Comment on
Inversions and Related Transactions (REG-135734-14)
(The "Serial Inverter" Rule)
Docket Number: IRS-2016-0015-0002
Docket RIN: 1545-BM45

We support Treasury's serial inverter rule, which seeks to ensure that Section 7874 applies to serial transactions that result in the kind of expatriation Congress sought to curb when it enacted Section 7874.

Congress enacted Section 7874 in 2004 to prevent U.S. companies from nominally shifting their tax residence to foreign jurisdictions while substantially remaining in the United States. This section treats an inverted corporation as "domestic" (still subject to U.S. tax) if it is 80-percent owned by shareholders of the former domestic parent (we refer to this rule as the "80% threshold"), unless it has "substantial business activities" in the country it is incorporated in. If shareholders of the pre-inverted entity own less than 80 percent but 60 percent or more of the new foreign entity, then the inverted corporation is taxed by the United States for a period of 10 years on any "inversion gains," which generally refers to certain gains from transfers related to the inversion transactions, including licensing arrangements. Inversions in which former shareholders own less than a 60 percent interest in the new foreign corporation (the "60 percent threshold") are not considered inversions at all for purposes of the Code and carry no adverse tax consequences to the inverted corporation.

Recent corporate expatriation transactions, such as Tyco-Johnson Controls and the failed Pfizer-Allergan merger, demonstrate that U.S. companies were finding ways to avoid the reach of these rules. As a result, firms are still trying to move their legal residence offshore for tax purposes, even as they continue to maintain operations and management in the United States. This results in less U.S. tax revenue to fund important priorities, such as improving our nation's infrastructure, educating and training our workforce and maintaining strong legal protections, all of which help make U.S. business and our economy more vibrant. Alternatively, the result is higher taxes for everyone else or more debt to be paid by future generations.

The proposed regulation appropriately identifies one means by which firms sought to avoid the reach of the current statute—through the technique of serial inversions. This is when a foreign company, often a former U.S. firm itself, acquired U.S. companies in succession. With each inversion and/or merger, the foreign firm was able to acquire a larger U.S. firm without tripping the thresholds of Section 7874. Having side-stepped the anti-inversion rules, the new foreign parent firm then would be in a position to engage in post-merger transactions to strip the remaining U.S. firm of income and access the U.S. firm's untaxed foreign profits—without paying U.S. tax.

The now-abandoned Pfizer-Allergan merger was a particularly notable example of a serial inversion, which illustrated several problems with the current law. First, the size of the transaction was huge. The Pfizer-Allergan merger would have been the largest inversion to date in terms of transaction value. The merger price tag was about $160 billion, and, if it had been completed, it would have enabled Pfizer to report a single-digit tax rate under generally accepted accounting principles (GAAP). It also would have enabled Pfizer to access about $148 billion of profits parked offshore, without ever paying U.S. tax on those profits.

Second, Pfizer's proposed inversion demonstrates how U.S. multinationals have perfected their income-shifting strategies, stripping income from the United States and other jurisdictions where such multinationals have real operations. In the past five years, Pfizer reported about $60 billion of pre-tax income worldwide. Ridiculous as it may seem, this included about a $16 billion *loss* in the United States. This is in spite of the fact that the United States is Pfizer's single largest market. This means that Pfizer, an immensely profitable corporation, was able to strip tremendous amounts of income out of the United States. Had Pfizer repatriated its foreign earnings to the United States, they would have been immediately subject to tax. This suggests the Pfizer inversion was motivated not necessarily by a desire to strip future earnings from the United States (though such motive may indeed have played a role since Pfizer may anticipate significant U.S. profits in the future), as much as the desire to access profits that have already been stripped out of the United States (as well from other countries where Pfizer has actual operations).

Third, the serial inverter rule is necessary because recent inversions reveal that U.S. multinationals many times invert by acquiring another previously inverted U.S. multinational, not a foreign competitor. For example, the Pfizer inversion would have been achieved by merging with Allergan, which itself is an inverted corporation (formerly known as Actavis, which inverted to Ireland in 2013). Medtronic inverted by acquiring Covidien, which itself inverted in 2007.

Serial inversions effectively sidestep the 60 percent and 80 percent thresholds. By doing so, they undercut the purpose of Section 7874, which was to distinguish inversions from acquisitions by foreign entities genuinely motivated by valid non-tax considerations. Allowing multiple step acquisitions enables a merger between two U.S. entities, one of which has inverted previously, to escape Section 7874 by treating the first inverter as a genuine foreign acquirer.

We support the Treasury's serial inverter rule, which prevents these types of transactions from gaining the purported tax benefits. We believe Treasury has acted appropriately to bring serial inversions within the anti-inversion rules under Section 7874. In fact, we believe Treasury has a duty to act given the substantial systemic risk to the U.S. tax base presented by inversions, including foreign acquisitions of U.S. firms that do not fall squarely within the technical definition of an inversion under Section 7874. The purpose of the Section 7874 thresholds was to distinguish inversions from genuine acquisitions of U.S. targets by foreign acquirers motivated by a valid non-tax business purpose. Allowing serial inversions in which former U.S. corporations are treated as the “foreign” acquirer of the U.S. target for purposes of Section 7874 subverts the Congressional intent behind the Section 7874 thresholds. We believe Treasury had the full authority to adopt the serial inverter rule under the anti-abuse provision of Sections 7874(g), 7874(c)(6) and 7805. We also believe that the effective date of the temporary regulations should meet the good cause exception in 5 U.S.C. 553(d)(3), and/or the prevention of abuse standard in IRC 7805(b)(3).

Sincerely,

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