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The Honorable Jacob J. Lew
Secretary of the Treasury
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

The Honorable Mark Mazur
Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Danielle Rolfes
International Tax Counsel
Office of the International Tax Counsel
Department of the Treasury
1500 Pennsylvania Avenue, NW, Room
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Washington, DC 20220

The Honorable William Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Robert Stack
Deputy Assistant Secretary (International
Tax Affairs)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

RE: Legislative and Administrative Proposals re Inversions

Dear Mr. Secretary, Ms. Rolfes, and Messrs. Stack, Mazur, and Wilkins:

I am writing to express my views on the approach the Treasury should take both in its legislative proposals and in its administrative actions in addressing inversions and related transactions. Let me emphasize that this letter is written in my capacity as a private citizen who has an interest in promoting good tax policy. The views expressed are my own and are not made on behalf of any other person or organization.

Background of My Interest in Stopping Inversions

By way of background, I have been a tax lawyer or professor since graduating from law school in 1971. Early in my career, I had the great pleasure of serving in the Treasury's (1) Tax Legislative Counsel's Office, and (2) International Tax Counsel's Office. I have also served as the Partner in Charge of the Tax Department of a Chicago based law firm, and I have been a professor at several law schools, including UVA and UCLA. I am now a Professor of Law and

the Director of the Center for the Study of Mergers and Acquisitions at Penn State Law in State College, Pa. I teach International Tax (as well as other business related courses), and I am the author of a law school casebook entitled, *International Tax Planning and Policy*.

I first expressed my views on inversions in a series of articles in Tax Notes and Tax Notes International beginning in 2002.¹ These first articles were published before the adoption in 2004 of Section 7874, the anti-inversion statute, which I strongly supported.

I have most recently expressed my views on inversions in an article in the June 23, 2014 issue of Tax Notes entitled, *New Inversions, the 'Joe Frazier Left Hook,' the IRS Notice, and Pfizer*,² which is included with this letter. Because the inversion issue is tied up with our system of international taxation, I am also including my article in the May 5, 2014 issue of Tax Notes entitled, *Logic Says No to Options Y, Z, and C, but Yes to Imputation*,³ I refer in this letter to several points made in these articles.

You may wonder why I feel so strongly about the need for legislative and administrative actions against inversions. It is because I believe strongly that (1) President Obama is right when he says that inverters are “corporate deserters,”⁴ and (2) as one who had the privilege of both serving as an officer in the Marine Corps and developing an understanding of our corporate and international tax laws, I have a special responsibility to advocate for laws that will stop these “desertions.” The balance of this letter addresses the following topics:

1. Treasury’s Current Legislative Proposal: *Inverter Treated as a U.S. Corporation Rule*;
2. Proposed Additional Legislative Initiative by Treasury: *The CFC Taxable Disposition Rule*;
3. Administrative Action: As Proposed by Professor Shay, Regulations under Section 385 for Future Inversions;
4. Administrative Action: Challenging the “Note-for-Stock” Part of Current and Past Inversions;

¹ Samuel C. Thompson, Jr., *Section 367: A “Wimp” for Inversions and a “Bully” for Real Cross Border Acquisitions*, 94 Tax Notes 11 (March 18, 2002) and 26 Tax Notes International 587 (May 6, 2002); Samuel C. Thompson, Jr., *Analysis of the Non-Wimpy Grassley/Baucus Inversion Bill*, 26 Tax Notes International 741 (May 13, 2002) and 95 Tax Notes 1515 (June 3, 2002); Samuel C. Thompson, Jr., *Treasury’s Inversion Study Misses The Mark: Congress Should Shut Down Inversions Immediately*, 26 Tax Notes International 969 (May 27, 2002) and expanded with comments on Treasury testimony in 95 Tax Notes 1673 (June 10, 2002); Samuel C. Thompson, Jr., *Treasury Official Gives Unconvincing Reason for Not Blockading Inversions*, 2002 Worldwide Tax Daily 112-15 (June 11, 2002), expanded with comments on Treasury testimony in 95 Tax Notes 1673 (June 10, 2002), and 26 Tax Notes International 1321 (June 17, 2002); Samuel C. Thompson, Jr., *Inversion Hearings Focus on Wrong Issues*, 96 Tax Notes 154 (July, 1 2002) and 27 Tax Notes International 193 (July 8, 2002).

