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CORPORATE TAX INVERSIONS
Will Either Congress Or The Administration Act In 2014?

There may be significant legislative and regulatory activity over the next few months as the US Congress and the Obama Administration continue to grapple with corporate tax inversions. While it remains unlikely that anti-inversion legislation will be enacted in September, policymakers may continue to utilize various legislative tools, including the annual appropriations process, in an effort to discourage inversion transactions. Beyond legislation, the Administration's promise to examine its regulatory options to curb inversion transactions will have all eyes on Treasury as it determines what steps to take.

Corporate inversions, whereby a US corporation acquires a non-US corporation and, in the process, relocates its headquarters abroad, have been the ongoing focus of heated political discourse, as a number of US companies have announced inversion deals in recent months. With heavy politicking, media hype, and threatened legislation and regulation, it has become increasingly difficult to identify exactly what issues companies need to consider when assessing the risks associated with an inversion transaction. This alert analyzes the likelihood for implementation of recent proposals to deter inversions and assesses the potential impact of each proposal. These issues are significant for US companies that have already inverted, have announced an intention to invert, or may consider inverting in the future. Further, many of the possible policy responses – whether legislative or regulatory – could have considerable ramifications for the larger US inbound investment community.

While a number of announced inversion deals remain pending, the pace of announcements has slowed in recent weeks. This August slowdown coincides with statements by President Obama and the US Department of the Treasury suggesting a near-term intention to act by regulation in an attempt to curb pending and future deals. Simultaneously, legislative proposals are in development on both sides of the Capitol, with the possibility that the US Senate could vote on anti-inversion legislation when it returns to session in September.

Inversion activity has not halted completely though. In late August, US-based Burger King Worldwide, Inc. and Canada-based Tim Hortons Inc. announced that both boards of directors had unanimously approved a merger with a new holding company to be domiciled in Canada.

Background

The US corporate income tax rate of 35 percent is one of the highest in the world, and the United States is the only G7 country that does not have a territorial tax system for multinational businesses based in-country. While these elements of the US tax system have been a major focus in the development of comprehensive tax reform proposals, they have also been cited as providing significant incentives for the recent wave of corporate inversions.[1]

The Obama Administration and many Congressional Democrats have called for an immediate ban on inversions, and some influential tax-writers have introduced various legislative proposals in an attempt to achieve this result. At the outset of the debate, leading Republican tax-writers staunchly opposed stand-alone legislation addressing inversions, maintaining that the best way to prevent US-based companies from locating abroad is through comprehensive tax reform that lowers the high US corporate tax rate and adopts a more competitive territorial system of taxation. This continues to be the dominant Republican position. However, following the recent string of inversion announcements, some Republicans have refined their positions, narrowly leaving open the possibility of legislating on inversions outside of broader tax reform. Still, as things now stand, the likelihood of passage and enactment of stand-alone inversion legislation when Congress returns for a short legislative session in September remains very low.

The Obama Administration's position on its authority to unilaterally act on inversions has changed significantly over the past month. After first expressing the view to Congress in July that Treasury had little statutory authority to further regulate such transactions, the Administration abruptly changed course in August, indicating that Treasury would take another look at the areas where it could act to curb inversions through regulatory force. Notably, President Obama has gotten involved directly, stating that the Administration is reviewing its options and may act unilaterally if Congress does not pass legislation quickly. Policymakers, tax professionals, and academics have been divided on whether such action may be beyond the Administration's executive authority.

1 While not the driving force behind all acquisition decisions, two primary tax benefits of inversions include: (1) the ability to reduce the amount of US tax on income across international operations through the location of a parent holding company in a country that has a territorial system of taxation; and (2) the ability to structure intragroup loans from foreign affiliates to US subsidiaries to generate interest deductions that reduce the amount of US taxable income – a practice called "earnings stripping."

