ECONOMIC ANALYSIS

Lessons From the Last War on Inversions

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I don’t approach retroactivity in legislation lightly, but corporations must understand that they won’t profit from abandoning the U.S.

Senate Finance Committee Chair Ron Wyden, D-Ore., May 9, 2014

If too many U.S. companies are able to shift their legal residence to foreign locations, the whole U.S. system of worldwide taxation could unravel.

If firms comprising a significant portion of an industry in the United States become legally domiciled outside it, they will enjoy tax advantages not available to their domestically domiciled competitors. The domestic firms left behind will justifiably cry foul and seek relief from Congress. If Congress doesn’t provide that relief, the domestic companies will seek foreign merger partners.

Congress can respond to the threat of inversions by either restricting tax relief made possible by inverting (as it did in 2004 when it enacted code section 7874) or by reducing the tax burden on domestically domiciled firms (as it might if it reformed the international tax system with a low tax rate on foreign-source income and the elimination of the lockout of foreign profits).

Congress can respond to the threat of inversions by either eliminating tax relief made possible by inverting or by reducing the tax burden on domestically domiciled firms.

On May 20 Sen. Carl Levin, D-Mich., introduced anti-inversion legislation (S. 2360) that takes the first approach. The bill adopts President Obama’s approach whereby newly merged entities would have at least 50 percent new ownership to avoid being treated as domestic corporations, and it would remain in effect for two years. His brother, House Ways and Means Committee ranking minority member Sander M. Levin, D-Mich., introduced similar legislation (H.R. 4679) without a sunset date. In a May 9 op-ed in The Wall Street Journal, Senate Finance Committee Chair Ron Wyden, D-Ore., put companies on notice that he was committed to imposing tougher anti-inversion rules on deals done after May 8, 2014. Both Levin bills follow Wyden’s suggestion and use May 8 as their effective date. (Related coverage: p. 876.)

The introduction of these bills was prompted by the attempt of U.S.-based Pfizer Inc. to merge with U.K.-based AstraZeneca PLC and legally domicile the headquarters of the merged entity in the United Kingdom. The proposed deal is just the latest and most prominent example of tax-motivated cross-border merger activity that moves the legal headquarters of large businesses or business components out of the United States. (See table on p. 866.) Even though the proposed Pfizer-AstraZeneca deal seems likely to fall apart — AstraZeneca has rejected three Pfizer offers (Financial Times, May 20) — it is by no means clear that the recent rise in the number of inversions has been slowed. (Related coverage: p. 878.)

Should investment bankers looking at possible cross-border acquisitions hit the pause button? After all, if anti-inversion legislation is enacted and the May 8 effective date holds, most or even all of the tax benefits of prospective deals may be lost. On the other hand, Congress may not pass anti-inversion legislation for years, and if legislation is enacted there is a good chance that it would have the effective date pushed later than May 8, 2014. In that case, dealmakers should hurry and get transactions done.

The last round of anti-inversion debate and legislation from Congress might provide insights into what businesses can expect this time.

Stemming the Tide

In February 2002 a flurry of press reports about several prominent U.S. corporations moving their legal headquarters to tax havens abruptly put corporate expatriations at the top of the tax policy agenda. For example, on February 18, 2002, David Cay Johnston reported in The New York Times that Stanley Works, Tyco International Ltd., Global Crossing Ltd., Ingersoll Rand, Foster Wheeler Ltd., Nabors Industries Ltd., and Cooper Industries had completed or were considering legal restructurings that would put their corporate headquarters in Bermuda.

On February 28 Treasury announced that it would study corporate expatriations. “We are seeing a marked increase in the frequency of the transaction announcements and an increase in the size of the transactions,” said Treasury Assistant Secretary for Tax Policy Mark Weinberger in a release. “The inversion transactions are no longer isolated occurrences.” Treasury was more worried about future deals than those that had been already announced.

