

Corporate Expatriation, Inversions, and Mergers: Tax Issues

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Summary

News reports in the late 1990s and early 2000s drew attention to a phenomenon sometimes called corporate “inversions” or “expatriations”: instances where U.S. firms reorganize their structure so that the “parent” element of the group is a foreign corporation rather than a corporation chartered in the United States in order to reduce the effect of the U.S. corporate income tax. These corporate inversions apparently involved few, if any, shifts in actual economic activity from the U.S. abroad, at least in the near term. Bermuda and the Cayman Islands—countries with no corporate income tax—were the location of many of the newly created parent corporations, and tax savings were the principal objective.

These types of inversions largely ended with the enactment of the American Jobs Creation Act of 2004 (JOBS Act, P.L. 108-357), which denied the tax benefits of an inversion if the original U.S. stockholders owned 80% or more of the new firm. The Act effectively ended shifts to tax havens where no real business activity took place.

However, two avenues for inverting remained. The Act allowed a firm to invert if it has substantial business operations in the country where the new parent was to be located; the regulations at one point set a 10% level of these business operations. Several inversions using the business activity test resulted in Treasury regulations in 2012 that increased the activity requirement to 25%, effectively closing off this method. Firms could also invert by merging with a foreign company if the original U.S. stockholders owned less than 80% of the new firm.

Two features made a country an attractive destination: a low corporate tax rate and a territorial tax system that did not tax foreign source income. Recently, the UK joined countries such as Ireland, Switzerland, and Canada as targets for inverting when it adopted a territorial tax. At the same time the UK also lowered its rate (from 25% to 20% by 2015).

Recently, several high profile companies have indicated an interest in merging or plans to merge with a non-U.S. headquartered company, including Pfizer and Chiquita. Pfizer, for example, was interested in merging with a smaller British firm, AstraZeneca, and moving headquarters to the UK. For Pfizer, which has accumulated substantial profits in subsidiaries in low tax foreign countries that would be taxed if paid to the U.S. parent, the territorial tax system is likely the most important tax benefit from such a merger. This “second wave” of inversions again raises concerns about an erosion of the U.S. tax base.

Two policy options have been discussed in response: a general reform of the U.S. corporate tax and specific provisions to deal with tax-motivated international mergers. Some have suggested that lowering the corporate tax rate as part of broader tax reform would slow the rate of inversions. Although a lower rate would reduce the incentives to invert, it would be difficult to reduce the rate to the level needed to stop inversions, especially given revenue concerns. Others tax reform proposals suggest that if the United States moved to a territorial tax, the incentive to invert would be eliminated. There are concerns that a territorial tax could worsen the profit-shifting that already exists among multinational firms.

The second option is to directly target the merger inversions. The President’s FY2015 budget proposes to treat all mergers as U.S. firms if the U.S. firm’s shareholders have 50% or more ownership of the combined firm or maintains management and control in the United States. Similar legislation has also been introduced in the 113th Congress.

Contents

Introduction.....	1
U.S. International Tax System	2
Anatomy of an Inversion	2
Substantial Business Presence	2
U.S. Corporation Acquired by a Larger Foreign Corporation	3
A Smaller Foreign Corporation Acquired by a U.S. Corporation.....	3
Response to Initial Inversions: The American Jobs Creation Act.....	4
Post-2004 Inversions and Treasury Regulations.....	5
Policy Options	7
U.S. Corporate Tax Reform.....	8
Lower the Corporate Tax Rate	8
Adopt a Territorial Tax System	9
Tax Reform Proposals	9
Targeted Approaches	10
Concluding Thoughts	11

Contacts

Author Contact Information.....	11
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Introduction

The U.S. corporate income tax is based on worldwide economic activity. If all of a corporation's economic activity is in the United States, then tax administration and compliance is, relatively, straight-forward. Many corporations, however, operate in several jurisdictions, which creates complications for tax administration and compliance. Further, corporations may actively choose where and how to organize to reduce their U.S. and worldwide tax liabilities. Some of these strategies have been referred to as expatriation, inversions, and mergers. This report examines them in light of recent expansion of their use and growing congressional interest.

This report begins with a brief discussion of relevant portions of the U.S. corporate income tax system before examining how inversions were commonly structured. The report then looks at how Congress and Department of the Treasury have reduced the benefits of inversions. The report concludes with an examination of methods that remain to invert and policy options available to prevent or limit these inversions.

Achieving tax savings using an inversion became more difficult with the enactment of the American Jobs Creation Act of 2004 (JOBS Act, P.L. 108-357). The JOBS Act denied or restricted the tax benefits of an inversion if the owners of the new company were not substantially different from the owners of the original company. The Act also allowed a firm to invert only if it had substantial business operations in the country where the new headquarters was to be located.