² Samuel C. Thompson, Jr., *New Inversions, the ‘Joe Frazier Left Hook,’ the IRS Notice, and Pfizer*, Tax Notes 1413 (June 23, 2013) [Thompson, *New Inversions*].

³ Samuel C. Thompson, Jr., *Logic Says No to Options Y, Z, and C, but Yes to Imputation*, Tax Notes 579 (May 5, 2014) [Thompson, *Logic of Imputation*]. See also Samuel C. Thompson Jr., *An Imputation System for Taxing Foreign-Source Income*, Tax Notes, Jan. 31, 2011, p., and Samuel C. Thompson, Jr., *Obama’s International Tax Proposal Is Too Timid*, Tax Notes, May 11, 2009, p. 738 [Thompson, *Too Timid*].

⁴ Lisa Lerer and Richard Rubin, *Corporate Inversions, Obama Says Tax Law Must Change To Stop ‘Corporate Deserters,’* BNA, Daily Tax Report (July 25, 2014).

5. Administrative Action: Fixing the “Joe Frazier Left Hook” in the Current Section 367 Regulations;
6. Administrative Action: Preventing Avoidance of the Purposes of Section 956;
7. Administrative Action: Addressing the Gross-Ups of the Section 4985 Excise Tax; and
8. A Word on the Merits of a Territorial Regime.

1. Treasury’s Current Legislative Proposal: *Inverter Treated as a U.S. Corporation Rule*

I commend the Treasury for its legislative proposal for curtailing inversions, which is set out in your Green Book. If enacted this proposal (which is similar to proposals of Sen. Carl Levin, D-Mich., and Rep. Sander M. Levin, D-Mich.)⁵ would “(1) reduce the 80 percent threshold in section 7874 to 50 percent and eliminate the 60 percent test [the *50% Inverter Test*], and (2) without regard to the level of shareholder continuity, prevent a U.S. company from shifting its tax residence to a foreign jurisdiction if the corporation is managed and controlled in the United States and has significant business operations there [the *U.S. Managed Inverter Test*].”⁶ I refer to the *50% Inverter Test* and the *U.S. Managed Inverter Test* as the *Inverter Treated as a U.S. Corporation Rule* legislative proposal.

2. Proposed Additional Legislative Initiative by Treasury: *The CFC Taxable Disposition Rule*

In addition to your *Inverter Treated as a U.S. Corporation Rule* legislative proposal, as initially proposed in my *New Inversions* article,⁷ I suggest that the Treasury also propose a new legislative rule that would treat a U.S. corporation as having disposed in a taxable transaction of the stock of its controlled foreign corporations (CFCs) whenever the U.S. corporation becomes a more than 50% subsidiary of a foreign corporation and the *Inverter Treated as a U.S. Corporation Rule* does not apply. I refer to this rule as the *CFC Taxable Disposition Rule*.

This rule would apply where a foreign corporation acquires a U.S. corporation and neither the *50% Inverter Test* nor the *U.S. Managed Inverter Test* is satisfied. This could happen if, for example, a foreign acquirer purchased for cash all of the stock of a U.S. target and the *U.S. Managed Inverter Test* did not apply. In such case, under the proposed *CFC Taxable Disposition Rule*, at the time of the acquisition of the U.S. target, the target would be treated as disposing of each of its CFCs in a taxable transaction, thereby ending the deferral benefit.

The purpose of the *CFC Taxable Disposition Rule* is to prevent a foreign acquirer from using various techniques to deploy the earnings of the U.S. target’s CFCs in a way that would avoid the purposes of Section 956. Thus, this rule would prevent the abuse of Section 956 with regard to the deferred earnings of such CFCs.

This *CFC Taxable Disposition Rule* would address the problem discussed in an article entitled *An Inversion in All but Name*,⁸ which was in the New York Times on August 8, 2014. The article discusses the acquisition for cash by a Dutch company of SafeNet, a U.S. company with

⁵ Thompson, *New Inversions*, *supra* note 2, at 1422.

⁶ *Id.*

⁷ *Id.* at 1421.

