Inversion Game With Burger King," Tax Notes, Sept. 15, 2014, p. 1317.


12Because shareholders of US Parent would not own more than 50 percent of vote or value of Foreign HoldCo, reg. section 1.367(a)-3(c) also would not apply, meaning this step could be a tax-free section 351 transaction for U.S. shareholders.
After the restructuring, all new future foreign operations would be developed under Foreign Parent, thus freezing the value of Foreign JV from the time of the restructuring until its business line eventually runs down. For example, if Foreign JV held patents for older pharmaceuticals sold in foreign jurisdictions, newer versions of the patents could be developed directly under Foreign Parent (or through a cost-sharing agreement with a new foreign entity). Over time, the business of Foreign JV could simply wind down as patents expire, or it could continue to exist for some small internal business functions such as an internal licensing company.

One difficulty in the subversion structure is control. If the steps are hard-wired and the structure would be unwound absent any step, the step transaction doctrine would likely apply to disregard the intermediate steps and treat the transaction as an inversion (assuming Foreign Parent is not larger than US Parent beforehand). Thus, for some period, US Parent and Foreign Parent must operate as independent publicly traded companies. Attempts to tie the companies together through stapling or other means would defeat the purpose under section 269B, among other provisions.

This is where the flip right and US MgtCo come in. The flip right in the preferred shares of Foreign JV acts much like an UPREIT. Thus, US Parent can terminate the structure and cash out for publicly traded stock at any time by exercising the flip right. While this would presumably be a taxable event to CFC, the income might not be subject F income (at least in the year of sale) under the section 954(c) look-through rule. Even if it were currently taxable, CFC would receive liquid Foreign Parent stock, which it could sell to pay the tax. Crucially, much like in many UPREITs, the conversion price should be set at a significant premium when the structure is formed. This provides two deterrents to Foreign Parent. First, a conversion would dilute the existing shareholders of Foreign Parent because of the premium. Second, assuming US Parent would immediately sell the stock of Foreign Parent in the event of a conversion, the forced sale of a large block of shares in Foreign Parent would likely cause a significant drop in the trading price of the stock. Taken together although Foreign Parent would not be obligated to engage in the restructuring, it would have a significant incentive to do so.

Third, this structure assumes that one of the purposes of an inversion is for a U.S. company to stay in control of the operation of its assets while merging with a strategic partner in another jurisdiction. To comply with the assumed enhanced 50 percent rule of section 7874, however, Foreign Parent shareholders would need to control Foreign HoldCo after the restructuring. Similarly, Foreign Parent would control Foreign JV at the formation of the structure. The use of US MgtCo resolves many of these problems by providing operational control of Foreign JV’s assets to the management of US Parent. Further, US MgtCo can partially shield tainted income of Foreign JV for subpart F purposes by paying an arm’s-length fee to a taxable U.S. corporation rather than to a related CFC. In this manner, US MgtCo serves a similar function to the taxable C corporations in the Blackstone structure by “cleansing” out bad income,13 while also furthering the business purpose of the merger.

Finally, since Foreign HoldCo would not be a surrogate foreign corporation (SFC) for purposes of section 7874, any antibuse rule tied to the SFC definition would also prove inapplicable. For example, assume that Treasury exercised its authority under section 385 to issue regulations providing that debt between an SFC (or a member of the expanded affiliated group of an SFC) and a U.S. corporation would be treated as equity for purposes of the interest deduction rules. Those rules would not apply because Foreign HoldCo is not an SFC.

Proposal 2 — The ‘Virtual Spinversion’

Notice 2014-52 directly addressed the use of spinversions by including section 355 distributions made within the three-year period before the inversion acquisition as part of the ownership fraction for section 7874 purposes. This effectively prevents a U.S. company from spinning off unwanted assets solely to “skinny down” to meet the 80 percent threshold of section 7874. That limitation would

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prove only more daunting if the section 7874 threshold was increased to 50 percent, because shareholders of the spun-off company would need to own more than 50 percent of the combined company to avoid the application of section 355(d) and (e).

Despite these provisions, a virtual separation\textsuperscript{14} using tracking stock (or letter stock) might still be possible to achieve similar ends.\textsuperscript{15} For example, assume US Parent owns US Sub and Foreign Sub and is publicly traded with a single class of stock. Foreign Parent is a publicly traded company in the same line of business as Foreign Sub, but because of the large, successful business of US Sub, Foreign Parent is significantly smaller than US Parent. Thus, the two cannot directly merge without triggering the section 7874 anti-inversion rules.