Although the 2004 legislation largely prevented the types of inversions that drew attention prior to its adoption, several companies have successfully inverted in the past few years by using the substantive business operations mechanism or merging.¹ Treasury regulations have subsequently limited the former mechanism.²

Recently, several high-profile companies have indicated an interest in merging or plans to merge with a non-U.S. firm, including Pfizer, Chiquita,³ and Omnicom (an advertising firm).⁴ News reports indicate that a group of Walgreens investors is urging such a move.⁵ This "second wave"

¹ McKinnon, John D. and Scott Thurm, "U.S. Firms Move Abroad to Cut Taxes: Despite '04 Law, Companies Incorporate Overseas, Saving Big Sums on Taxes," *Wall Street Journal*, August 28, 2012, http://online.wsj.com/news/articles/SB10000872396390444230504577615232602107536?mod=WSJ_business_LeadStoryCollection&mg=reno64-sj&url=http%3A%2F%2Fonline.wsj.com%2Farticle%2FSB10000872396390444230504577615232602107536.html%3Fmod%3DWSJ_business_LeadStoryCollection; Bret Wells, "Cant and the Inconvenient Truth about Corporate Inversions," *Tax Notes*, July 23, 2012, pp. 429-439; Reuven S. Avi-Yonah, "Territoriality: For and Against," *Tax Notes International*, May 13, 2013, pp. 661-663.

² Treasury Decision, T.D. 9592, July 12, 2012.

³ It is worth noting that a company may invert even if it does not currently expect to pay U.S. tax. See *10K Filing of Chiquita Brands International, Inc. to the Securities and Exchange Commission*, March 31, 2009.

⁴ Richard Rubin and Zachary R. Mider, "Pfizer Bids for U.K. Address With U.S. Tax Revamp Stalled, Bloomberg," April 29, 2014, http://www.bloomberg.com/news/2014-04-29/pfizer-bids-for-u-k-address-as-u-s-tax-revamp-stalls.html?utm_content=buffer1c951&utm_medium=social&utm_source=linkedin.com&utm_campaign=buffer. Omnicom has recently abandoned its proposed merger.

⁵ Ameet Sachdev and Peter Frost, "Walgreen Pressured To Move Headquarters To Europe," *Chicago Tribune*, April 14, 2014, http://articles.chicagotribune.com/2014-04-14/business/chi-walgreens-headquarters-to-europe-20140414_1_walgreen-co-tax-rate-tax-deals.

of inversions again raises concerns about an erosion of the U.S. tax base. While the substantial business avenue appears to have been largely eliminated by new Treasury regulations that increased the required share of activity, the option of merging with a much smaller foreign company remains. U.S. firms may also merge with larger firms, although in this case the tax benefits are less likely to be key factors in the decision to merge.

U.S. International Tax System

The United States uses a system that taxes both the worldwide income of U.S. corporations and the income of foreign firms earned within U.S. borders. All income earned within U.S. borders is taxed the same—in the year earned and at statutory tax rates up to 35%.

U.S. corporate income earned outside the United States is also subject to U.S. taxation, though not necessarily in the year earned. This occurs because U.S. corporations can defer U.S. tax on active income earned abroad in foreign subsidiaries until it is paid, or repatriated, to the U.S. parent company as a dividend.⁶ To mitigate double taxation, tax due on repatriated income is reduced by the amount of foreign taxes already paid.

Income from certain foreign sources earned by subsidiaries—which generally includes passive types of income such as interest, dividends, annuities, rents, and royalties and is referred to as Subpart F income—is generally taxed in the year it is earned. Subpart F applies only to shareholders who may be able to influence location decisions at the corporate level.⁷

Anatomy of an Inversion

A corporate inversion is a process by which an existing U.S. corporation changes its country of residence. Post-inversion the original U.S. corporation becomes a subsidiary of a foreign parent corporation. Corporate inversions occur through three different paths: the substantial activity test, merger with a larger foreign firm, and merger with a smaller foreign firm.⁸ Regardless of the form of the inversion, the typical result is that the new foreign parent company faces a lower home country tax rate and no tax on the company's foreign-source income.⁹

Substantial Business Presence

In this form of inversion, a U.S. corporation with substantial business activity in a foreign company creates a foreign subsidiary. The U.S. corporation and foreign subsidiary exchange

⁶ CRS Report R40178, *Tax Cuts on Repatriation Earnings as Economic Stimulus: An Economic Analysis*, by Donald J. Marples and Jane G. Gravelle. Income from branches and passive income earned directly, such as interest and royalties, is taxed currently.

