**The U.S. Anti-Inversion Regime:**

**Is it Time for the Hotel California to Adopt a New Check-out Policy?**[[1]](#footnote-1)

by

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The world economy has endured significant turmoil over the past two decades. The havoc commenced with the global financial crisis of 2008, followed by a global pandemic that reduced international commerce to virtually a trickle. Now, a post-pandemic inflationary period exacerbated by supply-chain disruptions, a protracted conflict in Eastern Europe, and an ongoing climate crisis have intensified the tumultuous period. Throughout this era, governments have attempted to provide relief to their populations while also addressing the consequences of the growing division between the haves and the have-nots. During this period of “simultaneous excess yet existential struggle, it is worth revisiting perhaps the greatest song ever written about the duality of the American experience and the human condition: ‘Hotel California’ by The Eagles.”[[3]](#footnote-3) Much has been written about the meaning behind this classic rock ballad. Some say Hotel California reflects the materialism and hyper-consumerism endemic to the Western World (“her mind is Tiffany-twisted; she drives the Mercedes-Benz.”); others see it as a metaphor for drug addiction (“mirrors on the ceiling, the pink champagne on ice; and she said ‘we are all just prisoners here, of our own device.’”); and still others see it as an ode to a psychiatric hospital (“there were voices down the corridor, I thought I heard them say”). Don Henley once told Rolling Stone magazine that Hotel California was about “facing some of the harsh realities of fame and life in Hollywood.” Although each view uniquely interprets the iconic song, they all speak to the allure of a better life only to be trapped by the idealization of what could be.

The feeling of entrapment feels apropos for the ensuing discussion—a suggested reset on how the United States should treat domestic multinationals wishing to expatriate—sometimes lured by the enchantment of a lower, global effective tax rate. This paper looks holistically at the U.S.’s anti-inversion regime and potential for reform, including (i) the history of the anti-inversion regime, (ii) the rationale for the series of rules causing more and more cross-border transactions to be classified as inversions, (iii) the U.S. government’s more recent proposals to place further restrictions on such transactions, and (iv) possible reforms to simplify the rules governing the regime while recentering it with global efforts to combat base erosion and profit shifting consistent with the inclusive framework proposals of the Organisation for Economic Co-operation and Development (the “OECD”).

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1. “Running for the Door:” Residency & Reason
   1. “Such a Lovely Place:” Corporate Tax Residency
      1. The U.S. Corporate Residency Rules

Domestic corporations,[[4]](#footnote-4) like U.S. citizens and residents, are taxed on their worldwide income.[[5]](#footnote-5) Foreign corporations, however, like nonresident alien individuals, are only taxed on U.S. source income and income effectively connected with the conduct of a trade or business in the United States.[[6]](#footnote-6) Thus, the status of a corporation as foreign or domestic has significant U.S. tax consequences. Luckily for corporate taxpayers, the U.S. adopted a simple test to determine corporate tax residency. Under the U.S. federal income tax system, a corporation is treated as a domestic corporation if it is created or organized under the laws of the United States, one of the states, or the District of Columbia.[[7]](#footnote-7) A corporation is treated as a foreign corporation if it is not a domestic corporation.[[8]](#footnote-8) That’s it.[[9]](#footnote-9) Simple. Straightforward. No multi-factor test to wade through. No need for the corporation’s tax director to toss and turn at night worrying whether his C.E.O. spent enough time in Ireland or whether the employee headcount in United States was assessed accurately.[[10]](#footnote-10) Yet the rules of other jurisdictions do not necessarily have this simplicity.

* + 1. Alternative Corporate Residency Tests

Other countries choose to determine corporate residency in, shall we say, a more nuanced fashion. As discussed above, U.S. tax law focuses singularly on a corporation’s jurisdiction of creation or organization to determine its residency. Other jurisdictions, in determining corporate residency, tend to focus on the location of certain activities—typically those related to management and board of directors’ meetings.[[11]](#footnote-11) For example, a corporation is a resident of Canada if Canada is the country in which it was incorporated *or* its central management and control is exercised there.[[12]](#footnote-12) Alternatively, a corporation generally is considered a resident of Mexico only if the place of the corporation’s main administration or effective management is in Mexico.[[13]](#footnote-13) A corporation generally will be tax resident in the United Kingdom if it is incorporated or managed and controlled there.[[14]](#footnote-14) These examples highlight the various methods jurisdictions use to determine corporate tax residency. Some jurisdictions follow a “central management and control” test,[[15]](#footnote-15) while other jurisdictions adhere to a “place of management” test.[[16]](#footnote-16) In both cases, though, the determination typically turns on facts and circumstances, and sometimes common law.[[17]](#footnote-17)

Corporations with operations in various jurisdictions struggle with their tax residency under these more complicated rules. If the corporation is managed and controlled in one country, but incorporated in another, for example, then the residence of the corporation is frequently determined by treaty, or the entity may be classified as a dual resident (i.e., a tax resident of two countries or jurisdictions). If a tax treaty is available, tiebreaker rules sometimes favor the location of the corporation’s management (as opposed to its place of incorporation). If no treaty is in force, the corporation may be subject to tax in both its country of incorporation and the country where its effective management is located.[[18]](#footnote-18) Although relief from double taxation may still be available under one of the jurisdiction’s domestic tax laws (e.g., a sufficiently robust foreign tax credit regime), entities face nontrivial corporate tax compliance nightmares. Even more troubling are corporate multinational enterprises (“MNEs”) that do not have certainty as to which country or countries consider them to be tax residents.[[19]](#footnote-19)

* 1. “Bring Your Alibis:” Corporate Taxpayer Rationale for Inverting
     1. Tax-Motivated Reasons

Before 2018 and the enactment of the Tax Cuts and Jobs Act of 2017 (“TCJA”), discussions emerged as to the reasons why U.S. MNEs sought to expatriate. During those discussions, the ability to compete against foreign MNEs with lower effective tax rates frequently topped the list.[[20]](#footnote-20) As part of this calculus, three potentially available tax benefits stood out—the avoidance of the U.S. controlled foreign corporation (“CFC”) regime (i.e., avoiding immediate U.S. taxation on certain foreign income), the increased facility to erode the U.S. tax base through deductions on related party interest and royalty payments, and the ability to tax-efficiently distribute ex-U.S. earnings to the group’s parent and ultimately to its shareholders.[[21]](#footnote-21)

The first of these benefits, the avoidance of the U.S. CFC regime, was primarily limited to passive-type income (i.e., subpart F income) and typically manageable by U.S. MNEs.[[22]](#footnote-22) The second of these benefits, stripping the U.S. tax base, was possible to achieve without inverting but it was limited in its scope in light of the types of payments required to be made from the U.S. parent (and its U.S. subsidiaries) to its CFCs,[[23]](#footnote-23) the relatively weak restrictions on deducting those payments,[[24]](#footnote-24) and the U.S. transfer pricing regime.[[25]](#footnote-25) The third benefit, the ability to repatriate foreign earnings without paying U.S. tax,[[26]](#footnote-26) became an endless game of cat and mouse where Treasury and the Internal Revenue Service (“I.R.S.”) would publish a new rule shutting down the latest repatriation technique only for U.S. MNEs and their tax advisors to find another path.[[27]](#footnote-27)

* + 1. Non-Tax-Motivated Reasons

Although tax no doubt plays a significant role in determining corporate residency, other non-tax factors enter the equation when a U.S. MNE considers whether to relocate the parent company. For one, not all mergers between U.S.- and foreign-based MNEs are hatched in the tax director’s office. As discussed below,[[28]](#footnote-28) many potential benefits enter into the equation about where best to locate the headquarters of newly combined enterprises—factors that the United States might not always be the best jurisdiction to provide—including local non-tax law, relevant infrastructure, proximity to essential natural resources, the experience and relative costs of the local (or nearby) labor force, reputational reasons, and proximity to key customers. In some cases, for example, small and mid-sized U.S. MNEs have sought quick, flexible, and efficient access to Canadian capital markets by completing an inversion with a Canadian-listed capital pool company. Such a move often has been driven by the additional non-tax benefit of achieving foreign private issuer status for U.S. securities law purposes.[[29]](#footnote-29) In other cases, industry regulations may be more favorable in the foreign jurisdiction.[[30]](#footnote-30)

1. “You Can Never Leave:” The History of the Anti-Inversion Regime
   1. Government Concerns

Corporate taxpayers have strived to reduce their global tax burden since the inception of the corporate income tax.[[31]](#footnote-31) They have employed countless techniques—some successful, some deemed abusive, and many ultimately thwarted by incremental changes to the tax law by Congress, Treasury, and the courts. Historically, efforts have included engaging in arrangements between U.S. and foreign related parties to obtain deductions against U.S. taxable income with the corresponding income inclusions in low- or no-tax jurisdictions. Some of the most common techniques involved intercompany debt and royalty arrangements. As commerce became more global and transitioned to an increased reliance on intangibles like patents, copyrights, customer lists, and more broadly know-how, shifting income away from the U.S. tax net through the transfer of these intangibles abroad became more and more commonplace. The U.S. government, in a perpetual game of catch up, passed new rules to combat these practices. The patchwork of changes to the Code and regulations have proven to be more akin to a series of screened doors than a brick wall.[[32]](#footnote-32)

In the 1980s, with news of high-profile corporate taxpayer attempts to permanently leave the U.S. tax net, Congress and Treasury took note.[[33]](#footnote-33) U.S. oil and gas conglomerate McDermott was the first to invert when, in 1982, it moved to Panama. In the transaction, a Panamanian subsidiary of the U.S. parent formed a U.S. corporation and merged that new corporation into the historical U.S. parent company. In the merger, the historical shareholders exchanged their U.S. parent stock for Panamanian subsidiary stock. The real tax juice in the inversion, however, was McDermott’s ability to effectively de-CFC its foreign subsidiaries that were rife with deferred, untaxed foreign earnings—earnings that would have been subject to U.S. corporate tax at full rates when ultimately repatriated back to its U.S. parent corporation.[[34]](#footnote-34) Congress responded to block such so-called stock inversions—albeit with a narrowly-tailored regulation modeled to thwart a McDermott-style inversion.[[35]](#footnote-35) Enacted in 1984,[[36]](#footnote-36) current section 1248(i) recharacterizes the McDermott inversion structure as a deemed distribution of historical CFC stock by the U.S. corporation to its shareholders in redemption of the parent stock. Under such a recharacterization, the historical U.S. parent is deemed as having received a taxable dividend—in essence forcing the inverting corporation to pay a repatriation tax with respect to all of its untaxed foreign earnings.

Perhaps they had it right—at least for a while. No other significant U.S.-parented business attempted such a maneuver for nearly a dozen years. That all changed in 1993 when Helen of Troy, a publicly-traded cosmetics company, reorganized and inverted into a Bermuda corporation. Treasury fought back with the publication of new regulations soon thereafter—Treasury Regulation (“Treas. Reg.”) section 1.367(a)-3T which generally rendered a U.S. person’s transfer of stock in a U.S. corporation to a foreign transferee corporation taxable even though the transaction might otherwise qualify for nonrecognition treatment under, for example, the subchapter C reorganization regime. That said, the temporary regulations provided a series of exceptions to the immediate taxation rule, the most relevant of which was referred to as the so-called “limited interest” exception.[[37]](#footnote-37) This “limited interest” exception generally provided that a U.S. person was eligible for nonrecognition treatment on the transfer of stock in a domestic corporation to a foreign corporation if (i) all of the U.S. transferors, in the aggregate, owned less than 50 percent of the total voting power and the total value of the transferee foreign corporation and (ii) the subject U.S. transferor owned less than five percent of both the total voting power and the total value of the stock of the transferee foreign corporation—in each case, taking into account the attribution rules of section 958.

* 1. The Helen of Troy Regulations: Tax the Shareholders

With the ball back in their court, Treasury and the I.R.S. attempted to thwart the potential inversion trend with the issuance of Notice 94-46,[[38]](#footnote-38) and ultimately the promulgation of Treas. Reg. section 1.367(a)-3(c) (frequently referred to as the “Helen of Troy regulations”). These rules primarily sought to protect the U.S. fisc against appreciated property leaving the U.S. taxing jurisdiction without paying an exit tax.

* + 1. The Modified Treas. Reg. Section 1.367(a)-3(c) Regulations

Section 367(a)(1) provides that if a U.S. person transfers property to a foreign corporation pursuant to section 354, then such foreign corporation shall not be treated as a corporation for purposes of determining the extent to which gain is recognized on such transfer. Section 354 applies only if a shareholder of a corporation, which is a party to a reorganization, transfers stock of such corporation in exchange for stock in another corporation, which is a party to such reorganization. Thus, section 367(a)(1), if applicable, renders section 354 inapplicable to transfers of stock in a domestic corporation in exchange for stock in a foreign corporation, which generally results in full gain recognition for U.S. persons on their transfers of such domestic corporation stock to the foreign corporation. However, when a U.S. person (referred to as a U.S. transferor) transfers stock in a domestic corporation (referred to as a U.S. target company) to a foreign corporation (referred to as a transferee foreign corporation) pursuant to section 354, Treas. Reg. section 1.367(a)-3(c) provides an exception to the general rule in section 367(a)(1) if the seven requirements discussed below are satisfied.

First, 50 percent or less of both the total voting power and the total value of the stock of the transferee foreign corporation must be received in the transaction, in the aggregate, by U.S. transferors.[[39]](#footnote-39) Second, 50 percent or less of each of the total voting power and the total value of the stock of the transferee foreign corporation must be owned, in the aggregate, immediately after the transfer, by U.S. persons that are either officers or directors of the U.S. target company or that are five-percent target shareholders.[[40]](#footnote-40) Third, each U.S. person who is a five-percent transferee shareholder[[41]](#footnote-41) must enter into a five-year agreement to recognize gain with respect to the U.S. target company stock in the form provided in Treas. Reg. section 1.367(a)-8.[[42]](#footnote-42) Fourth, the transferee foreign corporation, or a qualified subsidiary,[[43]](#footnote-43) must satisfy the active trade or business requirement in Treas. Reg. section 1.367(a)-3(c)(3).[[44]](#footnote-44) Fifth, at the time of the transfer, neither the transferors nor the transferee foreign corporation (and, if applicable, the qualified subsidiary) may have an intention to substantially dispose of or discontinue the active trade or business.[[45]](#footnote-45) Sixth, the substantiality requirement in Treas. Reg. section 1.367(a)-3(c)(3)(iii) must be satisfied.[[46]](#footnote-46) And finally, the U.S. target company must comply with the reporting requirements in Treas. Reg. section 1.367(a)-3(c)(6), which generally require the U.S. target company to attach a number of statements to its U.S. federal income tax return for the year of transfer.[[47]](#footnote-47)

* + 1. The Treas. Reg. Section 1.367(a)-3(c) Regulations in Practice

As can be seen from the explanation above, although somewhat challenging to satisfy, these narrowly drafted rules generally only apply to require gain recognition in transactions otherwise eligible for nonrecognition treatment where either the transferor group received 50 percent or more of the foreign acquiror’s stock or the transferred business exceeded the value of the foreign acquiror’s business.[[48]](#footnote-48) The potential for erosion of the U.S. tax base remained: U.S.-headquartered businesses could still combine with foreign businesses while partially or entirely escaping the U.S. tax net. Moreover, as individual capital gains rates fell and corporate boards became seemingly less concerned about shareholder-level, transaction-related taxes and more focused on reducing their MNE’s global effective tax rates,[[49]](#footnote-49) the Helen of Troy regulations, in many ways, became largely ineffective in the battle against inversions. Further, more and more shareholders of publicly-traded companies are either non-U.S. residents or tax-exempt entities—that is, not subject to U.S. tax on any gain realized in exchanging their U.S. stock for foreign corporation stock.[[50]](#footnote-50)

* 1. The Enactment of Section 7874
     1. Legislative Background

The rather limited impact of the Helen of Troy regulations and some high-profile expatriation-type transactions rekindled Congressional interest to consider more robust legislation to tackle the inversion problem. In early 2002, news outlets reported on the expectations of a new surge of corporate expatriations from the United States to foreign tax havens and a heightened sense of patriotism arose in the wake of the terrorist attacks of September 11, 2001. These formed the backdrop of bipartisan hostility toward inversions.[[51]](#footnote-51) As the inversion debate took center-stage among tax policy experts, MNEs and their lobbyists, and legislators on the tax-writing committees, two primary schools of thought emerged regarding U.S. international tax reform. One favored fundamentally changing the U.S. international tax rules to “level the playing field” and make the U.S. tax system more competitive vis-à-vis more tax-competitive jurisdictions.[[52]](#footnote-52) Pursuant to this line of thinking, the reformed U.S. tax laws would encourage U.S. MNEs to remain in the United States while incentivizing foreign MNEs to increase their U.S. investments. The other school of thought favored limiting a U.S. MNE’s ability to reduce its U.S. tax burden through self-help such as relocating the U.S. parent to a foreign jurisdiction. As fundamental tax reform continued to prove elusive, Congress hoped to constrain U.S. MNEs’ planning opportunities by, in certain circumstances, denying their departure—effectively adopting a Hotel California check-out policy for would-be corporate expatriates.[[53]](#footnote-53)

Some in the second school of thought, however, were opposed to enacting a provision targeted at restricting U.S. MNEs from engaging in inversions. They argued that (i) the U.S. tax law placed its U.S.-parented companies at a competitive disadvantage,[[54]](#footnote-54) (ii) a dividend exemption system would grow U.S. exports,[[55]](#footnote-55) (iii) the current system would continue to result in the takeover trend of U.S. corporations by foreign competitors—especially those headquartered in more tax-friendly jurisdictions,[[56]](#footnote-56) and (iv) lowering the U.S. corporate tax rate while moving to a territorial system would eliminate the need for U.S. MNEs to invert.[[57]](#footnote-57) Despite the two schools of thought, anti-inversion legislation was gaining momentum on both sides of the aisle. In 2002 and 2003, Democrats and Republicans both put forward several legislative proposals designed to curb the practice.[[58]](#footnote-58)

Advocates for passage of the legislation attempted to refute the above concerns in an effort to pass the legislation and stem the inversion tide. First, they believed arguments that the U.S. tax system was uncompetitive were inaccurate. They pointed to a study conducted by the Joint Committee on Taxation finding that most large economies at the time had CFC regimes and few had pure territorial systems where all foreign-source income was exempt from taxation.[[59]](#footnote-59) Further, anti-inversion-legislation advocates argued that the United States’ foreign tax credit rules were not that different from other countries’ dividend exemption systems taking into account cross-crediting and the ability to use excess credits relating to high-tax jurisdictions against earnings sourced in low-tax jurisdictions.[[60]](#footnote-60)

Second, some advocates for anti-inversion legislation likewise refuted the argument that a dividend exemption system would increase U.S. exports. They pointed to then-in-force Code provisions that benefitted U.S. exporters—mainly the extraterritorial income (or ETI) exclusion[[61]](#footnote-61) and the sales source rule[[62]](#footnote-62)—to the tune of over $5 billion annually that would have been lost under a dividend exemption system.[[63]](#footnote-63)

Third, there were many advocates (including Treasury at the time) who strongly believed that lowering the corporate tax rate and moving to a territorial system would end the incentive to invert—thus, rendering anti-inversion legislation unnecessary.[[64]](#footnote-64) Proponents of the legislation, however, argued that one of the primary benefits for would-be inverters was the ability to reduce their U.S. source income through intercompany transactions. Such transactions would result in deductions against U.S. source income while the related recipient would not pay tax in the United States (being no longer subject to the U.S.’s CFC regime) or in its home country.

* + 1. The Legislative History of Section 7874

Those favoring a targeted approach to the inversion problem—that is, legislation that focused specifically on the transactional structure historically used by inverters—ultimately won the day.[[65]](#footnote-65) Only the fine strokes remained. The House bill generally provided that if a domestic corporation underwent a 60-percent inversion (described in detail below),[[66]](#footnote-66) “any applicable corporate-level ‘toll charges’ for establishing the inverted structure [would not be] offset by tax attributes such as net operating losses or foreign tax credits.”[[67]](#footnote-67)

The Senate amendment created a second inversion category whereby if the domestic corporation underwent an 80-percent inversion (using the same requirements as the House’s 60-percent inversion, and only increasing the shareholder continuity percentage), the foreign acquiring corporation would be deemed to be a domestic corporation for all U.S. federal income tax purposes.[[68]](#footnote-68) In addition, the Senate amendment provided that the House’s 60-percent inversion rules would not change but for reducing the percentage from at least 60 percent to more than 50 percent.[[69]](#footnote-69) With respect to inverted companies, the Senate bill also increased return penalties and strengthened then-section 163(j) by eliminating the provision’s debt-to-equity threshold and reducing the 50-percent thresholds for excess interest expense and excess limitation to 25 percent.[[70]](#footnote-70)

The Senate and the House ultimately reached a compromise whereby the bill would retain the Senate’s 80-percent inversion rule and adopted the House’s 60-percent rule (rather than the Senate’s greater-than-50-percent inversion rule).[[71]](#footnote-71) Further, the bill would abandon the heightened return-related penalties and strengthening of section 163(j) for inverters.[[72]](#footnote-72)

* + 1. Enactment of Section 7874 and Its Aftermath

Section 7874 was ultimately enacted in 2004.[[73]](#footnote-73) As with the Helen of Troy regulations, taxpayers still managed to structure transactions that avoided the application of section 7874 (and thus avoided recharacterization of the new foreign parent as a domestic corporation for U.S. tax purposes). Yet, in the immediate years following its enactment, at least according to the Congressional Budget Office, there were a limited number of inversions (a total of 10 inversions between 2004 and 2011).[[74]](#footnote-74) This perceived slowdown in inversions was perhaps in part due to promised international tax reform that would shift the United States to a more territorial system and in part due to the continued ability of U.S. MNEs to indefinitely defer most of the U.S. tax on their foreign earnings by reinvesting them overseas.

* + - 1. Section 7874’s Statutory Scheme
         1. When is a Transaction a 60-Percent Inversion?

Section 7874 imposes certain U.S. federal income tax consequences upon “inverted” domestic corporations or partnerships that become subsidiaries of foreign corporations while retaining a specified portion of their historical ownership.[[75]](#footnote-75) The statute provides that a foreign acquiring corporation is treated as a “surrogate foreign corporation” (and thus subject to the inversion gain rules discussed below) if, pursuant to a plan (or a series of related transactions), three requirements are satisfied (a “60-percent inversion”). First, the foreign corporation must complete the direct or indirect acquisition of substantially all of the properties held directly or indirectly (by way of stock acquisition or otherwise) by a domestic corporation. Second, after the acquisition, at least 60 percent of the stock (by vote or value) of the foreign corporation must be held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation (the “60-percent test”).[[76]](#footnote-76) Third, after the acquisition, the expanded affiliated group (“EAG”) that includes the foreign corporation does not have substantial business activities in the foreign country in which or under the law of which the foreign corporation is created or organized, when compared to the total business activities of that EAG.[[77]](#footnote-77)

* + - * 1. What are the Consequences of a 60-Percent Inversion?

If a domestic entity is acquired pursuant to a 60-percent inversion (and, thus, becomes an expatriated entity),[[78]](#footnote-78) its taxable income during the “applicable period”[[79]](#footnote-79) *cannot be less than* its “inversion gain.”[[80]](#footnote-80) Inversion gain is equal to: (i) income or gain arising from the transfer of stock or other properties by an expatriated entity during the applicable period; and (ii) income received or accrued during the applicable period from a license of property (other than inventory).[[81]](#footnote-81) Both types of inversion gain can arise only from transfers or licenses by an expatriated entity as part of the direct or indirect acquisition of substantially all of the properties held directly or indirectly by the expatriated entity or after such acquisition if the transfer or license is to a foreign affiliate. Inversion gain cannot be offset by tax credits or other tax attributes such as net operating losses.[[82]](#footnote-82)

Further, the legislation also included new section 4985, a provision that imposes a 15-percent excise tax on stock-based compensation held by “disqualified individuals” of an expatriated entity during the 12-month period beginning six months before the acquisition described in section 7874(a)(2)(B)(i). For this purpose, a disqualified individual is generally defined as any person subject to the requirements of section 16(a) of the Securities Exchange Act of 1934 with respect to the relevant domestic entity or any member of the EAG that includes such entity.[[83]](#footnote-83) This excise tax does not apply in the event of an 80-percent inversion.

* + - * 1. When is a Transaction an 80-Percent Inversion?

The inversion gain-related consequences of a 60-percent inversion do not apply if the first and third requirements discussed in Part ‎II.C.3.a(2) above are satisfied and after the acquisition, former shareholders of the domestic corporation own at least 80 percent of the foreign acquiring corporation’s stock, by vote or by value, by reason of their stock ownership in the domestic corporation (the “80-percent test”).[[84]](#footnote-84) Instead, the foreign acquiring corporation is treated as a domestic corporation for all U.S. federal tax purposes.[[85]](#footnote-85)

* + - * 1. Treasury Authority to Grant Regulations

Section 7874(c)(4) disregards transfers of properties or assumptions of liabilities if the transfers or assumptions are part of a plan a principal purpose of which is to avoid the purposes of section 7874. Section 7874(c)(6) provides Treasury and the I.R.S. with the power to issue regulations enforcing section 7874(c)(4), and section 7874(g) provides Treasury and the I.R.S. with the general power to “issue such regulations as are necessary to carry out this section.”

* + - 1. The First Wave of Regulatory Guidance

Not long after the enactment of section 7874, Treasury and the I.R.S. published guidance generally relating to certain statutory ambiguities and also addressing certain “abuse” concerns. The commentary below does not pretend to cover the waterfront of the initial wave of section 7874 regulatory guidance. Rather it provides a summary of the primary provisions—provisions that generally sought to better explain the statute rather than expand its scope.

A first area in need of guidance concerned the definition of an EAG. The guidance provided that, notwithstanding the general rule that stock held by one or more members of the EAG is not included in the ownership fraction for determining whether a foreign acquiring corporation satisfies the 60-percent test or the 80-percent test, Treas. Reg. section 1.7874-1(c)(1) would include such stock in the denominator (but not in the numerator) of the ownership fraction if there is (i) a so-called “internal group restructuring” or (ii) a so-called “loss of control.” On balance, these rules limited the application of the anti-inversion regime by ensuring that certain related party transactions that, in spirit, were not intended to result in an inversion, did not.[[86]](#footnote-86)

A second area in need of clarification related to whether an indirect acquisition of property occurred for purposes of section 7874.[[87]](#footnote-87) As described above, section 7874 applies to direct and indirect acquisitions of the properties held by a domestic entity. Treas. Reg. section 1.7874-2(c) provided that, for the purposes of section 7874(a)(2)(B)(i), an indirect acquisition of properties held by a domestic entity includes (i) an acquisition of stock of a domestic corporation; (ii) an acquisition of an interest in a partnership; (iii) an acquisition by a corporation (the acquiring corporation) of properties held by a domestic corporation (or a partnership) in exchange for stock of a foreign corporation (the foreign issuing corporation) that is part of the EAG that includes the acquiring corporation after the acquisition; and (iv) an acquisition by a partnership (the acquiring partnership) of properties held by a domestic entity in exchange for stock of a foreign corporation that is part of the EAG that includes the acquiring partnership after the acquisition.

A third area in need of guidance centered on the treatment of options.[[88]](#footnote-88) Treas. Reg. section 1.7874-2(h)(1), published in 2012, provides that for purposes of section 7874 an option with respect to a corporation or partnership will generally be treated as stock in the corporation, or an interest in the partnership, with a *value* equal to the holder’s “claim on the equity” of the corporation or partnership, including for purposes of determining membership of an EAG. For this purpose, the claim on equity equals the value of the stock or partnership interest that can be acquired pursuant to the option, less the exercise price of the option.[[89]](#footnote-89) Unlike with respect to value, Treas. Reg. section 1.7874-2(h)(2) provides that an option will not be treated as exercised for purposes of determining the *vote* of a foreign corporation under section 7874, including for purposes of determining the membership of an EAG, unless a principal purpose for the issuance or transfer of the option is to avoid causing the foreign corporation to be treated as a surrogate foreign corporation.[[90]](#footnote-90)

A fourth area in need of guidance related to which stock of the foreign parent corporation should be included in the ownership fraction when received by a person other than a shareholder of the domestic target corporation in their capacity as such. The initial so-called “disqualified stock” rules under Treas. Reg. section 1.7874-4T(a) generally provided that any stock of the foreign acquiring corporation that was “disqualified stock” was not included in the denominator of the ownership fraction for purposes of the 60-percent test or the 80-percent test. Stock of the foreign acquiring corporation was generally disqualified stock if such stock was transferred to any person other than the domestic entity in exchange for “nonqualified property.”[[91]](#footnote-91) Although disqualified stock is excluded from the denominator of the ownership fraction, it is nevertheless taken into account for purposes of determining whether an entity is a member of an EAG, and for determining whether an acquisition qualifies for the internal group restructuring or loss of control rules in Treas. Reg. section 1.7874-1(c).[[92]](#footnote-92)

1. “My Head Grew Heavy and My Sight Grew Dim:” The Current Rules
   1. Introduction

The promise of tax reform remained elusive and, starting in 2012, a new trend of inversion transactions began. U.S. businesses sought to further reduce their effective tax rates, arguably to better compete with lower-taxed, foreign-parented competitors. And again, corporate boards willing to subject their shareholders to relatively low U.S. capital gains rates, coupled with their ability to avoid section 7874(b) by ensuring that the historical shareholders of the U.S. target did not acquire 80 percent or more of the foreign parent corporation’s stock in the combination, rendered the new statute insufficiently robust to combat the government’s income shifting and base erosion concerns. So as tax reform discussions between the Obama Administration and the Republican-controlled Congress reached a stalemate, Treasury crafted a series of regulatory dikes to hold back the tide of inversions. The measures taken were neither temporary nor simple. What ensued was a deluge of regulations significantly expanding the scope of section 7874 in ways unfathomable when originally enacted. In a span of less than two years, the statute’s regulatory scheme grew to the 12-section behemoth it is today. And that does not even take into account ancillary regulations to further confine the benefits of a successful inversion to which the 80-percent-or-more ownership rule of section 7874(b) does not apply.[[93]](#footnote-93)

When enacted, section 7874 contained numerous ambiguities, some of which were answered through the subsequent promulgation of regulations. For the most part, as discussed above, these regulations centered around the definition of an expanded affiliated group and certain issues relating to stock options and potentially abusive transactions designed to avoid the statute.[[94]](#footnote-94) Since then, however, the parade of new rules issued during President Obama’s second term was substantially devoted to expanding the scope of section 7874 by increasing the ownership fraction and resulted in making transactions once considered run-of-the-mill subject to section 7874(b).

* 1. Summary of the Obama-era Anti-Inversion Regulations

With the promise of fundamental corporate international tax reform politically unattainable during the Obama Administration’s second term and an increasing number of large publicly-traded U.S.-based MNEs announcing plans to invert, Treasury set out to promulgate a raft of new rules designed to stop thoughts of vacating the U.S. tax net in their tracks—or at least until reform could be achieved.

* + 1. The Notice 2014-52 Restrictions

On September 22, 2014, the I.R.S. issued Notice 2014-52 (the “2014 Notice”) to announce that Treasury and the I.R.S. intended to issue regulations applying to inversion transactions.[[95]](#footnote-95) The 2014 Notice contained six new rules, some of which became applicable to inversion transactions. The regulations containing these new rules would be effective for acquisitions completed on or after September 22, 2014.[[96]](#footnote-96)

The 2014 Notice announced four notable new rules. The first rule would supplement the “disqualified stock” rule under Treas. Reg. section 1.7874-4T by disregarding certain stock of a foreign acquiring corporation belonging to an EAG that holds a certain percentage of passive assets immediately after the acquisition of a domestic entity (or substantially all of its assets).[[97]](#footnote-97) In essence, under this so-called “cash box” rule, if more than 50 percent of the gross value of all foreign group property was foreign group nonqualified property, then the denominator of the ownership fraction would be reduced according to a formula.[[98]](#footnote-98)

A second rule disregarded so-called “non-ordinary course distributions” (or “NOCDs”) made by the domestic entity prior to an inversion for the purposes of applying the 60-percent test and the 80-percent test.[[99]](#footnote-99) Section 2.02 of the 2014 Notice provided that Treasury and the I.R.S. intended to issue regulations stating that if a domestic entity (including a predecessor) made NOCDs during the 36-month period ending on the date when the acquisition of the domestic entity is completed by a foreign acquiring corporation,[[100]](#footnote-100) such distributions would be treated as part of a plan a principal purpose of which was to avoid the purposes of section 7874 and would thus be disregarded pursuant to section 7874(c)(4). These rules, in what ultimately came to be known as the NOCD rules, proved to be one of the greatest expansions of the scope of the statute and led to the thwarting or restructuring of several would-be inversions.[[101]](#footnote-101)

A third rule was designed to prevent domestic corporations from inverting a piece of their business through so-called “spinversions.”[[102]](#footnote-102) The rule denies the use of the EAG rule and internal group restructuring exception in situations where a U.S. subsidiary of a U.S. parent transfers substantially all of its assets to a new foreign subsidiary and the shares of the new foreign subsidiary are distributed to the U.S. parent’s shareholders in a section 355-qualifying distribution. Pursuant to this rule, the new foreign acquirer (i.e., the controlled corporation in the section 355 context) would be treated as a domestic corporation under section 7874.

The fourth rule related to the 2014 Notice’s announcement that Treasury and the I.R.S. would issue regulations to prevent successfully inverted corporations from taking advantage of certain tax benefits otherwise available now that their ultimate parent company was a foreign corporation. These regulations would prevent (i) the use of hopscotch loans (by treating them as investments in U.S. property triggering current subpart F inclusions),[[103]](#footnote-103) (ii) decontrolling transactions whereby historical CFCs would no longer be controlled by U.S. shareholders (by deeming the CFC shares to be shares to continue to be held by the historical U.S. parent),[[104]](#footnote-104) and (iii) so-called “out-from-under” planning where the foreign parent would sell an interest in the U.S. parent to a CFC to later tap that CFC’s earning and profits without triggering a subpart F inclusion (by expanding the scope of the section 304 regulations).[[105]](#footnote-105)

* + 1. The Notice 2015-79 Restrictions

On November 19, 2015, the I.R.S. issued Notice 2015-79 (the “2015 Notice”) announcing that Treasury and the I.R.S. intended to issue additional anti-inversion regulations (i.e., beyond those announced in the 2014 Notice). The 2015 Notice outlined eight more changes to already existing or proposed rules. The first new rule would narrow the availability of the substantial business activities test exception. Historically, the substantial business activities test was determined based upon the level of business activities that the foreign acquiring corporation’s EAG had in the foreign acquiring corporation’s country of creation or organization without regard to whether it was a tax resident in that country. But, as mentioned earlier, many foreign jurisdictions instead determine tax residency based upon where a corporation is managed or controlled.[[106]](#footnote-106) The 2015 Notice announced a new rule that the substantial business activities test would no longer be satisfied if the foreign acquiring corporation was not subject to tax as a resident in the country in which it is created or organized.[[107]](#footnote-107)

The second new rule has come to be known as the “third-country rule.” In general, the third-country rule applies when a domestic corporation and a foreign corporation combine under a foreign parent corporation that is tax resident in a jurisdiction other than the jurisdiction in which the acquired foreign corporation is tax resident.[[108]](#footnote-108) Specifically, when a domestic entity acquisition is a third-country transaction, stock of the foreign acquiring corporation held by reason of holding stock in the acquired foreign corporation (i.e., the initial foreign acquiring corporation that acquired the domestic target corporation) is excluded from the denominator of the ownership fraction.[[109]](#footnote-109) The rule effectively requires only a 60-percent ownership percentage, rather than 80, to treat the foreign acquiring corporation as a domestic corporation under section 7874(b).[[110]](#footnote-110)

The third rule clarified the definition of “avoidance property” when foreign acquiring stock was received in exchange for “nonqualified property,” and thus disregarded from the ownership test.[[111]](#footnote-111) Nonqualified property was generally defined to include several types of passive assets and any property acquired in a transaction related to the inversion with a principal purpose of avoiding the purposes of section 7874.[[112]](#footnote-112) The 2015 Notice provided that avoidance property could be any type of property and was not limited to property used to indirectly transfer passive assets treated as nonqualified property to a foreign acquiring corporation.[[113]](#footnote-113)

The fourth rule expanded the definition of inversion gain.[[114]](#footnote-114) The 2015 Notice expanded this definition to include income or gain recognized with respect to certain indirect property transfers or licenses that are analogous to the then-current inversion gain definition.[[115]](#footnote-115) In an example provided in the Notice, this new rule would treat subpart F income recognized by a domestic target corporation as a result of its CFC transferring property to a related foreign person during the applicable period as inversion gain.[[116]](#footnote-116)

The 2015 Notice also announced that Treasury and the I.R.S. would issue regulations to (i) require full gain recognition in certain “de-CFCing” transactions (i.e., where a CFC’s ownership by U.S. shareholders is diluted), (ii) exclude certain insurance- and banking-related property from the definition of foreign group nonqualified property, and (iii) subject the NOCD rules to a less than five percent ownership continuity *de minimis* rule.

