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CORPORATE EXPATRIATION: A CASE ANALYSIS

by

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I. INTRODUCTION

During the 1990s and early 2000s, several large U.S. companies reincorporated abroad.¹ Corporate expatriations can take many different forms. One form is a stock inversion.

In an inversion, a U.S.-based multinational corporate group forms a foreign subsidiary, typically in a country that imposes little or no corporate income tax.² Then the group reorganizes. The new foreign subsidiary becomes the parent of the group, and the existing U.S. parent becomes a subsidiary.³ As the term suggests, the corporate structure inverts. The parent's place of incorporation changes to a foreign country.

An inversion involves only a change in the group's legal structure. It has little or no effect on the company's operations.⁴ The group does not need to move its headquarters or its other business operations.⁵

This article describes a typical stock inversion, using the 2001 Ingersoll-Rand reorganization as a model. The article examines how, under the law at that time, the transaction saved substantial taxes, immediately and into the future.

This article does not describe the history of inversions. Nor does it address all the tax policy issues associated with inversions. Many authorities have previously covered those topics.⁶ The purpose of this article is simply to explore the major U.S. international tax issues by analyzing one inversion.

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1. See Office of Tax Pol'y, Dep't of Treasury, Corporate Inversion Transactions: Tax Policy Implications 1, 3 (2002) at www.treas.gov/press/releases/docs/inversion.pdf [hereinafter Treasury Inversion Study].

2. See *id.* at 1.

3. See *id.*

4. *Id.*

5. *Id.* at 15.

6. See Michael S. Kirsch, The Congressional Response to Corporate Expatriations: The Tension Between Symbols and Substance in the Taxation of Multinational Corporations, 24 Va. Tax Rev. 475 (2005); Elizabeth Chorvat, You Can't Take It With You: Behavioral Finance and Corporate Expatriations, 37 U.C. Davis L. Rev. 453 (2003); Hal Hicks, Overview of Inversion Transactions: Selected

The Ingersoll-Rand reorganization consisted of two main transactions: a merger, and an exchange of assets for stock. Sometimes this article refers to the two transactions combined as the “inversion.”

Part II of this article describes the transactions. Part II also explains some international tax concepts necessary to understand the purposes of the transactions. Part III analyzes the tax consequences of the transactions under the law that was in effect at the time. Part IV examines how the 2004 American Jobs Creation Act (AJCA) eliminated the potential tax benefits of inversions. Finally, Part V concludes that the AJCA has stopped inversions. However, the Act did not address some flaws in the U.S. international tax system that drove companies to expatriate. Further, the Act did not address abusive practices such as earnings stripping through related company debt.

II. THE TRANSACTIONS

A. *The Merger*

1. *The Facts*

Ingersoll-Rand Company was incorporated and based in New Jersey.⁷ This article refers to this corporation as IR-NJ. IR-NJ was the original U.S. parent of the multinational corporate group. IR-NJ formed a subsidiary, Ingersoll-Rand Company Limited (IR-Ltd.), a Bermuda company.⁸ Before the reorganization IR-Ltd. had no significant assets, and had not engaged in any business or other activities.⁹ IR-Ltd. in turn formed IR Merger Corp., a New Jersey subsidiary, specifically for purposes of the merger.¹⁰ See Figure 1.

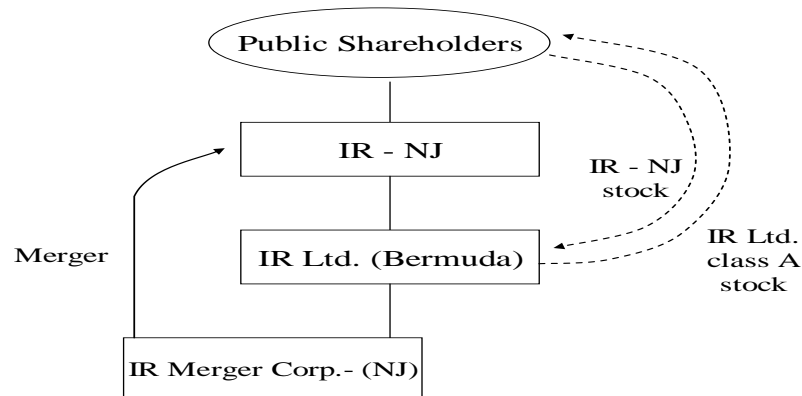
Historical, Contemporary, and Transactional Perspectives, 30 *Tax Notes Int'l* 899 (Jun. 2, 2003); John M. Peterson & Bruce A. Cohen, *Corporate Inversions: Yesterday, Today and Tomorrow*, 81 *Taxes* 161 (Mar. 2003); Treasury Inversion Study, *supra* note 1; Gregg D. Lemein & John D. McDonald, *Taxable Inversion Transactions*, 80 *Taxes* 7 (Mar. 2002); Carol P. Tello, *The Upside Down World of Corporate Inversions*, 30 *Tax Mgm't Int'l J.* 161 (2001); Willard B. Taylor, *Corporate Expatriations – Why Not?* 78 *Taxes* 146 (Mar. 2000); Boris I. Bittker & Lawrence Lokken, *Fundamentals of International Taxation* ¶ 66.2, Warren, Gorham & Lamont, (2006-07 edition) [hereinafter Bittker & Lokken].

7. Ingersoll-Rand Company, *Proxy/Prospectus*, at 6-7 (Nov. 2, 2001), available at www.shareholder.com/ir/downloads/proxybermuda.pdf [hereinafter IR *Proxy/Prospectus*].

8. *Id.* at 6.

9. *Id.* at 6-7.

10. *Id.* at 2, 6-7.

Figure 1 - Stock Inversion**Before**

On December 31, 2001, IR Merger Corp. merged into IR-NJ.¹¹ The outstanding IR-NJ common shares automatically converted into IR-Ltd. class A common shares.¹² IR-Ltd.'s shares in IR Merger Corp. converted into IR-NJ shares.¹³ IR-NJ, the surviving entity, became a wholly owned, indirect subsidiary of IR-Ltd.¹⁴

11. Ingersoll-Rand Co. Ltd. 2001 Financial Report 35 (2002).

12. IR Proxy/Prospectus, supra note 7, Annex I at 2-3 (Agreement and Plan of Merger, articles 3.1(a), 3.2(a)).

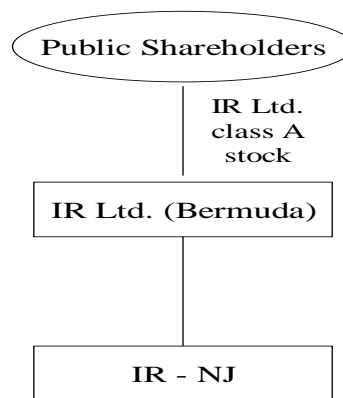
13. IR Proxy/Prospectus, supra note 7, Annex I at 3 (Agreement and Plan of Merger, article 3.1(d)).

14. IR Proxy/Prospectus, supra note 7, at 7, 17. For the purposes of analysis, this article treats the transaction as though IR-NJ became a direct subsidiary of IR-Ltd. as a result of the merger. The transaction, as described in the prospectus, appeared to cause that result. The company apparently did some additional restructuring, not mentioned in the prospectus, that caused IR-NJ to be an indirect subsidiary. One common strategy is to interpose a corporation, located in a jurisdiction with a favorable U.S. tax treaty, between the new foreign parent and the U.S. group. Therefore the dividends that the U.S. group pays to the next tier corporation are subject to a relatively low withholding tax. Peterson & Cohen, supra note 6, at 176.

As a result of the merger, IR-Ltd., a foreign corporation, replaced IR-NJ as the parent of the multinational corporate group. See Figure 2.

Figure 2 - Stock Inversion

After



According to the company's prospectus, the reorganization was to have "no material impact" on the company's day-to-day operations.¹⁵ IR-Ltd.'s principal executive offices were located at IR-NJ's headquarters in New Jersey.¹⁶ After the reorganization IR-Ltd. and its subsidiaries would continue to conduct the businesses that IR-NJ and its subsidiaries previously conducted.¹⁷ All of the directors and executive officers of IR-NJ would become directors and officers of IR-Ltd.¹⁸ Also following the merger, IR-Ltd. class A stock would trade on the New York Stock Exchange under the ticker symbol "IR," the symbol that previously represented the IR-NJ stock.¹⁹ The change of domicile to Bermuda would not affect the company's status as a member of the S&P 500 Index.²⁰

15. IR Proxy/Prospectus, *supra* note 7, at 4.

16. See *id.* at 7.

17. *Id.* at cover page, before Table of Contents on page i.

18. *Id.* at 20.

19. *Id.* at 10.

20. *Id.* at 22.

2. Tax-Related Objectives

The purpose of this transaction was to relocate the parent of the multinational group to a tax haven. Bermuda does not impose a corporate income tax on resident corporations.²¹

Before the merger IR-NJ, a domestic corporation, was the parent of the group. A corporation is a domestic corporation if it is created or organized under the law of the U.S. or of a state.²² Domestic corporations are subject to U.S. tax on their worldwide income.²³ To alleviate double taxation, the U.S. allows domestic corporations a credit for the foreign taxes they pay on their foreign source income.²⁴ However, this credit is subject to limitations.²⁵

By contrast, many other countries do not tax resident corporations on their worldwide income. Instead, they use a territorial system of taxation.²⁶ Under that system, a country only taxes income from domestic operations.²⁷ Active business income earned outside the country is exempt.²⁸

Commentators have argued that the U.S. international tax rules impose a heavier overall tax burden on U.S. multinational corporations than that borne by foreign multinationals.²⁹ This places U.S. multinationals at a competitive disadvantage.³⁰ Many U.S. companies, including Ingersoll-Rand, expatriated to lower their overall effective tax rates and remain competitive.

IR-Ltd., the new parent of the group, was a foreign corporation. Foreign corporations are only subject to U.S. tax on their nonbusiness income from U.S. sources and income effectively connected with the conduct of business in the U.S.³¹

21. See *id.* at 3; 2008ARD 059-111, Congressional Research Service Report for Congress - Firms That Incorporate Abroad for Tax Purposes: Corporate "Inversions" and "Expatriation," Updated Mar. 11, 2008 (Mar. 24, 2008) [hereinafter CRS Corporate Inversion Report].

22. 26 U.S.C. § 7701(a)(4) (CCH 2008). All section references are to the Internal Revenue Code of 1986 [hereinafter IRC or the Code], as amended, unless otherwise indicated.

23. Bittker & Lokken, *supra* note 6 ¶ 65.3.1.

24. See IRC § 901.

25. IRC § 904.

26. Charles H. Gustafson, Robert J. Peroni & Richard C. Pugh, *Taxation of International Transactions* ¶ 1070 (3rd ed. 2006).

27. See Treasury Inversion Study, *supra* note 1, at 28. In addition, most countries with territorial systems tax resident corporations on certain types of foreign source income, such as passive income. Gustafson, *et al.*, *supra* note 26 ¶ 1070.

28. Treasury Inversion Study, *supra* note 1, at 28.

29. *Id.* at 29.

30. *Id.*

31. Bittker & Lokken, *supra* note 6 ¶ 65.3.1. See IRC §§ 881 & 882.

IR-NJ was a domestic corporation. To limit IR-NJ's U.S. tax exposure, the company did some additional restructuring, described below.

B. The Transfer of Assets

1. The Facts

Also on December 31, 2001, as part of the same plan of reorganization, IR-NJ and certain of its subsidiaries transferred shares of certain existing IR-NJ subsidiaries (the "Transferred Assets"), and issued certain debt (the "Debt"), to IR-Ltd.³² In exchange IR-Ltd. issued to IR-NJ and the transferring subsidiaries IR-Ltd. class B common stock.³³ These transfers occurred before the merger transaction.³⁴ However, to facilitate understanding, Part III analyzes the tax consequences of the merger first.³⁵

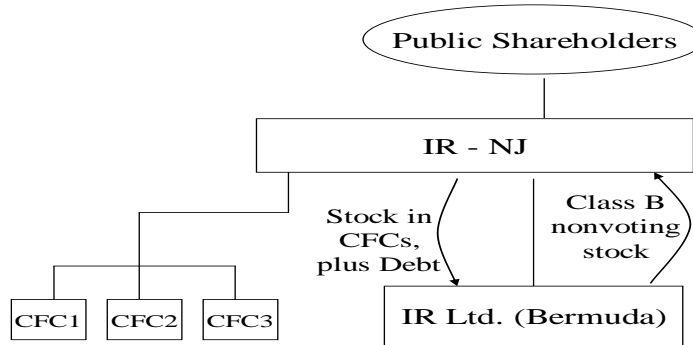
The company's prospectus did not specify which particular subsidiaries IR-NJ transferred to IR-Ltd. This article assumes that IR-NJ transferred its foreign subsidiaries, particularly those that were controlled foreign corporations (CFCs). The following section discusses CFCs. Transferring a U.S. subsidiary to a foreign parent would not save any tax. As a domestic corporation, a U.S. subsidiary is subject to U.S. taxation on its worldwide income regardless which entity is the parent of the group. See Figures 3 and 4.

32. IR Proxy/Prospectus, *supra* note 7, at 7, 17.

33. *Id.* The company stated that the B stock would not dilute the ownership interest of the class A common stockholders because only IR-NJ and other wholly owned subsidiaries of IR-Ltd would hold the B stock. *Id.* at 2.

34. Ingersoll-Rand Co. Ltd. 2001 Financial Report, *supra* note 11, at 35.

35. Other commentators generally address the merger transaction before the transfer of CFC stock. See, e.g., Peterson & Cohen, *supra* note 6, at 164-171 (discusses inversions first, but later says that the transfer of CFCs commonly occurs before the inversion). A subsidiary's ownership of parent company stock can raise some complex tax issues, not necessarily confined to the international tax field, that are outside the scope of this article. See Peterson & Cohen, *supra* note 6, at 172; Peter C. Canellos, Acquisition of Issuer Securities by a Controlled Entity: Peter Pan Seafoods, May Department Stores, and McDermott, 45 Tax Law. 1 (1991); Stephen B. Land, Strange Loops and Tangled Hierarchies, 49 Tax L. Rev. 53 (Fall 1993).

