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COMMENT

Solving the Corporate Inversion Phenomenon: An Exercise in Free Market Patriotism, Protectionism Through Facilitation

*By Brian Thompson**

ABSTRACT

The United States government grapples with the right solution to deter corporations from inverting abroad. A corporation's decision to invert is made in the interest of its shareholders, including many who are United States citizens. However, many have called inverting corporations unpatriotic, traders, and cheaters. These labels shift the blame to an easy scapegoat. In order to quell this recent phenomenon, the United States government must move beyond rhetoric and reevaluate the cause of the exodus. Politicians have no one to blame but themselves and the outdated corporate policy they have left in place. Heavy-handed government policies to punish corporations for doing what is best for their shareholders is not only counterproductive but also contrary to corporate duties imposed by existing law. The government must move in the opposite direction. The government must disregard punitive policies and reform the law to facilitate a competitive corporate market. The answer to global corporate competitiveness is less government interference. The only way to protect the United States' corporate base is for the government to facilitate a corporate friendly environment otherwise the corporate evacuation will persist.

I. INTRODUCTION

For the free market to perform as intended, lawmakers customarily allow the merger of United States corporations into foreign entities, a process known as a corporate or tax inversion. However, this right is not absolute. According to former U.S. Treasury Secretary, Jack Lew, "these activities [inversions] should be based on economic efficiency, not tax savings."[1] A 2014 Congressional Research Service report "estimated that 47 companies had undertaken inversions in the past decade,"[2] including 12 companies that have inverted since 2011.[3]

The above statistics have not been ignored, and as the rate of inversions has increased, so has public scrutiny. A poll conducted nationwide among registered voters found that 59% believed that Congress should act to "penalize and discourage companies" from inverting.[4] Even former President Barack Obama declared that corporate inversions are an exercise in "gaming the system."[5]

This type of rhetoric directed at "evil corporations" is an easy way to score political points, but it begs the question: what drives businesses to engage in inversions? As Judge Learned Hand said in 1934, "any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[6] Corporate directors and managers have a fiduciary duty to create as much wealth as possible for their shareholders.[7] U.S. corporations are accomplishing that legal obligation by moving to a foreign jurisdiction, usually one that offers a much lower tax rate.[8] Any government action aimed at preventing inversions runs contrary to free market principles, but more importantly, would result in a mandate for corporate directors to violate their fiduciary obligations by preventing a practice meant to generate more wealth for the company's shareholders.

Part two of this article will provide a definition of corporate inversions and explain the various ways companies structure these transactions. Part three

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1. Jacob J. Lew, *Close the Tax Loophole on Inversions*, WASH. POST (July 27, 2014), https://www.washingtonpost.com/opinions/jacob-lew-close-the-tax-loophole-on-inversions/2014/07/27/2ea50966-141d-11e4-98ee-daea85133bc9_story.html?tid=a_inl&utm_term=.5346b4453b39. Lew points out that recent inversions have not only been motivated by tax savings, but also "expressly justified by" tax considerations. *Id.*

2. Shane Zahrt, Note, *Ending Corporate Inversions: Past Failures, Continued Controversy, and Proposals for Reform*, 41 WM. MITCHELL L. REV. 1591, 1595 (2015).

3. Kathy Wong, Note, *Inverse Logic: The Shortcomings of Preventing Corporate Tax Inversions Through Amending Section 7874*, 14 CARDOZO PUB. L. POL'Y & ETHICS J. 451, 452 (2016).

4. John D. McKinnon, *Strong Support for Congressional Action on Inversions – WSJ/NBC Poll*, WALL ST. J.: WASH. WIRE (Sept. 9, 2014, 6:36 PM), https://blogs.wsj.com/washwire/2014/09/09/strong-support-for-congressional-action-on-inversions-wsjnbc-poll/.

5. Kevin McCoy, *Obama Steps Up Criticism of Tax Inversions*, USA TODAY (July 24, 2014, 7:18 PM), https://www.usatoday.com/story/money/business/2014/07/24/obama-tax-inversions-criticism/13120369/.

6. Helvering v. Gregory, 69 F.2d 809, 810-11 (2d Cir. 1934).

7. Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders . . . the powers of directors are to be employed for that end").

8. Melissa Lucar, *Corporate Inversions: The Fleeing Notion of an American Corporation*, 15 U.C. DAVIS BUS. L.J. 265, 268 (2015).

investigates the root causes of the corporate inversion phenomenon. Part four details the specific policies that the U.S. government has enacted in an attempt to limit inversions. Finally, part five consists of proposals designed to limit the incentive to invert rather than placing a barrier between directors and fiduciary compliance.

II. CORPORATE INVERSIONS

A. Corporate Inversion Defined

A now frequent and increasingly criticized phenomenon, corporate inversion is most simply defined as the reorganization of a U.S. corporation into a foreign entity.[9] The U.S. Department of the Treasury provides that a corporate inversion occurs when "a U.S. based multinational restructures so that the U.S. parent is replaced by a foreign corporation, in order to avoid U.S. taxes."[10] This practice has been labeled an "inversion" because the acquiring company eliminates its own corporate identity in order to preserve the target company's identity—the opposite of the standard merger and acquisition transaction.[11]

An inversion does not involve the physical relocation of the corporation; the transaction is more symbolic because the substantial change is reflected only in the business agreement.[12] Generally, there is not any change in the corporation's internal operations.[13] After a U.S. corporation has inverted, its management and business operations usually remain in the U.S.[14] The company is merely renouncing its U.S. citizenship so its economic activity is not disrupted.[15]

B. Approaches to Structuring a Corporate Inversion

There are three principal methods a U.S. corporation can use to structure its inversion: "(1) meeting the substantial activit[ies] test; (2) merging with a smaller foreign company; or (3) [being acquired by] a larger foreign company."[16] The second and third methods that require a merger can be achieved through a stock, asset, or drop-down transaction.[17]

First, the substantial activities test is an exception to § 7874 of the Internal Revenue Code. Under § 7874, a corporation is classified as "domestic," and can thereby be taxed at the domestic rate, if the U.S. corporation owns 80% or more of a foreign corporation after the inversion.[18] The substantial business activity

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9. Gregory Day, *Irrational Investors and the Corporate Inversion Puzzle*, 69 SMU L. REV. 453, 454 (2016).
10. Press Release, U.S. Dep't of the Treasury, Treasury Announces First Steps to Reduce Tax Benefits of Corporate Inversions (Sept. 22, 2014), http://www.treasury.gov/press-center/press-releases/Pages/jl2647.aspx.
11. Day, *supra* note 9, at 454-55.
12. Lucar, *supra* note 8, at 267-68.
13. James Mann, Note, *Corporate Inversions: A Symptom of a Larger Problem, The Corporate Income Tax*, 78 S. CAL. L. REV. 521, 524 (2005).
14. Lucar, *supra* note 8, at 268.
15. Wong, *supra* note 3, at 453.
16. Michael B. Cohen, Note and Comment, *Avoiding Double Taxation and Expatriation: A Comprehensive Solution to FATCA and Corporate Inversion*, 41 N.C. J. INT'L L. 595, 638 (2016).
17. Lucar, *supra* note 8, at 279.
18. *Id.* at 277-78.

exemption permits a company to invert "if it has substantial business activity in the country of reincorporation."[19]

Second, in an inversion where a smaller foreign corporation is acquired by a larger U.S. corporation, the merger is conducted to make the newly merged corporation subject to the foreign jurisdiction's tax rate.[20] After the merger is complete, the U.S. corporation becomes the majority owner of the foreign corporation, giving the U.S. based management team control of the foreign corporation.[21]

The third method of inversion occurs when a smaller U.S. corporation merges with a larger foreign corporation. The U.S. corporation may be legitimately attempting to enhance foreign operations, irrespective of the possible tax benefits, when an entity chooses this transactional approach.[22] The result of this merger is that the U.S. corporation assumes a minority ownership percentage in the merged company.[23] This approach is distinct and more than symbolic because management is moved to the foreign parent's headquarters.[24]

As stated above, the inversions that can be achieved through a merger are completed by employing one of the following techniques: a stock, asset, or a drop-down transaction.[25] A stock transaction is achieved when the shareholders of the U.S. corporation trade all their shares for equity in the foreign corporation.[26] The outcome of this transaction is that the foreign parent assumes ownership of the U.S. corporation and the now former shareholders of the U.S. corporation become majority owners in the existing foreign company.[27] Practically speaking, all this transaction does is convert ownership.[28] Normally, the foreign parent incorporates in a jurisdiction with low corporate rates as a holding company,[29] while "the U.S. corporation either becomes a subsidiary or transfers all its assets to the foreign parent."[30]

Asset transfers are typically employed in smaller-scale inversions.[31] An asset transaction can be structured in two different ways.[32] The first approach employs the use of a continuation transaction to transform the U.S. parent corporation into the foreign parent by automatically merging the U.S. corporation's shares into shares of the foreign corporation.[33] The second approach is when every asset and liability of the U.S. corporation is transferred to a foreign corporation in exchange

