BUILDING THE NEW BERLIN WALL: TREASURY'S ANTI-INVERSION REGULATIONS

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The Treasury no doubt felt that it could chalk one up in the win column early in April 2016 when, following its release[1] of a veritable carpet bombing of new regulations designed to blow-up inversion transactions, the primary target, Pfizer Inc., chose to wave the white flag and cancel—at least for the time being—its efforts to merge with Allergan PLC.

One can easily imagine, deep in the bowels of the IRS headquarters at 1111 Constitution Avenue in Washington, D.C., giddiness reigning supreme, with elated tax policy wonks exchanging awkward "high fives." Let's not go there.

Unfortunately, a more sober assessment is that the Treasury's "victory" was Pyrrhic at best and catastrophic at worst, as the Treasury "doubled down" on a U.S. corporate income tax policy that is in a shambles. Pfizer was trying to leave the U.S. for precisely the same reason that so many corporations have already left, and many others would be delighted to follow. The U.S. has one of the highest corporate tax rates in the world, and, moreover, asserts (almost uniquely among major countries) the right to tax the world-wide income of every U.S. corporation, including every multinational corporate group with a U.S. parent corporation, regardless of how minimal or tangential the U.S. relationship may otherwise be to that income.

Put it this way: Having a multinational corporate group with substantial worldwide operations owned beneath a U.S. corporation is not merely a "questionable" strategy, or even a "poor" idea; it is provably, mathematically the wrong structure if your goal is to operate the corporation in the best interests of its owners, employees, and other stakeholders.

Distilled to its basics, the current Treasury policy is both bullying and wrong-headed. Treasury has signaled, through three aggressive announcements over the past 18 months,[2] that it will do all it can to stop U.S. corporations from leaving—even when the law is not necessarily on the Treasury's side.

Some people think current U.S. policy is accurately described using a "Hotel California" metaphor—you can check-out anytime you like, but you can never leave—but the better analogy, precisely because it so clearly illustrates the melding of bad policy and all-but-certain failure, is the Berlin Wall. Khrushchev built the Berlin Wall in 1961 because growing hordes of East Germans were fleeing, and it grew increasingly awkward to try and defend the workers' paradise of the Eastern Bloc when large swatches of workers were intent on bailing out. So too with U.S. tax policy: Treasury thinks the natural answer to the fact that many U.S. corporations want to escape the U.S. is to make them stay unwillingly, by building the corporate tax equivalent of the Berlin Wall.

Ironically, the current U.S. tax mess is *easily* fixable, and indeed the United Kingdom, which itself was hemorrhaging corporations to Ireland just a few years ago, has provided an exact blueprint: Bring the corporate tax rate down, and stop trying to tax the repatriation of foreign earnings.[3] But accepting this simple, obvious solution and the related consequences seems oddly anathema in Washington D.C. these days.[4]

So, in the meantime, we are where we are, which is more or less on the wrong side of 1961 Berlin. How this will all shake out in the short- and medium-term is far from clear—politics hangs like a heavy fog—but one thing seems self-evident: In the long term, current U.S. tax policy seems likely to work out every bit as well for the U.S. as building the Berlin Wall did for Khrushchev. It will, eventually, need to come down.

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The Unspoken Target of the New Regulations

The desperation of Treasury to find some solution, any solution, to the current U.S. inversion stampede is perhaps best measured by the sheer length of its most recently issued regulations—some 200 pages of new regulations under Section 7874,[5] adding a dense layer of picayune provisions governing inversion transactions (but, let it be clearly stated, coming nowhere close to actually stopping inversions if the parties are determined and willing to stare down the Treasury's ire), plus, for good measure, another 135 pages under Section 385,[6] dealing with rules to distinguish debt from equity, with a special emphasis on preventing so-called "earnings stripping."

Of course, nowhere in the new regulations and the accompanying announcements did Treasury explicitly state that this was all part of an orchestrated "Stop Pfizer" movement, but on the other hand no one in the financial markets was the least bit deceived.

More than 50 former U.S. companies have incorporated outside the United States since 1982, and in recent years the exodus has picked up at an alarming pace, with more than 20 major corporations heading out the door to more congenial tax climes just since 2012.[7] The list of the newly departed is both demoralizingly long and peppered with the names of top-notch, even iconic, companies, including Burger King, Medtronic, Liberty Media, Eaton Corporation, Stanley Works, Ingersoll-Rand, Seagate Technology, Fruit of the Loom, and Tyco International.

The latest corporation to announce its fond farewells—and the biggest to date—was supposed to be Pfizer, the huge and highly regarded drug company (ranked #2 in the world)[8] heretofore headquartered in New York but soon to be owned via merger by Allergan PLC, a corporation formed under the laws of Ireland but also with a strikingly large managerial presence in New Jersey.

