RANKING MEMBER CHUCK GRASSLEY (R-IA)
AND CHAIRMAN MAX BAUCUS (D-MT)

REVERSING THE EXPATRIATION OF PROFITS OFFSHORE (REPO) ACT

PRESS BRIEFING MEMO
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Introduction

______Senate Finance Committee Ranking Member Chuck Grassley (R-IA) and Chairman Max Baucus (D-MT) today announce their legislative response to the growing problem of corporate inversions. Generally, corporate inversions result in the removal of foreign assets of a U.S. corporation from the United States' taxing jurisdiction, which may lead to a significant erosion of the U.S. tax base.

An inversion transaction typically involves the formation by a U.S. corporation of a subsidiary in a foreign tax haven. Certain of these tax havens do not share tax, banking, or other financial information with the United States. After forming the foreign subsidiary, the U.S. corporation causes the foreign subsidiary to become the parent corporation of the U.S. corporation itself, thereby "inverting" the corporate chain of ownership. This is generally accomplished by inducing the shareholders of the U.S. corporation to exchange their shares in the U.S. corporation for shares in the foreign subsidiary. This share exchange will cause the foreign subsidiary to simultaneously "invert above" the U.S. corporation and hold all (or nearly all) of the U.S. corporation's outstanding shares.

Once this inversion structure is in place, the new foreign "parent" corporation may cause the U.S. corporation (which is now a subsidiary of the foreign parent) to transfer its foreign assets and subsidiaries to the foreign parent corporation. When these assets and subsidiaries are moved under the ownership of the new foreign parent corporation, they are no longer subject to U.S. tax because the United States' taxing jurisdiction does not tax the foreign operations of a foreign corporation. Consequently, under this inversion structure, the United States' taxing jurisdiction is limited to the U.S. operations of the U.S. corporation itself. To further exacerbate this erosion of the U.S. tax base, many inversion schemes "strip" earnings out of the U.S. corporation by creating a U.S. deduction for payments to a foreign related party, with the related party receiving the payment in a tax free jurisdiction.

Some commentators have noted that inversion transactions are defensible as an elective territorial tax system. The territorial systems of most developed countries require that passive income remain taxable in the taxpayer's home country. The inversion structures, however, would block U.S. taxation of passive offshore income, and in this respect, yield a more advantageous result than would be allowed by most territorial tax systems.

An equally troubling aspect of inversion transactions is that the new foreign parent corporation is usually an inactive "shell" corporation, having no substantial operations or activities in its country of formation. Often, these foreign parent corporations are nothing more than a sheet of paper in a filing cabinet. Thus, the U.S. company that initiates a corporate inversion may escape U.S. taxation on foreign earnings through a purely paper transaction, with no substantive change in the current business operations of the U.S. corporation or its foreign subsidiaries.

Current U.S. tax laws permit inversions, but attempt to stem erosion of the U.S. tax base by capturing untaxed value that is migrating outside the U.S. taxing jurisdiction. For example, current law imposes income tax on U.S. shareholders when they exchange their U.S. corporation shares for shares in the foreign subsidiary. Tax is generally imposed on the difference between the fair market value of the shares and the shareholders' cost bases. This provision, however, may be ineffective when the shares' market values are severely depressed by recession or external events (such as the terrorist attacks of September 11th), or when the shares are held by institutional investors that are not subject to income tax.

Current tax laws may also impose tax on the U.S. corporation itself when it transfers its foreign assets and foreign subsidiaries to the newly formed foreign parent corporation. This tax is imposed on untaxed earnings and appreciation in value that may be imbedded in those foreign properties. This corporate level tax, however, may be offset by other corporate tax attributes, such as net operating loss carryforwards (which may accrue during a recessionary period) or minimized by suppressed asset values (which can be affected by recession and external events).

Senator Grassley and Senator Baucus believe that the current tax law provisions are ineffective in stemming the rising tide of corporate inversions. They are extremely displeased that corporations (and some partnerships) are capitalizing on a period of recession and terrorism to maximize their opportunities to escape U.S. taxation on foreign earnings. At the same time, the senators do not wish to impede cross-border transactions that are entered into for legitimate non-tax business reasons. Accordingly, the senators offer their bill, "Reversing the Expatriation of Profits Offshore" (REPO) Act, to remove the tax incentives associated with these corporate "expatriation" inversion schemes.

The REPO Act

______The REPO Act addresses two different classes of inversion transactions – the typical "pure" inversion and "limited" inversions.