Current Framework

In 2004, following an extended debate on inversions, section 7874 of the US Tax Code ("IRC" or "Code") was enacted to make it more difficult for companies to avoid US tax treatment on their worldwide income. At the time, a number of companies were moving their headquarters to low-tax jurisdictions, such as Bermuda and the Cayman Islands. Often, these early inversions did not involve a material business combination, giving rise to the belief that such transactions were being undertaken solely for tax purposes. In response to this phenomenon, IRC section 7874 treats inverted companies as US companies for tax purposes if: (1) substantially all of the assets of a domestic corporation are acquired by a foreign acquiring corporation; (2) the historical owners of the domestic corporation retain a sufficient ownership interest in the foreign acquiring corporation; and (3) the foreign acquiring corporation, together with the affiliated group that includes the foreign acquiring corporation, does not conduct substantial business activities[2] in the country in which it is created or organized.

Section 7874 sets an 80-percent test for purposes of measuring continuity of ownership – if the continuing ownership of historical shareholders of the domestic corporation in the new foreign parent is 80 percent or more (by vote or value), the new foreign parent corporation is treated as a domestic corporation for all US tax purposes (the "80-percent test"). If the continuing US shareholder ownership is less than 80 percent but at least 60 percent, the foreign status of the new foreign parent corporation is respected, but certain other adverse tax consequences apply (the "60-percent test").

Proposals For Reform

The Administration's Budget Request. Early this year, in its FY2015 budget request, the Obama Administration proposed replacing the 80-percent test with a greater than 50-percent test and eliminating the 60-percent test. The Administration's proposal includes a rule that, regardless of the level of shareholder continuity, a transaction will be considered an inversion to which section 7874 applies (a "7874 inversion") if, after the transaction, the affiliated group has substantial business activities in the United States, and the foreign parent corporation is primarily managed and controlled in the United States. Finally, the Administration's proposal provides that a 7874 inversion can occur if there is an acquisition either of substantially all of the assets of a domestic partnership or of substantially all of the assets of a trade or business of a domestic partnership.

Congressional Democrats' Stance. Over the last several months, as more inversion acquisitions have been announced, lawmakers have proposed various legislative solutions to the matter and debated the issue in the context of a Senate Finance Committee hearing, titled "The US Tax Code: Love It, Leave It, or Reform It!" (A full report on that July 22, 2014 hearing can be found here.) Proposals have focused on changes to section 7874, as well as additional provisions of the Code cited as important to inversion transactions. During the Senate Finance hearing, Committee Chairman Ron Wyden (D-OR) urged the Committee to respond on a bipartisan basis and work to immediately "cool the inversion fever," while using the time resulting from these immediate steps to implement comprehensive tax reform. The Chairman has stated that he is working on a bipartisan solution, but those efforts do not appear to have gone very far, despite recent comments that he hopes to have "in place" by September bipartisan anti-inversion legislation.

Proposed Tax Legislation. Senator Carl Levin (D-MI), a frequent critic of US tax policy and the tax planning employed by US-based multinationals, and Representative Sandy Levin (D-MI), Ranking Member of the House Ways and Means Committee, have introduced companion bills that would closely follow the Obama Administration's anti-inversion proposal. In addition to changing the section 7874 continuity of ownership threshold from 80 percent to greater than 50 percent, the legislation provides that the merged company will continue to be treated as a domestic corporation for tax purposes if management and control of the merged company remains in the United States and 25 percent of either of its employees, sales, or assets are also located in the United States. The Levin section 7874 bills also provide an exception that allows inverted companies to avoid being treated as a US entity for tax purposes if the new merged company maintains substantial business activities in its country of incorporation.[3]

Senator Charles Schumer (D-NY), a senior member of the Senate Finance Committee and Senate Democratic leadership, has also been actively engaged on the issue. At the Finance Committee hearing, Senator Schumer stated that while he agreed with much of the Levin legislation (though not the managed and controlled sections, which he believes would send management-level jobs overseas), such changes alone would be insufficient to curb inversions. Senator Schumer later said that he intended to introduce legislation that would alter Code section 163(j) to further mitigate the ability of inverted companies to deduct interest expense in the US.[4]

In mid-August, Senator Schumer released an outline of forthcoming legislation, with legislative text expected to follow when the Senate convenes in September.[5] While the legislation would significantly cut back the ability of inverted companies (past, present, and future) to deduct interest expense, quite a few important details remain to be filled in, including, for example, how the legislation will define inversion transactions. While the Schumer outline refers only to changes to 163(j), it is expected that forthcoming legislation may ultimately incorporate elements of other proposals as well (for example, Levin provisions and/or federal contracting provisions, discussed more fully below) should the measure be brought to the Senate floor for a vote.

