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Corporate Inversions: Frequently Asked Legal Questions

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Summary

Corporate inversions are transactions in which a U.S. company merges or takes similar action with a foreign entity so that the U.S. company becomes a subsidiary of a new foreign parent—in other words, the company is now headquartered overseas. Corporate inversions have been controversial because it appears, in at least some cases, there is arguably no real business purpose for the inversion and that the primary motivation for the parties is the reduction of U.S. income tax liability.

In 2004, Congress added Section 7874 to the Internal Revenue Code (IRC), which significantly limits the tax benefits associated with corporate inversions. While Section 7874 appeared to slow the rate of inversions in the years immediately after its enactment, there have been reports of numerous high-profile inversions (or plans to invert) in recent years. In light of these reports, some have questioned whether Section 7874 should be amended to further limit the ability of inverted corporations to reduce their U.S. tax liability. Others, meanwhile, have argued that these recent inversions are fundamentally different than those that led Congress to enact Section 7874 because the recent inversions are more likely to have legitimate, non-tax business reasons associated with them. As such, some argue that Section 7874 has effectively shut down the types of inversions motivated solely by tax reasons and that to amend the law would risk affecting legitimate, cross-border mergers.

This report answers frequently asked legal questions about corporate inversions. It answers questions relating to the scope and operation of Section 7874, including how key statutory terms have been interpreted by the Internal Revenue Service (IRS). It discusses important Department of Treasury regulations that were finalized in 2015 and 2016, and answers questions about the IRS's authority to issue these regulations. Other questions that are answered relate to legislation introduced in the 114th Congress, the interaction of Section 7874 with tax treaties, and the imposition of an excise tax on corporate insiders who benefit from an inversion.

This report only examines the federal tax consequences of corporate inversions. For a discussion of the federal contracting implications, see CRS Report R43780, *Contracting with Inverted Domestic Corporations: Answers to Frequently Asked Questions*, by Kate M. Manuel and Erika K. Lunder. For a discussion of the policy issues surrounding inversions, see CRS Report R43568, *Corporate Expatriation, Inversions, and Mergers: Tax Issues*, by Donald J. Marples and Jane G. Gravelle.

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Background

1. What is a corporate inversion and why do companies invert?

At its most basic level, a corporate inversion occurs when a U.S. company merges or takes similar action with a foreign entity so that the U.S. company becomes a subsidiary of a new foreign parent—in other words, the company is now headquartered overseas.¹ Corporate inversions can result in U.S. tax savings because the United States taxes domestic corporations on their world-wide income, while foreign companies are generally subject to tax only on their U.S. source income.²

Specifically, these tax savings occur because prior to the inversion, the company paid U.S. tax on all its income because it was a U.S. corporation. Post-inversion, only the U.S. subsidiary will be taxed on all its income, while the rest of the company—the new foreign parent and any foreign subsidiaries—will only be subject to U.S. income taxes on its U.S. source income. Thus, to the extent that the foreign parent and its foreign subsidiaries earn money overseas, these amounts will not be subject to U.S. income tax unless the money is repatriated to the United States (e.g., by paying dividends to the U.S. company). Furthermore, because companies often invert to countries with lower tax rates than the United States, the parts of the company that are overseas may also benefit from paying tax at a lower rate on their foreign income.

2. How has Congress addressed corporate inversions?

In the American Jobs Creation Act of 2004,³ Congress added Section 7874 to the Internal Revenue Code (IRC). Section 7874 imposes negative tax consequences on an inverted company, by reducing or, in some cases, eliminating the tax benefits described above. The section generally applies to companies that inverted after March 3, 2004 (the date the bill was introduced). The specifics of Section 7874 are discussed in Questions 4-8.

In addition to limiting the tax benefits for the inverted company, Congress has also imposed an excise tax on certain corporate insiders who benefit from an inversion and limited the ability of inverted companies to be federal contractors (see Questions 13 and 14).

3. In light of Section 7874, what is the current controversy about inversions?

When Congress added Section 7874 in 2004, the concern was with U.S. companies establishing a shell company in a no- or low-tax jurisdiction like Bermuda and then restructuring so that the

¹ See Orsolya Kun, *Corporate Inversions: The Interplay of Tax, Corporate, and Economic Implications*, 29 DEL. J. CORP. L. 313, 319-28 (2004) (detailing the possible ways in which inversions might be structured).

