To the Editor:

I write to comment on Edward D. Kleinbard's recent article on the subject of "inversions." Kleinbard is, as usual, erudite and funny, but all the erudition and humor in the universe cannot hide the hole in his argument.

There are two kinds of cross-border combinations in the world. One is a combination born out of business and economic sense, the kind that would happen whether or not there were tax advantages to doing the deal. The second kind of cross-border combination is one that is motivated at least in part by tax considerations. In the context of inversions, the motivating tax considerations are, usually, to reduce a U.S. company's effective tax rate on non-U.S. income and to find a way to redeploy offshore earnings outside the U.S. tax net.

So how do we define what is and is not an "inversion"? Kleinbard is unhappy with the definition Congress came up with, which employs an 80 percent ownership threshold to treat the foreign entity that is in form the acquiring corporation as a U.S. corporation. He wants to reduce that threshold to 50 percent. Presumably he wants to do that because he thinks that deals being done currently are bad "inversions" that aren't being captured. Apparently he doesn't believe that any of them are plain vanilla cross-border deals that would have been done whether or not any tax benefits were obtainable. In footnote 3, he states:

Some corporate apologists have tried to limit the term "inversion" exclusively to describe the initial pre-2004 wave of self-inversions. These individuals prefer to pretend that the current tsunamis of inversions are just ordinary course cross-border mergers, but this is commercially inaccurate.

I am perplexed as to how Kleinbard can state with such conviction that the current wave of inversions does not, at least in part, consist of ordinary cross-border mergers. I am certain he did not personally plan and conceive of all of them. We must assume that what he actually means us to focus on are the subset of deals in which a U.S. company finds a foreign merger partner that will represent just over 20 percent of the total deal value, and that the U.S. company is doing this solely because that's what will pass muster under section 7874. (I note that if this is true, it is odd that all the announced deals have been between companies in the same general line of business.)

Consider the illogic of the argument Kleinbard is making here. If we don't like the fact that U.S. firms are finding merger partners who contribute just over 20 percent to the combination, which is where Congress set the bar, and we decide to reduce that to just over 50 percent, then all that will happen is that deals will be done so as to keep the percentage of the deal owned by former shareholders of the U.S. merger partner just below 50 percent (rather than just below 80 percent). After a lot of these deals get done, everyone will get all riled up again and want to reduce the percentage to, I don't know, maybe 25 percent. And so on and so forth until we ban foreign purchases of U.S. businesses altogether. The real issue isn't the percentage threshold -- it's the purpose of the combination. And the solution isn't to reduce the percentage threshold -- it's to deal with the tax reasons companies are inverting.

The popular press, Congress, the administration, and Kleinbard seem to have lost sight of the fact that the "remedy" for a prohibited inversion at an 80 percent threshold -- treating the foreign acquiring corporation as a U.S. corporation for all
purposes of the code -- is draconian, and something that the United States should not take lightly. This is presumably why Congress chose the relatively high 80 percent threshold. But now imagine what would occur in the real world if we reduced that threshold to 50 percent.

When the merger of Daimler and Chrysler was announced many years ago, it appeared at first that Chrysler might be larger than Daimler, thereby implicating section 367(a). Although this eventually proved not to be the case, it was a close call. Under Kleinbard's proposal, that close call could be an inversion, with the result that we treat Daimler Benz as a U.S. corporation for all purposes of the code. Does anyone really believe that Germany or any other country would accept such a result?

The suggestion that we adopt a 50 percent threshold is particularly ludicrous given that section 7874 applies without reference to the residence of the U.S. company's shareholders. While section 367(a) generally applies only when U.S. shareholders end up with more than 50 percent of the combined entity, section 7874 counts all shareholders of the U.S. combining entity, even if all of them reside outside the United States. Thus, the jurisdictional basis for treating the foreign acquirer as a U.S. corporation is already extremely attenuated. It is also important to keep in mind that the IRS has already expanded section 7874 very far from where Congress left it, by refusing to take into account in the denominator of the ownership fraction any stock of the foreign acquirer issued for cash. Although the rationale for this rule is to avoid stuffing, there is no exception for deals where cash is integral to the business plan, as many bona fide deals are.

Consider how a plain vanilla cross-border merger gets structured from a tax perspective. When the tax lawyers are contacted about the pending deal, the first thing they do is get in a room and talk about who gets to be on top. The U.S. company? The foreign one? Or some new holding company set up in a neutral jurisdiction? The reason that this is what the tax lawyers spend nearly all their time talking about is that it matters a lot, from a tax perspective, who is on top.

The great majority of planned inversions feature a new company on top. That new company is never domestic, and that seems to be what is bugging Kleinbard and others. But what we have to acknowledge is that the company on top was almost never going to be in the United States, even back in the stone age before anyone was talking about inversions. To put a U.S. company on top of a true multinational makes no sense, given that only the United States has rules like subpart F and section 956. And the current hysteria over inversions, leading to the fear that Congress will act to shut the door even more tightly against foreign combinations, only increases the need to put the top company outside of the U.S. tax net. What we have here is a self-fulfilling prophesy.

Ultimately, Kleinbard does ask the right question -- why now? If cross-border combinations have been going on for decades, why does it seem that today they are being disproportionately structured to fall just under the 80 percent threshold? There are probably a number of factors that are contributing to the current trend, some of which he mentions in his article. But I would suggest that the main reason for the "tsunami" has been completely overlooked in the literature on this subject: the IRS's consistent history of broadening section 7874 considerably beyond what was originally intended. The result has been to define many completely innocent cross-border combinations as "inversions" potentially subject to the draconian remedy of section 7874. Most of us practicing in this area spend more time counseling "innocent" combining entities how to avoid the inadvertent application of these rules than we do planning into them advertently. We all have to structure ever more carefully around these increasingly arbitrary rules, making everything look structured even if the deal would have been done regardless of tax benefits.

On top of this, the IRS's pattern of announcing fundamental and unexpected changes to the section 7874 rules out of the clear blue sky makes taxpayers and their advisers anxious to get these deals done as soon as they can. The media have certainly played their part in whipping up a frenzy of activity; if nothing else, Tax Notes should take the lead on disabusing the now-prevalent myth that inversions involve the U.S. company disappearing into a foreign one. An inversion does not involve a redomestication or substituting a foreign corporation for a U.S. one; it involves putting a new foreign holding company on top of an existing U.S. corporation. The U.S. corporation remains in existence as a subsidiary, fully subject to U.S. tax on its worldwide income as before, and owning the same CFCs subject to subpart F that it owned before.

So in terms of where to set the ownership threshold -- I think we should declare victory and go home. Section 7874 has achieved its goal of putting a stop to single-company inversions of U.S. companies, which can still be done in other countries (and are in fact done quite routinely). The fact that deals can still happen below that threshold should not be news at all -- and certainly not fodder for several articles every week. If Kleinbard and others want to change the rules that apply to foreign-parented corporations, go for it. But we don't need more anti-inversion rules.

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FOOTNOTES

1 Kleinbard, "'Competitiveness' Has Nothing to Do With It," Tax Notes, Sept. 1, 2014, p. 1055.
2 For a discussion, see Staffaroni, "Size Matters: Section 367(a) and Acquisitions of U.S. Corporations by Foreign Corporations," 52 Tax Law. 523 (1999).

3 Reg. section 1.367(a)-3(c)(1).