More than a few observers believe that Treasury specifically tailored some of the newly issued regulations specifically to stop the Pfizer-Allergan merger.[9] For example, the new regulations contain a three-year look-back period[10] that seems suspiciously tailored to Allergan— a composite of an original smallish Irish corporation and several already-inverted U.S. corporations—and raised the question whether Allergan was really "Irish enough" to qualify as an inversion partner.

Admittedly, the only thing more embarrassing than having a corporate heavyweight like Pfizer leave the U.S. was the fact that it was merging into Allergan, a Frankenstein creation of several other previously inverted U.S. drug companies. In fact, previously inverted U.S. companies often seem to become a natural "foreign" partner for subsequent inverting U.S. companies.[11] The Treasury calls companies like Allergan "serial inverters," and the three-year look-back rule is designed to prevent serial inversions—but, the problem is, it only applies for a period of three years. Even under the Treasury's new-and-improved rules, Pfizer and Allergan can take a mulligan and redo their inversion transaction all over again—possibly as soon as next year, and in all events by 2018.

The Curiously Un-Irish History of Allergan Plc.

The history of Allergan is instructive of Treasury's deep concern that expatriated former U.S. companies are helping other U.S. companies to escape "over the wall" from U.S. taxation. The company now known as "Allergan" started out, way back when, as a small Irish

Summary of Section 7874

Section 7874 was enacted in 2004, and was explicitly intended to discourage so-called "inversion transactions." It has in fact made it more difficult to implement an inversion transaction but, as will be discussed below and in the accompanying article, U.S. corporations and their advisors have been increasingly effective at dodging the impediments put in place by Section 7874.

If an inversion transaction meets the statutory requirements in Section 7874 , certain adverse U.S. tax consequences (described more fully below) are triggered, depending on the characteristics of the inversion. A corporate inversion occurs when a US-based multinational restructures its operations so that the U.S. parent is replaced and superseded by a foreign parent, for the primary objective of reducing or avoiding U.S. taxes. Section 7874 applies to an "inversion" transaction if all of the following three requirements are met:

1. There is a transaction in which a foreign acquiring corporation[27] completes the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation ("First Requirement");
2. The shareholders of the former U.S. parent end up owning at least 60% (and with particularly punitive consequences if they end up owning 80% or more) of the foreign acquiring corporation ("Second Requirement"); and
3. After the acquisition, the expanded affiliated group (EAG) that includes the foreign acquiring corporation does not have substantial business activities in the foreign country in which, or under the law of which, the foreign acquiring corporation is created or organized, when compared to the total business activities of the EAG. ("Third Requirement").

Note: This "substantial business activities" test has already been beefed up by IRS regulations to mean at least 25% of the employment, assets, and income of the corporate group are located or derived in the foreign jurisdiction where the foreign acquiring corporation is incorporated.

As a practical matter, most inverting U.S. corporations try to fail either the Second Requirement or Third Requirement. To circumvent the Second Requirement, based on the 60% and 80% thresholds, many U.S. companies have been able to target a foreign corporation that is an attractive merger candidate to be used as the New Foreign Parent (NFP) in an inversion transaction. The goal is to make sure that the existing (premerger) shareholders of NFP hold over 20% of the stock in NFP following the merger (so that NFP ownership stays below the lethal 80% threshold).

Note: Any inversion transaction where USCo shareholders own more than 50% of the New Foreign Parent will be taxable under Section 367, but U.S. companies have been notoriously indifferent as to whether, in an inversion transaction, their shareholders are subject to tax.[28] Instead, the primary issue is to get the corporate tax regime into a much better configuration. So long as the former USCo shareholders are below the 80% ownership threshold in NFP post-merger, many U.S. companies have been willing to implement an inversion transaction. A U.S. company where the continuing stockholder ownership is at 60% or over but less than 80% is treated as having successfully inverted and is now a wholly owned subsidiary of NFP; the USCo is thereafter subjected to some corollary adverse U.S. tax consequences,[29] but in practice these tax penalties have not discouraged companies from doing inversions. On the other hand, if former USCo shareholders would end up owning 80% or more of NFP, then the inversion transaction is not respected and the NFP is treated as a U.S. corporation subject to full US taxation. No inversion transaction to date has exceeded the 80% threshold unless the transaction was able to avoid one of the other Requirements of Section 7874 (e.g., by having the NFP satisfy the "substantial business activities" test under the Third Requirement).

