

**DESCRIPTION OF PROPOSALS IN THE
"REVERSING THE EXPATRIATION
OF PROFITS OFFSHORE ACT"**

Scheduled for a Markup
By the
SENATE COMMITTEE ON FINANCE
on June 13, 2002

Prepared by
the Staff of the
JOINT COMMITTEE ON TAXATION



June 11, 2002
JCX-55-02

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INTRODUCTION

The Senate Committee on Finance has scheduled a markup on June 13, 2002, of S. 2119, the "Reversing the Expatriation of Profits Offshore Act", with certain modifications. This document¹ prepared by the staff of the Joint Committee on Taxation, provides a description of S. 2119 the "Reversing the Expatriation of Profits Offshore Act", as modified.

¹ This document may be cited as follows: Joint Committee on Taxation, *Description of Proposals in the "Reversing the Expatriation of Profits Offshore Act,"* (JCX-55-02), June 11, 2002.

A. Tax Treatment of Inversion Transactions

Present Law

Background

The United States employs a “worldwide” tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income is generally deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F² and the passive foreign investment company rules.³ A foreign tax credit is generally available to offset, in whole or in part, the U.S. tax owed on this foreign-source income, whether earned directly by the domestic corporation, repatriated as an actual dividend, or included under one of the anti-deferral regimes, subject to certain limitations.

In contrast, the United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Place of incorporation determines whether a corporation is treated as domestic or foreign for purposes of U.S. tax law.

Inversion transactions

Some U.S. corporations have reincorporated as foreign corporations in low-tax jurisdictions, thereby replacing the U.S. parent corporation of a multinational corporate group with a foreign parent corporation. These transactions, commonly referred to as “inversions,” place the corporate group in a position to derive two main U.S. tax benefits: (1) removing some or all of the group’s foreign operations and income from the U.S. taxing jurisdiction; and (2) reducing the U.S. taxes that otherwise would be incurred on income from U.S. operations, through the use of various “earnings stripping” strategies (e.g., making excessive payments of deductible interest or royalties to a new foreign parent). Inversion transactions may take many different forms, including stock inversions and asset inversions.

An inversion may be accompanied or followed by further restructuring of the corporate group. For example, in order to remove income from foreign operations from the U.S. taxing jurisdiction, the U.S. corporation may transfer some or all of its foreign subsidiaries directly to the new foreign parent corporation or other related foreign corporations.

In addition to removing foreign operations from the U.S. taxing jurisdiction, the corporate group may derive further advantage from the post-inversion structure by reducing U.S.

² Secs. 951-964.

³ Secs. 1291-1298.

tax on U.S.-source income through various “earnings stripping” or other transactions. This may include earnings stripping through payment by a U.S. corporation of deductible amounts such as interest, royalties, rents, or management service fees to the new foreign parent or other foreign affiliates, subject to certain limitations under present law. These limitations include section 163(j), which limits the deductibility of interest paid to related parties, if the payor’s debt-equity ratio exceeds 1.5 to 1 and the payor’s net interest expense exceeds 50 percent of its “adjusted taxable income.” More generally, section 482 and the regulations thereunder require that all transactions between related parties be conducted on terms consistent with an “arm’s length” standard, and permit the Treasury Secretary to reallocate income and deductions among such parties if that standard is not met.

Inversion transactions themselves may give rise to U.S. tax consequences at the shareholder and/or the corporate level, depending on the type of inversion. In stock inversions, the U.S. shareholders generally recognize gain (but not loss), based on the difference between the fair market value of the foreign corporation shares received and the adjusted basis of the domestic corporation stock exchanged. To the extent that a corporation’s share value has declined, and/or it has many foreign or tax-exempt shareholders, the impact of this “toll charge” is reduced.

The transfer by the U.S. corporation of foreign subsidiaries or other assets to the foreign parent corporation also may give rise to U.S. tax consequences at the corporate level (e.g., gain recognition and earnings and profits inclusions). The tax on any income recognized as a result of these restructurings may be reduced or eliminated through the use of net operating losses, foreign tax credits, and other tax attributes.