* + 1. “This Could Be Heaven or This Could Be Hell”: The Debt Recharacterization Rules

In both the 2014 Notice and the 2015 Notice, Treasury and the I.R.S. announced that they were “considering guidance to address strategies that avoid U.S. tax on U.S. operations by shifting or ‘stripping’ U.S.-source earnings to lower-tax jurisdictions, including through intercompany debt.”[[117]](#footnote-117) On April 8, 2016, the government made good on its promise with the publication of a sweeping set of proposed regulations aimed at related-party indebtedness.[[118]](#footnote-118) The main focus for MNEs was on the proposed regulations under Treas. Reg. section 1.385-3. Subject to limited exceptions, Prop. Treas. Reg. section 1.385-3 automatically treated related-party debt instruments that were issued in one of three enumerated transactions as stock. Although the preamble to the proposed regulations indicated that a distribution of a debt instrument is the prototypical transaction targeted by Prop. Treas. Reg. section 1.385-3, the proposed regulations applied equally to debt instruments issued in transactions that Treasury believes implicated “similar policy considerations.”[[119]](#footnote-119) In the preamble, the government stated that inverted and foreign-parented groups would often receive debt instruments in the form of dividends from U.S. subsidiaries, which would then make deductible interest payments and reduce U.S. source income. In addition, the government also noted that U.S.-parented groups could use the distribution of a debt instrument from a first-tier CFC to facilitate the receipt of untaxed foreign earnings without recognizing dividend income. Based on these policy concerns, a rule (referred to as the “general rule”) was published that recharacterized such debt instruments as stock.[[120]](#footnote-120)

The scope of the final Treas. Reg. section 1.385-3 regulations was narrowed. For example, they exempted certain U.S. shareholder-CFC debt instruments that were less likely to result in erosion of the U.S. tax base.[[121]](#footnote-121) That said, the regulations remained applicable to debt issued by a domestic corporation to its foreign parent (or related foreign subsidiary not underneath the domestic corporation). This was yet another deterrent to would-be inverters because a significant method of earnings stripping post-inversion would no longer be available.[[122]](#footnote-122)

* + 1. The Multi-Step Acquisition and Serial Inverter Rules

Before 2009, when a foreign acquiring corporation sought to acquire multiple domestic corporations, provided that no single acquisition resulted in the relevant target corporation satisfying the requisite ownership test, the acquisitions were not aggregated for purposes of calculating the ownership fraction. Treasury and the I.R.S. grew leery of such transactions as a possible end around the anti-inversion rules—at least when the acquisitions at issue were pursuant to a single, overall plan. Thus, in 2009, the government issued temporary regulations providing when two or more acquisitions were “pursuant to a plan (or series of related transactions),” the acquisitions were to be treated as a single transaction and the domestic entities treated as a single entity.[[123]](#footnote-123) This rule was finalized in 2012 as Treas. Reg. section 1.7874-2(e).[[124]](#footnote-124)

On its own, the aggregation rule under Treas. Reg. section 1.7874-2(e) was nothing more than a speed bump for U.S. MNEs and their would-be foreign acquirors. Subsequent transactions were inked, in which a foreign corporation serially would acquire U.S. targets without a formal plan, that is, until Irish-based Allergan attempted to acquire U.S.-based MNE Pfizer.[[125]](#footnote-125)

Allergan had been buying up U.S.-based pharmaceutical companies during the three-year period leading up to the Allergan-Pfizer announcement,[[126]](#footnote-126) but the parties (and presumably their counsel) were confident that none of Allergan’s previous acquisitions were part of the same plan as this mega-merger.[[127]](#footnote-127) The proposed transaction between Allergan and Pfizer, however, appears to have been the straw that broke the government’s back. A few months after the deal’s announcement and before it could be executed, Treasury and the I.R.S. promulgated two transaction aggregation rules in 2016—the multi-step acquisition rule and the serial inverter rule. The latter permanently ended Allergan’s attempt to acquire Pfizer and create a new super-pharmaceutical company organized in Ireland and headquartered in New York.

The multi-step acquisition rule provides that if a foreign corporation acquires substantially all the assets of a domestic corporation and is subsequently acquired in a related transaction by another foreign corporation, then the subsequent acquisition may be treated as a separate domestic entity acquisition.[[128]](#footnote-128) Specifically, a subsequent acquisition is treated as a separate domestic entity acquisition, and the subsequent acquiring corporation is treated as a separate foreign acquiring corporation.[[129]](#footnote-129)

Under the so-called “serial inverter” rule,[[130]](#footnote-130) stock of the foreign acquiring corporation attributable to acquisitions of domestic corporations occurring during the three-year period prior to the tested acquisition would be excluded from the denominator of the ownership fraction regardless of whether the acquisitions were pursuant to the same plan.[[131]](#footnote-131) The three-year period ends on the signing date of the tested acquisition.[[132]](#footnote-132)

Thus, turning back to Allergan, based on the deal terms and taking into account Allergan’s prior acquisitions during the pre-announcement, 36-month period, the ownership fraction would have significantly exceeded the 80-percent threshold rendering Allergan a domestic corporation under section 7874(b). This serial inverter rule also contained an anti-abuse rule provision to disregard terminations of signed but yet-to-be closed transactions replaced with similar transactions in the future (just in case Pfizer and Allergan had any notions of waiting three years before resurrecting their deal).[[133]](#footnote-133)

* + 1. “Plenty of Room at the Hotel California:” Catching the Unexpected

In the aggregate, the Obama-era anti-inversion regulations achieved their short-term goal: the parade of U.S. MNEs seeking to expatriate slowed to a crawl. That said, the new rules as promulgated also thwarted more than their fair share of acquisitions that seemingly were based on neither on U.S. tax savings nor any meaningful shareholder overlap. These were, in essence, transactions that died in the board room either because the ownership fraction was significantly higher than expected or due to one of a myriad of technical foot faults that would have rendered the foreign acquirer a surrogate foreign corporation under section 7874(a)(2)(B) or a domestic corporation under section 7874(b). And, perhaps even more unfortunate from a tax policy standpoint, the sheer arbitrariness of the regime often picks winners and losers based not on line-drawing or facts and circumstances, but rather on the limitations of Treasury’s authority to ensure that similar transactions are treated similarly. As one commentator put it:

Whatever the wisdom of the inversions rules may be, it is clear that the legislation and the decade of regulatory guidance that followed have imported a high degree of complexity and arbitrariness into the area. Transactions that should never be thought of as inversions turn out to be caught by the expatriation rules. Arbitrary distinctions cause vast differences in the outcome of similar transactions, and shareholders end up bearing the burden of penalties intended to be meted out to directors and managers.[[134]](#footnote-134)

Believe it or not, the above quote was actually written before the promulgation of the Obama-era anti-inversion regulations. Since its inception, section 7874 has been catching transactions that seem far afield from the purpose and policy for which it was enacted. The shear breadth of the statute and the regulations that followed can be illustrated by way of a few examples.

First, consider an individual owner. Individual (“FI”), a citizen and resident of Country X, directly owns 100 percent of a domestic corporation (“USP”),[[135]](#footnote-135) worth $80x, and a Country X corporation (“FP”) worth $20x. In an effort to consolidate their business (perhaps with an eye towards raising more capital in the future), FI transfers USP to FP solely in exchange for FP stock (or as a capital contribution). In this case, FP’s acquisition of USP would result in an 80-percent inversion rendering FP a domestic corporation under section 7874(b).[[136]](#footnote-136)

Second, consider two unrelated individuals. The first individual (IndX) a citizen and resident of Country X, owns 100 percent of USP, a domestic corporation worth $80x. The second individual (IndY) a citizen and resident of Country Y, owns 100 percent of FP, a Country Y corporation worth $20x. Both IndX and IndY believe that there are non-tax synergies to be achieved by combining their respective businesses. To that end, IndX and IndY transfer 100 percent of the stock of their respective corporations to FHCo, a newly formed holding company in Country Z, in exchange for 80 percent and 20 percent, respectively, of the stock of FHCo. FHCo has no assets (other than stock in USP and FP) or operations in FHCo. In this case, FHCo’s acquisition of USP would result in an 80-percent inversion rendering FHCo a domestic corporation under section 7874(b).[[137]](#footnote-137) FP would become a CFC of FHCo subject to the U.S. anti-deferral regime.

In both of the above examples, what policy objectives are achieved by subjecting not only USP but also FP to U.S. tax on its worldwide earnings? USP could just as easily erode the U.S. tax base before and after the transaction. Further, with respect to the first example, prior to the transaction FP could have grown its ex-U.S. business operations without subjecting the FP group’s income to U.S. taxation.

Third, consider two publicly-traded corporations. The first, USP, is a domestic corporation, and the second, FP, is a foreign corporation. FP, a pure holding company, owns 100 percent of FA, a foreign corporation that also acts as a pure holding company. A, an individual, owns 0.1 percent of the stock of both USP and FP. USP and FP decide to merge whereby the USP shareholders transfer their USP stock to FA in exchange for 49.9 percent of FA’s stock. At first blush, the combination should not result in an inversion (60 percent or 80 percent) because, pursuant to the “loss of control” exception to the EAG rules,[[138]](#footnote-138) the general EAG exclusion rule is turned off resulting in an ownership fraction of 49.9 percent.[[139]](#footnote-139) However, A’s 0.1-percent historical ownership of FP must be taken into account in determining whether the “loss of control” exception is available.[[140]](#footnote-140) As a result, FP’s stock in FA is excluded from both the numerator and the denominator of the ownership fraction resulting in a 100 percent fraction and an 80-percent inversion. Some would argue that such a transaction should not result in an inversion of any kind.[[141]](#footnote-141) The first three examples highlight a few of the many unexpected outcomes of a statutory and regulatory scheme that focuses more on bright lines than ensuring economically-similar transactions receive same treatment.

Fourth, consider a scenario relating to the NOCD rules under Treas. Reg. section 1.7878-10. USP, a publicly traded domestic corporation, USP, wholly owns two domestic corporate subsidiaries, S1 worth $20x, and S2, worth 80x. In a pro rata distribution qualifying under section 355, USP distributes all of the stock of S1 to the USP shareholders. Within 36 months of the distribution, FP, a foreign corporation worth $20x with 20 million shares outstanding immediately before the acquisition, acquires all of the stock of S1 at a time when S1 is still worth $20x whereby the USP shareholders received $10x in cash and 10 million shares of FP stock. FP’s acquisition of S1 does not result in a 60- or 80-percent inversion because the ownership fraction is 10/30 or 33⅓ percent.[[142]](#footnote-142) Alternatively, if USP had distributed the stock of S2 (instead of S1) in a section 355-qualifying distribution and FP engages in the same acquisition (albeit of USP stock instead of S1 stock), FP’s acquisition of USP would result in a 80-percent inversion with an ownership fraction of 90/110 or approximately 82 percent.[[143]](#footnote-143) At least group of commentators has written that these so-called “spinversion” rules could be interpreted such that USP’s distribution of S2 is not an NOCD.[[144]](#footnote-144)

Finally, consider the distinction between a corporate expatriation and a partnership expatriation.

*Corporate Example*. FP1, a foreign corporation, wholly owns FS1, also a foreign corporation, and FP1 and FS1 own 90 and 10 percent, respectively, of DP, a domestic corporation. FP1 is worth $100x (including the stock of DP) and the DP stock is worth $80x. In a value-for-value exchange, the FP1 shareholders transfer their FP1 stock to New Foreign Holdco for New Foreign Holdco stock representing 80 percent of the outstanding New Foreign Holdco stock immediately after the acquisition. Although New Foreign Holdco indirectly acquires substantially all of the properties of DP, the former shareholders of DP (i.e., FP1) do not hold any New Foreign Holdco stock and, thus, the transaction does not result in a 60- or an 80-percent inversion.

*Partnership Example*. Consider the same facts as the corporate example except FP1, FS1, and DP are partnerships and, prior to the acquisition, FP1 and FS1 transfer their respective interests in DP to a newly-formed, domestic corporation. In this partnership example, FP1, FS1, and DP are treated as one partnership.[[145]](#footnote-145) Thus, the FP1 partners are treated as partners of USP for purposes of the 60-percent and 80-percent ownership fraction analysis. As a result, the acquisition of FP1 could result in an 80-percent inversion thus treating New Foreign Holdco as a domestic corporation for U.S. federal income tax purposes.[[146]](#footnote-146)

Should the result in the corporate example be different than the result in the partnership example? Notwithstanding the lack of regulatory guidance providing for an exception to the partnership aggregation rule under section 7874(c)(5),[[147]](#footnote-147) the I.R.S. recently issued a private letter ruling turning off section 7874(c)(5) with respect to a transaction with substantially similar facts.[[148]](#footnote-148) In my view, the I.R.S. reached the correct conclusion in the private letter ruling from a policy perspective. Taken to its ludicrous conclusion, even if the domestic partnership represented a de minimis percentage of the aggregated partnerships’ value, New Foreign Holdco could be treated as a domestic corporation. But it is unclear is whether the statute is sufficiently ambiguous to allow for such an interpretation absent regulations.

As demonstrated in the above examples, the anti-inversion rules can lead to unexpected results—sometimes treating economically identical transactions quite dissimilarly. Further, the statute increasingly thwarts cross-border combinations based on seemingly arbitrary reasons. What is the government’s goal in its broad approach to shutting down foreign acquisitions of U.S. MNEs? To preserve the portion of the United States’ tax base related to CFC earnings? To preserve U.S. source income? To preserve U.S.-based jobs? Whatever the goal, a set of rules that picks winners and losers based on the outer limits of regulatory authority rather than a consistent and fair set of principles that render the same tax consequences to similarly-situated taxpayers is not an effective tax policy—especially as the world attempts to level the playing field to ensure that the tax residency of an MNE parent has little impact on that group’s global effective tax rate (“ETR”).

1. “They Just Can’t Kill the Beast:” Legislative Proposals and Changes

Both the Obama and Biden Administrations published proposals to expand the scope of section 7874.[[149]](#footnote-149) Further, the TCJA included certain inversion-related provisions. Interestingly, while the Obama proposals were arguably intended to serve as a stop-gap measure pending fundamental U.S. federal income tax reform, the Biden proposals have no such rationale. Because the Biden Administration’s proposals have been made in connection with proposals intended to bring the U.S. tax system in line with Pillar Two,[[150]](#footnote-150) the rationale for further expansion of section 7874 may be more challenging to discern.

* 1. The Obama-era Proposals

1. President Obama’s 2015 and 2016 Budget Proposals

On March 4, 2014, the Obama Administration and Treasury expressed concern over the use of corporate-inversion transactions for tax planning.[[151]](#footnote-151) To address those concerns, the General Explanation of the Administration’s Fiscal Year 2015 Revenue Proposals (the “2015 Greenbook”) proposed amendments to section 7874. These amendments would have generally lowered the threshold of the 80-percent test to greater than 50 percent while introducing a new rule that a foreign acquiring corporation would be treated as a domestic corporation following the acquisition of substantially all of the properties of a domestic entity if the affiliated group including such entity had “substantial business activities in the United States and the foreign entity was primarily managed and controlled in the United States.”[[152]](#footnote-152) Under this proposal, the historical 60-percent test would have been eliminated.[[153]](#footnote-153)

Later, on February 2, 2015, the Obama Administration and Treasury released the General Explanation of the Administration’s Fiscal Year 2016 Revenue Proposals (the “2016 Greenbook”). The 2016 Greenbook retained the 2015 Greenbook proposal to lower the threshold of the 80-percent test to 50 percent.[[154]](#footnote-154) The 2016 Greenbook also reiterated the proposal to introduce an inversion test based on substantial business activities and management and control in the United States, but proposed to limit such test to cases where the fair market value of the stock of the domestic entity is greater than the fair market value of the stock of the foreign acquiring corporation immediately before the transaction.[[155]](#footnote-155) Finally, a 2016 Greenbook proposal would have permitted the I.R.S. to share tax return information with other U.S. federal agencies for the purpose of administering such agencies’ anti-inversion rules.[[156]](#footnote-156)

1. The Stop Corporate Inversions Act of 2014

On May 20, 2014, Senator Carl Levin of Michigan, along with a number of Democratic co-sponsors, introduced the Stop Corporate Inversions Act of 2014 in the U.S. Senate.[[157]](#footnote-157) As in the Obama Administration’s proposal, the Stop Corporate Inversions Act of 2014 would have amended section 7874 to provide a greater than 50-percent threshold in lieu of the 80-percent test. In addition, it included an alternative test that would treat a foreign acquiring corporation as a U.S. corporation following an inversion if (i) the management and control of the EAG that included the foreign acquiring corporation took place, directly or indirectly, primarily within the United States, and (ii) such EAG had significant business activities in the United States, defined as having at least 25 percent of its employees, employee compensation, assets, and income in the United States. Unlike the Greenbook, the amendments proposed in the Stop Corporate Inversions Act of 2014 would have only been effective for a two-year period beginning on May 8, 2014.

On July 8, 2015, Senator Robert Casey of Pennsylvania introduced a proposed amendment to the Every Child Achieves Act of 2015 that also would have provided a 50-percent test in lieu of the 80-percent test.[[158]](#footnote-158) Unlike other proposals, Senator Casey’s proposed legislation did not include any alternative anti-inversion test based on management and control or substantial business activities in the United States.

In the end, none of the Obama-era legislative proposals were enacted.

* 1. Inversion-Related Provisions in the TCJA

As discussed above, fundamental corporate and international tax reform was believed by many to end the need for a strict anti-inversion regime like that found under section 7874 and the regulations thereunder. Interestingly, even as Congress was enacting that very reform (i.e., the TCJA), it not only retained the regime, but further tightened it by adding several additional penalties in the event of a 60-percent inversion.[[159]](#footnote-159) First, it made U.S. individual citizens and residents permanently ineligible to treat dividends from such corporations as “qualified dividend income” under section 1(h)(11).[[160]](#footnote-160) Second, if a domestic corporation was subject to the TCJA’s so-called transition tax under section 965 and that corporation inverts within 10 years after the enactment of the TCJA, such a corporation must recalculate its transition tax at a rate of 35 percent (a significantly higher rate compared to the reduced 8 percent and 15.5 percent rates that would have applied had there been no inversion).[[161]](#footnote-161) Third, the TCJA introduced retroactive rules making it more difficult to engage in post-inversion tax planning.[[162]](#footnote-162) Finally, for 60-percent inverted companies, the BEAT disallows not only deductible payments made to foreign related persons but also the cost of goods sold with respect to purchases from those related parties.[[163]](#footnote-163)

Although not a change referencing section 7874, the inversion gain rules for 60-percent inversions indirectly may have become more punitive indirectly through the passage of the 37.5-percent deduction for foreign-derived intangible income (“FDII”),[[164]](#footnote-164) the 50-percent deduction on global intangible low-taxed income (“GILTI”),[[165]](#footnote-165) and the participation exemption on certain distributions from CFCs.[[166]](#footnote-166) Consider an example to highlight these indirect punitive rules. FS, an expatriated foreign subsidiary, transfers an appreciated GILTI-producing asset to FP, a foreign acquiring corporation and FS’s indirect parent. The transfer gives rise to tested income that results in a GILTI inclusion to USP, FS’s U.S. shareholder and an expatriated entity. The tested income results in inversion gain as the transfer is treated as an “indirect transfer” by USP.[[167]](#footnote-167) Although it is not entirely clear, USP may not be permitted to reduce its GILTI-inclusion amount relating to the transfer of the appreciated asset by the 50-percent deduction under section 250.

* 1. The Biden-era Proposals
     1. Introduction

Before the summer of 2022, President Biden and Congressional Democrats were working on what was commonly referred to as the Build Back Better Act (the “BBBA”). This legislation would have made several changes to the U.S. international tax system. Ultimately, the BBBA was reduced to what became the Inflation Reduction Act—legislation that addressed many of President Biden’s domestic agenda priorities, but dropped the BBBA’s international tax reform proposals.[[168]](#footnote-168) Those proposals intended to align the U.S. international tax rules more closely with Pillar Two in three main ways: applying GILTI on a country-by-country basis (thereby limiting the ability of taxpayers to cross-credit high-taxed and low-taxed CFC income, and raising U.S. MNEs’ effective tax rate on income earned by their CFCs); reducing the section 250 deduction (and, thus, further raising the effective tax rate on GILTI); and changing the expense allocation rules.[[169]](#footnote-169) In addition, the BBBA would have further restricted the ability of taxpayers to erode the U.S. tax base by preventing MNEs from disproportionately leveraging their U.S. operations and by increasing the scope and rate of the BEAT.[[170]](#footnote-170)

* + 1. Proposed Changes to Section 7874
       1. Addition of a Management and Control Test

The Biden Administration and members of Congress have made more recent proposals to broaden the application of section 7874.[[171]](#footnote-171) Representative Lloyd Doggett introduced one of these proposed amendments (the “Doggett proposal”) that would add a second alternative rule by which a foreign acquiring corporation could be treated as a domestic corporation for U.S. federal income tax purposes. Under this rule, a foreign corporation—referred to as an “inverted domestic corporation”—would be treated as a domestic corporation if, pursuant to a plan (or series of related transactions) (i) the domestic corporation directly or indirectly acquires substantially all of the assets held directly or indirectly by a domestic corporation, and (ii) after the acquisition, either (A) there is more than 50-percent shareholder continuity, or (B) “the management and control of the expanded affiliated group which includes the entity occurs, directly or indirectly, primarily within the United States, and such expanded affiliated group has significant domestic business activities.”[[172]](#footnote-172) Such a rule would effectively rule out a cross-border merger of equals where the acquiring corporation is the foreign MNE.[[173]](#footnote-173)

Further, the Doggett proposal would introduce to the U.S. tax lexicon the phrase “management and control,” as is typically used in other foreign tax jurisdictions. As discussed at the beginning of this paper, the elegance of our current corporate tax residency rules lies in its simplicity—if an entity is organized in one of the 50 states or the District of Columbia, the corporation is domestic; if it is not, the corporation is foreign. The introduction of a corporate management and control test (albeit limited to cases where a domestic corporation is acquired by a foreign corporation) would muddy the waters. This proposal would inject subjectivity into conversations where MNEs are unsure of their tax residency status and may make foreign MNEs all the more reluctant to merge with U.S. MNEs—even with no U.S. MNE shareholder continuity.

The proposal does attempt to draw some lines for determining how to satisfy the management and control test. Although left to Treasury to draft regulations (which may or may not adopt bright-line rules), the proposal would instruct Treasury to publish regulations reflecting:

[T]he management and control of an [EAG] shall be treated as occurring, directly or indirectly, primarily within the United States if substantially all of the executive officers and senior management of the [EAG] who exercise day-to-day responsibility for making decisions involving strategic, financial, and operational policies of the [EAG] are based or primarily located within the United States. Individuals who in fact exercise such day-to-day responsibilities shall be treated as executive officers and senior management regardless of their title.[[174]](#footnote-174)

Thus, under the Doggett proposal, if too many of a corporation’s executive officers and senior management are based in the United States, the management and control test would be *per se* satisfied. Further, the proposal could result in a perverse incentive to move highly-compensated, talented individuals to locations outside the United States.

If the officers and management test is not satisfied, however, the foreign acquiring corporation is not quite out of the woods. Even if all of the executive officers and senior management never step foot in the United States, the foreign acquiring corporation would still be treated as a domestic corporation if the EAG is otherwise engaged in “significant domestic business activities.” Under the proposal, an EAG would have significant domestic business activities where at least 25 percent of the (i) employees of the EAG are based in the United States, (ii) EAG’s employee compensation-related expenses are incurred with respect to U.S.-based employees based, (iii) EAG’s assets are located in the United States, *or* (iv) EAG’s income is derived in the United States.[[175]](#footnote-175) Remember that tax director who slept soundly not having to count the days his C.E.O. visited the United States and the number of employees working in Singapore? That sleep would not be so sound under this proposal.

The Biden Administration’s proposal would add an additional layer of analysis to the inversion rules, and fundamentally shift how we think about them. In addition to the historical requirements, the proposal provides that an inversion would be deemed to have occurred, regardless of shareholder continuity if (1) the fair market value of the domestic entity is larger than that of the foreign acquirer, (2) the expanded group is primarily managed and controlled in the United States, and (3) the group does not conduct substantial business activities in the foreign acquirer’s country of organization.

It is unclear how all of these proposals would impact cross-border M&A. Arguably, the proposals would render foreign takeovers of large U.S.-based businesses too challenging, regardless of the form of consideration or the post-acquisition shareholder base. Interestingly, each of the determinations referenced in (1), (2), and (3) immediately above is made at the time of the acquisition (taking into account steps that are part of a plan or a series of related transactions). This could allow for some self-help (albeit not the kind Congress would be too excited about). For example, in advance of the closing, the U.S. MNE target with “too many” employees in the United States, could lay off (or relocate) a sufficient number to fall below the post-combination 25-percent threshold. Such a perverse incentive does not make for good tax policy, but it would not be the first time the best laid plans of Congress went awry.[[176]](#footnote-176) The temporal element, for the most part, was not as relevant when the analysis focused solely on the transaction.[[177]](#footnote-177) That said, if the Doggett proposal’s management and control test were open-ended such that at any time either (i) a sufficient number of relevant management personnel moved to the United States or (ii) one of the four significant domestic business activities’ factors reached 25 percent in the United States—the foreign acquiring corporation might be treated as a domestic corporation from that day forward. Presumably, Treasury would address this concern under its regulatory authority granted by the statute.

* + - 1. Expansion of “Covered Acquisition” Definition

The Doggett and other proposals also would expand the scope of a covered acquisition rendering seemingly benign transactions—in many cases where the equity holders of the U.S. business receive little to no equity in the foreign acquiring company—as inversions subject to section 7874(b) treatment.[[178]](#footnote-178) For instance, the Senate proposal would significantly expand the scope of a “covered acquisition” in both the corporate and partnership contexts. With respect to partnerships, the proposal would include the direct or indirect acquisition of a domestic partnership without requiring that the partnership be engaged in a trade or business as well as the direct or indirect acquisition of a foreign partnership with a U.S. trade or business. The proposal also would include in the “covered acquisition” definition the direct or indirect acquisition of one of a domestic corporation’s trades or businesses—regardless of size or location.[[179]](#footnote-179) Such an expansion would appear to capture unintended transactions—especially once the current section 7874 regulatory regime is applied to the proposed legislation.

1. “Those Voices Are Calling From Far Away:” What the Rest of the World Does to Thwart Inversions
   1. Exit Tax Regimes

On July 12, 2016, the European Union adopted the first of three Anti-Tax Avoidance Directives (“ATAD 1”),[[180]](#footnote-180) aimed at curbing ongoing base erosion and profit shifting (“BEPS”).[[181]](#footnote-181) Directives are not universal laws, but agreed-upon goals that E.U. member states must individually set out to achieve by a certain date—in this case, January 1, 2019.[[182]](#footnote-182) Article 5 and Declaration 10 of ATAD 1 address exit taxes.[[183]](#footnote-183) An exit tax is typically levied on the capital gains of a resident taxpayer, whether or not actually realized, when the taxpayer ceases to be a tax resident or shifts assets outside of that country’s taxing jurisdiction (absent any treaties or other exceptions).[[184]](#footnote-184)

Member states agreed to a method to calculate this exit tax. The calculation would assess the transferred assets at market value at the time of the resident’s exit,[[185]](#footnote-185) less the “value for tax purposes,” if one of four circumstances occurs: a taxpayer transfers the assets of (1) its “head office,” (2) “permanent establishment,” or (3) a “business function” from the member state to another country where the member state no longer has rights to tax the assets due to the transfer, or (4) a taxpayer transfers their tax residence to another country, except for those assets connected to a “permanent establishment” in the initial country.[[186]](#footnote-186) With this context in mind, the paper will provide a brief survey of exit tax regimes following the adoption of ATAD 1 and those of other certain OECD member states.

* + 1. European Union Countries
       1. France

France imposes an exit tax as of the day before the migration of a taxpayer’s tax residence.[[187]](#footnote-187) The tax applies to the unrealized capital gains of persons who were tax residents for six of the past ten years, or if the transferee’s net value of shares represents €800,000 or over 50 percent of the transferred entity’s profits.[[188]](#footnote-188) The exit tax rate is a combined 33 to 34 percent.[[189]](#footnote-189)

* + - 1. Germany

Germany imposes an exit tax when Germany’s right to tax the capital gain and income derived from an asset is limited or excluded—for example, when a taxpayer transfers assets or migrates their tax residence to another tax jurisdiction.[[190]](#footnote-190) The tax is imposed on the unrealized capital gains of the “profit potential” of the assets transferred out of Germany.[[191]](#footnote-191) The capital gains tax rate in Germany ranges from 22.825 to 32.825 percent.[[192]](#footnote-192)

* + - 1. Ireland

Ireland imposes an exit tax when a taxpayer migrates its tax residence or transfers assets, including intellectual property, to another tax jurisdiction.[[193]](#footnote-193) The tax is characterized as a “deemed disposal” of assets, assessed at the capital gains rate of 12.5 percent, with a potential for it to rise to 33 percent (anti-abuse rate) if a change in corporate form was done solely with the purpose of securing the 12.5 percent tax rate.[[194]](#footnote-194)

* + - 1. Italy

The Italian exit tax system uses an objective standard approach. An exit tax is levied when (1) an Italian entity is entirely expatriated, (2) an Italian entity transfers its assets to a foreign branch abroad, (3) a foreign entity transfers an entire “permanent establishment” in Italy out of the country, or (4) a foreign entity transfers one or more assets forming a “head office” in Italy out of the country.[[195]](#footnote-195) The tax is assessed at the time of migration, based on a hypothetical arm’s-length transaction, less the tax basis or going concern of the expatriated asset(s), subject to a 27.9% capital gains rate.[[196]](#footnote-196)

* + - 1. Luxembourg

Luxembourg imposes an exit tax that is assessed when a taxpayer migrates its tax residence, assets, or activities of a permanent establishment to another tax jurisdiction.[[197]](#footnote-197) The tax is calculated based on the “going concern value of the assets…less their tax value,” on the date of the transfer, assessed at the standard combined corporate income and municipal business tax rate of 24.94 to 28.69 percent.[[198]](#footnote-198)

* + - 1. Netherlands

Netherlands imposes an exit tax when a taxpayer migrates its tax residence. The tax is calculated based on the difference between the market value and book value of the assets, subject to a corporate income tax rate of 15 percent with respect to taxable income below €395,000 and 25.8 percent on taxable income exceeding €395,000.[[199]](#footnote-199)

* + - 1. Spain

Spain imposes an exit tax when a taxpayer is no longer a Spanish tax resident and it does not keep its assets allocated to a permanent establishment situated in Spain.[[200]](#footnote-200) The tax is levied on deemed unrealized capital gains, defined as the difference between the “market value and the fiscal value” of the transferred assets, subject to the flat capital gains rate of 25 percent. However, when moving to a jurisdiction within the European Union or an otherwise cooperative jurisdiction, this tax may be paid in installments during the five-year period commencing on the date of the transfer.[[201]](#footnote-201)

* + 1. Other OECD Countries
       1. Australia

Under Australian tax law, an exit tax is due when a taxpayer is no longer an Australian resident. It is assessed on the taxpayer’s assets as of the date of transfer and calculated at the standard capital gains rate.[[202]](#footnote-202) If the tax authority assessment results in a capital gain, each asset is valued at the “market value less the cost base,” and if the result is a capital loss, the “reduced cost base less the market value.”[[203]](#footnote-203) The standard capital gains rate for corporations is 30 percent, but may be reduced to 25 percent in certain situations.[[204]](#footnote-204)

* + - 1. Canada

Under Canadian tax law, an exit tax is imposed as of the day corporate management and control is treated as expatriated.[[205]](#footnote-205) The tax is characterized as a deemed disposition of all property at fair market value, taxed at the standard corporate income tax rate (of 15 percent) on 50 percent of the deemed capital gains, plus a 25 percent tax on all property at fair market value, less the “paid-up capital of all shares and debts.”[[206]](#footnote-206)

* + - 1. Mexico

Under Mexican tax law, a corporation is subject to exit tax when either the “principal center of administration” or “effective place of management” is migrated out of Mexico.[[207]](#footnote-207) The corporation is deemed to be liquidated as of the day of migration and is subject to the flat corporate tax rate of 30 percent.[[208]](#footnote-208)

* + - 1. Switzerland

Switzerland imposes an exit tax on hidden reserves and goodwill when a taxpayer is no longer a Swiss tax resident.[[209]](#footnote-209) If the taxpayer migrates entirely, valuation methods used include the discounted cash-flow and the “practitioners’ method . . . [of] averaging the double-weighted capitalized net profit and single weighted net asset value.”[[210]](#footnote-210) If assets are migrated, the tax is imposed on the difference between the tax basis and the fair market value of the migrated assets.[[211]](#footnote-211) The result under either approach is subject to direct federal tax as well as cantonal and communal taxes with current effective tax rates ranging from 12 to 22 percent, depending on the canton of residence.[[212]](#footnote-212)

* + - 1. United Kingdom

The United Kingdom imposes an exit tax when a company is no longer a U.K. resident. The tax is levied as of the time immediately prior to the migration, with taxable unrealized gains calculated as a deemed disposal and immediate reacquisition of assets at fair market value. There are some exceptions to, or deferrals of, this exit tax, including but not limited to: (i) any assets the company continues to use as part of a U.K. permanent establishment,[[213]](#footnote-213) and (ii) any interests in U.K. land it holds.[[214]](#footnote-214)

* + - 1. Brazil, China, and India

Brazil, China, and India do not levy an exit tax.[[215]](#footnote-215)

* + 1. Summary of Findings

The chart below summarizes our findings as to foreign exit tax regimes. Nearly every OECD country I reviewed has a robust participation exemption system on the sale of equity.[[216]](#footnote-216) Further, most countries had an exit tax on the expatriation of assets to a related person outside the country. However, I know of no country (other than the United States) that continues to treat an expatriating entity as a tax resident of that country when its mind and management determination—however constructed—is not satisfied. The United States stands alone.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Country** | **Exit Tax** | **Exit Tax Rate** | **Participation Exemption[[217]](#footnote-217)** | **P-E Rate for Capital Gains[[218]](#footnote-218)** |
| Australia | Yes | 30% or 25% (connected entities with < AUS 50 mil in turnover) | Yes | 100% |
| Canada | Yes | 15% (standard rate applied to 50% of gains) + 25% (departure tax) | Yes | 50% |
| France | Yes | 33–34% | Yes | 88% |
| Germany | Yes | 22.825–32.825% | Yes | 95% |
| Ireland | Yes | 12.5% (standard) or 33% (anti-abuse) | Yes | 100% |
| Italy | Yes | 27.9% | Yes | 95% |
| Luxembourg | Yes | 24.94–28.69% | Yes | 100% |
| Mexico | Yes | 30% | Yes (Div.) | N/A |
| Netherlands | Yes | 15% up to EUR 395,000  25.8% exceeding EUR 395,000 | Yes | 100% |
| Spain | Yes | 25% | Yes | 95% |
| Switzerland | Yes | 7.8% (effective, flat rate of 8.5%) | Yes | 100% |
| United Kingdom | Yes | 20% | Yes | 100% |
| Brazil, China, India | N/A | N/A | N/A | N/A |

* 1. The European Union’s Mobility Directive

In April 2019, the European Parliament and the Council of the European Union adopted the European Union Directive (2019/2121) (more commonly known as the “Mobility Directive”). The Mobility Directive introduced procedures governing the cross-border conversions and divisions of limited-liability companies.[[219]](#footnote-219) The Mobility Directive must be incorporated into the national laws of each E.U. member state by January 31, 2023. In addition to certain procedural rules, each E.U. member state will have to (i) implement rules for enhanced employee participation in the process, and (ii) designate a so-called “competent authority” that will be tasked to issue a pre-merger or pre-conversion certificate and, for that purpose, will have to assess compliance with all conditions and procedures. Perhaps of greatest relevance to our discussion, the competent authority will have to scrutinize whether “the cross-border operation is set up for abusive or fraudulent purposes leading to, or aimed at, evasion or circumvention of European Union or national law, or for criminal purposes.”[[220]](#footnote-220)

The Mobility Directive does not define the terms “abusive,” “fraudulent,” “evasion or circumvention,” and “criminal purposes.” In the context of E.U. company law, the Court of Justice of the European Union has recently opined that the “freedom of establishment”[[221]](#footnote-221) applies to the transfer of the registered office of a company from one E.U. member state to another via a cross-border conversion if the actual business is intended to be conducted in the transferee member state.[[222]](#footnote-222) Furthermore, the Mobility Directive provides that the competent authority *may* consider that the cross-border transaction lacks abuse or fraud if the transaction results in having the migrated entity’s place of effective management or economic activity in the member state where it is to be registered after the migration.

Although it is unclear at this point how the local implementation of the Mobility Directive will be interpreted and enforced at the local country level, migrations from one E.U. member country to another may have new hurdles to clear that could render migrations to low(er)-tax jurisdictions more difficult. The enactment of local, directive-compliant laws coupled with minimum standards for exit taxes across the European Union could act as a one-two blow to deter MNE attempts to move their tax residency to a new, more tax-favorable jurisdiction.

1. “Up Ahead in the Distance:” The U.S. Anti-Inversion Regime in a Post-TCJA and Post-OECD Reform World

Finally, a discussion of reforms to the U.S. anti-inversion regime would be incomplete without consideration of the OECD’s inclusive framework and its work towards implementing Pillar Two. Subsequent to Pillar Two’s implementation (with and without enactment of U.S. tax legislation to sufficiently comply with the new global regime), it is unclear whether the anti-inversion regime would still be sufficiently relevant to warrant the administrative complexity and potential for double taxation (especially in light of a global minimum tax rendering inversion-type planning far less beneficial). Below I discuss whether there would remain a sufficiently robust benefit to inverting if the United States enacts something akin to the Build Back Better Act’s Pillar Two provisions or otherwise becomes more complaint with the Global Anti-Base Erosion (“GloBE”) rules.