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19. *Id.* at 278.
20. *Id.* at 279.
21. *Id.*
22. *Id.* at 278.
23. *Id.*
24. *Id.*
25. Scott DeAngelis, Note, *If You Can't Beat Them, Join Them: The U.S. Solution to the Issue of Corporate Inversions*, 48 VAND. J. TRANSNAT'L L. 1353, 1359 (2015).
26. Joseph A. Tootle, Note, *The Regulation of Corporate Inversions and "Substantial Business Activities"*, 33 VA. TAX REV. 353, 363 (2013).
27. *Id.*
28. Eloine Kim, Note, *Corporate Inversion: Will the American Jobs Creation Act of 2004 Reduce the Incentive to Re-Incorporate?*, 4 J. INT'L BUS. & L. 152, 161 (2005).
29. Tootle, *supra* note 26, at 363.
30. Kim, *supra* note 28, at 161.
31. Lucar, *supra* note 8, at 280.
32. Joshua Simpson, *Analyzing Corporate Inversions and Proposed Changes to the Repatriation Rule*, 68 N.Y.U. ANN. SURV. AM. L. 673, 678 (2013).
33. *Id.*

Thompson: Solving Corporate Inversion Phenomenon

for stock that the U.S. corporation liquidates in order to convey the surplus value to its shareholders.[34]

A drop-down transaction or combined inversion,[35] utilizes elements of both the former techniques.[36] When a corporation uses a drop-down structure in exchange for stock, the U.S. corporation transfers its assets to the new foreign parent.[37] In order to complete the transaction, the foreign parent transfers some of its recently acquired assets back to a domestic subsidiary.[38] Following the completion of that transaction, the original U.S. corporation is defunct, but its former shareholders hold the same amount of equity in the new foreign corporation as they once held in the defunct corporation.[39]

III. CAUSES OF THE CORPORATE INVERSION PHENOMENON

The U.S. has always been a target for corporate domicile, given its propensity to provide corporate safeguards in addition to the obvious size of its consumer base.[40] These alluring attributes enabled the U.S. government to maintain a higher corporate tax rate without risking capital flight.[41] However, the current tax structure is outdated, which creates an issue for U.S. multinational corporations because of the anti-competitive corporate tax rate relative to others competing in the international arena.[42]

The National Foreign Trade Council conducted a study in 2002 examining U.S. international tax policy and found that the U.S. is an undesirable location for a multinational corporation's legal domicile.[43] The report concluded that, "a significant modernization of the U.S. rules is necessary to restore competitive balance in the vastly changed circumstances of the global economy of the 21st century."[44] Corporation inversions are the product of the dated U.S. tax rules in an increasingly competitive global economy.[45] This leaves U.S. corporations at a disadvantage and is consequently a key factor in influencing a company's decision to invert, thereby diminishing the burden imposed by the U.S. tax structure.[46]

34. *Id.*
35. DeAngelis, *supra* note 25, at 1360.
36. Lucar, *supra* note 8, at 280.
37. DeAngelis, *supra* note 25, at 1360.
38. *Id.*
39. Heather Campbell, Note, *When Good Tax Law Goes Bad: Stanley Works' Recent Dilemma and How the Internal Revenue Code Disadvantages U.S. Multinational Corporations Forcing their Flight to Foreign Jurisdictions*, 31 SYRACUSE J. INT'L L. & COM. 95, 104 (2004).
40. DeAngelis, *supra* note 25, at 1361.
41. *Id.*
42. *Id.*
43. *See* Skadden Arps Slate Meagher & Flom LLP & Washington Council Ernst & Young, *Territorial Tax Study Report,* NAT'L FOREIGN TRADE COUNCIL (June 11, 2002), http://www.nftc.org/default/Tax%20Policy/06_13_02_Territorial_Tax_Study_Report.pdf.pdf.
44. Kim, *supra* note 28, at 155.
45. *Id.* at 154.
46. DeAngelis, *supra* note 25, at 1361.

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A. Territorial Taxation Versus Worldwide Taxation

In a territorial system, income is taxed by the nation where the income originated.[47] Under this system, offshore income is exempt from domestic tax collectors.[48] Most foreign countries only tax domestic-sourced income, which includes 25% of Organization for Economic Cooperation and Development (OECD) countries.[49] Except for the U.S., all six co-members of the G-7, a group of the seven largest economies in the world, use some form of a territorial tax system.[50] Many countries have implemented provisions into their territorial system designed to stop companies from removing earned income to foreign jurisdictions, bypassing any potential domestic tax liability.[51]

Conversely, the U.S. employs a worldwide taxation system.[52] Under a worldwide tax scheme, the country where a corporation is domiciled, taxes all income regardless of whether it is earned domestically or abroad.[53] Under the U.S. tax structure, a levy on foreign corporations is imposed only on income-connected U.S. business operations, an advantage that is unavailable to domestic corporations.[54] In an attempt by the U.S. government to narrow this competitive gap, domestic corporations may claim a foreign tax credit on taxes paid to foreign countries if the income originates therein.[55] The foundation of the foreign tax credit system is formulated by grouping a corporation's income into specific and distinct classifications.[56] Following this classification, the foreign tax credit is calculated by combining general and passive income.[57] The foreign tax credit only applies to compulsory taxes (required taxes in foreign jurisdictions), therefore, voluntary taxes can incur double tax liability, as they do not qualify for the tax credit.[58]

The U.S. applies a "place-of-incorporation rule" for defining a corporation as domestic or foreign.[59] A corporation is domestic if it is organized under the laws of any state.[60] Conversely, if the corporation is organized under a foreign jurisdiction's laws, it is considered a foreign person under U.S. law.[61] The foreign person distinction applies to any foreign subsidiary of a U.S. multinational.[62] As a result, until foreign subsidiaries' earnings are repatriated back to the U.S. parent, there is no domestic tax liability on the parent's subsidiaries' foreign-earned income.[63] Once

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47. Chris Capurso, Note, *Burgers, Doughnuts, and Expatriations: An Analysis of the Tax Inversion Epidemic and a Solution Presented Through the Lens of the Burger King Tim Hortons Merger*, 7 WM. & MARY BUS. L. REV. 579, 584 (2016).
48. DeAngelis, *supra* note 25, at 1357.
49. James G.S. Yang, *Corporate Inversions: Rules and Strategies*, 27 J. INT'L TAX'N 37, 37 (2016).
50. Capurso, *supra* note 47, at 584.
51. DeAngelis, *supra* note 25, at 1357.
52. Capurso, *supra* note 47, at 584.
53. *Id.*
54. Michael S. Kirsch, *The Congressional Response to Corporate Expatriations: The Tension Between Symbols and Substance in the Taxation of Multinational Corporations*, 24 VA. TAX REV. 475, 485-86 (2005).
55. Zahrt, *supra* note 2, at 1599.
56. Cohen, *supra* note 16, at 632.
57. *Id.* (noting that general income is referring to "namely, active income").
58. *Id.*
59. Kirsch, *supra* note 54, at 485.
60. *Id.*
61. Tootle, *supra* note 26, at 358.
62. *Id.*
63. *Id.*

the foreign-earned income is repatriated to the U.S. parent, it is taxed at the U.S. domestic rate.[64] Domestic corporations are incentivized to defer potential domestic tax liability by leaving foreign income abroad and out of reach of the worldwide tax system.[65]

B. *U.S. Corporate Tax Rates*

During the 1980s, the U.S. corporate tax rate was relatively low among OECD countries.[66] At the same time, multinational corporations were incorporating in the U.S. to gain access to its large consumer market and corporate legal protections.[67] Then the competition caught up from 1979 to 2002, and the average corporate tax rate fell from 43% to 29% among OECD countries.[68] While this period of tax reformation was occurring abroad, the U.S. lost its competitive advantage by failing to modify its corporate tax rate.[69] President Obama's Economic Recovery Advisory Board warned that, "the growing gap between the U.S. corporate tax rate and the corporate tax rates of most other countries generates incentives for U.S. corporations to shift their income and operations to foreign locations with lower corporate tax rates to avoid U.S. taxes."[70]

The U.S. tax code received its last major reform in 1986.[71] This government complacency has left the U.S. corporate tax rate (currently 35%) as the *highest in the developed world*.[72] Accounting for state income tax, U.S. corporations could face a 39.1% tax rate.[73] The anti-competitiveness of the U.S. corporate tax rate is one of the primary sources associated with inversions.[74] Global variances in tax rates have consequences, namely, that it provides great incentives to transfer income to low-rate jurisdictions.[75] An unintended consequence of such a high tax rate is that it reduces the profits of U.S. corporations, exposing domestic entities to a foreign takeover.[76]