Figure 3 - Transfer of CFC Stock & Debt**Before**

The company expected that the class B shares IR-NJ received in exchange for the Assets and Debt would represent up to approximately 45% of the total value of the IR-Ltd. shares.³⁶ The class B stockholders were not entitled to vote, except in certain circumstances specified under Bermuda law.³⁷ Only IR-NJ and other wholly owned subsidiaries of IR-Ltd. would hold the B shares.³⁸ Holders would not transfer the B shares outside the group.³⁹ The B shares would not be registered with the SEC, nor would they be publicly traded.⁴⁰ If a holder transferred B shares to any person or entity other than a wholly owned, direct or indirect subsidiary of IR-Ltd., the shares would automatically convert into IR-Ltd. class A common shares on a one-

36. IR Proxy/Prospectus, *supra* note 7, at 14.

37. *Id.* at 26. Under the Bermuda Companies Act, each share of IR-Ltd. carried the right to vote regarding an amalgamation or merger. *Id.* IR-NJ and IR-Ltd. entered into a voting agreement. The agreement provided that in those limited instances where the class B shares had the right to vote, IR-NJ or any other IR-Ltd. subsidiary holding the class B shares would vote (or abstain from voting) the shares in the same proportion as the holders of IR-Ltd. class A common shares. Therefore the class B shares would not dilute the voting power of the class A shares. *Id.*

38. *Id.* at 28.

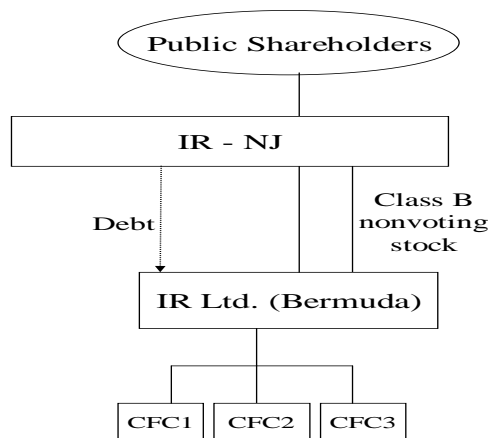
39. *Id.*

40. *Id.* at 22.

for-one basis.⁴¹ The company expected the class B shares to pay “comparable dividends to the class A common shares.”⁴²

Figure 4 - Transfer of CFC Stock & Debt

After



The class B shares were convertible into class A shares if they were (1) used in connection with a stock or deferred compensation plan of IR-Ltd. or its affiliates; or (2) used as consideration in an acquisition.⁴³ Holders of class B shares had “the right at any time following the issuance thereof upon notice to IR-Limited to require IR-Limited to purchase for cancellation any or all of the IR-Limited Class B common shares for cash at the per share fair market value of the IR-Limited Class A common shares as of the date of such notice.”⁴⁴

Considering the above features of the class B stock, especially the convertibility and the redemption at the holders’ option, the company apparently believed that the B shares were worth about the same as the A shares at the time of the reorganization.⁴⁵

41. Id. at 28.

42. Ingersoll-Rand Co. Ltd. 2001 Financial Report, *supra* note 11, at 35.

43. IR Proxy/Prospectus, *supra* note 7, at 28.

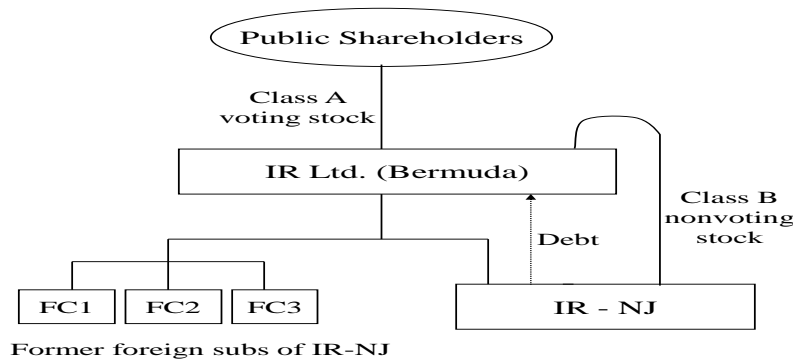
44. Id.

45. In its prospectus, issued on Nov. 2, 2001, almost 2 months before the effective date of the reorganization, the company said it expected that IR-NJ would receive class B shares representing up to approximately 45% of the total value of the

Figure 5 shows the group's structure after the company completed all the steps of the reorganization.

Figure 5 - Stock Inversion

Result at End of Day on Dec. 31, 2001



IR-Ltd. shares. IR Proxy/Prospectus, supra note 7, at 14. IR-Ltd. had 168,003,884 class A common shares issued as of Dec. 31, 2001. Ingersoll-Rand Co. Ltd. 2001 Financial Report, supra note 11, at 35. The company issued 135,250,003 class B shares to IR-NJ and its subsidiaries in the reorganization. Id. Therefore the B shares comprised 44.59959% of the total number of IR-Ltd. shares outstanding immediately after the reorganization.

If the B shares represented approximately 45% of the *number* of shares, and as predicted represented approximately 45% of the total *market value* of the shares, then it follows that the company considered the A and B shares to be nearly equal in value.

Also supporting this view is the following statement in the prospectus: "The number of IR-Limited Class B common shares owned by IR-New Jersey and other IR-Limited subsidiaries will reflect the fair market values as of the effective time of the merger of the Transferred Assets and IR-New Jersey, based on the market value of IR-New Jersey common stock at that time. We currently estimate the aggregate number of IR-Limited Class B common shares to be issued for the Transferred Assets and for the Debt to be approximately 140,000,000 shares." IR Proxy/Prospectus, supra note 7, at 7, 17.

This statement was rather obscure. It seemed to say that, to determine how many class B shares to issue in exchange for the transferred assets and debt, the company intended to use the market value of IR-NJ stock as a reference point. And it was reasonable to assume that immediately before the merger the IR-NJ stock was equal in value to the IR-Ltd. class A common stock received in exchange for the IR-NJ common stock. Indirectly, therefore, the company felt that the B stock's value closely correlated to the value of the A stock.

2. Tax-Related Objectives

The purpose of transferring the Assets was to move IR-NJ's foreign subsidiaries out from under the U.S. parent. Under a foreign parent, those subsidiaries are no longer controlled foreign corporations (CFCs) subject to the regime of subpart F.⁴⁶

Generally, the U.S. treats a corporation as a separate taxpayer from its shareholders.⁴⁷ If a U.S. corporation forms a foreign subsidiary to conduct business abroad, the U.S. tax law generally respects the foreign corporation as a separate entity from its shareholder, the U.S. parent.⁴⁸ The U.S. does not tax the parent on the subsidiary's income.⁴⁹ And the U.S. does not tax the foreign corporation on its foreign source income.⁵⁰ As discussed above, the U.S. only taxes a foreign corporation on certain income connected to the U.S.⁵¹ Therefore the foreign subsidiary's foreign earnings are not subject to U.S. tax until the subsidiary repatriates those earnings as dividends to the parent.⁵² Commentators call this concept the deferral principle.⁵³

Absent an exception to this principle, a U.S. parent could defer U.S. tax on a foreign subsidiary's earnings indefinitely simply by not paying itself a dividend.⁵⁴ To deal with perceived abuses of the deferral principle, Congress enacted several "anti-deferral" regimes.⁵⁵ The most significant regime is subpart F.⁵⁶

Under the subpart F rules, if a foreign subsidiary is a CFC, then certain income of the CFC is taxable to the U.S. parent, whether distributed or not.⁵⁷ The term "controlled foreign corporation" means any foreign corporation if "U.S. shareholders" own directly, indirectly or constructively more than 50% of either (i) the total combined voting power of all classes of stock entitled to vote, or (ii) the total value of the stock.⁵⁸

46. See Peterson & Cohen, *supra* note 6, at 170.

47. Kirsch, *supra* note 6, at 486.

48. Gustafson, et al, *supra* note 26 ¶ 6000.

49. Kirsch, *supra* note 6, at 487.

50. Gustafson, et al, *supra* note 26 ¶ 6000; Kirsch, *supra* note 6, at 487.

51. Kirsch, *supra* note 6, at 487.

52. See Treasury Inversion Study, *supra* note 1, at 11.

53. See Gustafson, et al, *supra* note 26 ¶ 6000.

54. Kirsch, *supra* note 6, at 487.

55. Gustafson, et al, *supra* note 26 ¶ 6000.

56. Kirsch, *supra* note 6, at 487-88.

57. Treasury Inversion Study, *supra* note 1, at 11-12; see IRC § 951(a). The term "subpart F" refers to where the rules are located within the Internal Revenue Code: subpart F of Part III of subchapter N of Chapter 1 of Subtitle A.

58. IRC § 957(a). The constructive ownership rules of § 318, with some modifications, apply for determining stock ownership for this purpose. IRC § 958.

A U.S. shareholder is a U.S. person who owns directly, indirectly or constructively 10% or more of the foreign corporation's voting stock.⁵⁹ A U.S. person includes an individual, corporation, partnership, estate or trust.⁶⁰ Note that the definition of "U.S. shareholder" only includes U.S. persons that own 10% or more of the stock. If the foreign corporation is publicly held, and no shareholder owns 10% or more of the voting stock, then the corporation cannot be a CFC, even if most of the shareholders are U.S. persons.

If the foreign corporation is a CFC, then each person who is a U.S. shareholder and who directly or indirectly owns stock in the foreign corporation on the last day of the year must include in income his pro rata share of the corporation's subpart F income.⁶¹ Such shareholders must also include in income their pro rata share of the foreign corporation's earnings that are invested in "U.S. property."⁶²

Subpart F income includes various types of income that taxpayers can easily shift to low-tax or no-tax foreign jurisdictions.⁶³ One type of Subpart F income is passive income, such as dividends, interest, royalties and rents.⁶⁴ Subpart F income also includes "certain business income that does not have sufficient connection to the foreign country in which the foreign subsidiary is incorporated."⁶⁵

Before the reorganization Ingersoll-Rand's foreign subsidiaries were CFCs because IR-NJ, a U.S. corporation, owned more than 50% of their stock. Therefore IR-NJ had to pay U.S. tax currently on the CFCs' subpart F income.

After the reorganization IR-Ltd., a foreign corporation, owned IR-NJ's former foreign subsidiaries. Therefore U.S. shareholders did not directly own any of the subsidiaries' stock. But our analysis does not end there. We must also analyze the indirect ownership. See Figure 6.

59. IRC § 951(b).

60. IRC §§ 951(b), 957(c), 7701(a)(30).

61. IRC § 951(a)(1)(A).

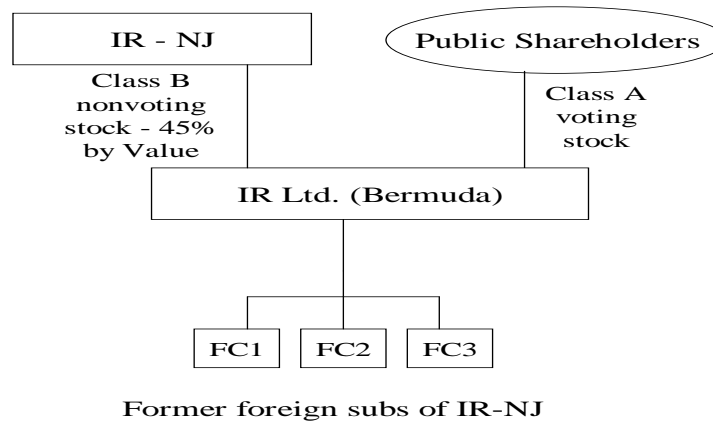
62. IRC § 951(a)(1)(B).

63. See Bittker & Lokken, *supra* note 6 ¶ 69.1.

64. IRC § 954(c) (foreign personal holding company income).

65. Kirsch, *supra* note 6, at 489. See, e.g., IRC § 954(d) (foreign base company sales income); § 954(e) (foreign base company services income). For the definition of Subpart F income, and a list of its components, see IRC §§ 952-954.

**Figure 6 –
Post-Reorganization Subpart F Analysis**



The public shareholders, shown at the top right of Figure 6, indirectly owned stock in IR-NJ's former foreign subsidiaries by reason of owning the IR-Ltd. class A stock.⁶⁶ But the class A stock was widely held by the public. It was extremely unlikely that any class A shareholder owned 10% or more of the A stock. So it was unlikely that any class A shareholder indirectly owned 10% or more of the subsidiaries. Therefore none of the public shareholders was a U.S. shareholder of the subsidiaries.⁶⁷

IR-NJ, shown at the top left of Figure 6, indirectly owned 45% of its former foreign subsidiaries by reason of owning the nonvoting B stock.⁶⁸ So IR-NJ was a U.S. shareholder of the subsidiaries.⁶⁹ But IR-NJ was the only U.S. shareholder. It indirectly owned less than 50%.

After the reorganization U.S. shareholders directly or indirectly owned less than 50% of the subsidiaries' stock. IR-NJ's former foreign subsidiaries were no longer CFCs.⁷⁰ Therefore the foreign subsidiaries' earnings were no longer potentially subject to subpart F.

Further, IR-Ltd. itself was not a CFC. Although most of its class A public shareholders were probably U.S. persons, it was extremely unlikely that any of them were "U.S. shareholders" (that is, owned 10% or more of the IR-Ltd. voting stock). IR-NJ was not a U.S. shareholder because it did

66. See IRC § 958(a)(2).

67. See IRC § 951(b).

68. See IRC § 958(a)(2).

69. IRC § 951(b).

70. IRC § 957(a).

not own any voting stock.⁷¹ So IR-Ltd. had no U.S. shareholders. Therefore it was not a CFC.⁷²

In addition, if IR-Ltd. expanded into new foreign markets in the future, those new foreign operations, as subsidiaries or branches of IR-Ltd., would similarly be outside the reach of subpart F.

The existence of the class B nonvoting stock could present some additional issues that might affect the above analysis. Part III discusses those issues. Generally, however, the reorganization effectively removed IR-Ltd. and its foreign subsidiaries from the reach of subpart F. After the reorganization the group's foreign operations were not subject to U.S. corporate level tax.⁷³

The purpose of issuing the intercompany Debt was, at least in part, so that IR-NJ could deduct the interest payments on the debt. The deduction enables IR-NJ to shield some of its U.S. earnings from U.S. taxation.⁷⁴ Using debt and other related party transactions to shift taxable income away from a domestic corporation is often referred to as "earnings stripping."⁷⁵ Part III discusses earnings stripping via intercompany debt.