Between March 6 and March 21, four anti-inversion bills were introduced in Congress. All would treat the new foreign parent of an inverted entity as a domestic corporation for federal tax purposes if shareholders of the original U.S. entity
owned some significant portion (either 80 or 50 percent) of the new foreign parent. The three Democratic bills — from Rep. Jim Maloney (H.R. 3892), from Sen. Paul Wellstone (S. 2050), and, most prominently, from Rep. Richard E. Neal of Massachusetts (H.R. 3884, with 152 cosponsors) — would apply to all specified inverted entities regardless of the date the inversion transaction was completed. The provisions of H.R. 3857 introduced by Republican Rep. Scott McInnis would apply only to transactions completed after December 31, 2001.

Even more threatening than these bills to prospective inverters was the statement at a March 21 Finance Committee hearing by then-ranking minority member Chuck Grassley, R-Iowa:

From what I have seen, these deals look like shams. I have also heard there may be an effort to rush these deals to market before Congress cracks down on them. Let me be clear to everyone developing or contemplating one of these deals — you proceed at your peril. Let me repeat that. Anybody thinking about rushing into an inversion transaction proceeds at their peril.

On April 11 Grassley and then-Senate Finance Committee Chair Max Baucus introduced the Reversing the Expatriation of Profits Offshore Act (S. 2119, commonly known as the REPO bill). For transactions completed after March 20, 2002, in which former U.S. shareholders owned more than 80 percent of the new foreign corporation, the new foreign corporation would be considered a U.S. corporation for tax purposes. For transactions completed after March 20 that resulted in original U.S. shareholders owning between 50 and 80 percent of the new foreign parent’s stock, and transactions completed before March 21, 2002, and after December 31, 1996, that resulted in original U.S. shareholders owning more than 50 percent of the new foreign parent’s stock, the new foreign entity would remain a domestic corporation but would have its tax benefits limited. These new limits included tighter rules for inverted corporations.

On the House side, Republicans led by then-Ways and Means Committee Chair William M. Thomas would have preferred a go-slow approach to the inversion issue. Consistent with the views of the Bush Treasury, House Republicans viewed the phenomenon primarily as a catalyst for international tax reform that would move the United States toward a territorial system.

Nevertheless, Neal and House Democrats were not going to relent on an issue that was a winner for them with voters. On May 14 Neal temporarily usurped Republican efforts to get a floor vote on marriage penalty relief when he proposed using his expatriation proposal as a revenue offset. The leadership overcame this hiccup, but Neal established a legislative tactic that would become common practice over the next two years. Whenever the opportunity arose, especially if a revenue raiser was needed, Democrats would insert anti-inversion legislation into the mix. And in response, Republican leadership would do everything they could to block an embarrassing vote.

On May 16 Treasury issued its report on inversions. “Measures designed simply to halt inversion activity may address these transactions in the short run, but there is a serious risk that measures targeted too narrowly would have the unintended effect of encouraging a shift to other forms of transactions to the detriment of the U.S. economy in the long run,” it said.

Republican Ways and Means Committee member Nancy Johnson introduced the Uncle Sam Wants You Act of 2002 (H.R. 4756). It was similar to the Neal bill except it applied only to transactions completed after September 11, 2001, and before December 31, 2003. The sunset date was meant to spur Congress to action on a long-term solution.

On June 18 the Senate Finance Committee approved the REPO bill by voice vote. It provided $2.1 billion of revenue to pay for additional tax breaks for charities in the CARE Act (H.R. 7). But neither the REPO bill nor H.R. 7 received any consideration on the Senate floor in 2002.

**Thomas Joins the Fray**

On July 11, 2002, Thomas introduced a package of international tax changes long sought by business lobbyists with his American Competitiveness and Corporate Accountability Act of 2002 (H.R. 5095). To offset some of the cost of these benefits, the bill included an anti-inversion provision. Like the Baucus-Grassley bill, the Thomas bill treated some inverted businesses as U.S.-headquartered for tax purposes and significantly reduced the tax benefits for inversions for others. In particular, it included some tightening of earnings stripping rules for inverted corporations.
The most notable difference between the Thomas proposal and the REPO bill was the effective date. H.R. 5095 applied only to transactions completed after March 20, 2002. And, consistent with the recommendation of the New York State Bar Association, Thomas made his provision temporary, applying only to transactions completed before March 20, 2005. Lack of support from both parties prevented Thomas from even moving the bill out of his committee.