Instead, US Parent engages in a tax-free E reorganization in which it exchanges the single class of publicly traded stock for two classes of stock: class D and class F. Both are authorized series of stock issued by US Parent for corporate law purposes and give shareholders voting rights and other shareholder rights only regarding US Parent. Under the terms of the stock, however, class D stock pays dividends only for the earnings of US Sub, and class F stock pays dividends only for the earnings of Foreign Sub.

Once the tracking stock structure is implemented, Foreign Parent acquires 51 percent of the stock of Foreign Sub in exchange for the stock of its foreign operating subsidiary, Foreign OpCo — or whatever amount the value of Foreign OpCo represents — as long as it is greater than 50 percent, and subject to any foreign tax requirements of Foreign Parent. This results in Foreign Sub ceasing to be treated as a CFC for U.S. tax purposes. Because Foreign Parent is not a specific related party to either US Parent or Foreign Sub and Foreign Sub is not an expatriated foreign subsidiary for purposes of section 3.02 of Notice 2014-52, the provisions of that section would not apply.

At this point, Foreign Sub could lend its cash to US Parent. Section 956 by its terms would not apply because Foreign Sub is no longer a CFC,\textsuperscript{16} and section 3.01 of Notice 2014-52 would not apply because Foreign Sub is not an expatriated foreign subsidiary for these purposes. US Parent could then use the cash (plus new borrowing or notes issued to class F shareholders, if it so desired) to redeem the class F stock. At this point, US Parent would own a minority portfolio investment in Foreign Sub and operate Foreign Sub as part of its worldwide business.

Alternatively, Foreign Sub could lend the cash to Foreign HoldCo, which also would not be subject to section 3.01 of the notice because Foreign Sub is not an expatriated foreign subsidiary. Foreign HoldCo could then tender for the class F shares the cash received from Foreign Sub (plus new debt or notes if desired). Assuming Foreign HoldCo could tender for all the class F shares, it would directly and indirectly own the rights to 100 percent of the growth and dividends of Foreign Sub, a company it controls. The resulting structure would look as follows:

\textbf{Figure 2}

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Under this structure, some percentage of Foreign Sub’s earnings would be subject to U.S. tax if distributed by Foreign Sub, but could continue to be deferred indefinitely for US Parent because Foreign Sub is no longer a CFC. At this point, Foreign Sub could recapitalize into common and preferred stock. US Parent would receive only common stock, US Parent might want to wait until after the end of the tax year to avoid any potential application of section 956(b)(3).

\textsuperscript{14}The name follows a long line of so-called virtual transactions using tracking stock. See James L. Dahlberg and Jay D. Perry, “Tracking Stock: Virtual Equity, Virtual Entities, and Virtual Mergers and Acquisitions,” 78 Taxes 18, 24 (2000).

\textsuperscript{15}Tracking stock has reportedly been considered in the context of inversions already. See Amy S. Elliott, “Practitioners Question IRS’s Reading of Anti-Inversion Statute,” Tax Notes, Nov. 18, 2013, p. 686. Also, tracking stock was at least mentioned as one of the issues to be considered when anti-inversion legislation was first proposed. See New York State Bar Association Tax Section, “Outbound Inversion Transactions,” Tax Notes, July 1, 2002, p. 127. As noted above, the discussion in this section is not based on any actual or proposed transaction.

\textsuperscript{16}US Parent might want to wait until after the end of the tax year to avoid any potential application of section 956(b)(3).
while Foreign HoldCo would receive preferred. The
preferred would be identical to the common in
every way except that it would be entitled to a
priority on dividends up to some set amount before
dividends could be paid on the common and pre-
ferred pro rata. In this way, Foreign Sub could pay
dividends to Foreign HoldCo without paying divi-
dends to US Parent, thereby avoiding tax at US
Parent. Further, since the preferred is issued to
Foreign HoldCo, neither section 305 nor section 306
would apply to US Parent.

At some point, however, US Parent could decide
to redeem the class F stock for its stock in Foreign
Sub, unwinding the structure. This would be a
taxable distribution to US Parent, but assuming
Foreign HoldCo does not own significant class D
stock, it would be a complete redemption of Foreign
HoldCo for purposes of section 302(b)(3) and thus
not a dividend subject to withholding.