² See 26 U.S.C. §§ 11, 61, 881-884. The use of a world-wide taxing regime is relatively uncommon. Most countries use a territorial regime in which companies are only subject to the country's income tax on amounts earned within or sourced to that country. See, e.g., PRICEWATERHOUSECOOPERS LLP, EVOLUTION OF TERRITORIAL TAX SYSTEMS IN THE OECD 3 (2013), http://www.techceocouncil.org/clientuploads/reports/Report%20on%20Territorial%20Tax%20Systems_20130402b.pdf (reporting that, as of 2012, 28 of the 34 members of the Organisation for Economic Co-operation and Development (OECD) had territorial tax systems).

³ P.L. 108-357, tit. VIII, § 801(a), 118 Stat. 1418, 1562 (2004).

foreign shell became the parent of the U.S. company.⁴ The company typically had no business operations in the foreign country, and it appeared likely these transactions were done solely to avoid or defer U.S. taxes.⁵

While Section 7874 shut down those types of inversions, recent media reports have brought attention to U.S. companies using inversions to relocate to Europe and Canada.⁶ Unlike the earlier inversions that generally involved countries in which the company had no presence other than the shell parent entity, these new inversions involve countries in which the company has some type of legitimate business presence after the inversion. Because the company is operating a business in the foreign country, these recent inversions generally are not covered by Section 7874 (see Questions 4 and 6). Some argue that this treatment is appropriate because these inversions can be genuine cross-border mergers that are not solely motivated by tax reasons, but others disagree and see them as evidence that Section 7874 did not go far enough.⁷

IRC Section 7874

4. What are the tax consequences under Section 7874 for engaging in a corporate inversion?

Section 7874 provides negative tax consequences for the U.S. subsidiaries (and their related persons, as defined in Question 5) of inverted corporations if three criteria are met:

- a foreign corporation completes after March 4, 2003, the direct or indirect acquisition of “substantially all” of the properties held by a U.S. corporation;
- after the acquisition, the new foreign parent and its expanded affiliated group do not have “substantial business activities” in its home country when compared to its total business activities; and

⁴ J. COMM. ON TAX’N, JCS-5-05, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS 343 (2005) (explaining that Congress added Section 7874 because it “believed that inversion transactions resulting in a minimal presence in a foreign country of incorporation were a means of avoiding U.S. tax and should be curtailed”).

⁵ See Kun, *supra* note 1, at 315-19 (generally discussing the tax motivations behind inversions); *Developments in the Law—Jobs and Borders: VI. Drawing Lines Around Corporate Inversions*, 118 HARV. L. REV. 2270, 2275-79 (2005) (discussing the tax motivations behind the 2002 Stanley Works inversion to Bermuda).

⁶ See, e.g., David Gelles & Chad Bray, *Drug Firms Make Haste to Elude Tax*, N.Y. TIMES DEALB%K (July 14, 2014, 4:09 a.m.), http://dealbook.nytimes.com/2014/07/14/shire-and-abbvie-in-talks-over-53-billion-pharmaceutical-merger/?_r=0 (reporting on the proposed inversion of two drug firms, one to Ireland and the other to the Netherlands); Anupreeta Das & Liz Hoffman, *Berkshire, Burger King Deal Draws Criticism Over Taxes*, WALL ST. J. (Aug. 26, 2014, 10:49 p.m.), <http://www.wsj.com/articles/berkshire-to-pay-u-s-tax-rate-on-burger-king-investment-1409057047> (reporting on Burger King’s plans to invert to Canada); Robert W. Wood, *Inversions May Be Trending Now, But They’re Not New*, L.A. DAILY J. (August 14, 2014), http://www.woodllp.com/Publications/Articles/pdf/Inversions_May.pdf (listing a variety of recent inversions to European countries).

⁷ Compare Steven Davidoff Solomon, *Inversion Critics and Investors May Be Misjudging Burger King Deal*, N.Y. TIMES DEALB%K (Aug. 26, 2014, 2:44 p.m.), http://dealbook.nytimes.com/2014/08/26/inversion-critics-and-investors-may-be-misjudging-burger-king-deal/?_php=true&_type=blogs&_r=1 (arguing there are legitimate business reasons for the Burger King inversion to Canada, including the fact that the Canadian company with which it is merging—Tim Hortons—has higher revenue and it makes sense for a business to be headquartered in the location of its greatest amount of business); with Mortimer B. Zuckerman, *Reform the Tax Code So We Can Have It Our Way*, U.S. NEWS & WORLD REP. (Sept. 19, 2014, 2:15 p.m.), <http://www.usnews.com/opinion/articles/2014/09/19/burger-kings-inversion-should-spur-congress-to-reform-the-tax-code> (arguing that even though there may be business reasons for the Burger King inversion, inversions nonetheless give rise to tax benefits that should be limited by strengthening Section 7874).