Some Deals Stop, Others Go

While all this was happening in Washington, three oil drilling companies in Texas were completing inversion restructurings. On April 30, 2002, Noble Drilling, a Delaware corporation, transformed into Noble Corp. of the Cayman Islands. On June 24, 2003, Nabors Industries changed its place of incorporation from Delaware to Bermuda. On June 26, 2002, Weatherford International Inc. of Delaware became Weatherford International Ltd. of Bermuda. The oil drillers were willing to take their chances with the effective dates proposed so far. If enacted, the REPO bill and the anti-inversion provisions of H.R. 5095 would have applied to all three of these transactions.

Not only was the approach advocated by Ensco rejected, its competitive disadvantage was made worse when the effective date of anti-inversion legislation was moved forward.

But not everybody was so bold. On August 1 New Britain, Connecticut-based toolmaker Stanley Works announced it was abandoning its plans to reincorporate in Bermuda. More than any other deal, it was Stanley Works’ proposed move that generated the largest public outcry. Stanley Works cited the “growing prospect of tax legislation” as a reason for its decision. Undoubtedly, another factor was the huge amount of negative publicity.

On September 23 and 27, Carl F. Thorne, chair of Ensco International Inc., wrote to Treasury and complained about the laxity not only of Thomas’s March 20, 2002, effective date but also of the REPO bill’s 1997 effective date for some inversion transactions. He urged that any anti-inversion legislation be “made retroactive without limitation” in order not to “punish companies like Ensco for having remained U.S. companies in the wake of corporate inversions by competitors.”

Not only was the approach advocated by Ensco rejected, its competitive disadvantage was made worse when the effective date of anti-inversion legislation was moved forward. Ultimately Ensco was able to remedy its problem with self-help rather than by lobbying. In December 2009 Ensco re-domiciled to the United Kingdom and avoided the provisions of section 7874 by establishing a substantial presence in the United Kingdom, which included moving its executives there.

A New Congress

Republicans retook the Senate in November 2002, clearing the path for a major tax cut. On May 28, 2003, President Bush signed into law the $350 billion Jobs and Growth Tax Relief Reconciliation Act (JGTRRA). It was enacted as part of a budget reconciliation process that required only a simple majority in the Senate. During the deliberations on JGTRRA, House Republicans flatly refused to consider revenue-raising offsets. The Senate bill had contained 46 pay-fors, but none made it into the final legislation.

On February 12, 2003, Neal reintroduced his anti-inversion legislation (H.R. 737). Many other House bills were to be introduced in the 108th Congress that also would treat all inverted corporations as domestic regardless of how far in the past the inversion transactions were completed. They included three bills introduced by House Ways and Means Committee ranking minority member Charles B. Rangel, D-N.Y.: the Taxpayer Fairness and Protection Act of 2003 (H.R. 1661), the Jobs and Growth Reconciliation Act of 2003 (H.R. 2046), and the Working Families Tax Credit Act of 2003 (H.R. 2286). Other bills that included Neal’s anti-inversion provisions were the Rebuild America Act (H.R. 2615), introduced by Democratic Rep. Jerry Costello and the American Workers and Manufacturers Support Act (H.R. 2615), introduced by Rep. John B. Larson, D-Conn.


Moving the Effective Date

On March 5 the House Rules Committee was considering the treatment of the Armed Forces Tax Fairness Act of 2003 (H.R. 878) and added an anti-inversion amendment. The amendment was the bare minimum. Only inversion deals in which 80 percent or more of the shareholders of the new foreign corporation had been shareholders of the original domestic corporation would be affected. In that case, the new foreign corporation would be
considered domestic. No other limitation on tax benefits for deals with smaller ownership changes was included. And the provision was temporary; it did not apply to deals completed after December 31, 2004. Most importantly, the effective date of the legislation was moved to deals completed after March 4, 2003.

H.R. 878 made no further progress in the House. The Republican-led effort to gain approval for the amended bill backfired after Democrats charged that it would permanently grandfather the two dozen corporate expatriates that had already left the country. “There’s been some concern [from members] about the negative press,” John Feehery, spokesman for Republican House Speaker J. Dennis Hastert, said. Several of these companies, Democrats pointed out, had their physical headquarters in the congressional district represented by House Majority Leader Tom DeLay.

