ANALYZING CORPORATE INVERSIONS AND PROPOSED CHANGES TO THE REPATRIATION RULE

*JOSHUA SIMPSON**

* J.D./M.B.A., New York University (2012); M.Ac., University of Iowa (2008); B.B.A., University of Iowa (2007).

EXECUTIVE SUMMARY

- Most countries only tax companies on profits earned inside their territory. However, the United States taxes corporations incorporated domestically on their worldwide income when it is repatriated to the U.S. In addition, the U.S. has the highest corporate tax rate within the thirty-four member Organization for Economic Co-operation and Development ("OECD").
- To avoid U.S. taxation of profits earned abroad, U.S. corporations may reincorporate in another country with a territorial tax system. Reincorporation can occur through a share inversion, asset inversion, or hybrid transaction. Companies also obtain tax benefits through corporate inversions due to an increased ability to shift income from the high tax United States to lower tax jurisdictions. The capital gains tax on an inversion is minimized when a company has nontaxable shareholders, depressed stock prices, a high basis in assets, large loss carryovers, and substantial foreign tax credits. Congress has periodically sought to address inversion activity by reducing the associated tax benefits, with the most recent effort in 2004.
- In comparison to the $181 billion of corporate income taxes raised in 2011,[1] the hidden annual cost of compliance

1. Office of Mgmt. & Budget, Receipts by Source: 1937–2017, *available at* http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/hist02z1.xls (last visited Mar. 25, 2012).

with U.S. regulations is now $1.75 trillion annually.[2] Major sources of U.S. regulatory costs include the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or "SOX"), the Foreign Corrupt Practices Act ("FCPA"), the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), and aspects of the U.S. litigation system. Corporate inversions may be motivated in part by the desire to achieve reduced regulatory costs, which may require delisting from U.S. exchanges.

- In 2009, President Obama proposed changes to the taxation of multinational corporations that would substantially reduce the benefit of deferral under the repatriation rule. In 2012, he proposed an international minimum tax on the overseas profits of U.S. firms.
- The President's proposals could be expected to increase the incorporation of new businesses overseas and to cause existing U.S. corporations to more frequently declare bankruptcy, sell themselves to foreign firms, and engage in corporate inversions. This could result in reductions in U.S. employment, investment, and exports, and has negative national security implications. The strongest argument for the elimination of the repatriation rule is that it will increase tax revenues. More suspect arguments include that it will encourage the repatriation of funds to the United States, increase investment and job creation, and result in a fairer tax system.
- Suggested alternatives to removing the repatriation rule include implementing a territorial taxation system with reduced corporate tax rates, removing anti-inversion regulations, and streamlining the U.S. regulatory structure.

INTRODUCTION

President Obama has advocated for substantial reform of the corporate tax landscape, arguing that the repatriation rule "reward[s] our companies for moving jobs off our shores or transferring profits to overseas tax havens."[3] The President's reforms would make substantial strides towards the elimination of the repatriation

2. Nicole V. Crain & W. Mark Crain, *The Impact of Regulatory Costs on Small Firms*, SMALL BUSINESS RESEARCH SUMMARY (SBA Office of Advocates, Washington, D.C.), No. 371, Sept. 2010, at 1, *available at* http://archives.sba.gov/advo/research/rs371.pdf [hereinafter SBA REPORT].

3. Jeanne Sahadi, *Obama Plans Corporate Tax Crackdown: Administration's Proposals Aim to Reduce Tax Breaks for U.S.-Based Multinationals*, CNN MONEY, May 4, 2009,

rule.[4] However, an analysis of the consequences of eliminating the repatriation rule shows that the President's goals are misguided. The President's reforms may succeed in raising revenues, but the argument that the repatriation rule encourages "shipping jobs overseas" is a fallacy.[5] In addition, the proposed reforms would likely cause many businesses to never incorporate in the United States, or to leave the United States through corporate inversions, leading to lower levels of investment, employment, and exports, with further negative consequences for national security. President Obama has already overseen an uptick in large businesses reincorporating outside of the United States, generating substantial revenue losses to the U.S. Treasury, with at least one business citing the President's rhetoric against the repatriation rule.[6] In comparison to the reforms proposed by the President, more attractive alternatives would seek to address the underlying problems with the U.S. tax and regulatory system that encourage shifting corporate activities and earnings abroad—high U.S. tax rates, a worldwide system of taxation, and substantial U.S. regulatory costs. By simultaneously removing anti-inversion regulation, policymakers would be provided with indicia of the competitiveness of U.S. policies and business regulation internationally.

A corporate inversion is a transaction in which a U.S. corporation's stock or assets are transferred to a foreign corporation to reduce tax and regulatory costs.[7] The foreign corporation will generally have the same common shareholders with the U.S. corporation and be incorporated in a low-tax jurisdiction in which it has relatively few operations.[8] A primary motivation for corporate inversions is to move from the U.S. system of global taxation to other countries' territorial taxation systems.[9] The incidence of foreign inversion activity is mitigated in part by the repatriation rule, which

http://money.cnn.com/2009/05/04/news/economy/obama_corporate_tax_proposals/index.htm.

4. *See infra* Section II(B).

5. *See infra* Section II(B)(2)(B).

6. John D. McKinnon & Scott Thurm, *U.S. Firms Move Abroad to Cut Taxes*, WALL ST. J., Aug. 28, 2012, http://online.wsj.com/article/SB10000872396390444230504577615232602107536.html.

