Inversion – The Basic Facts

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September 15, 2003

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Nishith Desai Associates is a multi-disciplinary law firm that specializes in Corporate & Securities laws, International Tax, Funds, ADRs, M&A, Information, Communication & Entertainment (ICE) laws, and Infrastructure & Project Finance. The firm was involved in the ADR listings of Infosys Technologies, Satyam Infoway, Rediff.com, Silverline Technologies and Wipro. It was involved in the first cross-border stock swap merger out of India, that is, BFL's acquisition of MphasiS, and was also involved in Silverline's (NYSE listed company) acquisition of Seranova (NASDAQ). The firm also has a very strong Private Equity Practice, which has been involved in setting up the maximum number of venture capital & private equity funds for inbound investments. The firm has constantly been involved in policy reform initiatives and Mr. Nishith Desai, founder of the firm has been on the Goverment committees for drafting regulations pertaining to venture capital funds and relating to employee stock options.

The firm has received the 'Indian Law Firm of the Year 2000' and the 'Asian Law Firm of the Year 2001 (Pro Bono)' awards given by International Financial Law Review (IFLR), a Euromoney publication.

Synopsis

1 INTRODUCTION

In recent months, several high-profile multinational corporations in the United States ("**U.S.**") have announced plans to reincorporate or invert their corporate structure outside the U.S. A corporate inversion is a transaction or series of transactions through which a U.S. based multinational restructures its corporate group so that the ultimate parent corporation of the group becomes a foreign entity. The documents prepared for shareholder approval and filed with the Securities and Exchange Commission cite substantial reductions in overall corporate taxes as a key reason for the transactions. Realizing this potential to save costs, several U.S. based software services companies having substantial activities in India are exploring alternatives to invert their corporate structure in order to take the benefit of the tax holiday in India. This article examines the recent developments on this subject.

2 DEFINITION OF INVERSION

The term ***"inversion"*** is one that crops up very frequently in the course of discussions relating to globalizations with a view to minimizing the tax of the group as a whole. In its simplest form, an inversion is simply the process by which a corporate entity, established in another country, buys an established U.S. company.

The transaction takes place when the overseas entity purchases either the shares or assets of a U.S. domestic company. Some inversions involve the purchase of both the shares of ownership and the corporate assets. The shareholders of the U.S. domestic company typically become shareholders of the new foreign parent company. In essence, the legal location of the company changes through a corporate inversion from the U.S. to another country[1].

The end result of an inversion transaction is that the U.S. operations get placed beneath a foreign parent that is located in a suitable jurisdiction.

3 ADVANTAGES ARISING OUT OF AN INVERSION

The United States taxes its domestic companies on their worldwide income, this means that, in general, U.S. companies are subject to a marginal tax rate of at least 35 percent on every dollar earned whether earned domestically or abroad.

The change in legal residence from the U.S. to another country allows the U.S. Company to take advantage of certain laws in that country. Typical advantages that draw U.S. companies to re-incorporate in another country include lower tax rates, more accommodating corporate governance rules, and more flexible banking laws.

The primary U.S. tax savings from inversions stems from the fact that the group's foreign operations are no longer conducted by or under a U.S. domestic company; since the foreign earnings are no longer realized by or pass through a U.S domestic company, thus such earnings are not subject to U.S. corporate tax[2].

A U.S. company that may benefit from an inversion will generally possess one or more of the following characteristics[3]:

- It owns intellectual property that is under current or continuous development
- It has substantial foreign operations or plans substantial foreign acquisitions

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[1] Source: www.taxfoundation.org Fiscal Policy Memo, by John S. Barry, Chief Economist, May 30, 2002, titled Corporate Inversions - An Introduction to the Issue and FAQ.