Although the initial effort may have failed, the newly proposed effective date would not fade away. It emerged a second time on April 3 when Ways and Means marked up the Energy Tax Policy Act (H.R. 1531). Basically, the committee inserted the same provision that had been added to the armed forces tax bill. The amendment was approved by a 24-12 vote. H.R. 1531 would be attached to an omnibus energy bill that passed the House, but it would die in conference.

The March 4, 2003, effective date would surface for a third time on July 25 when Thomas introduced the American Jobs Creation Act of 2003 (H.R. 2896). The anti-inversion provisions of this bill were considerably different from House Republicans’ two prior efforts. Under the new approach, all inversions completed after March 4, 2003, would not be treated as domestic corporations but would be subject to a special gain recognition rule. All inversions completed after December 31, 1996, would be subject to tougher earnings stripping rules under section 163(j). The Joint Committee on Taxation estimated that over 10 years, the extra tax on inversion gain would raise $340 million and the new limits on interest deductions would raise approximately $2.8 billion. The Ways and Means Committee approved H.R. 2896 by a 24-15 vote on October 28, 2003, but there would be no further action on the bill in 2003.

On October 1, 2003, the Finance Committee under the leadership of Grassley approved the Jumpstart Our Business Strength Act (S. 1637) by a 19-2 vote. The bill included an anti-inversion provision similar to the original Baucus-Grassley REPO bill, but it would get no further consideration in 2003.

2004

In 2004 House Democrats continued their efforts to get a vote on Neal’s retroactive anti-inversion proposal. They knew that obtaining approval of this provision was highly unlikely, but they benefited by repeatedly putting Republicans into the uncomfortable position of blocking legislation that was popular with the public. On May 12, during House floor debate on a healthcare bill (H.R. 4279), Democratic Rep. Fortney Pete Stark offered an amendment that included Neal’s provision. It failed. Rep. Jim McCrery explained the House Republicans’ position on retroactivity:

Maybe a little over half of the revenue that would be produced by the Democratic substitute is produced by a retroactive application of a change in the law which would affect companies that made a determination which was legal 30 or 40 years ago. And I do not know of anyone who thinks that that is a fair result, to impose suddenly a penalty on a company that in good faith operated under a law 30 or 40 years ago and has been operating that way ever since. So I would hope that this body would not suddenly choose to use a punitive, retroactive change in the law to penalize companies operating in good faith for decades under the United States Tax Code.

On June 4 Thomas introduced a second version of his American Jobs Creation Act (H.R. 4520). It was approved by the Ways and Means Committee on June 10 and by the entire House on June 17. The big difference between this new version and the 2003 version on expatriations was that Thomas dropped the part of his plan that would have tightened earnings stripping rules. This provision was strongly opposed by business groups, like the National Association of Manufacturers and the U.S. Chamber of Commerce. As a result of the deletion, the official estimated 10-year revenue increase from the Thomas anti-inversion legislation dropped from $3.1 billion to $400 million. And by dropping the earnings stripping provisions, inversions completed after March 4, 2004, were completely left out the bill.

Corresponding legislation moved on a parallel track in the Senate. Again, the Senate bill incorporated anti-inversion rules similar to those found in the original Baucus-Grassley REPO bill.

In conference, all provisions that applied to transactions completed before March 21, 2003, were excluded. All provisions that would strengthen the earnings stripping rules of section 163(j) were dropped. On October 22 Bush signed into law the American Jobs Creation Act of 2004, which added section 7874, incorporating elements of both the House and Senate final bills. If the continuing
ownership of historical shareholders of the domestic corporation in the foreign acquiring corporation is 80 percent or more, section 7874 follows the Senate bill in that it treats newly inverted foreign corporations as domestic corporations for tax purposes. If the continuing shareholder ownership is at least 60 percent but less than 80 percent, section 7874 follows the House bill in that the foreign status of the new corporation is respected but other adverse tax consequences apply.