⁸ Jeffrey Goldfarb, *An Inversion in All but Name*, Deal Book, New York Times (Aug. 8, 2014).

significant foreign operations. In explaining the difference between the SafeNet transaction and inversions, the article states:

[Unlike inversions], [s]ales of American companies to overseas buyers . . . are not in the cross-hairs. Yet SafeNet's deal could have a similar effect to an inversion. Presumably its tax home can shift from Baltimore to Amsterdam, where its new \$8 billion parent company is located. Over half of SafeNet's sales last year were generated outside the United States . . . and would therefore be eligible for a reduced tax rate under a new domicile.

To be clear, the *CFC Taxable Disposition Rule* would not prevent a foreign acquirer from structuring its post-acquisition foreign operations in its foreign subsidiaries that were not CFCs, thereby avoiding on a prospective basis the U.S.'s CFC rules. It would, however, prevent the tax-free use of the CFC's pre-acquisition deferred earnings.

3. Administrative Action: As Proposed by Professor Shay, Regulations under Section 385 for Future Inversions

I agree with Professor Shay's opinion, which he expressed in a recent Tax Notes article entitled *Mr. Secretary, Take the Tax Juice Out of Corporate Expatriations*.⁹ In the article, Professor Shay argues that the Treasury has the authority under Section 385 to curtail some of the interest stripping abuses that inverters are engaging in. I urge the Treasury to follow Professor Shay's suggestion and quickly issue proposed regulations, with an early effective date, reflecting the principles of his "*Related-party debt-to-equity limitation*" proposal.

From my prior study and analysis of the Treasury's proposed but withdrawn regulations under Section 385,¹⁰ I am confident that the Treasury has the authority to adopt regulations under Section 385 that are targeted at inversion and related transactions. Indeed, one of the problems with the previously proposed regulations was that they were attempting to deal with the universe of debt-to-equity issues, whereas regulations along the lines of those proposed by Professor Shay would be more focused and manageable and, therefore, more effective. Consequently, I strongly disagree with Robert Willens, "an influential tax commentator,"¹¹ who has apparently said that because the prior Section 385 regulations were "unworkable" Professor's Shay's proposal is merely "interesting reading with little, if any, practical significance."¹² By focusing on inversions, the regulations would be primarily concerned with artificial debt instruments issued in an inversion or related transaction by a U.S. corporation to its new foreign parent or related party, and not to "a [situation where a] long-term foreign parent [has] made a real loan of funds to [its] U.S. subsidiary and therefore [is] entitled to repayment and interest."¹³

⁹ Stephen E. Shay, *Mr. Secretary, Take the Tax Juice Out of Corporate Expatriations*, 144 Tax Notes 473 (July 28, 2014) [Shay, *Take the Juice Out of Inversions*].

¹⁰ See e.g., Samuel C. Thompson, Jr. et al, *Federal Taxation of Business Enterprises* (1994), at Sections 4:05-4.17.

¹¹ Victor Fleischer, *How Obama Can Stop Corporate Expatriations, for Now*, Deal Book New York Times (Aug. 7, 2014).

¹² *Id.*

¹³ Thompson, *New Inversions*, *supra* note 2, at 1421.

4. Administrative Action: Challenging the “Note-for-Stock” Part of Current and Past Inversions

As I have explained in my *New Inversion* article, the note-for-stock transactions which sets up the interest stripping opportunity in inversions is an artificial transaction that is vulnerable to attack under the business purpose doctrine and the codified economic substance doctrine. In the article, I state:

[T]he note-for-stock transaction is artificial on its face, lacks a true business purpose, and arguably should be treated as a constructive dividend regardless of the Killer B regulations. Moreover, the note-for-stock transaction is not essential for qualifying the transaction as a triangular reorganization because (1) the parent could transfer its stock directly to the target’s shareholders, or (2) the parent could contribute the stock to the subsidiary, which could then transfer the stock to the target’s shareholders. In both cases, the transaction would qualify as a reorganization.¹⁴

Thus, I believe that without regard to the potential prospective application of the Section 385 regulations to these transactions, the IRS should quickly state publicly that it will challenge the note portion of any inversion transaction under the business purpose and codified economic substance doctrines.