⁷ These stockholders are defined as owning at least 10% of a subsidiaries stock and only subsidiaries that are at least 50% owned by 10% U.S. stockholders.

⁸ The techniques corporations use to invert—stock-for-stock inversions, asset transfers, or drop-down inversions—apply to all forms of inversions. In drop-down inversions, assets are transferred to the new parent, and some of those assets are transferred to a domestic subsidiary.

⁹ William McBride, *Corporate Exits Accelerating, Taking Jobs with Them*, Tax Foundation, April 25, 2014, <http://taxfoundation.org/blog/corporate-exits-accelerating-taking-jobs-them>.

stock—resulting in each entity owning some of the other’s stock. After the stock exchange, the new entity is a foreign corporation with a U.S. subsidiary, as the exchange is generally in proportion to the respective company valuations. As this form of inversion does not require any change in the effective control of the corporation, it is referred to as a “naked inversion.”

U.S. Corporation Acquired by a Larger Foreign Corporation

In this form of inversion, a U.S. corporation would like to bolster its foreign operations and, perhaps, lower its U.S. tax. To do so, the U.S. corporation merges with a larger foreign corporation, with the U.S. shareholders owning a minority share of the new merged company. This results in the effective control of the new company being outside U.S. borders.

While this form of inversion may be driven by business considerations, tax considerations may also be part of the decision. An example of this can be seen in the following statement by the board of directors of a U.S. corporation recommending approval of a merger with a U.K. corporation. The board of directors pursued the merger in part because:

... Enesco 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.¹⁰

In this case, a U.S. firm, Pride, merged with a UK firm, Enesco, and the headquarters remained in the UK.

A Smaller Foreign Corporation Acquired by a U.S. Corporation

In this form of inversion, a U.S. corporation would like to bolster its foreign operations and lower its U.S. tax. To do so, the U.S. corporation merges with a smaller foreign corporation, with the U.S. shareholders owning a majority share of the new merged company. This merger results in the effective control of the new company staying with the shareholders of the U.S. corporations.

While this form of inversion may be driven by business considerations, tax considerations may also be part of the decision. An example is the Eaton Cooper merger. The following is an excerpt of a U.S. corporation’s (Eaton’s) press release announcing the acquisition of an Irish company (Cooper), with the company headquartering in Ireland (with a 12.5% tax rate and a territorial system).

At the close of the transaction ... Eaton and Cooper will be combined under a new company incorporated in Ireland, where Cooper is incorporated today. The newly created company, which is expected to be called Eaton Global Corporation Plc or a variant thereof (“New Eaton”), will be led by Alexander M. Cutler, Eaton’s current chairman and chief executive officer.¹¹

¹⁰ Enesco-Pride International Inc. Joint Proxy Statement, “Recommendation of the Pride Board of Directors and Its Reasons for the Merger,” April 25, 2011, <http://www.sec.gov/Archives/edgar/data/314808/000095012311039244/d80026b3e424b3.htm>.

¹¹ Eaton Corporation, “Eaton to Acquire Cooper Industries to Form Premier Global Power,” press release, May 21, 2012, http://www.eaton.com/ecm/groups/public/@pub/@eaton/@corp/documents/content/pct_361385.pdf.

At the close of the merger, it was expected that the shareholders of the U.S. company would control 73% of the combined company, with the shareholders of the Irish company controlling the remaining 27%. The press release notes expected tax benefits from the merger at \$165 million in 2016, out of \$535 million of total cost savings.

In this case, a U.S. corporation used a merger to achieve an inversion while its shareholders retained a significant majority of shares.

Response to Initial Inversions: The American Jobs Creation Act

In the late 1990s and early 2000s, news reports drew the attention of policymakers and the public to a phenomenon sometimes called corporate “inversions” or “expatriations”: instances where firms that consist of multiple corporations reorganize their structure so that the “parent” element of the group is a foreign corporation rather than a corporation chartered in the United States. Among the more high-profile inversions were Ingersoll-Rand, Tyco, the PXRE Group, Foster Wheeler, Nabors Industries, and Coopers Industries.¹²

These corporate inversions apparently involved few, if any, shifts in actual economic activity from the United States abroad, at least in the near term. In particular, inverted firms typically continued to maintain headquarters in the United States and did not systematically shift capital or employment abroad post inversion.¹³ Further, Bermuda and the Cayman Islands were the location of many of the newly created parent corporations—jurisdictions that have no corporate income tax but that also do have highly developed legal, institutional, and communications infrastructures.