[2] Source: www.foleylardner.com Inversions to cut U.S. Taxes, by George R. Goodman, Belinda S. Morgan, and Tamika S. Cushenberry -- Foley & Lardner©

[3] Source: www.bakernet.com Inversion Transactions, Baker & Mckenzie©, Global tax practice group

- Its non-U.S. earnings are subject to a relatively low rate of foreign tax or can be shifted to a jurisdiction in which they would be subject to a relatively low rate of foreign tax
- It has sufficient U.S. earnings to absorb significant additional interest expense
- Its shares are undervalued or it has significant losses due to economic or other conditions

A U.S. company seeks to achieve from an inversion one or more of the following objectives[4]:

- Avoidance of current or eventual U.S. income tax on earnings generated outside the U.S.
- Utilization of foreign tax reduction techniques free from the constraints of U.S. anti-deferral regimes
- Reduction in U.S. income tax through U.S. earnings stripping techniques available to foreign groups
- Enhanced financing flexibility and access to offshore cash to reduce debt, repurchase shares, and fund investments and acquisitions
- Increased access to non-U.S. debt and equity markets

While several jurisdictions can be chosen for an inversion transaction, such as Bermuda, Cayman Islands and even British Virgin Islands, Bermuda has emerged as the most popular jurisdiction in which to organize a new foreign parent company.

From 1983 to 1999 the value of assets of U.S. companies in Bermuda, the Cayman Islands and 11 other tax havens grew 44 percent more than their assets in Germany, England and other countries with tax rates similar to the United States, according to statistics released by the U.S. Commerce Department. The reported profits in tax havens grew far faster than elsewhere. Tax haven profits rose 735 percent, to $92 billion, from 1983 to 1999, while profits in countries that are not tax havens grew only 130 percent, to $114.2 billion. Bermuda and the other tax havens accounted for 45 percent of the total offshore profits in 1999, but only a fourth of those assets.

Actual taxes paid to the havens ranged from a fraction of 1 percent to 12.5 percent of profits, compared with an effective rate of 35.4 percent in the other countries, the Commerce Department data show. In all, the 10,000 biggest American companies reported $758 billion in profits worldwide in 1999 and paid taxes to the United States of $154 billion, or 20 percent[5].

4 TYPES OF INVERSIONS

There are two basic types of inversion transactions[6]

1. Formation of a new foreign holding company over the U.S. Parent Company
2. Reincorporating the U.S. Parent Company as a Foreign Corporation

New Foreign Holding Company (Stock transaction)

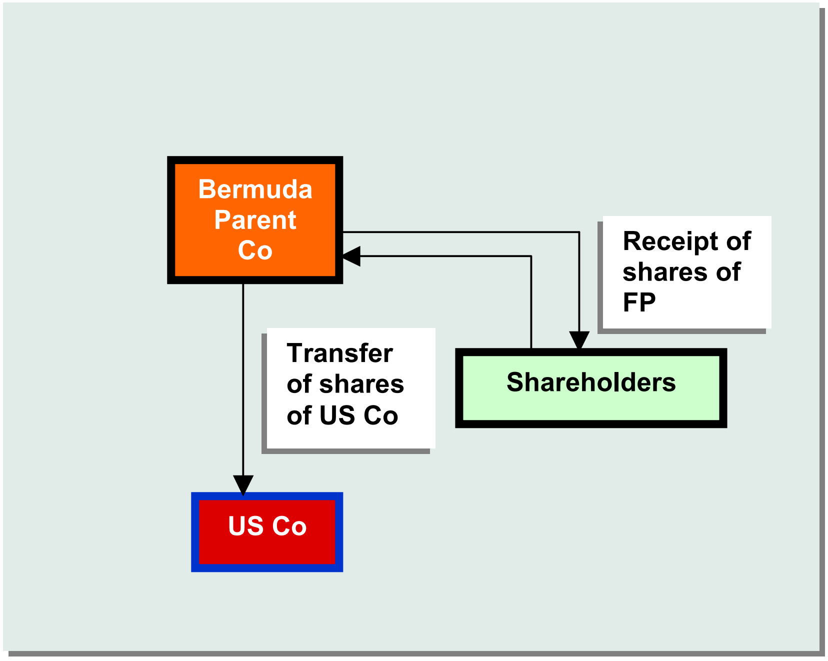
In this type of transaction, also known as a “stock transaction”, a new foreign parent is formed in a low-tax jurisdiction, such as Bermuda, and the stockholders of the existing U.S. parent corporation ("**US Co**") exchange their U.S. Co stock for stock of the foreign parent (“**FP**”).