5. Administrative Action: Fixing the “Joe Frazier Left Hook” in the Current Section 367 Regulations

For the reasons stated in my *New Inversion* article, the Treasury should eliminate the “Joe Frazier Left Hook” in the Section 367 regulations by immediately announcing that the Section 367 regulations will be amended to (1) treat all inversions where the target’s shareholders end up with between 50% and 80% of the foreign acquirer’s stock as being subject to the Section 367(a) Gain Recognition rule, and (2) treat all notes issued in inversion transactions as constructive dividends. I discuss the technical issues involving these proposals as follows in my *New Inversion* article:

[A]lthough the scope of the antiabuse rule in reg. section 1.367(b)-10(d) is not completely clear, Treasury might use that rule to make both the section 367(a) gain recognition rule and the deemed dividend rule (or a similar constructive dividend rule) apply in inversions. Indeed, it is curious that Treasury treats the note-for-stock part of an inversion transaction as a non-outbound transaction under the section 367(b) regulations. The note-for-stock part of the transaction is clearly part of a larger outbound transaction (that is, the exchange by the U.S. shareholders of their stock in the U.S. target for stock in the foreign holding company). And because the larger outbound transaction is governed by the section 367(a) regulations, the note-for-stock part of the transaction should also be subject to section 367(a). This type of change could be accomplished by providing under the section 367(a) regulations [or the Section 367(b) regulations] that the note-for-stock part of an inversion transaction is a deemed distribution.

¹⁴ *Id.*

[P]ossibly the most direct approach would be for the IRS and Treasury to issue a notice saying that the section 367 regulations would be changed, effective on the date of the notice, to expressly bring these transactions back under section 367(a) as well as under section 367(b).¹⁵

6. Administrative Action: Preventing Avoidance of the Purposes of Section 956

In the part of Professor Shay's article entitled *Protecting deferred U.S. taxation of CFC earnings*, he says:

Regulatory authority could be used to ensure that the inversion is not used to gain access to earnings that should be subject to deferred U.S. tax in companies that are not owned by the expatriated U.S. companies. This would protect the deferred U.S. taxation of untaxed CFC earnings and the integrity of section 956 rules for investments in U.S. property.¹⁶

I make the same point in my *New Inversion* article, except I suggest that the Treasury can take steps under the current law to curtail avoidance of Section 956. I make this point as follows:

A Word on Avoidance of Section 956

Sections 951(a)(1)(B) and 956 apply to certain indirect repatriations of deferred foreign income. For example, if a CFC made a 10-year loan to its U.S. parent, the loan would be treated as a dividend distribution from the CFC to the U.S. parent, thereby eliminating the deferral benefit.

Some taxpayers may attempt to use inversions as a way around sections 951(a)(1)(B) and 956. For example, after an inversion, a long-time CFC of the U.S. parent could make a 10-year loan to the new foreign holding company, which in turn could make a similar loan to the U.S. parent, which is a sub of the foreign holding company. By using these back-to-back loans, the parties could argue that the indirect repatriation rules are not applicable. Treasury should make it clear that this and similar transactions do not avoid those rules.¹⁷

7. Administrative Action: Addressing the Gross-Ups of the Section 4985 Excise Tax

As explained in my *New Inversion* article, Section 4985 imposes a 15 percent excise tax on certain "specified [unrealized] stock compensation held (directly or indirectly) by or for the benefit of" certain high-level executives of an inverted corporation. The purpose of the tax is to impose a tax penalty on the high-level executives of the inverted corporation, thereby reducing the incentives to invert.

As it turns out, some corporations engaging in inversions have been "grossing up" their high-level executives so that they do not bear the burden of the excise tax. Thus, these inverters are shifting to the shareholders of the inverted corporation the cost of the excise tax. Also, the inverted corporations may be claiming "ordinary and necessary" business deductions under Section 162 for the gross-up payments.

¹⁵ *Id.*

¹⁶ Shay, *Take the Juice Out of Inversions*, *supra* note 9.

¹⁷ Thompson, *New Inversions*, *supra* note 2, at 1423.

These gross-ups undermine the law and are unseemly. At a minimum, the Treasury should publicly state that it will deny any business deduction under Section 162 or otherwise for these payments. These payments clearly can't possibly meet the "ordinary and necessary" standard under Section 162.

Also, the Treasury may want to consult with the SEC about possible action under the securities laws to prohibit publicly held companies from undermining the purposes of the law in this manner.

