BACKGROUND AND DESCRIPTION OF PRESENT-LAW RULES AND PROPOSALS RELATING TO CORPORATE INVERSION TRANSACTIONS

Scheduled for a Public Hearing
Before the
COMMITTEE ON WAYS AND MEANS
on June 6, 2002

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INTRODUCTION

The House Committee on Ways and Means has scheduled a hearing on issues relating to corporate inversion transactions on June 6, 2002. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of these transactions and relevant provisions of present law, as well as a description of introduced bills addressing these transactions.

[1] This document may be cited as follows: Joint Committee on Taxation, *Background and Description of Present-Law Rules and Proposals Relating to Corporate Inversion Transactions* (JCX-52-02), June 5, 2002.

I. BACKGROUND AND PRESENT LAW

Determination of corporate residence

The U.S. tax treatment of a multinational corporate group depends significantly on whether the top-tier "parent" corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the law of the United States or of any State. All other corporations (i.e., those incorporated under the laws of foreign countries) are treated as foreign. Thus, place of incorporation determines whether a corporation is treated as domestic or foreign for purposes of U.S. tax law, irrespective of other factors that might be thought to bear on a corporation's "nationality," such as the location of the corporation's management activities, employees, business assets, operations, or revenue sources, the exchanges on which the corporation's stock is traded, or the residence of the corporation's managers and shareholders.

U.S. taxation of domestic corporations

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. In order to mitigate the double taxation that may arise from taxing the foreign-source income of a domestic corporation, a foreign tax credit for income taxes paid to foreign countries is provided to reduce or eliminate the U.S. tax owed on such income, subject to certain limitations.

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 F (sections 951-964) and the passive foreign investment company rules (sections 1291-1298). 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 repatriated as an actual dividend or included under one of the anti-deferral regimes.

The U.S. "worldwide" system for taxing domestic corporations may be contrasted with the systems used in some countries that rely to a greater extent than the United States does on "territorial" principles. Under a territorial system, a country mitigates the double taxation of foreign-source income of resident corporations primarily through an exemption mechanism, as opposed to a credit mechanism. While a pure territorial system would exempt all foreign-source income from residence-country tax, in practice it is common for systems described as "territorial" to exempt only certain categories of income, to exempt either all or part of such income, and/or to provide various exceptions to reduce opportunities for tax avoidance.

U.S. taxation of foreign corporations

The United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to U.S. tax only on income that is "effectively connected" with the conduct of a trade or business in the United States. Such "effectively connected income" generally is taxed in the same manner and at the same rates as the income of a U.S. corporation. An applicable tax treaty may limit the imposition of U.S. tax on business operations of a foreign corporation to cases in which the business is conducted through a "permanent establishment" in the United States.

In addition, foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of interest, dividends, rents, royalties, and certain similar types of income derived from U.S. sources, subject to certain exceptions. The tax generally is collected by means of withholding by the person making the payment. This tax may be reduced or eliminated under an applicable tax treaty.

Inversion transactions

Overview

Recent press reports and filings with the Securities and Exchange Commission ("SEC") indicate that some U.S. corporations have reincorporated, or plan to reincorporate, as foreign corporations in low-tax jurisdictions such as Bermuda, 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, thereby potentially achieving pure territorial tax treatment for the group with respect to the United States (i.e., with no limitations or exceptions such as those that are common under existing "territorial" tax systems); 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).

Structure of inversion transactions and potential tax benefits

Inversion transactions may take many different forms, including stock inversions, asset inversions, and various combinations of and variations on the two. Most of the known transactions to date have been stock inversions. In one example of a stock inversion, a U.S. corporation forms a Bermuda corporation, which in turn forms a domestic merger subsidiary. The domestic merger subsidiary then merges into the U.S. corporation, with the U.S. corporation surviving, now as a subsidiary of the new Bermuda corporation. The U.S. corporation's shareholders receive shares of the Bermuda corporation and are treated as having exchanged their U.S. corporation shares for the Bermuda corporation shares. (An asset inversion reaches a similar result, but through a direct merger of the top-tier U.S. corporation into a new Bermuda corporation, among other possible forms.)

An inversion may be accompanied or followed by further restructuring of the corporate group. For example, in the case of a stock inversion, 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. Thus, the subpart F anti-deferral rules applicable to controlled foreign corporations no longer would apply to these foreign subsidiaries, and no U.S. tax would be imposed on any actual dividends paid by such foreign subsidiaries in the future to the new foreign parent. As a result, the corporate group may be able to obtain the equivalent of a pure territorial tax system, depending on which country of incorporation is chosen. Even absent a direct transfer of existing foreign subsidiaries to the new foreign parent, similar benefits may be derived in connection with foreign operations that might be established in the future, by initiating such operations under the new foreign parent instead of under a U.S. corporation.

In addition to removing foreign operations from the U.S. taxing jurisdiction, the corporate group may derive further advantage from the inverted structure by reducing U.S. 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. In this respect, the post-inversion structure enables the group to employ the same tax-reduction strategies that are available to other multinational corporate groups with foreign parents and U.S. subsidiaries, subject to the same limitations. These limitations under present law include section 163(j), which limits the deductibility of certain interest paid to certain 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 Secretary of the Treasury to reallocate income and deductions among such parties if that standard is not met.

Potential tax costs of inversion transactions

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) under section 367(a), 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 section 367(a) "toll charge" is reduced. The transfer 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 under sections 1001, 311(b), 304, 367, 1248 or other provisions). 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) under section 367(a) 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 reorganization under section 368.