A 2002 study by the U.S. Treasury Department concluded that while inversions were not new—the statutory framework making them possible has long been in existence—there had been a “marked increase” in their frequency, size, and visibility.¹⁴

Taken together, these facts suggested that tax savings were one goal of the inversion, if not the primary goal. Beyond taxes, firms engaged in the inversions cited a number of reasons for undertaking them, including creating greater “operational flexibility,” improved cash management, and an enhanced ability to access international capital markets.¹⁵

The 2002 Treasury report identified three main concerns about corporate inversions: erosion of the U.S. tax base, a cost advantage for foreign-controlled firms, and a reduction in perceived

¹² “While Companies Shift Addresses to Tax Havens, CEO’s Stay Put,” *Bloomberg Visual Data*, May 4, 2014, <http://www.bloomberg.com/infographics/2014-05-04/companies-shift-addresses-abroad.html>.

¹³ U.S. Government Accountability Office, *Cayman Islands: Business and Tax Advantages Attract U.S. Persons and Enforcement Challenges Exist*, GA-88-778, July 24, 2008.

¹⁴ U.S. Department of the Treasury, Office of Tax Policy, *Corporate Inversion Transactions: Tax Policy Implications* (Washington: May, 2002), p. 1.

¹⁵ These reasons are cited by Stanley Works in a February 8, 2002, press release. See also the November 2, 2001, proxy statement by Ingersoll-Rand (IR), which cites “a variety of potential business, financial and strategic benefits.” The statement is available on the IR website at <http://www.shareholder.com/ir/edgar.cfm?Page=2>.

fairness of the tax system.¹⁶ These concerns, along with a growing awareness of inversion transactions, may have resulted in congressional concern and debate about how to address the issues surrounding inversions, culminating with the enactment of an anti-inversion provision (Section 7874) in the American Jobs Creation Act of 2004 (AJCA; P.L. 108-357).

The AJCA adopted two alternative tax regimes applicable to inversions occurring after March 4, 2003. The AJCA treats the inverted foreign parent company as a domestic corporation if it is owned by at least 80% of the former parent's stockholders. In these cases, the AJCA would deny the firm any tax benefits of the inversion (i.e., it would continue to be taxed on the combined group's worldwide income). The second regime applies when there is at least 60% continuity of ownership but less than 80%. In this case, the new foreign parent is not taxed like a domestic corporation, but any U.S. toll taxes (taxes on gains) that apply to transfers of assets to the new entity are not permitted to be offset by foreign tax credits or net operating losses. The AJCA also exempted corporations with substantial economic activity in the foreign country from the anti-inversion provisions, but it did not define substantial business activity in the statute.¹⁷

Post-2004 Inversions and Treasury Regulations

Although the 2004 Act largely eliminated the generic naked inversions, two alternatives remained that allowed a firm to shift headquarters and retain control of the business: the naked inversion via the business activity exemption, and merger with a smaller company.¹⁸

Both of these approaches likely preclude direct use of tax havens such as the Cayman Islands. These small tax havens have very little economic activity. Using the business activity route would require significant economic operations in the target country. An inversion by merger would require a large firm that would be at least 25% of the size of the U.S. firm. As discussed below, these types of inversions generally target countries such as Ireland, Switzerland, and, more recently, the UK.

A report in the *Wall Street Journal* in August 2012 highlighted some recent moves abroad.¹⁹ This report claimed 10 companies had inverted, with 6 within the past year or so. This was a small number of companies, but it is useful to look at the methods involved. The *Wall Street Journal* article identified by name 5 of the 10 companies that had moved abroad recently—Aon, Ensco, Rowan, Eaton, and DE Master Blenders 1763—as among the recent ones to move. (The article also referred to Transocean and Weatherford International, but these were firms that had inverted prior to the 2004 legislation: Transocean first to the Cayman Islands, and then Switzerland, and Weatherford first to Bermuda, and then Switzerland).

An article by Bret Wells identified the first three of these firms as using the second form of naked inversion (where the only apparent objective is tax savings), relying on the exception in the anti-

¹⁶ U.S. Department of the Treasury, Office of Tax Policy, *Corporate Inversion Transactions: Tax Policy Implications*, May 2002, p. 21.

¹⁷ Treasury initially defined substantial business activity as being 10% of worldwide activity in regulation.

¹⁸ The third form of inversion, merger with a larger foreign corporation, would result in control moving outside the United States.

¹⁹ McKinnon, John D. and Scott Thurm, "U.S. Firms Move Abroad to Cut Taxes: Despite '04 Law, Companies Incorporate Overseas, Saving Big Sums on Taxes," *Wall Street Journal*, August 28, 2012.

inversion rules for firms that had substantial business activities.²⁰ All three moved to the United Kingdom, where a recent move to a territorial tax, as well as decisions in the European Court of Justice that limited their anti-abuse rules, had made their tax system more attractive.²¹ The UK was also in the process of lowering its own corporate rate. Two of the firms are oil drilling firms; drilling in the North Sea might have affected their ability to use this exemption. Aon is an insurance firm.