As of now, several items lack clarity. For one thing, whether the Code’s anti-inversion rules and the Biden Administration’s proposed further tightening of the regime have taken into account the enforcement of Pillar Two and its impact on U.S. MNEs remains unclear. For another, the goals of the current anti-inversion regime (as well as the proposed expansions) in light of the global (or at least likely European) execution of a global minimum tax regime remain unclear. Is the goal to anchor U.S.-parented companies to the U.S. tax system to ensure the United States secures its “fair share” of IIR-related taxes? Or is the goal to combat additional erosion of the U.S. tax base through cross-border, related-party payments?

For a third, the policy drivers (if any) behind inversions that are the result of technical anomalies remain unclear. Is it the Administration’s view that, ideally, Treasury would have the authority to stop all U.S.-parented MNEs from changing the residency of their parents and that without such authority, Treasury feels compelled to draft rules that thwart as many inversions as possible—regardless of disparate treatment of economically similar transactions?

Finally, the current consequences of a section 7874(b) inversion where the foreign acquiring corporation is a resident of a jurisdiction of a U.S. tax treaty partner remain unclear.[[223]](#footnote-223) What can be done to ensure an equitable result when a U.S.-parented MNE combines with a foreign-parented MNE that results in a section 7874(b) inversion to eliminate double (or multiple) taxation—a result that would potentially be further exacerbated by the implementation of Pillar Two?

* 1. TCJA-Related Reforms: Key Changes and Their Impact on Inversion Demand

The TCJA ushered in several reforms designed, in part, to significantly reduce the attractiveness of inverting. These reforms fall into two categories: (i) reforms designed to encourage investment in the United States and (ii) reforms designed to discourage erosion of the U.S. tax base regardless of the ultimate parent’s country of organization. With respect to the first category, the TCJA significantly lowered the U.S. federal corporate tax rate from 35 percent (the then highest-corporate income tax rate among the 35 industrialized nations of the OECD) to 21 percent (a rate slightly below the OECD weighted average). Further, the TCJA affords domestic businesses new tax incentives including allowing for up to a 100-percent deduction of the cost of certain newly purchased business assets, creating a, albeit quite limited, participation exemption system with respect to certain dividend distributions, and providing for a deduction of certain foreign-derived intangible income.

With respect to the second category, the TCJA dramatically expands the scope of the U.S.’s CFC regime requiring U.S. shareholders to include most of their CFC’s income in the year earned at significantly reduced rates; thus, lowering the tax friction on the repatriation of foreign earnings.[[224]](#footnote-224) Further, the TCJA significantly restricts U.S. MNEs’ abilities to reduce their U.S. income tax liabilities through a series of anti-base erosion and anti-profit shifting provisions, including limiting the deductibility of net interest expense to 30 percent of earnings before interest, taxes, depreciation, and amortization (EBITDA) for four years, and 30 percent of earnings before interest and taxes (EBIT) thereafter (via an emboldened section 163(j)), implementing the BEAT,[[225]](#footnote-225) and enacting anti-hybrid rules (under a new section 267A) to further discourage shifting profits outside the United States.[[226]](#footnote-226)

* 1. The OECD’s Quest for a Global Minimum Tax and the Winnowing of Inversion Benefits to U.S. MNEs
     1. Overview of Pillar Two
        1. In or Out?

Since 2015, the OECD has worked to address the tax challenges related to BEPS through the so-called OECD/G20 Inclusive Framework resulting in the two-pillar solution. Pillar One would reallocate international taxing rights by expanding a country’s authority to tax profits from companies that make inbound sales without having a physical location in that country. Pillar Two would establish a global minimum tax regime, referred to as the GloBE rules, for relatively large MNEs—those with global revenues in excess of €750 million in at least two of the four fiscal years immediately preceding the year in question.[[227]](#footnote-227) In the event that two or more groups engaged in a “merger,” for example, in an inversion-type transaction, to determine whether the €750 million revenue threshold is satisfied in at least two of the four fiscal years with respect to the combined group, the revenue of each group in the pre-merger period will be aggregated.[[228]](#footnote-228) As Pillar Two is closer to potential implementation—at least in several if not all of the E.U. member states—the impact of its ascendence on a U.S. MNE’s global effective tax rate and thus its potential desire to invert for U.S. federal income tax purposes may be significant. As such, I focus on Pillar Two for our current discussion.[[229]](#footnote-229)

* + - 1. The GloBE Rules

The GloBE rules would impose a minimum tax rate of 15 percent on the earnings of large MNEs in each country in which they operate pursuant to an additional tax (sometimes referred to as a “top-up tax”). This global minimum tax would be imposed on all constituent entities in each country of the MNE Group with an effective tax rate below 15 percent,[[230]](#footnote-230) such that the GloBE effective tax rate on modified book earnings of the MNE group in that country (“GloBE ETR”) is increased to 15 percent. GloBE income is based on financial income but, to target intangible income in each country of operation, would apply the additional tax to income after a deduction for a share of the book value of tangible assets and for a share of payroll costs[[231]](#footnote-231)—a concept similar to the U.S. GILTI regime’s QBAI discussed above.[[232]](#footnote-232)

The determination of the jurisdiction that has the right to tax is subject to a series of ordering rules. The source country has the first right to tax income through a qualified domestic minimum top-up tax (“QDMTT”).[[233]](#footnote-233) The QDMTT is a top-up tax calculated the same way as the general top-up tax with some exceptions. Unlike for other GloBE determinations, the Pillar Two rules permit the local country to elect to calculate its top-up tax using local financial statements as opposed to the UPE’s financial statements. If the source country fails to impose a QDMTT on income earned there, the country of the parent company (i.e., the UPE) can collect the tax through the income inclusion rule (“IIR”) by increasing the income of the UPE subject to tax.[[234]](#footnote-234) If neither the QDMTT nor the IIR applies (or insufficiently apply to result in a 15 percent minimum GloBE ETR), then countries where other Entities are located may collect the tax either through the denial of a deduction for payments or by making an equivalent adjustment to ensure that a cash tax is paid in the country of the Entities.[[235]](#footnote-235) This is referred to as the undertaxed payments rule (“UTPR”).

* + 1. Pillar Two and the Possible U.S. Responses

As discussed previously, despite efforts by both the Biden Administration and Democrats in Congress, the United States has yet to enact Pillar Two-related legislation. Currently, the path that the United States will take on the Pillar Two front remains unclear. That said, President Biden’s proposal and the relevant BBBA international tax proposals provide a good place to start.

* + - 1. Proposed Changes to GILTI

The global “blending” of high-taxed and low-taxed GILTI permitted under current law would be replaced with a country-by-country calculation. This new rule would apply to both GILTI earned by CFCs and by foreign branches of U.S.-parent corporations. The QBAI benefit would be reduced to five percent so that more of a CFC’s net income would be subject to U.S. tax.[[236]](#footnote-236) The proposal also includes a reduction of the 50-percent deduction for GILTI to 25 percent. Such a reduction coupled with the Biden Administration’s proposed 28-percent corporate tax rate would effectively increase the tax rate on GILTI from 10.5 percent to 21 percent (significantly in excess of the 15-percent minimum effective tax rate (“ETR”) required under Pillar Two).[[237]](#footnote-237)

Further, the high-tax exemption to subpart F income and GILTI would be repealed. In what appears to be a carrot to the OECD, in the event a Pillar Two global minimum tax regime is adopted, a domestic corporation of a foreign-parented group that owns one or more CFCs or foreign branches would receive a foreign tax credit against GILTI and subpart F income for certain taxes paid by that foreign parent corporation under its jurisdiction’s global minimum tax. This new rule would likewise be determined under a country-by-country calculation. Finally, the BBBA also proposed changes to the indirect foreign tax credit rules, increasing the related credit to 95 percent of the CFC’s foreign income taxes and making foreign income taxes of a CFC creditable regardless of whether it has tested income or loss.[[238]](#footnote-238)

* + - 1. Whether Proposed Changes Would Qualify GILTI as an IIR

As currently drafted, the U.S. GILTI regime would likely not qualify as an IIR. The OECD has concluded that “[w]hile the GILTI and GloBE rules as described in this Blueprint have a similar purpose and overlapping scope, the design of GILTI differs from GloBE in a number of important respects.”[[239]](#footnote-239) The Blueprint Report continues by providing that:

[w]hile GILTI results largely, but not completely, in a global blending of foreign income and taxes, in a number of other respects, the GloBE rules, as described in this Blueprint, would be more permissive than GILTI, depending also on their final design. These include the carryforward of losses and excess taxes, a broader definition of covered taxes and a carve-out based on a broader range of tangible assets and payroll. Furthermore, GILTI applies without threshold limitations and incorporates expense allocation rules in the calculation of foreign tax credits which can result in effective rates of taxation above the minimum rate. Finally, the GILTI effective rate is currently set at 13.125% and will increase to 16.4% in 2026.[[240]](#footnote-240)

The above-mentioned reforms proposed by the Biden Administration and included in the BBBA would significantly bridge the gap, bringing the GILTI regime closer to a qualified IIR. Such changes, discussed above, include the move to applying GILTI on a country-by-country basis, the increase in the GILTI tax rate, and, when the U.S. corporation is a member of a foreign-parented group, the provision of a foreign tax credit against GILTI and subpart F income for certain taxes paid by that foreign parent under its qualified IIR. There would still be daylight between GILTI and the GloBE rules, though, even taking into account such reforms.[[241]](#footnote-241) One key deviation from the GloBE rules is that the tax base for tested income is, in essence, taxable income.[[242]](#footnote-242) Other differences include (i) the distinction between QBAI and SBIE,[[243]](#footnote-243) (ii) the threshold requirements for inclusion in each of the regimes, (iii) the possible makeup of a particular CFC/Entity’s shareholders subject to the applicable minimum tax, and (iv) while the QBAI would be reduced to five percent under BBBA, there would be no five percent tax-free return on employee and independent contractor expenses.[[244]](#footnote-244) In the event that none of the BBBA GILTI-related reforms are enacted, the treatment of the GILTI regime within the Pillar Two framework will remain uncertain. Some have concluded that the current GILTI regime should be treated as a CFC tax regime under the GloBE rules and should not qualify as a top-up tax imposed under an IIR.[[245]](#footnote-245)

* + - 1. Proposed Undertaxed Payment Rule

The Biden Administration’s proposal would repeal the BEAT and replace it with a UTPR that is consistent with the UTPR described in the OECD’s Pillar Two model rules. When another jurisdiction adopts a UTPR, the proposal also includes a domestic minimum top-up tax that would protect U.S. revenues from the imposition of a UTPR by other countries. The proposed UTPR would apply only to financial reporting groups that have global annual revenue of $850 million or more in at least two of the previous four years.[[246]](#footnote-246) Under this UTPR, U.S. tax deductions to the extent necessary to collect the 15-percent top-up tax in each foreign jurisdiction in which the group has profits would be disallowed to both domestic corporations that are part of a foreign-parented MNE group and domestic branches of foreign corporations.[[247]](#footnote-247) The proposed UTPR would not apply with respect to income subject to an IIR that is consistent with the Pillar Two model rules (as determined by Treasury), including income that is subject to GILTI.

* 1. Possible Remaining Tax Incentives to Inverting

As discussed above, in a world where the U.S. tax system has significantly beefed up its anti-base erosion regime (e.g., section 163(j), the BEAT, the CAMT, and stronger transfer pricing and outbound transfer rules) and the GloBE rules require a country-by-country minimum tax of 15 percent (a rate generally in excess of the current GILTI rate), the incentives for U.S. MNEs to invert appear to be at a low ebb. The remaining benefits to inverting are limited to five baskets: (i) the avoidance of subpart F (and its 21 percent rate) on CFC passive-type “operational” earnings, (ii) the avoidance of subpart F income (and its 21-percent rate) on the sale of CFC stock, (iii) the avoidance of the complex U.S. foreign tax credit regime and its impact on a U.S. shareholder’s GILTI effective tax rate (e.g., the section 861 expense allocation rules and the new section 901 attribution rule), (iv) potentially better transfer pricing results on the margins, and (v) fleeing the risk of future U.S. tax hikes and related taxpayer-unfavorable reform.[[248]](#footnote-248) Each benefit is addressed in-turn below.

* + 1. Subpart F Income Avoidance

In 1962, Congress enacted the set of provisions known as “subpart F” out of concern that U.S. taxpayers were avoiding tax through “deferral.”[[249]](#footnote-249) Deferral is the general principle that income earned offshore by a foreign corporation is not subject to U.S. income tax until it is repatriated to the United States through dividend distributions to U.S. shareholders. Congress believed that deferral enabled U.S. taxpayers to avoid current taxation on certain types of income that ordinarily would have been U.S. source by moving the income to a company located in a low-tax jurisdiction (a “tax haven”), even though there was no business reason for use of a foreign corporation located in the tax haven. In the end, Congress acted to end deferral of tax with respect to such “mobile income.”

In general, the Code has rules subjecting certain types of income to current U.S. taxation, even though earned through a foreign subsidiary. Such rules apply differently depending on whether the income is “subpart F income” defined in section 952 or tested income defined in section 951A. If the income is not taken into account in calculating subpart F income, it is tested income within the meaning of section 951A(c)(2), subject to certain exceptions not applicable here.[[250]](#footnote-250) Such “subpart F income” generally consists of income from passive investments (i.e., interest, dividends, and similar income) and a variety of income types whose source is thought to be easily manipulated. Thus, subpart F requires current income inclusion by “United States shareholders” of CFCs to the extent of their pro rata share of the CFC’s subpart F income.[[251]](#footnote-251)

Subpart F income includes other types of mobile income, such as certain insurance income, foreign base company income (“FBCI”), and certain types of income contrary to public policy. It also excludes U.S. source income effectively connected with a U.S. trade or business, limits subpart F income to the CFC’s current earnings and profits (“E&P”), and provides that certain types of subpart F income may be reduced by certain deficits.[[252]](#footnote-252) FBCI is defined in section 954 to include “foreign personal holding company income,”[[253]](#footnote-253) “foreign base company sales income,”[[254]](#footnote-254) and “foreign base company services income.”[[255]](#footnote-255) Section 954 provides definitions of each category of foreign base company income and contains exceptions for situations Congress did not feel were abusive or subject to manipulation.

Since its enactment in 1962, perhaps the two most significant developments to subpart F were the promulgation of the so-called “check-the-box” regulations under Treas. Reg. sections 301.7701-1, -2, and -3 in 1997,[[256]](#footnote-256) and the enactment of section 954(c)(6) in 2005.[[257]](#footnote-257) With respect to the check-the-box regulations, U.S. MNEs were able to effectively consolidate their foreign earnings under a single CFC holding company that owned, directly and indirectly, its entire foreign operations as disregarded entities for U.S. federal income tax purposes. As a result, corporations were able to engage in all sorts of related-party transactions that would otherwise have resulted in subpart F income.[[258]](#footnote-258) This resulted in a significant decrease in the amount of subpart F inclusions to U.S. shareholders—further exacerbating the indefinite deferral of U.S. MNEs’ foreign earnings.[[259]](#footnote-259) The later enactment of section 954(c)(6) further reduced the relevance of subpart F and the need to plan around it. Section 954(c)(6) is a semi-look-through-type rule providing that dividends received or accrued by a CFC from a related CFC will not be treated as FPHCI under subpart F to the extent attributable or properly allocable to income of the payor that is neither subpart F income nor income treated as effectively connected with a U.S. business.[[260]](#footnote-260) Given that the provision applies to payments between CFCs that need only be related (compared to the check-the-box-regulations that require direct ownership), U.S. MNEs can move capital and other assets between chains more efficiently without generating subpart F income.[[261]](#footnote-261) These developments raise the question of whether the subpart F rules should properly penalize transactions that erode the non-U.S. tax base with respect to non-U.S. operations where such erosion would not otherwise reduce U.S. income taxes (or may in fact increase such taxes due to a reduction of foreign tax credits).[[262]](#footnote-262)

That said, with the relatively reduced reach of the subpart F regime and U.S. MNEs’ foreign earnings primarily resulting in either (i) an immediate GILTI inclusion or (ii) an exemption from U.S. taxation altogether, the current likelihood of inverting to avoid the vestiges of subpart F may be unlikely.[[263]](#footnote-263) Rumored check-the-box reform and the expiring of section 954(c)(6) may, however, increase aggregate subpart F income generation going forward—perhaps significantly.[[264]](#footnote-264) Depending on the viability of alternative structures, a world without the check-the-box regulations and section 954(c)(6) again may put pressure on U.S. MNEs to consider expatriating. However, if such a world does not materialize, with a global 15 percent minimum tax under Pillar Two around the corner and the ability to restructure global operations (in many cases by converting CFCs to “true” pass-through entities), the small effective tax rate reduction layered onto a small percentage of a U.S. MNE’s global revenues constituting subpart F income would seem an insufficient reason for management to consider engaging in an inversion transaction—especially if it subjects the enterprise to the inversion gain and other inversion-related penalties discussed earlier.

* + 1. Sales of CFCs and the Lack of a Meaningful Participation Exemption

Of all the inversion benefits, the avoidance of subpart F and GILTI-related operating income receive the most attention; less frequently discussed are those related to the future sales of CFCs. As discussed above, unlike its E.U. counterparts, the United States does not offer a participation exemption on the sale of equity—foreign or otherwise. Therefore, when a U.S. MNE sells, directly or indirectly, either the stock or assets of a CFC, those sales are not entirely exempt from U.S. taxation. Rather, depending on the structure and timing of the transaction, the sale will result in the U.S. parent including some of the gain, if any, as a subpart F inclusion, a GILTI inclusion, or a combination of the two.[[265]](#footnote-265) When the U.S. shareholder directly sells the stock of its CFC, the proceeds essentially are divided into four buckets. First, to the extent of the U.S. shareholder’s “cost” basis (i.e., basis from the purchase of the stock under section 1012 and basis from the transferring of assets or cash in exchange for target CFC stock or as a capital contribution under section 358), the basis is available to offset any gain. Second, to the extent that the target CFC historically generated earnings that resulted in either a subpart F or GILTI inclusion, the U.S. shareholder’s basis in the target CFC stock would have been increased under section 361(a) and that basis also is available to offset any gain (assuming the related earnings were not subsequently distributed to the U.S. shareholder resulting in a basis reduction under section 361(b)). Third, to the extent the target CFC has untaxed earnings and profits (for example, from foreign oil and gas income), gain from the sale of the target CFC stock is recharacterized as a dividend to the extent of those untaxed earnings under section 1248(a) and exempt from the U.S. shareholder’s income under section 245A.[[266]](#footnote-266) Finally, any remaining gain is subject to U.S. capital gains tax under section 1001(a).

When the U.S. shareholder indirectly sells the stock of its CFC, the rules, although similar, are slightly more complex and less clear. Like in the direct-sale scenario, the proceeds essentially are divided into four buckets. First, to the extent of the selling CFC’s “cost” basis, the basis is available to offset any gain. Second, to the extent that the target CFC historically generated earnings that resulted in either a subpart F or GILTI inclusion to the U.S. shareholder, the selling CFC’s basis in the target CFC stock would have been increased under section 361(c) and that basis also should be available to offset any gain (assuming the related earnings were not subsequently distributed to the U.S. shareholder resulting in a basis reduction under section 361(c)).[[267]](#footnote-267) Third, to the extent the target CFC has untaxed earnings and profits, gain from the sale of the target CFC stock is recharacterized as a dividend to the extent of those untaxed earnings under section 964(e)(1) and the U.S. shareholder’s subpart F income inclusion is exempt under section 245A.[[268]](#footnote-268) Finally, any remaining gain results in foreign personal holding company income under section 954(c) and a subpart F inclusion to the U.S. shareholder.

Thus, although a significant portion of the gain from the sale of a CFC may be sheltered through prior basis adjustments and the availability of a dividends-received deduction under section 245A, to the extent that the purchase price represents appreciation in the CFC’s assets (including a premium at least in part allocated to goodwill), that premium will be subject to U.S. federal income tax. On the other hand, upon a successful inversion to a jurisdiction with a robust participation exemption,[[269]](#footnote-269) future sales of subsidiaries will not be subject to tax in the parent jurisdiction. With respect to historical CFCs underneath the U.S. parent, those future sales assume that successful “out-from-under planning” was executed subsequent to the inversion. But even if those efforts proved futile or too expensive, the inverted structure still affords the foreign parent the ability to form and grow new foreign subsidiaries, and the future sale of these may not be subject to tax in any jurisdiction.[[270]](#footnote-270)

* + 1. Limiting the Impact of the U.S. Foreign Tax Credit and Related Expense-Allocation System

The Code permits a taxpayer to claim a foreign tax credit (“FTC”) for “any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States.”[[271]](#footnote-271) Where a U.S. shareholder of a CFC is a corporation, an FTC also may be claimed on foreign income taxes paid or accrued by the CFC that are “deemed paid” by the U.S. shareholder.[[272]](#footnote-272) This type of FTC, frequently called an indirect FTC, is any foreign income tax paid or accrued by a CFC that is “properly attributable” to (i) a CFC’s subpart F or tested income that gives rise to a subpart F or GILTI inclusion, or (ii) a distribution of previously taxed earnings and profits arising from a subpart F or GILTI inclusion to an upper-tier CFC.[[273]](#footnote-273) A corporate U.S. shareholder may claim an FTC for its CFC’s deemed paid foreign income taxes,[[274]](#footnote-274) subject to certain expense allocation rules in section 861 and an FTC limitation, both of which are discussed below.

As found in other jurisdictions, the United States has a rule that limits a U.S. corporate taxpayer’s available FTCs to the foreign tax imposed on its foreign-source taxable income.[[275]](#footnote-275) But its FTC system is among the most complex of all. The Code limits a taxpayer’s ability to “cross-credit” between separate categories of foreign-source income. Although limited to two baskets pre-TCJA, the Code now has four “FTC baskets” to which foreign source income must be allocated—(i) the GILTI basket,[[276]](#footnote-276) (ii) the passive basket,[[277]](#footnote-277) (iii) the foreign branch basket,[[278]](#footnote-278) and (iv) the general basket.[[279]](#footnote-279) To calculate this separate basket FTC limitation, one multiplies the taxpayer’s pre-credit U.S. tax on its worldwide income by a fraction; the numerator is the taxpayer’s foreign-source net income in the relevant basket and the denominator is the U.S. shareholder’s worldwide income. Generally, FTCs not claimed in a given tax year may be carried back one year and carried forward 10 years.[[280]](#footnote-280) Items of foreign gross income and deduction must be assigned to each FTC basket to determine the foreign taxable income in each FTC basket. Certain expenses of the U.S. shareholder must be allocated and apportioned to each basket even if income in a particular basket consists of one or more inclusions from CFCs that did not incur such expenses. These expenses include interest and stewardship.[[281]](#footnote-281) When U.S. shareholder-level expenses are allocated to GILTI and subpart F inclusions, the FTC limitation is reduced. Where the U.S. shareholder is at or near an excess credit limitation position in the applicable basket, this can result, as an economic matter, in the imposition of U.S. taxes on the inclusion that would otherwise be non-taxable to the extent of the allocated expenses.

These FTC rules are even stricter in the case of GILTI. First, FTCs are available for only 80 percent of the foreign taxes, adjusted by the GILTI inclusion percentage, that are properly attributable to the tested income taken into account by the U.S. shareholder under section 951A. The 80-percent limitation results in an automatic loss of 20 percent of the amount of foreign income taxes available for credit (frequently referred to as a 20-percent haircut). Any foreign taxes “properly attributable” to GILTI and that may not be claimed as a credit because of the section 904 foreign tax credit limitation for any tax year not used as a credit in the current tax year are forfeited and may not be carried over.[[282]](#footnote-282) Since GILTI-related FTCs may not be carried backward or forward, the FTC limitation with respect to the GILTI basket is particularly less desirable because the credit is effectively lost forever.

All of these factors conspire together such that the ETR on a U.S. MNE’s foreign-source earnings is typically greater (sometimes significantly greater) than the 10.5-percent minimum rate on GILTI and 21-percent rate on subpart F income. Although many favorable holding company jurisdictions have foreign tax credit limitation provisions,[[283]](#footnote-283) few, if any, have a set of rules as complex or as limiting as the United States. The combination of the 80-percent haircut on GILTI FTCs, the inability to carry forward excess GILTI FTCs, the separate FTC basket scheme, and the worldwide expense allocation rules under section 861 (among other FTC-limiting rules) can render the U.S. FTC system far less generous than other jurisdictions that primarily operate under a quasi-territorial system.[[284]](#footnote-284) Thus, avoidance of the U.S. FTC regime can significantly impact a U.S. MNE’s ETR on foreign-source earnings—and is possibly one of the most significant inversion incentives that remains for a U.S. MNE.

* + 1. Transfer Pricing Benefits on the Margins

According to recent estimates, transfer pricing accounts for approximately 72 percent of the profit shifting that occurs worldwide.[[285]](#footnote-285) The I.R.S. polices transfer pricing abuses under section 482, which authorizes the agency to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among controlled parties in order to prevent tax evasion and to clearly reflect income of the parties. The guiding principle in the I.R.S.’s application of this authority is the arm’s length standard, which requires that controlled parties transact with each other on the same terms as they would if they were unrelated. Application of this standard is generally achieved by comparing the results of the controlled transaction to the results of comparable transactions under comparable circumstances.[[286]](#footnote-286) Generally, the evaluation must be performed by applying the method that, under the facts and circumstances, provides the most reliable measure of an arm’s length result.[[287]](#footnote-287) Further, the comparability of transactions and circumstances must be evaluated considering all factors that could affect prices or profits in arm’s length dealings.[[288]](#footnote-288)

Notwithstanding section 482 and the broad authority granted to the I.R.S. under the statute to police transfer pricing, the government is frequently at a disadvantage “due to information asymmetries” between the I.R.S. and tax authorities of the counterparty’s jurisdiction.[[289]](#footnote-289) In a 2002 report, after discussing the typical restructuring steps that a taxpayer takes in executing an inversion,[[290]](#footnote-290) Treasury acknowledged the special difficulty of policing the arm’s length standard between the U.S. group and its foreign affiliates.[[291]](#footnote-291) The report, however, went on to find that while the outbound transfer of intangibles is particularly challenging to value accurately, “[l]egislative and regulatory developments have helped to facilitate the appropriate application of the arm’s length standard to the transfer of intangible assets.”[[292]](#footnote-292) The report concluded that “[t]his arm’s length standard, as supplemented by the commensurate with income standard, provides the appropriate analytical framework for analyzing transfer pricing issues related to the transfer of intangible (and other) assets.”[[293]](#footnote-293) In sum, there is no reason to believe that the I.R.S.’s hand is weakened when the U.S. corporation is the subsidiary of a foreign parent as opposed to the parent of a foreign subsidiary because the same arm’s length analysis must take place. Moreover, the government has tightened up both the section 367 and section 482 regulations since enactment of the TCJA.[[294]](#footnote-294)

* + 1. Risk of Taxpayer-Unfavorable Changes to U.S. Law

Another benefit to inverting is the ability to avoid future unfavorable changes to the U.S. tax laws. Historically, the U.S. tax regime has been relatively friendly to businesses; since the end of World War II, the statutory corporate tax rate has gradually decreased from the low fifties in the 1950s and 1960s to 35 percent from 1987 through 2017, and finally to 21 percent with the TCJA’s enactment.[[295]](#footnote-295) The Code also has conferred other business-friendly provisions, including the 37.5 percent section 250 FDII deduction, the 20 percent section 199A passthrough deduction for certain qualifying business income, and generous expensing and accelerated depreciation and amortization upon the purchase of certain qualifying business assets,[[296]](#footnote-296) not to mention a suite of tax credits such as the 20 percent research and experimentation credit.

There is no guarantee, however, that the U.S. business tax environment will remain relatively attractive to business.[[297]](#footnote-297) In fact, many of the Biden Administration’s BBBA proposals would have forced MNEs to once again reconsider where to locate their business assets and activities.[[298]](#footnote-298) When considering where to form and grow businesses, studies have found that an important factor is “how business-friendly the tax administration is perceived to be.”[[299]](#footnote-299) Not surprisingly, “[i]nvestors look for certainty, predictability, consistency and timeliness in the application of tax rules, and in many cases these considerations are as important as the effective tax rate paid.”[[300]](#footnote-300)

Consider the management of a foreign business deciding today whether to relocate its research and development function to the United States after the enactment of the TCJA. Although the new law has made it harder to expatriate intellectual property, [[301]](#footnote-301) the taxpayer-favorable changes to the Code (including the FDII deduction) may entice management to relocate certain operations to the United States.[[302]](#footnote-302) Assuming they did and later decide to transfer the research and development function along with the intellectual property resulting therefrom, there would be nothing denying management the right to do so. The section 367(d) toll charge may be costly, but if management ultimately decided to have the business assets exit the United States, management could weigh the costs and benefits. Although the business may be able to separate the research and development function from the resulting intellectual property through the use of intercompany agreements, such an arrangement may not be feasible in all cases. Query whether U.S. tax policy should require such a structure.

Now consider the management of a startup business that is deciding where to incorporate their new enterprise. Would they be willing to do so in the United States with its currently friendly tax laws? Or would management be concerned that potential future changes to those laws could suddenly render that decision imprudent? This is definitely a facts and circumstances decision. But then throw into the mix that the decision is practically irrevocable due to section 7874.[[303]](#footnote-303) Does that factor tip the scales in most cases? To be sure, the U.S. technology and healthcare sectors have been the largest drivers of the American economy over the past decade with innovation continuing to emanate from U.S. startups in places like Silicon Valley, Seattle, and Boston. But with U.S. political instability reaching levels unseen in more than a century and what may result in frequent changes in U.S. tax policy and laws, will entrepreneurs continue to start new businesses with a domestic top entity or will they and their tax advisors form foreign corporations to commence activities over concerns that leaving later is not an option?

1. “We Haven’t Had That Spirit Here Since [2004]:” Possible Modifications to the Anti-Inversion Regime

As discussed above, Pillar Two has the effect of taxing affiliated foreign subsidiaries of U.S. MNEs (on a country-by-country basis) at a GloBE ETR of no less than 15 percent.[[304]](#footnote-304) Under current U.S. law, U.S. MNEs generally must include two categories of income earned by their foreign subsidiaries—GILTI and subpart F income. These inclusions are potentially eligible for a foreign tax credit equal to 80 percent of the taxes paid with respect to GILTI and 100 percent with respect to subpart F income. Prior to the adoption of Pillar Two by one or more key jurisdictions (say, for example, the members states of the European Union),[[305]](#footnote-305) U.S. MNEs continue to have an incentive (albeit significantly reduced in light of the enactment of the TCJA) to invert. Primary among those reasons may be to avoid the marginal rate differences between the U.S. corporate income tax rate of 21 percent on subpart F and 10.5 percent on GILTI,[[306]](#footnote-306) and the tax rate on such income in a low-taxed jurisdiction where the subsidiary is resident.

If, however, one or more key jurisdictions adopt Pillar Two,[[307]](#footnote-307) this should dramatically reduce the incentive for U.S.-based MNEs to invert—at least with respect to those groups that are within its scope.[[308]](#footnote-308) The adoption of Pillar Two by a critical mass of jurisdictions, including the United States,[[309]](#footnote-309) appears to significantly reduce the benefits of inverting.[[310]](#footnote-310) In essence, once the income of a U.S. MNE’s foreign subsidiaries are subject to a 15-percent GloBE ETR (albeit using a different tax base) before taking into account any GILTI or subpart F inclusions, the benefits of inverting under current law should be significantly reduced. As discussed above, there is still the potential for eroding the U.S. tax base with respect to income from U.S. operations but such erosion has been significantly reduced too by narrowing the rate differential on successful profit shifting to a six percent spread and backstopping the exploitation of this narrower spread with the enactment of the BEAT under section 59A and a more robust interest deduction limitation system under section 163(j). Yet can historically-minor tax benefits operate as sufficient reason to anchor U.S.-based MNEs to the U.S. worldwide system of taxation? Are there policy considerations other than those alluded to above in play?

With inversion benefits significantly diminished in a world with TCJA and Pillar Two, what, if any, reforms to the U.S. anti-inversion regime should be on the table? Providing assurance to would-be-inbound investors and U.S. entrepreneurs that—in the event that the U.S. tax and regulatory environment becomes materially less favorable than currently constituted—they would not be permanently anchored in the United States may keep it as the default jurisdiction for startups and mature businesses alike. Studies have concluded, however, that while a favorable tax environment is a significant factor in choosing where to invest, there are other (arguably more important) factors in play.[[311]](#footnote-311) That said, in comparing between stable jurisdictions with a strong rule of law and deep financial markets,[[312]](#footnote-312) a country’s tax system is a major decision point for business leaders.[[313]](#footnote-313) Further, as also discussed in detail above, section 7874 is a tax unicorn—the provision stands alone in the world by treating a nonresident corporation as a domestic corporation simply because it acquires a domestic corporation.[[314]](#footnote-314) To be sure, nearly every OECD country has a form of exit tax,[[315]](#footnote-315) albeit some more robust than others. And this makes sense. Those countries understand that when a business runs for the border, the appreciation of that business’s assets are ripe for taxation in that those gains were, at least in part, the product of the to-be-exited jurisdiction’s markets, labor force, infrastructure, and the other multitude of intangibles that permitted the departing company to take root and grow. But they do not go as far as the United States in permanently trapping that business as a tax resident.

Even so, the United States also has its share of exit taxes;[[316]](#footnote-316) however, this patchwork of taxes lack the cohesiveness needed to ensure that the U.S. fisc is able to fully tax the appreciation of a departing business.[[317]](#footnote-317) With this in mind, below are some possible solutions to improve the likelihood that the United States remains the default jurisdiction to form and grow the world’s leading businesses. None are perfect. Nor do any advocate for a full repeal of section 7874 with no replacement. But each hopefully furthers the debate on U.S. tax policy for businesses as we enter an age rife with the uncertainties brought about by the (dare I say) likely implementation of Pillar Two (and the possible implementation of Pillar One . . . one day).

* 1. Reform the Statute from a Shareholder Percentage Test to a Management and Control Test

While this paper contemplates whether a need to deny exit visas to U.S. corporations remains, I have not yet addressed the rationale for enacting a statute that hinges on the percentage of historical shareholders retaining an interest in the foreign acquiring corporation (assuming a policy based in part on forced-corporate residency is a good one). As described above, for section 7874 to apply, three tests must be satisfied—an “acquisition test,” a “stock ownership test,” and a “business activities test”—in order for the statute to either treat the foreign acquiring corporation as a domestic corporation for U.S. tax purposes or limit U.S. expatriated group members the use of their tax attributes for offsetting certain income and gain. While much has been said about the adoption of the acquisition of substantially all of the properties test and the substantial business activities test,[[318]](#footnote-318) from a policy perspective as well as Treasury’s subsequent efforts to further curtail taxpayer efforts to invert, the stock ownership test is typically the determining factor as to whether a particular transaction results in a section 7874 inversion.

As discussed above, the section 7874 shareholder continuity test provides that after the transferee foreign corporation’s acquisition, former shareholders of the domestic corporation must own at least 60 percent (or 80 percent) of the aggregate vote or value in the transferee foreign corporation’s stock. Further, the former shareholders must have acquired their interests in the transferee foreign corporation “by reason of holding stock in the domestic corporation.”[[319]](#footnote-319) Query, however, why Congress decided to focus on shareholder continuity in determining whether a domestic corporation should be punished for not remaining a member of a U.S.-parented MNE group.[[320]](#footnote-320) Admittedly, Congress needed only look at Treasury’s efforts under the Helen of Troy regulations of Treas. Reg. section 1.367(a)-3(c) to witness the government’s initial anti-inversion efforts that also focused on a lack of shareholder continuity. Yet Treasury intimated in a report that a focus on shareholder continuity may miss the mark and at least one commentator believed that the focus instead should be on the acquiror’s residency.[[321]](#footnote-321)

With hindsight, perhaps the shareholder continuity test misses the mark. As may have been a surprise to Congress (and many practitioners for that matter), several U.S. MNEs engaged in “self-help” tax planning using transactional structures that resulted in potentially significant tax bills to their taxable U.S.-resident shareholders.[[322]](#footnote-322) In essence, these enterprises purposely subjected their shareholder bases to immediate taxation while dramatically reducing their proportionate ownership of the newly combined group. In fairness, the promulgation of a series of notices, and ultimately regulations, that tended to result in increasing the percentage ownership held by the historical U.S. target shareholders stifled many would-be inverters. Even so, many large, publicly-traded U.S. MNEs have few, if any, large shareholders. As a result, management typically can focus on the future growth and competitiveness of the enterprise without the distraction of how a particular transaction affects its shareholders’ tax return.[[323]](#footnote-323) Interestingly, unlike section 7874 and its shareholder continuity test, Treas. Reg. section 1.367(a)-3(c) acknowledges the role of management in the decision-making by limiting the percentage of stock that certain officers, directors and five-percent or greater shareholders may collectively receive in the transferee foreign corporation before rendering the transaction taxable to the shareholders.