The Third Requirement allows USCo to avoid the application of Section 7874 if the NFP has "substantial business activities" in the foreign jurisdiction where NFP is incorporated. This test was initially interpreted by the IRS (in 2006 regulations) as a "facts and circumstances" test with a safe harbor that applied if at least 10% or more of the corporate group's worldwide employees, assets and sales were in the NFP jurisdiction after the acquisition. The 10% safe harbor was eliminated by Temporary Regulations in 2009[30] and then, in 2012, the IRS abandoned the facts and circumstances test entirely and instead defined "substantial business activities" to mean that at least 25% of the EAG's post-merger activities in each of three categories, including employees, assets, and income, must be located or derived in the foreign jurisdiction where NFP is incorporated. This enhanced set of limitations has stymied the so-called "self-inversion" or "naked inversion," where a U.S. multinational would invert into its own existing foreign subsidiary. Most foreign subsidiaries do not satisfy the requisite 25% threshold in each of the three key areas, and so it is much more difficult to avoid the Third Requirement.[31] Instead, U.S. corporations typically seek an unaffiliated foreign corporation with which to merge in a so-called "combination inversion" (i.e., avoid Section 7874 by avoiding the Second Requirement instead of the Third Requirement).

As the current feeding frenzy of inversion transactions amply suggests, there is an ability to find suitable merger partners in the marketplace, and thus implement a combination-inversion transaction that either avoids the Second Requirement entirely (and thus avoids Section 7874 entirely) or, at worst, falls into the greater-than-60%/less-than-80% bracket under the Second Requirement where Section 7874 applies to the transaction but the tax penalties are relatively benign.

pharmaceutical company called Galen Holdings, PLC. In 2000, Galen acquired its first U.S. target, Warner Chilcott, a pharmaceutical company based in Rockaway, New Jersey, in a transaction valued at approximately $296.5 million, and created a combined entity with a value of approximately $1.5 billion.[12] In 2004, Galen formally changed its name to Warner Chilcott.

In May 2013, Warner Chilcott, now an Irish corporation, was acquired in an inversion transaction by Actavis in a stock-for-stock transaction valued at $8.5 billion. Actavis, a U.S. company formerly known as Watson Pharmaceuticals that changed its name to Actavis when it acquired the Swiss-based Actavis Group in November 2012 for a reported EUR4.25 billion, now become an Irish PLC as a result of the Warner Chilcott merger.

In July 2014, Actavis PLC acquired another U.S. pharmaceutical company, Forest Laboratories (which had previously acquired, Furiex Pharmaceuticals Inc and Aptalis Pharma) in a cash and

equity transaction valued at approximately $25 billion. On March 17, 2015, Actavis, PLC completed the acquisition of Allergan, Inc., a U.S. corporation best known as the manufacturer of Botox, in a cash and equity transaction valued at approximately $70 billion, and leaving the post-merger corporation valued at well over $100 billion[13]—up from just $5 billion in 2009. In June 2015, Actavis, plc officially changed its name to Allergan, PLC.

The Pfizer merger valued Allergan at an estimated $160 billion, and the merger called for Pfizer shareholders to own 56% of the resulting Irish parent corporation and for Allergan shareholders to own approximately 44%. Pfizer shareholders would be treated as exchanging their Pfizer shares for Allergan shares in a fully taxable transaction,[14] but the transaction would fall below the crucial 60% and 80% thresholds under Section 7874, as described in the accompanying side bar. However, the recent acquisitions by the "Allergan" entity (including the Actavis acquisitions of Allergan in 2015 and Forest Laboratories in 2014) were estimated in news reports to represent about 55% of the total stock of the Irish target corporation,[15] and, under the proposed Treasury regulations, these shares are excluded from the denominator in the crucial percentage calculations (i.e., the percentage calculations under Section 7874 are made as if Allergan were a much smaller foreign entity).[16]

Why U.S. Corporations Invert. There are two basic reasons why a U.S. multinational corporation wants to invert:

1. To gain access to "trapped" offshore funds without triggering U.S. taxation ("retroactive benefit"); and
2. To generate future income sourced outside the United States and thus not subject to U.S. taxation ("prospective benefit").

A successful inversion has, up to now, generally achieved the first objective because the new foreign parent could generally access these funds without triggering U.S. taxation. The elimination of this retroactive benefit may discourage some existing U.S. corporations from inverting and, as discussed in the next section, that has been the predominant focus of the new Treasury rules. But the prospective benefits will continue to be (temptingly) available, and two things are likely to happen, both bad from a U.S. policy viewpoint. First, some U.S. companies will conclude that, even if the retroactive benefits are diminished, the prospective benefits still weigh in favor of inversion. Second, and more importantly, over-taxed assets will not stay in an over-taxed situation forever – new foreign corporations will naturally form outside the United States, with a U.S. operating subsidiary, and will achieve—elegantly, seamlessly, and irresistibly-–all the tax benefits sought by inverting U.S. companies. In the simplest transaction of all, foreign corporations can purchase over-taxed U.S. assets and move the assets offshore, and, unless the U.S. is inclined to prevent any acquisition whatsoever of U.S. business assets—a far-fetched proposition at the moment—then the economic equivalent of inversion can be accomplished by the simple expedient of writing a check.