Wells also mentions another firm, Tim Hortons, which used the second form of naked inversion in 2009 to relocate to Canada. In doing so, the firm was returning to its origins, as it was founded in Canada. It became an American company when Wendy's acquired it in 1995, but it was subsequently spun off in 2006.²² DE Master Blenders 1763, like Tim Hortons, was returning to its origins as well (a Netherlands firm), as it was spun off from Sara Lee which had acquired it in 1978.²³

In response, Treasury Regulations (T.D. 9592, June 12, 2012) increased the safe harbor for the substantial business activities test from 10% to 25%, effectively closing off this avenue in the future.²⁴ This action could be done by regulation because the statute did not specify how the substantial business activity test was to be implemented.

The remaining firm mentioned in the *Wall Street Journal* article is Eaton. Eaton's move abroad was a merger; it merged with Coopers, a firm effectively operating its headquarters in the United States, but one that had inverted prior to the law change.

The post-2004 approaches to inversions no longer involved countries such as Bermuda and the Cayman Islands, but larger countries such as the UK, Canada, and Ireland. The UK, in particular, has become a much more attractive headquarters. Because of freedom of movement rules in the European Union, the UK cannot have anti-inversion laws, which may have played a role in both moving to a territorial tax and lowering the corporate tax rate.

A number of recent mergers have either been effectuated or are in process: Chiquita, Actavis, and Perrigo (the latter two are pharmaceutical firms) moving to Ireland; Valeant Pharmaceuticals and Endo Health Services moving to Canada; and Liberty Global (a cable company) to the UK. Subsequently, the new Irish firm Actavis (itself the result of two prior mergers) merged with Forest Labs.²⁵ Omnicom (an advertising firm) planned a move to the UK (after proposed merger

²⁰ Bret Wells, "Cant and the Inconvenient Truth about Corporate Inversions." *Tax Notes*, July 23, 2012, pp. 429-439.

²¹ Cadbury-Schweppes, September 12, 2006. The UK rule required that income subject to a tax rate much lower than the UK rates be taxed; this rule was not accepted by the court. See Cleary Gottlieb, "Cadbury Schweppes: UK CFC Rules Too Restrictive," <http://www.cgsh.com/files/News/9e29ed20-66c5-4558-93eb-dc8ab51c54c9/Presentation/NewsAttachment/2fcd202-5144-4e40-8498-dd0d04f99926/cadbury-schweppes.pdf>.

²² Tim Hortons, "The Story of Tim Hortons," http://search.yahoo.com/search;_ylt=A0oG7kHeX4VQXGkAjbVXNyoA?p=tim%20horton's%20inc.&fr2=sb-top&fr=yfp-t-701.

²³ DE Master Blenders 1753, "Our Heritage," 2012 (visited), <http://www.demasterblenders1753.com/en/Company/Our-heritage/>

²⁴ Bret Wells, "Cant and the Inconvenient Truth about Corporate Inversions." *Tax Notes*, July 23, 2012, pp. 429-439; Kristen A. Parillo, "Government Defends Business Activities Test in New Regs." *Tax Notes*, July 23, 2012, pp. 370-371.

²⁵ For news reports, see Zachary R. Mider "Companies Flee U.S. Tax System by Reincorporating Abroad," *Bloomberg*, January 27, 2014, <http://www.bloomberg.com/infographics/2014-01-27/companies-flee-u-s-tax-system-by-reincorporating-abroad.html> and "Companies Fleeing Taxes Pay CEOs Extra as Law Backfires," *Bloomberg*, January 27, 2014, <http://www.bloomberg.com/news/2014-01-27/companies-fleeing-taxes-pay-ceos-extra-as-law-backfires.html>. (continued...)

with a French firm, creating a Netherlands holding company, resident in the UK for tax purposes), but has abandoned its merger.²⁶