Another revelation that has hurt U.S. corporations is the reality that the U.S. government's global competitors have been systematically reducing their corporate tax rates.[77] The U.S. tax rate is not only higher than that of any other OECD country, it is also "higher than the 30[%] average among developing nations."[78] A study by a University of Calgary economists found that the U.S. federal and state tax rate on

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64. Cathy Hwang, *The New Corporate Migration*, 80 BROOK. L. REV. 807, 814 (2015).
65. *Id.*
66. David M. Towarnicky, *Stop Calling Inverted Companies "Unpatriotic:" It is Congress's Patriotic Duty to Provide a Competitive Corporate Environment*, 45 PUB. CONT. L. J. 163, 165 (2015).
67. *Id.*
68. *Id.*
69. *Id.*
70. President's Econ. Recovery Advisory Bd., *The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation,* PROCON.ORG i, 69 (Aug. 2010), http://corporatetax.procon.org/sourcefiles/PERAB-tax-reform-report.pdf.
71. Zahrt, *supra* note 2, at 1596.
72. Towarnicky, *supra* note 66, at 165 (emphasis added).
73. Yang, *supra* note 49, at 38.
74. Zahrt, *supra* note 2, at 1598.
75. Yang, *supra* note 49, at 38.
76. *Id.*
77. Kim, *supra* note 28, at 156.
78. *Id.* at 157.

new capital investment, considering credits and deductions, was an uncompetitive 35% compared to a 19.5% OECD average and an 18% global average.[79]

C. Increased Regulatory Burden

Corporate inversions also allow companies to avoid the "thicket of complicated rules" that the U.S. regulatory environment imposes.[80] A 2007 study found that the regulatory costs of being a public company headquartered in the U.S. caused 16% of such companies to consider a sale and 14% to consider a merger.[81] In addition, the annual costs of regulatory compliance for firms incorporated in the U.S. is $1.75 trillion.[82] This marked an overall increase of 171% from 2001 to 2006 for firms with revenue under $1 billion, while firms with revenue over $1 billion experienced a 12% increase in compliance costs from 2005 to 2006.[83] The U.S. approach to regulation relies on rules and compliance as opposed to a principles-based approach.[84]

The U.S. regulatory system involves regulators at both the federal and state level, which is more complicated than countries with a single regulator, such as the United Kingdom ("U.K.").[85] Federal and state regulators are mandated by law to enforce their own regulations. As a result, it can take months to harmonize federal and state laws because the regulatory system has not been streamlined. As long as the U.S. regulatory system continues to be void of an overarching principle that instructs regulators on the approach to take toward supervision and enforcement, this inefficiency will continue to persist.[86] Consequently, regulators are left with only one option: to promulgate regulations under the statutory authority delegated by outdated legislative mandates.[87] These mandates have fallen behind the trends in today's global economy because they are not subject to substantial review.[88] This archaic regulatory framework has forced corporate executives to spend more time learning the purpose of each regulation and how it may impact their business.[89] This lack of understanding has facilitated an uneasy view toward any new regulations that could drive up the cost of compliance even further.[90]

The overarching legal market in which the regulatory environment operates strengthens its effectiveness. A legal market based on principles of fairness and

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79. *The Send Jobs Overseas Act: Ending the Deferral of Foreign Income is Another Tax on U.S. Employment*, WALL ST. J. (Sept. 28, 2010), https://www.wsj.com/articles/SB10001424052748703384204575509700366289206.

80. Simpson, *supra* note 32, at 688.

81. Foley & Lardner LLP, *Foley Study Reveals Continued High Cost of Being Public*, FOLEY (Aug. 2, 2007), https://www.foley.com/foley-study-reveals-continued-high-cost-of-being-public-08-02-2007/.

82. Nicole V. Crain & W. Mark Crain, *The Impact of Regulatory Costs on Small Firms*, SMALL BUS. ADMIN. i, iv (Sept. 2010), https://www.sba.gov/sites/default/files/The%20Impact%20of%20Regulatory%20Costs%20on%20Small%20Firms%20(Full).pdf.

83. Foley, *supra* note 81.

84. Michael R. Bloomberg & Charles E. Schumer, *Sustaining New York's and the US' Global Financial Services Leadership,* NYC.GOV i, 82 (Jan. 2007), http://www.nyc.gov/html/om/pdf/ny_report_final.pdf.

85. Simpson, *supra* note 32, at 693.

86. Bloomberg & Schumer, *supra* note 84, at 83.

87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.* (noting that the cost of compliance in the securities industry increased $12 billion from 2002 to 2005).

predictability is the second most important standard in determining the competitiveness of a financial center.[91] The legal system in the U.S. may be deteriorating its established reputation as an epicenter for ingenuity.[92] By simply shifting their listings to overseas exchanges, corporations can avoid exposure to meritless securities lawsuits and subsequent settlements that increase the operating costs for U.S. businesses.[93] The previous years have produced new highs in both the quantity and value of class action settlements in the security industry.[94] Furthermore, due to federalism in the U.S., sanctions are seen as arbitrary since state and federal courts provide independent directives and outcomes depending on if the suit is brought by regulators, government attorneys general, class actions, or individuals.[95] This regulatory volatility imposes even further costs on U.S. entities.[96]

D. Corporate Debt: Interest Expense Deduction

The U.S. treatment of interest expenses has provided another incentive for U.S. corporations to invert.[97] Generally, interest payments on corporate borrowing can be incurred anywhere in the corporate group, irrespective of where the corresponding benefit occurs.[98] Accordingly, a domestic parent can obtain a loan, use such funds to capitalize "foreign-source income-producing activities, and claim [an] interest deduction" in the domestic parent's country of incorporation for offshore income.[99] This interest deduction decreases the corporation's domestic tax liability, while allowing the corporation to use funds freed by the deduction to grow operations outside the country of incorporation.[100]

In the U.S., however, it is difficult to take advantage of this interest deduction. Since it is difficult to apportion interest expenses, the Internal Revenue Code distributes the expense "across the corporate group on a pro rata basis [based on each entity's] total assets."[101] This method of allocation is costly for multinationals that disproportionately borrow from U.S. lenders, which results in entities minimizing and effectively avoiding these costs by reincorporating overseas.[102]

E. Income Shifting: Earnings Stripping

The majority of tax benefits that corporations are able to receive from inversions are the product of post-inversion techniques, such as income shifting.[103] Income shifting is a technique that multinational corporations utilize to report income earned from one jurisdiction to another jurisdiction that offers a more advantageous

91. Simpson, *supra* note 32, at 694.
92. Bloomberg & Schumer, *supra* note 84, at 71.
93. *Id.* at ii (noting that this is an increase in both actual and apparent operating costs).
94. Simpson, *supra* note 32, at 694.
95. Bloomberg & Schumer, *supra* note 84, at 17.
96. Simpson, *supra* note 32, at 694.
97. Harvard Law Review Ass'n, *VI. Drawing Lines Around Corporate Inversion*, 118 HARV. L. REV. 2270, 2277 (2005) [hereinafter Harv. Ass'n].
98. *Id.*
99. *Id.*
100. *Id.*
101. *Id.*
102. *Id.* at 2278.
103. DeAngelis, *supra* note 25, at 1362.

corporate tax rate.[104] The income is transferred through inter-company payments in various forms of interest payments, "management fees, licensing fees, or royalties."[105] An accounting study found that "despite managements' claims that inversion-related tax savings will be due to the avoidance of U.S. tax on foreign earnings . . . most of the tax savings is attributable to the avoidance of U.S. tax on U.S. earnings [through earnings stripping]."[106]

Earnings stripping is a common income shifting technique.[107] Earnings stripping occurs when a corporation pays excessive interest amounts to related third-parties as a way to reduce its taxable income.[108] In an earnings stripping transaction, a foreign parent corporation lends money to its U.S. subsidiary.[109] Following the loan, the subsidiary can deduct from its taxable income the subsequent interest payments made to the foreign parent as a business expense, thereby reducing its domestic tax liability.[110] Similarly, the U.S. corporation could make tax-deductible royalty, management, or administrative expense payments to the foreign parent.[111]

As previously discussed, the U.S. worldwide tax structure levies tax on foreign corporations only on domestically generated income.[112] Consequently, the outcome of the earnings stripping transaction is the shifting of the subsidiary's U.S. generated income out of the U.S., in the form of interest payments, to the newly formed foreign parent.[113] The benefit of an earnings stripping transaction is immediately apparent to the corporation because any previous U.S. source taxable income is modified to a U.S. source expense, permitting a multinational to shift U.S. profits to offshore jurisdictions out of the reach of U.S. tax collectors.[114] Earnings stripping transactions are a significant incentive to invert and gross the largest tax savings among inversion transactions.[115]

IV. Government Responses to Inversions

It is not illegal to effectively utilize tax laws to lessen tax liabilities owed to the U.S. government.[116] Nevertheless, critics of the practice maintain that inversions are not within the spirit of the law because the goal is to gain a tax advantage, as tax