Because most, although certainly not all, OECD countries determine corporate tax residency by some combination of place of incorporation or formation and the application of some version of a mind and management test, perhaps the United States should revisit its corporate tax residency rules in the inversion context.[[324]](#footnote-324) As noted above, recent proposals would expand the scope of the section 7874(b) corporate-residency rule to apply to circumstances where the EAG’s management and control is determined to be within the United States. Those proposals, however, would enact such a rule in addition to, as opposed to in lieu of, a shareholder continuity test. Since decisions to invert are frequently borne and settled by the executive management and the board of directors, basing the decision on shareholder continuity may not be wholly consistent with inversion deterrence—especially with respect to widely-held, publicly-traded, U.S. MNEs.

Consider instead a reform whereby the mix of consideration received by the domestic target corporation shareholders is irrelevant. Instead, section 7874 could focus singularly on the EAG’s post-inversion mind and management to determine the group’s residency status (the “Management and Control Proposal”). If mind and management is found to be in the United States, then the foreign parent of the EAG would be treated as a domestic corporation for U.S. federal income tax purposes. Alternatively, if mind and management is found to be outside the United States, then the foreign parent would be treated as a foreign corporation. In the latter scenario, Congress could revamp and strengthen the U.S. exit tax regime to ensure the assessment of an appropriate outbound toll charge. Under such a management and control test, the devil would be in the test’s operational details. Although the test in the Doggett proposal, for example, could suffice, such a test is likely to lead to dual residency issues.[[325]](#footnote-325) Such issues can be addressed by competent authority under tie-breaker rules found in most bilateral income tax treaties so that ultimately only one jurisdiction can call the MNE home.[[326]](#footnote-326)

Finally, the acquisition of a small U.S. MNE by a large foreign MNE could lead to unexpected results. For example, under the Management and Control Proposal, if a Country X-resident MNE worth $99x with its mind and management in the United States were to acquire a U.S. MNE worth $1x, the Country X MNE would become a dual-resident MNE, resident in the United States (under the Management and Control Test) and resident in Country X (under the country of formation or location of management and control). Such a result could be avoided by providing a substantiality threshold—i.e., that the Management and Control Test only applies to foreign acquisitions of domestic corporations where the U.S. target is some minimum percentage of the value (or some other metric) of the foreign MNE.

In all, a balancing act to protect the U.S. corporate tax base while avoiding unnecessary multi-residency issues could very well render such a modification workable—but challenging.

* 1. Limit the Application of Section 7874 to Those U.S. MNEs Not Subject to Pillar Two

As discussed earlier, a U.S. MNE’s tax benefits obtained from “successfully” inverting appear limited in a TCJA-Pillar Two world. While the enactment of the BEAT, section 163(j), and more recently, the CAMT significantly limit a U.S. corporate group’s ability to reduce its U.S. source income, the avoidance of the U.S. CFC rules—especially one now subjecting nearly all of a U.S. MNE’s foreign earnings to immediate U.S. taxation through TCJA’s GILTI regime—may still provide sufficient tax juice for some to expatriate (or at least make an attempt). But with the GloBE rules on the precipice of adoption in a critical mass of E.U. countries, the modest benefits may make the prospect of an inversion not worth the hassle. Thus, perhaps it is worth exploring whether section 7874 could be reformed to only apply to domestic corporations not within the scope of Pillar Two, assuming the GloBE rules are enacted in at least a critical mass of OECD countries.

As also discussed earlier, an MNE group falls in the scope of the GloBE rules if its consolidated revenue exceeds €750 million in at least two of the four fiscal years immediately preceding the tested fiscal year. Further, in the event that two or more groups combine, for example, in an inversion-type transaction, to determine whether the €750 million revenue threshold is satisfied in at least two of the four fiscal years with respect to the combined group, the revenue of each group in the pre-merger period will be aggregated. Under a modification that focuses only on those domestic corporations not falling within Pillar Two, smaller U.S. MNEs would remain subject to the U.S. anti-inversion regime (the “Pillar Two Scope Proposal”). Even if neither the Expanded Inversion Gain Proposal (discussed below) nor the Management and Control Proposal were enacted, under the Pillar Two Scope Proposal the Hotel California would indeed have changed its check-out policy. Why? If enacted, the Pillar Two Scope Proposal would provide smaller U.S. MNEs, after sufficient growth, with the option of handing in their keys at the front desk and returning to that dark, desert highway in search of new lodging.

A byproduct of the Pillar Two Scope Proposal, like any rule based on a threshold, is that it can lead to unfair consequences to certain taxpayers while presenting other taxpayers with an opportunity for tax avoidance. Such a rule would need certain safeguards, one of which would be the need to protect the U.S. fisc against post-inversion bust-up transactions. U.S. taxpayers may be inclined to use their in-scope status as a means for inverting only to shrink soon thereafter. For example, two out-of-scope U.S. MNEs could merge, wait the two years needed to come within the scope of Pillar Two, invert, and then separate soon thereafter while remaining a foreign-parented company no longer subject to either the U.S. CFC regime or the GloBE rules. To protect against such risk, a rule could be enacted providing that if during the applicable period (i.e., the 10-year period following the completion of the 60-percent inversion as defined under section 7874(d)(1)) the EAG is no longer subject to the GloBE rules (for example, because the EAG engaged in a divisive reorganization, sold one or more lines of business or otherwise restructured thereby avoiding the GloBE regime), then the UPE of the EAG is treated as a domestic entity until it becomes subject to the GloBE rules again (if ever).

Alternatively, a scope-related rule could be adopted similar to that in the recently enacted CAMT.[[327]](#footnote-327) The CAMT only applies to “applicable corporations” using a scope-like provision similar to that in the GloBE rules.[[328]](#footnote-328) The scope rule, however, provides that once a taxpayer is an applicable corporation, it remains so until the corporation has a specified number of consecutive tax years (to be determined by the Secretary of the Treasury) where the corporation does not meet the average annual AFSI threshold and the Secretary determines that it is no longer appropriate to continue to treat the corporation as an applicable corporation.[[329]](#footnote-329) Similarly, the Pillar Two Scope Proposal could provide that a U.S. MNE that inverts while subject to the GloBE rules but later falls out of scope within the applicable period will continue to be subject to the GloBE rules—at least as far as the United States is concerned. One way to impose such treatment would be to provide for a UTPR for inverters that fall out of the GloBE rules’ scope (similar to the provision discussed below with respect to the Expanded Inversion Gain Proposal). This UTPR for inverters could permit the United States to tax the inverted group’s U.S. subsidiaries either through the denial of a deduction for payments or by making an equivalent adjustment to ensure that a cash tax is paid such that the group has a GloBE ETR of at least 15 percent.[[330]](#footnote-330) Such a rule has the benefit of avoiding the re-classification of a foreign corporation as a domestic corporation potentially years after the inversion transaction, thus avoiding the potential of corporate-dual residency issues.

With either approach, the Pillar Two Scope Proposal may prove an elegant compromise. Since the inversion benefits of yore arguably have been sufficiently diluted when the post-inversion EAG is subject to the GloBE rules, the application of section 7874 may no longer be unnecessary. At the same time, it may ensure that, should the global minimum tax regime no longer apply to that EAG, the then-greater benefits are appropriately reduced or eliminated.

* 1. Repeal the 80-Percent Test and Strengthen the Inversion Gain Rules

As discussed above, when a 60-percent inversion occurs, the foreign acquiring corporation is not treated as a domestic corporation but is subject to the inversion gain rules as well as other penalties sprinkled throughout the Code.[[331]](#footnote-331) The negative tax implications to would-be 60-percent inverters have grown since the 2004-enactment of section 7874, and thus fewer and fewer U.S. MNEs seem willing to engage in such a business combination.[[332]](#footnote-332) Further, the benefits of inverting will be significantly reduced once the world is effectively subject to the GloBE rules. Under such circumstances, one reform to consider is the repeal of the 80-percent inversion rule while further strengthening the 60-percent inversion rule (the “Expanded Inversion Gain Proposal”). Under such a reform, the United States would no longer be the outlier imposing domestic tax residency status on a foreign corporation due to its acquisition of a U.S.-resident corporation.[[333]](#footnote-333)

Under this approach, the 60-percent rule would become the United States’ primary inversion gatekeeper.[[334]](#footnote-334) In addition to the current penalties (including the loss of section 1(h)(11) qualifying dividends—an important provision for publicly-traded companies), the rule could be amended to ensure that would-be inverters are subject to the full suite of U.S. anti-base erosion and profit shifting provisions. For example, application thresholds could be removed to certain U.S. minimum tax regimes,[[335]](#footnote-335) such as the BEAT and the CAMT,[[336]](#footnote-336) further ensuring that expatriated entities are paying a minimum tax rate on their earnings. The additional protection to the U.S. tax base against deductible payments to foreign related parties of inverters could be coupled with a provision to effectively protect against profit shifting. One such possibility could be the denial of treaty benefits or the denial of deductions on U.S.-outbound, related-party payments.[[337]](#footnote-337) An alternative to the outright denial of treaty benefits or deductions could be to limit the denials to payments where the payment recipient is resident in a sufficiently low-tax jurisdiction. Such a rule would likely need a backstop to protect the U.S. fisc against subsequent payments to related parties resident in low-tax jurisdictions to ensure a sufficient rate of tax is paid.[[338]](#footnote-338)

With the above-changes to the consequences of 60-percent inversions, the U.S. fisc should be protected against meaningful base erosion of U.S. source income while ensuring that historical CFC earnings will be taxed at a GloBE ETR of at least 15 percent. Under such a regime, U.S. MNEs should be relatively indifferent to inverting for tax purposes (absent concerns over future tax law changes—a concern in any jurisdiction).

* 1. Repeal Section 7874 and Enact a Comprehensive Section 877/877A-Style Exit Tax

As discussed throughout this paper, currently, the United States has as a patchwork of rules that can be described loosely as a corporate exit tax. In general, when a U.S. person transfers property to a foreign corporation, the transferor is subject to U.S. tax on the built-in gain or loss in the transferred property.[[339]](#footnote-339) However, when such a transfer occurs in what would otherwise qualify for nonrecognition treatment, the Code’s last line of defense (outside of the application of anti-inversion regime under section 7874) is housed in section 367.

* + 1. Overview of Current U.S. Exit Tax Rules

As foreign corporations to which a U.S. person transfers property usually are not in the U.S. tax system, and the system has chosen to respect the separateness of a foreign corporation vis-à-vis its U.S. shareholders (but for subpart F, GILTI, and other anti-deferral regimes), Congress found it necessary to modify the Code’s subchapter C nonrecognition rules for cross-border exchanges to prevent built-in-gain assets from leaving the U.S. tax system in nonrecognition transactions and potentially escaping U.S. taxation.[[340]](#footnote-340) Section 367(a)(1) requires the recognition of gain (but not loss)[[341]](#footnote-341) for section 351-qualifying transfers of tangible property to foreign corporations.[[342]](#footnote-342) The amount of the gain recognized is the difference between the U.S. transferor’s basis in the transferred property and the property’s fair market value at the time of the transfer.[[343]](#footnote-343) Former section 367(a)(3) had provided an exception for certain tangible property transferred to a foreign corporation for use in an active trade or business outside the United States. In 2017, the enactment of the TCJA repealed the active trade or business exception under section 367(a)(3). As a result, gain on a transfer of tangible property by a U.S. person to a foreign corporation is now subject to immediate taxation. Further, the exception did not apply to a transfer of inventory, accounts receivable, foreign currency, or section 936(h)(3)(B) intangibles.

The outbound transfer of certain intangible assets in an otherwise qualifying nonrecognition transaction is not subject to immediate taxation.[[344]](#footnote-344) Instead, this type of transfer is taxable over time as a stream of royalty payments paid over the useful life of the asset, adjusted based on the income earned on the assets.[[345]](#footnote-345) Prior to the TCJA, section 367(d) looked to section 936(h)(3)(B) for the definition of intangibles.[[346]](#footnote-346) During that period, many taxpayers did not agree with the government’s treatment of intangibles that were not defined under section 936(h)(3)(B).[[347]](#footnote-347) In 2015, Treasury and the I.R.S. published proposed regulations that would treat the outbound transfer of foreign goodwill and going concern value as taxable under either section 367(a) or (d). In 2016, those regulations were finalized effective back to September 14, 2015.[[348]](#footnote-348) Congress put an end to this uncertainty by both repealing section 936 and adding section 367(d)(4) to the Code, which included in the new definition of intangibles “goodwill, going concern value, [and] workforce in place[.]”[[349]](#footnote-349)

To be clear, the above rules applied only on the outbound transfer of “property” (whether tangible or intangible) in an otherwise qualifying section 351 or section 361 transaction.[[350]](#footnote-350) In the most common inversion structures, property is rarely transferred outside the United States. Instead, the shareholders of the U.S. MNE transfer their stock to a foreign corporation for foreign acquiring corporation stock, cash, or a combination thereof. Thus, the only potential exit tax that is typically in play is the shareholder-level tax under either section 1001(a) or section 367(a) (by turning off either section 351 or section 354)—a tax that rarely concerns the U.S. target corporation’s management and board of directors.[[351]](#footnote-351)

* + 1. U.S. Taxation of Expatriating Citizens and Permanent Residents

Under section 877, certain former U.S. citizens (“Expatriates”) continue to be subject to U.S. income tax on their U.S.-source gross income and other income that is effectively connected with a U.S. trade or business (net of certain deductions) for a ten-year period following the year in which they renounce their U.S. citizenship.[[352]](#footnote-352) The Expatriate may not, however, claim any section 1212(b) capital loss carryover (although certain other deductions are permitted).[[353]](#footnote-353) There are several changes to the traditional sourcing rules for nonresident aliens to which an Expatriate is subject. One such rule provides that gains from the sale or exchange of a domestic corporation’s stock or debt obligations are treated as U.S.-source income.[[354]](#footnote-354) Another rule treats gain or income derived from stock in a foreign corporation as U.S.-source income for purposes of section 877(b) if an Expatriate owned or is treated as owning (taking into account certain attribution rules) at any time during the two-year period ending on the date of their expatriation, more than 50 percent of the total combined voting power or total value of the corporation’s stock.[[355]](#footnote-355)

In 2008, Congress enacted a “mark-to-market” exit tax regime.[[356]](#footnote-356) Under the regime, certain Expatriates are treated as if all of their property is sold at fair market value on the day before the expatriation date.[[357]](#footnote-357) In determining the amount of gain recognized, an Expatriate is not permitted to take into account “any provision of [the Code].”[[358]](#footnote-358) The “expatriation date” is the date on which the U.S. citizen relinquishes their U.S. citizenship or a long-term U.S. resident is no longer a lawful permanent U.S. resident.[[359]](#footnote-359) The section 877A exit tax allows for the Expatriate to elect to defer payment of the tax (on an asset-by-asset basis) until the relevant asset for which an election was made is sold.[[360]](#footnote-360)

* + 1. The Exit Tax Proposal

In Part ‎V.A., I analyzed the exit tax regimes of some of the largest economies in the world (e.g., France, Germany, Italy, Canada, and the United Kingdom) and those of popular inversion destinations (e.g., Ireland, Luxembourg, Netherlands, and (again) the United Kingdom). In addition I noted that some of the other largest economies (e.g., Brazil, China, and India) do not have exit tax regimes. For those jurisdictions that had exit tax regimes in place, none taxed a corporation on the built-in gain in its assets unless the corporation migrated to a new jurisdiction or otherwise engaged in an outbound asset transfer. This is not all that different from the United States’ current regime that, without the additional protection of section 7874, would result in significant untaxed value leaving the United States in the event of an inversion. One possible reform that could eliminate the need for section 7874 would be a corporate exit tax regime akin to some combination of section 877 and section 877A (the “Exit Tax Proposal”). Such a corporate exit tax could take on one of three forms—a section 877-style corporate exit tax, a section 877A-style corporate exit tax, or a combination of the two.

Under a section 877-style corporate exit tax regime, the expatriating corporation would remain subject to U.S. tax for a period of time after the inversion date. As described above, the regime could require that any assets sold that are either located in the United States (including stock in a domestic corporation) or held by a CFC (including stock of a CFC) be subject to the exit tax—in each case, subject to adequate safeguards against double taxation. Further, the expatriating corporation would be limited as to its ability to use certain tax attributes (e.g., net operating losses, capital loss carryforwards, and perhaps certain credits).[[361]](#footnote-361)

Alternatively, under a section 877A-style corporate exit tax regime, the expatriating corporation would be required to mark its assets to market. To be a sufficient deterrent to would-be inverters, such a rule would need to treat a stock inversion as a deemed asset inversion whereby the U.S. parent corporation would be deemed to sell all of its assets (perhaps akin to having made a section 338(g) election). As mentioned above, in determining the amount of gain recognized under section 877A, an Expatriate is not permitted to take into account any provision of the Code. A similar limitation on corporations could be included as part of this alternative.

Under the section 877A-style approach, the government may have heightened concerns about valuation issues and taxpayer efforts to time their exits advantageously (e.g., when business forecasts are at a presumed low point). To ameliorate such concerns, a hybrid approach could be considered. Under such an approach, the section 877A mark-to-market approach could apply akin to section 367—that is, built-in gain in tangible assets could be subject to immediate taxation while section 367(d) intangibles could be deemed sold in exchange for annual royalty payments over the life of the intangible property where the amount of the royalty is commensurate with the income generated by the intangible property. Other safeguards could also be considered to ensure that inappropriately low valuations do not suppress the expatriating corporation’s exit tax.[[362]](#footnote-362) Such an approach has the benefit of simplicity. Further, the infrastructure of such a regime already exists such that Treasury and the I.R.S. could piggyback off some combination of the existing section 367(a)(1) and (d) rules and the section 338(g) rules.

Finally, such an exit tax regime should have special procedural rules and reporting requirements sufficient to ensure that the government is able to collect the tax owed. The provision could provide the taxpayer with an election to pay the exit tax over a period of time (e.g., five years),[[363]](#footnote-363) possibly with an interest component,[[364]](#footnote-364) provided the I.R.S. is given adequate security to ensure the tax is paid.[[365]](#footnote-365) On the procedural front, these protections could include an extended statute of limitations,[[366]](#footnote-366) perhaps for a 10-year period, and providing that all members of the MNE group are jointly and severally liable for the exit tax.[[367]](#footnote-367) Further, there should be requirements such that the to-be-expatriating U.S. parent corporation would be (i) obligated to report to the I.R.S. its intention to expatriate and (ii) required to enter into a deemed gain recognition agreement with the I.R.S. prior to expatriating or else the foreign acquiring corporation would be treated as a domestic corporation.

1. Conclusion

As is hopefully evident through the above discussions, there are a myriad of policy and practical implications facing both the United States and its trading partners in deciding how and when to tax corporate MNEs. On the one hand, the U.S. anti-inversion regime as it is currently constructed, when viewed as part of the broader set of U.S. rules for determining when a corporation is a tax resident, provides certain benefits. At its core, the regime is rather straightforward—corporations organized in the United States are tax resident in the United States; only if they engage in a relatively rare transaction structure should they be confronted with the complexity that is section 7874 and its labyrinthine regulatory scheme. In addition, the majority of U.S. MNEs do not worry about the travails of dual residency status, the uncertainty surrounding residency tiebreaker rules, and the vagaries of competent authority assistance. Further, the I.R.S. has a potent set of weapons to protect the U.S. corporate tax base while maintaining perhaps the most comprehensive worldwide taxation system on the planet.

On the other hand is a policy that likely detracts from U.S. inbound investment while potentially frustrating non-tax-motivated, cross-border combinations—all as we cross the threshold into a new global tax system, the result of a more than decade-long peregrination that commenced in the aftermath of the 2008 global financial crisis and appears destined to conclude with a 15-percent global minimum tax. In addition, MNEs must contemplate the mostly-adopted, OECD-backed initiatives on (i) interest deductibility, (ii) CFC-type regimes for passive income, (iii) hybrid mismatches, (iv) a general anti-abuse rule (or GAAR) to deny tax benefits achieved pursuant to a “non-genuine arrangement”,[[368]](#footnote-368) and, yes, (v) exit taxation.[[369]](#footnote-369) After considering the collective impact of these reforms, one might question the need for section 7874 in the first place.

There is no obvious correct answer to the inversion question. My hope is that this paper (and others like it) will provide lawmakers, regulators, academics, tax advisors, economists, and taxpayers the opportunity to engage in a policy reset—a re-think of the U.S. anti-inversion regime, how and why it was assembled, and whether its current stasis is consistent with the post-global tax reform world in which we find ourselves. Perhaps, in the end, U.S. MNEs will never be able to leave. Or perhaps some combination of the modifications discussed above will provide the balance of affording MNEs the flexibility to come and go for the right (non-tax) reasons while ensuring sufficient safeguards are in place to protect the U.S. fisc. Whatever path is chosen, MNEs need not fret, the I.R.S. will leave the light on for you.[[370]](#footnote-370)

1. For global businesses considering where to call home, the decision points can be complex. Choose wisely. If you do not, to paraphrase Don Henley, Glen Frey, and Don Felder:

   The last thing you’ll remember

   As you slip into a dream

   Trying to find a structure back

   To a lower tax regime

   “Relax,” said the tax man

   “We are programmed to receive”

   “You can check-out any time you like”

   “But you can never leave!” [↑](#footnote-ref-1)
2. This paper is based on a panel discussion to be presented at the University of Chicago Law School’s 75th Annual Federal Tax Conference. I would like to thank Elizabeth Dengler, Omar Hussein, and Claire Voegele for their help in preparing this paper, Michael Caballero, Andrew Eisenberg, Christopher Hanfling, and Douglas Poms in addition to John Merrick, Caroline Ngo, and Chris Trump (my co-panelists at the 2022 University of Chicago Law School Federal Tax Conference) for their helpful comments. I appreciate all of your invaluable contributions and insights. Finally, please note that any opinions expressed in this paper are solely my own and do not necessarily represent the opinion of any of the above commentators, co-panelists, or Jones Day. [↑](#footnote-ref-2)
3. Reese, Ethan, “Revisiting the Meaning of the Eagles’ Hotel California As We Head Into 2022,” American Songwriter (Dec. 25,2021), https://americansongwriter.com/revisiting-the-meaning-of-the-eagles-hotel-california-as-we-head-into-2022/. [↑](#footnote-ref-3)
4. Throughout this paper, references made to a “domestic corporation” are references to a corporation (i) organized or formed in one of the 50 states of the United States or the District of Columbia, or (ii) organized or formed in a foreign jurisdiction but treated as a domestic corporation under section 7874(b). [↑](#footnote-ref-4)
5. The determination of corporate residency would be significantly less relevant if the United States chose to adopt a territorial system. U.S. source income would be subject to U.S. income taxation, foreign source income would be exempt. Although this debate is beyond the scope of this paper, the United States (and most, if not all, of the other OECD countries) rejected such an approach. For example, although many European countries afford their domestic corporation’s robust participation exemptions, they still maintain controlled foreign corporation (“CFC”) regimes typically focused on passive or low-taxed income and appear ready to launch a global minimum tax regime known as Pillar Two (more on this later). Although many OECD countries could once be described as territorial regimes, that ship appears to have sailed far out to sea. [↑](#footnote-ref-5)
6. *See* I.R.C. § 881 (withholding tax of 30 percent on foreign corporations receiving U.S. source dividends, certain interest payments, rents, royalties and certain other fixed, determinable, annual, or periodical income is not effectively connected to the conduct of a U.S. trade or business); I.R.C. § 882 (foreign corporations subject to U.S. federal income tax on income effectively connected to a U.S. trade or business). [↑](#footnote-ref-6)
7. I.R.C. § 7701(a)(4); Treas. Reg. § 301.7701-5(a) (providing that “[a corporation] is domestic if it is created or organized as . . . a corporation . . . in the United States, or under the law of the United States or of any State”). [↑](#footnote-ref-7)
8. I.R.C. § 7701(a)(5); Treas. Reg. § 301.7701-5(a) (providing that a corporation “is foreign if it is not domestic.  . . . [A corporation] that is created or organized both in the United States and in a foreign jurisdiction is a domestic entity.”). [↑](#footnote-ref-8)
9. Okay, that’s not exactly it. The Internal Revenue Code (the “Code”) provides for a few exceptions to the above bright-line rule—all but one are either at the taxpayer’s election or *de facto* election. First, pursuant to section 1504(d), a domestic corporation may elect to have a Canadian or Mexican subsidiary treated as a domestic corporation for all U.S. federal income tax purposes provided the domestic corporation owns 100 percent of the subsidiary, and the subsidiary is organized and “maintained solely for the purpose of complying with the laws of a contiguous foreign country [(i.e., Canada or Mexico)] as to the title and operation of property.” Second, pursuant to section 269B, if a domestic corporation and a foreign corporation are “stapled entities,” the foreign corporation is treated as a domestic corporation. Third, certain foreign insurance companies may elect to be treated as domestic corporations pursuant to section 953(d). Fourth, a foreign corporation may elect under section 897(i) to be treated as a domestic corporation for purposes of sections 897, 1445, and 6039C. The fifth, and perhaps more well-known, exception is under section 7874(b) treating a foreign corporation as a domestic corporation if that corporation underwent a so-called 80-percent inversion. It is this fifth exception that this paper will (re)consider. [↑](#footnote-ref-9)
10. *See*, *e.g.*, Part *‎*IV.C.2.a discussing Representative Doggett’s legislative proposal. [↑](#footnote-ref-10)
11. *See*, *e.g.*,Omri Marian, *Jurisdiction to Tax Corporations*, 54 B.C. L. Rev. 1613 (2013); Rubinger, *“Management and Control”—Should Place of Formation Determine U.S. International Tax Consequences?*, J. Int’l Tax’n (Oct. 2007); *see also* Calianno, *The Role of ‘Tax Residency’ in Applying the Section 7874 Inversion Rules*, J. Corp. Tax’n (May/June 2016) (discussing corporate tax residency as it applies to the section 7874 anti-inversion regulations’ substantial business activities and third-country tests). [↑](#footnote-ref-11)
12. Canadian Income Tax Act, § 250(4) (R.S.C. 1985, c. 1 (5th Supp)). If a company is not incorporated in Canada, it may still be a resident of Canada through the common law “central management and control” test. *See* Canada Revenue Agency, Residency of a Corporation, CANADA.CA (May 24, 2022), https://www.canada.ca/en/revenue-agency/services/tax/international-non-residents/businesses-international-non-resident-taxes/residency-a-corporation.html#res [↑](#footnote-ref-12)
13. Article 9, section II of the Mexican Federal Tax Code (Código Fiscal de la Federación) and Article 6 of the Regulations of the Mexican Federal Tax Code (Reglamento del Código Fiscal de la Federación) (place or organization or incorporation not relevant in Mexican residency analysis). [↑](#footnote-ref-13)
14. *See also* Australia (incorporated in Australia or if not incorporated in Australia, the corporation carries on business in Australia and has either its central management and control in Australia or its voting power controlled by shareholders who are residents of Australia); China (incorporated in China under Chinese law or incorporated elsewhere but has the place of effective management in China); France (legal seat or place of effective management is in France); Germany (place of management or registered office is located in Germany); India (incorporated in India or in a given tax year, the control and management of its affairs is situated wholly in India); Ireland (place of central management and control or incorporation); Luxembourg (legal seat or central administration in Luxembourg); Spain (corporation constituted according to Spanish law, registered address is in Spanish territory, or has its effective headquarters based in Spanish territory). *But see*, *e.g.*, Brazil (corporation deemed to be resident in Brazil if incorporated under Brazilian law or opts for registering its corporate headquarters in Brazil). [↑](#footnote-ref-14)
15. Central management and control jurisdictions include Australia, Canada, Ireland, Kenya, and the United Kingdom. [↑](#footnote-ref-15)
16. Place of management jurisdictions include Germany and Netherlands. A similar standard referred to as a “place of effective management” standard was incorporated into Swiss local law. Factors that courts and tax authorities consider under the place of effective management test include: (i) where the center of top level management is located, (ii) where the business operations are actually conducted, (iii) legal factors such as the place of incorporation, (iv) the location of the corporation’s registered office and public officers, (v) where controlling shareholders make key management and commercial decisions in relation to the corporation, and (vi) where the directors reside. [↑](#footnote-ref-16)
17. *See*, *e.g.*, *De Beers Consolidated Gold Mines* (1906) AC 455 (U.K.) (for U.K. residency focused on, among other factors, location of regular meetings of the board of directors); *Birmount Holdings Ltd v. R* (1978) CTC 358 (for Canadian corporate residency focused, in addition to place of incorporation, the place of residence of shareholders and directors, where the business operations take place, where financial dealings of the corporation occurred, and where the seal and minute books of the corporation were kept); *Malayan Shipping Co Ltd v. FC of T* (1946) 71 CLR 156 (for Australian corporate residency purposes, the court held that the company was a resident of Australia because the managing director exercised from Australia complete management and control over the business operations of the company, notwithstanding that the trading operations were conducted abroad). [↑](#footnote-ref-17)
18. For example, the U.S.-Canada Tax Convention does not relieve the dual-residency issue created as a result of an 80-percent inversion because the U.S. rules specifically and unilaterally override treaties (e.g., Article IV(3)(a) of the treaty would otherwise tie-break to the Canadian parent’s jurisdiction of formation). Thus, the Canadian parent would be subject to both U.S. and Canadian income tax on its worldwide income and dividends paid by the Canadian parent would be subject to both Canadian and U.S. withholding tax, as applicable. [↑](#footnote-ref-18)
19. The Delphi Automotive inversion is a prime example of the perils of inverting without the assurance that the rules of section 7874(b) do not apply. For a detailed discussion on the 80-percent inversion rule of section 7874(b), *see infra* Part ‎II.C.3.a(3). On May 19, 2011, Delphi Automotive PLC (“PLC”) was formed as a Jersey public limited company. PLC was a shell company prior to its initial public offering. On November 22, 2011, in connection with the completion of its initial public offering, all of the outstanding equity of Delphi Automotive LLP (“LLP”), a partnership for U.S. federal income tax purposes, was exchanged for PLC ordinary shares. As a result, LLP became a wholly-owned subsidiary of PLC. PLC was a U.K. resident taxpayer and thus not generally subject to U.K. tax on the distribution of foreign earnings from its subsidiaries. In its 2014 10-K, PLC reported that:

    On June 24, 2014, the [I.R.S.] issued us a Notice of Proposed Adjustment (the “NOPA”) asserting that it believes [section 7874(b)] applies to [LLP] and that it should be treated as a domestic corporation for U.S. federal income tax purposes, retroactive to [October 6, 2009]. If Delphi Automotive LLP is treated as a domestic corporation for U.S. federal income tax purposes, the Company expects that, although Delphi Automotive PLC is incorporated under the laws of Jersey and a tax resident in the United Kingdom, it would also be treated as a domestic corporation for U.S. federal income tax purposes.