Most of these firms are not household names or industry giants. Thus, perhaps none has created as much interest as the attempt by pharmacy giant Pfizer to acquire AstraZeneca with a UK headquarters, or the urging of some stockholders of Walgreens to invert to Switzerland. Pfizer represents a significant potential loss of future tax revenue, as much as \$1.4 billion per year.²⁷ According to a recent study by Martin Sullivan, in 2005, when a temporary tax exclusion of 85% of dividends (the repatriation holiday) was in force, Pfizer repatriated \$37 billion, the single largest amount of repatriations of any firm.²⁸ In 2009, Pfizer repatriated \$34 billion (and paid U.S. taxes on that amount) to finance the acquisition of Wyeth, but earnings abroad grew from \$42 billion in 2009 (after the repatriation) to \$73 billion by 2012. These earnings have not been repatriated and taxed in the United States.²⁹ An inversion by Pfizer would, however, result in current shareholders paying capital gains taxes on any stock appreciation when they are converted into shares of the new company. Shares held in IRAs and 401(k)s would not typically owe this tax, but shares owned directly by individuals and in mutual funds would owe tax even if they did not sell their stock.³⁰

Treasury has continued to regulate inversions where regulations are possible. For example, it recently took action to close the Killer B-Helen of Troy loophole that allowed Liberty Global to shareholders to avoid some capital gains taxes.³¹

Policy Options

The AJCA was successful at limiting a form of inversions, at least initially. In particular, the AJCA stopped the practice of basic “naked inversions,” in which little activity or presence in the

(...continued)

“Actavis, Forest Labs In Biggest Merger In Specialty Pharma,” May 5, 2014, *Investors Business Daily* [http://www.marketwatch.com/story/publicis-omnicom-merger-tangled-in-tax-red-tape-2014-04-25](http://finance.yahoo.com/news/actavis-forest-labs-biggest-merger-223800951.html;_ylt=A0LEV1G3kWdT7jEAEgFXNyoA;_ylu=X3oDMTEyaGV0M2l0BHNIYwNzcgRwb3MDMwRjb2xvA2JmMQR2dGlkA1FJMDQ5XzE-; Tom Fairless, “Publicis, Omnicom Merger Tangled in Tax Red-Tape,” <i>Wall Street Journal</i>, April 25, 2014, <a href=).

²⁶ David Gelles, “At Odds, Omnicom and Publicis End Merger,” May 8, 2014, *New York Times*, <http://dealbook.nytimes.com/2014/05/08/ad-agency-giants-said-to-call-off-35-billion-merger/>.

²⁷ Zachary R. Mider, “Tax Break ‘Blarney’: U.S. Companies Beat the System With Irish Addresses,” *Bloomberg*, May 5, 2014, <http://www.bloomberg.com/news/2014-05-04/u-s-firms-with-irish-addresses-criticized-for-the-moves.html>.

²⁸ Martin A. Sullivan, “Economic Analysis: Pfizer’s Tax Picture Dominated by U.S. Losses, Repatriation,” *Tax Notes* July 8, 2013, <http://www.taxanalysts.com/www/features.nsf/Articles/8A8A34FCBD7C3C3F85257BA200497696?OpenDocument>.

²⁹ For a news article on the proposed Pfizer merger see Kevin Drawbaugh, Pfizer Move to Join Tax-Driven Deal-Making Raises Red Flags in U.S., *Reuters*, April 14, 2014, <http://www.reuters.com/article/2014/04/28/us-usa-tax-pfizer-analysis-idUSBREA3R1FL20140428>. For an article on Walgreens see, Ameet Sachdev and Peter Frost, “Walgreen Pressured to Move Headquarters to Europe,” *Chicago Tribune*, April 14, 2014, http://articles.chicagotribune.com/2014-04-14/business/chi-walgreens-headquarters-to-europe-20140414_1_walgreen-co-tax-rate-tax-deals.

³⁰ Laura Saunders and Jonathan D. Rockoff, “Pfizer Holders Could Face Tax Hit in a Deal for AstraZeneca,” *Wall Street Journal*, May 8, 2014.

³¹ IRS Notice 2014-14. See “IRS Aims at Innovative M&A Inversion Structure,” Sidley Austin LLP, at <http://m.sidley.com/04-29-2014-Tax-Update/>.

new jurisdiction is required and the new parent is domiciled in a tax haven. Further, through regulation, Treasury has limited the use of the substantial business activity test safe harbor to invert. Recent activity, however, suggests that mergers continue to be used as a vehicle for corporate inversions.

These more recent mergers are increasingly resulting in a UK parent company, due to policy decisions by the UK government. Specifically, the UK lowered its corporate tax rate and adopted a territorial tax system. In addition, anti-abuse provisions for foreign source income were weakened by the European Union courts. The UK has also proposed taxing certain intangible income at a 10% rate. (This is referred to as a patent box.)

To restrict the occurrence of tax motivated inversions, both a general reform of the U.S. corporate tax and specific provisions to deal with tax-motivated international mergers have been discussed.