- after the acquisition, at least 60% or 80% of the foreign parent's stock is held by former shareholders of the U.S. company.⁸

The section creates two different taxing regimes for the inverted corporation depending on whether the 60% or 80% threshold is met. If at least 60% of the foreign parent's stock is held by former shareholders of the U.S. company, then the U.S. subsidiary (and related persons) is limited in its ability to claim credits and deductions against certain income when calculating its U.S. income taxes.⁹ If the 80% threshold is met, then the foreign parent is treated as a domestic corporation for U.S. tax purposes and subject to tax on its world-wide income.¹⁰

5. What does it mean to be “related” for purposes of Section 7874?

The unfavorable tax treatment provided under Section 7874 applies to the U.S. subsidiary of the inverted corporation and any related persons to that U.S. subsidiary.¹¹ **Table 1** summarizes the relationships that are treated as “related” for purposes of Section 7874.

Table 1. Meaning of “Related” for Purposes of Section 7874

Type of Entity	Relationship to Be Considered “Related”
Individuals	I. Two members of the same family (brothers and sisters, half-brothers and sisters, spouse, ancestors, and lineal descendants). II. An individual and a corporation if more than 50% in value of its outstanding stock is owned by or for such individual.
Controlled group of corporations	Two corporations that are members of the same controlled group under one of the following relationships: Parent-Subsidiary: One or more chains of corporations connected through stock ownership with a common parent corporation. Two criteria must be met: (1) stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of shares of all classes of stock of each of the corporations (except the parent) is owned by at least one of the other corporations, and (2) the common parent owns stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% percent of the total value of shares of all classes of stock of at least one of the other corporations. Brother-Sister: Two or more corporations if five or fewer persons who are individuals, estates, or trusts own stock possessing more than 50% of the total combined voting power of all classes of stock entitled to vote or more than 50% of the total value of shares of all classes of stock of each corporation. Combined group: Three or more corporations that are members of a group of corporations described in either of the above scenarios if one of them is a common parent in a parent-subsidiary group and is also in a brother-sister group.

⁸ 26 U.S.C. § 7874(a)(2)(B)(i)-(iii).

⁹ 26 U.S.C. § 7874(a)(1).

¹⁰ 26 U.S.C. § 7874(b).

¹¹ 26 U.S.C. § 7874(a)(2)(A)(i), (ii).

Type of Entity	Relationship to Be Considered “Related”
Trusts	1. A grantor and a fiduciary of a trust. 2. The fiduciaries of two trusts if the same person is a grantor of both trusts. 3. A fiduciary and a beneficiary of a trust. 4. A fiduciary of a trust and a beneficiary of another trust if the same person is a grantor of both trusts. 5. A fiduciary of a trust and a corporation if more than 50% in value of its outstanding stock is owned (directly or indirectly) by or for the trust or a grantor of the trust.
Tax-exempt organizations	A person and tax-exempt organization that is controlled by such person or, if such person is an individual, members of his/her family.
Partnerships	1. A corporation and a partnership if the same persons own more than 50% in value of the corporation’s outstanding stock and more than 50% of the partnership’s capital or profits interest. 2. A partnership and a person owning more than 50% of the partnership’s capital or profits interest. 3. Two partnerships in which the same persons own more than 50% of the partnerships’ capital or profits interests.
S corporations	1. Two S corporations if the same persons own more than 50% in value of the outstanding stock of each. 2. An S corporation and a C corporation if the same persons own more than 50% in value of the outstanding stock of each.
Estates	An executor and a beneficiary of an estate, except in the case of a sale or exchange in satisfaction of a pecuniary bequest.

Source: Congressional Research Service, based on IRC Sections 267(b), 707(b)(1), 1563(a), and 7874.

6. What does “substantial business activities” in Section 7874 mean?

One requirement in order for Section 7874 to be triggered is that, after the acquisition, the new foreign parent and its expanded affiliated group do not have “substantial business activities” in its home country when compared to its total business activities.¹² The term “substantial business activities” is not defined by statute. In 2015, the Internal Revenue Service (IRS) finalized regulations that primarily address the threshold for determining whether a company has “substantial business activities” in its home country when compared to its total business activities.¹³

The final regulations define “substantial business activities” to mean that the entire company must meet all three of these criteria:

- the number of employees (and compensation) in the foreign country must be at least 25% of the total world-wide number of employees (and compensation) on the applicable date;
- the value of assets in the foreign country must be at least 25% of the total value of all world-wide assets on the applicable date; and

¹² 26 U.S.C. § 7874(a)(2)(B)(iii).