In asset inversions, the U.S. corporation generally recognizes gain (but not loss) as though it had sold all of its assets, but the shareholders generally do not recognize gain or loss, assuming the transaction meets the requirements of a tax-free reorganization under the Code.

Description of Proposal

In general

The proposal would define two different types of corporate inversion transactions and would establish a different set of consequences for each type. Certain partnership transactions also would be covered.

Transactions involving at least 80 percent ownership

The first type of inversion would be a transaction in which, pursuant to a plan or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity; (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of 50 percent or greater ownership (i.e., the “expanded affiliated group”), does not have substantial business activities in the entity’s country of incorporation, compared to the total business activities of the group. The proposal would deny the intended tax

benefits of this type of inversion by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Code.

In determining whether a transaction would meet the definition of an inversion under the proposal, stock held by members of the expanded affiliated group that includes the foreign incorporated entity would be disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., “hook” stock), this stock would not be considered in determining whether the transaction meets the definition. Similarly, if a U.S. parent corporation converts an existing wholly owned U.S. subsidiary into a new wholly owned controlled foreign corporation, the stock of the new foreign corporation would be disregarded, and the definition would not be met. Stock sold in a public offering related to the transaction at issue also would be disregarded for these purposes.

Transfers of properties or liabilities as part of a plan a principal purpose of which is to avoid the purposes of the proposal would be disregarded. In addition, the Treasury Secretary would be granted authority to issue regulations to prevent the avoidance of the purposes of the proposal, including avoidance through the use of related persons, pass-through or other noncorporate entities, or other intermediaries, and through transactions designed to qualify or disqualify a person as a related person or a member of an expanded affiliated group. Similarly, the Treasury Secretary would be granted authority to issue regulations treating certain non-stock instruments as stock, and certain stock as not stock, where necessary to carry out the purposes of the proposal.

Transactions involving greater than 50 percent but less than 80 percent ownership

The second type of inversion covered by the proposal would be a transaction that would meet the definition of an inversion transaction described above, except that the 80-percent ownership threshold is not met. In such a case, if a greater-than-50-percent ownership threshold is met, then a second set of rules would apply to the inversion. Under these rules, the inversion transaction would be respected (i.e., the foreign corporation would be treated as foreign), but: (1) any applicable corporate-level “toll charges” for establishing the inverted structure would be strengthened; (2) the IRS would be given expanded power to monitor related-party transactions that may be used to reduce U.S. tax on U.S.-source income going forward; and (3) section 163(j), relating to “earnings stripping” through related-party debt, would be strengthened. These measures generally would apply for a 10-year period following the inversion transaction.

Specifically, any applicable corporate-level “toll charge” imposed under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person would be taxable, without offset by any tax attributes (e.g., net operating losses or foreign tax credits).

With respect to monitoring, the proposal would establish a new pre-filing procedure. Under this procedure, the taxpayer would be required annually to submit an application to the IRS for an agreement that all return positions to be taken by the taxpayer with respect to related-party transactions comply with all relevant provisions of the Code, including sections 482, 845, 163(j), and 267(a)(3). The Treasury Secretary would be given the authority to specify the form,

content, and supporting information required for this application, as well as the timing for its submission.

The IRS would be required to take one of the following three actions within 90 days of receiving a complete application from a taxpayer: (1) conclude an agreement with the taxpayer that the return positions to be taken with respect to related-party transactions comply with all relevant provisions of the Code; (2) advise the taxpayer that the IRS is satisfied that the application was made in good faith and substantially complies with the requirements set forth by the Treasury Secretary for such an application, but that the IRS reserves substantive judgment as to the tax treatment of the relevant transactions pending the normal audit process; or (3) advise the taxpayer that the IRS has concluded that the application was not made in good faith or does not substantially comply with the requirements set forth by the Treasury Secretary.