In the proxy and prospectus sent to shareholders before the reorganization, the company stated that it expected to save \$50 - \$60 million in taxes in the fourth quarter of 2001 as a result of the transactions, and an additional \$40 million annually thereafter.⁷⁶ The company also said that IR-NJ would not incur significant U.S. federal income or withholding tax as a result of the merger or the related reorganization transactions.⁷⁷

III. TAX CONSEQUENCES UNDER PRIOR LAW

This part examines the tax consequences of the transactions under the law before the American Jobs Creation Act added section 7874 to the Internal Revenue Code.

A. *The Merger*

On December 31, 2001, IR Merger Corp. merged into IR-NJ. The outstanding IR-NJ common shares converted into IR-Ltd. class A common

71. See IRC § 951(b).

72. See IRC § 957(a).

73. See Treasury Inversion Study, *supra* note 1, at 14; Kirsch, *supra* note 6, at 490.

74. See H.R. Rep. No. 108-755, at 527 (2004) (Conf. Rep.), *as reprinted in* 2005 U.S.C.C.A.N. 1341, 1625.

75. See Kirsch, *supra* note 6, at 491-94.

76. IR Proxy/Prospectus, at 18.

77. *Id.* at 3.

shares. IR-Ltd.'s shares in IR Merger Corp. converted into IR-NJ shares. IR-NJ, the surviving entity, became a subsidiary of IR-Ltd.

The tax law treats the IR-NJ shareholders as if they exchanged their IR-NJ shares for the IR-Ltd. shares.⁷⁸ Next we need to determine the consequences of that exchange.

1. General Corporate Tax Provisions

Generally, whenever a person sells or exchanges property, he must recognize gain or loss on the transaction.⁷⁹ The amount of gain is the excess of the amount realized over the adjusted basis of the property sold or exchanged.⁸⁰ The amount realized is the sum of any money received plus the fair market value of any property received.⁸¹ The taxpayer's adjusted basis of the property is generally his cost, with certain adjustments.⁸²

To facilitate business restructuring, the Internal Revenue Code provides some exceptions to the rule that one must recognize gain or loss on an exchange of property. If the transaction satisfies certain requirements, then the Code defers recognition of gain or loss until a later time.⁸³ If an exception did not apply, then the IR-NJ shareholders had to recognize gain or loss when they exchanged their shares for the IR-Ltd. class A shares.

Therefore we must determine whether a corporate nonrecognition provision applied to the merger transaction. The following analysis might seem extraneous to an article on international taxation. However, we need to address these issues before we discuss section 367, which deals with foreign corporations. Sections 367(a) and (b) apply only when a corporate nonrecognition provision applies. Several provisions potentially applied to the transaction.

78. See Hicks, *supra* note 6, at 909 (states that the stock in the domestic parent converts into stock in the new foreign parent, then analyzes whether the transaction qualifies as a tax-free exchange under IRC §§ 351, 354, 367 and 368); Peterson & Cohen, *supra* note 6, at 164 (same); see also IR Proxy/Prospectus, at 7-9 (states that IR-NJ shares will automatically become IR-Ltd. class A shares, then describes the tax consequences of the "exchange" to the shareholders).

79. IRC § 1001(c).

80. IRC § 1001(a). The amount of loss is the excess of the adjusted basis over the amount realized. *Id.*

81. IRC § 1001(b).

82. IRC §§ 1011, 1012.

83. IRC § 351 provides that no gain or loss shall be recognized when property is transferred to a controlled corporation. Section 354 provides that, under certain conditions, a shareholder recognizes no gain or loss when stock or securities are exchanged in a reorganization. Similarly, § 361 provides that, under certain conditions, a corporation recognizes no gain or loss when stock or securities are exchanged in a reorganization. A reorganization is defined in § 368.

The merger, combined with the asset transfers, qualified as a section 351 transfer. Section 351 provides that “No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control ... of the corporation.”⁸⁴ “Control” means “the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.”⁸⁵

A threshold issue is that section 351 requires a transfer to the controlled corporation. But the public shareholders did not actually transfer their IR-NJ shares to IR-Ltd. IR-Ltd. acquired the IR-NJ shares indirectly as a result of the merger.

However, the end result of all the steps in the transaction was the same as if the IR-NJ public shareholders actually transferred their shares to IR-Ltd. We disregard the transitory existence of IR-Merger Corp.⁸⁶ The merger was merely a means of transferring the IR-NJ stock to IR-Ltd.,⁸⁷ and a means of transferring the IR-Ltd. class A stock to the IR-NJ shareholders. Therefore we analyze the transaction as though the IR-NJ shareholders actually transferred their IR-NJ shares to IR-Ltd. in exchange for IR-Ltd. shares.⁸⁸

Standing alone, this exchange did not qualify as a section 351 transfer because the public shareholders alone were not in control of IR-Ltd. immediately after the exchange. The public shareholders owned all of the voting stock, but none of the other classes of stock. On the same day, before the merger, IR-NJ acquired all of the class B nonvoting stock in exchange for the Assets and Debt.

However, the merger and Asset Transfer were parts of an integrated plan. The step transaction doctrine applies to collapse both exchanges into one integrated transaction. Under the step transaction doctrine, “an integrated transaction must not be broken into independent steps.”⁸⁹ Conversely, “the separate steps must be taken together in attaching tax consequences.”⁹⁰

84. IRC § 351(a).

85. IRC § 368(c).

86. Rev. Rul. 67-448, 1967-2 C.B. 144; Peterson & Cohen, *supra* note 6, at 164. Rev. Rul. 67-448 is an application of the step transaction doctrine, discussed below. The ruling involved a B reorganization, but its rationale applies to § 351 transfers as well. See P.L.R. 200049026 (Dec. 11, 2000).

87. See Peterson & Cohen, *supra* note 6, at 164.

88. See *id.*

89. Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 1.05[2][d] (Warren, Gorham & Lamont, 7th Ed. 2000) [hereinafter Bittker & Eustice].

90. *Id.*

IR-NJ and the public shareholders collectively transferred property to IR-Ltd. solely in exchange for stock. The public shareholders transferred their IR-NJ shares in exchange for class A stock. IR-NJ transferred the Assets and Debt in exchange for class B stock. Immediately after the transfers, the public shareholders and IR-NJ collectively were in control of IR-Ltd. The public shareholders owned 100% of the IR-Ltd. class A voting stock. IR-NJ owned 100% of the B stock, the only other class of stock. Therefore all the transfers to IR-Ltd. qualified under section 351.⁹¹

The merger, standing alone, also likely qualified as a B reorganization. Section 368(a)(1)(B) defines a “B” reorganization as the acquisition by one corporation, in exchange solely for all or a part of its voting stock or its parent’s voting stock, of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of the other corporation.⁹²

We need to address a threshold issue similar to the issue discussed above regarding section 351. Typically, a B reorganization involves a stock-for-stock exchange between the target shareholders and the acquiring corporation.⁹³ But the IR-NJ shareholders did not actually transfer their shares to IR-Ltd. IR-Ltd. acquired the IR-NJ shares indirectly as a result of the merger.

However, the end result of all the steps in the transaction was the same as if the IR-NJ public shareholders actually transferred their shares to IR-Ltd. in exchange for the IR-Ltd. class A shares. We disregard the transitory existence of IR-Merger Corp.⁹⁴ The merger was merely a means of transferring the IR-NJ stock to IR-Ltd.,⁹⁵ and a means of transferring the IR-Ltd. class A stock to the IR-NJ shareholders. Therefore we analyze the transaction as though the IR-NJ shareholders actually transferred their IR-NJ shares to IR-Ltd. in exchange for IR-Ltd. shares.⁹⁶

IR-Ltd. acquired stock in IR-NJ in exchange for its own voting stock. After the transaction IR-Ltd. had control of IR-NJ. The transaction met the statutory definition of a B reorganization.

There is another possible issue. For an exchange to qualify as a “B” reorganization, the acquiring corporation must acquire the stock of the target “solely for all or a part of its *voting* stock.”⁹⁷ On the same day as the purported reorganization, IR-Ltd. issued class B stock to IR-NJ and its

91. See Peterson & Cohen, *supra* note 6, at 171 & n.71.

92. IRC § 368(a)(1)(B).

93. Bittker & Eustice, *supra* note 89 ¶ 12.23[4].

94. Rev. Rul. 67-448, 1967-2 C.B. 144; Peterson & Cohen, *supra* note 6, at 164; Hicks, *supra* note 6, at 909.

95. Peterson & Cohen, *supra* note 6, at 164.

96. See *id.*

97. IRC § 368(a)(1)(B) (emphasis added).

subsidiaries. The class B stockholders could not vote, except in limited circumstances specified under Bermuda law.⁹⁸ The IRS might argue, using the step transaction doctrine, that using the nonvoting B stock disqualified the transaction as a B reorganization.

But IR-Ltd. did not acquire any IR-NJ stock in exchange for the B stock. It acquired other assets, namely stock in IR-NJ's subsidiaries and a note. The exchange of assets and debt for the B stock should not affect the status of the B reorganization.⁹⁹

Besides meeting the definition in the statute, a reorganization must satisfy some judicially created requirements.¹⁰⁰ One requirement is the continuity of business enterprise (COBE).¹⁰¹ The acquiring corporation must continue the business enterprise of the target under modified corporate form.¹⁰² On the same day as the purported reorganization, IR-NJ transferred stock in its foreign subsidiaries to IR-Ltd. Using the step transaction doctrine, the IRS might argue that this transfer disqualified the B reorganization because IR-NJ disposed of some of its business assets before the reorganization, partially destroying the continuity of the business.¹⁰³

But IR-NJ transferred the stock to IR-Ltd., the acquiring corporation. This transfer should not violate the COBE requirement.¹⁰⁴ Therefore the merger likely qualified as a B reorganization.

The merger also appeared to qualify as an A reorganization pursuant to section 368(a)(2)(E).¹⁰⁵ That provision authorizes a merger using the

98. IR Proxy/Prospectus, *supra* note 7, at 26.

99. See Bittker & Eustice, *supra* note 89 ¶ 12.23[3] (the acquiring corporation can use consideration other than voting stock to acquire various properties owned by the target corporation without affecting the B reorganization).

100. *Id.* ¶ 12.60.

101. See *id.* ¶ 12.61[2].

102. Treas. Reg. § 1.368-1(b); Bittker & Eustice, *supra* note 89 ¶ 12.61[2][a].

103. The COBE requirement applies to type B reorganizations. Rev. Rul. 81-92, 1981-1 C.B. 133.

104. See Treas. Reg. § 1.368-1(d)(5), Example 1. Target sold 2 of 3 equally sized businesses to an unrelated third party before a C reorganization. The acquiring corporation continued to operate the third business after the reorganization. The transaction met the COBE requirement. If the target can sell two-thirds of its assets to an unrelated third party before the reorganization, then arguably it should be allowed to transfer stock in some of its subsidiaries to another member of the corporate group (the new parent company) in a partially or fully taxable transaction without violating COBE.

105. Lee A. Sheppard, Ingersoll-Rand's Permanent Holiday, 93 Tax Notes 1528, 1530 (Dec. 17, 2001). An "A" reorganization is a statutory merger or consolidation. IRC § 368 (a)(1)(A). Section 368(a)(2)(E) provides that a transaction otherwise qualifying as a statutory merger or consolidation shall not be disqualified

voting stock of a corporation controlling the merged subsidiary. IR Merger Corp. merged into IR-NJ. The IR-NJ shareholders received voting stock in IR-Ltd., the corporation that controlled IR Merger Corp.

However, section 368(a)(2)(E)(i) requires that the surviving corporation (IR-NJ) continue to hold “substantially all of its properties” after the transaction.¹⁰⁶ On the same day as the merger, IR-NJ transferred stock in its subsidiaries to IR-Ltd. Therefore the IRS could use the step transaction doctrine to argue that the merger failed to satisfy that provision.

In summary, the merger qualified for nonrecognition of gain or loss under at least one provision. The merger, combined with the asset transfers, definitely qualified as a section 351 transfer. The merger probably also qualified as a B reorganization. It might also have qualified as an A reorganization pursuant to section 368(a)(2)(E).

Before applying section 367, we determined that the IR-NJ shareholders did not have to recognize gain or loss when they exchanged their IR-NJ shares for the IR-Ltd. shares. Next we need to determine whether section 367 changed this result.

2. Section 367

Section 367(a)(1) provides that, for purposes of determining gain, if a U.S. person transfers property to a foreign corporation in an otherwise qualifying exchange, the foreign corporation shall not be considered a corporation.¹⁰⁷ This provision effectively denies nonrecognition of gain treatment for such transactions. Section 367 imposes a tax, or “toll charge,” when a U.S. person transfers appreciated property beyond the U.S. taxing jurisdiction.¹⁰⁸

Section 367(a)(6) authorizes the Treasury to except certain transfers by regulations.¹⁰⁹ Treasury Regulations section 1.367(a)-3(c)(1) applies when U.S. persons transfer stock or securities of a domestic corporation to a foreign corporation.¹¹⁰ The regulations provide that a transfer will not be subject to section 367(a)(1) if the following four conditions are satisfied:¹¹¹

if stock of a corporation controlling the merged corporation is used in the transaction, provided certain other requirements are satisfied. IRC § 368(a)(2)(E).

106. IRC § 368(a)(2)(E)(i).

107. IRC § 367(a)(1). The statute is artfully drafted so that *losses* are *not* recognized. Treas. Reg. § 1.367(1)-1T(b)(3)(ii).

108. See Gustafson, et al, *supra* note 26 ¶ 10,000.

109. IRC § 367(a)(6).

110. Treas. Reg. § 1.367(a)-3(c)(1). The Treasury promulgated these regulations in response to the 1994 Helen of Troy inversion. Hicks, *supra* note 6, at 905-07.

