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International Tax ADVISORY

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House and Senate Bills Aim to Tighten Anti-Inversion Rules

Following the administration budget's proposal for stricter anti-inversion legislation, Congressmen Chris Van Hollen and Sander Levin have introduced the Stop Corporate Expatriation and Invest in America's Infrastructure Act (H.R. 4679) to stiffen the provisions of Section 7874. (Senator Carl Levin introduced a similar proposal, S. 2360, in the Senate.) The proposed legislation epitomizes the government's anti-inversion frenzy, as more U.S. companies look for greener tax pastures overseas. (Democrats on the House Ways and Means Committee, of which Congressman Levin is a ranking member, released a list of inverted U.S. corporations earlier this month, claiming that more inversions have occurred in the last 10 years than during the previous 20.)

Background

Section 7874 was added by the 2004 American Jobs Creation Act to curb the perceived abuse of tax-motivated inversions of U.S. entities into foreign corporations. Section 7874 applies if (1) a foreign corporation acquires substantially all the assets of a U.S. corporation (or partnership), (2) the former owners of the U.S. entity hold at least 60 percent by vote or value of the stock of the foreign corporation after the acquisition by reason of holding stock of (or partnership interests in) the U.S. entity and (3) the foreign acquiring corporation's expanded affiliated group (connected by greater than 50-percent ownership) does not have substantial business activities in the foreign country where the foreign acquiring corporation is incorporated. The anti-inversion rules tax fully any inversion gain (disallowing the use of offsetting tax attributes) or, in cases where the former U.S. entity owners hold 80 percent or more of the foreign corporation, treat the foreign acquiring corporation as a domestic corporation for U.S. tax purposes.

The Proposed Legislation

Like the President's budget proposal, the congressmen's bill toughens Section 7874 in two main ways. First, the 80-percent ownership threshold for treating a foreign acquiring corporation as a domestic corporation would be lowered to "more than 50 percent." (The existing 60-percent test, which only results in taxation of inversion gain, would be eliminated.)

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Second, even if the more-than-50-percent ownership threshold is not met, the foreign acquiring corporation could still be treated as a domestic corporation if the affiliated group's management is primarily in the United States and the group has significant domestic business activities.

Under the bill, "management and control" is considered primarily within the United States if "substantially all of the executive officers and senior management of the expanded affiliated group [or other individuals, regardless of title] who exercise day-to-day responsibility for making decisions involving strategic, financial, and operational policies of the expanded affiliated group are based or primarily located within the United States." A group will have significant U.S. business activities if at least 25 percent of (i) its employees, (ii) its employee compensation, (iii) its assets, or (iv) its income is located or derived from the United States. The same rules for determining "substantial business activities" under existing regulations would apply to making the determination.

The bill would authorize Treasury to issue regulations, including rules that would increase the threshold (currently 25 percent) for substantial business activities in the relevant foreign jurisdiction, on the one hand, and lower the proposed 25-percent threshold for significant domestic business activities, on the other. Either change, of course, would more easily trigger the anti-inversion rules. The bill's provisions (and related regulations) would be retroactive to May 9, 2014.

Conclusion

Anti-inversion proponents note that inversions unnecessarily strip the U.S. tax base, but others contend that proposals like the Stop Corporate Expatriation and Invest in America's Infrastructure Act could have wide-reaching implications, such as stifling cross-border investment (most evidently, inbound acquisitions). The consequences of a foreign acquiring corporation being treated as a domestic corporation are significant, especially considering how the controlled foreign corporation rules and other anti-deferral regimes operate.

An interesting aspect of the bills is the potential to treat a foreign acquiring corporation as domestic even if it does not meet the statutory ownership threshold, by looking at its primary place of management and control and U.S. business activities. This provision raises the question why such corporations are not otherwise subject to tax under current law. Many other countries, including treaty partners, consider corporations as tax residents on the basis of management and control (as well as place of incorporation). The proposed legislation seems to be moving closer to redefining "domestic corporation" for U.S. tax purposes, independently of Section 7701.

Despite the shared weariness with "corporate expatriations," critics of the bills (including many congressional Republicans and even some Democrats) argue that such proposals are myopic in scope, attacking a mere symptom of the true problem: the current U.S. corporate tax system. Given the fact that inversions are often tax-motivated, fundamental tax reform obviously merits consideration. Of course, such comprehensive overhaul is no small feat, which the bills' proponents no doubt realize.

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