II. DESCRIPTION OF INTRODUCED BILLS RELATING TO INVERSIONS

H.R. 3857

H.R. 3857 was introduced in the House of Representatives by Mr. McInnis on March 6, 2002. This bill would deny the intended tax benefits of certain inversion transactions by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Code. This bill would apply if, immediately after a transaction in which a domestic corporation transfers property to a foreign corporation, more than 80 percent of the stock (by vote or value) of the foreign corporation is held by the former shareholders of the domestic corporation. In addition, this 80-percent test would be lowered to 50 percent if: (1) the stock of the foreign corporation is traded on a U.S. exchange, (2) less than 10 percent of the corporation's gross income is derived from activities in the corporation's country of incorporation, and (3) less than 10 percent of the corporation's employees are permanently located in such country.

The bill would apply to transactions occurring after December 31, 2001.

H.R. 3884

H.R. 3884, the "Corporate Patriot Enforcement Act of 2002," was introduced in the House of Representatives by Mr. Neal on March 6, 2002. This bill would deny the intended tax benefits of "corporate expatriation transactions" by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Code. A "corporate expatriation transaction" would be any transaction in which: (1) a U.S. corporation becomes a subsidiary of a "nominally foreign corporation" or otherwise transfers substantially all of its properties to such a corporation; and (2) the former shareholders of the U.S. corporation hold more than 80 percent (by vote or value) of the stock of the "nominally foreign corporation" immediately after the transaction. In addition, this 80-percent test would be lowered to 50 percent in cases in which: (1) the "nominally foreign corporation" does not have substantial business activities in the corporation's country of incorporation (compared to the total business activities of the corporation and all companies connected to it by a chain of 50 percent or greater ownership), and (2) the stock of the corporation is traded principally in a U.S. public market.

The bill also would apply to certain partnership transactions. Specifically, the proposal would apply to transactions in which a "nominally foreign corporation" acquires substantially all of the properties constituting a trade or business of a domestic partnership, if after the acquisition more than 80 percent of the stock of the entity is held by former partners of the partnership, the "substantial business activities" test is not met, and the corporation's stock is traded principally in a U.S. public market.

The bill generally would be effective for transactions completed after September 11, 2001. The bill also would apply to transactions completed on or before September 11, 2001, but only for taxable years beginning after December 31, 2003.

H.R. 3922

H.R. 3922, the "Save America's Jobs Act of 2002," was introduced in the House of Representatives by Mr. Maloney on March 11, 2002. This bill is the same as H.R. 3884, except that this bill also includes a provision that would lower corporate tax rates from year to year in such a way as to make the provision revenue-neutral, based on estimates to be provided by the Secretary of the Treasury.

H.R. 4756

H.R. 4756, the "Uncle Sam Wants You Act of 2002," was introduced in the House of Representatives by Mrs. Johnson on May 16, 2002. This bill provides the same definitions and sanctions as H.R. 3884, but this bill also includes a sunset provision, pursuant to which the provisions of the bill would not apply to transactions beginning after December 31, 2003. Thus, the bill would effectively impose a moratorium on inversion transactions.

S. 2050

S. 2050 was introduced in the Senate by Senators Wellstone and Dayton on March 21, 2002. This bill would deny the intended tax benefits of certain inversion transactions by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Code. The transactions covered would be those in which property is transferred by a domestic corporation to a foreign corporation, or stock in a domestic corporation is transferred to a foreign corporation, if the former shareholders of the domestic corporation hold more than 50 percent of the stock of the foreign corporation immediately after the transaction. The bill would authorize the Secretary of the Treasury to provide by regulation that the provision not apply in cases in which the foreign corporation was engaged in the conduct of an active trade or business that was substantial relative to the trades or businesses of the domestic corporation immediately before the inversion transaction.

The bill would be effective for taxable years beginning after December 31, 2002, regardless of when the inversion transaction occurs.

S. 2119

S. 2119, the "Reversing the Expatriation of Profits Offshore Act," was introduced in the Senate by Senators Grassley and Baucus on April 11, 2002. This bill would define two different types of corporate inversion transactions and establish a different set of consequences for each type. The bill also would apply to certain partnership transactions.

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 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 bill 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.

The second type of inversion covered by the proposal would be a transaction similar to the inversion transaction defined 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 Internal Revenue Service ("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 tightened. These measures generally would apply for a 10-year period following the inversion.

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 other tax attributes (e.g., net operating losses or foreign tax credits). No similar measures would apply to any shareholder-level toll charges imposed under section 367(a).

In addition, the bill would establish a "pre-approval" process, under which no deductions or additions to basis or cost of goods sold for payments to foreign related parties would be permitted unless the taxpayer concludes an annual "pre-approval agreement" with the IRS, to ensure that all related-party transactions comply with all relevant provisions of the Code, including sections 482, 845, 163(j), and 267(a)(3). Similarly, the transfer or license of intangible property from a U.S. corporation to a related foreign corporation would be disregarded, and cost-sharing arrangements would not be respected, unless such an agreement is concluded. The confidentiality and disclosure rules normally applicable to advance pricing agreements ("APAs") would apply to all pre-approval agreements entered into pursuant to the proposal, and the parameters for the IRS's required annual APA report would be amended to require a summary section for inversion transactions.

The "earnings stripping" rules of section 163(j), which deny or defer deductions for certain interest paid to foreign related parties, would be tightened 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.

Under the bill, 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, 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.

The bill also would modify the rules of section 845, relating to authority for the Secretary of the Treasury to allocate income, deductions and other items among related persons in the case of a reinsurance agreement, to permit allocation if needed to reflect the proper source, character or amount of the item. This provision would not be limited to taxpayers engaged in inversion transactions.

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 all inversion transactions meeting the 50-percent test, regardless of when completed. The measures set forth in the second prong also would apply to inversion transactions that would have met the 80-percent test but for the March 20, 2002, effective date of the first prong. The reinsurance provision would be effective for any risk reinsured after April 11, 2002.