7. DONALD J. MARPLES, CONG. RESEARCH SERV., RL31444, FIRMS THAT INCORPORATE ABROAD FOR TAX PURPOSES: CORPORATE "INVERSIONS" AND "EXPATRIATION" 1, 3 (2008), *available at* http://www.policyarchive.org/handle/10207/bitstreams/1433.pdf [hereinafter CRS REPORT 1]; Aaron G. Murphy, *The Migratory Patterns of Business in the Global Village*, 2 N.Y.U. J.L. & BUS. 229, 231 (2005).

8. John M. Peterson, Jr. & Bruce A. Cohen, *Corporate Inversions: Yesterday, Today and Tomorrow*, 81 TAXES 161, 162 (2003).

9. *See* CRS REPORT 1, *supra* note 7, at 5.

allows U.S. corporations to defer U.S. tax on the income of foreign subsidiaries until that income is repatriated to the United States.[10]

This Article begins with a discussion of corporate inversion transactions in Section I. An overview of inversion structures is provided, followed by a description of the relevant tax law and the tax benefits of corporate inversions. Next, recent changes in tax law in response to corporate inversions are presented, along with a brief analysis of the tax code related to inversions in light of the normative goal of fairness. Then the non-tax regulatory benefits of corporate inversion activity are shown. Finally, a history of corporate inversion activity and the related policy responses is presented.

Section II focuses on the potential consequences of eliminating the repatriation rule. It begins with an overview of the President's proposed changes to the repatriation rule. Then, this Article engages in an economic analysis of the natural extension of the President's plan, the elimination of the repatriation rule, considering the anticipated costs and benefits thereof. Costs are expected to include reduced competitiveness of U.S. firms causing decreased valuations and bankruptcies; increased corporate inversion activity and sales of U.S. firms to foreign firms; reduced U.S. exports, investment, and employment; and negative national security implications. Benefits of eliminating the rule may include an increase in U.S. investment and consumption, and increased fairness in the tax code. The most likely benefit of eliminating the repatriation rule is increased federal tax revenues. Finally, this Article analyzes alternative proposals to correct the deficiencies of the present U.S. system of taxation.

I.
CORPORATE INVERSIONS

A. Structure

In a corporate inversion, the stock or assets of a U.S. corporation are transferred to a new foreign shell corporation specially created for the transaction in an effort to reduce the corporation's worldwide effective tax rate.[11] In a share inversion, a new corporation is incorporated in a foreign, low-tax jurisdiction as a first tier subsidiary of the U.S. parent.[12] This foreign corporation creates a U.S. chartered subsidiary that, through a stock merger, is subsumed

10. *Id.* at 4.
11. Peterson & Cohen, *supra* note 8, at 162.
12. *Id.* at 164.

by the original U.S. corporation.[13] U.S. shareholders' stock of the original U.S. corporation is automatically converted into shares of the foreign parent company.[14] Asset inversions may be carried out in two ways. First, when available, a continuation transaction is used to convert the U.S. parent corporation into a foreign parent corporation, with an automatic conversion of the U.S. corporation's shares into the foreign corporation's shares.[15] Second, all of a U.S. corporation's assets and liabilities may be transferred to a foreign corporation for stock, with the U.S. corporation distributing the stock to its shareholders in a liquidating distribution.[16] Inversions can be structured as partially share and partially asset hybrid inversions.[17] In these transactions, assets located outside of the United States without significant built-in gains are likely to be transferred to a foreign corporation, after which a share inversion occurs.[18]

B. Tax Benefits

1. Overview of Relevant Tax Provisions

As stated by President Obama's Economic Recovery Advisory Board, "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."[19] In 2011, the United States had the second highest corporate income tax rate among the thirty-four Organization for Economic Co-operation and Development ("OECD") member countries, behind Japan.[20] However, Japan has recently lowered its tax rates below U.S. rates, leaving the United States with the developed world's highest corporate tax rates.[21] The United States has become progressively less competitive since the late 1980s,[22] and it may become even less so in the fu-

13. CRS REPORT 1, *supra* note 7, at 3.
14. *Id.*
15. Peterson & Cohen, *supra* note 8, at 165.
16. *Id.*
17. *Id.* at 167.
18. *Id.*
19. PAUL A. VOLCKER ET AL., PRESIDENT'S ECON. RECOVERY ADVISORY BD., THE REPORT ON TAX REFORM OPTIONS: SIMPLIFICATION, COMPLIANCE, AND CORPORATE TAXATION 69 (2010), *available at* http://www.whitehouse.gov/sites/default/files/microsites/PERAB_Tax_Reform_Report.pdf [hereinafter PERAB REPORT].
20. *See supra* Appendix Exhibit 1.
21. Patrick Temple-West & Kim Dixon, *US Displacing Japan as No 1 for Highest Corp Taxes*, REUTERS, Mar. 30, 2012, http://uk.reuters.com/article/2012/03/30/usa-tax-japan-idUKL2E8EU5VV20120330.
22. *See infra* Appendix Exhibit 2.

ture.[23] Governments outside of the United States, such as those in Luxembourg, Ireland, and London, have used favorable tax incentives as a centerpiece in highly successful business attraction programs.[24] Moreover, the United States ranked 69th among 185 countries in its tax burden, according to the World Bank's June 2013 ease of doing business index.[25] This ranking is below Botswana (39), Lebanon (37), Croatia (42), Iraq (65), Cambodia (66), and Djibouti (67).[26] A study by economists at the University of Calgary found that the U.S. federal and state tax rate on new capital investment, considering credits and deductions, was 35% relative to a 19.5% OECD average and an 18% global average.[27] These relatively high U.S. tax rates provide ample incentive for U.S. corporations to shift income abroad to maximize shareholder value.