[4] Source: refer footnote no 3

[5] Source: www.nytimes.com Key Company Assets Moving Offshore, by David Cay Johnston, New York Times (edition dated November 22, 2002)

[6] Source: Refer footnote no 2

U.S. Co thus becomes a subsidiary of FP. Under U.S. tax laws, the stockholders of U.S. Co recognize gains, but not losses, on the outbound transfer of their U.S. Co stock. However, the resulting tax in the U.S. may be small due to a depressed trading price for US Co stock, or substantial ownership of US Co stock by holders exempt from U.S. tax, such as pension funds or non U.S. residents.



After or in connection with FP's acquisition of U.S. Co's stock, U.S. Co's foreign operations would generally be spun-off or transferred to FP. Such transfer could be a taxable event. Thus, the resulting U.S. tax should be carefully considered before moving ahead, as it could make the inversion uneconomic depending on the size of the gain, foreign growth projections, etc.

Re-incorporation as Foreign Corporation (Asset transaction)

In this basic transaction format, also known as an "asset transaction", the U.S. Co would simply reincorporate itself as FP, by forming and merging into FP. In this case, U.S. Co generally recognizes gain on all its appreciated assets.

Again, the U.S. taxes generated by the transaction itself would need to be carefully measured against the future U.S. tax savings in evaluating the transaction. However, in contrast to the new holding company formation transaction, U.S. Co's shareholders may not taxable on the exchange of their U.S. Co stock for FP stock in a re-incorporation qualifying as reorganization under section 368 of the Internal Revenue Code.

Reduction of tax on US source income

In addition to reducing taxes on foreign source income via an inversion transaction, to reduce the US taxes on domestically earned income, the following methods are generally adopted.

1. Structuring of debt and payment of interest to FP
2. Transfer of intangible assets to the FP

The U.S. Co issues debt to its FP in exchange for additional equity in FP. U.S. Co then deducts the interest expenses associated with the debt from its taxable income. The U.S. Co transfers ownership of intangible assets to the new FP. These assets continue to produce income in the

United States, but that income is attributed to the FP that faces a lower tax rate, because of that entity's ownership of the asset. The U.S. Co also pays an arm's length royalty for which it earns a tax deduction.

In evaluating the net U.S. tax savings from an earnings strip, consideration must be given to foreign taxes, U.S. withholding or other taxes on or resulting from such dividend or transfer of intangibles, and U.S. withholding taxes on the interest and royalty payments, which may be reduced by treaty.

5 TAX CONSEQUENCES OF AN INVERSION[7]

The tax consequences depend upon the precise nature of the transaction. Generally inversions are in the nature of a stock transaction or an asset transaction. An inversion can also be a combination of a stock and asset transaction. In all cases, however, the re-incorporation step of the inversion results in potential tax, either at the shareholder level or at the corporate level, reflecting the amount of built-in gain at the shareholder or corporate level.

Stock Transaction

A stock transaction is typically structured to qualify as a re-organization within the meaning of section 368. Because the transaction involves the transfer of property to a foreign corporation, section 367 also applies.

Tax-free Reorganizations

Regulations under section 367 treat the outbound transfer of stock of a U.S. corporation as a taxable event, except where certain conditions are satisfied. In other words, section 367 regulations permit tax-free treatment of the outbound transfer of stock of a U.S. Corporation only if:

1. U.S. shareholders of the transferor U.S. company receive 50 per cent or less of the total voting power and total value of stock of the transferee foreign corporation;
2. 50 percent or less of the total voting power and total value of stock of the transferee foreign corporation is owned by former officers, directors and 5 percent shareholders of the U.S. corporation immediately after the transaction;
3. Each 5 percent shareholder of the U.S. corporation enters into a "gain recognition agreement"[8];
4. The transferee foreign corporation satisfies an active trade or business requirement[9];
5. Certain reporting requirements are satisfied

In a Stock Transaction, where the foreign acquiring corporation typically is a newly formed entity without significant assets, the section 367 regulations require the shareholders to recognize gain on the exchange for tax purposes. The amount of taxable gain recognized is equal to the excess, if

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[7] Source: www.ustreas.gov/press/releases/docs/inversion - Corporate Inversion Transactions – Tax Policy Implications

[8] In general, a gain recognition agreement provides that if the stock or substantially all of the assets of the transferred corporation is subsequently disposed of during the five-year period following the initial transfer, the taxpayer must include the realized gain that was not recognized in the original transaction, plus interest. See Treas. Reg. § 1.367(a)-8