111. Treas. Reg. § 1.367(a)-3(c)(1). In addition, the domestic corporation (target company) must comply with certain reporting requirements. *Id.*

- (i) U.S. transferors, in the aggregate, receive in the transfer 50% or less of the total voting power and value of the transferee corporation's stock (the 50% ownership threshold);¹¹²
- (ii) U.S. persons that are officers, directors or 5% shareholders, in the aggregate, own 50% or less of the total voting power and value of the transferee corporation's stock immediately after the transfer;¹¹³
- (iii) The transferor is either
 - (A) not a 5% transferee shareholder; or
 - (B) must enter into a 5-year gain recognition agreement;¹¹⁴ and
- (iv) The active trade or business test is satisfied.¹¹⁵ This test requires that
 - (A) the transferee or its qualified subsidiary be engaged in an active trade or business outside the U.S. for the entire 36-month period immediately before the transfer;
 - (B) At the time of the transfer, neither the transferors nor the transferee have an intention to substantially dispose of or discontinue such trade or business; and
 - (C) The substantiality test is satisfied.¹¹⁶ This last test requires that, at the time of the transfer, the fair market value of the transferee corporation is at least equal to the fair market value of the U.S. target company.¹¹⁷

The Ingersoll-Rand inversion obviously failed the first and fourth requirements. It failed requirement (i) because the IR-NJ public shareholders acquired 100% of the IR-Ltd. class A voting stock, violating the 50% ownership threshold. It failed requirement (iv) because IR-Ltd. did not engage in an active trade or business before the merger.¹¹⁸

112. Treas. Reg. § 1.367(a)-3(c)(1)(i).

113. Treas. Reg. § 1.367(a)-3(c)(1)(ii).

114. Treas. Reg. § 1.367(a)-3(c)(1)(iii).

115. Treas. Reg. § 1.367(a)-3(c)(1)(iv).

116. Treas. Reg. § 1.367(a)-3(c)(3)(i).

117. Treas. Reg. § 1.367(a)-3(c)(3)(iii).

118. See IR Proxy/Prospectus, at 6-7. The merger transaction presents one additional minor issue. Section 367(a)(1) literally applies when a U.S. person transfers property to a foreign corporation. But the shareholders did not actually transfer anything to IR-Ltd. As explained above, the IR-NJ stock converted automatically into IR-Ltd. class A stock without any need for an actual exchange. The regulations, however, make it clear that section 367(a)(1) "applies to such a transfer whether it is made directly, indirectly or constructively." Treas. Reg. § 1.367(a)-1T(c)(1).

Therefore section 367(a)(1) applied to the merger. Each shareholder recognized gain to the extent that the fair market value of the IR-Ltd. stock he received exceeded his basis in the IR-NJ stock.¹¹⁹

But if a shareholder's adjusted basis in the IR-NJ stock was higher than the fair market value of the IR-Ltd. stock received, he did not recognize the loss.¹²⁰ Instead, the shareholder's basis in the new IR-Ltd. stock received was equal to his basis in the old IR-NJ stock.¹²¹ Therefore the shareholder could recognize the loss, or less gain, when he later sold the IR-Ltd. stock.¹²²

When the Treasury adopted the above quoted regulations in the 1990s, commentators assumed that the potential tax on shareholder level gain was sufficient to deter most inversion transactions.¹²³ However, stock values declined in the early 2000s. This decline meant that shareholders would recognize only a modest gain, or no gain, in the inversion transaction, making an expatriation more feasible.¹²⁴ In addition, shareholders that are either "tax-exempt, such as pension funds, or tax-indifferent, such as mutual funds" own a significant amount of stock of U.S. multinationals.¹²⁵

There were no tax consequences at the corporate level. The merger between IR-NJ and IR Merger Corp. was between two domestic corporations, so section 367(a) did not apply.¹²⁶ IR-NJ, the surviving corporation, did not undergo any corporate level transaction in the merger, so it recognized no gain or loss.¹²⁷ IR-Ltd., the acquiring corporation, was not subject to any meaningful U.S. tax consequences.¹²⁸

119. IRC §§ 367(a), 1001.

120. Treas. Reg. § 1.367(a)-1T(b)(3)(ii). Section 367(a) only applies for the "purposes of determining the extent to which *gain* shall be recognized." IRC § 367(a)(1) (emphasis added). If the shareholder realized a loss, § 367(a) did not apply. Therefore the normal corporate nonrecognition provisions, such as §§ 351 or 354, still applied, so that the loss was not recognized.

121. IRC § 358(a).

122. In its proxy and prospectus, the company stated that the above would be the tax consequences of the reorganization to the shareholders. IR Proxy/Prospectus, supra note 7, at 8-9, 48-49.

123. See Hicks, supra note 6, at 906-07; Peterson & Cohen, supra note 6, at 165.

124. See Kirsch, supra note 6, at 495-96.

125. Peterson & Cohen, supra note 6, at 165. Also, foreign taxpayers are exempt from tax on the gain. Kirsch, supra note 6, at 495-96.

126. See Bittker & Lokken, supra note 6 ¶ 71.1.3, example 4a.

127. See Peterson & Cohen, supra note 6, at 165; Hicks, supra note 6, at 909. The transaction should not have caused the IR-NJ U.S. consolidated group to terminate. See Hicks, supra note 6, at 909.

128. See Hicks, supra note 6, at 909.

B. *The Transfer of Assets*

1. *Introductory Issues*

In the reorganization IR-NJ and certain of its subsidiaries transferred shares of certain existing IR-NJ subsidiaries (the “Transferred Assets”), and issued certain debt, to IR-Ltd. In exchange, IR-Ltd. issued “that number of IR-Limited Class B common shares that” had “an aggregate value equal to the fair market value of the Transferred Assets and the amount of the Debt.”¹²⁹ As noted above, these transfers occurred before the merger.¹³⁰

This exchange had to be for fair market value.¹³¹ Section 482 requires that exchanges between commonly controlled entities be at arm’s length.¹³² If the U.S. transferor receives stock that has less value than the assets transferred, the IRS could attempt to characterize the shortfall as a deemed dividend to the foreign parent, which would be subject to withholding tax.¹³³ In this case the transfer occurred before IR-NJ became a subsidiary of IR-Ltd. Therefore the IRS would have to use the step transaction doctrine or another theory to characterize any shortfall as a dividend. Nevertheless, the company acknowledged in its prospectus that there was a possibility of U.S. withholding tax if the IRS successfully disputed the value of the Transferred Assets.¹³⁴

2. *Corporate Nonrecognition Provisions*

The next step is to determine whether a nonrecognition provision covered this exchange. The exchange qualified under section 351. IR-NJ transferred assets to IR-Ltd. in exchange for IR-Ltd. stock. Immediately after the exchange IR-NJ owned all the IR-Ltd. stock, so IR-NJ was in control of IR-Ltd.¹³⁵ (Recall that the asset transfer occurred before the merger.)

129. IR Proxy/Prospectus, supra note 7, at 7, 17.

130. Ingersoll-Rand Co. Ltd. 2001 Financial Report, supra note 11, at 35.

131. See Peterson & Cohen, supra note 6, at 170; Treasury Inversion Study, supra note 1, at 10-11.

132. See Bittker & Lokken, supra note 6 ¶ 79.1.1. In the case of two or more organizations owned or controlled directly or indirectly by the same interests, § 482 authorizes the Secretary of the Treasury to distribute, apportion, or allocate gross income, deductions, credits or allowances between or among such organizations if he determines that such reallocation is necessary to prevent the evasion of taxes or clearly to reflect income. IRC § 482.

133. Treasury Inversion Study, supra note 1, at 10-11.

134. IR Proxy/Prospectus, supra note 7, at 14.

135. See IRC §§ 351(a), 368(c). Alternatively, since the company executed the merger and the accompanying transfers all on the same day pursuant to an integrated plan, the step transaction doctrine could apply to collapse the merger with

The exchange did not qualify for nonrecognition under any other provision.¹³⁶

3. Section 367

Before applying section 367, we determined that IR-NJ did not have to recognize gain or loss on the exchange.¹³⁷ Next we need to examine whether section 367 changed this result.

a. Section 367(a)

Section 367(a)(1) provides that, for purposes of determining gain, if a U.S. person transfers property to a foreign corporation in an otherwise qualifying exchange, the foreign corporation shall not be considered a

IR-NJ's transfer of subsidiary stock and debt into one integrated transaction. When the doctrine applies, both the public shareholders and IR-NJ are "transferors," and both are included in the "control group." Therefore all the transfers to IR-Ltd. qualify under § 351. Part III.B.3 below discusses the application of the step transaction doctrine to the asset transfers.

One might ask if § 304 applied to this exchange. That section provides that, if one or more persons are in control of each of two corporations, and in return for property, one of the corporations acquires stock in the other corporation from the person in control, then the property shall be treated as a distribution in redemption. IRC § 304(a)(1). Before the inversion IR-NJ was in control of its CFCs and of IR-Ltd. Then IR-Ltd. acquired stock of the CFCs from IR-NJ. But IR-Ltd. used its own class B stock to acquire the CFC stock. Stock in the corporation making the distribution is not "property" within the meaning of § 304. IRC § 317(a). Therefore § 304 did not apply. See Bittker & Eustice, *supra* note 89 ¶ 12.63[4][d].

136. At first glance, the exchange of assets and debt for B stock might have qualified for nonrecognition as a D reorganization. A "D" reorganization is "a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders..., or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356." IRC § 368(a)(1)(D). IR-NJ transferred part of its assets to IR-Ltd., a corporation that IR-NJ controlled immediately after the transfer. So the exchange satisfied the first phrase of the statute. But the exchange did not satisfy the last phrase because IR-NJ did not distribute any of the B stock that it received from IR-Ltd. Therefore the exchange did not qualify as a D reorganization.

137. Even if § 351 did not apply, IR-NJ could not recognize a loss upon transferring the assets, because § 267 denies recognition of losses on certain transfers between related parties. Treasury Inversion Study, *supra* note 1, at 10. IR-Ltd. recognized no gain or loss on the exchange. IRC § 1032.

corporation.¹³⁸ Section 367(a)(2) provides that, except as provided in regulations, the general rule of section 367(a)(1) does not apply to the transfer of stock or securities of a foreign corporation which is a party to the exchange.¹³⁹ Section 1.367(a)-3(a) of the regulations provides that a U.S. person's transfer of foreign stock or securities to a foreign corporation is taxable unless the exceptions provided in section 1.367(a)-3(b) apply.¹⁴⁰ That section states that a U.S. person's transfer of stock or securities of a foreign corporation to a foreign corporation shall not be subject to section 367(a)(1) if either:

- (i) The U.S. person owns less than 5% of both the total voting power and value of the transferee corporation's stock immediately after the transfer; or
- (ii) The U.S. person enters into a five-year gain recognition agreement (GRA).¹⁴¹

In its prospectus, the company stated that after the transfer, IR-NJ's class B common shares would constitute up to approximately 45% of the total value of the IR-Ltd. shares.¹⁴² IR-NJ obviously owned more than 5% of IR-Ltd., by value, after the exchange. Therefore clause (i) of the above regulations did not apply. However, under clause (ii), IR-NJ could avoid gain recognition by entering into a GRA, if it chose to do so.¹⁴³

If the company did not enter into a GRA, it would have recognized gain, but no loss, on the exchange.¹⁴⁴ If the company recognized gain, section 1248 probably applied to the gain.¹⁴⁵

Section 1248 applies if a U.S. person sells or exchanges stock in a foreign corporation, and the U.S. person owned 10% or more of the voting power of the stock at any time during the 5-year period ending on the date of the sale or exchange, when the foreign corporation was a CFC.¹⁴⁶ Section

138. IRC § 367(a)(1).

139. IRC § 367(a)(2).

140. Treas. Reg. § 1.367(a)-3(a).

141. Treas. Reg. § 1.367(a)-3(b)(1).

142. IR Proxy/Prospectus, *supra* note 7, at 14.

143. See Peterson & Cohen, *supra* note 6, at 171. Gain recognition agreements present an interesting planning opportunity. Generally, the corporate tax provisions are not elective. If a nonrecognition provision covers a transaction, the taxpayer recognizes no gain or loss, whether that result is to his advantage or not. But in some circumstances, under § 367, if a taxpayer is eligible for a GRA, he can effectively choose to recognize gain (but not loss), if that is to his advantage, by simply not entering into an agreement.

144. IRC § 367(a).

145. See Treas. Reg. § 1.367(a)-3(b)(2)(ii), Example, part (ii).

146. IRC § 1248(a).

1248 recharacterizes the gain as a dividend to the extent of the CFC's earnings and profits, attributable to the stock transferred, which were accumulated while the U.S. person held the stock and while the subsidiary was a CFC.¹⁴⁷ The purpose of section 1248 is to ensure that undistributed earnings and profits of the CFC that were not previously taxed to the shareholder under subpart F are taxed as a dividend, rather than as capital gain.¹⁴⁸

If IR-NJ recognized gain, section 1248 likely characterized some of that gain as a dividend from the CFCs. This dividend income was foreign source income.¹⁴⁹ The dividend came with an important tax benefit.

Under section 902, if a domestic corporation receives a dividend from a foreign corporation, and it owns at least 10% of the foreign corporation's voting stock, then the domestic corporation is eligible for an indirect foreign tax credit.¹⁵⁰ The domestic corporation is deemed to have paid a portion of the foreign corporation's foreign income taxes.¹⁵¹ The domestic corporation can claim a credit for the foreign taxes deemed paid, subject to the same limitations that apply to foreign taxes actually paid.¹⁵²

The domestic corporation computes the foreign tax deemed paid by multiplying the foreign corporation's foreign tax by a fraction.¹⁵³ The numerator of the fraction is the amount of the dividend.¹⁵⁴ The denominator is the foreign corporation's undistributed earnings.¹⁵⁵

The indirect credit is also available when another Code section characterizes an amount as a "dividend," even though there was no actual distribution.¹⁵⁶ A deemed dividend under sections 367(b) or 1248 is treated as a dividend for purposes of section 902.¹⁵⁷ Therefore, if IR-NJ recognized dividend income under section 1248, the company could claim a credit for the foreign taxes that the CFCs paid on the earnings deemed distributed.¹⁵⁸

147. *Id.*

148. Bittker & Lokken, *supra* note 6 ¶ 69.14.

149. See *id.* ¶ 73.6.5 (General source rules for gain on disposition of foreign stock do not apply to any amount characterized as a dividend under § 1248 because the source rules for dividends apply to this amount). Dividends from a foreign corporation are generally foreign source income. *Id.* ¶ 73.3.

