To the Editor:

A recent article by Mindy Herzfeld, "What Can Treasury Do About Inversions?" *Tax Notes*, Aug. 25, 2014, p. 895, overlooks a simple and sensible alternative available to the Treasury Department that is not of questionable legality. Treasury could submit a proposal to Congress to redefine a corporation's "residence" for tax purposes -- which determines whether the entire panoply of U.S. tax rules applies to it -- based on the location of the enterprise's principal customer base.

This idea is stimulated by the recent decision by Walgreens to back away from its contemplated corporate inversion. Had Walgreens inverted, it would have gained important tax benefits but might have lost U.S. market share. Prospective customers who viewed an inversion as "unpatriotic" might have begun patronizing instead one of the company's competitors. This possibility was presumably one of the factors influencing the company's decision.

But if this worry was meaningful enough to change Walgreens' mind, why not make it the controlling factor for all corporations? Companies whose principal customers are in the United States would be treated as U.S. residents for tax purposes, no matter how cleverly lawyers devise the corporate and financial structure of the organization.

This idea has a number of advantages. First, the mere proposal of this rule by the administration -- with an effective date as of the date of announcement -- would put an immediate halt to virtually all contemplated inversion activity. Throughout the period Congress fiddles with the proposal, the prospect of change would create too much tax risk for companies with any significant amount of U.S. business to move forward with their plans. This lull would buy valuable time to develop (and maybe pass) meaningful tax reforms to change the calculus of inversion activity. Much better to stop inversions in this way than to exercise questionable regulatory authority (of dubious policy coherence) to achieve that end.

Second, the idea is prudent. Increasing the tax cost of an inversion might actually induce more such activity as companies seek to escape from just one more draconian U.S. tax rule. Other ways of redefining a corporation's residence -- such as determining it based on the location of the company's headquarters personnel -- might also backfire. The United States would be hurt if too many corporate leaders shifted their residence abroad to enable their companies to skirt this tax rule. But it's hard to imagine very many enterprises being willing to give up U.S. market share simply to gain a tax advantage. Again, the Walgreens' experience may be instructive.

Third, the test is fair to competing businesses. If Walgreens had inverted, it might have disadvantaged CVS and other competitors unless they took similar action. Likewise, the rumored inversion by Burger King might cause a shake-up in the tax profiles of companies in that industry. Assuming, however, that Walgreens and its
major competitors -- and Burger King and its principal competitors -- all have mostly U.S.-based customers, none of them would be able to invert under the proposed rule, no matter how aggressive their corporate management might be.

Fourth, the proposed rule would target and stop inversions by exactly the enterprises posing the greatest risk to the fisc. Since the location of a company's customers may be indicative of the source of its income, the rule directly addresses the principal risk of corporate inversions -- loss of the U.S. corporate income tax base. The proposal also targets tax-driven inversions, as opposed to acquisitions impelled by non-tax exigencies that should be less affected by change of a tax rule.

Finally, the proposal has common-sense appeal. If businesses tap heavily into the U.S. consumer market in order to gain their profits, why shouldn't they be subject to the full range of U.S. tax rules? The proposal is certainly much more intuitive than defining tax residence based on a company's place of incorporation or other proposed ideas.

To be sure, determining the location of one's principal customer base may be a challenging exercise. But the problems should not be overstated. For many businesses, the answer will be obvious and straightforward if any reasonable statutory test is developed. A minority of multinational businesses would face uncertainty under the test, and would have the problem of a changing tax residence if the location of their customers shifted over time. One way to avoid some of these difficulties would be to require any company incorporated in the United States to be a U.S. resident for tax purposes, and apply the new test only to foreign-incorporated firms.

These and other issues could be resolved in elaborations of the statutory rule. And the time necessary to work out the details would again help to preserve the status quo until broader reforms could be passed.

According to Herzfeld's article, the Obama administration is currently contemplating what it can do on its own to prevent the possible tide of corporate inversion activity. The answer is to look to Walgreens' experience and propose a redefinition of corporate tax residence -- effective upon announcement -- based on the location of the business's principal customer base. The administration can act effectively "on its own" while still respecting the important role of Congress in the formation of tax policy.

Sincerely,

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Tax Analysts Information

Code Sections: Section 367(a) -- Transfers From the U.S.
Section 385 -- Interest as Stock or Indebtedness
Section 7874 -- Expatriated Entities and Foreign Parents
Section 163(j) -- Earnings Stripping
Section 956 -- CFC Earnings Investment

Jurisdiction: United States

Subject Areas: Expatriate taxation
Earnings and profits

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