[9] The active trade or business requirement generally requires that: (i) the transferee foreign corporation must have been engaged in an active trade or business outside the United States for a 36-month period prior to the transaction; (ii) at the time of the transaction, there is no intention to dispose of or discontinue such trade or business; and (iii) the fair market value of the transferee foreign corporation must be equal to or greater than the fair market value of the U.S. corporation. Treas. Reg. § 1.367(a)-3(c)(3).

any, of the fair market value of the stock over the shareholder's adjusted tax basis therein. Shareholders with a loss on the exchange do not recognize this loss for tax purposes, and instead such loss is preserved in the tax basis of the stock of the foreign parent received in the transaction. Although the company's shareholders are required to recognize gain in a Stock Transaction, there are no reporting requirements such as apply in the case of other dispositions of stock.

In a Stock Transaction, the former U.S. parent itself is not subject to tax on the re-incorporation transaction; however, associated transfers of assets by the U.S. parent or its subsidiaries may be taxable.

Asset transaction

Because an Asset Transaction involves an outbound transfer of assets by the U.S. parent to the newly formed foreign parent, the U.S. parent must recognize gain (but not loss) for U.S. tax purposes, calculated as if all of its assets had been sold at the time of the transaction for their fair market value[10].

The shareholders of the corporation are not subject to a second level of tax, provided that the transaction qualifies as a re-organization under section 368[11]. If the transaction qualifies as a re-organization, the shareholders will hold the shares of the new foreign parent with the same tax basis and holding period for tax purposes that they had in their stock of the former U.S. parent[12].

Tax treatment on transfer of stock of foreign subsidiaries

A restructuring of the foreign operations of the U.S. group as part of an inversion transaction presents various U.S. tax issues, many of which depend upon the precise mechanism used to effectuate the restructuring[13].

The U.S. parent (or another U.S. member of the corporate group) may transfer the stock of a foreign subsidiary to the foreign parent or foreign affiliate in a transaction that otherwise would qualify for non-recognition treatment. However, the regulations under section 367 generally require the U.S. parent (or other transferor) of the foreign subsidiary to recognize for tax purposes the gain, if any, on the foreign subsidiary stock transferred to a foreign corporation, to the extent of the accumulated earnings and profits of the foreign subsidiary attributable to the stock transferred[14].

Any loss on the foreign subsidiary stock would not be recognized for tax purposes. Any required inclusion would be treated as a dividend for U.S. tax purposes; accordingly, the U.S. parent (or

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[10] Section 367 provides limited exceptions to this rule requiring gain recognition for tax purposes. These exceptions apply to the outbound transfer of certain assets for use in the active conduct of a trade or business outside the United States, or the outbound transfer of certain stock or securities of foreign corporations. Section 367(a)(2), (3). These exceptions are not available unless the foreign transferee corporation is controlled by five or fewer U.S.corporations, which would not be the case in the inversion of a public company. Section 367(a)(5). See Treas. Reg. § 1.367(a)-3(a), (d)(3) (Example 12).

[11] In order for a transaction to qualify as a reorganization under section 368(a), the transaction must be undertaken for reasons germane to the continuance of the business of a corporation that is a party to the reorganization. SeeTreas. Reg. § 1.368-2(g).

[12] Sections 358(a), 1223(1).

[13] There also may be non-U.S. tax consequences arising from the restructuring transaction.

[14] The section 367 regulations also require the transferring U.S. members of the corporate group to enter into a five-year gain recognition agreement.

other transferor) would be entitled to indirect foreign tax credits under section 902 for the foreign taxes paid by the foreign subsidiary with respect to the earnings deemed distributed[15].

Alternatively, the U.S. parent (or other transferor) may transfer the stock of a foreign subsidiary to the foreign parent or a foreign affiliate in a taxable exchange. In such a case, the full amount of any gain on the stock of the foreign subsidiary would be recognized for tax purposes. To the extent of any accumulated earnings and profits attributable to the stock, this gain would be treated for tax purposes as a dividend under section 1248, with indirect foreign tax credits under section 902 for the foreign taxes paid by the foreign subsidiary with respect to such earnings. Under section 267 (which denies losses on transfers between related parties), any loss on the foreign subsidiary stock would not be recognized for tax purposes.