    The company went on the state that “[n]otwithstanding the issuance of the NOPA, we continue to believe, after consultation with counsel, that neither Delphi Automotive LLP nor Delphi Automotive PLC should be treated as a domestic corporation for U.S. federal income tax purposes. We intend to vigorously contest the conclusions reached in the NOPA through the IRS’s administrative appeals process, and, if we are unable to reach a satisfactory resolution with the IRS, through litigation.” A little less than two years later, on April 13, 2016, PLC announced that I.R.S. Appeals concluded that no adjustments were necessary for 2009 and 2010—two years that had the 2009 transaction tripped the 80-percent test would have resulted in significant tax exposure to the company. In its public statement, PLC announced that “[w]e are satisfied that the IRS appeals process worked as intended and reached the correct ruling regarding Delphi Automotive PLC being a [U.K.] company.” [↑](#footnote-ref-19)
20. *See*, *e.g.*, Statement of the U.S. Chamber of Commerce on Comprehensive Tax Reform Comments (April 15, 2015) (concluding that “[o]ur high tax rate and possibility of double taxation, while mitigated by provisions such as deferral and the foreign tax credit, harms the ability of American worldwide companies to compete globally.”); *see also* Andrew Ross Sorkin, *Reluctantly, Patriot Flees Homeland for Greener Tax Pastures*, The New York Times (July 14, 2014) (quoting then-C.E.O. of Mylan Heather Bresch’s concerns over her company’s competitiveness stating “We were one of the last ones in our sector to do this. So it’s not like I was blazing the trail. If you put on your business hat, you can’t maintain competitiveness by staying at a competitive disadvantage.” Ms. Bresch went on to state “You know what makes me want to cry? I think whoever the next Facebook is, why would you ever start that company here in the United States?”); Complaint (Doc. 2-1, filed Aug. 4, 2016), at 6, *Chamber of Commerce of the U.S. v. Internal Rev. Serv.*,No. 1:16–CV–944, 2017 WL 4682049 (W.D. Tex. Sept. 29, 2017)(“Inversions thus allow MNE corporations to bring more money earned abroad into the United States, leading to the creation of new American facilities and more American jobs, as well as increased profits for U.S. shareholders. For example, in connection with its 2015 inversion, Medtronic agreed to create more jobs in Minnesota and to invest more profits earned abroad in the United States. Inversions are nonetheless controversial because they reduce the potential amount of federal income tax for foreign companies with a U.S. presence.”). This view, however, was not universal. *See*, *e.g.*, Edward D. Kleinbard,*‘Competitiveness’ Has Nothing to Do With It*, 144 Tax Notes 1055, (Sept. 1, 2014) (arguing before the enactment of the TCJA that “[t]hrough large investments in aggressive tax planning technologies, and unencumbered by any of the anti-abuse rules to which non-U.S. MNEs domiciled in jurisdictions with better designed territorial systems might be subject, U.S.-domiciled MNE firms have become adroit at moving income that as an economic matter is earned in high-tax foreign countries to very low-taxed ones” and, thus, not a competitive disadvantage.); *see also* Reuven S. Avi-Yonah & Omri Marian, Inversions and Competitiveness: Reflections in the Wake of Pfizer-Allergan, 41 Int’l Tax J. 39 (2015). [↑](#footnote-ref-20)
21. These benefits have since been significantly reduced (as discussed in detail below). For example, base stripping through outbound related party payments has been somewhat curtailed under the base erosion and anti-abuse tax (“BEAT”) rules of section 59A and outbound interest payments under the interest deduction limitation rules of a revamped section 163(j). [↑](#footnote-ref-21)
22. *See*, *e.g.*, Sicular, David, *The New Look-Through Rule: W(h)ither Subpart F?*, Tax Notes (Apr. 23, 2007); Tim Anson et. al., “The Substantial Assistance Rules: An Evolution in Subpart F Planning”, Tax Notes Int’l, Nov. 12, 2007; Christopher Ocasal and Greg Lubkin, *New TIPRA CFC Look-Through Rule: Time To Begin Tailored Tax Planning-One Size Does Not Fit All*, J. of Int’l Tax’n, Sept. 2006; *see also* Brian Abbey, “Reconsidering Subpart F in Light of The Green Book GILTI Proposal”, Tax Notes State, Vol. 101, Sept. 6, 2021. This was not always the case. Some of the initial of inversions were executed, at least in part, to avoid foreign base company services income and the stricter substantial assistance rules under the pre-2007 regulations. *See* T.D. 6981, 1968-2 C.B. 314 (Nov. 13, 1968). [↑](#footnote-ref-22)
23. Interest and royalty payments, for example, generally give rise to subpart F inclusions vitiating the benefit of any related U.S. source deductions. [↑](#footnote-ref-23)
24. Interest payments, for example, made between a U.S. parent and its CFCs were subject to a series of disallowance and limitation rules, but still resulted in a significant reduction of U.S. taxable income. *See*, *e.g.*, Former I.R.C. § 163(j) (requiring (i) a *domestic* corporation or a U.S. branch of a foreign corporation to pay interest to a *related* person (or to an unrelated person (such as a third-party bank) if there is a “disqualified guarantee” of the underlying debt), (ii) the recipient of the interest to be exempt from U.S. tax on some portion of the income (or subject to a reduced rate of tax under a treaty), (iii) the interest-paying corporation to fail the debt-to-equity ratio safe harbor (i.e., 1.5 or less), and (iv) the corporation’s net interest expense to exceed 50 percent of its adjusted taxable income plus any excess limitation carryforward). [↑](#footnote-ref-24)
25. Although section 482 and the regulations thereunder sought to ensure related party payments were indeed arm’s length, taxpayers were still able to shift income offshore with sufficient planning (in particular when sufficiently comparable third-party transactions were not available). *See*, *e.g.*, OECD/G20 Base Erosion and Profit Shifting Project Aligning Transfer Pricing Outcomes with Value Creation, ACTIONS 8-10: 2015 Final Reports, at 9 (concluding that with the arm’s length principle’s “. . . perceived emphasis on contractual allocations of functions, assets and risks, the existing guidance on the application of the principle has [ ] proven vulnerable to manipulation. This manipulation can lead to outcomes which do not correspond to the value created through the underlying economic activity carried out by the members of an MNE group.”). [↑](#footnote-ref-25)
26. U.S. MNEs frequently referred to these overseas earnings as “trapped” or subject to the “lockout effect.” *See*, *e.g.*, Comprehensive Tax Reform for 2015 and Beyond, Republican Staff, Committee on Finance, United States Senate (Dec. 2014) (stating that “the U.S. international tax system was designed when U.S. companies did not have significant amounts of earnings trapped offshore. The “lockout effect” created by the current international tax system is a symptom of a problem, namely, that the current rules are not working well.”). Arguments were made as to the need to repatriate these earnings in order to increase domestic investment in research and development, expansion, and investment in hiring new American employees. *See* H.R. 1162, Invest in America Act of 2003 (The House asserted that a repatriation tax holiday would “encourage the investment of foreign earnings within the United States for productive business investments and job creation.”); *see also* Marr and Huang, *Repatriation Tax Holiday Would Lose Revenue and Is a Proven Policy Failure*, Ctr. Budget & Pol’y Priorities, at 7 (June 19, 2019) at 7 (“Large MNE corporations lobbying for the 2004 tax holiday claimed they would use the repatriated profits to expand operations in the United States, boosting capital spending, economic growth, and job creation.”). Some questioned U.S. tax policy’s impact on the repatriation of foreign earnings citing the limited increase in investment after the 2004 temporary repatriation tax holiday under the 2004 Jobs Act. *See*, *e.g.*, *An Analysis of the Tax Holiday for Repatriation Under the Jobs Act*, Tax Notes (Aug. 25, 2008), at 759 (authors concluded that the repatriation tax holiday funds were used principally for share repurchases and that companies that benefited from the holiday were no more likely to spend on growing their businesses than companies that did not benefit). Others found that “the evidence suggests that a large portion of untaxed earnings not reinvested in a [U.S. MNE]’s foreign business is held in U.S. financial assets and is made available to the U.S. economy through financial intermediation.” *See* Stephen E. Shay, “The Truthiness of ‘Lockout’: A Review of What We Know,” TNT Int’l (Mar. 16, 2015). [↑](#footnote-ref-26)
27. *See*, *e.g.*, Notice 2006-85, 2006-41 I.R.B. 677 (I.R.S. issues notice addressing cash repatriations referred to as “Killer B” transactions where, in one iteration, a foreign subsidiary would purchase a domestic parent corporation’s stock directly from that domestic parent, and then the stock was exchanged for shares of a foreign affiliate in a tax-free transaction before the end of the calendar quarter, when investment in U.S. property is measured under section 956); Notice 2007-48, 2007-25 I.R.B. 1428 (targeting a similar transaction where the foreign subsidiary would purchase shares of its U.S. parent from the public and then transfer them to a U.S. subsidiary of that parent in exchange for shares of a new foreign subsidiary owned by the U.S. subsidiary); Treas. Reg. § 1.367(b)-10 (regulation targeting Killer “B”-type transactions). [↑](#footnote-ref-27)
28. For more detail, *see* Note 311. [↑](#footnote-ref-28)
29. *See* “Cross-Border Topics of Interest,” IFA Canada Tax Conference, May 16, 2022, Slide 46; Form F-4/A filed with the U.S. Securities and Exchange Commission on November 6, 2014, Registration No. 333-197569 (Overland Storage, Inc.’s inversion to Canada with Sphere 3D Corporation, a Canadian capital pool company). [↑](#footnote-ref-29)
30. For example, cannabis issuers that have difficulty listing in the United States due to cannabis’s illegality under U.S. federal law find other jurisdictions, such as Canada, more accommodating. *See*, *e.g.*, Initial Public Offering Prospectus of Charlotte’s Web (Aug. 23, 2018) (CWB Holdings, Inc.’s inversion to Canada). (Apparently the Canadian government is more tolerant than the United States of the “warm smell of *colitas* rising up through the air.”) Other regulatory, non-tax benefits appear to exist in Canada for oil and gas companies and certain technology-based businesses. [↑](#footnote-ref-30)
31. The U.S. tax rules were not always so internationally focused. Some have argued that through the 1950s, U.S. international tax policy was focused primarily on source-based taxation (as opposed to residence-based taxation). *See*, *e.g.*, Thomas S. Adams, *The Taxation of Business*, Proc. 11TH Ann. Conf., Nat’l Tax Ass’n 185, 186 (1917) (believing that “business ought to be taxed because it costs money to maintain a market and those costs should in some way be distributed over all the beneficiaries of that market.”). Others believe that “surprisingly little has changed in the course of the last hundred years: U.S. international taxation is still dominated by the same kind of concerns that troubled [policy makers] in the 1910s and 1920s, namely how to balance the desire to prevent both double taxation and complete tax avoidance with sustaining the competitive position of U.S. businesses.” Avi-Yonah, Reuven S. “All of a Piece Throughout: The Four Ages of U.S. International Taxation.” 25 Va. Tax Rev. 313, 313 no. 2 (2005): 313-38. [↑](#footnote-ref-31)
32. *See*, *e.g.*, The Revenue Act of 1932 (June 6, 1932, ch. 209, 47 Stat. 169) (the predecessor to section 367 whereby Congress first attempted to prevent tax-free transfers of appreciated property to foreign corporations by U.S. persons); Revenue Act of 1937, Pub. L. No. 75-377, 50 Stat. 813. §§ 201-207 (the foreign personal holding company rules); Revenue Act of 1962 (the subpart F regime); Tax Reform Act of 1986 (the passive foreign investment company regime); I.R.C. § 367(d) (enacted by the Deficit Reduction Act of 1984); I.R.C. § 163(j) (as enacted by the *Omnibus Reconciliation Act of 1989*, Pub. L. No. 101-293, and amended by the *Tax Cuts and Jobs Act of 2017*, Pub. L. No. 115-97); I.R.C. § 367(e)(2) (as enacted by the *Tax Reform Act of 1984*, Pub. L. No. 98-369); I.R.C. § 482 (as enacted by the Revenue Act of 1928, ch. 852 § 45, 45 Stat. 791, amended by the Tax Reform Act of 1986, 100 Stat. 2085, 26 USC § 482, *amended further by the Tax Cuts and Jobs Act of 2017*, Pub. L. No. 115-97). [↑](#footnote-ref-32)
33. *See* General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, H.R. 4170, 98th Cong, P.L. 98-369 (Dec. 31, 1984) at 446 (“In the view of Congress, the ability to avoid ordinary income tax by causing a foreign corporation to engage in a transaction with the shareholders of its U.S. parent corporation would undermine the principle of taxing accumulated earnings and profits of foreign corporations upon repatriation.”). [↑](#footnote-ref-33)
34. Planning whereby non-U.S. shareholders (as defined under section 951(b)) acquire sufficient stock in a foreign corporation that historically is treated as a CFC resulting in the foreign corporation losing its CFC status is sometimes referred to as “de-CFCing.” [↑](#footnote-ref-34)
35. HR Rep. No. 432, pt. 2, 98th Cong., 2d Sess. 1327 (1984) (referenced an example akin to the transaction executed by McDermott); *see also* S. Rep. No. 169, 98th Cong., 2d Sess. 372 (1984). [↑](#footnote-ref-35)
36. H.R. Rep. No. 432, pt. 2, 98th Cong., 2d Sess. 1327 (1984); S. Rep. No. 169, 98th Cong., 2d Sess. 372 (1984). [↑](#footnote-ref-36)
37. Temp. Treas. Reg. § 1.367(a)-3T(f) (1986). [↑](#footnote-ref-37)
38. 1994-1 C.B. 356 (modified exception to section 367(a) rendering taxable any transfer of stock or securities of a domestic corporation by U.S. persons to a foreign corporation in a transaction otherwise eligible for nonrecognition treatment, if those U.S. persons, in the aggregate, hold 50 percent or more of the total voting power or value of the foreign acquiring corporation immediately after the exchange; suggested exception for acquisitions by unrelated foreign corporations engaged in an active trade or business). [↑](#footnote-ref-38)
39. Treas. Reg. § 1.367(a)-3(c)(1)(i). [↑](#footnote-ref-39)
40. Treas. Reg. § 1.367(a)-3(c)(1)(ii). A “five-percent target shareholder” means a person that owns at least five percent of either the total voting power or the total value of the stock of the U.S. target company immediately prior to the transfer described in section 367(a)(1). Treas. Reg. § 1.367(a)-3(c)(5)(iii). For purposes of this requirement, any stock of the transferee foreign corporation owned by U.S. persons immediately after the transfer will be taken into account, whether or not such stock was received in the exchange for stock or securities of the U.S. target company. Treas. Reg. § 1.367(a)-3(c)(1)(ii). [↑](#footnote-ref-40)
41. A “five-percent transferee shareholder” means a person that owns at least five percent of either the total voting power or the total value of the stock of the transferee foreign corporation immediately after the transfer described in section 367(a)(1). Treas. Reg. § 1.368(a)-3(c)(5)(ii). [↑](#footnote-ref-41)
42. Treas. Reg. § 1.367(a)-3(c)(1)(iii)(B). [↑](#footnote-ref-42)
43. A “qualified subsidiary” means a foreign corporation whose stock is at least 80-percent owned (by total voting power and total value), directly or indirectly, by the transferee foreign corporation, but excluding any subsidiary that (i) was affiliated (within the meaning of section 1504(a) substituting “50 percent” for “80 percent”) with the U.S. target company within 36 months prior to the transfer or (ii) acquired by the transferee foreign corporation at any time within 36 months prior to the transfer for the principal purpose of satisfying the active trade or business requirement. Treas. Reg. § 1.367(a)-3(c)(5)(vii). [↑](#footnote-ref-43)
44. Treas. Reg. § 1.367(a)-3(c)(1)(iv). Generally, to satisfy the active trade or business requirement, the transferee foreign corporation (or its qualified subsidiary) must be engaged in the active conduct of the trade or business outside the United States. Treas. Reg. § 1.367(a)-3(c)(i)(A). Whether the transferee foreign corporation (or its qualified subsidiary) is actively engaged in the conduct of the trade or business outside the United States is determined based on all facts and circumstances. Treas. Reg. § 1.367(a)-2(d)(2) and (3). [↑](#footnote-ref-44)
45. Treas. Reg. § 1.367(a)-3(c)(3)(i)(B). [↑](#footnote-ref-45)
46. Treas. Reg. § 1.367(a)-3(c)(3)(i)(C). A transferee foreign corporation is deemed to satisfy the substantiality requirement if, at the time of the transfer, the fair market value of the transferee foreign corporation is at least equal to the fair market value of the U.S. target company. Treas. Reg. § 1.367(a)-3(c)(3)(iii)(A). The substantiality test was recently amended to provide that for purposes of determining the value of the U.S. target company, such value includes the aggregate amount of non-ordinary course distributions (determined under the principles of Treas. Reg. section 1.7874-10) made by the U.S. target company. Treas. Reg. § 1.367(a)-3(c)(3)(iii)(C). [↑](#footnote-ref-46)
47. Treas. Reg. § 1.367(a)-3(c)(1), (6)(i). [↑](#footnote-ref-47)
48. For a detailed discussion of Treas. Reg. section 1.367(a)-3(c) and its current relevance, *see* Deborah L. Paul, *Has Helen’s Ship Sailed? A Re-Examination of the “Helen of Troy” Regulations*, Taxes - The Tax Magazine, 148 (Mar. 2020). [↑](#footnote-ref-48)
49. Prior to May 6, 1997, the maximum individual capital gains rate for U.S. citizens and residents was 28 percent. In 1997, the maximum rate was reduced to 20 percent. In 2003, the maximum rate was again reduced, this time to 15 percent. (Note that the maximum rate was later increased back to 20 percent in 2013 and taking into account the net investment income tax (also added in 2013), currently stands at 23.8 percent.) Further, as a result of unanticipated events, the stock markets have shown significant and broad volatility in relatively short periods of time resulting in significant loses in many widely-held, publicly-traded MNE businesses. In the days following the September 11, 2001, terrorist attacks, the S&P 500 index fell more than 11 percent extending a broader decline caused by the technology bubble in 2000, which saw the tech-heavy NASDAQ sink 78 percent between March 2000 and October 2002. Six years later, the market again experienced a rapid decline at the end of the second George W. Bush Administration as a result of the financial crisis. In the midst of that crisis, the Dow Jones Industrial Average (“DJIA”) fell by over half—51.1 percent—from a peak of 14,165 on October 9, 2007, to a low of 6,926 on March 5, 2009. The DJIA did not recoup its losses until February 2013. Each of these crises would render many long- and medium-term shareholders unconcerned about a cross-border business combination not satisfying the requirements of Treas. Reg. section 1.367(a)-3(c). N.B. Although the more recent pandemic-inspired market decline saw, for example, the DJIA lose approximately 37 percent of its value between February 12, 2000, and March 23, 2020, the decline was relatively short lived whereby the index completely rebounded by August, 2020. [↑](#footnote-ref-49)
50. More than 75 percent of U.S.-based MNEs’ shareholder base consists of tax-exempt or foreign shareholders—shareholders who are not subject to U.S. tax on an otherwise taxable exchange of U.S. target corporation stock for some mix of foreign acquiring corporation stock and cash. *See The Dwindling Taxable Share of U.S. Corporate Stock*, Tax Notes, at 923 (May 16, 2016) (“estimate[ing] that the share of U.S. corporate stock held in taxable accounts fell more than two-thirds over the last 50 years, from 83.6 percent in 1965 to 24.2 percent in 2015.”). [↑](#footnote-ref-50)
51. *See* Hearing before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, Serial No. 107-75 (June 25, 2002) Hon. Nancy Johnson of Connecticut, at 15 (“American companies should act like American companies and pay their fair share to keep our country strong.”), *id. Hon. Richard Neal of Massachusetts at 18* (urging the Committee on Ways and Means to “[s]top the corporate traitors by shutting down the corporate loophole now and permanently.”), *id*. Hon. Mike McNulty of New York at 13 (having “no sympathy” for “Benedict Arnold” companies who justified “tax avoidance at a time of war by complaining about the laws.”). [↑](#footnote-ref-51)
52. *See*, *e.g.*, Testimony by Martin A. Regalia, Vice President and Chief Economist, U.S. Chamber of Commerce before the Committee on Ways and Means, Doc 2002-23413 (4 original pages), 2002 TNT 201-23 (October 16, 2002), at 2 (“Corporate inversions replace the U.S. parent of a multinational corporate group with a foreign parent, with the U.S. corporation thereby becoming its subsidiary. This has the effect of removing foreign operations income from the more onerous U.S. taxing jurisdiction, since the parent is no longer U.S.-based. The resulting tax savings help “level the playing field” for the corporate group, allowing the multinational operations to attain tax rates enjoyed by its foreign competitors.”). [↑](#footnote-ref-52)
53. Not everyone agrees with this analogy. *See*, *e.g.*,Joseph B. Darby III, “Building the New Berlin Wall: Treasury’s Anti-Inversion Regulations,” Business Entities (WG&L), May/Jun 2016 (concluding that “the better analogy, precisely because it so clearly illustrates the melding of bad policy and all-but-certain failure, is the Berlin Wall. Khrushchev built the Berlin Wall in 1961 because growing hordes of East Germans were fleeing, and it grew increasingly awkward to try and defend the workers’ paradise of the Eastern Bloc when large swatches of workers were intent on bailing out. So too with U.S. tax policy: Treasury thinks the natural answer to the fact that many U.S. corporations want to escape the U.S. is to make them stay unwillingly, by building the corporate tax equivalent of the Berlin Wall.”). That said, I will stick with the Hotel California comparison in deference to those who believe that an analogy to the Berlin Wall “diminish[es] the real injustices caused by the former communist regimes.” *See* Buckley and Davis, “Extraterritorial Income/Corporate Inversion Debate: Will Myths Prevail?”, Tax Notes (July 8, 2002), 289, 290. [↑](#footnote-ref-53)
54. *See*, *e.g.*, Office of Tax Policy, U.S. Dep’t of the Treasury, *Corporate Inversion Transactions: Tax Policy Implications*, Doc 2002-12218 (31 original pages) (May 17, 2002). The report concluded that:

    We must work to ensure that our tax system does not operate to place U.S.-based companies at a competitive disadvantage in the global marketplace. The tax policy issues raised by the recent inversion activity are serious issues. Further work is needed to develop and implement an appropriate and effective long-term response. As an immediate matter, careful attention should be focused on ensuring that an inversion transaction, or any other *transaction resulting in a new foreign parent*, cannot be used to reduce inappropriately the U.S. tax on income *from U.S. operations*. A comprehensive review of the U.S. tax system, particularly the international tax rules, is both appropriate and timely. Our overarching goal must be to maintain the position of the United States as the most desirable location in the world for place of incorporation, location of headquarters, and transaction of business.

    Emphasis added suggesting that any time a domestic corporation is acquired by a foreign corporation, the U.S. tax system is at risk of losing revenue—albeit perhaps mostly focused on income derived from U.S.-based operations. *See infra* Part ‎VII.A. for a discussion on whether the focus on shareholder continuity missed the mark. [↑](#footnote-ref-54)
55. *See*, *e.g.*, Harry Grubert and John Mutti, “Dividend Exemption Versus the Current System for Taxing Foreign Business Income,” U.S. Dep’t of the Treasury, (draft), October 1999. [↑](#footnote-ref-55)
56. *See*, *e.g.*, Statement of Representative Kevin Brady of Texas, Corporate Inversions Hearing before the Committee on Ways and Means, Serial No. 107-73, at 34 (June 25, 2002) (“I may not like it, but the hard truth is that Houston companies have incorporated overseas in order to compete fairly and to endure. As a result, a lot of good manufacturing and research jobs in the Houston region have been preserved and created as a result of corporate inversion.”); Statement of Representative Tim Ryan of Wisconsin, *id*. at 36 (“if we try and put up barriers to inversions, penalize inversions, you are simply going to make it easy for our companies to be purchased and acquired by foreign countries, foreign competitors.”). [↑](#footnote-ref-56)
57. *See*, *e.g.*, Statement of Gary Hufbauer, Reginald Jones Senior Fellow, Institute for International Economics, Corporate Inversions Hearing before the Committee on Ways and Means, Serial No. 107-73, at 41 (June 6, 2002) (“Sure enough, over the last three decades, the United States has created a tax atmosphere that encourages inversions, but not in the way we feared back in the 1970s. Instead, other legislative changes in the 1980s and 1990s gradually made the United States less desirable as a location for parent corporations (the extraterritorial income problem).”). [↑](#footnote-ref-57)
58. *See*, *e.g.*, Corporate Patriot Enforcement Act of 2002, H.R. 3884, 107th Cong. (Mar. 6, 2002) (Rep. Neal); Uncle Sam Wants You Act of 2002, H.R. 4756, 107th Cong. (2002) (Rep. Johnson); No Tax Breaks for Corporations Renouncing America Act, H.R. 4993, 107th Cong. (2002) (Rep. Doggett); American Competitiveness and Corporate Accountability Act of 2002, H.R. 5095, 107th Cong. (2002) (Rep. Thomas); H.R. 3857 (Mar. 6, 2002) (Rep. McInnis); Save America’s Jobs Act of 2002, H.R. 3922, 107th Cong. (March 11, 2002) (Rep. Maloney); S. 2050, 107th Cong. (Mar. 21, 2002) (Sens. Wellstone and Dayton); Reversing the Expatriation of Profits Offshore Act, S. 2119 (Apr. 11, 2002) (Sens. Grassley and Baucus). [↑](#footnote-ref-58)
59. Joint Committee on Taxation, *Background Materials on Business Tax Issues Prepared for the House Committee on Ways and Means Tax Policy Discussion Series*, April 4, 2002, JCX 23-02, at 41-43 (Apr. 4, 2002) (providing that, at the time of the study, of the 13 countries analyzed, Australia, Canada, France, Germany, Italy, Japan, Mexico, Spain, and the United Kingdom had CFC rules; Netherlands had limited anti-deferral rules for passive income; and only Belgium, China and Ireland did not). [↑](#footnote-ref-59)
60. *See*, *e.g.*, Buckley and Davis at 290-291. For additional discussion on whether the U.S. federal income tax system placed U.S. MNEs in a competitive disadvantage vis-à-vis their foreign-parented-MNE competitors, *see supra* note 20. [↑](#footnote-ref-60)
61. The provision reduced corporate tax on U.S. export sales by 15 percent resulting in an effective tax rate of 29.75 percent. The World Trade Organization later determined that the ETI provision violated the General Agreement on Tariffs and Trade’s prohibition on export subsidies and was repealed pursuant to 2004 Jobs Act that ushered in the section 7874 anti-inversion law. *See* Pub. L. No. 108-357. [↑](#footnote-ref-61)
62. Former I.R.C. § 863(b) (since repealed provision that permitted 50 percent of export sales income to be sourced foreign if title passed outside the United States; new rule provides that 100 percent U.S. source if “produced” domestically). [↑](#footnote-ref-62)
63. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2002-2006* (JCS-1-02), at 21 (Jan. 17, 2002). [↑](#footnote-ref-63)
64. *See*, *e.g.*, The U.S. Treasury Preliminary Report, “Corporate Inversion Transactions: Tax Policy Implications,” May 17, 2002, Doc 2002-12218 (31 original pages), 2002 TNT 98-49; *see also* Testimony by Pamela Olson, Acting Assistant Treasury Secretary for Tax Policy before the Committee on Ways and Means, Doc 2002-13680 (9 original pages), 2002 TNT 110-31 (June 6, 2002), at 9 (testifying that “[b]oth the recent inversion activity and the increase in foreign acquisitions of U.S. MNEs are evidence that the competitive disadvantage caused by our international tax rules is a serious issue with significant consequences for U.S. businesses and the U.S. economy.”). [↑](#footnote-ref-64)
65. It may be worth noting that although the enactment of section 7874 was a rifle shot aimed at inversion transaction structures, the House admitted that the U.S. international tax rules needed revamping and that the new provision was intended to be a stop-gap measure as a opposed to a long-term solution. *See* H.R. Rep No. 108-541, at 244 (June 16, 2004) (providing as the “reasons for change”:

    The Committee believes that corporate inversion transactions are a symptom of larger problems with our current uncompetitive system for taxing U.S.-based global businesses and are also indicative of the unfair advantages that our tax laws convey to foreign ownership. The bill addresses the underlying problems with the U.S. system of taxing U.S.-based global businesses and contains provisions to remove the incentives for entering into inversion transactions. Imposing full U.S. tax on gains of companies undertaking an inversion transaction is one such provision that helps to remove the incentive to enter into an inversion transaction.

    Those other provisions referenced in the statement above included, among others, a temporary repatriation of earnings holiday (former section 965), the limitation on the importation of build-in losses (section 362(e)(1)), an excise tax on stock compensation of insiders in inverted companies (section 4985); reduction of foreign tax credit baskets from nine to two (section 904(d)(1)); and exceptions to the definition of U.S. property for purposes of section 956. [↑](#footnote-ref-65)
66. The bill had similar rules for certain transactions involving the acquisition of substantially the properties constituting a trade or business of a domestic partnership. [↑](#footnote-ref-66)
67. H.R. Rep No. 108-541, at 244. [↑](#footnote-ref-67)
68. H.R. Conf. Rep. No. 108-755, at 1627-1628; S.R. Rep. No. 108-192 at 141-42. [↑](#footnote-ref-68)
69. H.R. Conf. Rep. No. 108-755 at 1628. [↑](#footnote-ref-69)
70. *Id*. at 1628-1629. [↑](#footnote-ref-70)
71. *Id*. at 1629-31. [↑](#footnote-ref-71)
72. *Id*. at 1629-32. [↑](#footnote-ref-72)
73. *American Jobs Creation Act of 2004*, P.L. 108-357, § 801(a) (2004). [↑](#footnote-ref-73)
74. *See* Cong. Budget Office Report, An Analysis of Corporate Inversions at 6 (Sept. 2017), <http://www.cbo.gov/publication/53093>. An “inversion” is in the eye of the beholder and it is not entirely clear how the Congressional Budget Office defined an inversion for purposes of its report other than that the report provides that in an inversion “the shareholders of the original U.S. company retain more than 50 percent of the new combined company.” *Id*. at 1. [↑](#footnote-ref-74)
75. The section 7874 anti-inversion rules also apply to certain acquisitions of domestic partners. This paper focuses on issues related to acquisitions of domestic corporations and, thus, will not discuss the anti-inversion rules as they relate to domestic partnerships. [↑](#footnote-ref-75)
76. In determining whether ownership of a foreign acquiring corporation meets the 60-percent test, the following stock is disregarded: (i) stock held by members of the expanded affiliated group (“EAG”) that includes the foreign acquiring corporation, and (ii) stock of the foreign acquiring corporation that is sold in a public offering related to the acquisition of the domestic entity. I.R.C. § 7874(c)(2). The same rules apply in determining whether the 80-percent test (discussed below) is satisfied. *Id*. [↑](#footnote-ref-76)
77. As described above, the term EAG generally means one or more chains of corporations (including foreign corporations) connected through more than 50-percent stock ownership (by vote and value) with a common parent corporation, but only if (i) the common parent directly owns more than 50 percent of the vote and value of the stock of at least one other corporation in the EAG, and (ii) more than 50 percent of the vote and value of the stock in each corporation in the EAG is owned directly by one or more of the other EAG members. I.R.C. § 7874(c)(1). Multiple direct owners of a corporation’s stock can be aggregated to satisfy the 50-percent threshold. I.R.C. § 1504(a)(1)(B)(ii). [↑](#footnote-ref-77)
78. The term “expatriated entity” means any domestic corporation (including any U.S. person related thereto pursuant to sections 267(b) or 707(b)(1), the “domestic entity”) with respect to which a foreign corporation (the “foreign acquiring corporation”) is a “surrogate foreign corporation.” I.R.C. § 7874(a)(2)(A). [↑](#footnote-ref-78)
79. The applicable period is defined as the time period beginning on the first day that properties of a domestic entity are acquired as part of the inversion transaction and ending 10 years after the last date that properties are acquired as part of such transaction. I.R.C. § 7874(d)(1). [↑](#footnote-ref-79)
80. These rules are intended to ensure that an appropriate “toll charge” is paid on transactions that accompany or follow an inversion transaction where the transaction is designed to “remove income from foreign operations from the U.S. taxing jurisdiction.” *See* H.R. Conf. Rep. No. 755, at 568, 574 (2004); J.C.T. Explanation, at 342, 345. [↑](#footnote-ref-80)
81. I.R.C. § 7874(d)(2). [↑](#footnote-ref-81)
82. I.R.C. § 7874(a)(1), (e); *see also* H.R. Rep No. 108-541, at 244 (June 16, 2004) (providing that inversion gain may not be “offset by tax attributes such as net operating losses or foreign credits.”). [↑](#footnote-ref-82)
83. *See* I.R.C. § 4985(e)(1). [↑](#footnote-ref-83)
84. I.R.C. § 7874(b). [↑](#footnote-ref-84)
85. *Id*. [↑](#footnote-ref-85)
86. Pursuant to Treas. Reg. section 1.7874-1(c)(2), an internal group restructuring occurs if (i) before the acquisition of the domestic entity, 80 percent or more of the stock (by vote and value) or the capital and profits interest of the domestic entity, as applicable, was held by the corporation that is the common parent of the EAG after such acquisition; and (ii) after the acquisition of the domestic entity, 80 percent or more of the stock (by vote and value) of the foreign acquiring corporation is held by such common parent. Pursuant to Treas. Reg. section 1.7874-1(c)(3), a loss of control occurs if, after the acquisition of the stock in, or properties held by, a domestic entity, the former shareholders or partners of the domestic entity do not hold, in the aggregate, more than 50 percent of the stock (by vote or value) of any member of the EAG. [↑](#footnote-ref-86)
87. *See* Treas. Reg. § 1.7874-2(c). [↑](#footnote-ref-87)
88. Section 7874(c)(6)(A) provides that “[t]he Secretary shall prescribe such regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations—(A) to treat warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock, and (B) to treat stock as not stock.” [↑](#footnote-ref-88)
89. Pursuant to Treas. Reg. section 1.7874-2(h)(3), the value of the option holder’s claim on equity is determined: (i) in the case of an option to acquire interests in a domestic entity, immediately before the acquisition of the domestic entity described in section 7874(a)(2)(B)(i) (i.e., a foreign acquiring corporation’s acquisition of substantially all of the properties of a domestic corporation or partnership), and (ii) in the case of a foreign entity, immediately after the acquisition described in section 7874(a)(2)(B)(i). [↑](#footnote-ref-89)
90. The rules under former Treas. Reg. section 1.7874-2(h)(1) will not apply to an option, and thus such option will be disregarded for section 7874 purposes, if (i) a principal purpose of the issuance or acquisition of the option is to avoid causing the foreign acquiring corporation to be treated as a surrogate foreign corporation; or (ii) at the time of the acquisition described in section 7874(a)(2)(B)(i), the probability of the option being exercised is remote. *See* Treas. Reg. § 1.7874-2(h)(4). Further, for purposes of Treas. Reg. section 1.7874-2(h), an option includes an interest similar to an option, including a warrant, a convertible debt instrument, and a put option. Treas. Reg. § 1.7874-2(h)(5). [↑](#footnote-ref-90)
91. Former Treas. Reg. § 1.7874-4T(c)(1)(i). Pursuant to former Treas. Reg. section 1.7874-4T(i)(7), “nonqualified property” consisted of (i) cash or cash equivalents; (ii) marketable securities; (iii) any obligation owed by (A) a member of the EAG that includes the foreign acquiring corporation; (B) a former shareholder of the domestic entity; or (C) a person that, before or after the acquisition, owns stock of a person described in (A) or (B) or is related to such a person; and (iv) any other property acquired in a transaction related to the acquisition described in section 7874(a)(2)(B) with a principal purpose of avoiding the purposes of section 7874. Former Treas. Reg. section 1.7874-4T(f) generally provided that if stock and other properties are exchanged for qualified property and nonqualified property, such stock was treated as transferred in exchange for qualified and nonqualified property, respectively, based on the relative value of the property. [↑](#footnote-ref-91)
92. Former Temp. Treas. Reg. § 1.7874-4T(h). [↑](#footnote-ref-92)
93. *See*, *e.g.*, Treas. Reg. § 1.385-3 (treating as stock certain interests in a corporation issued between members of an expanded group that would otherwise be treated as debt for federal tax purposes); Treas. Reg. 1.367(b)-4(e) (section 367(b) income inclusion rule expanded to apply to any exchange by a domestic corporation (or its CFC) of foreign corporate stock subsequent to an inversion, regardless of whether the exchange results in loss of CFC or section 1248 shareholder status); Treas. Reg. § 1.956-2(a)(4) (“United States property includes an obligation of a foreign person and stock of a foreign corporation if (i) the obligation or stock is held by a CFC that is an expatriated foreign subsidiary, (ii) the foreign person or foreign corporation is a non-CFC foreign related person, and (iii) the obligation or stock was acquired either during the applicable period or in a transaction related to the inversion transaction.”). An “expatriated foreign subsidiary” is generally defined as a CFC with respect to which an expatriated entity is a U.S. shareholder. For a more detailed definition, *see* Treas. Reg. §1.7874-12(a)(9). [↑](#footnote-ref-93)
94. *See* T.D. 9238, *Guidance Under Section 7874 for Determining Ownership by Former Shareholders or Partners of Domestic Entities*, 70 Fed. Reg. 9834 (Dec. 28, 2005) (promulgating Treas. Reg. section 1.7874-1T); T.D. 9265, *Guidance Under Section 7874 Regarding Expatriated Entities and Their Foreign Parents*, 71 Fed. Reg. 32427 (June 6, 2006) (promulgating Treas. Reg. section 1.7874-2T). [↑](#footnote-ref-94)
95. 2014-42 I.R.B. 712. [↑](#footnote-ref-95)
96. *See id.* at § 4. [↑](#footnote-ref-96)
97. Section 2.01 of the 2014 Notice provided that Treasury and the I.R.S. intended to issue regulations providing that if more than 50 percent of the gross value of all “foreign group property” constituted “foreign group nonqualified property” immediately following an inversion, a portion of the stock of the foreign acquiring corporation owned by the historical shareholders of the foreign acquiring corporation would be excluded from the denominator of the ownership fraction for purposes of the 60-percent test and the 80-percent test under section 7874.

    The term “foreign group property” was defined as any property held by the EAG after the acquisition of a domestic entity was completed (and all transactions related to that acquisition, if any, are completed), other than (i) property that is directly or indirectly acquired in the acquisition and that, at the time of the acquisition, was held directly or indirectly by the domestic entity, and (ii) stock or a partnership interest in a member of the EAG and certain obligations of a member of the EAG “to avoid double counting.” On the other hand, “foreign group nonqualified property” was generally defined as any foreign group property that constitutes nonqualified property under Treas. Reg. section 1.7874-4T(i)(7).

    The definition of foreign group nonqualified property excludes assets giving rise to income described in sections 1297(b)(2)(A) or 954(h) or (i), including income derived in the active conduct of banking, financing, or insurance businesses. [↑](#footnote-ref-97)
98. More specifically, if more than 50 percent of all foreign group property constituted foreign group nonqualified property following the acquisition of a domestic entity by a foreign acquiring corporation, the portion of the stock of the foreign acquiring corporation that was excluded from the denominator of the ownership fraction was equal to the product of (i) the value of the stock of the foreign acquiring corporation, excluding for this purpose (a) stock received in the transaction by the former shareholders of the domestic entity, (b) stock that was disqualified stock under Treas. Reg. section 1.7874-4T, and (c) stock excluded from the ownership fraction because it was held by an EAG member under Treas. Reg. section 1.7874-1(b); and (ii) a fraction, the numerator of which was the gross value of all foreign group nonqualified property, and the denominator of which was the gross value of all foreign group property.

    Solely for the purposes of calculating the fraction described in the preceding sentence, property received by the foreign acquiring corporation that had given rise to disqualified stock under Treas. Reg. section 1.7874-4T was excluded from the numerator and the denominator. Nonqualified property that had given rise to disqualified stock was not counted in the fraction because such nonqualified property gave rise to disqualified stock by operation of Treas. Reg. section 1.7874-4T. Including the nonqualified property in the fraction would have improperly resulted in double-counting the nonqualified property to disqualify foreign acquiring stock twice based on the same nonqualified property.