The Future
Several authors correctly predicted that inversion activity would increase despite the considerable obstacles imposed by section 7874:

Section 7874 is widely believed to have had a severe chilling effect on inversions of publicly held corporations, but these inversions may stage a comeback. In addition to potentially increased tax costs due to new international tax rules, factors such as . . . rapid growth in foreign markets might lead to more inversions in the future. (Jefferson VanderWolk, “Inversions Under Section 7874 of the Internal Revenue Code: Flawed Legislation, Flawed Guidance,” Northwestern Journal of International Law and Business, 2010, p. 3.)

Since section 7874 was enacted, corporate inversions have attracted less attention. But this may change in the near future . . . . High tax rates and worldwide taxation policies may make the U.S. a less attractive headquarters location. Moving abroad might be an escape route more will consider, and there are still ways this can be accomplished, despite section 7874 and supporting Treasury regulations. (Stuart Webber, “Escaping the U.S. Tax System: From Corporate Inversions to Re-Domiciling,” Tax Notes Int’l, July 25, 2011, p. 273.)

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 [multinational corporations], not U.S. MNCs, as U.S. MNCs reach reasonably foreseeable events in their life cycles. (Bret Wells, “Cant and the Inconvenient Truth About Corporate Inversions,” Tax Notes, July 23, 2012, p. 429.)

Does the threat of tougher anti-inversion rules change any of this? Let’s consider three scenarios.

Scenario 1: Credible threat. If there were a forceful bipartisan announcement from taxwriters in both chambers of Congress that inversion deals completed after the date of announcement would be shorn of all tax benefits and that Congress was expected to pass this legislation sometime in the foreseeable future, tax-motivated cross-border mergers in the pipeline would be shut down. In this case, the credible threat of retroactive legislation is a powerful force. Note, however, that cross-border deals whose economics do not hinge on tax benefits from the merged entity domiciling outside the United States will still occur.

Scenario 2: Next to nothing happens. If future legislation with a retroactive effective date lacks broad congressional support, some prospective deals may be derailed, but the risk of a retroactive effective date is small enough that those deals with big profit potential will proceed. Note that Pfizer was still bidding for AstraZeneca on May 20, after Wyden announced his intention to enact tougher rules. However, for this steady-as-she-goes scenario to continue, the pace of deals cannot gain so much speed that they attract widespread attention from the nonbusiness news media and the general public.

Scenario 3: Pace of deals accelerates. If for whatever reason there are more inversion deals of prominent companies, the situation could become unstable. If there is a loud public outcry about unpatriotic U.S. businesses, if firms that do not or cannot invert believe their relatively tax-disadvantaged situation is no longer tolerable, and if projected corporate revenue losses threaten to enlarge future deficits, it may be impossible for Republicans to maintain their subdued approach on inversions. To stem the tide, they might have to concede that a stopgap anti-inversion law with a retroactive effective date may be necessary until international tax reform can be enacted.

The situation in 2002 most resembled the first scenario. There was a strong adverse public reaction to seemingly disloyal firms renouncing their U.S. residency. Democrats and Senate Republicans were strongly committed to act, and although House Republicans were lukewarm, they were careful not to appear to be defenders of inverting corporations. It is worth noting that even in this environment, House Republicans were able to prevail on a much later effective date.

The situation in 2014 looks more like scenario 2. The public outcry is not nearly as strong, and congressional response is much more tepid. Significantly, on May 20, Wyden, the most powerful supporter for new anti-inversion legislation, stated that he wanted international tax reform, now with a stand-alone bill. (Related coverage: p. 876.) Because international tax reform is probably years away and perhaps even impossible, Wyden has clearly signaled that there is no need for urgent action on
inversions. There is a total lack of interest among Republicans in addressing inversions unless it is part of international tax reform. This is a far cry from the leadership on anti-inversion legislation Grassley provided last time.

The wild card is the future of cross-border mergers and acquisitions. If the Pfizer-AstraZeneca deal collapses and no other high-profile inversions emerge, the inversion kerfuffle may just fade away. But it is hard to believe that corporate America can permanently resist the temptation to invert as opportunities to do deals with foreign partners arise.