This type of transaction may be re-characterized under section 304, depending on the relationship of the parties that participate in the transfer of the foreign subsidiary stock and the type of consideration exchanged[16].

However the transfer of the foreign subsidiary's stock is accomplished, the transfer must be conducted at arm's length. If the members of the U.S. corporate group that previously owned the foreign subsidiary's stock receive property in exchange that has less value than the stock transferred, the shortfall may be characterized as a deemed dividend to the foreign parent, which would be subject to a U.S. withholding tax (although possibly at a reduced rate if the recipient foreign parent qualifies for benefits under a U.S. income tax treaty).

Tax consequences arising by structuring of debt and payment of interest to the FP and also by transfer of intangible assets to the FP

The tax consequences of establishing inter-company indebtedness depend on the particular facts of the transaction. The indebtedness may be distributed by a U.S. corporation to the foreign parent. This distribution should constitute a dividend to the extent of any earnings and profits of the distributing corporation, and therefore should be subject to a U.S. withholding tax, which may be reduced under an applicable U.S. income tax treaty.

Alternatively, the debt could be issued by a U.S. corporation in exchange for property of the foreign parent of equivalent value, which generally should not produce any immediate U.S. tax consequences.

The outbound transfer of intangible assets generally is treated as a taxable transaction under general tax principles or, if structured as part of a transaction that otherwise would be a non-recognition transaction, under section 367(d)[17].

The applicable transfer pricing rules under section 482 require that the transaction be conducted in accordance with the arm's length standard and that the income with respect to the transaction be commensurate with the income attributable to the intangible assets transferred[18].

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[15] In general, the foreign taxes that are associated with a dividend are the ratable portion of the overall foreign taxes paid by the foreign corporation as compared to the overall earnings and profits. The relationship between earnings and foreign taxes paid is done on an annual basis for taxable years prior to 1987, and generally across all taxable years after 1986.

[16] Section 304 applies to certain transactions involving two corporations that are commonly controlled in which one corporation acquires the stock of the other corporation directly or indirectly from the person (or persons) so in control. If section 304 applies, the transaction generally is re-characterized as a dividend to the extent of the earnings and profits of both corporations involved.

[17] An outbound transfer of an intangible asset to which section 367(d) applies is treated as a sale of the intangible asset in exchange for deemed annual payments based on the productivity of the asset. Such deemed payments are treated as ordinary income to the transferor. Section 367(d)(2)(C).

6 POST INVERSION TAX CONSEQUENCES[19]

Taxation of U.S. operations

After an inversion, the U.S. operations conducted by the corporate group continue to be subject to U.S. tax at the corporate level. If the U.S. operations are conducted through a U.S. company, the company remains subject to U.S. tax. If the U.S. operations are conducted through a pass-through entity owned by foreign members of the corporate group, or as a branch of a foreign corporation, the income that is effectively connected with the conduct of a trade or business within the U.S. is subject to U.S. net basis taxation.

Because the inversion transaction interposes a foreign corporation between the former U.S. parent and the shareholders, an additional U.S. withholding tax applies to the distribution of earnings from the U.S. members of the corporate group to the new foreign parent. The U.S. withholding tax rate generally is 30 percent of the gross amount of any dividend; however, that rate may be reduced under an applicable tax treaty.

Although most inversion transactions have involved a re-incorporation into a foreign jurisdiction that does not have a tax treaty with the United States (or that has a treaty that does not reduce the withholding tax rate for dividends), many of these transactions are structured with the new foreign parent resident in a treaty country (typically Barbados) so that the U.S. withholding tax on dividends from the U.S. corporation to the foreign parent is reduced (typically to 5 percent) under the applicable income tax treaty.

The restructuring that may accompany an inversion makes available several opportunities for increasing the payments that are made by the U.S. members of the group to foreign members of the group. These payments, if deductible for tax purposes, reduce the effective rate of U.S. taxation on U.S. operations by reducing the net income subject to U.S. tax. For example, many inversion transactions have involved the establishment of inter-company indebtedness to the foreign parent or another foreign affiliate from the U.S. members of the corporate group. Interest paid on such indebtedness generally would be deductible in the United States, subject to the limitations of section 163(j) and certain other provisions. The interest income on the debt typically is received in a jurisdiction that subjects that income to little or no taxation. Although the United States imposes a withholding tax of 30 percent on interest payments to a related party, this withholding tax may be substantially reduced or eliminated under an applicable U.S. income tax treaty.