Almost all the regulatory efforts to date, beginning with the First Announcement in 2014, have focused on curbing retroactive benefits. One can argue that the Treasury has a legitimate interest in preventing the retroactive benefits but, in all due respect, the offshore cash held in foreign subsidiaries is not the central problem. Rather, the main motivator for U.S. companies is that they are forced to operate at a permanent dis-

1 "Treasury Announces Additional Action to Curb Inversions, Address Earnings Stripping," 4/4/2016, found at https://www.treasury.gov/press-center/press-releases/Pages/jl0405.aspx.

2 The first Treasury announcement, announced by press release on 9/22/2014, and followed up by the more formal guidance of Notice 2014-52, 2014-42 IRB 712, contained a variety of interesting and important proposals, and was reviewed in detail in the article by Darby, "Inverted Priorities: Why the Proposed Treasury Rules are Unlikely to Stop Inversion Transactions," 18 Practical International Tax Strategies 2 (2014). As the article title suggests, the first round of Treasury proposals addressed perceived abuses and tightened the rules, but did not prevent inversion transactions. The second announcement, 'Fact Sheet: Additional Treasury Actions to Rein in Corporate Tax Inversions," 11/19/2015, found at https://www.treasury.gov/press-center/press-releases/Pages/jl0281.aspx, contained further tweaks that expanded and embellished the rules proposed in the first announcement but suggested, by the exceptional length and relatively modest additions of substantive content, that Treasury was already running dry on further ideas. As will be discussed below, the third announcement seems to offer even less substance – except where is it taking steps that at least some commentators believe go beyond the boundaries of the Treasury's rule-making authority.

3 The Congressional Research Service, in a report "Corporate Expatriation, Inversions, and Mergers: Tax Issues" issued 5/27/2014, stated: "Two features made a country an attractive destination: a low corporate tax rate and a territorial tax system that did not tax foreign source income. Recently, the UK joined countries such as Ireland, Switzerland, and Canada as targets for inverting when it adopted a territorial tax. At the same time the UK also lowered its rate (from 25 percent to 20 percent by 2015)."

4 Congressional Research Service, in its 5/27/2014 report, stated (almost too candidly) as follows: "Some have suggested that lowering the corporate tax rate as part of broader tax reform would slow the rate of inversions. Although a lower rate would reduce the incentives to invert, it would be difficult to reduce the rate to the level needed to stop inversions, especially given revenue concerns." A revised report, issued 10/3/2014, was much less candid on this issue.

5 FR Doc. 2016-07300, filed 4/4/2016, 5:00 pm, publication date 4/8/2016, is a terse, economical 204 pages.

6 FR Doc. 2016-07425, filed 4/4/2016 5:00 pm, publication date 4/8/2016, is 136 pages.

7 Bloomberg has maintained a running list of expatriated U.S. companies since 5/27/2014, which can be found at http://www.bloombergview.com/quicktake/tax-inversion. The list identifies the year, the destination, and, where applicable, the merger partner. Prior to about 2012 (when Treasury first began aggressively jiggering the rules under Section 7874) it was often possible to do a "naked inversion" into a wholly owned foreign subsidiary. Today, the most promising mechanism under Section 7874 is to merge into a foreign corporation in the desired jurisdiction that is at least 25% the size of the U.S. corporation. See Darby, "Inverted Priorities: Why the Proposed Treasury Rules are Unlikely to Stop Inversion Transactions," note 2, *supra*.

8 A Forbes magazine article dated 6/4/2015 ranked Johnson & Johnson #1, Pfizer #2 and Swiss-based Novartis #3 in size in the pharmaceutical industry. See http://www.forbes.com/sites/liyanchen/2015/06/04/2015-global-2000-the-worlds-largest-drug-and-biotech-companies/#7b9203285768.

9 Among those who think so is Allergan CEO Brent Saunders, who stated so publicly immediately after the merger was called off. See "Allergan CEO: Merger with Pfizer was targeted by U.S. government," published at http://www.cnbc.com/2016/04/05/ AbbVie, Inc. had a similar complaint in 2014 when its proposed $52 billion merger with Shire Plc was terminated following the first round of Treasury announcements attacking inversion transactions. The 2014 tax proposals "reinterpreted longstanding tax principles in a uniquely selective manner designed specifically to destroy the financial benefits of these types of transactions," AbbVie said in a statement at the time. See article at http://www.bloomberg.com/news/articles/2016-04-06/pfizer-allergan-plan-to-mutually-end-merger-cnbc-reports.

10 The new look-back period is described in the Third Announcement as follows: Limiting inversions by disregarding foreign parent stock attributable to certain prior inversions or acquisitions of U.S. companies (Action under section 7874 of the code).

advantage compared to foreign corporations. New ideas and technologies will come into existence elsewhere – and there is every reason to think that an intellectual property drain is already taking place, to Ireland, the United Kingdom, the Netherlands, and other welcoming jurisdictions.

Some Good Things in the New Regulations

The new regulations do contain some good ideas that are appropriate to protect the legitimate interests of the U.S. Treasury and the revenues of the U.S. government—although there is a separate, legitimate concern that the wide scope of these regulations may impact standard commercial transactions that have nothing to do with inversions.