¹³ Substantial Business Activities, 80 Fed. Reg. 31,837 (June 4, 2015) (codified at Treas. Reg. § 1.7874-3).

- the income derived in the foreign country must be at least 25% of the total worldwide income during the testing period.¹⁴

This is the third time the IRS has defined “substantial business activities.” Initially, the IRS promulgated temporary regulations in 2006 under which the determination of whether a company had “substantial business activities” in the foreign country was made by either (1) looking at the facts and circumstances of each case, considering such things as the local employee headcount and payroll, property, and sales; its historical presence and management activities in the foreign country; and the strategic importance of the business activities in that country; or (2) satisfying a safe harbor if at least 10% of the company’s employees, assets, and sales were in the foreign country.¹⁵ In 2009, after concerns that businesses were taking advantage of the safe harbor, the IRS issued new proposed regulations that got rid of the safe harbor, while keeping the facts and circumstances test.¹⁶ In 2012, the IRS redid the proposed regulations to replace the facts and circumstances test with the bright line 25% threshold, explaining its belief that this “will provide more certainty in applying section 7874 to particular transactions” and “will improve the administrability of this provision.”¹⁷ The final regulations maintain this 25% threshold.¹⁸

7. Has the IRS taken any recent action with respect to inversions?

In April 2016, the IRS issued temporary regulations under Section 7874 that are intended to make it more difficult for companies to invert.¹⁹ Some of the regulations address issues identified in previous IRS guidance that was released in 2014 and 2015.²⁰

Some of the key provisions in the April 2016 regulations address potential ways that companies might try to avoid Section 7874’s ownership threshold. For example, when computing the ownership threshold, the temporary regulations disregard any stock issued by a foreign corporation in prior acquisitions of U.S. corporations occurring during the three-year period before the inversion.²¹ These previous acquisitions are disregarded regardless of whether they were part of a plan to avoid Section 7874.²² The IRS has explained that this regulation is intended to address foreign companies who were acquiring multiple U.S. companies during a short period of time, which allowed the foreign company to keep increasing its value and thus avoid the ownership threshold that triggers Section 7874 treatment when it subsequently acquired the inverted company.²³ Another example is that the regulations impose an “anti-slimming” rule that

¹⁴ Treas. Reg. § 1.7874-3(b)(1)-(3).

¹⁵ Guidance Under Section 7874 Regarding Expatriated Entities and Their Foreign Parents, 71 Fed. Reg. 32,437, 32,444-45 (June 6, 2006) (temporary regulations) (codified at Treas. Reg. § 1.7874-2T(d)(1)-(2) (2006)).

¹⁶ Guidance Under Section 7874 Regarding Surrogate Foreign Corporations, 74 Fed. Reg. 27,921, 27,922, 27,927 (June 12, 2009) (final and temporary regulations) (codified at Treas. Reg. § 1.7874-2T(g)(1)-(3) (2009)).

¹⁷ Substantial Business Activities, 77 Fed. Reg. 34,785, 34,786, 34,787 (June 12, 2012) (temporary regulations) (codified at Treas. Reg. § 1.7874-3T(b)(1)-(3) (2012)).

¹⁸ Treas. Reg. § 1.7874-3(b)(1)-(3).

¹⁹ Inversions and Related Transactions, 81 Fed. Reg. 20,857 (April 8, 2016) (final and temporary regulations) (codified at Treas. Reg. §§ 1.7874-2T to 1.7874-12T, among other sections).

²⁰ I.R.S. Notice 2014-52, 2014-42 I.R.B. 712; I.R.S. Notice 2015-79, 2015-49 I.R.B. 775.

²¹ Treas. Reg. § 1.7874-8T.

²² See Inversions and Related Transactions, 81 Fed. Reg. at 20,865 (“the Treasury Department and the IRS do not believe that the application of section 7874 in these circumstances should depend on whether there was a demonstrable plan to undertake the subsequent domestic entity acquisition at the time of the prior entity acquisitions”).