U.S. Corporate Tax Reform

Interest in reforming the corporate income tax is longstanding,³² with recent interest calling for explicit accommodation of international concerns.³³ As noted earlier, two aspects of the U.S. corporate tax system are particularly relevant to corporate location decisions: the corporate tax rate and the taxation of foreign-source earnings. Taken together, these factors can yield a substantial reduction in taxes paid. In the case of the proposed merger of Forest Laboratories Inc. (a U.S. company) and Actavis (an Irish company), the tax reduction is estimated to be roughly \$100 million.³⁴ However, before examining proposals that address these concerns, a discussion of each separately is warranted.

Lower the Corporate Tax Rate

The U.S. corporate statutory tax rate is higher than both the average statutory rates of the other Organisation for Economic Co-operation and Development (OECD) countries and that of the 15 largest economies in the world.³⁵ This has led many to assert that the U.S. statutory tax rate needs to be lowered to reduce the incentive for inversion transactions.³⁶ While lowering the corporate tax rate would reduce the incentive to invert, there are reasons to suggest that it would be impractical to reduce the rate to the level needed to stop inversions. Namely, to stop inversions through a reduction in the corporate tax rate would require a U.S. corporate tax rate set equal to the lowest tax rate of a destination company, or zero.

A lower corporate tax rate would reduce the incentive for corporate inversions, primarily by reducing the tax rate applied to repatriated earnings.³⁷ For a company like Pfizer, with large

³² CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle.

³³ CRS Report RL34115, *Reform of U.S. International Taxation: Alternatives*, by Jane G. Gravelle.

³⁴ Forest Labs, *Acquisition of Forest Laboratories, Inc. by Actavis Plc Call*, February 18, 2014, <http://www.sec.gov/Archives/edgar/data/38074/000119312514058927/d679348d425.htm>.

³⁵ CRS Report R41743, *International Corporate Tax Rate Comparisons and Policy Implications*, by Jane G. Gravelle.

³⁶ Hank Gutman, Principal, Director of the Tax Governance Institute, KPMG LLP, *Changes in the Tax Law: How Are Effects Measured, and Who is Affected?*, May 2, 2014.

³⁷ A corporate rate reduction would also reduce taxes due on U.S. earnings. This is incidental to a corporation's incentive to invert or its competitiveness, because there is no difference of the taxation of U.S. earnings between U.S. and foreign corporations.

foreign earnings, a rate reduction could yield significantly lower taxes paid. However, as discussed below, the benefit of a lowered rate is negligible relative to the benefit to corporate taxpayers afforded by territorial tax systems, when income earned in low- or no- tax foreign jurisdictions is never subject to U.S. tax.

Two factors present challenges for lowering the corporate tax rate. First, if revenue neutrality is the goal, there may not be enough base broadening provisions with revenue offsets to provide deep cuts in the corporate tax; and, if such offsets were found, they might have their own consequences for investment. Of course reducing the corporate tax without corresponding base broadening would likely reduce corporate tax revenue, adding to chronic budget deficits.

Adopt a Territorial Tax System

The United States is one of the few countries that has a worldwide tax system and levies a tax on the foreign-source income of domestic corporations. Changing corporate tax residence to a country with a territorial tax system (where foreign earnings would not be taxed at all) is thought to drive inversion decisions. This issue has led to proposals for the United States to adopt a territorial tax system to stop inversion transactions.³⁸

One concern about adopting a territorial tax system is the strain it would likely place on the current transfer pricing system.³⁹ From this perspective, the current worldwide tax system provides a backstop on the amount of profit shifting or base erosion possible, because shifted profits will eventually be repatriated. Under a territorial tax system, this is not the case. Research has found evidence of significant profit shifting, especially related to mobile intellectual property, suggesting a lot of income from foreign sources is really U.S. income in disguise.⁴⁰

Numerous other issues surround the adoption of a U. S. territorial tax. For example, while some support a territorial tax to eliminate the incentive to keep earnings abroad, others oppose it because it likely discourages domestic investment and activity in the United States.⁴¹

Adopting a territorial tax, as in the case of a rate reduction, would likely reduce corporate tax revenue and add to current budget pressures unless it is offset by other tax increases.

Tax Reform Proposals

Two recent proposals that involve comprehensive reform, the Wyden, Coats, and Begich proposal from the 112th Congress (S. 767) and the proposal by Chairman Camp of the Ways and Means Committee (The Tax Reform Act of 2014),⁴² would reduce the corporate rate to 24% and 25%,

³⁸ McBride (2014).

³⁹ Gutman (2014).

⁴⁰ See CRS Report R40623, *Tax Havens: International Tax Avoidance and Evasion*, by Jane G. Gravelle for a review of methods and the empirical evidence on profit shifting by U.S. multinational firms.