8. A Word on the Merits of a Territorial Regime

As you know many in Congress have been pushing for the U.S. to move to a territorial regime for international tax. For example an article in the July 30, 2014 edition of the Daily Tax Report says that in responding to efforts to curtail inversions, Republican Senator Hatch said: "The best approach . . . is in 'making it more wonderful to be here' by [1] lowering corporate tax rates and [2] moving toward a more territorial international tax system."¹⁸

Moving to a territorial system will exacerbate the interest and other income stripping problems that are present with inversions. Under a territorial regime every corporation in America will have an incentive to send earnings to a low tax jurisdiction so that the income could be returned to the U.S. without tax. Any territorial system would have to have guards against such tax avoidance "round-tripping," but clever tax lawyers and accountants will find a way to push the law to its limits. Thus, Senator Hatch and others are dead wrong when they say we need to both (1) lower the corporate tax rate, and (2) adopt a territorial system. Doing both would be a double corporate tax cut that could not be undertaken unless we are prepared to (1) dramatically increase the deficit, (2) dramatically raise taxes on individuals, or (3) dramatically cut government services, three things virtually every politician is against.

This brings me to the point I have made in my *Logic of Imputation* article. By adopting an imputation system for income of CFCs and thereby taxing on a current basis U.S. parents on all foreign income of CFCs, we would eliminate one of the largest, if not the largest, corporate tax expenditure, and on a revenue neutral basis, we could reduce the corporate tax rate to somewhere around 28% or lower for all corporations, including foreign corporations doing business in America. Also, an imputation system would significantly avoid, if not eliminate, transfer pricing abuses in outbound transactions. This would give U.S. corporations an incentive to work with the Treasury in developing rules that would curtail transfer pricing abuses on inbound transactions. In other words, American companies would have an incentive to say: "If we can't engage in aggressive transfer pricing in our foreign transactions, then foreign corporations should not be able to engage in aggressive transfer pricing transactions in their U.S. transactions."

While an imputation system would not eliminate the need for anti-inversion rules, it would not, as would a territorial system, give American corporations a tax reason to invest abroad as opposed to at home. To be clear, in proposing a territorial regime, Senator Hatch is arguing for a

¹⁸ *Corporate Inversions: Democrats Propose Tightened Ban On Contracts to Inverted Companies*, BNA, Daily Tax Report (July 30, 2014).

system that will encourage investment in the UK as opposed to investment in Utah. On the other hand, an imputation system would create a level tax playing field between investment in UK and Utah, and if the increased revenues from the adoption of an imputation system were used to reduce the corporate tax rate, investment in Utah would be even more attractive.

I realize that under the current political environment in Washington, there is little chance of Congress adopting an imputation system or a territorial system. But, I am confident that sooner or later, Congress will seriously turn to international tax reform and that it is important for the Administration to put an imputation system on the table as a real possibility. Although the proposals in the Treasury's Green Book have moved in the direction of curtailing deferral, I believe that those proposals have been "*Too Timid*,"¹⁹ and the Green Book should go the whole way and propose the adoption of an imputation system, returning to a proposal made by President Kennedy and his Assistant Secretary for Tax Policy, Stanley Surrey, one of the most influential tax policy thinkers in the 20th Century. I am confident that if parties are forced to engage in a real debate about the merits of an imputation system as compared to a territorial or other system, it would become clear that the *Logic* for an imputation system is overwhelming. Finally, for the reasons I set out in my *Logic of Imputation* article, the "Me Tooism" arguments for adopting a territorial regime (*i.e.*, "other countries have it, so we should to") should be flatly rejected.

Concluding Thought

Adoption of the above proposals would not have the purpose or the effect of curtailing cross-border acquisitions that are motivated by sound economic principles. Adoption would, however, curtail purely tax motivated cross-border mergers.

Sincerely



Samuel C. Thompson, Jr.

Enclosures: *New Inversions, the 'Joe Frazier Left Hook,' the IRS Notice, and Pfizer*; June 23, 2014 issue of Tax Notes
Logic Says No to Options Y, Z, and C, but Yes to Imputation, May 5, 2014 issue of Tax Notes

¹⁹ Thompson, *Too Timid*, *supra* note 3.