A. Pure Inversions

The first class of inversion transactions are the "pure" inversions, in which:

1. A U.S. corporation becomes a subsidiary of a foreign corporation or otherwise transfers substantially all of its properties to a foreign corporation,

2. The shareholders of the U.S. corporation end up with 80% or more of the vote or value of the stock of the foreign corporation immediately, and

3. The foreign corporation, including its subsidiaries, does not have substantial business activities

in its country of incorporation.

Corporations with no significant operating assets, few or no permanent employees, or no significant real property in the foreign country do not meet the substantial business activity test. Under this legislation, companies are not considered to be conducting substantial business activity in the country of reincorporation by merely conducting board meetings in the foreign country or by relocating a limited number of executives to the foreign jurisdiction. The purpose of this substantial business activity requirement is to attack inversion structures that utilize a manila folder in a filing cabinet or a foreign post office box to establish their corporate presence.

For corporations that engage in a pure inversion transaction, the new foreign parent corporation would be deemed a domestic corporation for U.S. tax purposes. By dragging the foreign shell corporation back onto U.S. shores, the anticipated benefit of escaping U.S. tax on foreign operations would be completely denied. This pure inversion legislation will extend to U.S. partnerships that invert into a foreign corporation.

B. Limited Inversions

Limited inversions are similar to pure inversions, except that the shareholders of the U.S. corporation end up with more than 50% and less than 80% of the vote or value of the stock of the foreign corporation. Limited inversions capture inversion transactions that are structured to evade the 80% test of the pure inversion provisions, while at the same time allow the U.S. shareholders to effectively control the new foreign parent corporation. Limited inversions, which include inverted partnerships, will be treated in the following manner:

1. Unlike pure inversions, the foreign parent corporation created by limited inversion transactions will not be treated as a U.S. corporation.

2. The current law provisions that impose tax on the U.S. corporation when it transfers its foreign assets and foreign subsidiaries to the newly formed foreign parent corporation would be strengthened. Specifically, the REPO Act would not allow the tax imposed on the untaxed earnings and appreciation in value of foreign properties to be reduced by any corporate tax attribute, credit, or other means. This is intended to strengthen the current law provisions that impose the corporate-level "toll charge" for moving assets out of the U.S. taxing jurisdiction.

3. Limited inversion structures will be monitored to ensure that income cannot be stripped out of the U.S. corporation through transactions with foreign related parties. The REPO Act will require that, before any related party deduction is allowed, the U.S. corporation must obtain IRS approval of the terms of their related-party transactions annually for 10 years following the inversion. This would cover all related party transactions, including intangibles transfers, cost sharing arrangements, and similar transactions. As a further measure to prevent income stripping, the REPO Act will modify current law to substantially reduce the amount of interest expense that may be deducted by a U.S. corporation for interest payments remitted to a related foreign party after an inversion transaction.

Effective Dates

During the Finance Committee hearing on March 21, 2002, Senator Grassley and Senator Baucus made clear that any corporations engaging in inversion transactions would do so at their own peril. Accordingly, the REPO Act is generally effective for inversions occuring on or after March 21, 2002.

Numerous U.S. companies have engaged in inversion transactions prior to March 21, 2002. The REPO Act would not reverse those transactions, even if they were pure inversions. However, concern remains that certain of those prior inversions were structured to inappropriately strip-out the earnings of the U.S. company that is now a subsidiary of a foreign corporation. Accordingly, these companies will be subject to the 10-year IRS deduction approval process otherwise imposed on limited inversion transactions. In addition, any asset transfers by those companies on or after March 21, 2002 will be subject to the limited inversion provisions prohibiting reduction of the corporate-level tax "toll charge" for moving assets out of the U.S. taxing jurisdiction.

Closing Comment

Senators Grassley and Baucus are committed to halting corporate inversions. Nonetheless, the senators also recognize that the rising tide of corporate expatriations demonstrates that our international tax rules are deeply flawed. In many cases, those flaws seriously undermine an American company's ability to compete in the global marketplace. This competitive disadvantage is often cited by companies that engage in inversion transactions.

The senators believe that we need to bring our international tax system in line with our open market trade policies. They wish to affirm their view that reform of our international tax laws is necessary for our U.S. businesses to remain competitive in the global marketplace. Moreover, those U.S. companies that rejected doing a corporate inversion are left to struggle with the complexity and competitive impediments of our international tax rules. This is an unjust result for companies that chose to remain in the United States of America. The senators are committed to remedying this inequity.

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Senators Grassley and Baucus welcome public comment on the new inversion proposal. Please direct your comments to John Angell, Majority Staff Director, and Kolan L. Davis, Republican Staff Director, of the Senate Finance Committee, 219 Dirksen Senate Building, Washington, D.C. 20510.