150. See IRC § 902(a).

151. *Id.*

152. Bittker & Lokken, *supra* note 6 ¶ 72.9.1; see IRC § 901(a).

153. Bittker & Lokken, *supra* note 6 ¶ 72.9.3.

154. *Id.*; see IRC § 902(a).

155. Bittker & Lokken, *supra* note 6 ¶ 72.9.3; see IRC § 902(a).

156. Bittker & Lokken, *supra* note 6 ¶ 72.9.2.

157. *Id.*; Treas. Reg. § 1.902-1(a)(11).

158. See IRC § 902(a); Treas. Reg. § 1.1248-1(d); Bittker & Lokken, *supra* note 6 ¶ 69.14.

Gain in excess of the dividend portion would have been capital gain. Under section 865, when a U.S. corporation sells or exchanges stock in a foreign corporation, the capital gain is U.S. source, unless the exceptions in sections 865(f) or 865(h) apply.¹⁵⁹ If the capital gain was significant, it might have been to the company's advantage to enter into a GRA.

b. Section 367(b)

But even if the company entered into a GRA, section 367(b) probably required IR-NJ to recognize income anyway.¹⁶⁰ The regulations state that certain transfers might be subject to both sections 367(a) and 367(b).¹⁶¹

Section 367(b) provides that in the case of an otherwise qualifying exchange where "there is no transfer of property described in" section 367(a)(1), "a foreign corporation shall be considered to be a corporation except to the extent provided in regulations"¹⁶² Therefore we need to determine whether the section 367(b) regulations applied to the exchange.

Section 1.367(b)-4 of the regulations requires a shareholder to include in income as a deemed dividend the "section 1248 amount" when an exchange results in the loss of status as a section 1248 shareholder.¹⁶³ The section 1248 amount is the net positive earnings and profits that would have been attributable to the CFC stock and includible in income as a dividend under section 1248 if the transferor had sold the stock.¹⁶⁴ The purpose of this

159. IRC § 865(a)(1), (i)(2). Section 865(f) provides that if (1) a U.S. resident sells stock in an affiliate which is a foreign corporation, (2) such sale occurs in a foreign country in which the affiliate is engaged in the active conduct of a trade or business, and (3) more than 50% of the affiliate's gross income for the previous 3 years was derived from the active conduct of a trade or business in such foreign country, then any gain from such sale shall be sourced outside the U.S. In this case, the transfer took place at Ingersoll-Rand's New Jersey headquarters, not in a foreign country. Therefore § 865(f) did not apply. Section 865(h) provides that if gain would otherwise be U.S. source, but under a treaty would be foreign source, the taxpayer may elect to follow the treaty source rule.

160. Even if a transferor enters into a GRA, the concurrent application of the section 367(b) regulations might require the transferor to recognize the "section 1248 amount" on the exchange. Treas. Reg. § 1.367(a)-3(b)(2)(ii), Example. This example uses a B reorganization. However, the last sentence of the explanation states that the result would be unchanged if the exchange qualified as a § 351 exchange. *Id.* at (iii) in the example.

161. Treas. Reg. § 1.367(a)-3(b)(2)(i).

162. IRC § 367(b)(1). The regulations seem to take the approach that, if the taxpayer enters into a GRA, then the transfer is "not described in" § 367(a)(1), thereby triggering further scrutiny under § 367(b).

163. Treas. Reg. § 1.367(b)-4(b)(1).

164. Treas. Reg. § 1.367(b)-2(c)(1).

rule is “to prevent nonrecognition transactions from erasing the potential for applying section 1248 to U.S. shareholders’ stock sales.”¹⁶⁵

A section 1248 shareholder is a U.S. person that owns directly, indirectly or constructively 10% or more of the voting stock of the foreign corporation at any time during the 5-year period ending on the date of the sale or exchange, when the corporation was a controlled foreign corporation.¹⁶⁶ A loss of status as a section 1248 shareholder occurs if the exchanging shareholder was a section 1248 shareholder before the exchange, but after the exchange the stock he received is not stock in a corporation that is a CFC, as to which he is a section 1248 shareholder.¹⁶⁷

Before the asset transfer, IR-NJ was a section 1248 shareholder with respect to its former CFCs. In exchange for the assets and debt, IR-NJ received the IR-Ltd. B stock. Immediately after this transfer, but before the merger, IR-Ltd. was still a CFC of IR-NJ. So IR-NJ was still a section 1248 shareholder with respect to IR-Ltd. Therefore the asset transfer alone did not cause IR-NJ to lose its status as a section 1248 shareholder.

In a 2003 article Peterson & Cohen pointed out that the IRS could use the step transaction doctrine to argue that the section 367(b) regulations applied to the exchange.¹⁶⁸ The merger and the accompanying transfers both took place on the same day, pursuant to an integrated plan. Under the step transaction doctrine, we collapse the two transactions together into one transaction.¹⁶⁹ This integrated transaction still qualified as a section 351 exchange. IR-NJ and the public shareholders collectively contributed property to IR-Ltd. in exchange for stock.¹⁷⁰ Immediately thereafter, IR-NJ and the public shareholders collectively controlled IR-Ltd.¹⁷¹

After this integrated section 351 exchange, IR-Ltd. was not a CFC. As a public company, it likely had no U.S. shareholders (that is, no U.S. persons owning 10% or more of the voting stock).¹⁷²

Using the step transaction doctrine to collapse the two transactions into one integrated exchange, the IRS could successfully contend that the section 367(b) regulations applied to the exchange. Before the exchange IR-NJ was a section 1248 shareholder with respect to its former CFCs. In the exchange, IR-NJ received the B stock in IR-Ltd., which was not a CFC. Therefore IR-NJ lost its status as a section 1248 shareholder. Consequently,

165. Bittker & Lokken, *supra* note 6 ¶¶ 71.2.1; see generally *id.* ¶ 71.2.3.

166. Treas. Reg. § 1.367(b)-2(b); IRC § 1248(a)(2).

167. Treas. Reg. § 1.367(b)-4(b)(1).

168. Peterson & Cohen, *supra* note 6, at 171.

169. *Id.*

170. See IRC § 351(a).

171. See IRC § 368(c); Peterson & Cohen, *supra* note 6, at 171 n.71.

172. See IRC §§ 951(b), 957(a).

IR-NJ had to include the section 1248 amount in income as a deemed dividend, even if the company entered into a GRA.¹⁷³

The deemed dividend from the CFCs was foreign source income. A deemed dividend is treated as a dividend for all purposes of the Internal Revenue Code.¹⁷⁴ Therefore, under section 902, IR-NJ could claim an indirect credit for the foreign taxes that the CFCs paid on the earnings deemed distributed.¹⁷⁵

c. Result Under Section 367

Without access to the company's tax returns and other relevant details, it is difficult to know for sure whether IR-NJ (a) recognized gain under section 367(a), and then recharacterized some or all of that gain as dividend income under section 1248; or (b) recognized the section 1248 amount as dividend income under section 367(b). The company probably recognized significant dividend income under one provision or the other. However, under section 902, the company could claim an indirect credit for the foreign taxes that the CFCs paid on the earnings deemed distributed. In its 2001 Financial Report, the company stated "As a result of the reincorporation from New Jersey to Bermuda, the company recorded a one time tax benefit of \$59.8 million related to the utilization of previously limited foreign tax credits and net operating loss carryforwards in certain non-U.S. jurisdictions."¹⁷⁶

173. Treas. Reg. § 1.367(a)-3(b)(2). The actual transactions were more complex. Besides transferring its own direct subsidiaries, IR-NJ transferred some lower-tier subsidiaries. IR Proxy/Prospectus, *supra* note 7, at 7. The regulations provide that "a deemed dividend coming from earnings and profits of a lower-tier subsidiary is deemed distributed through the chain of ownership." Bittker & Lokken, *supra* note 6 ¶ 71.2.6; Treas. Reg. § 1.367(b)-2(e)(2).

174. Treas. Reg. § 1.367(b)-2(e)(2); Bittker & Lokken, *supra* note 6 ¶ 71.2.6.

175. See IRC § 902(a); Treas. Reg. § 1.367(b)-2(e)(4), Example 1; Bittker & Lokken, *supra* note 6 ¶ 71.2.6.

176. Ingersoll-Rand Co. Ltd. 2001 Financial Report, *supra* note 11, at 39. The company's 2007 Annual Report disclosed that, in the audit of tax years 2001 and 2002, the Internal Revenue Service proposed some adjustments. The Service did not contest the validity of the reincorporation transactions. However, the IRS proposed to treat the intercompany Debt as equity. As a result, the IRS disallowed the deduction for interest paid on the debt. The IRS recharacterized the interest payments as dividends, and it imposed dividend withholding taxes on those payments. The company has filed a formal written protest. Ingersoll-Rand Co. Ltd. 2007 Annual Report (Form 10-K), at 12 (Feb. 29, 2008).

C. Future Tax Consequences

1. IR-Ltd., The New Parent Company

As a result of the reorganization, IR-Ltd., a foreign corporation, became the parent of the multinational group. A foreign corporation is only subject to U.S. tax on its nonbusiness U.S. source income and income effectively connected with the conduct of business in the U.S.¹⁷⁷

IR-Ltd. owned the group's foreign operations. As discussed in Part II, those foreign operations were not subject to U.S. corporate level tax. And Bermuda has no corporate income tax.¹⁷⁸ Further, Bermuda does not impose a withholding tax on dividends that a Bermuda corporation pays to its foreign shareholders.¹⁷⁹

IR-NJ, a domestic corporation, is potentially subject to U.S. tax on its worldwide income.¹⁸⁰ But after the reorganization, IR-NJ held only the domestic operations. Therefore only the domestic operations were subject to U.S. tax.

2. Dividends on the IR-Ltd. Class A stock

For U.S. stockholders, dividends from IR-Ltd., a foreign corporation, are generally foreign source income.¹⁸¹ The source of income is an important issue if a taxpayer claims the foreign tax credit. Even though no Bermuda tax is withheld from the dividends on IR-Ltd. stock, the shareholder might claim the credit if he has other foreign source income that is subject to foreign tax.

U.S. taxpayers are subject to U.S. tax on their worldwide income.¹⁸² To alleviate double taxation, the U.S. allows U.S. taxpayers a credit for the foreign income taxes they pay on their foreign source income.¹⁸³ This credit is limited to the U.S. tax on the income from foreign sources.¹⁸⁴ The taxpayer

177. Bittker & Lokken, *supra* note 6 ¶ 65.3.1.

178. CRS Corporate Inversion Report, *supra* note 21; IR Proxy/Prospectus, *supra* note 7, at 52.

179. IR Proxy/Prospectus, *supra* note 7, at 52.

180. See Bittker & Lokken, *supra* note 6 ¶ 65.3.1.

181. Bittker & Lokken, *supra* note 6 ¶ 73.3. Before the inversion, IR-NJ withheld a 30% U.S. tax from dividends paid to foreign shareholders, subject to reduction by any applicable treaty. See Treasury Inversion Study, *supra* note 1, at 15; IRC §§ 871(a)(1)(A), 881(a)(1), 1441, 1442. After the inversion, dividends that IR-Ltd. paid to foreign shareholders were no longer subject to U.S. withholding tax. See Treasury Inversion Study, *supra* note 1, at 15.

182. Bittker & Lokken, *supra* note 6 ¶ 65.3.1.

183. See IRC § 901.

184. Bittker & Lokken, *supra* note 6 ¶ 72.6.1.

computes the limitation by multiplying his U.S. tax by a fraction.¹⁸⁵ The numerator of the fraction is the foreign source taxable income.¹⁸⁶ The denominator is the worldwide taxable income.¹⁸⁷ The higher the proportion of income that a U.S. taxpayer receives from foreign sources, the greater is his potential foreign tax credit.

Section 904(h) treats some dividends from a foreign corporation as U.S. source income in certain circumstances.¹⁸⁸ The section applies if U.S. persons own 50% or more of the stock,¹⁸⁹ and if the corporation derives a certain amount of income from U.S. sources.¹⁹⁰ Ingersoll-Rand expected that section 904(h) would apply to IR-Ltd. after the reorganization.¹⁹¹ In its prospectus, the company stated that “only a portion of the dividends received by a U.S. holder ... will be treated as foreign source income for purposes of calculating” the foreign tax credit limitation.¹⁹²

But as a practical matter the source of the dividends on IR-Ltd. class A stock has become a non-issue. Since the inversion, the company has characterized much of its distributions to shareholders as nontaxable returns of capital, not as dividends.¹⁹³

Under section 316, a distribution to shareholders constitutes a “dividend” only to the extent of the corporation’s earnings and profits.¹⁹⁴ For this purpose, a foreign corporation computes its earnings and profits in the

185. *Id.*; see IRC § 904(a).

186. Bittker & Lokken, *supra* note 6 ¶ 72.6.1; see IRC § 904(a).

187. Gustafson, et al, *supra* note 26 ¶ 5220.

188. Treasury Inversion Study, *supra* note 1, at 14 n.32. Section 904(h), entitled Source Rules in Case of U.S.-Owned Foreign Corporations, was formerly § 904(g). The AJCA re-designated it as § 904(h). American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 402(a), 118 Stat. 1418, 1491 (2004).

189. IRC § 904(h)(6).

190. IRC § 904(h)(4), (5).

191. See IR Proxy/Prospectus, *supra* note 7, at 50.

192. *Id.*

193. For 2007, distributions were 100% nontaxable. Ingersoll-Rand investor relations website, available at http://investor.shareholder.com/ir/dividend_info.cfm?Land=DividendInfo (last visited Sept. 29, 2008). They were 100% nontaxable in 2006, 96% nontaxable in 2005, 92% nontaxable in 2004, and 100% nontaxable in 2003. CCH Capital Changes Reporter, online subscription service. Distributions in 2002 were 47% nontaxable. Letter from Ingersoll-Rand in-house tax counsel, dated Mar. 3, 2003, on file with author. Other expatriated companies have also characterized a significant portion of their distributions as non-taxable. For example, Cooper Industries’ 2005 - 2007 distributions were 100% nontaxable. Wall Street Concepts, online subscription service. Regarding the 2007 distributions, see also Cooper Industries Ltd. investor relations website: <http://www.cooperindustries.com/common/investorCenter/dividendsFAQ.cfm> (last visited Sept. 29, 2008).