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104. *Id.*
105. Orsolya Kun, *Corporate Inversions: The Interplay of Tax, Corporate, and Economic Implications*, 29 DEL. J. CORP. L. 313, 338 (2004).
106. Jim A. Seida & William F. Wempe, *Effective Tax Rate Changes and Earnings Stripping Through Corporate Inversion*, 57 NAT'L TAX J. 805, 806 (2004) (outlining the pervasiveness of earnings stripping in inversion transactions).
107. Tootle, *supra* note 26, at 361.
108. *Earnings Stripping Law and Legal Definition,* USLEGAL.COM, http://definitions.uslegal.com/e/earnings-stripping/ (last visited Nov. 22, 2017).
109. Lucar, *supra* note 8, at 271.
110. *Id.*
111. Derek E. Anderson, *Turning the Corporate Inversion Transaction Right Side Up: Proposed Legislation in the 108th Congress Aims to Stamp Out Any Economic Vitality of the Corporate Inversion Transaction*, 16 FLA. J. INT'L L. 267, 281-82 (2004).
112. Lucar, *supra* note 8, at 269.
113. Damian Palleta, *Treasury Could Target 'Earnings Stripping' in Inversion Hunt*, WALL ST. J.: WASH. WIRE (Aug. 6, 2014, 1:06 PM), http://blogs.wsj.com/washwire/2014/08/06/treasury-could-target-earnings-stripping-in-inversion-hunt/.
114. Tootle, *supra* note 26, at 362.
115. Seida & Wempe, *supra* note 106, at 805 (analyzing the impact of earnings stripping transactions on four corporations that completed inversions in 2002).
116. Wong, *supra* note 3, at 455.

Thompson: Solving Corporate Inversion Phenomenon

inversions were expected to reduce government revenue by over $2.2 billion in 2015.[117] Furthermore, according to a Congressional Budget Office report, inversions were expected to cost the U.S. Treasury $19.5 billion in lost tax revenue over the next decade.[118]

Based on the above figures, the Treasury Department has taken the position that "there is no policy reason to permit a domestic entity to engage in an inversion transaction when its owners retain a controlling interest in the resulting entity, only minimal operational changes are expected, and there is significant potential for substantial erosion of the U.S. tax base."[119] The potential loss of government revenue prompted Congress to introduce more than 30 bills to combat corporate inversion transactions in the early 2000s.[120]

A. *Government Contracts: Section 835 of the Homeland Security Act of 2002, Consolidated Appropriations Act of 2008, and the Federal Acquisition Regulation*

The Department of Homeland Security was formed in 2002 following the enactment of the Homeland Security Act.[121] As part of the Act, Congress was to discourage corporate inversions through the federal procurement process.[122] Section 835 of the Act deters corporate expatriations by preventing the company from acquiring lucrative government contracts.[123] Section 835 explicitly provides that "[t]he Secretary [of Homeland Security] may not enter into any contract with a foreign incorporated entity which is treated as an inverted domestic corporation."[124] By passing the Consolidated Appropriations Act of 2008, Congress extended the contracting prohibition against inverted domestic corporations to other federal agencies.[125] In the succeeding appropriation acts and continuing resolutions, Congress instituted government-wide statutory prohibitions on the use of appropriated funds to contract with inverted corporations.[126]

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117. *Id.*
118. Memorandum from Thomas A. Barthold, Chief of Staff, Joint Comm. on Taxation, to Karen McAfee, Chief Tax Counsel, House Comm. On Ways and Means (May 23, 2014), *available at* http://democrats.waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/113-0927%20JCT%20Revenue%20Estimate.pdf.
119. Zahrt, *supra* note 2, at 1595.
120. Kirsch, *supra* note 54, at 496.
121. Douglas Chiu, *Inversion Subversion: Corporate Inversions and the New Federal Laws Against Them*, 20 FORDHAM J. CORP. & FIN. L. 717, 726 (2015).
122. Towarnicky, *supra* note 66, at 168.
123. Chiu, *supra* note 121, at 726-27.
124. Homeland Security Act of 2002, Pub. L. No. 107-296, § 835(a), 116 Stat. 2135, 2227 (2002) (codified as amended at 6 U.S.C. § 295(a) (2012)).
125. Towarnicky, *supra* note 66, at 168.
126. Prohibition on Contracting with Inverted Domestic Corporations, 80 Fed. Reg. 38309, 38310 (July 2, 2015) (to be codified at 48 C.F.R. pt. 9 and pt. 52). In FY 2009, the prohibition was continued by § 743 of Division D of the Omnibus Appropriations Act of 2009, Pub. L. No. 11-8, § 743, 123 Stat. 524, 692 (2009); in FY 2010, by § 740 of Division C of the Consolidated Appropriations Act of 2010, Pub. L. No. 111-117, § 740, 123 Stat. 3034, 3215 (2009); in FY 2012, by § 738 of Division C of the Consolidated Appropriations Act of 2012, Pub. L. No. 112-74, § 738, 125 Stat. 786, 938 (2012); in FY 2014, by § 733 of Division E of the Consolidated Appropriations Act of 2014, Pub. L. No. 113-76, § 733, 128 Stat. 5237 (2014); and, most recently, for FY 2015, by § 733 of Division E of the Consolidated and Further Continuing Appropriations Act of 2015, Pub. L. No. 113-235, § 733, 128 Stat. 2130, 2386 (2014).

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The current ban is a result of the Federal Acquisitions Regulation, which prohibits the use of appropriated funds for contracting with any "foreign incorporated entity [that] is treated as an inverted domestic corporation . . . or [with] any subsidiary of such an entity," as defined in 6 U.S.C. § 395(a).[127] The statute calls for a foreign incorporated entity to be treated as an inverted domestic corporation,

> [i]f (1) the entity completes . . . the direct or indirect acquisition of substantially all of the properties [of a] domestic corporation; (2) after the acquisition, at least 80% of the stock . . . of the entity . . . is held . . . by former shareholders of a domestic corporation; and (3) . . . the entity does not have the substantial business activities in the foreign country in which [it is now incorporated].[128]

This statute will be discussed further in the following section.

Despite these Congressional attempts at preventing inversions, inverted companies continue to receive federal government contracts.[129] Many companies have effectively taken advantage of loopholes in order to procure federal contracts by claiming in private legal briefs that their company has not met the standard to be characterized as an inverted domestic corporation.[130] These loopholes run the gamut from military exchanges that do not receive appropriated funds, to maintaining equipment on military bases, or even winning contracts during periods of temporary lapses in the ban.[131] A 2014 study found that over 12 former U.S. corporations that inverted "collect[ed] more than $1 billion a year" procured from the U.S. Treasury in the form of federal contracts.[132]

B. The American Jobs Creation Act and Section 7874

The American Jobs Creation Act of 2002 ("AJCA") amended nearly 600 code sections, which made it the largest revision since the 1986 Tax Reform Act.[133] The AJCA added § 7874, the most formidable barrier to inversion transactions, to the Internal Revenue Code after Congress had become aware that a number of multinational businesses with U.S. parent entities inverted to a corporate structure with foreign ownership.[134] The law includes provisions to punish inversions by levying tax penalties on corporations that undergo such transactions.[135]

Section 7874 only applies to corporate inversions if a certain percentage of former shareholders of the U.S. company own stock in the foreign parent company, or the "surrogate foreign corporation" in the statute's language.[136] A corporation is a

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127. 6 U.S.C. § 395(a) (2012).
128. *Id.*
129. Towarnicky, *supra* note 66, at 169.
130. *Id.*
131. *Id.* at 171.
132. Zachary R. Mider, *Ingersoll-Rand Cleared for U.S. Contracts Despite Inversion*, BLOOMBERG (Dec. 22, 2014, 8:37 AM), http://www.bloomberg.com/news/2014-12-22/ingersoll-rand-cleared-for-federal-contracts-despite-inversion.html.
133. Kim, *supra* note 28, at 163.
134. Jefferson P. VanderWolk, *Inversions Under Section 7874 of the Internal Revenue Code: Flawed Legislation, Flawed Guidance*, 30 NW. J. INT'L L. & BUS. 699, 700 (2010).
135. Kim, *supra* note 28, at 164.
136. Tootle, *supra* note 26, at 368.

"surrogate foreign corporation" if: (1) it "directly or indirectly acquires substantially all the properties of a domestic corporation," and (2) post-transaction is at least 60% of the foreign corporation's stock as a result of its equity in the domestic corporation.[137] If accountings show that a corporation's "expanded affiliated group" [138] ("EAG") has substantial business activities in a foreign country relative to the total business activities of the foreign group, the entity does not meet the statutory standard of a "surrogate foreign corporation."[139] "In a[n] inversion transaction, the foreign parent company is [normally] a surrogate foreign corporation."[140] Section 7874 is applicable if the former shareholders of the U.S. corporation constitute an ownership rate of at least 60% in the foreign parent undertaking the acquisition.[141] In addition, special rules are in place when the former shareholders of the inverted corporation own 80% of the foreign parent,[142] these rules will be explored below.

