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International Tax

United States Tax Alert

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Schumer Anti-Inversion Bill

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[This alert updates the alert distributed on September 8, 2014 with the language in the bill as introduced.]

In response to the multiple announcements of international acquisitions facilitating the global growth of US businesses (referred to as inversions during public debate), Senate Finance Committee member Charles Schumer (D. NY) introduced a bill September 10 (the "Corporate Inverters Earnings Stripping Reform Act of 2014") to prevent earnings stripping of domestic corporations that are members of a worldwide group of corporations that includes an inverted corporation and to require agreements with respect to certain related party transactions with those members. The bill appears intended to supplement the "Stop Corporate Inversions Act of 2014" that Senator Carl Levin introduced on May 20, 2014. (For a discussion of that Act, see U.S. International Tax alert dated May 21, 2014.)

Sen. Schumer's bill, if enacted, would tighten the earnings stripping rules of section 163(j) and impose a requirement for prefiling agreements (with a threat of loss of deductions, basis, and other tax attributes) for acquisitions of domestic targets with an ownership continuity of over 50 percent (including acquisitions that occurred before enactment). The rules are quite broad in that they are relevant to not only acquisitions running afoul of section 7874 (broadened as discussed below) but also any acquisition made after that initial acquisition (even if the subsequent acquisition was not otherwise subject to section 7874). For example, the bill would impose new earnings stripping limitations or pre-filing burdens on a U.S. target acquired subsequent to an inversion (as now defined) that occurred even decades ago.

Inversion Standard at 50 Percent Ownership Continuity

The bill applies to "applicable entities," which means a member of an expanded affiliated group (EAG) that includes as a member a foreign acquirer of a domestic target that is treated as a "surrogate foreign corporation" under section 7874, but by reducing the ownership continuity required under section 7874(a)(2)(B) from at least 60 percent to more than 50 percent. This broader standard for treating a foreign acquirer as a surrogate foreign corporation applies to any acquisition before enactment without limitation (e.g., a foreign corporation that acquired a U.S. company in 1980 could be a surrogate foreign corporation for purposes of the new rules). Status as an applicable entity for non-corporate entities is

analyzed using the related party test of section 954(d) (generally, over 50 percent ownership directly, indirectly, or constructively). The bill would not affect those foreign acquirers that were treated as domestic corporations by application of section 7874(b) or were outside of the section 7874 regime because they qualified for the substantial business activities exception.

Proposed Changes to Section 163(j)

The bill tightens the section 163(j) earnings stripping rules in the case of applicable entities for their first taxable year after enactment or becoming applicable entities. Specifically, the bill proposes to:

- limit the amount of related party interest expense allowed under section 163(j)(2)(A)(ii) to 25% of adjusted taxable income (as opposed to 50% under current law),
- remove the carry forward of any excess related party interest expense under section 163(j)(1)(B) (as opposed to unlimited carry forward under current law),
- remove the 1.5:1 debt to equity safe harbor under section 163(j)(2)(A)(ii), and
- remove the carry forward for unused limitation under section 163(j)(2)(B).

These new limits would to apply to all subsequent taxable years of applicable entities, with no 10-year sunset (as is the case for inversion gains under section 7874 or the new proposed approval process rules discussed below).

Proposed Transaction Approval Process

Each applicable entity would be required to file with the Treasury an application for an approval agreement for each taxable year beginning after enactment or becoming an applicable entity, for the 10 taxable years starting with the year of becoming an applicable entity. In other words, if a U.S. company were acquired in an acquisition to which section 7874 applied (as modified by the bill), then the bill's approval agreement regime would apply to that U.S. company (and its domestic affiliates) for a 10-year period. In addition, if a foreign multinational's EAG includes a foreign corporation that is treated as a surrogate foreign corporation under section 7874 (as modified by the bill) as a result of a transaction that occurred in, for example, 1980, any U.S. entity acquired by the EAG from 10 taxable years before enactment and onward would also be subject to the bill's approval agreement regime for a 10-year period, even if the acquisition of the U.S. entity was not otherwise within the scope of the section 7874 regime (e.g., a subsequent all-cash purchase of a U.S. entity).

The approval agreement means a prefiling, advance pricing, or other agreement specified by the Treasury, which contains provisions the Treasury determines necessary to ensure that sections 163(j), 267(a)(3), 367, 482, and 845, and any other provision of the Code applicable to transactions between related persons and specified by the Treasury, are met. The time, manner and information to be included in the application will be as specified by the Treasury.

If a taxpayer fails to file an application or the approval agreement does not contain the provisions required by the Treasury, then (i) there shall not be allowed a deduction, or addition to basis or cost of goods sold, for amounts paid or incurred, or losses incurred, by reason of a transaction between the entity and a foreign related person, (ii) any transfer or license of intangible property (as

defined in section 936(h)(3)(B)) between the entity and a foreign related person will be disregarded, and (iii) any cost sharing arrangement between the entity and a foreign related person will be disregarded.

Effective Date

As noted above, the bill proposes to be effective for taxable years beginning on or after enactment, and could cover entities that were acquired by a foreign parent before enactment of section 7874 or in compliance with section 7874.

Comment/Outlook

The inversion issue continues to be a topic of interest, with substantial policy and political implications. Sen. Schumer's bill is among many proposals suggested by politicians supporting a legislative response to inversions.

In the few remaining legislative days before the House and Senate adjourn to campaign ahead of the November mid-term elections, it remains uncertain whether, how or when, Congress will deal with the inversion issue either directly (by attempting to disregard such transactions) or indirectly (by attempting to make them less attractive to companies contemplating such transactions).

Nevertheless, the issue is volatile, and the politics could change suddenly and unpredictably, particularly after the election concludes and Congress reconvenes for a lame duck session expected to address other tax issues, including the extenders. Moreover, as reiterated earlier this week in a speech by Treasury Secretary Lew, although Treasury favors addressing inversions through legislation, the administration is continuing to evaluate whether it has regulatory tools to directly or indirectly limit inversions. While the Secretary gave no specific indication about what steps Treasury might take or when, this is an area that bears close monitoring in the coming weeks and months.

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