Inversion transactions raise two specific areas of potential abuse that merit full and proper U.S. policy responses. First, many of the inverting U.S. companies have huge stashes of offshore cash trapped in controlled foreign corporations, or CFCs, and it is a legitimate question to ask whether these funds should in some way be taxable by the U.S. at the time of, or following, an inversion transaction.[17]

Recent estimates suggest that there may be more than $2 trillion dollars of cash earned overseas by U.S. corporations, held in their CFCs and not currently taxable (unless the earnings are repatriated) but theoretically taxable at some point in time in the future, precisely because the money will otherwise be trapped forever in the CFC layer of the U.S. corporate structure and will never be distributable to shareholders.

Inverting U.S. companies have in the past have gained access to these funds through various mechanisms, including through "out from under" transactions where the CFC is moved tax-free from beneath the former U.S. parent, and through so-called "hopscotch" loans where "trapped" money in CFCs is lent to the new (often Irish) holding company above the inverted U.S. corporation. The recent Treasury regulations are relentlessly thorough in trying to close down these types of transactions.

As will be discussed more fully below, the policy preference of the author leans toward allowing low-tax or even tax-free repatriation of foreign earnings, but if the U.S. is determined at some point in time[18] to tax the foreign earnings trapped in the CFC layers of a multi-national U.S. corporate group, then the Treasury efforts to block "out from under" transactions and hopscotch loans are defensible (and indeed necessary).

Earnings Stripping Issues. A second major perceived abuse of inversion transactions is that, following the inversion, there are instances where the new foreign parent makes substantial loans to the U.S. corporation (now a subsidiary of the foreign parent) motivated predominantly by "earnings stripping," namely, transferring most of the profits out of the U.S. corporation to the parent-lender through deductible interest payments.

Earnings stripping is not even remotely close to being a "new" issue or a new abuse. As far back as the late 1980s, the U.S. adopted rules under Section 163(j) to prevent U.S. corporations from using excessive interest deductions in order to reduce their taxable income in the United States and shift income to other countries (presumably with lower tax rates). These rules prohibit U.S. corporations from deducting a portion of interest paid to related foreign corporate affiliates when (a) the U.S. debtor's debt-to-equity ratio is greater than 1.5 to 1 and (b) the interest amount exceeds 50% of the U.S. debtor's adjusted taxable income.

U.S. tax policy embodied in Section 163(j) is not only reasonable but consistent with world standards and is eminently worthy of enforcement. U.S. fiscal policy should appropriately protect taxation of U.S.-source income, in a sound and pragmatic way. The authority to protect against improper erosion of the U.S. income tax base is inherent in the powers of the IRS under Section 482, and those powers already exist regardless of the Service's recent efforts to put an extra, barracuda-like bite into its enforcement arsenal through the new Section 385 regulations.

One potential problem with the recently issued Section 385 regulations is that the IRS may not actually have the authority to issue them in their current form. A smart, experienced tax practitioner cheerfully told me that, in his opinion, the Section 385 regulations are "a clear example of Treasury exceeding the boundaries of its authority." Beyond that rather significant gating issue, the new Section 385 regulations are extremely complex, have a scope far beyond inversion transactions, and in important ways ignore the many practical issues that arise in garden-variety loan transactions—including domestic transactions where the inversion issues are irrelevant.

The UK Paradigm. Until 2009, the United Kingdom also suffered from serious corporate inversion problem—the UK was losing many of its large multi-national corporations to Ireland. Sound familiar? In response, the UK took two specific actions:

1. It reduced its corporate tax rate from 28% in 2010 to 20% in 2015, coupled with a "Patent Box" Regime that lowered the corporate tax rate to just 10% for revenues attributable to patents developed in the UK; and
2. It eliminated taxation of foreign income earned by controlled foreign subsidiaries in most circumstances, and generally allowed tax-free repatriation of foreign earnings to the UK parent corporation.

Is it really that simple? Yes. In fact, a striking feature of recent U.S. inversion transactions is that, while Ireland still remains the most popular inversion destination,[19] the UK is now in second place! The Bloomberg list of U.S. inversions shows that since 2012, seven U.S. companies have inverted to Ireland, while five have inverted to the UK.[20] In addition, at least one other major U.S. inversion with a UK destination was contemplated but later called off, the proposed Walgreens merger with Boots.