²³ *Id.*

disregards certain extraordinary distributions made by the U.S. company within the three-year period prior to the inversion, and thus prevents U.S. companies from avoiding the ownership threshold by paying out large dividends prior to the inversion in order to reduce its size.²⁴

The 2016 regulations also address other statutes, besides Section 7874, that can be implicated by corporate inversions. Among other things, the regulations:

- Limit the tax benefits from using “hopscotch loans.” Under current law, U.S. companies are generally not taxed on the profits of their controlled foreign corporations (CFCs) until such profits are paid to the U.S. company as a dividend.²⁵ IRC Section 956 prevents companies from trying to avoid this repatriation of earnings by means of the CFC investing in certain U.S. property, such as by making a loan to the U.S. parent or subsidiary: in such circumstances, the section provides that the U.S. parent will be treated as if it got a dividend from the CFC. Inverted companies may try to get around this rule through the means of the CFC making a loan to the new foreign parent (rather than to the U.S. parent or subsidiary) which would not be treated as “U.S. property” and thus would not be a taxable dividend. The regulations provide that these “hopscotch loans” will be treated as U.S. property and therefore taxable as dividends.²⁶
- Limit use of the “decontrolling” strategy. Some inverted companies may have the foreign parent buy stock to take control of the CFC from the former U.S. parent, which would give the foreign parent access to the CFC’s deferred earnings without paying U.S. tax. The regulations remove the tax benefits that arise from this strategy by providing that the foreign parent will be treated as owning stock in the former U.S. parent, rather than the CFC.²⁷
- Limit the use of “spinversions”—where a company transfers assets to a newly formed foreign corporation and then spins-off that corporation to its public shareholders—by treating the spun-off foreign corporation as a domestic corporation.²⁸

8. Has legislation affecting inversions been introduced in the 114th Congress?

In the 114th Congress, legislation has been introduced that would amend Section 7874 or otherwise affect inverted corporations. For example, multiple bills have been introduced to (1) decrease Section 7874’s 80% ownership threshold to 50% so that, if after the acquisition, at least 50% of the foreign parent’s stock is held by former shareholders of the U.S. company, the foreign parent would be treated as a domestic corporation for U.S. tax purposes and subject to tax on its world-wide income; and (2) set a minimum floor of 25% for the “substantial business activity” standard in Section 7874 (the IRS would be authorized to increase the percentage). Examples of bills that include these provisions are the Corporate Tax Dodging Prevention Act (H.R. 1790 and S. 922); Stop Tax Haven Abuse Act (H.R. 297 and S. 174); In the Red Act of 2016 (H.R. 5106

²⁴ Treas. Reg. § 1.7874-10T.

²⁵ 26 U.S.C. §§ 951-965 (commonly referred to as “Subpart F”).

²⁶ Treas. Reg. § 1.956-2T.

²⁷ Treas. Reg. § 7701(l)-4T.

²⁸ Treas. Reg. § 1.367(b)-4T.

and S. 2677); GROW America Act (H.R. 3064); and Stop Corporate Inversions Act (H.R. 415 and S. 198).

Other bills take different approaches to addressing the tax treatment of inverted companies, such as by limiting the ability of inverted companies to engage in earnings stripping through the deduction of interest payments or by taxing income that had been subject to deferral (which means it was not taxed because it was kept overseas). Examples of bills with the earnings stripping provisions are the Corporate Inverters Earnings Stripping Reform Act of 2016 (S. 2666) and the Stop Corporate Earnings Stripping Act of 2016 (H.R. 4581); while examples of the latter are the Corporate Expatriates and Inverters Tax Fairness Act (H.R. 5125) and the Corporate EXIT Fairness Act (S. 2662).

IRS's Authority to Regulate Corporate Inversions

9. What authority does the IRS have to regulate inversions without further statutory changes by Congress?

Section 7874 provides two express grants of rulemaking authority for the IRS.²⁹ Section 7874(c)(6) provides:

The [Treasury] 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.³⁰

Section 7874(g), meanwhile, states:

The [Treasury] Secretary shall provide such regulations as are necessary to carry out this section, including regulations providing for such adjustments to the application of this section as are necessary to prevent the avoidance of the purposes of this section, including the avoidance of such purposes through—(1) the use of related persons, pass-through or other noncorporate entities, or other intermediaries, or (2) transactions designed to have persons cease to be (or not become) members of expanded affiliated groups or related persons.³¹

As of the date of this report, there are no court decisions interpreting the scope of these authorities. This may change soon, however, as a lawsuit was filed in August 2016 that challenges the IRS's authority to issue one of the April 2016 temporary regulations. This lawsuit is discussed in Question 11.

One potentially interesting aspect to the authority provided by Section 7874(g) is the language authorizing the Treasury Secretary to issue regulations “providing for such adjustments to the application of this section.” It might be questioned whether the term “adjustment” could be interpreted broadly to perhaps allow, for example, the IRS to adjust the statutory thresholds in

²⁹ While Section 7874 expressly grants the rulemaking authority to the Treasury Secretary, in practice these actions are delegated to the IRS. *See also* 26 U.S.C. § 7805(a) (providing IRS general authority to “prescribe all needful rules and regulations for the enforcement of this title [the IRC], including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue”); 26 C.F.R. § 301.7805-1 (specifying that the IRS Commissioner has the authority to prescribe regulations).