    Although the amount of stock resulting from this calculation was excluded from the denominator of the ownership fraction, it is nevertheless taken into account for purposes of determining whether an entity is an EAG member under section 7874(c)(2)(A) and for determining whether stock held by members of the EAG was included in the ownership fraction under Treas. Reg. sections 1.7874-1(c)(2) and (c)(3) (i.e., the internal group restructuring and loss of control rules). [↑](#footnote-ref-98)
99. *See* Notice 2014-52 I.R.B. 712at § 2.02. For this purpose, “non-ordinary course distributions” were defined as the excess of all distributions made during any taxable year by the domestic entity with respect to its stock or partnership interests over 110 percent of the average of such distributions during the 36-month period immediately preceding such taxable year. A distribution was defined for this purpose as “any distribution, regardless of whether it is treated as a dividend or whether, for example, it qualifies under section 355.” The 2014 Notice provided as examples of distributions (i) redemptions in distribution of stock under section 302(a); and (ii) any transfer of money or other property to the owners of the domestic entity made in connection with the acquisition of the domestic entity, to the extent that the money or other property is directly or indirectly provided by the domestic entity (including a distribution of boot to the shareholders of the domestic entity if the acquisition of the domestic entity qualifies as a reorganization under section 368(a)). N.B. Section 2.02 of the Notice provided that a similar rule will be added for the purposes of section 367(a) under Treas. Reg. section 1.367(a)-3(c). [↑](#footnote-ref-99)
100. The acquisition of the domestic entity was considered completed on the “acquisition date” pursuant to Treas. Reg. section 1.7874-3T(d)(1), which was the date when the acquisition of substantially all of the domestic entity’s properties under section 7874(a)(2)(B)(i) was completed. Following the issuance of the 2014 Notice, final regulations under Treas. Reg. section 1.7874-3 were issued on June 3, 2015, in replacement of Treas. Reg. section 1.7874-3T. *See* T.D. 9720, 2015-25 I.R.B. 1070. As finalized, Treas. Reg. section 1.7874-3(d)(1) contains the same definition of “acquisition date” as Treas. Reg. section 1.7874-3T(d)(1). [↑](#footnote-ref-100)
101. *See*, *e.g.*, Silvia Aloisi, “Cyberonics, Italy’s Sorin merge to create medical technology leader,” Reuters, <https://www.reuters.com/article/us-sorin-m-a-cyberonics/cyberonics-italys-sorin-merge-to-create-medical-technology-leader-idUSKBN0LU0QE20150226> (merger of U.S.-based Cyberonics with Italian-based Sorin where combined company will be headquartered in the United Kingdom); Liana B. Baker and Supantha Mukherjee, “Avago to buy Broadcom for $37 billion in biggest-ever chip deal,” Reuters, <https://www.reuters.com/article/us-broadcom-m-a-avago-correction/avago-to-buy-broadcom-for-37-billion-in-biggest-ever-chip-deal-idUSKBN0OE28220150529> (merger of Broadcom with Singapore-based Avago); Anne Steele and Shayndi Raice, “HIS and Market to Merge in an Inversion Deal, Creating Data Heavyweight,” March 21, 2016, Wall Street Journal, <https://www.marketwatch.com/story/ihs-and-markit-to-merge-in-an-inversion-dealcreating-data-heavyweight-2016-03-21> (information and analytics provider HIS merger with Markit Ltd, a U.K. firm, to be headquartered in the U.K., with than 60 percent inversion); Nasdaq, “Johnson Controls to Proceed With Tyco Merger Plan,” April 21, 2016, <http://www.nasdaq.com/article/johnson-controls-to-proceed-with-tyco-merger-plan-20160421-00578> (Johnson Controls merger with Tyco). [↑](#footnote-ref-101)
102. *See* Notice 2014-52 I.R.B. 712at § 2.03; Treas. Reg. § 1.7874-1(c), -6(e). [↑](#footnote-ref-102)
103. *See* Notice 2014-52, § 3.01; *see also* T.D. 9761, *Inversions and Related Transactions*, 81 Fed. Reg. 20858, 20873-75 (Apr. 8, 2016); (Treas. Reg. § 1.956-2T(a)(4)(i) (providing that “United States property includes an obligation of a foreign person and stock of a foreign corporation if (A) the obligation or stock is held by a CFC that is an expatriated foreign subsidiary, (B) the foreign person or foreign corporation is a non-CFC foreign related person, and (C) the obligation or stock was acquired either during the applicable period or in a transaction related to the inversion transaction.”). This rule has since been published as final. T.D. 9834, Vol. 83, No. 134 (July 12, 2018); Treas. Reg. § 1.956-2(a)(4)(i). [↑](#footnote-ref-103)
104. *See* Notice 2014-52, § 3.02; Treas. Reg. § 1.367(b)-4(e) (Apr. 8, 2016) (post-60-percent inversion, where a U.S. shareholder or its CFC transfers stock of another CFC, that U.S. shareholder is required to include as a deemed dividend the section 1248 amount, if any, attributable to stock exchanged and any remaining gain inherent in such stock (after appropriate basis adjustment for inclusion of section 1248 amount) that would not otherwise be recognized); Treas. Reg. § 1.7701(l)-4 (Apr. 8, 2016) (recharacterizing expatriated foreign subsidiary stock issued or transferred to certain related persons such that U.S. shareholders remain treated as owning such stock thus avoiding any dilution of stock owned by U.S. shareholders). [↑](#footnote-ref-104)
105. *See* Notice 2014-52, § 3.03; T.D. 9761 at 20880; Treas. Reg. 1.304-7. [↑](#footnote-ref-105)
106. *See* Part I.A. [↑](#footnote-ref-106)
107. The new rule did not permit the taxpayer, under such circumstances, to look to the country in which it was considered a resident under the relevant managed and control test to determine whether the substantial business activities test was satisfied. [↑](#footnote-ref-107)
108. The third-country rule was based on Treasury and the I.R.S.’s determination that the use of a new foreign parent corporation, tax resident in a third country, was generally driven by tax planning, including the avoidance of U.S. tax. Thus, according to the government, subjecting those third-country transactions to section 7874 was consistent with the policy behind section 7874. T.D. 9834, *Inversions and Related Transactions*, 83 Fed. Reg. 32527 (July 12, 2018); Notice 2015-79 § 2.02(b). [↑](#footnote-ref-108)
109. Treas. Reg. § 1.7874-9(b). [↑](#footnote-ref-109)
110. This rule may effectively render a business combination to which neither the 60-percent or 80-percent ownership tests otherwise apply, a 100-percent inversion. For example, when calculating the foreign ownership percentage, stock of the foreign acquiring corporation received by former shareholders of the acquired domestic corporation is not taken into account. Treas. Reg. § 1.7874-9(e)(3)(i); *see also* T.D. 9761, *supra*, 81 Fed. Reg. 20867 (stating that, for purposes of calculating the Foreign Ownership Percentage, “stock of the foreign acquiring corporation held by former domestic entity shareholders (or former domestic entity partners) is not taken into account” (citing former Treas. Reg. § 1.7874-9T(e)(3)(i)). Treas. Reg. § 1.7874-9(e)(3)(ii) and (iii) sets forth additional modifications not relevant to this opinion letter. Thus, when a domestic and foreign corporation combine under a new foreign parent corporation tax resident in a third country, the foreign ownership percentage generally is 100 because only stock of the new holding company received by shareholders of the acquired foreign corporation is taken into account in both the numerator and the denominator of the ownership fraction. [↑](#footnote-ref-110)
111. *See* Former Treas. Reg. § 1.7874-4T. [↑](#footnote-ref-111)
112. *See* Note 91 for a more detailed definition of “nonqualified property” including category (iv) relating to “avoidance property”. [↑](#footnote-ref-112)
113. The 2015 Notice included an example illustrating this clarification. In the example, a foreign acquiring corporation acquired business assets in exchange for stock in a transaction related to the inversion with a principal purpose of avoiding the purposes of section 7874. The example concluded that the business assets were nonqualified property. As a result, the foreign acquiring corporation stock issued in exchange for the business assets was disregarded under former Treas. Reg. section 1.7874-4T for purposes of the ownership test. [↑](#footnote-ref-113)
114. For a discussion on the definition of “inversion gain”, *see supra* Part‎II.C.3.a(2). [↑](#footnote-ref-114)
115. *See also* T.D. 9761, 81 Fed. Reg. 20858, 20881 (April 8, 2016) (in referencing the definition of “inversion gain,” Treasury and I.R.S. provide that “[a]s described in the 2015 notice, the inversion gain rule provides that inversion gain includes income or gain recognized by an expatriated entity from an indirect transfer or license of property, such as an expatriated entity’s section 951(a)(1)(A) gross income inclusions taken into account during the applicable period that are attributable to a transfer of stock or other properties or a license of property, either: (i) As [sic] part of the acquisition, or (ii) after such acquisition if the transfer or license is to a specified related person. However, clause (ii) of the preceding sentence generally does not apply to transfers or licenses of property that is inventory in the hands of the transferor or licensor.”). [↑](#footnote-ref-115)
116. Final regulations also included a dividend under section 78 in the definition of income from inversion gain. *See* Treas. Reg. § 1.7874-11(b). [↑](#footnote-ref-116)
117. *See* 2014 Notice, Section 5; 2015 Notice, Section 6. These announcements may have been presaged by a 2007 Treasury report warning of the ability of inverted companies to strip the U.S. tax base via interest deductions paid on U.S. group issued debt to the new foreign parent.

     [A] major tax benefit is achieved by leveraging the U.S. parent corporation and the U.S. group as part of the inversion transaction. The leveraging of the U.S. operations of the group is accomplished through intercompany loans from related foreign entities. The result is a major reduction in the level of U.S. tax on domestic operations of the group through deductible interest payments to foreign members of the overall group that are subject to little or no U.S. tax. In the SEC filings seeking shareholder approval of these transactions, significant reductions in U.S. corporate taxes are listed as a key reason that the former U.S. parent corporations undertook these transactions.

     U.S. Dep’t of the Treasury, Report to The Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties at 2 (Nov. 2007). [↑](#footnote-ref-117)
118. 81 Fed. Reg. 20912 (April 8, 2016). [↑](#footnote-ref-118)
119. 81 Fed. Reg. at 20917. [↑](#footnote-ref-119)
120. Prop. Treas. Reg. § 1.385-3(b)(2) (providing that a debt instrument issued to an expanded group member would be treated as stock for all purposes of the Code if it was issued in (i) a distribution, (ii) exchange for stock of an expanded group member (other than an “exempt exchange”), or exchange for property in an asset reorganization, but only to the extent that, pursuant to the plan of reorganization, a shareholder that is an expanded group member received the debt instrument with respect to its stock in the target corporation. Prop. Treas. Reg. section 1.385-3 also contained a second rule (referred to as the “funding rule”) that automatically recharacterized a debt instrument issued for property, including cash, as stock if the debt instrument was issued to an expanded group member with a principal purpose of funding one of three transactions similar to the transactions listed in the general rule. Prop. Treas. Reg. § 1.385-3(b)(3). The preamble noted that the funding rule was deemed necessary to prohibit taxpayers from successfully circumventing the general rule through multi-step transactions that achieve “economically similar outcomes.” 81 Fed. Reg. at 20918. [↑](#footnote-ref-120)
121. T.D. 9790, 81 Fed. Reg. 72858, 72863 (Oct. 21, 2016) (“the final and temporary regulations apply only to [expanded group instruments] and debt instruments issued by members of an expanded group that are domestic corporations . . . .”). [↑](#footnote-ref-121)
122. Prior to the promulgation of Treas. Reg. section 1.385-3, inverted companies were leveraging up their U.S. operations and thus significantly reducing their net U.S. income tax liability. For example, “in two post-inversion years (2002 and 2003), [Cooper Industries, Ingersoll-Rand, Nabors Industries, and Noble Drilling] reported a combined total of approximately $2 billion of U.S.-based intercompany interest expense and fees, a substantial increase over the combined total of $300 million reported in two pre-inversion years (2000 and 2001).” Jim Seida and William F. Wempe, Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion at 2-3 (May 6, 2004). [↑](#footnote-ref-122)
123. Treas. Reg. § 1.7874-2T(e). The government revealed its intensions a year earlier in T.D. 9399, 73 Fed. Reg. 29,054, 29,056 (May 20, 2008). The preamble to the 2008 final regulations provided:

     The Treasury Department and the IRS also understand that some taxpayers may be taking the position that, where two or more domestic entities described in section 7874(a)(2)(B)(i) are acquired pursuant to an overall plan, section 7874(a)(2)(B) is applied separately to each such domestic entity. …The Treasury Department and the IRS disagree with this interpretation under current law and are considering issuing regulations to clarify the proper application of the rules. These regulations would clarify that the references in section 7874(a)(2)(B) to “a domestic corporation” shall, as appropriate, mean “one or more domestic corporations” where the properties of such corporations are, directly or indirectly, acquired pursuant to the same plan.” [↑](#footnote-ref-123)
124. *See* T.D. 9591, 77 Fed. Reg. 34,788 (June 12, 2012). [↑](#footnote-ref-124)
125. No prior proposed transactions had received more attention from the public and the U.S. government than Allergan’s attempted acquisition of Pfizer. Around the time of the deal’s initial public announcement, Pfizer stated that “[t]here is a myth that we are skirting U.S. taxes. Not true. All companies must pay taxes on U.S. income regardless where they are incorporated. The proposed combination will not affect the tax rate Pfizer pays on U.S.-based income, reflecting our two companies’ earnings and 30 R&D and manufacturing locations in the U.S. It also allows us to maintain a strong base of 40,000 high-skill, high-wage jobs in the U.S.” It’s fair to say that the I.R.S. and Treasury did not entirely agree with Pfizer’s statement. Neither did the two major 2016 U.S. Presidential candidates. *See* de la Merced, Gelles, and Picker, “Pfizer Chief Defends Merger with Allergan as Good for U.S.”, New York Times (Nov. 23, 2015) (“Hillary Rodham Clinton, the Democratic candidate, said, ‘We cannot delay in cracking down on inversions that erode our tax base.’ Donald J. Trump, the Republican candidate, said in a statement: ‘The fact that Pfizer is leaving our country with a tremendous loss of jobs is disgusting. Our politicians should be ashamed.’”). [↑](#footnote-ref-125)
126. To start, in October 2013, Actavis, Inc., a U.S. pharmaceutical company, entered into a deal with Warner Chilcott plc, an Irish pharmaceutical company. As part of that transaction, a new corporation, Actavis plc, was incorporated in Ireland. Actavis plc then acquired both Warner Chilcott plc and Actavis, Inc. In connection with the latter acquisition, Actavis plc issued approximately 134 million shares of its stock in exchange for Actavis, Inc. stock. Then, in June 2014, Actavis plc acquired Forest Laboratories, Inc. (“Forest Labs”), a U.S. pharmaceutical company, and issued approximately 99 million shares of stock to the owners of Forest Labs in exchange for Forest Labs stock. Finally, in March 2015, Actavis plc acquired Allergan, Inc., a U.S. pharmaceutical corporation, and issued approximately 128 million shares of stock to the owners of Allergan, Inc. in exchange for Allergan, Inc. stock. [↑](#footnote-ref-126)
127. The parties to the transaction also believed that the combination would not render the Irish top company a domestic corporation taking into account section 7874 and the regulations thereunder at the time of the deal’s announcement. *See* Section 6.14 of the “AGREEMENT AND PLAN OF MERGER by and among PFIZER INC., ALLERGAN PLC and WATSON MERGER SUB INC. Dated as of November 22, 2015,” filed as Exhibit 2.1 to S.E.C. Form 8-4 (November 23, 2015) (providing that the parties to the agreement shall not “take any action that, in combination with the Merger, causes, or could reasonably be expected to cause, the ownership threshold of Section 7874(a)(2)(B)(ii) of the Code to be met . . . .”). [↑](#footnote-ref-127)
128. Treas. Reg. § 1.7874-2(c)(4). The multi-step acquisition rule was designed to prevent taxpayers from circumventing provisions of the Section 7874 Regulations (such as the third-country rule (as defined below) or the business activities prong of the section 7874 test) by structuring an acquisition in two or more steps rather than one, and thereby frustrating the purpose behind section 7874. T.D. 9761, *Inversions and Related Transactions*, 81 Fed. Reg. 20858, 20862 (Apr. 8, 2016). Treasury believed that taxpayers could, for example, interpose a first-step acquisition to satisfy the business activities prong or avoid application of the third-country rule and, as part of the same plan, undertake a second-step acquisition with a foreign acquiring corporation that could not satisfy the business activities prong or that would cause the third-country rule to apply. *Id.* [↑](#footnote-ref-128)
129. Treas. Reg. § 1.7874-2(c)(4)(i), (k) (Ex. 21). These rules also apply to successive subsequent acquisitions that occur pursuant to the same plan. Treas. Reg. § 1.7874-2(c)(4)(iii). [↑](#footnote-ref-129)
130. *See* T.D. 9761, 81 Fed. Reg. 20858, 20865 (Apr. 8, 2016) where Treasury stated:

     The Treasury Department and the IRS are concerned that a single foreign acquiring corporation may avoid the application of section 7874 by completing multiple domestic entity acquisitions over a relatively short period of time, in circumstances where section 7874 would otherwise have applied if the acquisitions had been made at the same time or pursuant to a plan (or series of related transactions). In these situations, the value of the foreign acquiring corporation increases to the extent it issues stock in connection with each successive domestic entity acquisition, thereby enabling the foreign acquiring corporation to complete another, potentially larger, domestic entity acquisition to which section 7874 will not apply. In some cases, a substantial portion of the value of a foreign acquiring corporation may be attributable to its completion of multiple domestic entity acquisitions over the span of just a few years, with that value serving as a platform to complete still larger subsequent domestic entity acquisitions that avoid the application of section 7874. That is, the ownership percentage determined with respect to a subsequent domestic entity acquisition may be less than 60, or less than 80, if the shares of the foreign acquiring corporation issued in prior domestic entity acquisitions are respected as outstanding (thus, included in the denominator but not the numerator) when determining the ownership fraction.

     *See also* Ronald Orol*, Treasury Department Was ‘Targeting’ Pfizer-Allergan Deal,* The Street(Apr. 26, 2016)*, https://www.thestreet.com/politics/treasury-department-was-targeting-pfizer-allergan-deal-13538798*. [↑](#footnote-ref-130)
131. Former Temp. Treas. Reg. § 1.7874-8T. [↑](#footnote-ref-131)
132. The serial inverter rule is effective for transactions completed on or after April 4, 2016, regardless of when the prior acquisitions were completed. Former Temp. Treas. Reg. § 1.7874-8(i). [↑](#footnote-ref-132)
133. The serial inverter rule was challenged in court on both procedural and substantive grounds. In *Chamber of Commerce of the United States v. Internal Revenue Serv.*, No. 1:16-CV-944, 2017 WL 4682050 (W.D. Tex. Oct. 6, 2017), amending No. 1:16 –CV–944, 2017 WL 4682049 (W.D. Tex. Sept. 29, 2017), the U.S. District Court for the Western District of Texas invalidated the temporary regulation on procedural grounds because it had not been subjected to prior notice and comment as required under the Administrative Procedures Act. Nonetheless, the court held that the rule was substantively valid concluding that it did not exceed the government’s statutory authority because it was within their authority under section 7874 to “treat stock as not stock.” [↑](#footnote-ref-133)
134. Friedman, “The Discreet Charm of the Inversion Rules”, Tax Notes (September 8, 2014) 1147, 1148. [↑](#footnote-ref-134)
135. To drive the point home, assume that USP does not own any foreign subsidiaries or foreign branches. [↑](#footnote-ref-135)
136. Assume that the transaction does not qualify under the substantial business activities test as one or more of the relevant metrics follow the relative values (i.e., 80/20) of the two corporations. Further, none of the EAG exceptions are available, because an individual cannot be a member of an EAG. *See* § I.R.C. 7874(c)(1) (as discussed above, definition of EAG limited to corporate members of an affiliated group under section 1504 with certain modifications). Although technically not available, subjecting such a transaction to the penalties of section 7874 does not appear to jive with the overall Congressional intent and spirit of the regime. *See* T.D. 9238, *Guidance Under Section 7874 for Determining Ownership by Former Shareholders or Partners of Domestic Entities*, 70 Fed. Reg. 76685, 76686 (Dec. 28, 2005) (“Congress intended that the affiliate-owned stock rule could operate in specified situations to prevent the section from applying to certain transactions occurring within a group of corporations owned by the same common parent corporation before and after the transaction.”). [↑](#footnote-ref-136)
137. *Id*. [↑](#footnote-ref-137)
138. Treas. Reg. § 1.7874-1(c)(1), (3) (if loss of control exception applies, stock held by EAG members included in denominator (but not numerator) of ownership fraction). [↑](#footnote-ref-138)
139. Treas. Reg. § 1.7874-1(b).h [↑](#footnote-ref-139)
140. *Id*. The loss of control exception requirements are satisfied “if after the acquisition, the former domestic entity shareholders… do not hold, *in the aggregate*, directly or indirectly, more than 50 percent of the stock (by vote or value) of any member of the EAG.” (emphasis added). The exception does not include the “by reason of” language in section 7874(a)(2)(B)(ii)(I). [↑](#footnote-ref-140)
141. *See*, *e.g.*, Friedman, “The Discreet Charm of the Inversion Rules”, Tax Notes (September 8, 2014) 1147, 1153 (Example 9 relating to “minor overlap”). [↑](#footnote-ref-141)
142. Under Treas. Reg. § 1.7874-10(g), for ownership fraction calculation purposes, FP is treated as worth $30x and is not attributed any of the value of USP or S2 because immediately before the section 355-qualifying distribution of S1, S1 was worth less than 50 percent of USP. [↑](#footnote-ref-142)
143. Under Treas. Reg. § 1.7874-10(b), for ownership fraction calculation purposes, FP is treated as having the sum of 30 million shares (the actual number of FP shares outstanding) and the additional number of shares that would have been outstanding had USP not spun off S2 (i.e., 80 million) because the distribution of S2 is a distribution that meets the definition of a NOCD and the distribution occurred within 36 months of FP’s acquisition of USP. Treas. Reg. § 1.7874-10(k)(1)(i) (any distribution with respect to USP stock; section 355-qualifying distributions not excepted). Thus, the sum of the $80x of NOCD (equal to 80 million shares of FP stock) and 10 million shares of FP stock actually received results in a numerator of 90 million and a denominator of 110 million or approximately 82 percent. [↑](#footnote-ref-143)
144. *See* Nicholas DeNovio, Eli McCrain, and Pierce Pandolph, *No One Is Doing Inversions Anymore, So Why Does Code Sec. 7874 Apply to My Deal?*, Int’l Tax Journal (Jul.-Aug. 2022) at 43 (wondering “can Reg. § 1.7874-10(g) be helpful to NOCD determination?”; the article contains numerous examples with potentially unexpected results). [↑](#footnote-ref-144)
145. *See* I.R.C. § 7874(c)(5) (“For purposes of applying [section 7874(a)(2)(B)(ii)] to the acquisition of a trade or business of a domestic partnership, except as provided in regulations, all partnerships which are under common control (within the meaning of section 482) shall be treated as 1 partnership.”). To date, no regulations have been promulgated providing for any exceptions to the partnership aggregation rule under section 7874(c)(5). [↑](#footnote-ref-145)
146. Section 7874(c)(5)’s reference to “1 partnership” is not entirely clear as the statute does not assign a residency to the entity—i.e., domestic or foreign. A fair reading of the statute suggests that the aggregation rule was designed to ensure that the acquisition of multiple *domestic* partnerships under common control should be aggregated for purposes of the determining the ownership fraction under the section 7874(a)(2)(B)(ii) equity continuity requirement. *See*, *e.g.*, A.B.A., *Comments Regarding the Proposed Regulations under Section 7874*, at 23 (May 19, 2006) (suggesting that the “by reason of” requirement in section 7874(a)(2)(B)(ii) should not result in the aggregation of multiple acquisitions of domestic corporation and then comparing the “specific anti-abuse rule effectively requiring the consolidation of transfers by commonly controlled partnerships under [section] 7874(c)(5).”); AICPA, *Recommendations for 2007-2008 Guidance Priority List (Notice 2007-41)*, at 6 (in its request for section 7874(c)(5)-related guidance, asking Treasury and the I.R.S. for guidance “with respect to the special rule in section 7874(c)(5) for related partnerships in which all commonly controlled partnerships are aggregated, clarify (i) whether the rule applies to both domestic and foreign partnerships and (ii) for which purposes aggregation is required.”). Although the legislative history to section 7874(c)(5) is silent, it is likely that Congress had the Accenture inversion in mind when drafting the statute. In the transaction, Accenture had been conducting its business through a series of related partnerships and corporations under the control of the individual partners. The partnerships were rolled into a corporate structure with a newly formed Bermuda holding corporation as the parent in connection with an initial public offering of the corporation’s stock. For more detail, *see* NYSBA Report No. 1014, *Report on Outbound Inversion Transactions*, at 19-20 (May 24, 2002). [↑](#footnote-ref-146)
147. Further, there is no suggestion from the statutory language in section 7874(c)(5) (i.e., “except as provided in regulations”) that regulations under section 7874(c)(5) exempting potentially sympathetic facts and circumstances is self-executing. [↑](#footnote-ref-147)
148. *See* P.L.R. 202237005 (June 21, 2022). In the private letter ruling, the sole ruling provides that:

     Based solely on the information submitted, we rule as follows regarding the Transfer for purposes of section 7874(a)(2)(B):

     The stock of New Foreign Holdco held by reason of holding an interest in a domestic partnership, taking into account section 7874(c)(5) and the regulations under 7874, including Treas. Reg. 1.7874-2(f), includes a proportion of the stock held by reason of holding an interest in FP1 determined based on FP1’s indirectly held interest in DP relative to FP1’s interests in all its properties (including such indirectly held interest in DP), and does not otherwise include stock held by reason of directly or indirectly holding an interest in FP1, FP2, or FP3.

     In the ruling, the partners and FP1 own FP2 and FP2 owns certain interests in FP3. [↑](#footnote-ref-148)
149. Despite the continued assertions from Republicans that the Obama Treasury Department’s regulations under section 7874 exceeded Treasury’s authority and that a robust anti-inversion regime would no longer be necessary once fundamental international tax reform is achieved, the Trump Administration did not repeal (or materially modify for that matter), the hundreds of pages of section 7874 regulations, even after passage of the TCJA. In fact, it finalized the slew of temporary regulations that were set to expire on its watch. *See* T.D. 9834, *Inversions and Related Transactions*, 83. Fed. Reg. 32524 (Jul. 12, 2018) (finalizing proposed and temporary regulations published on April 8, 2016, “that address transactions that are structured to avoid the purposes of sections 7874 and 367 of the [I.R.C.] and certain post-inversion tax avoidance transactions.”). Further, during the first year of the Trump Administration but prior to the passage of the TCJA, Treasury stated, according to Tax Notes, that “[t]he enactment of tax reform is expected to obviate the need for the [Treas. Reg. section 1.385-3] distribution regulations, which includes the funding rule, after which revocation of those rules could be possible []. But until then, the rules remain as is, and to the extent tax reform legislation doesn’t eliminate the need for the rules, ‘Treasury and the IRS may then propose more streamlined and targeted regulations,’ it added.” Velarde et al., *Treasury Report Signals Significant Overhauls Coming to Regs* 2017 TNT 192-1 (Oct. 5, 2017). *See also* 84 Fed. Reg. 59318 (Nov. 4, 2019) (Treasury and the I.R.S. announced plans to substantially modify the anti-inversion debt-equity funding rules). In the end, however, the Trump Administration was unwilling to keep its promise and repeal Treas. Reg. section 1.385-3 because “a complete withdrawal of [those regulations] could [have] restore[ed] incentives for multinational corporations to generate additional interest deductions without new investment.” T.D. 9897, 85 Fed. Reg. 28867, 28868 (May 14, 2020). [↑](#footnote-ref-149)
150. For a discussion on Pillar Two, *see* Part ‎VI.B. [↑](#footnote-ref-150)
151. General Explanation of the Administration’s Fiscal Year 2015 Revenue Proposals. These proposals predate Notice 2014-52. [↑](#footnote-ref-151)
152. 2015 Greenbook at 65. [↑](#footnote-ref-152)
153. This proposal was never enacted. [↑](#footnote-ref-153)
154. 2016 Green Book at 37-38. [↑](#footnote-ref-154)
155. *Id*. at 38. [↑](#footnote-ref-155)
156. *Id*. Further, like the proposal in the 2015 Greenbook, this proposal also was never enacted. [↑](#footnote-ref-156)
157. S. 2360, 113th Cong. (May 20, 2014). Representative Sander Levin, D-Mich., introduced companion legislation in the House of Representatives on the same date. *See* H.R. 4679, 113th Cong. (May 20, 2014). The bill’s contents were the same as those introduced in the Senate, except that it contained no two-year sunset provision that the latter bill included. On July 30, 2014, Senator Carl Levin, along with Senators Dick Durbin and Jack Reed, introduced a bill entitled the “No Federal Contracts for Corporate Deserters Act of 2014” in the Senate, which aimed to strengthen the existing ban on federal contracts for inverted corporations and used a definition of inverted corporation similar to the one proposed in the Stop Corporation Inversions Act of 2014. S. 2704, 113th Cong. (July 30, 2014). Representative Rosa DeLauro, D-Conn., introduced a companion bill was introduced in the House of Representatives. H.R. 5278, 113th Cong. (July 30, 2014). [↑](#footnote-ref-157)
158. S. 1177, Amendment Proposed by Robert Casey, 114th Cong., 1st Sess. (2015). [↑](#footnote-ref-158)
159. For a summary of some of the key international-tax-related provisions enacted under the TCJA and their impact on inversion demand, *see* Part ‎VI.A. [↑](#footnote-ref-159)
160. Section 1(h)(11) provides that U.S. individual citizens and residents are eligible for the lower capital gain rate of 23.8 percent for the highest bracketed taxpayers on dividends from qualified foreign corporations as opposed to ordinary income rates (37 percent for the highest bracket scheduled to increase to 39.6 percent in 2026). A 60-percent (but less than 80-percent) inverted corporation, however, is not treated as a qualified foreign corporation if it inverted after May 8, 2003. *See* I.R.C. § 1(h)(11)(C)(iii)(II). [↑](#footnote-ref-160)
161. I.R.C. § 965(l). Some commentators have acknowledged that this penalty can have severe consequences to U.S. MNEs with significant foreign earnings. *See*, *e.g.*, Sutton, Scanlon, and Massed, “Inversion 2.0: The Proposal to Expand the Scope of Section 7874,” 106 Tax Notes Int’l, at 60 (Apr. 4, 2022) (providing that “[t]his result is potentially catastrophic for taxpayers that had significant foreign earnings as of the enactment of the TCJA, particularly if those earnings have been distributed to shareholders or used to repay debt and are therefore unavailable to satisfy the resulting tax liability.”). [↑](#footnote-ref-161)
162. *See* Notes 104, 104, and 105. [↑](#footnote-ref-162)
163. I.R.C. § 59A(d)(4). For a summary of the BEAT regime, *see* Note 225. [↑](#footnote-ref-163)
164. *See* I.R.C. § 250(a)(1)(A). *But see* Sutton, Scanlon, and Massed, *Inversion 2.0: The Proposal to Expand the Scope of Section 7874,* Tax Notes Int’l, Vol. 106, (Apr. 4, 2022), note 7 (providing that “[w]hile [the inversion-gain rule] is commonly described as restricting the use of net operating losses and foreign tax credits to shelter inversion gain, the deduction under section 250 for foreign-derived intangible income earned by reason of a related-party sale or license *might* also be disallowed by reason of this provision.”) (emphasis added). [↑](#footnote-ref-164)
165. *See* I.R.C. § 250(a)(1)(B). *But see* Zimet, *Inverted Debt Restructurings: A Mind-Numbing Maze*, 105 Tax Notes Int’l (Jan. 3, 2022), note 48 (providing that “[t]he section 250 deduction *might* be available to reduce the income inclusion for the GILTI inclusion.”) (emphasis added). [↑](#footnote-ref-165)
166. *See* I.R.C. § 245A (perhaps to the extent related to a deemed dividend of the section 1248 amount upon the sale of foreign expatriated corporation stock). [↑](#footnote-ref-166)
167. *See* Treas. Reg. § 1.7874-11(b); Treas. Reg. § 1.7874-11(e). [↑](#footnote-ref-167)
168. Inflation Reduction Act of 2022 (“I.R.A.”), Pub. L. No. 117-169 (2022). The I.R.A. did include an anti-inversion-related provision—a one-percent stock repurchase excise tax on publicly-traded domestic corporations that also applies to “repurchases” (as defined in section 4501(c)(1)) of shares of publicly-traded surrogate foreign corporations. I.R.C. § 4501(d)(2). [↑](#footnote-ref-168)
169. The BBBA also would have increased the federal statutory corporate income tax rate from 21 percent to 28 percent. [↑](#footnote-ref-169)
170. Under the proposal, the BEAT would be modified, among other proposed changes, to include cost of goods sold as base erosion payments and gradually raise the rate and eliminate the base erosion percentage threshold. *See* H.R. REP. NO. 117-130, Build Back Better Act, Sec. 138131 (Sep. 27, 2021).

     Further, the Biden Administration’s 2022 Green Book, Treasury recommended replacing the BEAT with a new anti-base erosion provision referred to as the “stopping harmful inversions and ending low-tax developments (or “SHIELD”). When applicable, SHIELD would have denied taxpayers a deduction for certain payments made to related parties and, where the payment is for the cost of goods sold or other costs that effectively produce a deduction, other deductions of the taxpayer (including payments to unrelated persons) would be denied up to the amount of the payment. The entire payment from a covered taxpayer made directly to a low-tax member of the same financial reporting group would be subject to SHIELD. A percentage of any payment from a covered taxpayer to any other member of the same financial reporting group would also be deemed subject to SHIELD whereby the percentage would be equal to the financial reporting group’s low-taxed profits, divided by its total profits, as reflected on the financial reporting group’s consolidated financial statements.

     SHIELD would apply to certain actual or deemed payments made in years in which it is effective by certain taxpayers (U.S. corporations or U.S. branches of non-U.S. entities) who are members of a financial reporting group with more than $500 million in global annual revenues, as reported on the group’s consolidated financial statements. The effective tax rate of a financial reporting group member would be determined by comparing the group’s income earned in the member’s jurisdiction with the group’s taxes paid in that jurisdiction, as reported on the consolidated financial statements. A member would be a “low-tax member” if the member’s income is subject to an effective tax rate below the designated minimum rate (i.e., 21 percent, to be replaced by the Pillar Two rate if and when finalized). [↑](#footnote-ref-170)
171. *See* H.R. 2976, Stop Corporate Inversions Act of 2021 (May 4, 2021); *see also* S.1501, Stop Corporate Inversions Act of 2021 (Apr. 29 2021) (identical Senate legislation to H.R. 29762022 Green Book, pp. 4–8. [↑](#footnote-ref-171)
172. *See* H.R. 2976, Stop Corporate Inversions Act of 2021 (May 4, 2021). [↑](#footnote-ref-172)
173. Even in the case where there is a true “merger of equals,” the likelihood that the ownership fraction would remain 50 percent after the application of the section 7874 regulations is seemingly impossible. For example, a single redemption or buyback by the U.S. MNE in the previous 36-month period could result in increasing the fraction above 50 percent under Treas. Reg. section 1.7874-10. [↑](#footnote-ref-173)
174. *Id.* [↑](#footnote-ref-174)
175. *Id.* The proposal provides that the methodology to be used in determining whether the significant domestic business activities test is satisfied would be the substantial business activities test currently in effect. *See* Treas. Reg. § 1.7874-3. [↑](#footnote-ref-175)
176. *See*, *e.g.*, I.R.C. §§ 250(b)(2)(B), 951A(d) (arguably incentivizing U.S. MNEs to invest in property, plant, and equipment outside the United States). [↑](#footnote-ref-176)
177. Under section 7874(a)(2)(B)(i), the shareholder fraction is determined after the foreign acquiring corporation “completes” the acquisition of substantially all of the properties of the domestic target corporation. Although the acquisition of substantially all of the properties could be spaced out over time (for example, if there were a pending local country antitrust approval that was needed to acquire substantially all but not significant enough to delay the overall acquisition), in most, if not nearly all, cases the acquisition of *all* of the properties occurs at same time. [↑](#footnote-ref-177)
178. S.1501 (Stop Corporate Inversions Act of 2021) (United States Senate equivalent to H.R. 2976); For additional insights on these proposals, *see* Wade Sutton, et. al., *Inversion 2.0: The Proposal to Expand the Scope of Section 7874*, 175 Tax Notes Federal 27, 27 (Apr. 4, 2022); Gary Scanlon, et. al., *More Sledgehammers, Fewer Flies: The Green Book’s Anti-Inversion Proposals*, 103 Tax Notes International 433, 433 (Jul. 26, 2021). [↑](#footnote-ref-178)
179. S.1501 at 2, ln. 23. [↑](#footnote-ref-179)
180. Council Directive (EU) No. 2016/1164, Laying Down Rules Against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market, 2016 O.J. (L. 193) (“ATAD 1”); Council Directive (EU) No. 2017/952, Amending Directive (EU) 2016/1164 as Regards Hybrid Mismatches with Third Countries, 2017 O.J. (L. 144) (“ATAD 2”); Proposed Council Directive (EU) No. 2021/0434 (CNS), Laying Down Rules to Prevent the Misuse of Shell Entities for Tax Purposes and Amending Directive 2011/16/EU, 2021 (“ATAD 3”). [↑](#footnote-ref-180)
181. ATAD 1, Decl. 1, 2016 O.J. (L. 193) 1. [↑](#footnote-ref-181)
182. ATAD 1, art. 11 §5, 2016 O.J. (L. 193) 14. [↑](#footnote-ref-182)
183. *See generally* ATAD 1, Decl. 10, 2016 O.J. (L. 193) 3.; ATAD 1, art. 5, 2016 O.J. (L. 193) 9–10 [↑](#footnote-ref-183)
184. ATAD 1, Decl. 10, 2016 O.J. (L. 193) 3. [↑](#footnote-ref-184)
185. For purposes of ATAD 1, market value is defined as “the amount for which an asset can be exchanged or mutual obligations can be settled between willing unrelated buyers and sellers in a direct transaction.” ATAD 1, art. 5 § 6, 2016 O.J. (L. 193) 10. [↑](#footnote-ref-185)
186. ATAD 1, art. 5 § 6, 2016 O.J. (L. 193) 9. Member states also agreed to allow for payment deferral over a five-year installment period, with interest in certain circumstances, if the taxpayer transfers within the European Union or to another nation that is a part of the Agreement on the European Economic Area (“EEA Agreement”). *Id.* If there is a “demonstrable and actual risk of non-recovery,” the member nation can require a guarantee on the part of the migrating taxpayer as a condition of deferral. Additionally, if one of the following situations occurs following such a transfer, the payment deferral plan is terminated, and the full amount is due to the initial transferee nation:

