# Schumer Releases Draft Anti-Inversion Bill

September 10, 2014

A draft of the bill that is being considered by Senator Schumer (D-NY) to reduce some of the economic incentives for corporate inversions was made publicly available yesterday. Senator Schumer has indicated that, while the proposed bill is still the subject of discussion and is subject to change, he intends to introduce the bill into the Senate this week. The following is a summary of the provisions in the proposed bill as it currently stands.

## Tightened Earnings Stripping Rules.

As previously reported, the bill would tighten the existing "earnings-stripping" rules (which generally limit the ability of a U.S. corporation to deduct interest on debt to, or guaranteed by, a related foreign party) as applied to inverted companies. The primary change made by the bill would be to reduce the allowable amount of interest that could be paid on such debt to 25% (from 50%, under current law) of the U.S. corporation's adjusted taxable income, a measure similar to EBITDA. The bill would also eliminate the ability to carry forward interest deductions that were disallowed by this rule, and eliminate a safe harbor for a U.S. corporation with a low debt-to-equity ratio. These rules would apply for any taxable year beginning on or after the later of (i) the enactment of the bill and (ii) the first taxable year for which a U.S. corporation is subject to these rules, as described below.

*The effect of this provision would be to reduce substantially the ability of an inverted U.S. company to use intercompany leverage after an inversion transaction to reduce its U.S. tax liability.*

## Pre-Approval of Related Party Transactions.

The bill would also require a U.S. corporation that is subject to the bill to file with the IRS an application for an annual "approval agreement," at the time and in the manner specified by the IRS, with respect to the positions it intends to take on its tax return. An "approval agreement" is defined as a pre-filing, advance pricing or similar agreement containing such provisions as the IRS determines are necessary to ensure that the requirements of various provisions of the Code relating to related-party transactions (including the provisions relating to earnings-stripping and transfer pricing) are met. Within 90 days after receipt of the application, the IRS must either:

- enter into the agreement for the relevant taxable year – in which case the IRS would generally be bound by the agreement for purposes of any later audit;
- notify the U.S. corporation that the IRS has determined that the application was filed in good faith and substantially complies with the requirements for such application – in which case the IRS would not be bound by the agreement and could, on audit, still challenge any of the positions taken by the U.S. corporation in the application; or
- notify the U.S. corporation that the IRS has determined that the application was not filed in good faith or does not substantially comply with such requirements – in which case the bill provides that, for the relevant taxable year, (x) the U.S. corporation is not allowed any deduction, or addition to basis or cost of goods sold, for amounts paid or incurred or losses incurred by reason of any transaction between the corporation and a related foreign person, (y) any transfer or license of intangible property between the U.S. corporation and a related foreign person is disregarded, and (z) any cost-sharing arrangement between the U.S. corporation and a related foreign person is disregarded.

The application for such an agreement would be required for any taxable year, beginning on or after the date of enactment of the bill, that is within the ten-year period beginning with the first taxable year for which a U.S. corporation is subject to these rules, as described below.

*It is difficult to predict with certainty the effects of this novel provision. If the bill ever became law, it is difficult to see how the IRS could ever effectively administer this arrangement, given the IRS's resource constraints and the complexity of multinational intercompany arrangements. However, in light of the draconian consequences of an IRS rejection of an application, and the absence of any clear standards for how the IRS is to determine whether to accept or reject an application (which in turn makes it difficult to contest a rejection of an application), the proposal, if enacted, would make it very difficult for a U.S. corporation that is considering an inversion transaction to engage in all but the most conservative of tax planning (including with respect to existing tax planning).*

## Inverted Companies to Which the Bill Would Apply.

The bill would generally apply to any inverted U.S. company if, in the inversion transaction, the former shareholders of the inverted U.S. company owned more than 50% of the foreign parent corporation after the transaction. Significantly, in the current version of the proposed bill, these rules would apply to any U.S. company that inverted in a transaction occurring after April 17, 1994, even if the inversion transaction pre-dated the current Section 7874 inversion regime enacted in 2004 or, at the time of the transaction the U.S. company inverted, it avoided the application of the U.S. anti-inversion rules of Section 7874(b) by satisfying the "less than 80%" continuity test in the current Section 7874. (The bill would not apply to any U.S. company that inverted in a transaction that satisfied the "substantial business activities" exception in Section 7874.) These rules would also apply to any noncorporate entity that controls or is controlled by any member of the group that includes that inverted U.S. company.

*The justification for applying the bill to U.S. companies that inverted as far back as 1994 appears to be that the first IRS Notice specifically relating to inversion transactions, Notice 94-46, was effective for transactions occurring on or after April 18, 1994. This Notice announced the IRS's intention to issue the so-called "Helen of Troy" regulations, pursuant to which shareholder-level tax is imposed on any outbound transaction, including an inversion transaction, in which U.S. shareholders of the inverting U.S. company receive 50% or more of the stock of the foreign acquiring corporation in the transaction. Senator Schumer indicated yesterday, however, that he is open to considering changing this date.*

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