Unlike other countries, the United States taxes the foreign income of domestic corporations, encouraging them to engage in corporate inversions. Internationally, most countries only tax the profits of domestic and foreign firms earned in their territories.[28] The United States follows this approach for foreign companies but taxes the worldwide income of U.S. corporations.[29] When taxing the global income of U.S. corporations, the United States provides a foreign tax credit that reduces corporations' taxes by the amount of foreign taxes paid up to the total tax owed on foreign income.[30] This essentially makes corporations pay taxes at the higher of the

23. For instance, the U.K. Treasury strongly favors reducing the corporate tax rate. Kenneth J. Kies, *Response to Anti-Repatriation Holiday Article*, 129 TAX NOTES 1145, 1146 (2010) [hereinafter *Response*].

24. MCKINSEY & CO. ON BEHALF OF MICHAEL R. BLOOMBERG & CHARLES E. SCHUMER, SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP 122 (2007), *available at* http://www.nyc.gov/html/om/pdf/ny_report_final.pdf [hereinafter MCKINSEY & CO.].

25. Int'l Fin. Corp. & the World Bank, *Economy Rankings*, DOING BUSINESS, http://www.doingbusiness.org/rankings (last visited Nov. 27, 2012).

26. *Id.*

27. Editorial, *The Send Jobs Overseas Act: Ending the Deferral of Foreign Income is Another Tax on U.S. Employment*, WALL ST. J., Sept. 28, 2010, http://online.wsj.com/article/SB10001424052748703384204575509700366289206.html?mod=WSJ_Opinion_AboveLEFTTop.

28. Peterson & Cohen, *supra* note 8, at 180. An increasing number of countries have shifted to a territorial tax system in recent years. J. Clifton Fleming Jr. et al., *Perspectives on the Worldwide vs. Territorial Taxation Debate*, 125 TAX NOTES 1079, 1081 (2009) [hereinafter Fleming et al, *Perspectives*]. However, other countries often tax passive income earned abroad by domestic companies. Peterson & Cohen, *supra* note 8, at 181.

29. CRS REPORT 1, *supra* note 7, at 4.

30. *Id.*

U.S. tax rate and the local tax rate,[31] forcing U.S. multinationals to pay higher tax rates than foreign competitors taxed on a territorial basis in low tax foreign jurisdictions.

Mitigating the disadvantage of incorporation in the United States is the repatriation rule. The repatriation rule allows U.S. corporations to defer the payment of tax on foreign income earned by a separate foreign subsidiary corporation until the funds are repatriated, or remitted to the United States as dividends or other income.[32] This comports with the normative goal that taxes should be applied based on ability to pay, with taxation not occurring until cash is available with which to pay the tax.[33] In contrast, the earnings of foreign branches of U.S. corporations that are not separately incorporated are taxed on a current basis.[34] However, to take advantage of the repatriation rule, a corporation can easily incorporate a new subsidiary and employ check-the-box regulations to change status from a branch to a subsidiary.[35] Many OECD countries—including Germany, Japan, the United Kingdom, Russia, Canada, France, Spain, Italy, and Australia—tax repatriated earnings at 0% to 2%, as they realize that they benefit when capital is repatriated.[36]

Deferral reduces the cost of U.S. taxes incurred on earnings from low-tax jurisdictions. If earnings are never repatriated to the United States, no U.S. tax must ever be paid. This places U.S. multinationals in the same tax position as foreign multinationals taxed on a territorial basis, who only need to pay local taxes. Thus many companies never repatriate foreign-source income,[37] being inclined to invest their foreign earnings in any country except the United States given the low earnings potential of domestic investments—investment grade corporate bond yields in the United States are below 5%—and a combined state and federal tax rate

31. *See id.*

32. *Id.*

33. *See* STEPHEN F. GERTZMAN, FEDERAL TAX ACCOUNTING ¶ 3.01[1] (2012).

34. CRS REPORT 1, *supra* note 7, at 4.

35. *See* Joseph Tobin, *Going from the Frying Pan into the Fire? A Critique of the U.S. Treasury's Newly Proposed Section 987 Currency Regulations*, 17 U. MIAMI BUS. L. REV. 211, 213 n.3 (2008).

36. John Chambers & Safra Catz, Op-Ed., *The Overseas Profits Elephant in the Room: There's a Trillion Dollars Waiting to be Repatriated if Tax Policy is Right*, WALL ST. J., Oct. 20, 2010, http://online.wsj.com/article/SB10001424052748704469004575533880328930598.html.

37. Peterson & Cohen, *supra* note 8, at 181.

potentially higher than 40%.[38] Estimates are that approximately $1.7 trillion in foreign earnings of U.S. corporations are currently abroad, partially to avoid the imposition of U.S. taxes on repatriation.[39] These restrictions on the free flow of capital within organizations obviously impose costs on them. For instance, unrepatriated earnings may be invested in foreign investments expected to generate returns below the cost of capital as the tax cost of repatriating those earnings to the United States would more than offset the cost of making a suboptimal investment.