⁴¹ A territorial tax lowers the tax on returns to investment abroad, increasing after-tax returns and encouraging firms to displace domestic investment with foreign investment.

⁴² U.S. Congress, Joint Committee on Taxation, Technical Explanation of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title IV—Participation Exemption System for the Taxation of Foreign Income, committee print, 113th Cong., February 26, 2014, JCX-15-14.

respectively. The first would move away from a territorial tax by ending deferral. Eliminating deferral would raise a significant amount of revenue that would have been used to reduce the corporate tax rate from 35% to 24%.⁴³ The second proposal would adopt a territorial tax and offset a reduction in the corporate tax rate. The proposal also contains anti-abuse provisions to tax intangible foreign source income. There has been some agreement that adopting a territorial tax without some significant anti-abuse provisions (which the Camp proposal contains) could be problematic, as it would likely increase profit shifting abroad by U.S. firms.⁴⁴ The Senate Finance Committee also issued several tax reform discussion drafts in 2013 that proposed, in the international arena, a current but lower tax on foreign source income (without specifying the type of corporate tax that would be feasible).⁴⁵

Reforming the U.S. corporate tax system may be a desirable objective that can contribute to economic efficiency and growth. However, the types of corporate rate cuts that are feasible given revenue constraints and the concerns about profit shifting for moving to a territorial tax, as reflected in these proposals, suggest that reforming the tax code for the purpose of discouraging tax driven mergers may reduce—but not eliminate—the incentive to invert.

Targeted Approaches

An alternative is to directly restrict the ability of U.S. firms to invert by merger. The President's FY2015 budget proposal contains a provision that would further restrict the use of inversions.⁴⁶ The proposal would modify the 80% test enacted in the AJCA to a 50% test and eliminate the 60% test. In effect, this proposal would reduce the percentage of shareholders that are owners of the "old U.S. company" and the "new foreign merged company." The proposal would also require that the new foreign corporation be managed and controlled from outside the United States and prohibit transactions where the new foreign company has substantial business activities in the United States.

Representative Levin, the ranking Member of the House Ways and Means Committee, has introduced a bill, The Corporate Inversion Prevention Act of 2014 (H.R. 4679), which would reflect these changes, retroactive to May 8, 2014. The inversion would not be recognized if the U.S. stockholders have 50% of the shares or if 25% of the business activity is in the United States. A companion bill, which would sunset in two years to provide time for tax reform, has been introduced in the Senate by Senator Levin.⁴⁷

In addition, a number of legislative proposals have been introduced that would limit the tax benefits associated with inversions for certain corporations. For example, H.R. 1554 (Doggett), H.R. 3666 (DeLauro), H.R. 3793 (Maffei), S. 268 (Levin), S. 1533 (Levin), and S. 1844

⁴³ Revenue estimates of an earlier version of the bill are available at <http://www.wyden.senate.gov/download/?id=1ba9073f-9ee8-4f8b-a2e3-2b70ebc96d35&download=1>.

⁴⁴ All of the proposals to move to a territorial tax have been accompanied by provisions that attempt to limit profit shifting, particularly of intangible income. See CRS Report R42624, *Moving to a Territorial Income Tax: Options and Challenges*, by Jane G. Gravelle, for further discussion.

⁴⁵ United States Committee on Finance, Baucus Unveils Proposals for International Tax Reform, <http://www.finance.senate.gov/newsroom/chairman/release/?id=f946a9f3-d296-42ad-bae4-bcf451b34b14>.

⁴⁶ Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals*, <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf>.

⁴⁷ See "Senators Announce Bill to Reduce Corporate Inversion 'Loophole'," *Tax Notes Today*, May 21, 2014.

(Shaheen) would each treat corporations managed and controlled from the United States as domestic corporations regardless of their legal tax home.

Other proposals, H.R. 694 (Schakowsky) and S. 250 (Sanders), would eliminate deferral (taxing foreign source income currently), in addition to limiting the benefits of inversions when management and control continues to reside in the United States. While some support these targeted approaches, others argue that corporate tax reform should be addressed first.

Concluding Thoughts

The debate in Congress on inversions is fluid. Some, as noted above, prefer a targeted approach. Others believe that inversions should be addressed only in the context of comprehensive tax reform. While Ways and Means Chairman Camp's Tax Reform Act of 2014 discussion draft does not directly address profit shifting aspects of inversions, it does include elements that may have an impact on such transactions. Profit shifting practices and inversion techniques may be addressed more directly as tax reform proposals unfold. Finance Chairman Ron Wyden has indicated that he would address inversions—his approach is similar to Senator Levin's, as described above—but in the context of broader tax reform. He has indicated support for making changes relating to inversions retroactive to May 8, 2014.

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