Significantly, even though the UK now has the lowest corporate tax rate among the G20 nations, the UK government has announced further tax cuts, reducing the maximum corporate tax rate to 19% for fiscal years 2017, 2018, and 2019, and then down to 18% for fiscal year 2020. In announcing these further cuts, the Chancellor of the Exchequer, George Osborne, asserted that the previous reductions in the corporation tax, from 28% to 20%, had created jobs and increased investment, and then added, "Now at 20% for large and small businesses alike, we have the joint

Some foreign companies may avoid section 7874 – the tax code's existing curbs on inversions - by acquiring multiple American companies over a short window of time or through a corporate inversion. The value of the foreign company increases to the extent it issues its stock in connection with each successive acquisition, thereby enabling the foreign company to complete another, potentially larger, acquisition of an American company to which section 7874 will not apply. Over a relatively short period of time, a significant portion of a foreign acquirer's size may be attributable to the assets of these recently acquired American companies.

It is not consistent with the purposes of section 7874 to permit a foreign company (including a recent inverter) to increase in its size in order to avoid the inversion threshold under current law for a subsequent acquisition of an American company. For the purposes of computing the ownership percentage when determining if an acquisition is treated as an inversion under current law, today's action excludes stock of the foreign company attributable to assets acquired from an American company within three years prior to the signing date of the latest acquisition.

11 In addition to Allergan, examples include Eaton Corporation, a major manufacturer of valves formerly headquartered in Cleveland, which merged in 2012 into Cooper Industries, a former U.S. corporation that moved to Ireland in 2009. Similarly, Tim Hortons expatriated to Canada in 2007, and then became the foreign merger partner for Burger King, which moved to Canada in 2015.

12 See http://www.prnewswire.com/news-releases/galen-holdings-plc-to-acquire-warner-chilcott-plc-nasdaq-listing-of-galen-73000537.html.

13 One source, for example, suggested that the post-merger entity would be valued at $147 billion. In all events, it was soon valued by Pfizer at approximately $160 billion for purposes of the proposed Pfizer-Allergan merger.

14 A transaction where a U.S. corporation is acquired by a smaller foreign corporation, as evidenced by the fact that the U.S. shareholders own more than 50% of the foreign acquirer stock following the acquisition, if treated as a fully taxable disposition of the U.S. corporation's stock by its shareholders under Section 367 and the applicable regulations. In general, inverting U.S. corporations have been notoriously indifferent about whether the inversion inflicts an unwanted tax on its U.S. shareholders – their principal worry is successfully inverting from U.S. tax jurisdiction (that generally means making sure the transaction is less than the 80% threshold under Section 7874) and not having a taxable event at the corporate level.

15 The calculations under Section 7874 to apply the 80% test to the Pfizer situation are at once overly precise and strangely fuzzy, because (a) the percentage being calculated is based on a numerator and the denominator that both fluctuate based on daily market prices of the target and acquirer, (b) there are various "skinny down" and "bulk up" anti-abuse rules already issued under the 7874 regulations, and (c) the new rule disallowing recently acquired US corporations in valuing the foreign target, all introduce significant "wiggle" in the calculations. For example, in valuing the disallowed assets of Allergan or Forest Laboratories, does that disallowance include all growth in the value of thosze assets since the respective acquisition dates? Or, for example, in calculating the percentage of "good assets" contributed by Allergan Plc to the merged entity, do the values ascribed to the recently acquired assets of Allergan and Forest Laboratories count in the denominator even though they are not included in the numerator (i.e., are they "bad assets") or should they be subtracted from both the numerator and the denominator? Using the arithmetic most favorable to Treasury – and very mindful of the mathematical folly of using very large round numbers to calculate very precise percentages – the author made some "back of the envelope" calculations and found that, under the "bad equity" construct, one might conclude that the Pfizer percentage of the proposed Allergan merger, for Section 7874 purposes, was 80.2%—just over the "deal fatal" threshold of 80%. However, the larger truth is that the 7874 calculations are very difficult to make with any kind of reliable precision—which is probably no accident and, indeed, may well be one of the Treasury's tactical objectives as it seeks to discourage inversions.

16 Attempting to apply the 60% and 80% tests under Section 7874 to the Pfizer situation quickly becomes an exercise that is at once extremely precise and strangely opaque, because (a) the percentage being calculated is based on a numerator and a denominator that can both fluctuate widely based on how one interprets and applies the laundry list of "anti-abuse" rules issued to date by Treasury, (b) there are various "skinny down" and "bulk up" anti-abuse rules contained in the 7874 regulations that may or may not apply to the Pfizer situation, and (c) the new (anti-Allergan) rule disallowing recently acquired U.S. corporations in determining the stock of the foreign target, is clearly a substantial negative factor in this particular calculation. The author made some very rough, "back of the envelope" calculations and estimated that if 56% of the resulting corporation were "bad" stock (included in the numerator) and if 55% of the remaining 44% (representing the market capitalization of Allergan attributable to Forest Laboratories (23%) and Allergan (32%) were excluded from the denominator, the 7874 percentage would be 73.88%

–arguably not enough to be "deal fatal," which generally requires the 7874 percentage to exceed an 80% threshold. However, the larger truth is that the 7874 calculations have become very difficult to make in a complicated factual situation with any kind of reliable precision—which is probably no accident and, indeed, may well be one of the Treasury's tactical objectives as it seeks to discourage inversions.