In response to the shifting of passive investment income that can be easily moved from one jurisdiction to another by U.S. corporations, Subpart F[40] was enacted to "limit the concentration of passive-investment income [in] firms in tax havens."[41] Subpart F allows U.S. parent firms to be taxed on specified types of unrepatriated foreign-subsidiary income, including passive-investment income (such as interest, dividends, rents, and royalties) and income for which the source is easily manipulated (such as sales of goods outside of the subsidiary's country of incorporation when the purchase or sale of those goods involves a related party).[42] However, Subpart F only applies to the income of controlled foreign corporations ("CFCs")—foreign corporations that are controlled, or more than 50% owned, by U.S. shareholders owning blocks of at least 10% of the corporations' stock.[43] Congress implemented an active-financing exception to Subpart F to ensure that the anti-deferral rules only apply to passive or easily moveable income.[44] Thus:

38. Chambers & Catz, *supra* note 36. For bond yield information see *Tracking Bond Benchmarks*, WALL ST. J.: MKT. DATA CTR., http://online.wsj.com/mdc/public/page/2_3022-bondbnchmrk.html?mod=topnav_2_3022 (last visited July 13, 2013).

39. Editorial, *Google's Bermuda Billions*, WALL ST. J., Dec. 11, 2012, http://online.wsj.com/article/SB10001424127887324024004578173193485975674.html?mod=WSJ_Opinion_AboveLEFTTop; *see* Steven M. Davidoff, *The Benefits of Incorporating Abroad in an Age of Globalization*, N.Y. TIMES, Dec. 20, 2011, http://dealbook.nytimes.com/2011/12/20/the-benefits-of-incorporating-abroad-in-an-age-of-globalization/?emc=eta1 (noting older estimates that U.S. corporations hold $1.375 trillion overseas).

40. Subpart F—Controlled Foreign Corporations, 26 U.S.C. §§ 951–965 (2011).

41. CRS REPORT 1, *supra* note 7, at 4.

42. *Id.* at 4–5; Peterson & Cohen, *supra* note 8, at 163.

43. CRS REPORT 1, *supra* note 7, at 5.

44. Kenneth J. Kies, *Kies Critiques CTJ Corporate Tax Report*, 133 TAX NOTES 1043, 1043 (2011).

> [The exception] generally requires a [CFC] in the lending or finance business, through its own employees located in its home country, to conduct substantially all the activities necessary to produce the income, including soliciting customers, negotiating terms with the customers, designing the products, performing credit underwriting, making collections, and instituting foreclosure proceedings.[45]

With a similar purpose to Subpart F, Congress adopted passive foreign investment company ("PFIC") rules to remove the benefit of the repatriation rule for foreign corporations that invest extensively in passive assets.[46] Unlike Subpart F, in some cases PFIC rules will allow deferral through the repatriation rule but apply an interest charge on deferred taxes, eliminating the advantage of deferral.[47] These rules may also remove the benefit of the repatriation rule for all of a corporation's income and apply regardless of the level of U.S. ownership of a foreign corporation.[48] Ultimately, Subpart F and the PFIC rules reduce the benefit of the repatriation rule.

2. Tax Rationale for Corporate Inversions

A corporate inversion's primary purpose is to minimize the worldwide effective tax rate of the inverted company.[49] An inversion does this in two ways. First, by reincorporating through a corporate inversion to a jurisdiction with a territorial tax system, a U.S. corporation may eliminate U.S. taxes on income earned in foreign jurisdictions.[50] Second, inverted corporations can more easily shift income from the high-tax United States to lower tax jurisdictions, including the country in which the corporation reincorporated, through earnings stripping and other transactions.[51] "With globally integrated operations and headquarters, arbitrary assignment of

45. *Id.*

46. CRS REPORT 1, *supra* note 7, at 5.

47. *Id.*

48. *See id.*

49. Peterson & Cohen, *supra* note 8, at 162; *see* CRS REPORT 1, *supra* note 6, at 1.

50. OFFICE OF TAX POLICY, U.S. DEP'T OF THE TREASURY, CORPORATE INVERSION TRANSACTIONS: TAX POLICY IMPLICATIONS 14 (2002), *available at* http://faculty.law.wayne.edu/tad/Documents/Country/Treasury%20inversion%20report%205%2017%2002.pdf [hereinafter TREASURY REPORT 1]. For the tactics used to achieve these benefits, see *id.* at 9–11.

51. *Id.* at 2; CRS REPORT 1, *supra* note 7, at 5; *see* Mihir A. Desai & James R. Hines Jr., *Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions*, 55 NAT'L TAX J. 409, 409 (2002).

profits and expenses across borders becomes increasingly problematic."[52] Earnings-stripping transactions move U.S. earnings to a foreign parent by intra-firm transactions.[53] Many inversions include foreign lending to a U.S. subsidiary, allowing the subsidiary to deduct the interest costs on its U.S. tax return.[54] However, I.R.C. § 163(j) denies interest deductions for interest paid to related corporations that is subject to low- or no withholding tax, due to the application of a treaty, if the U.S. corporation has a high debt-to-equity ratio and a high interest expense to earnings before interest, taxes, depreciation, and amortization ("EBITDA") ratio.[55] Corporations may also use agreements that share the cost of intellectual property research and development between the foreign parent and the U.S. subsidiary, and that provide the foreign parent with rights to exploit the intellectual property abroad and the U.S. subsidiary with rights to use the intellectual property in the United States.[56] Corporations must split research and development costs proportionately to reasonably anticipated benefits to avoid the Internal Revenue Service ("IRS") imputing royalties.[57] Thus, many U.S. multinationals have shifted research, manufacturing, and regional headquarters overseas, resulting in 600 U.S. companies employing 100,000 people in Ireland alone.[58] Without the tax advantages, many of those jobs may have been located in the United States. Another strategy would use transfer pricing to decrease the price of sales out of the United States and to increase the cost of U.S. purchases, reducing U.S. income.[59]

In addition to creating tax benefits at the corporate level, corporate inversions help avoid some shareholder-level taxes. The United States imposes a withholding tax on dividends paid by U.S. corporations to foreign shareholders.[60] The low-tax destination ju-

52. Kimberly A. Clausing, *The Revenue Effects of Multinational Firm Income Shifting*, 130 TAX NOTES 1580, 1586 (2011).

53. TREASURY REPORT 1, *supra* note 50, at 21–22.

54. *Id.* Note that a U.S. withholding tax of 30% typically applies to interest paid by U.S. corporations to related foreign corporations. *Id.* at 24. However, the withholding tax is often reduced or eliminated by tax treaties. *Id.*

55. *Id.* at 22.