Taxation of foreign operations

To the extent the ownership of foreign subsidiaries has been shifted out of the former U.S. group to the new foreign parent or a foreign subsidiary thereof, an inversion transaction eliminates the U.S. corporate-level taxation of these foreign operations[20].

Accordingly, the significance of the foreign tax credit limitation (and the related rules concerning the allocation of expenses, including interest) to the inverted corporate group is reduced or

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[18] Section 482 authorizes the Secretary to allocate income, deductions, credits, or allowances between persons under common control if necessary to prevent evasion of taxes or clearly to reflect the income of any such person. The section 482 regulations provide that in determining the taxable income of a controlled person, the standard to be applied is that of a person dealing at arm's length with an uncontrolled person. Treas. Reg. § 1.482-1(b)(1).Section 482 also provides that in the case of any transfer of intangible property, the income with respect to such transfer shall be commensurate with the income attributable to the property.

[19] Refer footnote no 7

[20] Following the inversion, the income from foreign operations will continue to be subject to shareholder-level tax when the earnings of the corporation are distributed to U.S. shareholders

eliminated, as foreign-source earnings of the corporate group will not be subject to U.S. tax. To the extent foreign operations are not shifted offshore (*i.e.*, the foreign operations are still owned by U.S. members of the post-inversion group), income from such operations will remain subject to U.S. taxation, although it may be possible to reduce the amount of income that ultimately is taxed in the United States (either immediately under subpart F or upon repatriation) by restructuring the foreign operations in a manner similar to the restructuring that may occur with respect to the domestic operations of the company (*e.g.*, increased payments of interest and royalties to the foreign parent or its foreign affiliates) or through other means (*e.g.*, transfers of customers, goodwill or know-how to the foreign parent or its foreign affiliates). Even without the restructuring of foreign operations or transferring of intangibles, future growth of the multinational's foreign operations may occur through new subsidiaries owned by the new foreign parent, in which case the income would be outside the U.S. tax base.

Taxation of shareholders

Because shareholders will own stock of a foreign corporation (rather than a U.S. corporation) following the inversion, different tax consequences may apply to dividends and gain from that stock. The changes in the taxation of shareholders of the inverted company will depend on the status of the shareholder.

Non-corporate U.S. shareholders will generally be taxed in the same manner after the transaction as before, except that any dividends received generally will be foreign-source income instead of U.S.-source income. Corporate U.S. shareholders will have significantly different tax treatment because they generally will no longer be entitled to a dividends received deduction for dividends from the new foreign parent.

In general, foreign shareholders receive substantially more favorable U.S. tax treatment following an inversion transaction. Prior to the inversion, the foreign shareholders were subject to a U.S. withholding tax on any dividends paid by the U.S. Corporation, imposed at a rate of 30 percent but subject to reduction under an applicable U.S. income tax treaty. Following the inversion, dividends should no longer be subject to U.S. withholding tax. Additionally, any stock of the U.S. Corporation held directly by a non-resident alien individual was includible in his or her estate; in contrast, stock of the new foreign parent held by a nonresident alien individual is not subject to U.S. estate tax.

7 LATEST LEGISLATIVE DEVELOPMENTS

On November 12, 2002, the U.S. Treasury Department issued temporary regulations requiring corporations to notify the IRS and their shareholders when they move their headquarters offshore or are acquired by a foreign company. Under the temporary regulations, corporations that inverted in 2002 are required to furnish Form 1099s reporting the fair market value of any stock and other consideration received by the shareholders in the transaction.

Requiring reporting of these transactions through Form 1099 is expected to increase the IRS's access to information about these transactions and is also expected to serve as a reminder to the shareholders, many of whom who would be liable to tax on the inversion, of the tax consequences to them from the transaction the company undertook during the year and to insure that the income is reported[21]. Proposed regulations on disclosure of inversion transactions have also been made public and are yet to be finalized.

[21] Source: www.ustreas.gov Treasury issues temporary regulations for inversion transaction reporting.