     (a) the transferred assets or the business carried on by the permanent establishment of the taxpayer are sold or otherwise disposed of; (b) the transferred assets are subsequently transferred to a third country; (c) the taxpayer’s tax residence or the business carried on by its permanent establishment is subsequently transferred to a third country; (d) the taxpayer goes bankrupt or is wound up; or (e) the taxpayer fails to honour its obligations in relation to the instalments and does not correct its situation over a reasonable period of time, which shall not exceed 12 months. *Id.* at 9–10. [↑](#footnote-ref-186)
187. *See* French Tax Code, Article 167(a). [↑](#footnote-ref-187)
188. *See* Hugh MacDonald, *What is France’s ‘Exit Tax,’ Who Pays it, and on What*, The Connextion (Feb. 4, 2022), <https://www.connexionfrance.com/article/Practical/Your-Questions/Money/What-is-France-s-exit-tax-who-pays-it-and-on-what> [↑](#footnote-ref-188)
189. The exit tax rate is comprised of a flat 30 percent rate (12.8 percent income tax and a 17.2 percent social security contribution) and a three-to-four percent “exceptional contribution rate.” *See* Bloomberg Law Country Guides, France, 9. Other Taxes (2022). [↑](#footnote-ref-189)
190. German Corporate Income Tax Act (“KStG”) Section 12(1); German Law on Taxation in Foreign Relations (“Foreign Tax Law”) Article 3, Section 6; *see also* Alexander Linn and Andreas Maywald, International Tax: Germany Highlights 2022, Deloitte (Updated Apr. 2022). [↑](#footnote-ref-190)
191. The exit tax is characterized as either a deemed sale or a hypothetical arms-length transaction. Several valuation approaches may be used, including the discount cash flow method or the “business function” method, a comprehensive test that is preferred when valuing a large corporate expatriation. *See* Alexander Linn and Andreas Maywald, International Tax: Germany Highlights 2022, Deloitte (Updated Apr. 2022). [↑](#footnote-ref-191)
192. The combined tax rate includes a 15 percent flat rate, plus a 0.825 percent solidarity surcharge, and municipal trade tax ranging from seven to 17 percent. *Id.* [↑](#footnote-ref-192)
193. Taxes Consolidation Act of 1997, §§ 627–629C, *as amended by* the Finance Act of 2018, § 32; *see also* Bloomberg Law Country Guides, Ireland, 9. Other (2022). [↑](#footnote-ref-193)
194. *Id*. [↑](#footnote-ref-194)
195. Italian tax law also provides that an entity is a resident for tax purposes if it is incorporated in Italy, the place of effective management is in Italy (presumed if the company is controlled by an Italian resident or majority board of Italian residents), or if the company’s main business occurs in the country for more than 183 days in a calendar year. *See* Italian Legislative Decree no. 142/2018 (Jan. 12, 2019); *see also*, Tremonti, Romagnoli, Piccardi, & Associati, Legislative Decree 29 November 2018, n. 142 Transposition of the ATAD Directive (Jan. 25, 2019), [https://www.virtax.it/2019/01/25/dec‍‌reto-le‍gislativo-29-novembre-2018-n-142-recepimento-della-direttiva-atad/](https://www.virtax.it/2019/01/25/decreto-legislativo-29-novembre-2018-n-142-recepimento-della-direttiva-atad/); Francesca Muserra and Francesca Falsini, International Tax, Italy Highlights 2022, Deloitte (Updated Jan. 2022). [↑](#footnote-ref-195)
196. The capital gains rate is comprised of a flat 24 percent tax and an additional 3.9 percent regional “tax on productive activities.” *Id*. [↑](#footnote-ref-196)
197. *See* Art. 38 of the Luxembourg Income Tax Act, as amended. [↑](#footnote-ref-197)
198. The tax rate includes a 17 percent flat rate, plus a 1.19 percent unemployment fund contribution and a 6.75-to-10.5-percent municipal business tax. *Id*. [↑](#footnote-ref-198)
199. *Id.* In addition to the current system, members of a Dutch opposition party proposed an amendment to the Dutch Dividend Withholding Tax Act of 1965 to include a new exit tax. This separate tax would be a deemed distribution of “latent profit reserves exceeding EUR 50 million” to be imposed on the “withholding agent” of the corporation upon migration. *See* Charlotte Tolman and Michael Molenaars, *Netherlands Considers an Exit Levy Proposal in Response to Corporate Relocations*, 105 Tax Notes Int’l 1 (Jan. 3, 2022), [https://www.my.stibbe.com/mysti‌bbe/attachment\_dw.action?attkey=FRbANEucS95NMLRN47z%2BeeOgEFCt8EGQJsWJiCH2WAUTleh6%2BAJHro2ROelybgb0&nav=FRbANEucS95NMLRN47z%2BeeOgEFCt8EGQbuwypnpZjc4%3D&attdocparam=pB7HEsg%2FZ312Bk8OIuOIH1c%2BY4beLEAeRfAt40h%2FlLs%3D&fromContentView=1](https://www.my.stibbe.com/mystibbe/attachment_dw.action?attkey=FRbANEucS95NMLRN47z%2BeeOgEFCt8EGQJsWJiCH2WAUTleh6%2BAJHro2ROelybgb0&nav=FRbANEucS95NMLRN47z%2BeeOgEFCt8EGQbuwypnpZjc4%3D&attdocparam=pB7HEsg%2FZ312Bk8OIuOIH1c%2BY4beLEAeRfAt40h%2FlLs%3D&fromContentView=1) [↑](#footnote-ref-199)
200. Spanish Law 27/2014 on Corporate Income Tax, art. 19 amended by Law 11/2021, art. 1(1); *see also,* Joan Mestre, *Exit Tax*, Krestoniberaudit (Sep. 22, 2021), <https://www.kreston.es/en/blog/exit-tax-eng/>; Brian Leonard, International Tax, Spain Highlights 2022, Deloitte (Update, Jan. 2022). [↑](#footnote-ref-200)
201. *Id*. [↑](#footnote-ref-201)
202. Australian tax law defines capital gains tax as the rate applied to the sale of a capital asset. Although not defined as an exit tax, the “Events Tables” provided by the Australian Taxation Office indicate that the migration of tax residence or assets gives rise to capital gains tax. *See* *Income Tax Assessment Act of 1997* (Cth) Div. 104 (Austl.); *See also* Australian Taxation Office, *CGT Events: How and When a CGT Event is Triggered*, Ato.Gov.Au (2022), <https://www.ato.gov.au/individuals/capital-gains-tax/cgt-events/#WhatisaCGTevent> (as described in Capital Gains Tax (“CGT”) Event I4, “Cessation of Residency”). [↑](#footnote-ref-202)
203. *Id*. [↑](#footnote-ref-203)
204. The 25 percent rate applies if the company is a “connected entity” and has AUS 50 million or less in aggregate turnover. *See* Claudio Cimetta and David Watkins, Int’l Tax: Australia Highlights 2022, Deloitte (Updated Jan. 2022). [↑](#footnote-ref-204)
205. Canadian Income Tax Act, Sec. 128.1(14), 219.1 (R.S.C. 1985, c. 1 (5th Supp); *See* Canadian Revenue Agency, *Residency of a Corporation* (May 24, 2022), <https://www.canada.ca/en/revenue-agency/services/tax/international-non-residents/businesses-international-non-resident-taxes/residency-a-corporation.html#emcorp> (characterizing the exit tax as a “departure tax” and explaining that it applies only to corporations that cease to be Canadian residents, rather than only cease to be Canadian corporations). [↑](#footnote-ref-205)
206. *Id*. *See also* Mark Dumalski and Denis DeGrace, International Tax, Canada Highlights 2020, Deloitte (Updated August 2020). [↑](#footnote-ref-206)
207. *See* Mexico Income Tax Law (*Ley del Impuesto Sobre la Renta, “LISR”*), Arts. 1, 78, 140, 171 (2022). [↑](#footnote-ref-207)
208. Additionally, a representative for the migrating company must notify Mexican tax authorities of the transaction 15 days prior to such a transaction, and a final corporate income tax return must be filed no later than 15 business days after the change is complete. *Id*. *See also* International Tax, Mexico Highlights 2022, Deloitte (Updated Feb. 2022) [↑](#footnote-ref-208)
209. Switzerland Federal Tax Administration, *The Swiss Tax System* (2021), [https://www.estv.admin.ch/dam‌/estv/en/dokumente/estv/steuersystem/schweizer-steuersystem/ch-steuersystem\_2021.pdf.download.pdf/ch-steuersystem\_2021.pdf](https://www.estv.admin.ch/dam/estv/en/dokumente/estv/steuersystem/schweizer-steuersystem/ch-steuersystem_2021.pdf.download.pdf/ch-steuersystem_2021.pdf); *see also*, Silvia Zimmerman and Jonas Sigrist, *Tax Rules Relating to Cross-Border Relocations out of Switzerland and Exit Taxation*, Bloomberg Law Daily Tax Report: International (May 4, 2020), ‍[https://www.bloomberglaw.com/product/tax/bloombergtaxnews/daily-tax-report international/X12B38JG00‌0000?bna\_news\_filter=daily-tax-report-international#jcite](https://www.bloomberglaw.com/product/tax/bloombergtaxnews/daily-tax-report%20international/X12B38JG000000?bna_news_filter=daily-tax-report-international#jcite), Peter Locher, *Kommentar zum Bundesgesetz über die direkte Bundessteuer*, Teil II, 2. Auflage, 2022, art. 61b, *see also* Pascal Hinny, *Neue steuerliche Behandlung des Zuzugs in die Schweiz und des Wegzugs aus der Schweiz (einschliesslich Funktionsverlagerung) im Rahmen des STAF*, *see also* Botschaft vom 21.3.2018 zum Bundesgesetz über die Steuervorlage 17, BBl 2018 2527 ff. [↑](#footnote-ref-209)
210. Even the transfer of a single asset subjects a taxpayer to the Swiss exit tax system if the relevant assets are not subject to taxation in Switzerland anymore. *Id*. [↑](#footnote-ref-210)
211. The transfer of establishments and parts of establishments, the registered office, the actual administration and the relocation of functions abroad can also result in a taxation in Switzerland. *Id*. [↑](#footnote-ref-211)
212. *Id*, see also Pascal Hinny, *Steuerrecht 2022*, Textausgabe mit Anmerkungen. [↑](#footnote-ref-212)
213. Taxation of Chargeable Gains Act of 1992, 72 Eliz. 13 c. 92, § 185(4) (Eng.). [↑](#footnote-ref-213)
214. Taxation of Chargeable Gains Act of 1992, 72 Eliz. 13 c. 92, § 187B (Eng.). [↑](#footnote-ref-214)
215. *See* Henrique Lopez, Brazil: Corporate Tax Comparative Guide, MONDAQ (Nov. 5, 2019), ‌‌[https://www.mondaq.‌com/‌‌brazil/tax/814554/‌‌‌corporate-tax-comparativeguide#:~:text=4.6%20Are%20the‌re%20exit%20taxes,the%20‌nationality%20of%20the%20taxpayer](https://www.mondaq.‌com/‌‌brazil/tax/814554/‌‌‌corporate-tax-comparativeguide#:~:text=4.6%20Are%20there%20exit%20taxes,the%20‌nationality%20of%20the%20taxpayer); Kevin Zhu and Julie Zhang, International Tax: China Highlights 2022, Deloitte (Updated Jan. 2022); Some members of Indian industry have proposed an exit tax as an attempt to curb the expatriation of high-net worth individuals and valuable businesses. Siriam Iyer*, India Wants to Use an “Exit Tax” to Stop Its Millionaires from Fleeing*, QUARTZ INDIA (Updated July 20, 2022), <https://qz.com/india/1246023/india-plans-an-exit-tax-to-stop-millionaires-from-fleeing/> [↑](#footnote-ref-215)
216. Participation exemptions eliminate the additional domestic tax on foreign income by allowing domestic companies to either ignore foreign income in the calculation of their taxable income or to deduct foreign income when it is paid back to the domestic parent company. Participation exemptions can also apply to capital gains. Such participation exemptions may provide that when a domestic company sells its shares in a controlled foreign subsidiary realizing a gain, the domestic company may be subject to little to no domestic capital gain tax on the sale. [↑](#footnote-ref-216)
217. Tax Foundation, *Appendix Table 1, Participation Exemptions in OECD Countries* (2021), <https://files.taxfoundation.org/20210706170552/Appendix-Anti-Base-Erosion-Provisions-and-Territorial-Tax-Systems-in-OECD-Countries.pdf> [↑](#footnote-ref-217)
218. *Id*. [↑](#footnote-ref-218)
219. Note that Luxembourg is one of very few E.U. member states that has codified provisions on cross-border conversions outside of the European Union permitting both a migration from Luxembourg to a non-E.U. country and cross-border mergers from Luxembourg to a non-E.U. country. *See* Arts. 120-1 to 1024-1 of the Luxembourg law dated August 10, 1915 on commercial companies, as amended and restated. [↑](#footnote-ref-219)
220. Council Directive (EU) No. 2019/2121, amending Directive (EU) 2017/1132 as Regards[sic] Cross-Border Conversions, Mergers and Divisions, Decl. 34, 2019 O.J. (L. 321). [↑](#footnote-ref-220)
221. TFEU, Arts. 49, 54 (providing for the freedom of establishment). [↑](#footnote-ref-221)
222. *Polbud–Wtkonawstwo sp. z o.o., in Liquidation*, 2017 E.C.R. C-106/16 (2017); *see also Centros Ltd v Erhvervs- og Selskabsstyrelsen*, 1999 E.C.R. C-212/97 (1999) (The court held that E.U. law is applied to the establishment of subsidiaries, branches and agencies in other E.U. member states and, in that regard, it is immaterial that the company was formed in one member state only for the purpose of establishing itself in another member state, where its main, or indeed entire, business is to be conducted). [↑](#footnote-ref-222)
223. If a company is resident in both treaty partner jurisdictions, some treaties simply tell the company to work it out with the competent authorities. *See* Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, Ir.-U.S., art. 4(4), July 28, 1997, 2141 U.N.T.S. 167 (“Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour by mutual agreement to deem, for purposes of the Convention, the person to be a resident of one Contracting State only.”); Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, U.K.-U.S., art. 4(5), Jan. 24, 2001, T.I.A.S. No. 13161 (“Where by reason of the provisions of paragraph 1 of this Article a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the mode of application of this Convention to that person.”). However, a competent authority process would take several years and the company would face major uncertainty, e.g., as to the tax filings during the process and the ultimate outcome on tax residency. [↑](#footnote-ref-223)
224. In order to encourage U.S. MNEs to repatriate their historical foreign retained earnings and to provide for a transition to the new CFC regime, the TCJA also included a transition tax under new section 965. Section 965 required that a U.S. shareholder include in its gross income previously untaxed accumulated earnings of certain foreign subsidiaries (referred to as a “deferred foreign income corporations). I.R.C. § 965(a). In an effort to make this transition tax more digestible, low rates of tax were imposed on those untaxed foreign earnings (15.5 percent on cash and cash equivalents, eight percent on the remainder). I.R.C. § 965(c). Further, the U.S. shareholders were given up to eight years to pay the tax with the bulk of the tax due in the out years. I.R.C. § 965(h). U.S. shareholders were treated as if their untaxed earnings had been repatriated as dividends just prior to the adoption of TCJA. When U.S. shareholders would later distribute those earnings, the distributions would not be subject to tax. [↑](#footnote-ref-224)
225. Section 59A imposes an excise tax (i.e., the BEAT) on certain corporations with gross receipts in excess of $500 million with a sufficient percentage of deductions relating to payments made to foreign related-parties, in addition to their regular income tax. The BEAT is designed to limit the impact of deductions and similar benefits arising from amounts that a corporation pays or accrues to related foreign persons not subject to U.S. tax. Designed as a minimum tax, the BEAT applies only to the extent that it exceeds the corporation’s “regular” tax liability—in essence the difference between that tax liability and what is referred to as “modified taxable income.” Modified taxable income is computed without deductions for payments or accruals to related foreign parties, except those payments on which U.S. income tax is imposed and withheld before they are transferred to the foreign related party. The current BEAT rate is 10 percent and is scheduled to increase to 12.5 percent in 2026. [↑](#footnote-ref-225)
226. The TCJA also tightened the U.S.’s exit tax rules, in relevant part, by expanding the definition of intangible under section 367(d) to include goodwill and going concern value and eliminating the section 367 exception for outbound transfers of active businesses. [↑](#footnote-ref-226)
227. *See* OECD (2022), Tax Challenges Arising from the Digitalization of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two), OECD, Paris, at 15 (hereinafter “Pillar Two Commentary”) (In explaining the rationale for the €750 million threshold, the OECD explained that “[t]he consolidated revenue threshold reflects cost/benefit considerations within the context of the overall tax policy rationale of the GloBE Rules. By restricting the rules to those MNE Groups that meet the requirements of Article 1.1 [of Pillar Two], the compliance and administration costs of adopting a coordinated global minimum tax are minimized, while preserving the overall impact and revenue benefits.”). [↑](#footnote-ref-227)
228. OECD (2021), Tax Challenges Arising from the Digitalization of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS, OECD, Paris, art. 6.1.1(a) (hereinafter “Pillar Two”. With respect to group separations (or demergers), the threshold is deemed satisfied in (i) the year of the demerger (i.e., year one) if the demerged group has annual revenues of at least €750M in that year and (ii) years two through four if the demerged group has annual revenues of at least €750M in at least two of the years following the year of the demerger. *See* Pillar Two, art. 6.1.1(c). [↑](#footnote-ref-228)
229. This paper does not address the potential impact of Pillar One on the inversion discussion for what may or may not be the best of reasons. First, Pillar One is likely to apply to only a very small number of MNEs (estimates hover around 100) as it has a €20 billion revenue threshold while excluding certain mining companies and financial institutions. Second, its prospects for adoption are currently quite low—especially as currently proposed. [↑](#footnote-ref-229)
230. Constituent entities (“Entities”) would include the ultimate parent and its subsidiaries, branches, and permanent establishments. Pillar Two, Arts. 1.3-1.4. An MNE Group is defined as a collection of Entities that are related through ownership or control such that the assets, liabilities, income, expenses, and cash flows of those Entities are either (i) included in the consolidated financial statements of the parent of the MNE Group (referred to as the Ultimate Parent Entity (or “UPE”), or (ii) are excluded from the consolidated financial statements of the UPE solely on size or materiality grounds, or on grounds that the Entity is held for sale. Pillar Two Commentary, art. 1.2.2. [↑](#footnote-ref-230)
231. This deduction under the GloBE rules is referred to as the substance-based income inclusion or SBIE. [↑](#footnote-ref-231)
232. In general, the amount of GloBE income or loss of an Entity is determined by taking the financial accounting net income or loss for the Entity for the fiscal year as used in the UPE’s consolidated financial statements (before any consolidation adjustments) and then making certain other adjustments. *See* Pillar Two Commentary, art. 3.2.1 at 4659. Adjustments made to calculate the GloBE income or loss for each Entity include (i) net taxes expense (including covered taxes); (ii) certain excluded dividends; (iii) certain excluded equity gains/losses (e.g., arising from the disposal of shares); (iv) certain included revaluation method gains/losses; (v) gains/losses from transfers of assets/liabilities as part of a “GloBE Reorganization”; (vi) asymmetric foreign currency gains/losses; (vii) policy disallowed expenses (e.g., bribes); (viii) prior period errors and changes in accounting principles; (ix) accrued pension expenses; (x) intragroup financing expenses without a commensurate increase in taxable intragroup income of a counterparty; and (xi) and certain other adjustments. *Id*.

     These rules were drafted with a bias in favor of jurisdictions with a strong participation exemption. For example, the definition of excluded equity gain or loss includes the net gain or loss included in the financial accounting net income or loss of an Entity arising from gains and losses from the disposition of an equity interest in an Entity. *Id*. Thus, if an equity sale results in a taxable gain (or loss) in the local jurisdiction, GloBE income or loss would still exclude net gain or loss and any related local tax liability (or tax asset) would be excluded from covered taxes calculation. For example, assume the following: USP, a domestic corporation, wholly owns CFC, a Country X corporation. USP has a basis of $10x in CFC. In Year 1, USP sells all of the CFC stock to Y, an unrelated person, for $110x realizing a $100x capital gain. In Year 1, USP also earned $100x of other net income and that income is not excluded from GloBE income. Thus, in Year 1, USP earns a total of $200x of income resulting in a $42x U.S. federal income tax liability. Under such facts, USP’s $100x capital gain on the sale of CFC is excluded from GloBE income as an excluded equity gain or loss. Thus, USP’s Year 1 GloBE income is $100x. USP’s adjusted covered taxes for Year 1 are $21x (an amount that excludes the $21x tax on USP’s excluded equity gain of $100x).

     Other anomalies arise that also result in a potential mismatch between U.S. GAAP and GloBE income or loss, which is more aligned with IFRS. For example, if a qualifying nonrecognition transaction under U.S. federal income tax law does not qualify as a GloBE Reorganization (e.g., in an all-boot section 368(a)(1)(D) reorganization) and the accounting standards used in preparing the UPE of the acquiring entity’s consolidated financial statements (e.g., IFRS) provide for an acquiring entity under such circumstances to carry the acquired assets at fair value, the target entity’s gain or loss would be included in GloBE Income or Loss with no corresponding covered taxes. As a result, the target entity will have a (possibly significant) lower effective rate for GloBE purposes in the year of the sale if there is built-in gain in its assets. [↑](#footnote-ref-232)
233. Jane G. Gravelle & Mark P. Keightley, Congressional Research Serv., R47174, The Pillar 2 Global Minimum Tax: Implications for U.S. Tax Policy Summary (2022). An important note, however, is that when an Entity is determining its covered taxes to calculate its effective tax rate, subject to certain exceptions, CFC taxes arising in connection with an income inclusion imposed on another Entity (e.g., the U.S. shareholder in the case of a CFC of a U.S.-parented group) are allocated to the CFC Entity, and included in the covered taxes of that CFC Entity. *See* Pillar Two, Article 4.3.2(c); *see also* Pillar Two Commentary, at 88. It also appears that CFC taxes paid by another Entity (e.g., a U.S. shareholder relating to GILTI and subpart F income inclusions) would be taken into account *prior* to the QDMTT. *See* Pillar Two Commentary, at 96 (“It is intended that the GloBE Rules apply after the application of the Subject to Tax Rule and domestic tax regimes, including regimes for the taxation of . . . CFCs.”). For a detailed discussion of CFC regimes under the GloBE rules, *see* Herzfeld, “More on GloBE Ordering CFC Rules,” Tax Notes Int’l, May 2, 2022, at 603; *see also* Wardell-Burrus, “Should CFC Regimes Grant a Tax Credit for Qualified Domestic Minimum Top-Up Taxes?”, Tax Notes Int’l, June 27, 2022, at 1649 (discussing the interaction of the U.S. CFC regime with the GloBE rules paying particular attention to the “spiral” effect on the local jurisdiction’s ultimate tax collection if it were to offer a tax credit for CFC taxes paid). If the United States were to amend its foreign tax credit rules to allow for QDMTTs (and possibly non-qualified domestic top-up taxes) to be creditable taxes, absent an increase in the GILTI rate, one would expect there to be little if any residual U.S. tax paid by a U.S. MNE on income earned in the CFC jurisdiction. *But see* Treas. Reg. § 1.901-2(e)(6)(i) (providing that a foreign tax is not creditable “to the extent that liability for the foreign income tax is dependent (by its terms or otherwise) on the availability of a credit for the tax against income tax liability to another country.”). [↑](#footnote-ref-233)
234. Gravelle & Keightley, *supra* Note 233. [↑](#footnote-ref-234)
235. *Id*. This tax would effectively allocate the top-up tax to the countries where the UPE has Entities based on a formula that takes into account the number of employees and the value of tangible assets in each qualifying country. *Id*. at 9. [↑](#footnote-ref-235)
236. BBBA, Sec. 138126(d). The QBAI benefit is something akin to Pillar Two’s SBIE discussed above, but sufficiently different. QBAI is an amount based on 10 percent of a CFC’s basis in its tangible assets (less certain interest expense). *See* I.R.C. 951A(d). SBIE is an amount based on the combination of a certain of an MNE’s payroll expenses and five percent of the carrying value of certain tangible assets in a particular jurisdiction. *See* Pillar Two, Article 5.3. [↑](#footnote-ref-236)
237. The tax base for GILTI, however, is quite different than under the GloBE rules and could result in circumstances where the effective tax rate on GILTI for a particular taxpayer does result in a 15 percent GloBE ETR. Further, taking into account that only 80 percent of foreign taxes paid on GILTI are eligible for a foreign tax credit (and not taking into account complex rules governing the allocation of certain expenses), a U.S. parent corporation would not pay any residual U.S. corporate tax if its aggregate GILTI were taxed at an effective tax rate of 26.25 percent or higher. [↑](#footnote-ref-237)
238. H.R. Rep. No. 117-130, *Build Back Better Act*, Sec. 138127 (Sep. 27, 2021). [↑](#footnote-ref-238)
239. OECD (2020), *Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project* (the “Blueprint Report”) at 19, OECD Publishing, Paris (2020), https://doi.org/10.1787/abb4c3d1-en. [↑](#footnote-ref-239)
240. *Id*. [↑](#footnote-ref-240)
241. It may be worth noting that in the Blueprint Report, the OECD stated that “[g]iven the pre-existing nature of the GILTI regime and its legislative intent there are reasons for treating GILTI as a qualified income inclusion rule for purposes of the GloBE rules provided that the coexistence achieves reasonably equivalent effects.” Blueprint Report at 19. Further, speaking in June, 2022, at a conference in Washington hosted by the U.S. Council for International Business and the OECD, Itai Grinberg, U.S. Treasury Deputy Assistant Secretary, Multilateral Tax, Office Of Tax Policy, stated that “it was ‘extraordinarily clear’ that a reformed GILTI would constitute a qualified income inclusion rule under Pillar 2.” Mindy Herzfeld, *Questioning the Promise of GILTI Conformity*, 107 Tax Notes Int’l, at 115 (July 11, 2022). Herzfeld concludes that: “No text produced by the OECD has yet provided any guidance about whether GILTI might be considered a qualifying IIR under the model rules. And the requirements laid down in the EU directive for a qualifying IIR regime aren’t necessarily consistent with that conclusion.”). *Id*. at 119. [↑](#footnote-ref-241)
242. *See* I.R.C. § 951A(c)(2). [↑](#footnote-ref-242)
243. *See* Note 236. [↑](#footnote-ref-243)
244. For more detail on the differences between the GloBE rules’ IIR and the U.S. GILTI regime, *see* NYSBA Report No. 1465, *Report on the OECD Global Anti-Base Erosion Model Rules (Pillar Two)*, at 25-34 (July 21, 2022). [↑](#footnote-ref-244)
245. *Id*. at 3. [↑](#footnote-ref-245)
246. In certain circumstances, this could result in subjecting some foreign-parented MNEs to, for example, the European Union’s Pillar Two-related rules (with a €750 million global annual revenue minimum) but the U.S. ceding revenue to other countries with a UTPR because the proposed U.S. UTPR would apply only to financial reporting groups that have global annual revenue of $850 million or more in at least two of the previous four years. [↑](#footnote-ref-246)
247. A special rule would reduce the proposed UTPR’s disallowance of deductions against U.S. income to reflect any top-up tax collected by members of the group under a qualified UTPR in one or more other jurisdictions. [↑](#footnote-ref-247)
248. There may be other benefits to inverting including, for example, the avoidance of (i) relatively high withholding tax rates on distributions to shareholders and other payments coupled with the potential benefit of a superior treaty network in the foreign acquiring corporation’s jurisdiction, (ii) the new corporate alternative minimum tax (“CAMT”) under section 55(b)(2), (iii) the new one-percent stock repurchase excise tax under section 4501 and (iv) the United States’ relatively onerous tax compliance and reporting rules. These additional potential benefits are more challenging to determine. The withholding tax/treaty benefit is dependent on the jurisdiction of the foreign acquiring corporation and the savings on compliance and reporting burdens are difficult to quantify. [↑](#footnote-ref-248)
249. Pub. L. 87-834. [↑](#footnote-ref-249)
250. I.R.C. § 951A(c)(2)(A)(i)(II). [↑](#footnote-ref-250)
251. Certain additional types of income not technically included in the definition of subpart F income, such as certain investments in U.S. property by CFCs covered by section 956, are also included in a U.S. shareholder’s current income pursuant to subpart F. [↑](#footnote-ref-251)
252. I.R.C. § 952(b), 952(c)(1)(A), 952(c)(1)(B). [↑](#footnote-ref-252)
253. FBCI includes foreign personal holding company income (“FPHCI”). Section 954(c)(1) defines FPHCI, subject to a number of conditions and exceptions, as generally consisting of the following types of income: dividends, interest, royalties, rents and annuities; net gains from the sale of certain non-inventory property; net gains from certain commodities transactions; net gains from certain foreign currency transactions; income that is “equivalent to interest”; net income from notional principal contracts; certain payments in lieu of dividends; and amounts received under certain personal service contracts. FPHCI does not include rents and royalties that are derived in the active conduct of a business and received from an unrelated person. I.R.C. § 954(c)(2)(A); Treas. Reg. § 1.954-2(b)(6). [↑](#footnote-ref-253)
254. FBCI also includes foreign base company services income (“FBCSVI”). I.R.C. § 954(a)(3). In general, FBCSVI means income (whether in the form of compensation, commissions, fees or otherwise) derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial or similar services that are performed (A) for or on behalf of any related person, and (B) outside the country under the laws of which the CFC is created or organized. I.R.C. § 954(e)(1). As with the other types of FBCI, the policy underlying FBCSVI is “to deny tax deferral where a service subsidiary is separated from manufacturing or similar activities of a related corporation and organized in another country primarily to obtain a lower rate of tax for the service income.” S. Rep. No. 1881, 87th Cong., 2d Sess. 8479 (1962). For purposes of this rule, the jurisdiction where services are considered to be performed is generally where the person providing the service is physically located when the service is performed. Treas. Reg. § 1.954-4(c). [↑](#footnote-ref-254)
255. FBCSI is income derived in connection with certain types of transactions in personal property. The income must be derived in one of four types of transactions: (i) the purchase of personal property from a related person and its sale to any person, related or unrelated; (ii) the purchase of personal property from any person and its sale to a related person; (iii) the sale of personal property to any person “on behalf of” a related person; and (iv) the purchase of personal property from any person “on behalf of” a related person. I.R.C. § 954(d)(1). Among other exceptions, income is not FBCSI if the personal property is manufactured, produced, or constructed by the CFC. Treas. Reg. § 1.954-3(a)(4). [↑](#footnote-ref-255)
256. *Simplification of Entity Classification Rules*, T.D. 8697, 61 Fed. Reg. 66,584 (Dec. 18, 1996). [↑](#footnote-ref-256)
257. Pub. L. No. 109-222 § 103(b)(1). [↑](#footnote-ref-257)
258. For a detailed discussion on the impact of the check-the-box elections on subpart F planning, *see*, *e.g.*,David Sicular, *The New Look-Through Rule: W(h)ither Subpart F?*, 115 Tax Notes 349 (Apr. 23, 2007). [↑](#footnote-ref-258)
259. Jane G. Gravelle, Congressional Research Service, R40623, Tax Havens: International Tax Avoidance And Evasion (2013) (“The use of hybrid entities was greatly expanded by [the ‘check-the-box’ regulations] that had unintended consequences for foreign firms. In addition, earnings from income that is taxed can often be shielded by foreign tax credits on other income. On average very little tax is paid on the foreign source income of U.S. firms. Ample evidence of a significant amount of profit shifting exists, but the revenue cost estimates vary from about $10 billion to $60 billion per year.”). This benefit is somewhat reduced by the branch rules of section 954(d)(2). [↑](#footnote-ref-259)
260. For this purpose, two CFCs are related if, *inter alia*, the same person directly or indirectly owns more than 50 percent of the total vote or value of the stock of both CFCs. I.R.C. § 954(d)(3). For the purposes of section 954(c)(6), whether two CFCs are related persons is an inquiry tested at the time that the dividend is received by the payee. Notice 2007-9, 2007-1 C.B. 401, Sec. 3. [↑](#footnote-ref-260)
261. *See* Sicular at 367. These developments, in particular section 954(c)(6), also created opportunities for foreign tax credit planning in certain circumstances, such as facilitating the separation of low-tax and high-tax income into different CFC chains, although the benefits of such planning was reduced with the repeal of section 902 and the introduction of the GILTI rules under TCJA. [↑](#footnote-ref-261)
262. *See*, *e.g.*, Michael J. Graetz & Michael M. O‘Hear, The “Original Intent” of U.S. International Taxation, 46 Duke L.J. 1021, 1035–43 (1997); Reuven S. Avi-Yonah, The Structure of International Taxation: A Proposal for Simplification, 74 Tex. L. Rev. 1301, 1313–16 (1996); Julie Roin, Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems, 81 Va. L. Rev. 1753, 1759–87 (1995). [↑](#footnote-ref-262)
263. The U.S. tax laws do not impact all U.S. MNEs the same. Depending on a particular U.S. MNE’s footprint and activities, the MNE may pay significant subpart F-related taxes and, thus, perhaps pose a relatively strong incentive for that MNE to expatriate. [↑](#footnote-ref-263)
264. In addition, depending upon how yet-to-be issued section 245A regulations treat a CFC’s receipt of dividends, subpart F income concerns may be heightened further for many U.S. MNEs. *See* T.D. 9865, *Limitation on Deduction for Dividends Received From Certain Foreign Corporations and Amounts Eligible for Section 954 Look-Through Exception*, 84 Fed. Reg. 28398, 28405 (Dec. 28, 2005) (“The Treasury Department and the IRS continue to study whether, and to what extent, proposed regulations should be issued that provide that dividends received by a CFC are eligible for a section 245A deduction.”); *cf*. Conf. Rep. to Accompany H.R. 1, 115th Congress, 1st Session, Report 115–466 (December 15, 2017) at 599, fn. 1486 (“a CFC receiving a dividend from a 10-percent owned foreign corporation that constitutes Subpart F income may be eligible for the DRD with respect to such income.”). [↑](#footnote-ref-264)
265. More specifically, if a CFC sells the stock of another CFC, some of the gain, if any, on that sale is treated as foreign personal holding company income, and, thus, subpart F income. *See* I.R.C. § 954(c)(1)(B)(i). Alternatively, if the equity to be sold is that of a disregarded entity, some of the gain, if any, on that sale is likely to be treated as tested income. *See* I.R.C. § 951A; *Dover Corp. v. Comm’r*, 122 T.C. 19 (2004). [↑](#footnote-ref-265)
266. For the section 245A dividends-received deduction to apply, among other requirements, the U.S. shareholder must satisfy the 365-day holding period requirement under section 246(c)(5). [↑](#footnote-ref-266)
267. Section 961(c) provides that, under Treasury regulations, adjustments similar to those provided in sections 961(a) and 961(b) are to be made with respect to the basis of certain lower-tier CFCs, but only for purposes of determining the amount to be included in the U.S. shareholder’s gross income under section 951. Without the upward adjustments of section 961(a), when a U.S. Shareholder sells its stock in a CFC, the U.S. shareholder would be taxed on the increased stock value attributable to income that was already taxed under section 951. *See*, *e.g.*, A.B.A., Comments on the Proposed Regulations Concerning Section 951A, at 42-3 (Nov. 21, 2018); A.B.A. Comments on Temporary Regulations under Section 245A, Proposed Regulations under Sections 951A and 958, and Final Regulations under Section 951A, at 52-3 (Sept. 11, 2019). [↑](#footnote-ref-267)
268. *See* I.R.C. § 964(e)(4). [↑](#footnote-ref-268)
269. As discussed above, many jurisdictions offer participation exemptions on the sale of subsidiary stock and the receipt of dividends from controlled corporations. Historically popular holding company destinations including Ireland, Luxembourg, Netherlands, and the United Kingdom offer 100 percent exemptions. To benefit from these exemptions, Ireland requires a 12-month continuous holding period in the two years prior to disposal, Luxembourg requires an “uninterrupted” 12-month holding period, and the United Kingdom requires the shares be continuously owned for at least 12 months in the six years prior to disposal. Netherlands does not require a holding period, but rather, that the “subsidiary is not a mere portfolio investment.” *See* Tax Foundation, *Appendix Table 1, Participation Exemptions in OECD Countries* (2021), https://files.taxfoundation.org/20210706170552/Appendix-Anti-Base-Erosion-Provisions-and-Territorial-Tax-Systems-in-OECD-Countries.pdf. For a list of other participation exemptions, *see* Part ‎V.A.3. [↑](#footnote-ref-269)
270. Note that there are several jurisdictions that have enacted nonresident capital gains taxes. *See*, *e.g.*, Art. 161 of Mexican Income Tax Law (direct transfer of Mexican entity shares taxed at a 25 percent rate on the gross purchase price or 35 percent rate on the capital gain (provided certain requirements are met)); Sec. 18 of Law No. 9249/95; Sec. 21 of Law No. 8981/95 (withholding tax on foreign currency exchange variation over time at rate up to 22.5 percent); Art. 17 No. 8(a) and 74 No. 4 of Chilean Income Tax Law (direct transfer of Chilean entity shares or ownership interests taxed at a 35 percent rate on capital gain, or at reduced treaty rate; tax imposed via withholding at a 10 percent on gross purchase price); Art. 9(h) and 76 of Peruvian Income Tax Law (direct transfer of shares issued by Peruvian entities taxed at rate of 30 percent on capital gain provided tax basis is previously certified by Peruvian tax authority (otherwise on gross sale proceeds)). Further, a growing number of jurisdictions have enacted indirect transfer taxes that would render the indirect sale a subsidiary subject to tax in the local jurisdiction. *See*, *e.g.*, Arts. 10(e) and 76 of Peruvian Income Tax Law and Art. 4-A of Peruvian Income Tax Regulations (subjecting the indirect sale of Peruvian subsidiary to Peruvian tax, if either: (i) FMV of Peruvian subsidiary is 50 percent or more of total FMV of target company, and at least 10 percent of shares issued by target company are transferred; or (ii) total value of Peruvian shares indirectly transferred is approximately $49 million or more; tax is imposed at rate of 30 percent on capital gain, provided tax basis is previously certified by Peruvian tax authority (otherwise on gross sale proceeds); Article 90-3 of Colombian Tax Code (indirect transfer of shares of a Colombian company is subject to tax in Colombia unless: (i) the shares sold are transferred in a “recognized stock market” and no beneficial owner owns more than 20 percent of the entity’s equity, or (ii) when the value of the equity of the Colombian entity represents less than 20 percent of the book value and the commercial value of the total assets possessed by the transferred non-Colombian entity); Arts. 10, 58 No., 74 No. 4 of Chilean Income Tax Law (Chilean tax is imposed at 35 percent rate on capital gain if Chilean assets are either (i) worth more 20 percent or more of total assets of target; (ii) worth approximately $160 million or more; or (iii) target is incorporated in jurisdiction with preferential tax regime (with certain exceptions)). That said, at least under U.S. rules, such taxes are no longer creditable. Such a sale will be subject to full double taxation whether it is a direct or indirect subsidiary of a U.S. corporation. *See*, *e.g.*, Treas. Reg. § 1.901-2(b)(5). [↑](#footnote-ref-270)
271. *See* I.R.C. § 901. For simplicity, I will refer to such taxes as “foreign taxes.” [↑](#footnote-ref-271)
272. *See* I.R.C. § 904. [↑](#footnote-ref-272)
273. In certain circumstances, foreign taxes paid by a CFC may not be properly attributable to the CFC’s subpart F income, tested income, or PTEP distributions in which case such taxes are not deemed paid by the U.S. shareholder and not result in FTCs. *See* Treas. Reg. § 1.960-1(d)(3)(ii) and (e). Further, a U.S. shareholder is not permitted an FTC for foreign income taxes paid or accrued with respect to any dividend eligible for the section 245A deduction. *See* I.R.C. § 245A(d). [↑](#footnote-ref-273)
274. *See* I.R.C. § 960(d)(1); Treas. Reg. § 1.960-2(c)(1). [↑](#footnote-ref-274)
275. *See* I.R.C. § 904. This FTC limitation is designed to alleviate the double taxation on a taxpayer’s foreign-source income, while not permitting a foreign income tax to be credited against the U.S. tax on U.S.-source income. [↑](#footnote-ref-275)
276. *See* I.R.C. § 904(d)(1)(A). [↑](#footnote-ref-276)
277. *See* I.R.C. § 904(d)(1)(C). [↑](#footnote-ref-277)
278. *See* I.R.C. § 904(d)(1)(B). [↑](#footnote-ref-278)
279. *See* I.R.C. § 904(d)(1)(D) (sometimes referred to as the “residual basket”). [↑](#footnote-ref-279)
280. *See* I.R.C. § 904(c). [↑](#footnote-ref-280)
281. *See* Treas. Reg. §§ 1.861-8, -9. [↑](#footnote-ref-281)
282. *See* I.R.C. § 960(c) (last sentence). [↑](#footnote-ref-282)
283. For example, under the Dutch tax laws, the amount of FTCs that may be claimed in a certain year may not exceed the lower of the following two limitations: (i) the amount of the foreign tax incurred in the relevant year with respect to foreign-source income; and (ii) the amount of Dutch corporate income tax against the highest applicable Dutch corporate income tax rate that is allocable to the foreign source income in the relevant year. *See* Article 36, paragraph 2 of the Netherlands Unilateral Relief Regulations. [↑](#footnote-ref-283)
284. Note, however, that the U.S. FTC system does afford (at least under current law) U.S. MNEs the ability to blend the same basket of income on an ex-U.S. global basis and does not require country-by-country basketing as provided in the OECD’s GloBE model rules. There have been recent proposals to eliminate this cross-crediting benefit as part of the BBBA in an effort to move the GILTI regime more in line with the OECD model GloBE rules. *See* H.R. REP. NO. 117-130, Build Back Better Act, Sec. 138126 (Sep. 27, 2021). [↑](#footnote-ref-284)
285. Congressional Research Service, *Tax Havens: International Tax Avoidance and Evasion* (Updated Jan. 6, 2022) (citing Jost H. Hecklemeyer and Michael Overesch, *MNEs’ Profit Response to Tax Differentials: Effect Size and Shifting Channels*, 50 Canadian J. Econ. 4, at 965-94 (Nov. 2017)). [↑](#footnote-ref-285)
286. *See* Treas. Reg. § 1.482-1(b)(1). [↑](#footnote-ref-286)
287. *See* Treas. Reg. § 1.482-1(c)(1). [↑](#footnote-ref-287)
288. *See* Treas. Reg. § 1.482-1(d)(1). [↑](#footnote-ref-288)
289. *See*, *e.g.*, Rudd A. De Mooij and Li Liu, 2018, “At a Cost: the Real Effects of Transfer Pricing Regulations,” IMF Working Paper WP/18/69, International Monetary Fund. [↑](#footnote-ref-289)
290. In the report, Treasury acknowledges restructuring steps that include “the movement of foreign subsidiaries out of the U.S. group” via dividend distributions, pre-inversion contributions of foreign subsidiary stock, the transfer of intangibles to the foreign parent, and, the post-inversion allowance of the U.S. group’s historical CFCs to “‘wither away,’ with new business and growth opportunities directed to the foreign subsidiaries of the new foreign parent.” Office of Tax Policy, U.S. Dep’t of the Treasury*, Corporate Inversion Transactions: Tax Policy Implications*, Doc 2002-12218 (31 original pages) (“The 2002 Treasury Report”), at 25 (May 17, 2002). [↑](#footnote-ref-290)
291. Treasury concluded as follows:

     These cross-border transfers of subsidiaries and assets give rise to significant valuation issues. In addition, the ongoing transactions – both explicit and implicit – between the various entities give rise to significant income allocation issues. The magnitude of the potential tax savings at stake puts significant pressure on the application of the section 482 income allocation rules. The transfer of foreign operations or other assets to the foreign parent or a foreign subsidiary thereof puts significant pressure on the implementation and enforcement of the arm’s length standard under the transfer pricing rules. Where the arm’s length standard is not properly applied or enforced, the inappropriate income shifting that results can significantly erode the U.S. tax base.