In the case of a compliance failure described in (3) above (and in cases in which the taxpayer fails to submit an application), the following sanctions would apply: (1) no deductions or additions to basis or cost of goods sold for payments to foreign related parties would be permitted; (2) any transfers or licenses of intangible property to related foreign parties would be disregarded; and (3) any cost-sharing arrangements would not be respected for the taxable year for which the application was required.

If the IRS fails to act on the taxpayer's application within 90 days of receiving it, then the taxpayer would be treated as having submitted an application that substantially complies with the above-referenced requirements. Thus, the deduction-disallowance and other sanctions described above would not apply, but the IRS could examine the transactions at issue under the normal audit process. The IRS would be authorized to request that the taxpayer extend this 90-day deadline in cases in which the IRS believes that such an extension might help the parties to reach an agreement.

The "earnings stripping" rules of section 163(j), which deny or defer deductions for certain interest paid to foreign related parties, would be strengthened as to inverted corporations. With respect to such corporations, the proposal would eliminate the debt-equity threshold generally applicable under that provision and reduce the 50 percent thresholds for "excess interest expense" and "excess limitation" to 25 percent.

Partnership transactions

Under the proposal, both types of inversion transactions are defined to include certain partnership transactions. Specifically, both prongs of the proposal would apply to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership, if after the acquisition at least 80 percent (or more than 50 percent but less than 80 percent, as the case may be) of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), and the "substantial business activities" test is not met. For purposes of determining whether these definitions are met, all partnerships that are under common control within the meaning of section 482 would be treated as one partnership, except as provided otherwise in regulations. In addition, in situations in which the strengthened "toll charge" provisions would apply, those provisions would apply at the partner level.

Effective Date

The first prong of the proposal would apply to inversion transactions meeting the 80-percent test that are completed after March 20, 2002. The second prong of the proposal, limiting the benefits of other inversions, would apply to inversion transactions meeting the 50-percent test that are completed after 1996. The measures set forth in the second prong also would apply to inversion transactions completed after 1996 that would have met the 80-percent test but for the March 20, 2002, effective date of the first prong.

B. Reinsurance Agreements

Present Law

In the case of a reinsurance agreement between two or more related persons, present law provides the Treasury Secretary with authority to allocate among the parties or recharacterize income (whether investment income, premium or otherwise), deductions, assets, reserves, credits and any other items related to the reinsurance agreement, or make any other adjustment, in order to reflect the proper source and character of the items for each party.⁴ For this purpose, related persons are defined as in section 482. Thus, persons are related if they are organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) that are owned or controlled directly or indirectly by the same interests. The provision may apply to a contract even if one of the related parties is not a domestic company.⁵ In addition, the provision also permits such allocation, recharacterization, or other adjustments in a case in which one of the parties to a reinsurance agreement is, with respect to any contract covered by the agreement, in effect an agent of another party to the agreement, or a conduit between related persons.

Description of Proposal

The proposal would modify the rules of section 845, relating to authority for the Treasury Secretary to allocate among the parties to a reinsurance agreement, recharacterize items, or make any other adjustment, in order to reflect the proper source and character of the items for each party. The proposal would authorize such allocation, recharacterization, or other adjustment, in order to reflect the proper source, character or amount of the item. It is intended that this authority⁶ be exercised in a manner similar to the authority under section 482 for the Treasury Secretary to make adjustments between related parties, including in situations in which the related persons (or agents or conduits) are engaged in cross-border transactions that require allocation, recharacterization, or other adjustments in order to reflect the proper source, character or amount of the item or items.

Effective Date

The provision would be effective for any risk reinsured after April 11, 2002.

⁴ Sec. 845(a).

⁵ See S. Rep. No. 97-494, "Tax Equity and Fiscal Responsibility Act of 1982," July 12, 1982, 337 (describing provisions relating to the repeal of modified coinsurance provisions).

⁶ The authority to allocate, recharacterize or make other adjustments was granted in connection with the repeal of provisions relating to modified coinsurance transactions.