1. 60% Inversions

Congress viewed 60% inversion transactions as having a limited tax affect, yet warranting restriction to guard against the erosion of the U.S. tax base.[143] "60% inversions are likely [the result of] either mergers with established foreign corporations or partial sales to unrelated individuals"—dissimilar from the pure inversions that prompted public outrage and the enactment of § 7874.[144]

If, after the inversion transaction, former shareholders of the U.S. operating corporation own at least 60%, but less than 80% of the foreign parent, then § 7874 considers the foreign corporation to be a "surrogate foreign corporation."[145] This structure imposes partial tax liability on the U.S. corporation based on a special gain recognition requirement that limits some taxes of the U.S. corporations for an "applicable period" that applies after the inversion is initiated to ten years after its conclusion.[146] The "inversion gain includes any gain on property or stock transferred to the foreign parent, and any licensing income from that property, without offset for losses or credits other than the foreign tax credit."[147]

The provision pertaining to inversion gain is a deterrence mechanism, aimed at preventing corporations with existing losses and credits from undergoing opportunistic inversions.[148] Section 7874 achieves this deterrence, regardless of the

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137. I.R.C. § 7874(a)(2)(B) (2012).
138. *Id.* § (c)(1) (explaining that an "expanded affiliated group" is defined by § 1504(a), which includes the foreign corporations, and corporations owned by more than 50% of its voting power or value).
139. *Id.* § (a)(2)(B)(iii).
140. Tootle, *supra* note 26, at 369.
141. *Id.*
142. *Id.* at 370-71.
143. *See, e.g.*, S. Rep. No. 108-192, at 142 (2003) ("The Committee believes that other inversion transactions [involving greater than 50 but less than 80 percent identity of stock ownership] may have sufficient non-tax effect and purpose to be respected, but warrant heightened scrutiny and other restrictions to ensure that the U.S. tax base is not eroded through related-party transactions.").
144. Tootle, *supra* note 26, at 370.
145. I.R.C. § 7874(a)(2)(B)(ii) (2012).
146. *Id.* §§ (a)(1), (d)(1).
147. *Id.* § (d)(2). Losses are ignored because § 7874(a)(1) provides that "[t]he taxable income of an expatriated entity . . . shall in no event be less than the inversion gain of the entity for the taxable year." The application of credits (other than foreign tax credits) is disallowed by § 7874(e)(1). *See* Tootle, *supra* note 26, at 369.
148. Tootle, *supra* note 26, at 369.

corporation's tax structure, through the nullification of any offset associated with existing losses and credits that would otherwise be available.[149] The strength of this deterrence can be determined by observing whether the corporation has operating losses or credits alternative to those applicable to the foreign tax credit.[150]

> If the U.S . . . corporation has neither, its inversion gain will not exceed its taxable income and the provision [is irrelevant;] if the U.S. corporation has a . . . small amount of losses or credits other than the foreign tax credit, its inversion gain will [only slightly] exceed its taxable income.[151]

In the latter case, the company's taxable income does not prevent corporations that engage in a 60% inversion from earning many of their tax benefits through techniques such as interest allocation or earnings stripping.[152]

2. 80% Inversions

If former shareholders of the U.S. corporation own 80% or more of the stock in the new foreign parent following the inversion, the corporation will be exposed to much harsher tax treatment.[153] Section 7874 treats the new foreign parent corporation as a domestic corporation despite its foreign address,[154] and any foreign-source income is considered to be domestic income within reach of U.S. tax collectors.[155] The classification in § 7874 eliminates the tax benefits associated with an inversion transaction.[156] The multinational corporation will still incur tax liability under the U.S.'s worldwide tax regime, every potential earnings stripping transaction with the foreign parent will be futile, and the foreign parent will then be within the jurisdictional reach of the U.S.[157]

3. Substantial Business Activities

The legislative history underlying the various statutes that codified an overt hostility toward inversions establishes "that § 7874 was enacted to [dissuade] inversions to tax-haven jurisdictions, where . . . multinational [corporations would] not have substantial business activities" relative to their global operations.[158] Section 7874 contains a "substantial business activities" exemption, where a corporation is not a surrogate foreign corporation if its expanded affiliate group has substantial business activities in the foreign country when compared to the total business activities of the group.[159] Attempts of inverting companies to elude § 7874's treatment of 80% inversions by qualifying for the substantial business activities

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149. *Id.*
150. *Id.* at 369-70.
151. *Id.* at 370.
152. *Id.*; *see generally* I.R.C. § 7874(d)(1).
153. Tootle, *supra* note 26, at 369-70.
154. I.R.C. § 7874(b).
155. *See* VanderWolk, *supra* note 134, at 704.
156. Tootle, *supra* note 26, at 368.
157. *Id.* at 370-71.
158. *Id.* at 373.
159. I.R.C. § 7874(a)(2)(B)(iii).

exception is purely financial since the exemption renders § 7874 inapplicable and permits the corporation to obtain the full tax benefit of the inversion.[160]

However, the statute offers no specifics regarding the activities that constitute substantial business activities.[161] Congress delegated the power to interpret substantial business activities to the Treasury through two statutory sources, § 7874(c)(6) and § 7874(g).[162] Section 7874(c)(6) obliges the Secretary of the Treasury to "prescribe such regulations as may be appropriate to determine [whether] a corporation is a surrogate foreign corporation."[163] Section 7874(g) compels the Secretary of the Treasury to "provide such regulations as are necessary to carry out [the] section, including regulations providing for such adjustments to the application of [the] section as are necessary to prevent the avoidance of the purposes of [the] section."[164] Under this authority, the Treasury has promulgated numerous regulations, both temporary and permanent, outlining and defining the standard associated with the substantial business activities exception.[165]

C. Department of the Treasury and other Executive Branch Actions

Despite this legislation, several U.S. corporations have still been able to conduct financially successful inversions.[166] Instead of fleeing to traditional offshore tax havens, companies are now inverting to countries where they have substantial business activities such as Canada, Ireland, and the U.K.[167] Since 2004, the Department of the Treasury has promulgated various regulations instructing the text of § 7874 to be read in a manner that restricts inversions conducted by merging a domestic entity with a foreign corporation.[168]

1. 2006 Treasury Regulation

In 2006, the Treasury Department promulgated a temporary regulation that interpreted § 7874.[169] This regulation clarified the ambiguity of the "substantial business activities" test by setting forth a clear standard.[170] To satisfy the "substantial business activities" standard, the activity must meet either of the following tests: (1) the "facts-and-circumstances" test, or (2) the safe harbor test.[171]

The "facts-and-circumstances" test identifies the existence of substantial business activity related to the worldwide activities of the corporate group.[172] The worldwide activities determination is made on a case-by-case basis, analyzing the factors and facts of the individual case.[173] The "safe harbor test" depends on the

160. Tootle, *supra* note 26, at 371.
161. *Id.*
162. *Id.* at 377-78.
163. I.R.C. § 7874(c)(6).
164. *Id.* § (g).
165. Tootle, *supra* note 26, at 378.
166. Wong, *supra* note 3, at 457.
167. *Id.*
168. *Id.*
169. T.D. 9265, 2006-2 C.B. 1 [hereinafter T.D. 9265].
170. *Id.*
171. *Id.*
172. *Id.*
173. *Id.*

activities of the corporation's EAG.[174] The EAG is the resulting entity after the inversion, which makes up the foreign and domestic corporation.[175] The "safe harbor test" deems a corporation to have substantial business activities automatically if the foreign corporation accounts for at least 10% of their EAG's (1) employees, (2) assets, and (3) sales in a 12-month period.[176]

2. 2009 and 2012 Treasury Regulations

The IRS and Treasury Department promulgated Treasury Regulation 9453 in 2009.[177] Regulation 9453 amended the 2006 Treasury Regulation that attempted to clarify the "substantial business activities" test.[178] Regulation 9453 removed the safe harbor test while maintaining the "facts-and-circumstances" test in its original form.[179] Consequently, eliminating the safe harbor test made it much more difficult to determine what constituted a "substantial" business activity under 7874.[180]

Following the 2009 regulation, the Treasury Department enacted Treasury Regulation 9592 in 2012.[181] This regulation further amended the 2006 Treasury Regulation concerning the test for substantial business activity.[182] Reversing the 2009 regulation, this regulation removed the "facts-and-circumstances" test and replaced it with a new version of the "safe harbor test."[183] For the purpose of clarity, the new safe harbor test deems there to be substantial business activity relative to the total business activities of the corporation group worldwide only if the foreign corporation accounts for at least 25% of both the foreign and domestic corporations in: (1) employees, (2) assets, and (3) sales in a 12-month period.[184]