     The 2002 Treasury Report, at 25. [↑](#footnote-ref-291)
292. The 2002 Treasury Report, at 25-26. Note that this report predates several additional changes to the Code and regulations that further restricted the outbound transfer of intangibles and other assets. *See*, *e.g.,* TCJA § 14102(e) (repeal of the active trade or business exception under section 367(a)(3)); Notice 2012-39, 2012-31 I.R.B. 95 (treating every asset involved in an outbound reorganization transfer as covered by either section 367(a) deferral or section 367(d) corporate-level taxation; concluding that any cash received in an outbound reorganization involving intangibles treated as a repatriation of future earnings from transferred intangibles); 80 Fed. Reg. 55568 (Sept. 16, 2015) (providing that goodwill, workforce in place, and going concern value are intangibles subject to section 367(d) and not property eligible for section 367(a)(3)’s active trade or business exception; also “clarify” the coordination between section 367 and section 482 to combat taxpayers who “value the property transferred in a manner contrary to section 482 in order to minimize the value of the property transferred that they identify as section 936(h)(3)(B) intangible property for which a deemed income inclusion is required under section 367(d) and to maximize the value of the property [such as goodwill and going concern value] transferred that they identify as exempt from current tax.”). [↑](#footnote-ref-292)
293. *Id*. at pp. 25-26. [↑](#footnote-ref-293)
294. For a discussion on the changes to sections 367 and 482, *see* Part ‎VII.D.1. [↑](#footnote-ref-294)
295. The Tax Reform Act of 1986 lowered the maximum tax rate on capital gains to 34 percent for 1987 and thereafter. The highest corporate tax rate bracket was increased to 35 percent in 1993. [↑](#footnote-ref-295)
296. Enacted pursuant to the TCJA, the expansion of the accelerated depreciation and, in certain circumstances, expensing (i.e., deducting 100 percent of the cost of an asset in the year placed in service) under section 168(k) is temporary. In general, the percentage of basis for which a deduction may be taken declines by 20 percent each year after 2022 and reaches zero percent by 2027. [↑](#footnote-ref-296)
297. There is also no guarantee that the rest of the world, on balance, will either. In addition to Pillar Two efforts that will likely result in forcing historically tax-competitive jurisdictions (e.g., Ireland) to raise their corporate tax rates, other jurisdictions that were historically at the center of the MNEs’ efforts to minimize their global ETRs (e.g., Netherlands) have joined the chorus of countries leading the charge to implement Pillar Two and ensure a global minimum corporate tax. Further, jurisdictions that not long ago were active participants in the “race to the bottom” (e.g., the United Kingdom) are rethinking their international tax policy towards MNEs. *See* Daniel Thomas, “UK business demands fresh help after Truss U-turn on corporation tax,” Financial Times, Oct. 14, 2022, https://www.ft.com/content/69e50608-a817-4df2-bbfd-29260cfc1c2c. [↑](#footnote-ref-297)
298. *See General Explanations of the Administration’s Fiscal Year 2022 Revenue Proposals* (May 28, 2021) (some of the relevant proposals include increasing the statutory corporate rate to 28 percent, imposing a 15 percent minimum tax on global book income of certain large corporations, reducing to 25 percent the deduction for GILTI, eliminating the QBAI exemption, and imposing a jurisdiction-by-jurisdiction calculation, repealing the deduction for FDII, replacing the BEAT with a new regime that would deny U.S. tax deductions for payments to foreign related parties subject to a “low effective tax rate,” limiting the ability of domestic corporations to expatriate by tightening the anti-inversion rules, restricting the deduction of interest by a financial reporting group attributable to disproportionate U.S. borrowing, and denying certain deductions related to offshoring jobs). The 15 percent corporate minimum tax based on book income proposal was ultimately enacted, albeit in modified form, under the IRA. *See* Pub. L. 117-169 § 10101. [↑](#footnote-ref-298)
299. *See* Policy Brief, O.E.C.D., *Tax Effects on Foreign Direct Investment*, at 4 (Feb., 2008). [↑](#footnote-ref-299)
300. *Id*; *see also* Foreign Direct Investment In Emerging Market Countries, Report of the Working Group of the Capital Markets Consultative Group, at (September 2003) (finding that key factors investors look to in making foreign direct investment decisions include (i) “[m]arket size and growth prospects,” (ii) “[w]age-adjusted productivity of labor, rather than the cost of local labor,” (iii) “availability of infrastructure,” (iv) “reasonable levels of taxation and the overall stability of the tax regime,” (v) “stable political environment, as well as conditions that support physical and personal security,” (vi) “[c]orruption and governance concerns,” and (vii) “legal framework and the rule of law”). [↑](#footnote-ref-300)
301. When determining whether intercompany transactions are conducted at arm’s length consistent with transfer pricing principles, the TCJA amended section 367(d)(2) to empower the I.R.S. to require the valuation of transfers of intangible property on an aggregate basis and on the basis of the “realistic alternatives” to the transfer. The TCJA also eliminated the section 367 exception for outbound transfers of active businesses and amended then-existing statutory law to change the operation of section 367 for outbound transfers of goodwill and going concern value. Thus, under the TCJA, goodwill and going concern value expressly constitute intangible property for purposes of the outbound transfer rules of section 367. Therefore, an otherwise tax-free U.S.-to-foreign transfer of goodwill and going-concern value will be treated as a U.S.-to-foreign license of such assets for deemed royalties commensurate with the value of such property pursuant to section 367(d). [↑](#footnote-ref-301)
302. It is not lost on this author that the reduced inclusion of a U.S. shareholder from its CFC’s “qualified business asset investment” (or “QBAI”) acts as a counterweight to a U.S. MNE’s decision to repatriate assets to the United States (or make new investments in the United States). QBAI is the aggregate adjusted tax basis of a CFC’s so-called specified tangible property, which is depreciable tangible assets used in the production of tested income (not tested loss), measured on a quarterly average basis. [↑](#footnote-ref-302)
303. While management could of course later sell the business for cash or combine with a large enough foreign suitor to avoid transmogrifying the acquiror’s status from a foreign to a domestic corporation, those options may be quite undesirable to management and the domestic corporation’s shareholder base. [↑](#footnote-ref-303)
304. For purposes of this discussion, unless stated otherwise, I will assume that the GloBE tax base is the same as the tax base for U.S. federal income tax purposes (an assumption that I understand to be practically incorrect in light of the significant differences between the U.S. federal income tax system and U.S. GAAP or IFRS, as the case may be, as modified by the GloBE rules). [↑](#footnote-ref-304)
305. Recently, France, Germany, Italy, Netherlands, and Spain publicly stated that they are willing to implement Pillar Two unilaterally if unanimity among the E.U. member states is not achieved in the coming weeks. In a joint statement signed by representatives of the five countries stated:

     At the June 2022 Ecofin, 26 out of 27 EU member states expressed their willingness to implement this important step towards tax justice, and our first goal remains to gather a consensus. Should unanimity not be reached in the next weeks, our governments are fully determined to follow through on our commitment. We stand ready to implement the global minimum effective taxation in 2023 and by any possible legal means. We are also fully committed to complete the work on the better reallocation of taxing rights from huge global multinationals’ profits with the objective of signing a multilateral convention by mid-2023.

     Joint Statement by France, Germany, Italy, Netherlands and Spain (Prague, Sept. 9, 2022). Since the publication of this statement, Belgium has also publicly stated it is prepared to implement Pillar Two without E.U. unanimity. (Belgian Finance Minister Vincent Van Peteghem stated “If Hungary were to hold its veto, the enhanced cooperation mechanism should open an alternative solution; Belgium would then be ready to take part to it[.]” *See* Tax Notes, *Belgium Is Open to Enhanced Cooperation on Pillar 2*, Elodie Lamer (Oct. 6, 2022). [↑](#footnote-ref-305)
306. The effective U.S. tax rate on GILTI and subpart F income varies significantly based on a number of factors including the allocation of certain U.S.-borne expenses to foreign income for U.S. foreign tax credit purposes. These allocation rules, among others, can result in an effective U.S. tax rate on GILTI, for example, well in excess of 13.125 percent, possibly increasing the incentive for certain U.S.-based MNEs to consider inverting to a low-tax jurisdiction. [↑](#footnote-ref-306)
307. There is an expectation that once one such a jurisdiction adopts Pillar Two (especially if that jurisdiction consists of most or all of the European Union member states), most other OECD jurisdictions will quickly adopt their own versions of Pillar Two in order to avoid ceding tax revenue to other jurisdictions—revenue that if not collected by the UPE’s tax resident jurisdiction, would be collected by one or more jurisdictions in which MNE group members have tax residency. [↑](#footnote-ref-307)
308. In general, MNE groups that have consolidated revenue exceeding €750 million in at least two of the four fiscal years immediately prior to the tested fiscal year are within the scope of Pillar Two. For a more detailed discussion, *see*  Part ‎VI.B.1.a. [↑](#footnote-ref-308)
309. If the United States fails to enact compliant legislation, the incentive to invert may actually increase. A non-Pillar Two-compliant, U.S.-income-tax system could increase a U.S. MNE’s global ETR independent of the increase associated with a 15-percent-minimum tax in each country a U.S. MNE earns income. In part, whether there is an ETR hike, and the amount thereof, will be dependent on how other countries treat the U.S. GILTI regime. *See*, *e.g.,* Allison Christians, “Let the GILTI/GLOBE Games Begin,” 106 Tax Notes Int’l 913 (May 16, 2022); Mindy Herzfeld, “Questioning the Promise Of GILTI Conformity,” 107 Tax Notes Int’l 115 (July 11, 2022). For a more detailed discussion on Pillar Two-GILTI-compliance issues, *see* Part *‎*VI.B.2. [↑](#footnote-ref-309)
310. A U.S.-based MNE may be concerned about the possibility of future taxpayer-unfavorable legislation, such as a significant increase in the U.S. corporate tax rate on GILTI and subpart F income beyond the Pillar Two 15-percent tax rate on book earnings. If such concerns exist among some, a relatively neutral “should I stay or should I go” environment ushered in by the adoption of Pillar Two could once again be upended. [↑](#footnote-ref-310)
311. *See*, *e.g.*, *Tax Effects on Foreign Direct Investment*, Policy Brief, O.E.C.D., at 1 (Feb., 2008) (concluding that “while tax is recognized as being an important factor in decisions on where to invest, it is not the main determinant. [foreign direct investment (“FDI”)] is attracted to countries offering: access to markets and profit opportunities; a predictable and non-discriminatory legal and regulatory framework; macroeconomic stability; skilled and responsive labour markets; and well-developed infrastructure.”); Thornton Matheson et. al. , The Impact of the Tax Cuts and Jobs Act on Foreign Direct Investment in the United States, Tax Policy Center Urban Institute & Brookings Institution (Jan. 2021). [↑](#footnote-ref-311)
312. There are other ways to gain access to the United States’ deep equity and debt markets such as through the issuance of American Depository Receipts and American Depository Securities. [↑](#footnote-ref-312)
313. *Tax Effects on Foreign Direct Investment*, at 2 (finding that “[s]tudies examining cross-border flows suggest that on average, FDI decreases by 3.7 percent following a 1 percentage point increase in the tax rate on FDI.”). *But see* Matheson, et. al., *The Impact of the Tax Cuts and Jobs Act on Foreign Investment in the United States*, IMF Working Paper WP/22/79 (2020) (“find[ing] little evidence that FDI financed with new equity or debt responded to the changes in effective tax rates introduced by TJCA.”). [↑](#footnote-ref-313)
314. As discussed above, some jurisdictions, in addition to looking at the country of the corporation’s formation, use some variation of a management and control test. In circumstances where the corporation was formed in one country and has located its management and control functions in another country, there is typically a tiebreaker rule. This is quite different, however, from treating a corporation that has neither its place of formation nor its management in a country but nonetheless is a resident of that country. [↑](#footnote-ref-314)
315. As noted above, none of Brazil, China, or India currently impose exit taxes on expatriating businesses. *See* Part ‎V.A.2.f. [↑](#footnote-ref-315)
316. *See*, *e.g.*, I.R.C. § 367(a) (requires immediate gain (but not loss) recognition when a domestic corporation transfers its assets to a foreign corporation in exchange for voting stock in an otherwise qualifying reorganization); I.R.C. § 367(b) (addressing certain other transfers not covered by section 367(a) including, for example, inclusion of section 1248 amount upon CFC losing its status as such); I.R.C. § 367(d) (requiring deemed royalty inclusion on certain outbound transfers of intellectual property offshore); I.R.C. § 367(e)(1) (domestic distributing corporation required to recognize gain only to the extent shares of a foreign controlled corporation are distributed to a person other than a U.S. citizen or resident or a domestic corporation); I.R.C. § 367(e)(2) (renders nonrecognition under section 337 when domestic liquidating corporation distributes assets to foreign 80-percent foreign corporate shareholder); *cf.* I.R.C. § 877A (imposing a mark-to-market exit tax regime on expatriating individuals generally requiring that all property of a “covered expatriate” is deemed sold for its fair market value on the day before the expatriation date). [↑](#footnote-ref-316)
317. For a detailed discussion, *see* Part ‎VII.D. [↑](#footnote-ref-317)
318. We note that the “substantial business activities” -related regulations evolved over time ultimately rendering the exception almost never available. Treas. Reg. § 1.7874-3(b) (requiring 25 percent of employees, assets, and income in the surrogate foreign corporation’s country of organization). Whatever Congress considered to be a reasonable percentage of the metrics (i.e., employees, assets, and income) associated with a particular jurisdiction, there are few if any large MNE enterprises that boast 25 percent or more “activities” in a single jurisdiction other than the United States. This is the case regardless of whether the MNE was historically parented in the United States or in some other jurisdiction. In fact, the global economy that evolved over the past 20 or so years virtually requires jurisdictional diversification—possibly for operations, but certainly for income. In turns out that few, if any, Fortune 100 companies for which publicly-available information can be found earn 25 percent or more of their income in a jurisdiction other than the United States. Further, many of those businesses do not earn 25 percent or more of their income in any single jurisdiction (including the United States). Query whether Congress intended to draft an exception that is nearly impossible to satisfy. We do acknowledge, however, that some foreign corporations with nearly all of their revenue earned from local sources have chosen to invert into the United States (say, for example, to tap the U.S. public equity or debt markets). If such a taxpayer later decided to “un-invert” back to their original jurisdiction, the substantial business activities exception may be available. [↑](#footnote-ref-318)
319. I.R.C. § 7874(a)(2)(B)(ii)(I). [↑](#footnote-ref-319)
320. *See* 2002 Treasury Report at 4-5 (possibly suggesting that the reason for the shareholder test relates to the form of the first generation inversion transactions—transactions where there was 100 percent continuity between the shareholders of the U.S. target corporation and the foreign acquiring corporation, having nothing to do with traditional cross-border M&A transactions); S. 1637, *“Jumpstart Our Business Strength (JOBS) Act*,” 108th Congress, Senate Committee on Finance Report 108-192 at 141 (Nov. 7, 2003) (each inversion example provided resulted in 100 percent U.S. target shareholder continuity in the new foreign acquiring corporation). [↑](#footnote-ref-320)
321. *See*, *e.g.*, U.S. Dep’t of the Treasury, Office of Tax Policy, *Corporate Inversion Transactions: Tax Policy Implications*, Doc 2002-12218 (May 17, 2002) (31 original pages) (describing an inversion as “a transaction or series of transactions through which a U.S.-based multinational restructures its corporate group so that the *ultimate parent corporation* of the group becomes a foreign entity” and making no mention of the relevancy of shareholder continuity); Reuven Avi-Yonah, *For Haven’s Sake: Reflections on Inversion Transactions*, Tax Notes at 1793 (June 17, 2002) (concluding that “[i]t would be better to define an inversion directly as any transaction in which a foreign corporation becomes the parent of an affiliated group formerly headed by a U.S. corporation;” but conceding that although “this definition would include takeovers by existing foreign multinationals, but they could be excluded by the other prongs.”). [↑](#footnote-ref-321)
322. Avi-Yonah, *For Haven’s Sake* at 1793 (the most problematic feature of the proposed [inversion legislative proposals] is their focus on the composition of share ownership in the new foreign parent. …the fundamental problem with a share ownership test: It is not related to what makes a multinational U.S.-based, and management does not care very much about the composition of public shareholders. Large U.S. multinationals and large foreign multinationals currently trade on 20 or more exchanges all over the world. Their share ownership is widely dispersed and it is doubtful whether some ‘U.S.’ multinationals have many more U.S. shareholders than some ‘foreign’ multinationals. In short, the share ownership test is manipulable at little business cost precisely because it has little to do with what makes a publicly traded multinational U.S.-based.”). *But see*, *e.g.*, Treas. Reg. § 1.7874-10 (one of several Treasury-inspired “anti-abuse” rules aimed at preventing the manipulation of the ownership fraction). [↑](#footnote-ref-322)
323. *See* Note 50 *supra*. [↑](#footnote-ref-323)
324. As discussed in Part ‎I.A., for the vast majority of businesses conducted in corporate solution, residency based on the jurisdiction of formation is simple and straightforward. This proposal does not suggest reforming the U.S. corporate residency test across the board—just certain cross-border transactions as discussed in this Part ‎VII.A. [↑](#footnote-ref-324)
325. Any test that uses multiple factors but the satisfaction of only one factor renders the foreign acquiring corporation a U.S. resident is likely to result in competing residency claims. Further, the significant domestic business activities test in the Doggett proposal could very well lead to more than two jurisdictions claiming residency (if adopted by other countries). *See* Part ‎IV.C.2.a. for a more detailed discussion. [↑](#footnote-ref-325)
326. Such a process, however, is far from ideal. Competent authority proceedings can take years to conclude and positive outcomes are far from assured. [↑](#footnote-ref-326)
327. On August 16, 2022, President Biden signed the I.R.A. into law. The legislation establishes a new 15-percent minimum tax regime on large U.S. corporations (generally those with pre-tax earnings in excess of $1 billion) and U.S. subsidiaries and branches of certain large foreign-parented corporate groups. For tax years beginning after December 31, 2022, corporations subject to the CAMT will owe additional tax if they do not otherwise pay taxes equal to at least 15 percent of their pre-tax financial statement income as adjusted by the IRA. Pub. L. 117-169 § 10101. [↑](#footnote-ref-327)
328. Applicable corporations are: (i) U.S. corporations with average annual adjusted financial statement income (“AFSI”) in excess of $1 billion measured on a consolidated basis using a three-year average; (ii) U.S. corporations with average annual AFSI of $100 million or more, measured on a consolidated basis using a three-year average, that are members of foreign parented groups with average annual AFSI in excess of $1 billion, again measured using a three-year average; and (iii) foreign corporations that meet the above-income thresholds taking into account any U.S. branches as if each were a U.S. corporation. Annual AFSI is generally net income for financial statement (book) purposes but taking into account numerous modifications, some of which are discussed below. The book net income is generally based on the corporation’s applicable financial statement, which in most cases will be a Form 10-K or a similar foreign financial statement. Pub. L. 117-169 § 10101. *Compare* I.R.C. § 1298(b)(1) (the “once a PFIC, always a PFIC” rule). [↑](#footnote-ref-328)
329. I.R.C. § 59A(k)(1)(A), (C). [↑](#footnote-ref-329)
330. If the MNE’s U.S. group lacks sufficient size vis-à-vis the worldwide group, the U.S. group may lack sufficient cross-border intercompany items and related tax attributes to collect the total tax needed to make the U.S. fisc whole. [↑](#footnote-ref-330)
331. *See* Parts ‎II.C.3.a(2) and ‎IV.B for a discussion on the inversion gain rules as initially enacted and the penalties for 60-percent inversions added to the Code pursuant to TCJA. Penalties, in addition to the inversion gain rules, include a 15-percent excise tax on stock-based compensation on certain executives of the domestic target corporation, denying otherwise eligible shareholders qualified dividend treatment, increasing the transition tax rate to 35 percent in certain cases, the denial of out-from-under and de-CFC planning, and extending the definition of a BEAT payment to include cost of goods sold. [↑](#footnote-ref-331)
332. *See* Marples and Gravelle, *Corporate Expatriation, Inversions, and Mergers: Tax Issues*, Congressional Research Service at 18 (June 17, 2021) (finding that inversions have been on the decline since the publication of the final anti-inversion regulations in 2016). [↑](#footnote-ref-332)
333. Some have suggested that a corporation may have the legal right to expatriate akin to U.S. citizens and permanent residents renouncing their U.S. citizenship (and, at least eventually, escaping the U.S. tax net on income from ex-U.S. operations). Such arguments typically stem from a series of Supreme Court decisions holding (both expressly and impliedly) that corporations may assert certain constitutional protections. These include, for example, rights under the Contract Clause, *Trs. of Dartmouth Coll. v. Woodward*, 4 Wheat. 518 (1819); due process and equal protection rights, *Metro. Life Ins. Co. v. Ward*, 470 U.S. 869 (1985); certain protections against unreasonable government searches and seizures, *Marshall v. Barlow’s, Inc.*, 436 U.S. 307 (1978); protections under the Double Jeopardy Clause, *United States v. Martin Linen Supply Co.*, 430 U.S. 564 (1977); the right to have a jury determine facts that increase certain criminal penalties, *S. Union Co. v. United States*, 567 U.S. 343 (2012); free-speech rights, including rights to political speech, *Citizens United v. Fed. Election Comm’n*, 558 U.S. 310 (2010); and protections stemming from the separation of powers, *Metropolitan Washington Airports Authority v. Citizens for Abatement of Aircraft Noise*, 501 U.S. 252 (1991); *Panama Refining Co. v. Ryan*, 293 U.S. 388 (1935).

     Corporations, however, do not enjoy all constitutional protections. For example, corporations cannot assert rights under the Privileges and Immunities Clause, *Asbury Hosp. v. Cass Cty.*, 326 U.S. 207 (1945); they do not hold the same rights of privacy that individuals hold, *Cal. Bankers Ass’n v. Shultz*, 416 U.S. 21 (1974); they cannot assert the right against self-incrimination, *Hale v. Henkel*, 201 U.S. 43 (1906); and they lack due-process liberty interests, *Nw. Nat’l Life Ins. Co. v. Riggs*, 203 U.S. 243 (1906). We also note that U.S. individual citizens were not permitted to renounce (at least formally) their U.S. citizenship until the passage of the Expatriation Act of 1868.

     Notwithstanding the above precedent, the suggestion that corporation-rights laws somehow render section 7874(b) unconstitutional is misguided. Section 7874(b) does not deny a corporation the right to migrate to another jurisdiction. In fact, section 7874(b) has no impact on a domestic corporation’s residency in most inversions (other than a true corporate migration) as it treats the *foreign* acquiring corporation as a domestic corporation. Further, the foreign acquiring corporation maintains all of its legal rights and obligations in its jurisdiction of formation or incorporation and it is no more subject to U.S. federal non-tax law than if section 7874(b) had never been enacted. In the case of a corporate migration (e.g., from Delaware to Luxembourg), the same holds true—section 7874(b) would have no effect on the surviving corporation’s legal rights and obligations in the country to which it migrated. *Cf.* Part ‎V.B and the discussion on the European Mobility Directive. Finally, U.S. individual citizens who renounce their citizenship are required to recognize capital gain on a deemed sale of their assets in the year of the expatriation. *See* I.R.C. § 877A. Similar rules apply to long-term U.S. residents. I.R.C. § 877A(e). Further, under prior law, expatriating citizens, remained subject to U.S. federal income taxation on their worldwide taxation for an additional 10 years. *See* I.R.C. § 877. As the Supreme Court once concluded, “[s]ometimes the grossest discrimination can lie in treating things that are different as though they were exactly alike[.]” *Buckley v. Valeo*, 424 U.S. 1, 97–98 (1976). [↑](#footnote-ref-333)
334. Recent proposals have suggested reducing the 80-percent threshold to greater than 50 percent. For more detail, *see* Part ‎IV.C.2.a. The percentage threshold for this modified rule could be changed to a threshold deemed appropriate by Congress. [↑](#footnote-ref-334)
335. The inversion gain regime also acts as a minimum tax of sorts by ensuring that, with respect to a taxable year during the applicable period, the taxable income of an expatriated entity is no less than its inversion gain for that year. I.R.C. § 7874(a)(1). [↑](#footnote-ref-335)
336. I.R.C. § 59A(e)(1)(B) (removing both the $500 million gross receipts and the three-percent base erosion percentage thresholds); I.R.C. § 59(k)(1)(B)(i) (removing the $1 billion and $100 million applicable financial statement income requirements for U.S. and foreign MNEs, respectively). [↑](#footnote-ref-336)
337. The U.S. Model Income Tax Convention disallows certain treaty benefits to 60-percent inverters. *See also*, U.S. Treasury Dep’t, United States Model Income Tax Convention 2016 (Feb. 17, 2016), art. 4(4) (“Where by reason of the provisions of paragraph 1 of this Article a company is a resident of both Contracting States, such company shall not be treated as a resident of either Contracting State for purposes of its claiming the benefits provided by this Convention.”). [↑](#footnote-ref-337)
338. For a similar proposal that was intended to apply to inverting and non-inverting corporations alike, *see* Note 170 (discussing the Biden Administration’s “SHIELD” proposal). [↑](#footnote-ref-338)
339. I.R.C. § 1001(a). [↑](#footnote-ref-339)
340. *See also* I.R.C. § 1374 (tax on net recognized built-in gain on assets on conversion from subchapter C corporation to subchapter S corporation if sold during five-year recognition period); I.R.C. § 337(d); Treas. Reg. § 1.1374(d)-7 (election to apply deemed-sale treatment or section 1374 regime on conversion from taxable subchapter C corporation to real estate investment trusts and regulated investment companies). [↑](#footnote-ref-340)
341. If the U.S. transferor transfers a mix of built-in gain and built-in loss assets, the transferor must recognize the gain with respect to each built-in gain asset and is *not* permitted to recognize any loss with respect to any built-in loss asset. Treas. Reg. § 1.367(a)-1(b). *Compare* I.R.C. § 362(e)(1) (allowing the taxpayer to net built-in gains and losses to arrive at a net built-in loss). [↑](#footnote-ref-341)
342. A “foreign corporation” for purposes of section 367 is the general definition provided in section 7701(a)(5). For more detail, *see supra* Note 8. [↑](#footnote-ref-342)
343. For purposes of section 367(a), the terms “property” and “transfer” generally look to the definitions of those terms in section 351. [↑](#footnote-ref-343)
344. *See* I.R.C. § 367(d); Treas. Reg. § 1.367(d)-1, -1T. [↑](#footnote-ref-344)
345. Treas. Reg. § 1.367(d)-1T(c)(1), -1(c)(3). Said another way, section 367(d) provides that the transfer is treated as if the domestic corporation sold the intangible property to the CFC in exchange for annual royalty payments over the life of the intangible property. The amount of the royalty is commensurate with the income generated by the intangible property. [↑](#footnote-ref-345)
346. Prior to the enactment of the TCJA, the section 936(h)(3)(B) definition of intangibles included any “(i) patent, invention, formula, process, design, pattern, or know-how; (ii) copyright, literary, musical, or artistic composition; (iii) trademark, trade name, or brand name; (iv) franchise, license, or contract; (v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or (vi) any similar item, which has substantial value independent of the services of any individual.” [↑](#footnote-ref-346)
347. I.R.C. §367(d)(1) (prior to TCJA enactment); *see also* 80 Fed. Reg. 55568, 55570 (Sept. 16, 2015) (“Section 1.367(d)–1T(b) generally provides that section 367(d) and § 1.367(d)–1T apply to the transfer of any intangible property, but not to the transfer of foreign goodwill or going concern value, as defined in § 1.367(a)– 1T(d)(5)(iii) (foreign goodwill exception).”). This foreign goodwill exception was removed from the section 367(d) regulations in 2016. *See* T.D. 9803, *Treatment of Certain Transfers of Property to Foreign Corporations*, 81 Fed. Reg. 91012 (Dec. 16, 2016). [↑](#footnote-ref-347)
348. T.D. 9803 at 91020 (Dec. 16, 2016); *see also* 80 Fed. Reg. 55568, 55571 (Sept. 16, 2015) (“The Treasury Department and the IRS have determined that allowing intangible property to be transferred outbound in a tax-free manner is inconsistent with the policies of section 367 and sound tax administration and therefore will amend the regulations under section 367” to provide that “upon an outbound transfer of foreign goodwill or going concern value, a U.S. transferor will be subject to either current gain recognition under section 367(a)(1) or the tax treatment provided under section 367(d).”). [↑](#footnote-ref-348)
349. *See* TCJA, § 401(d)(1)(C), (D)(viii)(I); I.R.C. § 367(d)(4)(F). [↑](#footnote-ref-349)
350. Note that sections 367 and 482 are not the only provisions addressing the outbound transfer of assets. *See*, *e.g.*, I.R.C. § 91 (stronger branch loss recapture rule enacted pursuant to the TCJA). [↑](#footnote-ref-350)
351. *See also* I.R.C. § 367(e)(1) (turns off sections 355(c) and 361(c) nonrecognition rules for certain outbound otherwise qualifying section 355 distributions); I.R.C. § 367(e)(2) (turns off section 337 for both gains and losses in the event of an outbound subsidiary liquidations. [↑](#footnote-ref-351)
352. I.R.C. § 877(b). U.S. citizens who renounce their citizenship that are under certain income and net worth thresholds are exempt from section 877. I.R.C. § 877(a)(2). [↑](#footnote-ref-352)
353. I.R.C. § 877(b)(2). [↑](#footnote-ref-353)
354. I.R.C. § 877(d)(1)(B). [↑](#footnote-ref-354)
355. I.R.C. § 877(d)(1)(C). This special source rule applies only to the extent that such income or gain does not exceed the earnings and profits attributable to the stock that were earned or accumulated before the expatriation and during periods that the stock ownership requirements were met. *See* I.R.C. § 877(d)(1)(C)(ii). [↑](#footnote-ref-355)
356. P.L. 110-245, The Heroes Earnings Assistance and Relief Tax (HEART) Act of 2008 (adding section 877A to the Code). [↑](#footnote-ref-356)
357. I.R.C. § 877A(a)(1). The mark-to-market regime allows for built-in gain assets to be offset by built-in loss assets except that the wash sale rules of section 1091 are turned off with respect to any loss. I.R.C. § 877A(a)(2). Further, the section 877A rules on apply to inclusions in excess of $600,000 (adjusted for inflation). I.R.C. § 877A(a)(3). [↑](#footnote-ref-357)
358. I.R.C. § 877A(a)(2)(A) (initial phrase). [↑](#footnote-ref-358)
359. I.R.C. § 877A(g)(3). [↑](#footnote-ref-359)
360. I.R.C. § 877A(b)(1). If the Expatriate elects to defer the exit tax with respect to a particular asset, adequate security must be provided, interest must be paid, treaty benefits must be waived, and a tax deferral agreement must be entered into with the I.R.S. *See* Notice 2009-85, 2009-45 IRB 598 (Oct. 15, 2009). [↑](#footnote-ref-360)
361. *Compare* I.R.C. § 877(b)(2) *with* Treas. Reg. § 1.7874-11. [↑](#footnote-ref-361)
362. Such an approach could also include a limitation on the use of certain tax attributes to offset the exit tax as discussed in the other two exit tax approaches above. [↑](#footnote-ref-362)
363. *See*, *e.g.*, I.R.C. § 965(h) (deferral of transition tax to be paid over eight-year period). [↑](#footnote-ref-363)
364. *See*, *e.g.*, I.R.C. § 453A. [↑](#footnote-ref-364)
365. I.R.C. § 877A(b)(4) (election to defer until property disposed of provided adequate security provided such as a bond meeting the requirements of section 6325; this reference is not to suggest that the expatriating corporation should be permitted to indefinitely defer the exit until the disposal of the deemed sold assets). [↑](#footnote-ref-365)
366. *See*, *e.g.*, I.R.C. § 965(i)(6) (“Any limitation on the time period for the collection of a liability deferred under this subsection shall not be treated as beginning before the date of the triggering event with respect to such liability.”); Treas. Reg. § 1.367(a)-8(f)(1) (when filing a gain recognition agreement, the U.S. transferor must file a waiver of the statute of limitations on assessment of tax on such gain, extending the assessment period to the end of the eighth taxable year following the year during which the initial transfer occurs). [↑](#footnote-ref-366)
367. *But see* Treas. Reg. § 1.1502-6 (“the common parent corporation and each subsidiary which was a member of the group during any part of the consolidated return year shall be severally liable for the tax for such year computed in accordance with the regulations under section 1502 prescribed on or before the due date (not including extensions of time) for the filing of the consolidated return for such year.”). [↑](#footnote-ref-367)
368. Pursuant to Article 6 of ATAD, “A non-genuine arrangement or a series thereof shall be regarded as non-genuine to the extent that they are not put into place for valid commercial reasons that reflect economic reality.” [↑](#footnote-ref-368)
369. *See* ATAD 1, Decl. 1, 2016 O.J. (L. 193) 1. [↑](#footnote-ref-369)
370. Even without mirrors on the ceiling or pink champagne on ice, the Motel 6 does have its charm. [↑](#footnote-ref-370)