194. IRC § 316(a).

same manner as a domestic corporation, with a few differences.¹⁹⁵ Apparently IR-Ltd. characterized much of the distributions on its stock as nontaxable returns of capital because the company had little or no earnings and profits.

A distribution that is not a dividend is excluded from the shareholder's income, to the extent of the shareholder's basis in the stock.¹⁹⁶ Therefore the distribution is not included in either the numerator or the denominator of the fraction used to calculate the limitation on the foreign tax credit.¹⁹⁷ In summary, for determining a U.S. stockholder's foreign tax credit, the source of such nondividend distributions is simply not relevant.

A shareholder must reduce his basis in the stock by the amount of the nontaxable distribution.¹⁹⁸ This means that the shareholder will recognize more gain when he eventually sells the stock. The law does not permanently exempt the income; it merely defers recognition. However, this deferral benefits the shareholder due to the time value of money.

Unfortunately, without access to more detailed, inside financial data, it is impossible to determine why the company has so little earnings and profits. Immediately after the reorganization IR-Ltd. was a brand new company with no earnings and profits. As a holding company, its main source of earnings and profits is the dividends it receives from its subsidiaries. It is possible that some subsidiaries made distributions to IR-Ltd. that were not derived from earnings and profits. But to support the cash distributions that IR-Ltd. has consistently paid to its shareholders since 2002, ultimately some members of the group must earn a profit and must remit those earnings to the parent.

3. *The IR-Ltd. Class B Nonvoting Stock*

In the reorganization IR-Ltd., a publicly held foreign corporation, became the new parent of the group. It was unlikely that any U.S. person held 10% or more of the IR-Ltd. class A voting common stock. Therefore IR-Ltd. had no U.S. shareholders. IR-Ltd. was not a controlled foreign corporation (CFC).¹⁹⁹ Also in the reorganization, IR-NJ's former foreign subsidiaries became subsidiaries of IR-Ltd. As explained above, those

195. See Joel D. Kuntz & Robert J. Peroni, *US International Taxation* ¶ B6.02[11] (Warren, Gorham & Lamont 2008).

196. See IRC § 301(c)(2).

197. See IRC § 904(a); Bittker & Lokken, *supra* note 6 ¶ 73.3.

198. IRC § 301(c)(2). If nontaxable distributions exceed the shareholder's basis, the excess is treated as gain from the sale or exchange of property. IRC § 301(c)(3)(A).

199. See IRC § 957(a).

subsidiaries were no longer CFCs. The foreign subsidiaries' earnings were no longer potentially subject to subpart F.

In the reorganization IR-NJ received class B shares that represented approximately 45% of the total value of the IR-Ltd. shares.²⁰⁰ The company knew that this structure entailed some risks.²⁰¹ Refer again to Figure 6 on page 1015.

Through its ownership of the B stock, IR-NJ indirectly owned 45% of IR-Ltd.'s newly acquired foreign subsidiaries.²⁰² Therefore IR-NJ was a U.S. shareholder of those subsidiaries.²⁰³ If another U.S. person accumulated 10% or more of the class A stock, then U.S. shareholders would indirectly own more than 50% of the subsidiaries' voting stock. This would cause the subsidiaries to become CFCs,²⁰⁴ thereby defeating a major purpose of the reorganization.²⁰⁵

Another risk was that the IRS might attempt to classify the B stock as voting stock for purposes of section 951(b).²⁰⁶ If the IRS were successful, then IR-NJ, directly owning 45% of the voting stock, would become a U.S. shareholder of IR-Ltd.²⁰⁷ If another U.S. person accumulated 10% or more of the A stock, then IR-Ltd. itself would become a CFC, defeating a major purpose of the reorganization.

4. Dividends on the IR-NJ Stock

The U.S. imposes a 30% withholding tax on dividends that a U.S. corporation pays to its foreign shareholders.²⁰⁸ If a shareholder is a resident of a country that has a treaty with the U.S., the treaty might reduce or eliminate the tax. The U.S. does not have a tax treaty with Bermuda. Therefore IR-NJ would have to withhold the 30% tax from dividends it pays to IR-Ltd., its foreign parent.

Typically, however, companies have structured inversions so that the new foreign parent or a subsidiary qualifies as a resident of a country such as Barbados, which has a treaty with the U.S. The treaty reduces the withholding tax, typically to 5 percent.²⁰⁹ Meanwhile, by taking advantage of the Barbados International Business Companies (IBC) Act, the company

200. IR Proxy/Prospectus, *supra* note 7, at 14.

201. *Id.*

202. See IRC § 958(a)(2).

203. IRC § 951(b).

204. IRC § 957(a).

205. See Peterson & Cohen, *supra* note 6, at 171.

206. IR Proxy/Prospectus, *supra* note 7, at 14.

207. IRC § 951(b).

208. See IRC §§ 871(a)(1)(A), 881(a)(1), 1441, 1442.

209. Treasury Inversion Study, *supra* note 1, at 12-13.

pays Barbados tax at a rate of only 1% to 2.5%, depending on the income subject to tax.²¹⁰

But under a new Protocol to the U.S.-Barbados Tax Treaty,²¹¹ IR-Ltd. will likely fail to qualify for the lower withholding rate.²¹² The new protocol tightens the Limitation on Benefits article of the treaty, effective February 1, 2005.²¹³ The protocol makes it more difficult for a foreign company such as IR-Ltd. to qualify as a Barbados resident. If the company does not qualify, then it is not eligible for the reduced withholding rates under the Interest or Dividends articles of the treaty. Therefore IR-NJ might have to withhold U.S. tax at the general 30% rate.²¹⁴

5. *The Debt*

In the reorganization IR-NJ transferred certain subsidiaries and issued certain debt in exchange for IR-Ltd. class B stock. The Debt was an intercompany note for about \$3.6 billion.²¹⁵ The note had an 11% fixed interest rate.²¹⁶ In 2002 IR-Ltd. contributed the note to a subsidiary, which subsequently contributed portions of the note to several other subsidiaries.²¹⁷

The interest that IR-NJ pays to IR-Ltd. or its foreign affiliates on the debt is potentially subject to 30% U.S. withholding tax.²¹⁸ The “portfolio interest” exception to the withholding rule does not apply because IR-Ltd. (or under the attribution rules, another subsidiary holding the debt) is a 10%

210. *Id.* at 12-13 & n.27; Michael J. Miller, Pending Protocol Will Prevent Inverted Corporations from Accessing the Barbados Treaty, 33 *Tax Mgm't Int'l J.* 643 (Nov. 12, 2004).

211. Second Protocol Amending the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Barb., Jul. 14, 2004, S. Treaty Doc. No. 108-26.

212. See Janette Zive, Ian Bristol, Steve Fernandes, and James Payne, New Protocol to U.S.-Barbados Income Tax Treaty May Mean Restructuring for Some Foreign Multinationals, 16 *J. Int'l Tax'n* 38, 41 (May 2005); Dep't of Treasury, Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties 80-81 (Nov. 2007), available at www.treas.gov/offices/tax-policy/library/ajca2007.pdf [hereinafter 2007 Treasury Earnings Stripping Report].

213. Zive et al., *supra* note 212, at 40.

214. A thorough discussion of this topic would constitute another article. For more in-depth analysis, see Zive et al., *supra* note 212; Miller, *supra* note 210.

215. Ingersoll-Rand Co. Ltd. 2002 Financial Report 52 (2003). The exact amount of the note was \$3,647.4 million. Ingersoll-Rand Co. Ltd. 2001 Financial Report, *supra* note 11, at 46 (Condensed Consolidating Balance Sheet).

216. Ingersoll-Rand Co. Ltd. 2002 Financial Report 52 (2003).

217. *Id.*

218. IRC §§ 881, 1442.

shareholder of the debtor, IR-NJ.²¹⁹ A lower withholding rate might apply if the note holder is a resident of a country with a favorable treaty with the U.S.

If the interest that IR-NJ pays on the note is deductible, then the group can effectively strip earnings from the U.S. tax base. Meanwhile the interest that IR-Ltd. or a subsidiary earns on the note might be subject to little or no tax in the foreign creditor's country of residence.²²⁰

Section 163(j) limits a corporation's ability to deduct interest paid to a related person.²²¹ The section applies if the payor corporation's debt to equity ratio as of the end of the tax year exceeds 1.5 to 1, and if it has "excess interest expense."²²² Excess interest expense means the amount by which the corporation's net interest expense exceeds 50% of its adjusted taxable income.²²³ Section 163(j) disallows a deduction for "disqualified interest" to the extent it does not exceed the corporation's excess interest expense.²²⁴ A corporation may carry disallowed interest forward to a subsequent year and deduct it if the corporation does not exceed the limit in that year.²²⁵

Disqualified interest includes interest that is paid to a related person and that is not subject to U.S. tax.²²⁶ Interest is not disqualified if it is subject to U.S. withholding tax.²²⁷ If related party interest is subject to a reduced rate of withholding pursuant to a treaty, then a portion of the interest is disqualified.²²⁸

The debt to equity ratio is the ratio which the total indebtedness of the corporation bears to the sum of money and all other assets of the corporation reduced (but not below zero) by the taxpayer's debt.²²⁹ Assets are included at their adjusted basis.²³⁰ For the purpose of computing the ratio, the Proposed Regulations exclude short-term liabilities and commercial financing liabilities from debt.²³¹ However, the corporation must reduce its equity by the amount of the liabilities so excluded.²³² Short-term liabilities means accrued operating expenses, accrued taxes payable, and any account

219. IRC §§ 881(c), 871(h); See Miller, *supra* note 210, at n.30.

220. See Treasury Inversion Study, *supra* note 1, at 13.

221. See Bittker & Lokken, *supra* note 6 ¶ 66.6.

222. IRC § 163(j)(2)(A).

223. IRC § 163(j)(2)(B)(i).

224. IRC § 163(j)(1)(A).

225. IRC § 163(j)(1)(B).

226. IRC § 163(j)(3); see Treasury Inversion Study, *supra* note 1, at 22.

227. IRC § 163(j)(3)(A).

228. IRC § 163(j)(5)(B).

229. IRC § 163(j)(2)(C).

230. IRC § 163(j)(2)(C)(i).

231. Prop. Reg. § 1.163(j)-3(b)(2).

232. Prop. Reg. § 1.163(j)-3(c)(3).

payable for the first 90 days of its existence, if no interest accrues for any portion of such 90 day period.²³³

Generally, under the Proposed Regulations, an affiliated group determines its debt to equity ratio as if all the members are a single taxpayer.²³⁴ However, a foreign corporation cannot be part of an affiliated group.²³⁵ Accordingly, an example in the Proposed Regulations suggests that a nonincludible foreign corporation is not included in the computations for the various tests under section 163(j).²³⁶ This presumably means that, to calculate IR-NJ's affiliated group debt to equity ratio, we must exclude IR-Ltd. and its foreign subsidiaries. (Unfortunately, the Proposed Regulations do not provide any examples of the debt to equity ratio calculation in the affiliated group context.)²³⁷

The debtor calculates its debt to equity ratio as of the end of the tax year.²³⁸ IR-NJ issued the intercompany note on Dec. 31, 2001. So IR-NJ only accrued one day's interest expense on the note in 2001. Applying the above principles, I reviewed IR-Ltd.'s condensed consolidating balance sheet as of December 31, 2002 to estimate whether IR-NJ exceeded the 1.5 to 1 limit for 2002. See Figure 7.

233. Prop. Reg. § 1.163(j)-3(b)(2)(i).

234. Prop. Reg. § 1.163(j)-5(d); see also IRC §163(j)(6)(C); Prop. Reg. § 1.163(j)-5(a).

235. IRC § 1504(b)(3).

236. See Prop. Reg. § 1.163(j)-5(a)(3).

237. Bittker & Eustice, *supra* note 89 ¶ 13.23[8].

238. IRC § 163(j)(2)(A).

Figure 7

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INGERSOLL RAND CO LTD

TABLE66

Form Type: 10-K

Period End: Dec 31, 2002

Date Filed: Mar 05, 2003

Condensed Consolidating Balance Sheet

December 31, 2002

In millions	IR-Limited	IR-New Jersey	Other Subsidiaries	Consolidating Adjustments	IR-Limited Consolidated
Current assets:					
Cash and cash equivalents	\$ -	\$ 209.00	\$ 133.20	\$ -	\$ 342.20
Accounts and notes receivable, net	-	113.60	1,291.70	-	1,405.30
Inventories, net	-	136.10	1,053.70	-	1,189.80
Prepaid expenses and deferred income taxes	-	55.20	325.90	-	381.10
Assets held for sale	-	1.40	792.60	-	794.00
Accounts and notes receivable affiliates	1.30	-	10,554.30	(10,555.60)	-
Total current assets	1.30	515.30	14,151.40	(10,555.60)	4,112.40
Investment in affiliates	3,768.60	12,239.10	3,313.60	(19,321.30)	-
Property, plant and equipment, net	-	265.00	1,014.90	-	1,279.90
Intangible assets, net	-	173.30	4,723.10	-	4,896.40
Note receivable affiliate	-	-	-	-	-
Other assets	0.10	(37.80)	558.60	-	520.90
Total assets	\$ 3,770.00	\$ 13,154.90	\$ 23,761.60	\$ (29,876.90)	\$ 10,809.60
Current liabilities:					
Accounts payable and accruals	\$ -	\$ 104.30	\$ 2,243.10	\$ -	\$ 2,347.40
Loans payable	-	1,073.20	82.30	-	1,155.50
Liabilities held for sale	-	-	295.20	-	295.20
Accounts and note payable affiliates	291.80	3,236.70	7,027.10	(10,555.60)	-
Total current liabilities	291.80	4,414.20	9,647.70	(10,555.60)	3,798.10
Long-term debt	-	1,854.80	237.30	-	2,092.10
Note payable affiliate	-	3,647.40	-	(3,647.40)	-
Other noncurrent liabilities	-	95.60	1,345.60	-	1,441.20
Total liabilities	291.80	10,012.00	11,230.60	(14,203.00)	7,331.40
Shareholders' equity:					
Class A common shares	169.20	-	-	-	169.20
Class B common shares	135.30	-	-	(135.30)	-
Common shares	-	-	2,362.80	(2,362.80)	-
Other shareholders' equity	8,551.70	4,040.80	15,034.20	(23,804.60)	3,822.10
Accumulated other comprehensive income	(191.60)	(418.90)	(158.60)	256.00	(513.10)
	8,664.60	3,621.90	17,238.40	(26,046.70)	3,478.20
Less: Contra account	(5,186.40)	(479.00)	(4,707.40)	10,372.80	-
Total shareholders' equity	3,478.20	3,142.90	12,531.00	(15,673.90)	3,478.20
Total liabilities and equity	\$ 3,770.00	\$ 13,154.90	\$ 23,761.60	\$ (29,876.90)	\$ 10,809.60

Admittedly, the publicly filed financial statements are only a rough substitute for the corporation's tax returns. First, the financial statements show assets at their book values for financial accounting purposes, not at their adjusted bases for tax purposes. Second, column 3 of the consolidated balance sheet, entitled "Other Subsidiaries," may have

included data for both domestic and foreign members of the corporate group. If it did mingle the domestic and foreign subsidiaries, then it would be impossible to determine the combined ratio for all the U.S. members of the corporate group.