2 "Substantial business activities" is currently defined by reference to Treasury regulations requiring at least 25 percent of the total business activity of the worldwide group to be in the country of incorporation.

3 Senator Levin's legislation functions as a two-year moratorium on inverted companies that do not meet these stricter tests and is meant to provide Congress time to consider a long-term solution as part of comprehensive tax reform; Congressman Levin's proposal would function as permanent law.

4 Section 163(j) of the Code limits the deductibility of interest expense payments made by US subsidiaries of non-US-based companies in an effort to prevent erosion of the US tax base, a practice known as known as "earnings stripping." The current rules, which have been thoroughly debated in Congress, do not apply to companies with a debt to equity ratio below 1.5 to 1 and are meant to balance the legitimate need of businesses to acquire debt to finance company operations with the recognition that the ability to deduct large amounts of interest expense, coupled with the relatively high US corporate tax rate, could lead to income shifting through excessive intercompany loans.

5 The proposal would (1) repeal the current law debt to equity safe harbor; (2) reduce allowable net interest expense from 50 percent to 25 percent of adjusted taxable income (ATI); (3) repeal the interest expense deduction carryforward and excess limitation carryforward; and (4) require a US subsidiary to obtain annual IRS preapproval on the terms of related-party transactions for 10 years post-inversion.

Non-Tax Legislative Approaches: Proposed Bans on Federal Contracting. Numerous Members have also weighed in with non-tax proposals to deter inversions, turning to the annual appropriations process as a means of indirectly affecting tax policy. Pending appropriations bills in both the House and Senate contain provisions aimed at curbing corporate inversions. Representatives Rosa DeLauro (D-CT) and Lloyd Doggett (D-TX) have included an amendment in several of the House-passed annual spending bills that prohibits any federal government entity from awarding contracts to companies that have reincorporated in the Cayman Islands or Bermuda. Representative DeLauro has indicated that future amendments will likely include additional jurisdictions, including Ireland. Along those lines, the Senate Appropriations Committee's Department of Defense Appropriations Act of 2015 contains a provision authored by Subcommittee Chairman Senator Dick Durbin (D-IL), which prohibits a broad range of inverted corporations from receiving defense contract funding under the bill absent a national security waiver by the Secretary of Defense. Senators Durbin and Levin and Representatives DeLauro and Doggett have also introduced stand-alone legislation, the No Federal Contracts for Corporate Deserters Act of 2014, which would apply similar restrictions across all departments and agencies of the federal government. Additionally, in a separate effort to indirectly thwart inversion transactions, several Members from both the House and the Senate recently sent a letter to President Obama urging him to take "executive action to deny federal contracts to inverted corporations."

Congressional Republicans' Stance. Many influential Republican lawmakers continue to oppose standalone inversion legislation. For example, House Ways and Means Committee Chairman Dave Camp (R-MI) has argued that anti-inversion legislation should not be viewed as a solution and, instead, continues to focus his efforts on comprehensive reform. Likewise, House Speaker John Boehner (R-OH) has challenged President Obama to work on comprehensive tax reform, making clear that fixing the US Code is his preferred solution for tackling inversions.