3. 2014 Treasury Notice

In 2014, the Treasury Department issued an official Treasury Notice aimed at the second prong of § 7874, which concerns ownership and control.[185] For ownership to be under 60% in the foreign corporation and 80% in the newly created entity, which protects U.S. corporations from tax liability under § 7874, corporations must either dilute their domestic control or inflate the total foreign ownership.[186]

Section 2.02 of the regulation is characterized as an anti-dumping provision. This characterization is derived from its operational effect, which is to prevent U.S. corporations from paying out non-ordinary or "extraordinary dividends," thereby diluting domestic ownership, in the period preceding the inversion.[187] Moreover, "[a] dividend is considered non-ordinary if it is 110% greater than the average from

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174. Temp. Treas. Reg. § 1.7874-2T(d)(1) (2006).
175. I.R.C. § 1504(a) (2012); *see also* Treas. Reg. § 1.199-7(a) (2017).
176. T.D. 9265, *supra* note 169.
177. T.D. 9453, 2009-28 I.R.B. 114.
178. Wong, *supra* note 3, at 459.
179. *Id.*
180. VanderWolk, *supra* note 134, at 713.
181. Wong, *supra* note 3, at 459.
182. *Id.*
183. *Id.*
184. *Id.*
185. I.R.S. Notice 2014-5, 2014-2 I.R.B. 276; *see also* Wong, *supra* note 3, at 460.
186. Wong, *supra* note 3, at 460-61.
187. *Id.* at 461.

the year before"; this is also known as a "skinny-down" dividend.[188] If a domestic corporation's dividend payout is within three years of the inversion, § 2.02 omits these dispersals that attempt to dilute the domestic corporation's size.[189]

Section 2.01 of the regulation is an anti-inflation provision that prevents U.S. corporations from inflating the ownership in the foreign corporation by incorporating specified "passive assets," resulting in a smaller ownership percentage.[190] Assets that are not part of a corporation's daily business operations are designated as passive assets.[191] Examples of passive assets include "cash, cash equivalents, or marketable securities."[192] Section 2.01 will disregard a segment of a foreign corporation's passive assets, whose purpose is to artificially inflate the foreign corporation's size, if those assets constitute at a minimum of 50% of the entity's total assets.[193]

Additionally, the Treasury Notice disincentivizes U.S. corporations from inverting by eliminating post-inversion outlets access to foreign earnings without being subject to repatriation taxes.[194] Before the promulgation of the 2014 Treasury Notice, U.S. corporations used inversions to take advantage of deferred earnings by employing maneuvers, which were allowed by the tax code, where the entity would leave income earned by the foreign corporation abroad, thereby beyond the reach of U.S. tax authorities.[195] "The 2014 . . . Notice prevents three tactics . . . U.S. corporations [commonly] use to access foreign income [while] avoid[ing] repatriation."[196] "First, the [Notice] closed the loophole to 'hopscotch' loans . . . by treating [these] loans as U.S. property subject to [a] tax for a ten-year period following the date of the inversion."[197] A "hopscotch" loan enables the controlled foreign corporation to fund the acquisition by loaning cash to the targeted corporation—skipping the domestic corporation.[198]

Second, the Notice endeavors to close the loophole for "decontrolling" transactions whereby the EAG and controlled foreign corporation conduct a "stock-asset swap."[199] Following the swap, the EAG owns 50% or more of the controlled foreign corporation's stock, making the controlled foreign corporation a foreign subsidiary of the EAG.[200] The Notice prevents U.S. corporations from evading repatriation by recognizing the subsidiary in these transactions as a controlled foreign corporation if it occurs within ten years of the inversion date.[201] Third, the Notice completely precludes a "spinversion" whereby the domestic corporation "spins off a portion of

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188. *Id.*
189. *Id.*
190. *Id.*
191. *Id.*
192. *Id.*
193. *Id.* at 461-62.
194. *See* Donald J. Marples & Jane G. Gravelle, *Corporate Expatriation, Inversions, and Mergers: Tax Issues,* CONG. RESEARCH SERV. 1, 9 (2014), http://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=2329&context=key_workplace.
195. I.R.S. Notice 2014-52, 2014-52 I.R.B. 172; *see also* Wong, *supra* note 3 at 462.
196. Wong, *supra* note 3, at 462.
197. *Id.* at 462-63.
198. *Id.* at 463.
199. *Id.*
200. *Id.*
201. *See* BakerHostetler, *U.S. Treasury Department Takes Action to Slow (But Not Stop) Corporate Inversions: A Summary for Executives*, JDSUPRA (Sept. 29, 2014), http://www.jdsupra.com/legalnews/us-treasury-department-takes-action-to-94236/.

its business or assets into a separate . . . subsidiary."[202] A foreign corporation then acquires the subsidiary by giving the shareholders stock in the foreign corporation that is subject to lower tax rates in the foreign country.[203] The Notice eliminates any incentives and resulting tax benefits by classifying the spin-off company as a domestic corporation.[204]

4. 2016 Treasury Regulations

The most recent regulations announced by the Department of the Treasury are intended to reduce companies' incentive to avoid paying taxes through earnings stripping.[205] The main thrust of the new regulations is to "limit inversions by disregarding foreign parent stock attributable to [certain prior] inversions or acquisitions of U.S. companies."[206] It is inconsistent with the intent of § 7874 to permit a foreign company to increase its size "to avoid the current inversion threshold for a subsequent . . . acquisition" of a U.S. entity.[207] The 2016 regulation limits this practice by utilizing an inventive methodology for determining whether the post-acquisition ownership percentage indicates the transaction should be treated as an inversion.[208] The method determines ownership percentage by "exclude[ing the] stock of the foreign company attributable to assets acquired from [a U.S. entity] within three years prior to the signing date of the latest acquisition."[209]

In addition to the limits imposed above, this regulation also addresses earnings stripping by "targeting transactions that increase [the] related-party debt that does not finance new investment[s]" in the U.S. under § 385.[210] The regulation makes it more difficult for foreign-parented groups to allocate related-party debt swiftly to their U.S. subsidiaries "following an inversion or foreign takeover, by treating as stock the instruments issued to a related corporation in a dividend or a limited class of economically similar transactions."[211] The regulation:

> (1) treat[s] as stock an instrument that might otherwise be considered debt if it is issued by a subsidiary to its foreign parent in a shareholder dividend distribution; (2) addresses a "two-step" version of a dividend distribution of debt in which a U.S. subsidiary (i) borrows cash from a related company, and (ii) pays a cash dividend distribution to its foreign parent; and (3) treat[s] as stock an instrument that might otherwise be considered debt if it is issued in connection with certain acquisitions of stock or assets from

202. Wong, *supra* note 3, at 463.
203. *Id.* at 463-64.
204. John C. Hamlett, *The Declining Allure of Being "American" and the Proliferation of Corporate Tax Inversions: A Critical Analysis of Regulatory Efforts to Curtail the Inversion Trend*, 93 WASH. U. L. REV. 767, 790 (2016).
205. Press Release, U.S. Dep't of the Treasury, Treasury Announces Additional Act to Curb Inversions, Address Earnings Stripping (Apr. 4, 2016), https://www.treasury.gov/press-center/press-releases/Pages/jl0405.aspx.
206. *Id.*
207. *Id.*
208. Press Release, U.S. Dep't of the Treasury, Fact Sheet: Treasury Issues Inversion Regulations and Proposed Earnings Stripping Regulations (Apr. 4, 2016), https://www.treasury.gov/press-center/press-releases/Pages/jl0404.aspx.
209. *Id.*
210. *Id.*
211. *Id.*

Thompson: Solving Corporate Inversion Phenomenon

related corporations in transactions that are economically similar to a dividend distribution.[212]

Another aspect of this regulation issued under § 385 permits the IRS on audit to divide a purported debt instrument into part debt and part stock.[213] This proposed regulation implements "statutory authority to treat an instrument issued to a related party as in part debt and in part equity to eliminate distortions" under the current law that treats instruments as either entirely debt or entirely equity.[214] Finally, the new regulations require "documentation for members of large corporate groups to include key information for a debt-equity tax analysis."[215] This action requires companies to "undertake certain due diligence and complete documentation up front to establish that a financial instrument is really debt."[216] Specifically, companies are required to document key information, "including a binding obligation for the issuer to repay the principal amount borrowed, creditor's rights, a reasonable expectation of repayment, and evidence of ongoing debtor-creditor relationship."[217] "If these requirements are not met, instruments will be characterized as equity for tax purposes."[218]

Finally, the 2016 regulations formalize two previous actions that the Treasury Department took to curb inversions.[219] One addresses a technique that U.S. companies use to avoid § 7874 "by structuring an inversion as a multi-step transaction using back-to-back foreign acquisitions."[220] The other "requires a foreign subsidiary of the inverted U.S. [corporate] group to recognize all realized gain upon certain post-inversion asset transfers that dilute the inverted U.S. group's ownership of those assets."[221]

V. PROPOSALS

While politicians in the United States may describe companies that invert as unpatriotic or deserters,[222] corporate officers and boards of directors have a duty of loyalty to the shareholders, which is independent of national loyalty.[223] As stated above, the directors' fiduciary duty of loyalty essentially imposes an obligation to maximize profitability and stock value.[224] A report published by the University of Chicago found that for inversions that took place in the two decades between 1993

212. *Id.*
213. *Id.*
214. *Id.*
215. *Id.*
216. *Id.*
217. *Id.*
218. *Id.*
219. *Id.*
220. *Id.*
221. *Id.*
222. Brian Faler, *Obama Blasts 'Corporate Deserters'*, POLITICO (July 24, 2014, 6:29 PM), http://www.politico.com/story/2014/07/obama-corporate-deserters-taxes-109357.html (reporting that President Obama and other lawmakers consider those companies who invert to be "deserters").
223. Harv. Ass'n, *supra* note 97, at 2279.
224. Towarnicky, *supra* note 66, at 167.