56. Peterson & Cohen, *supra* note 8, at 173.

57. *Id.* at 173–74.

58. Bill Leary, *60 Minutes Targets Foreign Tax Havens*, MFR, http://www.mfrpc.com/New-Insights/60Minutes (last visited Apr. 14, 2012).

59. *See* Peterson & Cohen, *supra* note 8, at 176–77. However, there is no evidence to suggest that inverted corporations are engaging in transfer price manipulation, and most large multinational corporations have sophisticated compliance programs. *Id.* at 185.

60. *Id.* at 163.

risdictions used in inversions generally do not impose withholding taxes on outbound dividends.[61] Thus, foreign shareholders may avoid withholding taxes on dividends through corporate inversions. Corporate inversions also avoid the application of the U.S. estate tax to foreign shareholders.[62]

At the shareholder or corporate level, corporations are required to pay tax on capital gains after a corporate inversion.[63] With mixed asset and share inversions, tax is imposed based on the economic substance of each element of the transaction.[64] During share inversions, I.R.C. § 367(a)(1) provides for shareholder level capital gains tax on any share appreciation since purchase to ensure that capital gains are subject to U.S. taxation at some point.[65] This may cause taxable and non-taxable shareholders to have divergent interests.[66] As the original U.S. parent survives the merger, it does not need to recognize gain or loss in a share inversion.[67] Given this treatment, share inversions are more likely to occur due to lower capital gains taxes when corporations have non-taxable shareholders or when the stock market is depressed, as occurs during recessions.[68]

By comparison, asset inversions are tax-free I.R.C. § 354 transactions to shareholders but give rise to corporate gain under I.R.C. § 367(a)(1), unless limited exceptions are met.[69] Companies must declare gains in the amount of the difference between fair market value and tax basis for most assets, and the difference between a value commensurate with income and basis for intangible assets, excluding foreign goodwill and going concern value.[70] In addition, I.R.C. § 1248 provides that unrepatriated earnings of the U.S. parent corporation will be treated as dividends in an asset inversion.[71] Tax consequences may also result from the termination of a group.[72] Thus, asset inversions will occur more frequently in corpo-

61. *Id.*

62. TREASURY REPORT 1, *supra* note 50, at 15.

63. *Id.* at 7.

64. Peterson & Cohen, *supra* note 8, at 167.

65. CRS REPORT 1, *supra* note 7, at 6–7.

66. *Id.* at 7. For instance, Stanley Works pointed out that only 40% of its shareholders were taxable. *Id.*

67. Peterson & Cohen, *supra* note 8, at 165.

68. *Id.*; *see also* CRS REPORT 1, *supra* note 7, at 1–2.

69. Peterson & Cohen, *supra* note 8, at 166.

70. *Id.*

71. *Id.*

72. *Id.* at 167.

rations with a high basis in assets relative to fair market value, large loss carryovers, and significant foreign tax credits.[73]

3. Recent Regulatory Response

The American Jobs Creation Act of 2004 created I.R.C. § 7874 in order to reduce corporate inversion activity.[74] This Part provides that when a foreign corporation is determined to be a surrogate foreign corporation, the U.S. corporation's gain on the transaction (possibly from asset sales) cannot be offset by foreign tax credits or net operating losses, reducing the benefits from an inversion.[75] A surrogate foreign corporation is a foreign corporation that (1) acquires (directly or indirectly) substantially all of the property held by a U.S. corporation; (2) after the acquisition, the shareholders of the U.S. corporation (by vote or value) own at least 60% of the foreign corporation; and (3) after the acquisition, the foreign corporation does not have substantial business activities in the country of incorporation in comparison to its total business activities.[76] IRS regulations issued in 2009 make it substantially more difficult to determine whether the substantial business activities requirement will be met in an inversion, as they eliminate examples and a safe harbor.[77] If a foreign corporation meets the test for a surrogate foreign corporation with the U.S. corporate shareholders owning at least 80% of the foreign corporation, the foreign corporation is treated as a domestic corporation for U.S. tax purposes (redomestication),[78] eliminating the tax benefits from engaging in a corporate inversion. Thus, § 7874 deters corporate inversions using structures popular in the past by removing the associated tax benefits. It was expected in 2008 to increase tax revenue by approximately $937 million over ten years.[79]

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73. *Id.* at 166.

74. *Id.* at 162.

75. I.R.C. §§ 784(a), (e) (2012); Joy MacIntyre & Stephen Feldman, *IRS Advises "Anti-Inversion" Regulations Under Code Section 7874*, CLIENT UPDATE (Morrison & Foerster LLP, New York, N.Y.), June 12, 2009, at 1; *available at* http://www.mofo.com/pubs/xpqPublicationDetail.aspx?xpST=PubDetail&pub=7885.

76. I.R.C. § 7874(a)(2)(B).

77. *Id.* at §§ 7874(a), (e); MacIntyre & Feldman, *supra* note 75, at 2. Exacerbating the problem, the IRS will ordinarily not issue private letter rulings on the substantial business activities requirement. *Id.* at 3. Assets, business activities, income, and employees located in the foreign jurisdiction may not be taken into account for the substantial business activities test if they were transferred to the foreign jurisdiction to avoid the anti-inversion rules. *Id.* at 2.