Besides these regulations, which call for greater disclosure, several members of the U.S. Congress have introduced legislations aimed at curbing corporate inversions. Members of Congress have proposed numerous bills in response to the growing number of inversions.

At the core of all the Bills that have been introduced, are provisions that would treat foreign corporations created with the sole purpose of buying a U.S. company (*i.e.*: sole purpose of inversion) as a U.S. company with all its attendant consequences. In other words, the Bills propose to provide that the inversion itself and the creation of a new foreign parent will be ignored in Toto for the purpose of levy of U.S. taxes on worldwide income.

Salient features of two such Bills, "The Reversing the Expatriation of Profits Offshore Act ("**REPO**") proposed by Senators Baucus and Grassley ("**Grassley-Baucus Bill**") and another Bill, "H.R. 5095, The American Competitiveness and Corporate Accountability Act of 2002" proposed by Congressman Thomas, the Chairman of the House Ways and Means Committee, ("**Thomas Bill**") are briefly enumerated below:

Grassley Baucus Bill[22]

This Bill proposes to prevent the desired savings in the U.S. taxes resulting from inversions by treating the foreign corporations as U.S. corporations when certain factors characteristic of an inversion are met.

Typical factors include whether:

- The stockholders of U.S. Co owns more than 80 percent of the stock of the foreign parent;
- Foreign parent's business activity in its country of incorporation are insignificant; and
- Foreign parent's stock is principally traded in the U.S.

Once the foreign parent, is treated as a U.S. company, the foreign parent would also be subject to U.S. tax on its worldwide income, including foreign source income. The Grassley-Baucus Bill also applies to "Limited inversion" transactions, in which the U.S. Co shareholders own only 50 to 80 percent of the stock in the foreign parent, wherein normal provisions related outbound stock transfer of stock.

Thomas Bill[23]

The Thomas Bill requires the Treasury to study inversions and report to the Congress before December 31. It contains three important features aimed as dissuading U.S. companies from undertaking inversion transactions.

- It proposes a three-year moratorium on "mailbox inversions"[24]. Any mailbox inversion that takes place after March 20, 2002 would be disregarded
- It proposes to impose a 20 percent excise tax on the value of all stock options and stock-based compensation held by insiders, top executives and directors when a company

[22] Section 7874 of the Bill

[23] Source: www.taxfoundation.org Fiscal Policy Memo, by Scott A Hodge, executive director, September 24, 2002

[24] A mailbox inversion occurs when a U.S. company transfers its incorporation to a foreign tax jurisdiction, typically one like Bermuda that has no corporate income tax, without relocating employees or any other business activity to the new jurisdiction. The company continues to act like a U.S. company in all respects other than its tax liability on income earned abroad.

inverts[25]It proposes to disallow U.S. companies that transfer assets to a newly incorporated foreign parent company from using foreign tax credits or net operating losses (NOLs) to offset the taxes due on such transfer of assets[26]

8 CONCLUSION:

It is likely that both the above-mentioned Bills may come up for further discussion this in the year 2003. Various associations in the U.S. are advocating a long-term overhaul of the existing tax system, to look into the cause for inversions and find a solution, rather than a virtual ban on inversions, as proposed in these Bills. Any proposed move to shift the U.S. operations to a tax free jurisdictions must be taken after considering both the tax and non tax advantages and keeping in view, that even if these Bills are not enacted, the future will hold more stringent disclosures to the IRS.

The contents of this paper should not be construed as legal opinion or professional advice.

[25] Under current law, if a company's re-incorporation is accomplished through a stock transaction, in which the overseas corporation purchases most of the shares in the domestic corporation, existing shareholders (whether or not they become shareowners in the new, foreign corporation) may face capital gains taxation at the time of inversion. This is due to section 367 of the U.S. Internal Revenue Code, added in 1998, which requires shareholders to recognize a gain on the exchange of stock for tax purposes. This provision was added to the code as an "exit toll" with the intention of making inversions less palatable to U.S. corporations. H.R. 5095 would apply the section 367 exit toll to stock options held by top corporate executives and directors. The goal of this provision is to give corporate managers a greater financial stake in any decision to invert.

[26] Under current law, when a U.S. company transfers assets to a foreign parent company, the U.S. company faces a tax liability equal to 35 percent of the sale, which may be offset by foreign tax credits or NOLs