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International Tax ADVISORY ■

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Land of the Freely Inverting Corporation

Debate continues on "closing [the] unpatriotic tax loophole" of corporate inversions. In the weeks since President Obama criticized "corporate deserters" in his late-July address, there has been a flurry of activity and comment. Some believe the administration could curb inversions through regulatory measures to limit earnings stripping. Others contend that administrative action would be inadequate at best and that Congress must act to curtail inversions. Of course, with the slim prospect of comprehensive U.S. corporate and international tax reform any time soon, the recent legislative proposals tend to focus on disciplining inverted corporations rather than addressing the root causes of the behavior.

Background

The American Jobs Creation Act of 2004 added Section 7874 to the Internal Revenue Code to curtail tax-motivated inversions of U.S. companies into foreign corporations. The anti-inversion rules apply 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. Section 7874 fully taxes any inversion gain (disallowing the use of offsetting tax attributes) or, in cases where the former U.S. owners hold 80 percent or more of the foreign corporation, treats the foreign acquiring corporation as a domestic corporation for U.S. tax purposes.

Previous Anti-Inversion Law Proposal

Following up on the President's fiscal year 2015 budget proposal, Congressman Sander Levin introduced the Stop Corporate Expatriation and Invest in America's Infrastructure Act (H.R. 4679) to tighten the rules of Section 7874. (Sen. Carl Levin introduced a similar bill, S. 2360.) That bill lowered the 80 percent threshold to more than 50 percent for treating a foreign acquiring corporation as a U.S. corporation and eliminated the 60 percent gain recognition threshold.

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The bill further provided that, even if the more than 50 percent threshold was not met, domestic tax treatment could still apply if the affiliated group is primarily managed in the United States and has significant U.S. business activities.

Recent Legislative Proposals

In contrast to the anti-inversion bills, recent congressional proposals do not wrestle with Section 7874 directly but rather provide disincentives for inverted companies. Congressman Levin recently released a discussion draft of his Stop Corporate Earnings Stripping Act of 2014, which has two main prongs: (1) tighten the Section 163(j) rules to limit earnings stripping and (2) expand the Section 956 rules to prevent controlled foreign corporations (CFCs) from lending their untaxed earnings to non-CFC foreign affiliates to make tax-free U.S. investments. Under Section 163(j), the proposal would eliminate the debt-to-equity safe harbor, limit net interest expense to 25 percent of adjusted taxable income and repeal the excess limitation carryforward (allowing only a five-year carryforward for disallowed net interest expense deduction). Section 956 would be broadened to require U.S. shareholders to include in income their share of "foreign group property," which would include stock and debt obligations of non-CFC foreign affiliates. Congressman Levin intends the new proposals as complements to his anti-inversion bill.

Other Democrats have introduced the No Federal Contracts for Corporate Deserters Act, which, as its name suggests, bars the awarding of government contracts to inverted companies and companies with inverted subcontractors. In addition to making permanent the temporary bans in annual appropriation bills, the federal contracts bill adopts the 50 percent threshold and May 8, 2014, effective date of Sen. and Rep. Levins' companion bills. Republicans generally disagree with retroactively punishing otherwise legal behavior, arguing that fixing the U.S. corporate tax system is the only real solution.

Administrative (In)action

As Congress busies itself with legislative proposals, some people–including former Treasury official Stephen Shay and more recently Sens. Jack Reed, Dick Durbin and Elizabeth Warren–are urging executive action to curb the trend in the meantime. Shay claims that, under Section 385, the Treasury has authority to issue regulations to limit benefits to inverted companies–namely, interest deductions and access to offshore cash without U.S. taxation. Section 385 permits the Treasury to issue regulations to determine whether a corporate interest constitutes debt or equity and, consequently, whether related payments are deductible interest or nondeductible dividends. Critics question Section 385 as a legitimate or practical basis for anti-inversion action.

The administration, including Treasury Secretary Jacob Lew, puts the anti-inversion onus on Congress, having initially concluded that the executive branch does not have the requisite authority (to say nothing of the political ramifications, such as claims of executive overreaching). But as legislative proposals stack up with uncertain prospects of passage, the administration has stated that the Treasury is now exploring avenues for executive action to curb inversions or restrict post-inversion tax benefits.

Conclusion

Given the ongoing game of hot potato between the administration and Congress, the anti-inversion cause is unlikely to be fulfilled in the near term. The more limited measures, such as tightening anti-earnings stripping rules, tend to have more bipartisan support. However, those proposals scarcely address the systemic issues that drive U.S.

companies to "desert" for tax purposes. Some commentators have suggested that even comprehensive tax reform may be inadequate to break the inversion wave unless the reform thoughtfully addresses and reduces the disparity in U.S. tax treatment between U.S. and foreign corporations. On the other hand, such "residence-neutral" reform presents more of a political minefield than other reforms, such as lowering the corporate tax rate and moving toward a territorial system. For now, public opinion may hold some sway: given the increasingly uncertain legal landscape, investors have punished companies contemplating inversions. Plus, U.S. companies that decide against inverting are now lauded here at home as "patriots."

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