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and 2013, companies outperformed the market average in the subsequent years.[225] Given these results and the reality of global competition, corporate directors will have difficulty continuing as a U.S. domicile when an inversion into a foreign jurisdiction could produce millions in savings, which increases shareholder value.[226] In order to achieve these results without completely eroding the tax base, the U.S. government has the burden and obligation to create a more business-friendly environment.[227] The proposals below will do exactly that.

A. Replace the Worldwide Tax Scheme with a Territorial Tax System

Advocates of the U.S. worldwide tax system cite a benefits theory to justify an anticompetitive tax structure.[228] The premise of the benefits theory is that favorable and predictably enforced property and contract laws, combined with advanced public infrastructure, can validate the U.S. system—despite the fact it undeniably results in greater tax liability for domestic corporations.[229] Additionally, proponents claim a worldwide tax structure creates an environment where it is advantageous for domestic businesses to keep their active investments in the U.S. instead of shifting them abroad.[230]

Despite these alleged benefits, Congress's right to tax profits earned outside the U.S. is one of the primary reasons for the U.S. corporate exodus.[231] U.S. multinational corporations are operating at an existing and overt competitive disadvantage as a result of the worldwide system since it allows U.S. tax collectors to reach profits earned offshore.[232] Far from incentivizing investments, by punishing domestic incorporation, these costs and taxes actually induce entities to incorporate abroad.[233] In addition, the worldwide system reduces the dividends that a U.S. company can distribute to its investors because the entity cannot repatriate the foreign earnings without domestic tax liability.[234] Lastly, the current tax structure restricts investment of "productive capital" back into the U.S.[235] Following an inversion, however, the corporation foregoes all tax liability, enabling the entity to invest foreign earnings into U.S. operations without being subject to additional U.S. taxes.[236]

To keep American businesses competitive, congressional inaction is no longer an option. Although the majority of OECD countries have already adopted a territorial system, which taxes only domestically earned corporate income, it is not too late for Congress to follow suit.[237] The switch to a territorial system has the potential

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225. Brooke Sutherland, *Investors Cheer, U.S. Jeers at Tax-Driven Deals: Real M&A*, BLOOMBERG (June 17, 2014, 3:42 PM), http://www.bloomberg.com/news/articles/2014-06-16/investors-cheer-u-s-jeers-at-tax-driven-deals-real-m-a.
226. DeAngelis, *supra* note 25, at 1361-62.
227. *Id.* at 1361.
228. Hamlett, *supra* note 204, at 771.
229. *Id.*
230. *Id.*
231. Towarnicky, *supra* note 66, at 179.
232. *Id.*
233. *See* John Richardson, *Guest Post: Inversions, Planning & Corporate Tax Rates*, FORBES (Oct. 8, 2014, 7:43 PM), https://www.forbes.com/sites/kellyphillipserb/2014/10/08/guest-post-inversions-planning-corporate-tax-rates/#b3de2782c48a.
234. *Id.*
235. *Id.*
236. *Id.*
237. Towarnicky, *supra* note 66, at 179.

to create more jobs and higher wages as a result of U.S. businesses increasing domestic investment.[238] Research has illuminated evidence of actual benefits when U.S. businesses are able to expand and invest overseas without the threat of additional taxes.[239] More specifically, domestic investment increases 2.6% for every 10% increase U.S. foreign investments.[240] Domestic investment is required to support prospective foreign investments and typically results in the creation of new domestic jobs.[241] Thus, the adoption of a territorial system would reduce the inversion incentive because the system encourages a multi-layer domestic and global investment strategy that can cause domestic job creation and an increase in domestic wages.[242]

B. Lower Corporate Tax Rates

Lowering the corporate tax rates in the U.S. would assist in eliminating the incentive for U.S. multinational corporations to invert, while also helping to create an environment where these entities are able to generate revenue comparable to foreign multinationals without having to invert.[243] Within the field of economics, there is a general consensus that a broad tax base with low rates is more advantageous than a narrow tax base with high rates.[244] As evidence, the U.S. corporate tax rate of 35%, the highest among OECD nations,[245] generated approximately "half as much revenue . . . as the average OECD" country applying a corporate tax rate of approximately 29%.[246] Lowering the corporate tax rate will broaden the tax base, eliminate incentives to expatriate, induce multinational corporations to incorporate in the U.S., and benefit the U.S. corporate tax base going forward.[247]

If Congress is able to enact a lower corporate tax rate, the U.S. will align itself with other OECD rates, which will result in greater global competition.[248] U.S. multinationals will only invert if it will result in positive returns.[249] If the cost of inverting exceeds the benefit, corporate inversions by multinationals will violate obligations to shareholders of maximizing profits.[250] Decreasing the tax rate eliminates

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238. Curtis Dubay, *A Territorial Tax System Would Create Jobs and Raise Wages for U.S. Workers*, HERITAGE FOUND. (Sept. 12, 2013), http://www.heritage.org/research/reports/2013/09/a-territorial-tax-system-would-create-jobs-and-raise-wages-for-us-workers.
239. Mihir A. Desai et al., *Domestic Effects of the Foreign Activities of U.S. Multinationals*, 1 AM. ECON. J.: ECON. POL'Y 181, 181-82 (2009).
240. *Id.*
241. *Id.* at 201.
242. Towarnicky, *supra* note 66, at 181.
243. Tyler M. Dumler, *Charging Less to Make More: The Causes and Effects of the Corporate Inversion Trend in the U.S. and the Implications of Lowering the Corporate Tax Rate*, 13 U.C. DAVIS BUS. L. J. 89, 103 (2012).
244. Kimberly A. Clausing, *The Role of U.S. Tax Policy in Offshoring*, CITESEERX 1, 29 (June 2005), http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.128.8648&rep=rep1&type=pdf.
245. Kyle Pomerleau & Andrew Lundeen, *The U.S Has the Highest Corporate Income Tax Rate in the OECD*, TAX FOUND. (Jan. 27, 2014), https://taxfoundation.org/us-has-highest-corporate-income-tax-rate-oecd.
246. Clausing, *supra* note 244, at 19.
247. Dumler, *supra* note 243, at 104.
248. *Id.*
249. Hale E. Sheppard, *Fight or Flight of U.S-Based Multinational Businesses: Analyzing the Cause for, Effects of, and Solutions to the Corporate Inversion Trend*, 23 NW. J. INT'L L. & BUS. 551, 560-61 (2003).
250. *Id.*

the reason to invert because of the limited benefits of tax revenue savings.[251] Therefore, there will be less incentive to expatriate because the decrease in the mechanism's appeal is correlated to the decrease in the corporate tax rate.[252]

1. Case Study: The United Kingdom

To illustrate the impact of these proposals, in 2009, the U.K. began enacting a series of reforms that resulted in the reincorporation of multinational companies and the growth of the Commonwealth's corporate tax base.[253] Two key reforms were aimed at stopping the inversion problem and creating a more attractive business environment: (1) reducing the corporate tax rate, and (2) moving to a territorial tax system.[254] The corporate tax reform reduced the corporate tax rate from 30% in 2009 to its present rate of 20%.[255]

The results are staggering. U.S. corporations, such as Liberty Global, Rowan, Aon, and Ensco have reincorporated in the U.K.[256] A 2013 Ernst & Young report found "approximately 60 multinational companies were considering relocating . . . a regional [or global] headquarters to the U.K." due to the reduction in tax rates.[257] Furthermore, the move to a territorial tax scheme increased the competitiveness of corporations in the U.K. regarding international mergers and acquisitions.[258] These reforms have also effectuated growth because U.K. corporations are growing by approximately 80% per year and are projected to surpass the total number of U.S. corporations by 2017.[259]

Even more important from the standpoint of a government hesitant in enacting reforms, the U.K has consistently raised more corporate tax revenue than the U.S. when measured as a share of gross domestic product.[260] These reforms have also produced a more stable economy: following the financial crisis in 2008, U.K. corporate tax revenue was less affected, averaging 3% of GDP while the U.S. revenue averaged 2.2%.[261] Furthermore, "[t]he U.K. now collects more revenue from non-financial corporations than the U.S. does from *all* corporations."[262]