17 As will be discussed below, the author endorses a very different approach, namely, to make the repatriation of foreign earnings subject to no tax or to a relatively nominal tax—as happened once before, with great success, in 2005. However, the Author is far more concerned about leveling the tax "playing field" through U.S. corporate tax reform and thus eliminating the prospective benefits, which are—or should be—the central concern.

18 The irony, pointed out in the article by Darby, "Gertrude Stein Was Wrong: A Dollar is a dollar is a dollar…except when it Is not," 6 Practical U.S. Domestic Tax Strategies No. 3 (2006), is that when a dollar in an offshore account is worth a dollar, but the same dollar returned to the U.S. becomes worth $0.65 (assuming a 35% corporate tax rate), not many dollars come back to the United States. Therefore, the U.S. right to tax these offshore funds has always been more theoretical than real. Meanwhile, the inability to use those funds effectively is a huge hindrance and detriment to U.S. corporations. Low-tax or tax-free repatriation of foreign profits seems like a far more promising policy alternative.

19 The Irish corporate tax rate of 12.5% is low enough, and the Irish determination to attract business is strong enough, to make Ireland still the top destination choice, even though Ireland has begun winding down its legendary "Double Irish" structure.

20 The five UK-bound companies were Steris (2015), Cyberonics (2015), Liberty Global (2013), Rowan (2012), and Aon (2012). Trailing Ireland and the UK as inversion destinations were the Netherlands (3), Canada (2), and one each for Australia, Israel, Bermuda, and Cayman Islands.

21 From the full text of Osborne's speech to Parliament, as reported at www.independent.co.uk, Wednesday, July 8, 2015.

22 The new (2013) UK controlled foreign companies law represented a clear move towards territorial taxation. The new rules are complex, and can still result in UK taxation in certain circumstances, such as where a UK-resident company is considered to have artificially diverted UK profits to a controlled foreign company in a lower-tax jurisdiction.

23 See Joscelyne and Wentworth-May, "The UK's New CFC Regime," March 1, 2012, found at http://www.olswang.com/media/20300344/mxj_cfcs_article.pdf.

24 *Id.*

25 See Darby, "Gertrude Stein Was Wrong: A Dollar is a Dollar is a Dollar…Except When It's Not," note 18, *supra*, pointing out that a dollar in a CFC was worth a dollar, but repatriated it was immediately worth $0.65, and that was why so few dollars were repatriated.

26 See Pinson, "Effects of 2004 Int'l Tax Holiday, Recommendations Going Forward," Tax Analysts, 8/31/2011. The article, citing an IRS study, asserts that $362 billion was repatriated in 2005, of which $312 billion qualified for the special favorable treatment under Section 965, and generated $16 billion in additional revenues. The article comments, "While some argue that $16 billion is low compared with what could have been collected at full tax rates, advocates counter that the IRS would see none of it as foreign profits showed no sign of coming home pre-holiday."

27 Technically, the foreign acquiring corporation is called the "surrogate foreign corporation" under the language of Section 7874(a)(2)(B). This article uses "New Foreign Parent" as a more user friendly term, because it includes the new foreign parent in the restructured corporate group whether or not it meets the technical definition of a surrogate foreign parent.

28 Fortunately for the U.S. shareholders of inverting U.S. companies, most inversions in recent years have resulted in a dramatic increase in the market value of the inverted company. See, e.g., Eaton Corporation, Ingersoll-Rand, and Seagate, just to mention three. Part of this rise in value is attributable to rising U.S. and world stock markets generally, but part also appears to be a premium placed by the market on the tax savings anticipated to result from the inversions transaction.

29 Adverse consequences under the 60% anti-inversion threshold are (1) for the next ten years after inversion, the USCo's taxable income cannot be less than the "inversion gain," meaning the gain recognized on its transfer of stock or assets plus certain royalty income from foreign affiliates, and USCo cannot use its tax attributes (e.g., NOLs) to offset such income or gain; and (2) a 15% excise on insiders' equity-based compensation to the extent such compensation would otherwise be deferred. As noted, these consequences do not deter inversions-unlike the 80% anti-inversion rules, which are considered lethal.