78. I.R.C. §§ 7874(a)(2)(B)(ii), (b).

79. *See* CRS REPORT 1, *supra* note 7, at 12.

At the same time that Congress enacted § 7874, it implemented I.R.C. § 4985 to tax executive and director stock options during an inversion, both for the goal of fairness, given that shareholders are taxed, and to align managements' incentives with those of shareholders.[80] Section 4985 imposes an excise tax at the maximum capital gains rate on the value of stock-based compensation held by executives or directors of inverted corporations that are not redomesticated.[81] If inverting corporations pay the excise tax, the payment is subject to the excise tax and is not deductible.[82] Despite §§ 7874 and 4985, new IRS regulations demonstrate that innovation in inversion structures is still occurring.[83] For instance, corporations today may spin-off foreign subsidiaries, which would not fall within § 7874 due to the substantial business activities test.

4. Areas of Unfairness in Inversion Tax Law

This Part briefly points out a few areas in which the tax law relevant to inversions performs poorly in terms of fairness, a primary normative goal of taxation in conjunction with efficiency.[84] First, the tax code leads to an unfair disparity in income tax treatment, as some corporations owned by U.S. shareholders may avoid U.S. taxes on the earnings of their foreign subsidiaries if they were not historically U.S. corporations. For instance, a start-up can initially incorporate in a foreign jurisdiction, with most of its business or shareholders located in the United States, and avoid § 7874's effect.[85] This may occur more often as the world becomes progressively more globalized.[86] Alternatively, U.S. individuals may increasingly own the stock of historically foreign firms that conduct business in the United States. Finally, private equity funds incorporated abroad that have U.S. investors can acquire a U.S. corporation's stock or assets without triggering § 7874.[87] All of these scenarios would avoid U.S. tax on the global income of companies

80. Peterson & Cohen, *supra* note 8, at 186.

81. *Id.*

82. *Id.*

83. For a list of IRS regulatory changes made in 2009 which obviously are in response to inversion activity, see I.R.C. §§ 7874(a), (e); MacIntyre & Feldman, *supra* note 75, at 3.

84. *See* Neil H. Buchanan, *The Case Against Income Averaging*, 25 VA. TAX REV. 1151, 1162 (2006).

85. Peterson & Cohen, *supra* note 8, at 162–63.

86. *Id.* at 180.

87. *Id.* Note, however, that the original owners of the U.S. corporation would not be the same as the private equity investors. Continuity of ownership is part of the traditional inversion.

owned by U.S. shareholders, but the tax code only seeks to tax the global income of U.S. companies and foreign companies owned by U.S. shareholders that have inverted. Thus, the tax treatment of a company is based on its history, but "[d]ifferences in the taxation of foreign corporations should be based on economics, not on history."[88] Legislative solutions that would "effectively prevent[ ] inversions altogether by established companies but ha[ve] no effect on the other structures described above may lead to an even greater advantage for [the structures above] and thus an unfair and inefficient tax distinction between similarly situated U.S. businesses."[89]

The policy rationale for § 7874 can also be challenged on fairness grounds. The carryforward and carryback of tax attributes, such as net operating losses, is necessary to ameliorate the problems with annual income measurement.[90] However, § 7874 denies the use of beneficial tax attributes to inverting corporations with between 60% and 80% carried-over ownership. This may cause arbitrary results by taxing income twice or taxing capital, not income.[91] The only justification for this policy may be "a desire to inflict fiscal pain on [ ] inverting corporation[s]."[92]

Finally, criticism may also be levied against I.R.C. § 4985, which was implemented partly on the premise that officer and shareholder incentives are not aligned regarding the cost of taxes from inversions.[93] In addition, supporters of § 4985 argued that option holders have no downside risk, and thus benefit from inversions that work out well while not being harmed by inversions that cause stock price declines.[94] However, as managers are often sizeable shareholders in their corporations,[95] managers' incentives should be aligned with shareholders' goals, as managers face downside risk

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88. *Id.*

89. DAVID SICULAR ET AL., N.Y. STATE BAR ASS'N TAX SECTION REPORT ON OUTBOUND INVERSION TRANSACTIONS 31 (2002), *available at* http://old.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1014report.pdf [hereinafter N.Y. STATE BAR REPORT].

90. Peterson & Cohen, *supra* note 8, at 185; *see* Burnet v. Sanford & Brooks Co., 282 U.S. 359, 365 (1931) (stating that the Sixteenth Amendment allows the use of an annual system, as it is the most practicable way to assess income and collect taxes).

91. Peterson & Cohen, *supra* note 8, at 185.

92. *Id.*

93. *Id.* at 186.

94. *Id.*

95. *Id.*; *CEO Compensation 2012: America's Highest Paid Chief Executives*, FORBES, http://www.forbes.com/lists/2012/12/ceo-compensation-12_rank.html (last visited Apr. 22, 2012) (reporting the value of shares held by top American CEOs in their own companies).

from inversions that decrease stock prices. Thus, there is ample room to debate whether § 4985 should be labeled as an effort to increase fairness or as an attempt to reduce inversion activity, regardless of shareholders' interests.