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251. Dumler, *supra* note 243, at 106.
252. *Id.* at 104-06.
253. William McBride, *Tax Reform in the UK Reversed the Tide of Corporate Tax Inversions*, TAX FOUND. 1, 4-6 (Oct. 14, 2014), https://files.taxfoundation.org/legacy/docs/TaxFoundation_FF442.pdf.
254. *Id.* at 4.
255. *Id.* at 3-4.
256. *Id.* at 5.
257. James Quinn, *EY: Cutting UK Tax Draws in More Multinationals*, TELEGRAPH (Nov. 25, 2013, 11:13 AM), http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/10472446/EY-Cutting-UK-tax-draws-in-more-multinationals.html.
258. Lars P. Feld et al., *Effects of Territorial and Worldwide Corporate Tax Systems on Outboard M&As*, CTR. FOR EUR. ECON. RES. 1, 2 (July 7, 2013), http://ftp.zew.de/pub/zew-docs/dp/dp13088.pdf; *see also* McBride, *supra* note 253 at 6 (attributing this statistic directly to the anticompetitive U.S. Tax Code).
259. McBride, *supra* note 253 at 5-6.
260. *Id.* at 6.
261. *Id.*
262. *Id.* at 7 (emphasis added).

2. *Case Study: Canada*

Actions taken by the Canadian government offers great insight into the benefits of a lower corporate tax rate. Since 2000, Canada has incrementally lowered its corporate tax rate from 43% to 26%.[263] As the corporate tax rate has gradually decreased, Canada's corporate tax revenue as a share of GDP has progressively increased,[264] averaging 3.3% as rates began to decline in 2000, compared to 2.6% over the preceding 12 years.[265] Even more convincing, compared to the total corporate tax revenue as a percentage of GDP of the U.S., Canada has experienced 1% greater overall revenue.[266] During this time, Canada's revenue share has averaged 3.3%, while the U.S. has averaged only 2.3%.[267]

Firms are taking notice that Canada is open for business. For instance, companies such as accounting powerhouse KPMG, Spectra Energy Corp., and Tim Hortons (who left Canada after being acquired by Wendy's International, Inc. in 1995) have all moved back to Canada.[268] Beyond these specific companies, the financial services industry began entering the Canadian market, bringing with it a large inflow of capital, to benefit from the obvious advantages of this business friendly environment.[269] Canada is the perfect example of how a reduction in the corporate tax rate, which as demonstrated can actually increase tax revenue, at a minimum neutralizes any alleged loss in tax revenue by encouraging and stimulating economic activity.[270]

C. *Changing the Definition of Corporate Tax Residence*

There are two primary tests for locating a corporation: (1) "the 'place of incorporation' ("POI") rule, or [(2)] a version of the 'real seat' rule."[271] The U.S. uses the POI test,[272] an advantage of which is that it requires no interpretation.[273] The POI standard "lower[s] compliance costs, avoid[s] litigation risks, and can be easily administered, especially in cases that involve a complex chain of related corporations."[274] U.S. corporations have the option to invert due to the U.S.'s adherence to the POI system, which inverting companies avoid by incorporating in a foreign jurisdiction.[275] The U.S. should adopt a residence test that employs two criteria for

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263. William McBride, *Canada's Lower Corporate Tax Rate Raises More Tax Revenue*, TAX FOUND. (Aug. 27, 2014), https://taxfoundation.org/canadas-lower-corporate-tax-rate-raises-more-tax-revenue/.
264. David Khanjyan, Comment, *Demanding Corporate Patriotism: A Regulatory Attempt to Curb International Corporate Inversions and Stop Tax Avoidance Schemes*, 9 J. BUS. ENTREPRENEURSHIP & L. 129, 146 (2015).
265. McBride, *supra* note 263.
266. *Id.*
267. *Id.*
268. Khanjyan, *supra* note 264, at 147.
269. *Id.*
270. *Id.*
271. Mitchell A. Kane & Edward B. Rock, *Corporate Taxation and International Charter Competition*, 106 MICH. L. REV. 1229, 1235 (2008).
272. I.R.C. § 7701(a)(4) (2014).
273. Kara Baquizal, *The Challenges of Redefining Corporate Tax Residence in a Competitive Global Market*, FED. BAR 1, 7 (2012), http://www.fedbar.org/image-library/sections-and-divisions/tax/2012-taxlawcomp-1st.pdf.
274. *Id.*
275. Omri Mariam, *Jurisdiction to Tax Corporations*, 54 B.C. L. REV. 1613, 1629 (2013).

determining a corporate domicile for the purpose of federal income tax. Under this test, the corporation will be treated as "domestic" if the corporation is "(1) managed and controlled from the U.S.; or (2) the securities of which are listed on a [stock] exchange in the U.S."[276] One benefit a standard set by a "management and control" test is that it presents more insight and transparency into the operational structure of the corporation and its actual "resident" status.[277] Even more important, such a system would make the process more burdensome, which in turn would reduce the incentive to participate.[278]

The U.K. uses a "substantive connection between the country and the taxpayer" in order to define "management and control" by looking to the board of directors, to determine "where high level decision-making occurs."[279] Additionally, in 1988, the U.K. set a criteria for companies incorporated in the Commonwealth that based the status of a corporation on its place of formal incorporation.[280] Some civil law jurisdictions, most notably Sweden and Italy, use a multitude of factors such as the "[entity's] place of incorporation, place of legal registry, or the location of the taxpayer's legal office location or headquarters" to determine corporate status.[281] In Asia, Japan being the third largest economy in the world,[282] uses the corporation's headquarters to determine its domicile.[283] Importantly, "[m]ost other countries, [namely] Germany and the Netherlands, [use] a combination of these methods."[284]

VI. CONCLUSION

Corporate inversions have undoubtedly proven to be a difficult phenomenon to prevent. Throughout all attempts to curb the amount of inversions over the years, one truism has emerged: the executive branch cannot solve this problem alone. The solution to the inversion phenomenon lies in a comprehensive reformation of our tax structure and code. There has been a movement toward reformation. President Donald J. Trump recently said to a group of CEOs, "[w]e're trying to get it [corporate tax rate] down to anywhere from fifteen to twenty percent."[285] This proposal has broad congressional support among republicans, including Speaker of the House Paul Ryan, whose "A Better Way" agenda has proposed a flat 20% corporate tax rate.[286]

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276. *Id.* at 1664.
277. Baquizal, *supra* note 273, at 7.
278. Zahrt, *supra* note 2, at 1619.
279. De Beers Consol. Mines Ltd. v. Howe [1906] AC 455 (HL) (appeal taken from Eng.); *see also* Baquizal, *supra* note 273, at 8, 25.
280. Baquizal, *supra* note 273, at 8; *see also* HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION 434-35 (3d ed. 2010).
281. Baquizal, *supra* note 273, at 8.
282. *Gross Domestic Product 2016*, WORLDBANK (Apr. 17, 2017), http://databank.worldbank.org/data/download/GDP.pdf.
283. Baquizal, *supra* note 273, at 8.
284. *Id.*
285. Andrew Ross Sorkin, *Trump's Take on Corporate Tax Rate Could Look Very Much Like Obama's*, N.Y. TIMES (Mar. 27, 2017), https://www.nytimes.com/2017/03/27/business/dealbook/trump-corporate-tax-cuts.html?_r=1.
286. Pete Sapp, *The Way Forward on Tax Reform*, U.S. NEWS & WORLD REP. (Mar. 27, 2017, 12:30 PM), https://www.usnews.com/opinion/economic-intelligence/articles/2017-03-27/paul-ryan-has-a-better-way-on-tax-reform.

These proposals are a step in the right direction. However, the President and Congress should not stop there. Lowering the corporate tax rate will produce results for America, as shown by the results achieved by Britain and Canada, however, to win the free market battle, the structure of America's system of taxation must also be reformed. Despite a lower tax rate, the worldwide system of taxation will continue to incentivize U.S. multinationals to invert because of the additional burden imposed that multinationals in other jurisdictions with similar tax rates do not encounter.

There needs to be a complete leveling of the playing field on all fronts. Such a widespread problem calls for bold action, not just a simple tax cut. The global economy is a competition and America is currently losing. As the former chair and CEO of Citibank Walter Winston said, "money goes where it is wanted, and stays where it is well treated."[287] Until the U.S. government institutes these reforms, money will continue to go where it is wanted and well treated, overseas.

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287. Richard Russell, *Money Goes Where it is Wanted and Stays Where it is Well-Treated*, MONEY TALKS (Aug. 15, 2009, 1:55 AM), http://moneytalks.net/old-daily-updates/2025-qmoney-goes-where-it-is-wanted-and-stays-where-it-is-well-treatedq.html.