30 TD 9453, 2009-2 CB 114.

31 Prior to the change, there were a number of prominent "self inversions" including Aon, Rowan, and Sara Lee. Since 2012, almost all of the inversion transactions have been merger or combination inversions below the 80% threshold.

lowest rate of corporation tax in the G20. And so there are those who say we do not need to do more. I profoundly disagree with them …A new 18% rate of corporate taxation— sending out loud and clear the message around the world: Britain is open for business."[21]

In addition to lowering corporate tax rates, the UK also abandoned efforts to tax the earnings of foreign subsidiaries. Effective January 1, 2013, the UK went from a controlled foreign company regime similar to the United States to a territorial tax system, coupled with anti-abuse provisions to prevent UK companies from moving profits offshore (an anti-abuse policy similar to the U.S. Treasury's renewed focus on earnings stripping, which this Author applauds).[22] An article by a prominent UK law firm, Olswang, describes the transition in tax policy as follows:

> The UK has had controlled foreign company (CFC) rules since 1984. In common with similar regimes of other jurisdictions, their purpose is to ensure that the extra–territorial reach of the UK corporation tax system is not undermined by multinational groups establishing subsidiary companies in low tax jurisdictions. This is achieved by taxing profits diverted from the UK by apportioning the profits of non–resident subsidiaries to any UK holding company. In recent years the existing CFC regime (the Original Regime) has been seen as increasingly outmoded in its scope and has been held in large part responsible for the exodus from the UK during the 2000s of a significant number of multinational groups. The Original Regime works on the basis that all activities that could have been undertaken by a UK company within the group should be taxed as if that was the case, unless one of a number of exceptions applies.[23]

The same article goes on to comment:

> The stated purpose of the New Regime is to protect UK tax revenues against the artificial diversion of profits from the UK while having a CFC regime that is territorial in its approach so that the UK is a more attractive location for holding companies of multinational groups.[24]

Imagine if, instead of taxing the repatriation of foreign earnings by CFCs at a 35% tax rate (and thereby ensuring that almost no money is in fact repatriated),[25] the U.S. treated the CFC distributions as a low-tax or even as a tax-free event? In fact, the U.S. has an exact "laboratory" for examining the likely consequences. In 2005, the U.S. declared a one-year de facto tax holiday under Section 965, and allowed U.S. corporations to repatriate foreign profits subject to a tax rate of just 5.25%. The results were stunning: Over $300 *billion* was repatriated to the U.S. in that single year, generating tax revenues and providing a huge infusion of liquidity to U.S. corporations.[26] The special tax rate under Section 965 was accompanied by a "fig leaf," which was that the money had to be earmarked for investment in U.S. activities, but from all evident appearances that requirement was never seriously enforced, nor, in the end, is it likely to be necessary under a future permanent rule.

Allowing U.S. companies to access the large sums of cash trapped offshore, which they can then spend as they wish or distribute to shareholders as dividends, is likely to produce hugely beneficial results throughout the U.S. economy, whatever minor "leakage" there may be through stock redemptions or other devices. Bear in mind that the money does not go "outside" the parent corporation tax-free, it simply comes up to the parent corporation tax-free, in the same way that dividends from a controlled domestic corporation are received entirely tax-free by the parent corporation under Section 243. Taxing these repatriation dividends never made a whole lot of sense, and the proof is the staggering $2 trillion of foreign profits currently trapped offshore.

The idea of repatriating of foreign earnings at minimal tax rates has attracted bi-partisan support from politicians as ideologically diverse as Harry Reid (D-Nev.) and Rand Paul (R-Ky.), both of whom proposed plans that would have taxed dividends from CFCs at under 10%. But a zero tax, similar to the UK, would be even more effective.

A driving force behind inversion transactions is that U.S. corporations with large amounts of offshore earnings are unable to bring that money back to the U.S. except at what is considered a prohibitive 35% tax rate. Some of those corporations are choosing to leave the U.S. in order to go join their money offshore.

The Treasury has gone to enormous lengths to prevent that joyful offshore reunion between U.S. corporations and their foreign cash, but the more salient point is that the U.S. corporations would have every incentive to stay put if the U.S. corporate income tax rates were even half-way competitive and if foreign earnings could be repatriated at a modest (or zero) tax rate. The U.S. corporations could then use those funds for the many purposes for which corporations employ available cash, almost all of which would create jobs, wealth, and prosperity in these United States.

Conclusion

The Berlin Wall approach to global corporate taxation seems unpromising, as the UK recognized clearly, even though the U.S., at present, resists that conclusion. The harder question to answer, because it is so deeply mired in politics, is how long the U.S. will remain committed to its "wall them in" approach, and how long the U.S. will choose to bear the collateral damage, before the U.S. finally embraces the necessary corporate tax reforms to make it, once again, an attractive tax jurisdiction in the competitive world economy—a destination rather than a departure point.

In the case of the real Berlin Wall, that terrible idea lasted a full 28 years, so practical experience shows that even the worst of policies can have a pretty long shelf life. But in the end, policies destined to fail will eventually fail. Whether it involves East German citizens or U.S. corporations, any policy predicated on preventing people from leaving your jurisdiction smacks so clearly of failure, of a final bankruptcy of ideas and ideals, that even people who defend current U.S. policy must be riven with concern and self-doubt. How we got here has been outlined in this article, and where we are likely to go has also been suggested. It may well take a while for a better policy to blossom, but now is definitely the right time to start planting the seeds. And then, one day, we will be able to say:

Mr. President and Mr. Treasury Secretary — tear down this Wall! ■