³⁰ 26 U.S.C. § 7874(c)(6).

³¹ 26 U.S.C. § 7874(g).

certain circumstances. The provision's legislative history is silent on the matter, and it does not appear the IRS has publicly indicated how the agency might interpret the breadth of this language.

10. Are the “substantial business activity” regulations within the IRS’s authority to promulgate?

Some commentators have argued that the IRS has overstepped its express regulatory authority when making the 25% threshold for purposes of determining whether the “substantial business activity” standard is met.³² Their argument is that the standard is too strict and will be met by few, if any, multinational companies, including those engaging in legitimate business activity in low- or no-tax countries.³³ In light of concerns expressed about the 25% standard, it seems possible the regulations might be challenged in court, although it does not appear that any such litigation has been filed as of the date of this report.

A court analyzing such an argument would likely grant significant deference to the IRS’s interpretation of the statute. Such deference is known as *Chevron* deference after the case in which the Supreme Court first articulated the standard.³⁴ *Chevron* deference applies when an agency’s interpretation is the product of a formal agency process, such as notice-and-comment rulemaking, through which Congress has authorized the agency “to speak with the force of law.”³⁵ A court conducting a *Chevron* analysis first looks at whether Congress has “directly spoken to the precise question at issue.”³⁶ If the court determines that Congress has done so, then that is the end of the matter because the “law must be given effect.”³⁷ But if the statute does not directly address the issue, then “the court does not simply impose its own construction of the statute,” but rather determines whether the agency interpretation is a permissible construction of the statute.³⁸ If so, the court will generally defer to the agency’s position,³⁹ regardless of whether “it is the only possible interpretation or even the one a court might think best.”⁴⁰

Here, it appears Congress did not speak to the issue because it did not directly or indirectly define “substantial business activities” in Section 7874. Therefore, under step one of *Chevron*, it appears that “substantial business activities” could be viewed as ambiguous. Thus, a court could move on to the second part of the *Chevron* test. Those criticizing the standard argue that the regulation’s 25% standard is unreasonable because it goes beyond the type of transactions that Congress

³² See Davies Ward Phillips & Vineberg LLP, *Anti-inversion regulations severely limit substantial business activities exception, as illustrated with Canada*, LEXOLOGY (Aug. 10, 2012), <http://www.lexology.com/library/detail.aspx?g=6dfe6910-a256-4d30-bb6b-b36c9b49fcbe>.

³³ *See id.*

³⁴ See *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984); *Mayo Found. for Med. Educ. & Research v. United States*, 562 U.S. 44, 55 (2011) (“The principles underlying our decision in *Chevron* apply with full force in the tax context.”). For more information on *Chevron*, see CRS Report R43203, *Chevron Deference: Court Treatment of Agency Interpretations of Ambiguous Statutes*, by Daniel T. Shedd and Todd Garvey.

³⁵ *United States v. Mead Corp.*, 533 U.S. 218, 229 (2001); *see also Christensen v. Harris County*, 529 U.S. 576 (2000).

³⁶ *Chevron*, 467 U.S. at 842.

³⁷ *Id.* at 843.

³⁸ *Id.*

³⁹ See, e.g., *Astrue v. Capato*, 132 S. Ct. 2021 (2012) (deferring to the Social Security Administration’s longstanding interpretation in regulations, finding the regulations “warrant the Court’s approbation” as they were “neither arbitrary or capricious in substance, [n]or manifestly contrary to statute” (internal quotations omitted)).

⁴⁰ *Holder v. Gutierrez*, 132 S. Ct. 2011, 2017 (citing *Chevron*, 467 U.S. at 843-44).

intended to address when enacting Section 7874.⁴¹ The IRS, in the preamble to the final regulations, alluded to the controversy by noting that some commentators had characterized the standard as “overly stringent,” but went on to describe it as “consistent with the policies underlying section 7874.”⁴²

11. Are the April 2016 regulations within the IRS’s authority to promulgate?

In August 2016, the U.S. Chamber of Commerce and Texas Association of Business filed suit in federal district court in Texas, challenging one of the temporary regulations issued in April 2016.⁴³ As of the date of this report, the case is pending before the court and the federal government has not filed its response brief to the plaintiffs’ claims, which are summarized below.