C. Regulatory Benefits

Corporate inversions do not only generate tax benefits for corporations. In addition, they avoid the "thicket of complicated rules, rather than a streamlined set of commonly understood principles," that compromises the U.S. regulatory framework.[96] Correspondingly, New York is viewed poorly relative to other markets by financial service leaders with respect to its regulatory environment, the legal environment's fairness and predictability, its corporate tax regime, and the response of government and regulators to business needs.[97] The high regulatory cost of being a public company incorporated in the United States caused 23% of companies in one survey to consider going private, 16% to consider a sale, and 14% to consider a merger in 2007.[98] The hidden annual cost of compliance with regulations in the United States is now $1.75 trillion,[99] whereas corporate income taxes only raised $181 billion in 2011.[100] Significant sources of U.S. regulatory costs that may be avoided through inversions include the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or "SOX"), the Foreign Corrupt Practices Act ("FCPA"), and the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[101] The recently passed Jumpstart Our Business Startups ("JOBS") Act is seeking to decrease some of the regulatory costs of accessing U.S. capital markets.[102] The JOBS Act will roll

96. McKinsey & Co., *supra* note 24, at ii.

97. *See infra* Appendix Exhibit 3.

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

99. SBA Report, *supra* note 2, at 1. This compares to a regulatory cost of $1.172 trillion annually in 2005. *Id.*

100. Receipts by Source: 1934–2017, *supra* note 1.

101. Note that this Section is not designed to provide a comprehensive analysis of these laws, concluding that they are bad policy. Instead, this Section simply aims to explore some laws that may encourage corporate inversions.

102. *See* Dan Primack, *JOBS Act: The Good, the Bad, the Irrelevant*, CNNMoney (Mar. 22, 2012), http://finance.fortune.cnn.com/2012/03/22/jobs-act-the-good-the-bad-the-irrelevant. Some recent anecdotal evidence suggests that the Act is meeting its goal, with two companies planning initial public offerings under the Act within the first week after its passage. Randall Smith & Emily Chasan, *JOBS Act Jolts Firms to Action*, Wall St. J., Apr. 12, 2012, http://online.wsj.com/article/SB10

back some of the fundraising and financial regulations of SOX and Dodd-Frank.[103]

1. Sarbanes-Oxley Act

Sarbanes-Oxley, passed in response to the Enron and WorldCom accounting scandals,[104] introduced changes with the goal of "protect[ing] investors by improving the accuracy and reliability of corporate disclosures."[105] These changes included the creation of the Public Company Accounting Oversight Board, standards for auditor independence, certification of financial statements and internal controls, new regulations for security analysts, and whistleblower protections.[106] Inverted corporations can avoid the costs of SOX compliance by delisting from U.S. stock exchanges, removing themselves from the U.S. equity markets.[107] Thus, "American companies deregistering from public stock exchanges nearly tripled during the year after Sarbanes-Oxley became law, while the New York Stock Exchange ("NYSE") had only 10 new foreign listings in all of 2004."[108] SOX's whistleblower protections also do not apply to foreign citizens working for a foreign company that is indirectly related to a U.S. corporation, according to a recent Department of Labor Administrative Review Board opinion.[109]

The law is universally viewed as being too expensive for the benefits conferred, stifling of innovation by creating a risk-averse culture, and pushing of businesses overseas as opposed to address-

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0014240527023036240045773401819145729 46.html?mod=WSJ_business_whatsNews.

103. Ben Cole, *JOBS Act Moves Forward; Would Cut Back Sarbanes-Oxley Requirements*, SEARCHCOMPLIANCE (Mar. 21, 2012), http://searchcompliance.techtarget.com/news/2240147241/JOBS-Act-moves-forward-would-cut-back-Sarbanes-Oxley-requirements.

104. *Sarbanes-Oxley Overview*, ARGOS: IT RISK ASSESSMENT SERVICES, http://www.argossecurity.com/sarbanes-oxley-overview.html (last visited Jan. 31, 2012).

105. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

106. *Id.* (scattered sections).

107. *See* MCKINSEY, *supra* note 24, at 87.

108. 151 Cong. Rec. 657 (2005) (Statement of Sen. Ron Paul), *available at* http://www.gpo.gov/fdsys/pkg/CREC-2005-04-15/pdf/CREC-2005-04-15-pt1-PgE657-3.pdf.

109. *Sox Whistleblower Provision Does Not Apply to Employee Working Overseas, Says the Department of Labor*, INTERNATIONAL HR NEWS (Proskauer Rose LLP, New York, N.Y.), Jan. 2012, at 1, *available at* http://www/proskauer.com/files/News/0bce9f36-d8ad-42eb-b834-0f272388265f/Presentation/NewsAttachment/c41781d4-3fd1-403d-a910-12cdfefd654f/international-hr-news-january-2012.pdf (citing Villanueva v. Core Labs. NV, Arb. Case No. 09-108 (Dep't of Labor Dec. 22, 2011)).

ing the real issues in the United States.[110] A Financial Executives International survey showed average annual compliance costs for 200 companies of $2.9 million for SOX § 404 alone, requiring certification of internal controls.[111] Of those surveyed, 78% of companies felt that SOX's costs outweighed its benefits.[112] A McKinsey report, signed onto by New York Mayor Michael Bloomberg and Senator Charles Schumer, ranks providing clearer guidance for the implementation of SOX first on the list of the nation's most critical priorities for maintaining financial services leadership.[113] The report suggests that additional guidance should stress materiality and provide auditors and management the ability to exercise judgment.[114] Sarbanes-Oxley results in a particularly significant compliance burden for smaller companies.[115] This is important given that small businesses create more than half of new jobs in the United States.[116] With the passage of each year—2012 was the third year in a row where the leading exchange for initial public offerings

110. McKinsey & Co., *supra* note 24, at 83.

111. *FEI Survey: Management Drives Sarbanes-Oxley Compliance Costs Down by 23%, But Auditor Fees Virtually Unchanged*, Fin. Execs. Int'l (May 16, 2007), http://www.financialexecutives.org/KenticoCMS/News—-Publications/Press-Room/2007-press-releases/FEI-Survey—Management-Drives-Sarbanes-Oxley-Compl.aspx [hereinafter *FEI Survey*]. The JOBS Act will exempt companies with less than $1 billion in revenue from Section 404(b) for five years. Cole, *supra* note 103. Note, however, that nearly half of companies found financial reports to be more accurate due to SOX. *FEI Survey*.