The underlying tax advantages of being a foreign corporation — the ability to strip profits out of the United States, the lower rate of tax on passive income, the freedom to use future non-U.S. earnings to pay dividends, repurchase shares, and purchase U.S. businesses — are not going away. If anything, they are likely to grow. So it would be no surprise if the Levins’ legislation is just the beginning of a whole new round of congressional efforts to clamp down on corporate expatriation.

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**Some Recent Completed and Proposed Corporate Migrations Out of the United States**

### A. Completed Deals

<table>
<thead>
<tr>
<th>Date of Completion</th>
<th>U.S. Company</th>
<th>Foreign Company</th>
<th>Residence of New Company</th>
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<tr>
<td>Sept. 28, 2010</td>
<td>Valeant Pharmaceuticals Intl.</td>
<td>Biovail Corp. (Canada)</td>
<td>Canada</td>
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<tr>
<td>Sept. 16, 2011</td>
<td>Alkermes Inc.</td>
<td>Elan Drug Technologies (Ireland)</td>
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<td>Jan. 18, 2012</td>
<td>Jazz Pharmaceuticals PLC</td>
<td>Azar Pharma Inc. (Ireland)</td>
<td>Ireland</td>
</tr>
<tr>
<td>June 15, 2012</td>
<td>Tronox mineral sands</td>
<td>Exxaro mining (South Africa)</td>
<td>Australia</td>
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<td>June 15, 2012</td>
<td>D.E Master Blenders</td>
<td>Joh. A. Benckiser GmbH (Netherlands)</td>
<td>Netherlands</td>
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<tr>
<td>Sept. 28, 2012</td>
<td>Pentair Ltd.</td>
<td>Tyco Flow Control (Switzerland)</td>
<td>Switzerland</td>
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<tr>
<td>Nov. 30, 2012</td>
<td>Eaton Corp.</td>
<td>Cooper Industries (Ireland)</td>
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<td>Feb. 28, 2013</td>
<td>Endo Health Solutions Inc.</td>
<td>Paladin Labs Inc. (Canada)</td>
<td>Ireland</td>
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<td>June 7, 2013</td>
<td>Liberty Global PLC</td>
<td>Virgin Media Inc. (U.K.)</td>
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<td>Oct. 1, 2013</td>
<td>Actavis PLC</td>
<td>Warner Chilcott (Ireland)</td>
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<td>Dec. 18, 2013</td>
<td>Perrigo Co.</td>
<td>Elan Corp PLC</td>
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<td>Mar. 19, 2014</td>
<td>Cadence Pharmaceuticals Inc.</td>
<td>Mallinckrodt Pharmaceuticals (Ireland)</td>
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### B. Prospective Deals

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<th>Foreign Company</th>
<th>Residence of New Company</th>
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<td>Feb. 18, 2013</td>
<td>Forest Laboratories Inc.</td>
<td>Actavis PLC (Ireland)</td>
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<td>Sept. 26, 2013</td>
<td>Applied Materials Inc.</td>
<td>Tokyo Electron Ltd. (Japan)</td>
<td>Netherlands</td>
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<td>Mar. 10, 2014</td>
<td>Chiquita Brands Intl.</td>
<td>Fryles PLC (Ireland)</td>
<td>Ireland</td>
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<tr>
<td>Mar. 19, 2014</td>
<td>Horizon Pharma Inc.</td>
<td>Vidara Therapeutics Intl. (Ireland)</td>
<td>Ireland</td>
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<tr>
<td>Apr. 7, 2014</td>
<td>Questcor Pharmaceuticals</td>
<td>Mallinckrodt Pharmaceuticals (Ireland)</td>
<td>Ireland</td>
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<tr>
<td>Apr. 28, 2014</td>
<td>Pfizer Inc.</td>
<td>AstraZeneca PLC (U.K.)</td>
<td>U.K.</td>
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<td>May 5, 2014</td>
<td>Merck consumer care unit</td>
<td>Bayer AG (Germany)</td>
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<tr>
<td>May 8, 2014</td>
<td>Mondelez Intl. coffee unit</td>
<td>D.E Master Blenders (Netherlands)</td>
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