The plaintiffs take issue with the regulation that disregards any stock issued by a foreign corporation in prior acquisitions of U.S. corporations occurring during the three-year period prior to the inversion. They allege that the regulation was promulgated in violation of the Administrative Procedure Act because (1) it was issued without the agency providing the opportunity for notice and comment; and (2) it is arbitrary and capricious.⁴⁴ Key to the plaintiffs’ claims is their argument that the IRS knew that the agency did not have the authority to act,⁴⁵ but did so anyway once it became clear Congress was not going to amend the statute because the agency wanted to stop the proposed Pfizer-Allergan inversion (which had been announced in 2015⁴⁶). The plaintiffs characterize the regulation as:

a clear case of federal Executive Branch officers and agencies bypassing Congress and short-circuiting legislative debate over a hotly contested issue by unilaterally imposing the Administration’s preferred policy result in violation of clear statutory limits.⁴⁷

Furthermore, while noting that the IRS cites to Section 7874(c)(6) and (g) as authority for the regulation, the plaintiffs argue that the agency “offered no reasoned explanation for how these provisions authorized it to disregard transactions that were not part of a plan intended to circumvent the clear numerical thresholds of Section 7874.”⁴⁸ As noted, the federal government has not yet filed its brief responding to these allegations.

⁴¹ See Phillips, *supra* note 32.

⁴² Substantial Business Activities, 80 Fed. Reg. at 31,838.

⁴³ Complaint, Chamber of Commerce of the United States of America v. IRS, No. 1:16-cv-94481 (W.D. Tex. Aug. 4, 2016).

⁴⁴ See 5 U.S.C. §§ 553(b)(3) & (c) (requiring notice-and-comment rulemaking in certain circumstances), 706(2)(A) (forbidding agency action that is “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law”). See also CRS Report RL32240, *The Federal Rulemaking Process: An Overview*, coordinated by Maeve P. Carey; CRS Report R41546, *A Brief Overview of Rulemaking and Judicial Review*, by Todd Garvey and Daniel T. Shedd.

⁴⁵ See *Complaint*, *supra* note 43, at 11 (quoting Treasury Secretary Lew as stating, “There are a lot of obscure provisions that we do not believe we have the authority to address this inversion question through administrative action. If we did, we would be doing more. That’s why legislation is needed. That’s why we proposed it in our budget.... There are limits to what we can do without legislative action.”).

⁴⁶ See, e.g., Geoffrey Smith & Claire Groden, *Pfizer, Allergan Confirm \$160 Billion Merger Deal*, FORTUNE (Nov. 23, 2015, 8:00 a.m.), <http://fortune.com/2015/11/23/pfizer-allergan-merger/>

⁴⁷ See *Complaint*, *supra* note 43, at 1.

⁴⁸ *Id.* at 13 (also arguing that Treasury did not “acknowledge that it was changing its position from the one taken in its earlier regulations issued in June 2009 and January 2014, both of which would not have disregarded such transactions unless they were part of a plan to avoid Section 7874’s purposes”) (internal citations omitted).

Tax Treaties

12. How does Section 7874 interact with U.S. income tax treaties?

The United States has signed bilateral income tax treaties with numerous countries.⁴⁹ The primary purposes of these treaties are to reduce the incidence of double taxation and to prevent tax evasion.⁵⁰

Section 7874 contains a provision that expressly overrides tax treaties. Specifically, Section 7874(f) states:

Nothing in section 894 or 7852(d) or in any other provision of law shall be construed as permitting an exemption, by reason of any treaty obligation of the United States heretofore or hereafter entered into, from the provisions of this section.⁵¹

It might be asked whether the statute can override tax treaties. There does not seem to be any question that this override is permissible with respect to pre-existing treaties. This conclusion is reached because the Supreme Court has ruled that treaties and statutes are on equal footing under the Constitution,⁵² which provides that the Constitution, federal laws, and treaties are “the supreme Law of the Land....”⁵³ As such, the Supreme Court has ruled that treaties and statutes should generally be construed to be harmonious, but when they conflict, the one that is last in date takes precedence over the earlier one.⁵⁴ Based on these principles, courts have repeatedly determined that tax statutes override inconsistent treaty provisions when the statute was enacted after the treaty was in effect.⁵⁵

⁴⁹ See I.R.S., *United States Income Tax Treaties-A to Z*, <https://www.irs.gov/businesses/international-businesses/united-states-income-tax-treaties-a-to-z> (last visited on Aug. 31, 2016).

⁵⁰ See Convention Between the Government of the United States of America and the Government of _____ for the Avoidance of Double Taxation and the Prevention of Tax Evasion With Respect to Taxes on Income, Preamble (Feb. 17, 2016).

⁵¹ 26 U.S.C. § 7874(f). Section 894(a) provides that the IRC “shall be applied to any taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer,” while Section 7852(d) provides that when a treaty and federal tax statute conflict, “neither ... shall have preferential status by reason of its being a treaty or law.”