IR-NJ had a debt to equity ratio of 2.12 to 1 on December 31, 2002.²³⁹ See Figure 8. Therefore section 163(j) might have disallowed some of the company's related party interest for 2002.

Figure 8
Ingersoll-Rand NJ
Debt to Equity Ratio Calculation
Dec. 31, 2002

(In Millions)	IR-NJ
Total Liabilities	\$10,012.0
Exclusions:	
Accounts payable & accruals	(104.3)
Accounts & note payable affiliates	(3,236.7)
A Net Liabilities	6,671.0
Total Assets	13,154.9
Reductions:	
Net Liabilities	(6,671.0)
Reduction for excluded liabilities, per Prop. Regs. § 1.163(j)-3(c)(3).	(3,341.0)
B Net equity	3,142.9
Ratio (A/B)	2.12

In a 2004 article Seida & Wempe analyzed the publicly filed financial statements of several inverted companies, including Ingersoll-Rand, to determine whether the inversions reduced the companies' effective tax

239. In the column for IR-NJ on the balance sheet, "accounts and note payable affiliates" totaling \$3,236.7 million were lumped together as a single line item. Ingersoll-Rand Co. Ltd. 2002 Annual Report (Form 10-K), at 70 (March 5, 2003) (Condensed Consolidating Balance Sheet as of Dec. 31, 2002). Under the definitions in the proposed regulations, accounts payable are excluded from the debt to equity ratio calculation, but notes payable are not, unless they constitute commercial financing liabilities. Prop. Reg. § 1.163(j)-3(b)(2)(i). However, even if the entire item is excluded from IR-NJ's liabilities, IR-NJ exceeded the 1.5 to 1 limit.

rates.²⁴⁰ The article concluded that earnings stripping through intercompany debt reduced effective tax rates.²⁴¹

The article also concluded that section 163(j) likely did not apply to Ingersoll-Rand for 2002 or 2003.²⁴² Seida & Wempe did not explain how they calculated the debt to equity ratio. If they included data for both IR-NJ and the “Other Subsidiaries” in the computation, then the ratio for 2002 would have been under 1.5 to 1.

D. Tax Policy Issues

The exchange of CFCs and Debt for the IR-Ltd. class B stock raises some serious tax policy issues. One issue is whether a subsidiary’s acquisition of parent company stock in exchange for a note represents a real economic investment. The debt-financed portion of this exchange had some indicia of a sham.

When IR-NJ transferred its foreign subsidiaries to IR-Ltd., the company used the occasion to load up with as much debt as possible. The only limit on the amount of debt was that the face amount of the debt, plus the fair market value of the Transferred Assets, could not exceed 50% of the company’s value. Issuing B stock that was worth more than 50% of the company’s value would have caused IR-Ltd. to become a CFC.²⁴³

To be safe, IR-Ltd. issued to IR-NJ class B stock representing 45% by value, just a few percentage points less than 50%. The value of that B stock was about \$5.6 billion.²⁴⁴ The accountants probably calculated the value of the “Transferred Assets” at about \$2 billion.²⁴⁵ IR-NJ transferred those assets to IR-Ltd. Then IR-NJ gave IR-Ltd. a \$3.6 billion note for the balance.

240. Jim A. Seida & William F. Wempe, *Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion*, 57 Nat’l Tax J. 805 (Dec. 2004).

241. *Id.* at 825.

242. *Id.* at 821.

243. IRC § 957.

244. On Dec. 31, 2001, the A stock was worth \$41.81 per share. Ingersoll-Rand investor relations website, available at <http://files.shareholder.com/downloads/IR/234349907x0x84384/7C2A60CA-1535-44E3-8D60-980393782036/GeneralTaxInformation.htm> (last visited Sept. 29, 2008). As discussed in Part II.B, the company considered the A and B shares to be about equal in value. IR-Ltd. issued 135,250,003 B shares in the reorganization. Ingersoll-Rand Co. Ltd. 2001 Financial Report, *supra* note 11, at 35. Using a value of \$41.81 per share of B stock, this works out to a total value of \$5,654,802,625.

245. The value of the “Transferred Assets” must have been about \$2,007,402,625, the value of the B stock, \$5,654,802,625, minus the face amount of the \$3,647,400,000 note.

There is a consensus that sections 163(j) and 482 are insufficient to prevent such aggressive earnings stripping.²⁴⁶ As part of the American Jobs Creation Act, Congress considered strengthening section 163(j) for inverted corporations.²⁴⁷ The proposal would have eliminated the 1.5 to 1 debt to equity threshold for such corporations, and would have reduced the 50% threshold for “excess interest expense” to 25%.²⁴⁸ However, in response to extensive lobbying by multinational corporations, the House dropped the provision tightening section 163(j).²⁴⁹ As discussed below, Congress enacted a provision that narrowly targeted inversion transactions, leaving the earnings stripping issue for another day.

The potential for earnings stripping through related party debt is not unique to inversion transactions.²⁵⁰ If Congress is not inclined to strengthen section 163(j) in general, then it should at least address the problem of a subsidiary that acquires stock in its parent company using related party debt. One possible solution would be a provision that denies a deduction for interest on any related party debt used to acquire stock in a corporation that directly or indirectly controls the debtor.

Another approach might be to amend section 163(j) to provide that, for purposes of determining the debt to equity ratio, stock in a corporation that controls the debtor shall have a zero basis.²⁵¹ This provision would apply only to the extent of the corporation’s related party debt. Stock acquired in exchange for property other than debt would have a basis. Assigning a zero basis to the debt-financed stock would reduce the debtor’s equity for purposes of computing its debt to equity ratio.²⁵² This, in turn, would make it

246. Treasury Inversion Study, *supra* note 1, at 21-25; Kirsch, *supra* note 6, at 493; 2007 Treasury Earnings Stripping Report, *supra* note 212, at 8, 26. See also Lee A. Sheppard, Turbo-Charged Income Stripping, *Tax Notes Today* (Dec. 6, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 235-4) (suggesting that interest deductions should be disallowed for all intercompany debt).

247. H.R. Rep. No. 108-755, at 531 (2004) (Conf. Rep.), *as reprinted in* 2005 U.S.C.C.A.N. 1341, 1629, 2004 WL 2335174 (2004).

248. *Id.*

249. Kirsch, *supra* note 6, at 518-19.

250. Treasury Inversion Study, *supra* note 1, at 22.

251. The Treasury has the regulatory authority to prescribe adjustments in the debt to equity ratio calculation. IRC § 163(j)(2)(C)(iii); see also § 163(j)(8). But this authority probably does not extend to treating an asset that has a basis for all other purposes of the Code as having no basis. Congress would have to amend the statute.

252. To avoid dividing by zero, however, in no event could total equity be reduced below \$1.00 by reason of the recommended provision. *Cf.* Prop. Reg. § 1.163(j)-3(c)(1) (equity means the sum of money and the adjusted basis of all other assets of the corporation reduced (but not below zero) by the taxpayer’s debt).

more likely that the debtor will exceed the 1.5 to 1 limit. If the debtor exceeds the limit, then the related party interest might be nondeductible.

IV. CONSEQUENCES UNDER SECTION 7874

A. Description of Provision

As part of the 2004 American Jobs Creation Act (AJCA), Congress added section 7874 to the Internal Revenue Code.²⁵³ This section removes the potential tax benefits of an inversion.²⁵⁴ The provision defines two types of corporate inversion transactions, with a different set of consequences for each type.²⁵⁵

1. Section 7874(b) Transactions

Section 7874(b) applies if, pursuant to a plan or a series of related transactions:

- (i) After March 4, 2003, a foreign corporation directly or indirectly acquires substantially all the properties held directly or indirectly by a domestic corporation;
- (ii) After the acquisition, the former shareholders of the U.S. corporation hold, by reason of holding stock in the domestic corporation, at least 80% of the foreign corporation's stock (by vote or value); and
- (iii) After the acquisition, the expanded affiliated group²⁵⁶ which includes the foreign corporation does not have substantial business activities in its country of incorporation compared to the total worldwide business activities of the group.²⁵⁷

If the above conditions apply, then the foreign corporation is a "surrogate foreign corporation."²⁵⁸ Section 7874(b) denies the intended tax

253. Pub. L. No. 108-357, § 801(a), 118 Stat. 1418, at 1562 (2004).

254. Kirsch, *supra* note 6, at 506-07; see generally Bittker & Lokken, *supra* note 6 ¶ 66.2.

255. H.R. Rep. No. 108-755, at 532 (2004) (Conf. Rep.), *as reprinted in* 2005 U.S.C.C.A.N. 1341, 1629. The provision also potentially applies when a U.S. partnership expatriates. IRC § 7874(a)(2)(B).

256. The expanded affiliated group is an "affiliated group" as that term is defined for purposes of the consolidated return provisions, except that foreign corporations are included, and the ownership threshold is "more than 50%" instead of "at least 80%." IRC § 7874(c)(1); see Bittker & Lokken, *supra* note 6 ¶ 66.2.2.

257. H.R. Rep. No. 108-755, at 532 (2004) (Conf. Rep.), *as reprinted in* 2005 U.S.C.C.A.N. 1341, 1629-30.

258. IRC § 7874(a)(2)(B), 7874(b).

benefits of this type of inversion by deeming the top-tier foreign corporation (the surrogate foreign corporation) to be a domestic corporation for all purposes of the Code.²⁵⁹ Section 7874(b) is “a significant departure from the long-standing place-of-incorporation rule for determining corporate residence.”²⁶⁰

For determining whether a transaction meets the 80% continuity of ownership test in (ii) above, section 7874 disregards stock held by members of the expanded affiliated group that includes the foreign incorporated entity.²⁶¹ Also for this purpose, the statute disregards stock sold in a public offering related to the transaction.²⁶²

2. Section 7874(a) Transactions

Section 7874(a) covers a transaction that would meet the definition of an inversion transaction described above, except that the transaction does not meet the 80% continuity of ownership threshold. In that case, section 7874 respects the inversion transaction (that is, it treats the foreign corporation as foreign).²⁶³ However, if there is at least a 60% continuity of ownership, then the domestic corporation, and any U.S. person related to it, is an “expatriated entity.”²⁶⁴ An expatriated entity cannot use tax attributes such as net operating losses or foreign tax credits to offset any corporate level income or gains incident to establishing the inverted structure.²⁶⁵ These measures generally apply for a 10-year period following the inversion transaction.²⁶⁶

B. Effect of Section 7874(b)

If section 7874(b) applies, then the new foreign parent of the group (the surrogate foreign corporation) is treated as a domestic corporation for all purposes of the Code.²⁶⁷ If a U.S. person transfers property to the surrogate foreign corporation, section 367 does not apply to the transaction because

259. H.R. Rep. No. 108-755, at 532 (2004) (Conf. Rep.), *as reprinted in* 2005 U.S.C.C.A.N. 1341, 1629-30.

260. Kirsch, *supra* note 6, at 546.

261. IRC § 7874(c)(2)(A); H.R. Rep. No. 108-755, at 532 (2004) (Conf. Rep.), *as reprinted in* 2005 U.S.C.C.A.N. 1341, 1630.

262. IRC § 7874(c)(2)(B).

263. H.R. Rep. No. 108-755, at 533 (2004) (Conf. Rep.), *as reprinted in* 2005 U.S.C.C.A.N. 1341, 1630.

264. IRC § 7874(a)(2)(A).

265. H.R. Rep. No. 108-755, at 533 (2004) (Conf. Rep.), *as reprinted in* 2005 U.S.C.C.A.N. 1341, 1630.

266. *Id.* at 533, *as reprinted in* 2005 U.S.C.C.A.N. 1341, 1631.

267. IRC § 7874(b).

there is no transfer to a foreign corporation.²⁶⁸ Further, section 367(a) does not apply to the shareholders' exchange of stock in the inversion transaction.²⁶⁹

The surrogate foreign corporation is subject to U.S. tax on its worldwide income.²⁷⁰ Further, if the surrogate foreign corporation directly or indirectly owns more than 50% of the stock, by vote or value, in another foreign corporation, then the other foreign corporation is a CFC.²⁷¹ The CFC's subpart F income is taxable to the surrogate foreign corporation.