The Senate's leading Republican tax writer, Senator Orrin Hatch (R-UT), has taken a slightly different approach. While generally agreeing with Chairman Camp that the preferred solution to inversions is comprehensive reform, Ranking Member Hatch, in a letter to Secretary Lew, stated that "there may be steps Congress can take, short of comprehensive tax reform, to address corporate inversions, and related issues," potentially opening the door to negotiations on a short-term solution to curbing corporate inversions. However, the barrier to entry in these discussions is quite high, as Senator Hatch has made clear that any interim inversion proposal must adhere to four principles: (1) it must serve as a bridge to comprehensive tax reform; (2) it must not be retroactive; (3) the approach taken should move the US toward a territorial system of taxation; and (4) it must be revenue neutral. In a recent op-ed, Ranking Member Hatch reiterated that all of the current Democratic-authored legislative proposals fall far short of meeting this test.

Legislative Outlook for September

The House and Senate return to session on September 8 and are expected to be in session for several weeks before adjourning until November, with passage of a Continuing Resolution ("CR") funding the government beyond September 30 as the most significant order of business. While House Republicans will likely not allow amendments to the CR, House Democrats may attempt to force a vote on inversions when the House brings the CR to the floor (as they have on other bills recently considered by the House). However, as in the past, such a vote would likely be procedural in nature (*e.g.*, a motion to recommit with instructions) and therefore, be opposed by nearly all House Republicans.

In the Senate, the odds of a vote relating to inversions are increasing as Congressional Democrats and the Obama Administration seek to frame issues prior to the upcoming Congressional elections. At this point, it is not known what form such a vote (or votes) might take – for example, whether an anti-inversion amendment might be offered to broader legislation or voted on as a stand-alone matter. It also remains to be seen whether, as part of such an exercise, Senate Republicans (led by Senator Hatch) will unveil a competing inversion approach.

While both Chairman Wyden and Ranking Member Hatch have stated that they are discussing a bipartisan path forward, the odds of agreement in the short term remain low given the wide gulf separating their positions. Therefore, any anti-inversion legislation advanced by Senate Democrats is unlikely to overcome Republican opposition in the Senate and absent a dramatic sea change in dynamics, certainly would not be advanced in the Republican-controlled House.

The White House and Possible Regulatory Action

In mid-July, Treasury Secretary Jack Lew sent a strongly worded letter to leaders of the Congressional tax-writing committees calling for a "new sense of economic patriotism" and urging lawmakers to take action to curb corporate tax inversions. Lew also indicated that, after examining the Code, Treasury "do[es] not believe we have the authority to address this inversion question through administrative action." In recent weeks, however, as it has become increasingly apparent that Congress is not likely to take legislative action on inversions, the Administration has radically changed its view, suggesting that yet-to-be-defined regulatory restrictions can be put in place that will affect the economics of inversion transactions, thereby curbing them. While not offering specifics, in August, President Obama stated that the Administration is examining how elements of "existing statutes . . . are interpreted by rule or regulation or tradition or practice that can at least discourage some of the folks who may be trying to take advantage of this loophole." Treasury officials have met with President Obama directly on this subject and are reportedly still in the process of putting together a list of options for Secretary Lew's consideration. Recently, Treasury announced that, on September 8, the day Congress returns from its August recess, Secretary Lew will comment on inversions as part of a broader speech on corporate tax reform. According to Treasury officials, the Secretary will not, as part of his remarks, provide detail on the regulatory approaches the Administration might pursue. While some form of Treasury action is expected in the near term, precisely when and how Treasury will act remain important open questions.

Treasury Process. Any action taken by Treasury this fall could take a number of forms. For example, Treasury could issue a temporary regulation that is effective immediately. However, Treasury may have a difficult time laying out specifics of a credible path forward that meaningfully affects inversion transactions, especially given its July position on the limits of its authority. Second, Treasury could release a standard Notice of Proposed Rulemaking ("NPRM") to address inversions, allowing time for public comment. However, this approach also requires Treasury to develop a credible detailed proposal.[6] Third and most practical, Treasury could issue a notice stating that it intends to issue regulations to curb inversions pursuant to its authority under one or more sections of the Code and such rules, whenever promulgated, will be retroactive to the date of the notice. There is ample precedent for such an approach, which would likely be intended to foster continued uncertainty for companies moving forward.