⁵² See *Reid v. Covert*, 354 U.S. 1, 18 (1957) (plurality opinion). (“[A]n Act of Congress ... is on a full parity with a treaty....”); *The Cherokee Tobacco*, 78 U.S. 616, 621 (1871) (“A treaty may supersede a prior act of Congress, and an act of Congress may supersede a prior treaty.”) (internal citations omitted).

⁵³ U.S. CONST. art. VI, cl. 2. In the event of a conflict between the Constitution and a treaty or a statute, the Supreme Court has held that the Constitution is controlling. *See, e.g., Reid*, 354 U.S at 17 (“This Court has regularly and uniformly recognized the supremacy of the Constitution over a treaty.”); *Cherokee Tobacco*, 78 U.S. at 620 (“It need hardly be said that a treaty cannot change the Constitution or be held valid if it be in violation of that instrument.”).

⁵⁴ *See Breard v. Greene*, 523 U.S. 371, 376 (1998) (“We have held ... ‘that when a statute which is subsequent in time is inconsistent with a treaty, the statute to the extent of conflict renders the treaty null.’”) (quoting *Reid*, 354 U.S. at 18)); *The Chinese Exclusion Case*, 130 U.S. 581, 600 (1889) (noting that in the event of a conflict between a treaty and an act of Congress, “the last expression of the sovereign will must control”); *Whitney v. Robertson*, 124 U.S. 190, 194 (1888) (“When the two [a treaty and statute] relate to the same subject, the courts will always endeavor to construe them so as to give effect to both, if that can be done without violating the language of either; but if the two are inconsistent, the one last in date will control the other, provided always the stipulation of the treaty on the subject is self-executing.”). With respect to the issue of whether a statute and treaty actually are in conflict, the Supreme Court has stated that “[a] treaty will not be deemed to have been abrogated or modified by a later statute unless such purpose on the part of Congress has been clearly expressed.” *TWA v. Franklin Mint Corp.*, 466 U.S. 243, 252 (1984) (quoting *Cook v. United States*, 288 U.S. 102, 120 (1933)).

⁵⁵ *See, e.g., Cherokee Tobacco*, 78 U.S. at 621 (holding that a federal statute imposing a tax on alcohol and tobacco overrode an earlier treaty with the Cherokee nation); *Head Money Cases*, 112 U.S. 580, 597 (1884) (stating that a law (continued...)

Thus, it seems clear that Section 7874's treaty override provision is permissible as it applies to inconsistent provisions in pre-existing treaties. However, while Section 7874(g) evidences clear congressional intent to override any conflicting provisions in future treaties as well, it may be unclear how a court would interpret such language in light of the last-in-time rule. At this time, there is no case law interpreting this provision.

Other Consequences for Corporate Inversions

13. Are there other tax consequences for corporate inversions?

In some instances, an excise tax is imposed on certain corporate insiders who benefit from a corporate inversion. Specifically, such individuals are subject to a 15% excise tax on the value of any stock compensation held by or for the benefit of the individual or his/her family during the specified time period.⁵⁶ The specified time period is the 12-month period beginning on the date which is six months prior to the date that the corporation inverts.⁵⁷ Individuals who are subject to this tax are certain beneficial owners, officers, and directors of the corporation or any of its affiliates.⁵⁸

14. Are there non-tax consequences under federal law?

There are also consequences for inverted corporations under federal procurement law. For more information, see CRS Report R43780, *Contracting with Inverted Domestic Corporations: Answers to Frequently Asked Questions*, by Kate M. Manuel and Erika K. Lunder.

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imposing a tax on immigrants would override any conflicting treaties); *Kappus v. Comm'r*, 337 F.3d 1053, 1056-57 (D.C. Cir. 2003) (holding that an IRC provision overrode the income tax treaty with Canada); *Lindsey v. Comm'r*, 98 T.C. 672, 677 (T.C. 1992) (holding that an IRC provision overrode the tax treaty with Switzerland).

⁵⁶ 26 U.S.C. § 4985(a) (added by P.L. 108-357, tit. VIII, § 802(a), 118 Stat. 1566 (2004)). *See also* 26 U.S.C. §§ 267 (defining family to mean brothers and sisters (including half-siblings), spouse, ancestors, and lineal descendants); 4985(d) (providing exceptions for certain compensation on which tax was fully paid).

⁵⁷ 26 U.S.C. §4985(a)(2), (e)(1).

⁵⁸ 26 U.S.C. § 4985(e)(1).