If section 7874(b) had been in effect when Ingersoll-Rand completed its inversion, then the above tax consequences would have applied to it. First, IR-Ltd., a foreign corporation, directly or indirectly acquired all the properties held by IR-NJ, a domestic corporation. Second, for purposes of computing whether the transaction met the 80% ownership threshold, section 7874 would disregard the B stock held by IR-NJ.²⁷² Therefore the former shareholders of IR-NJ acquired 100% of the IR-Ltd. stock.²⁷³ Third, it is unlikely that the group's Bermuda activities after the inversion were substantial when compared to the group's worldwide activities.²⁷⁴ IR-Ltd. had operating subsidiaries in Bermuda after the inversion. But it also had dozens of subsidiaries in numerous countries throughout the world.²⁷⁵ The company's 2001 Annual Report did not contain a detailed country-by-country breakdown of its international activities. However, according to that Report, the company had sales in over 100 countries.²⁷⁶ Approximately 32,000 of its 56,000 employees worked in the U.S.²⁷⁷

If section 7874(b) applied, then IR-Ltd., the acquiring corporation, would have been a surrogate foreign corporation. It would have been taxable

268. Bittker & Lokken, *supra* note 6 ¶ 66.2.3.

269. H.R. Rep. No. 108-755, at 532 n.432 (2004) (Conf. Rep.), *as reprinted in* 2005 U.S.C.C.A.N. 1341, 1630; Temp. Reg. § 1.7874-2T(h).

270. Bittker & Lokken, *supra* note 6 ¶ 66.2.3.

271. *Id.*

272. See IRC § 7874(c)(2).

273. See Treas. Reg. § 1.7874-1(f), Example (1).

274. The determination of whether, after the acquisition, the expanded affiliated group (EAG) has substantial business activities in the foreign country in which, or under the law of which, the acquiring foreign entity is created or organized, when compared to the total business activities of the EAG, shall be made on the basis of all of the facts and circumstances. Temp. Reg. § 1.7874-2T(d). A proposed amendment, however, would change this standard. H.R. 2937, 110th Cong. § 1 (2007); see 153 Cong. Rec. E1455-04, 2007 WL 1875731 (June 29, 2007) (remarks of Rep. Neal).

275. Ingersoll-Rand Co. Ltd. 2001 Annual Report (Form 10-K), at Exhibit 21 (List of Subsidiaries) (March 13, 2002).

276. *Id.* at 5 (Part I, Item 1, Business - Operations by Geographic Area).

277. *Id.* at 6 (Part I, Item 1, Business - Employees).

on its worldwide income, like a domestic corporation. Further, its foreign subsidiaries would have been CFCs.

But this discussion is academic. If section 7874 had been in effect when the company was contemplating the inversion, the company would not have completed the transaction in the first place.

Ingersoll-Rand completed its inversion on December 31, 2001, before the March 4, 2003 effective date. Therefore section 7874 does not apply to it.²⁷⁸ Further, the proposed amendment discussed below would not apply to it because the company completed the inversion before March 20, 2002.

C. *Effective Date & Proposed Amendment*

Section 7874 applies to companies that completed inversion transactions after March 4, 2003,²⁷⁹ for taxable years ending after March 4, 2003.²⁸⁰ Under a proposed amendment, section 7874(b) would apply to companies that completed inversions after March 20, 2002, for taxable years beginning after the date the amendment becomes law.²⁸¹

278. In its 2006 Annual Report, the company stated “We completed our reincorporation in Bermuda on Dec. 31, 2001, and therefore our transaction is grandfathered by the American Jobs Creation Act.” Ingersoll-Rand Co. Ltd. 2006 Annual Report (Form 10-K), at 12 (March 1, 2007).

279. IRC § 7874(a)(2)(B).

280. Pub. L. No. 108-357, § 801(c), 118 Stat. 1418, at 1566 (2004).

281. American Infrastructure Investment and Improvement Act of 2007, S. 2345, 110th Cong. § 209 (2007); see Staff of Joint Comm. on Taxation, 110th Cong., Description of the American Infrastructure Investment and Improvement Act, JCX-79-07 (2007), at 38 [hereinafter JCX-79-07], available at <http://www.house.gov/jct/x-79-07.pdf>. On Feb. 14, 2008, Sen. Klobuchar introduced a bill containing a provision that was the same as § 209 of S. 2345, except that it would apply to tax years beginning after Dec. 31, 2006. American Renewable Energy Act of 2008, S. 2642, 110th Cong. § 272 (2008). For another recent version of this proposal, see the Aviation Investment and Modernization Act of 2008, H.R. 2881, 110th Cong. § 819 (2008). For some prior versions of this same proposal in the current Congress, see Energy Advancement and Investment Act of 2007, H.R. 6, 110th Cong. § 892 (2007), available at <http://finance.senate.gov/sitepages/leg/LEG%202007/Leg%20110%2062007a1.pdf>; H.R. 1591, 110th Cong. § 532 (Mar. 29, 2007); and S. 554, 110th Cong. § 215 (Feb. 12, 2007). The Senate proposed a similar change as part of the 2005 Tax Increase Prevention and Reconciliation Act, but the proposal was not included in the final version of Pub. L. No. 109-222, enacted in May 2006. See H.R. Rep. 109-455, 109th Cong., 2nd Sess., 2006 U.S.C.C.A.N. 234, at 435; CRS Corporate Inversion Report, supra note 21.

Congress considered many anti-inversion tax bills before it passed the AJCA.²⁸² One of those bills, the 2002 Reversing the Expatriation of Profits Offshore (REPO) Act, contained a provision similar to current section 7874(b).²⁸³ The provision would have applied to companies that completed inversions after March 20, 2002.²⁸⁴

None of those earlier bills became law. However, the Senate Finance Committee believes the bills put companies on notice “that eventual legislation on this issue could be effective after March 20, 2002.”²⁸⁵ Companies that completed inversions after March 20, 2002 did so at their own risk.²⁸⁶ Therefore the committee believes it is not unfair at this point to move the applicable date back from March 4, 2003 to March 20, 2002.

If this proposal becomes law, it will be a setback for companies that completed inversions from March 21, 2002 through March 4, 2003.²⁸⁷ For tax years beginning after the date of enactment, section 7874(b) will treat those companies as domestic corporations.²⁸⁸

Under the amendment the foreign corporation will be treated, at the close of its first taxable year ending after the date of enactment, as transferring all of its assets, liabilities, and earnings and profits to a domestic corporation in a nontaxable reorganization.²⁸⁹ This repatriation of the foreign parent corporation would be an F reorganization. An F reorganization is “a mere change in identity, form, or place of organization of one corporation, however effected.”²⁹⁰

282. See Kirsch, *supra* note 6 at 504-05 & n.92.

283. S. 2119, 107th Cong. § 2 (2002).

284. *Id.* On March 21, 2002, Senators Wellstone and Dayton introduced another bill that would have treated inverted corporations as domestic corporations for taxable years beginning after Dec. 31, 2002, without regard to whether the corporation became an inverted domestic corporation before, on, or after such date. S. 2050, 107th Cong. (2002).

285. See S. Rep. 110-228, at 32, “Reasons for Change” (2007), available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_reports&docid=f:sr228.110.pdf. In fact, the pending bills may have been a factor when Stanley Works canceled its proposed inversion in August 2002. See Kirsch, *supra* note 6, at 529-30.

286. See Kirsch, *supra* note 6, at 545 n.234 (“Any corporation considering expatriation after March 20, 2002 would have had to consider the possibility that the desired tax benefits would be lost if the Senate proposal eventually were enacted.”).

287. For example, Cooper Industries completed its inversion on May 22, 2002. Seida & Wempe, *supra* note 240, at 811.

288. S. 2345, 110th Cong. § 209 (2007); JCX-79-07, *supra* note 281, at 38.

289. S. 2345, 110th Cong. § 209 (2007); JCX-79-07, *supra* note 281, at 38.

290. IRC § 368(a)(1)(F).

Under current law, the section 367 regulations that govern repatriations of foreign corporate assets would apply to such a transaction.²⁹¹ U.S. shareholders would include as a deemed dividend the “all earnings and profits” amount with respect to their stock in the foreign corporation.²⁹² The term “U.S. shareholder” for this purpose has the same meaning as in subpart F.²⁹³ Exchanging shareholders that are U.S. persons but who are not U.S. shareholders (that is, less than 10% shareholders), however, would recognize gain, but not loss, on the exchange.²⁹⁴ A de minimis rule provides that such a shareholder does not have to recognize gain if his stock is worth less than \$50,000 on the date of the exchange.²⁹⁵

Fortunately, according to the Joint Committee on Taxation Report, the transfer of earnings and profits “is not a deemed dividend and does not result in a tax upon the domestic corporation or its shareholders.”²⁹⁶ The deemed repatriation of the surrogate foreign corporation is not a taxable event at either the corporate or shareholder level.²⁹⁷

291. Hicks, *supra* note 6, at 924-25; see also Bittker & Lokken, *supra* note 6 ¶¶ 71.2.5 (Reincorporations of Foreign Corporations), 71.2.2 (Repatriations of Foreign Assets). The temporary regulations under § 7874 address an analogous situation. If § 7874(b) causes an existing foreign corporation to be converted to a domestic corporation, then the conversion shall be treated as a reorganization under § 368(a)(1)(F) occurring immediately before the acquisition described in § 7874(a)(2)(B)(i). Temp. Reg. § 1.7874-2T(g)(1).

292. Treas. Reg. § 1.367(b)-3(b)(3)(i). Such shareholders may elect instead to recognize the gain (but not loss) that they realize in the deemed exchange. Treas. Reg. § 1.367(b)-3T(b)(4)(i).

293. Treas. Reg. § 1.367(b)-3(b)(2).

294. Treas. Reg. § 1.367(b)-3(c)(2). But under certain conditions those shareholders may elect to include the all earnings and profits amount instead of recognizing gain. Treas. Reg. § 1.367(b)-3(c)(3).

295. Treas. Reg. § 1.367(b)-3(c)(4).

296. JCX-79-07, *supra* note 281, at 38; S. Rep. 110-228, at 33 (2007). But any foreign taxes attributable to the transferred earnings and profits are not creditable. JCX-79-07, *supra* note 281, at 38; S. Rep. 110-228, at 33 (2007).

297. The special rules regarding the deemed repatriation provide:

- (i) The foreign corporation shall be treated, as of the close of its last taxable year after the date of enactment of the American Infrastructure Investment and Improvement Act of 2007, as having transferred all of its assets, liabilities, and earnings and profits to a domestic corporation in a transaction with respect to which no tax is imposed under this title;
- (ii) the bases of the assets transferred in the transaction to the domestic corporation shall be the same as the bases of the assets in the hands of the foreign corporation, subject to any adjustments under this title for built-in losses;

Setting aside the general tax policy issues regarding anti-inversion legislation, the fairness of retroactively changing the applicable date is debatable. True, companies that completed inversions after March 20, 2002 knew that the law might change. However, those companies and their shareholders paid the section 367 “toll charges” associated with the inversion transactions. Under the proposal the government gets to keep the taxes it collected as a result of the inversion transactions, but the companies do not achieve the intended future tax benefits.

V. CONCLUSION

Ingersoll-Rand and other U.S. multinationals cleverly used stock inversions to lower their overall effective tax rates. Congress responded with legislation that removed incentives for companies to invert. Further, the government has taken concrete measures to thwart treaty shopping by renegotiating its tax treaties with Barbados and other countries.

Section 7874 has stopped inversions for now. However, the American Jobs Creation Act did not address some flaws in the U.S. international tax system that drove companies to expatriate.

Commentators have suggested that the U.S. reexamine its reliance on the place-of-incorporation rule to determine corporate residence.²⁹⁸ An alternative approach, used by many countries, looks to where the corporation is “managed and controlled” to determine whether it is a resident.²⁹⁹

Another suggestion has been to lower the corporate tax rate.³⁰⁰ A more radical suggestion is that the U.S. should stop taxing the worldwide

(iii) the basis of the stock of any shareholder in the domestic corporation shall be the same as the basis of the stock of the shareholder in the foreign corporation for which it is treated as exchanged; and

(iv) the transfer of any earnings and profits by reason of clause (i) shall be disregarded in determining any deemed dividend or foreign tax creditable to the domestic corporation with respect to such transfer.

S. 2345 § 209(a), 110th Cong. 1st Session, Nov. 13, 2007.

298. See Kirsch, *supra* note 6, at 580-86.

299. See Peterson & Cohen, *supra* note 6, at 183-84. For a proposal in the current Congress adopting the “management and control” standard, see the Manufacturing, Assembling, Development, and Export in the USA Tax Act, S. 3162, 110th Cong. § 211 (2008) [MADE in the USA Tax Act].

300. See Hale E. Sheppard, *Fight or Flight of U.S.-Based Multinational Businesses: Analyzing the Causes for, Effects of, and Solutions to the Corporate Inversion Trend*, 23 *NW. J. Int’l L. & Bus.* 551, 571-72 (2003).

income of resident corporations and adopt a territorial system.³⁰¹ Whatever the merits of this proposal, such major reform is not likely to occur soon.³⁰²

But Congress can take some steps without making major changes to the U.S. international tax system. In particular Congress should reconsider measures to reduce earnings stripping through related party interest payments.

The most comprehensive approach is to generally strengthen section 163(j).³⁰³ However, if such an approach is not politically feasible, then as suggested in Part III, Congress should consider other measures.

Congress should disallow a deduction for interest expense on related party debt used to acquire stock in a corporation that directly or indirectly controls the debtor. Alternatively, Congress could amend section 163(j) to provide that, for purposes of determining the debt to equity ratio, debt-financed stock in a corporation that controls the debtor shall have a zero basis. Such a provision would increase the taxpayer's debt to equity ratio, making it more likely that the related party interest will be nondeductible.

301. See Steven V. Melnik, *Corporate Expatriations – The Tip of the Iceberg: Restoring the Competitiveness of the United States in the Global Marketplace*, 8 N.Y.U. J. Legis. & Pub. Pol'y 81, 116 (2005).

302. See Kirsch, *supra* note 6, at 550-51 (assuming that the U.S. will retain a residence-based tax system that taxes domestic corporations, however defined, on their worldwide income, and providing a foreign tax credit to alleviate the potential for double taxation).

303. A proposal in the current Congress would, among other things, eliminate the 1.5 to 1 debt to equity ratio threshold, and lower the 50% threshold for "excess interest expense" to 25%. MADE in the USA Tax Act, S. 3162, 110th Cong. § 224 (2008). The President's proposed fiscal 2009 budget contained a provision that would tighten § 163(j) for expatriated entities. Staff of Joint Comm. on Taxation, 110th Cong., *Description of Revenue Provisions Contained in the President's Fiscal Year 2009 Budget Proposal*, JCS-1-08 No. 6, 2008 WL 2485227 (2008).