Technical Policy Options. As noted above, Treasury has not detailed any substantive changes it may seek to make to existing regulations. However, a number of tax experts have speculated that the Administration may focus its efforts in one or more of several areas. Some commentators have expressed doubt as to whether Treasury can promulgate such administrative changes in a manner that would materially affect inversion transactions without overstepping its authority under current statute and/or adversely affecting companies that have not inverted. Even the mere suggestion of tackling inversions through regulation has brought strong criticism from the Hill, including a response from House Speaker John Boehner, who has argued that any attempts by President Obama to unilaterally reduce or prevent inversions would exceed the President's executive authority.

Section 7874 Percentage Tests. As detailed above, section 7874 of the Code sets forth an 80-percent test for purposes of measuring continuity of ownership and, consequently, determining treatment as a domestic corporation for US tax purposes. While the Administration cannot alter the percentages, it could attempt to amend the regulatory framework implementing the statutory provisions, including the rules regarding related transactions and ownership of stock (*e.g.*, treatment of disqualified stock and shares subject to voting restrictions), making it more difficult for corporations to pass the test. However, Treasury updated these regulations in the recent past and seemed to conclude then that the current statutory framework provides little additional room to meaningfully affect inversion transactions.

Earnings Stripping. As noted above, section 163(j) of the Code limits the deductibility of interest expense payments made by US subsidiaries of non-US-based companies in an effort to prevent erosion of the US tax base. Over the last ten years, there has been no shortage of legislative proposals on 163(j), and the Administration may look to advance regulations to further limit the ability of overseas-based companies with US subsidiaries to deduct interest expense in the US. If they choose this route, it remains unclear whether they will seek to apply such changes to inverted companies only or seek to make regulatory changes that affect the inbound community generally. While the current-law 50 percent adjusted taxable income limitation is statutory and, thus, could not be directly lowered, Treasury could reduce the current 1.5 to 1 debt to equity safe harbor, but that, in and of itself, may do very little to affect inversion transactions.

Reclassification of Debt As Equity. Under section 385 of the Code, Treasury has the authority to reclassify certain debt as equity; for example, by converting a deductible interest payment into a nondeductible dividend in certain circumstances. Former Treasury official and Harvard Law School professor Stephen Shay claimed in a published article that the Administration could limit the ability of inverted companies to take interest deductions in the US or access their foreign cash without first paying US taxes (*i.e.*, the US tax due upon "repatriating" foreign-earned income) by reclassifying debt as equity. A formerly deductible interest payment would be reclassified as a dividend for which no deduction may be claimed—resulting in a greater portion of income being taxable at US corporate rates. Historically, Treasury's attempts to regulate under section 385 have fallen flat for a variety of reasons, and tax experts have differing views as to whether Treasury can limit such changes solely to expatriated entities.

Treatment of Deferred Overseas Earnings. Although the US currently taxes income on a worldwide basis, US tax owed on overseas earnings is in many cases deferred until such earnings are repatriated to the US parent. Subpart F of the Code includes an anti-abuse mechanism under section 956 for certain categories of income, which, if tripped, causes US companies to be taxed on a current basis on income earned abroad, whether or not repatriated. Similar to discussion draft legislation released by Representative Levin that would expand the scope covered by section 956 investments, Treasury may look to further strengthen the Subpart F regime by, for example, attempting to prevent financing of inversions with untaxed offshore earnings of a US parent company.

Section 482. In addition to the provisions outlined above, there has been speculation that Treasury may look to section 482 of the Code, which gives the IRS broad authority to reallocate deductions and income among a company's subsidiaries for the purpose of preventing tax evasion or to more clearly reflect the income of such business. Current regulations under section 482 require that transactions between subsidiaries occur under an arms-length standard. While not likely that any regulatory proposal would focus exclusively on section 482, the Administration might attempt to use the provision, in concert with others, to create potential disincentives for inversion transactions.

6 Further, regulations developed through the standard rulemaking process that change past practice or interpretation of law are usually prospective in nature, though Treasury could propose rules that, if adopted, would be effective on the date of publication.

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