This structure could make sense if the goal is to
separate the U.S. and foreign business of US Parent
without triggering an inversion. If the goal is to
continue the business under a single ownership
structure, however, another alternative could be
available. Rather than have US Parent redeem the
class F stock or Foreign HoldCo tender for the class
F stock, Foreign HoldCo and US Parent could staple
the class F stock to the publicly traded stock of
Foreign HoldCo. Since by assumption, Foreign Sub
is smaller than US Sub, the class F stock would
constitute less than 50 percent of the value of all
beneficial interests in US Parent, and thus, section
269B would not apply under reg. section 1.269B-
1(b)(1). In this manner, investors who want a “pure
play” in the combined foreign operations of the two
companies could own the stapled class F/Foreign
HoldCo stock, while investors wanting a pure play
on the U.S. operations of US Parent could own class
D stock, and investors interested in the joint returns
could buy both separately.

Regardless which approach is adopted, the use of
tracking stock could achieve something close to a
spinversion by permitting a U.S. conglomerate to
strip out the value of a foreign business to be
acquired by a foreign acquirer without triggering
the rules of Notice 2014-52, the enhanced anti-
inversion rules, or the anti-Morris Trust legislation.
As with any tracking stock, there is a risk that it
could be challenged as a de facto distribution of the

stock of Foreign Sub, but assuming it is properly
structured, this risk should be no greater than with
any tracking stock.\(^{18}\)

**Conclusion**

This article is not a legal opinion, nor is it trying
to be. There are several potentially successful at-
tacks against any of these structures. What this
article is trying to highlight is that there is no magic
bullet to the perceived abuse of the tax system.
The structures discussed are not the only ones possible,
nor would shutting them down necessarily end
inversions forever.

Although Ginsburg liked to repeat the analogy of
Moses’ rod, perhaps a closer analogy in the inver-
sions setting would be that of the Maginot Line.\(^{19}\)
Of course, we can learn the lessons of the past and
dig a trench that would completely prevent a cav-
alry with muskets from invading. But what hap-
pens when the enemy brings tanks and airplanes
through Belgium?

As with the Maginot Line, the one certainty in tax
law is that fighting the battles of the last war will
not necessarily prevent us from losing the battles of
the next one. The “anti-Helen of Troy” regulations
stopped inversions with tax-sensitive shareholders.
The enactment of section 7874 stopped so-called
naked inversions by drawing the line at 20 percent.
Now we are observing 20 percent inversion deals.
The law can definitely stop 20 percent inversion
deals by raising the threshold to 50 percent — but
should it? Would 50 percent inversion deals —
otherwise known as buyouts — be better from a
policy standpoint?

This is not to say that I am opposed to antibuse
rules or even unilateral administrative responses to
perceived abuses in the tax law. In 2007 I published
an article supporting Treasury’s power to use its
authority under section 7701(f) to treat positions in
carried interest as straddles, thereby tolling the
holding period and treating income on carried
interest as short-term capital gain.\(^{20}\) The goal, how-
ever, is to find ways to proactively incorporate
antiabuse provisions into the larger structural goals
of the income tax. While this could mean moving
more slowly in response to any one perceived
abuse, ideally it could lead to a more coherent
overall system of tax law. I’m not saying that any
particular anti-abuse rule or proposal is flawed or
less than fully thought out; in fact, some of the best

\(^{17}\)If made within five years of ceasing to be a CFC, section 1248 would continue to apply.

\(^{18}\)See Stephen B. Land, “Entity Identity: The Taxation of

\(^{19}\)See, e.g., Robert W. Wood, “Getting Physical: Emotional

\(^{20}\)See Adam H. Rosenzweig, “Not All Carried Interests Are
and most thoughtful lawyers in the world work in tax law.21 Rather, what is striking is that despite this fact, the problems identified by Ginsburg 30 years ago seem to continue to arise.

I will end the way I began, by quoting Ginsburg: “The ancient Chinese curse is, may you live in interesting times. You do, and you will hereafter.”22 As has proven true so many times in my professional life, I continue to learn from the wisdom of his words.

21While individual tax lawyers can and do make mistakes, tax lawyers as a whole have proven remarkably adept at remedying them through engaged and thoughtful commentary. Cf. Calvin H. Johnson, “Johnson Withdraws Shelf Project Recommendation,” Tax Notes, Sept. 26, 2011, p. 1441. Hopefully, this article can also generate engaged and thoughtful responses, even — or especially — if they demonstrate that the structures discussed herein do not work. Being wrong can be almost as valuable as being right, as long as the ideas contribute to the advancement of knowledge in the field.

22Ginsburg, supra note 3.