112. *Id.* Still, a research paper found that firms with SOX internal control deficiencies faced a 1.04% higher cost of capital, showing that the information provided by SOX is useful. Hollis Ashbaugh-Skaife et al., *The Effect of Internal Control Deficiencies on Firm Risk and Cost of Equity Capital* 39 (Sch. of Accountancy, Sing. Mgmt. Univ., Working Paper No. 2005/06-15, 2006), *available at* http://www.accountancy.smu.edu.sg/research/seminar/pdf/Hollis%20ASHBAUGHSKAIFE.pdf. In addition, SOX has decreased the number of financial restatements, improving the quality of financial reporting. Daniel Tyukody & Gerald Silk, *Understanding the Dip in Class-Action Securities Settlements*, N.Y. Times, Apr. 2, 2012, http://dealbook.nytimes.com/2012/04/02/understanding-the-dip-in-class-action-securities-settlements/?nl=business&emc=edit_dlbkpm_20120402. However, other evidence suggests that audit quality has declined. *See* Floyd Norris, *Bad Grades are Rising for Auditors*, N.Y. Times, Aug. 23, 2012) http://www.nytimes.com/2012/08/24/business/bad-grades-rising-at-audit-firms.html?_r=1&nl=business&adxnnl=1&emc=edit_dlbkam_20120824&ref=todayspaper&adxnnlx=1346007719-W81zXMG1oxrEDcKMnIPKgw.

113. McKinsey & Co., *supra* note 24, at 19.

114. *Id.* at 19–20.

115. *Id.* at 20.

116. Shawne Carter McGibbon & Chad Moutray, SBA Off. of Advocacy, The Small Business Economy: A Report to the President 1 (2009), *available at* www.sba.gov/sites/default/files/files/sb_econ2009.pdf.

("IPOs") was located in Hong Kong and not New York—it is getting more difficult for supporters to argue that SOX is worth its compliance costs to companies.[117]

2. Foreign Corrupt Practices Act

The Foreign Corrupt Practices Act was enacted in 1977, after a Securities and Exchange Commission ("SEC") investigation found that over 400 U.S. companies admitted making questionable or illegal payments in excess of $300 million to foreign government officials, politicians, or political parties.[118] A prominent example was Lockheed Aircraft (now Lockheed Martin), which admitted paying $22 million in bribes after the U.S. government had bailed out Lockheed by guaranteeing repayment of its loans in 1971.[119] Thus, the FCPA was enacted to "mak[e] it unlawful . . . to make payments to foreign government officials to assist in obtaining or retaining business."[120] The Act also contains accounting provisions that require issuers to keep accurate financial records and maintain a reasonable system of internal controls.[121] Although the FCPA was scarcely enforced for twenty years, it has more recently become "widely regarded as among the most important and fearsome statutes in international business."[122] For instance, Siemens was fined $800 million in 2008, KBR/Halliburton was fined $579 million in 2009, and $1.8 billion in total fines were levied in 2010, including three fines of over $300 million.[123] The FCPA imposes costs on companies by requiring them to maintain compliance programs,

117. Editorial, *America as Number Two: Hong Kong Again Beat the NYSE in New Stock Offerings in 2011*, WALL ST. J., Jan. 3, 2012, http://online.wsj.com/article/SB10001424052970204720204577129052317747614.html.

118. *Foreign Corrupt Practices Act*, LAWS.COM, http://criminal.laws.com/bribery/government-and-bribery/foreign-corrupt-practices-act (last visited Mar. 25, 2012).

119. John Cassidy, *Back to the Trough*, UPSTART BUS. J., http://upstart.bizjournals.com/news-markets/national-news/portfolio/2008/02/19/Past-Government-Bailouts.html (last modified June 12, 2012, 11:09pm); *Scandals: Lockheed's Defiance: A Right to Bribe?*, TIME, Aug. 18, 1975, *available at* http://www.time.com/time/magazine/article/0,9171,917751-1,00.html.

120. *Foreign Corrupt Practices Act*, DEP'T OF JUSTICE, http://www.justice.gov/criminal/fraud/fcpa (last visited Mar. 25, 2012).

121. 15 U.S.C. § 78m(b)(2)(A)–(B) (2006).

122. Andrew Brady Spalding, *The Irony of International Business Law: U.S. Progressivism and China's New Laissez-Faire*, 59 UCLA L. REV. 354, 371 (2011).

123. Danielle McClellan, *FCPA Fines in the News*, EXP. COMPLIANCE TRAINING INST. (Feb. 18, 2011, 4:21 PM), http://learnexportcompliance.bluekeyblogs.com/2011/02/18/fcpa-fines-in-the-news.

pay fines for bribes paid, and lose business to international competitors willing to engage in bribery.

The FCPA applies to U.S. issuers, companies incorporated in the United States or maintaining their principal place of business in the United States, and foreign firms that (directly or through agents) take an act, while in U.S. territory, in furtherance of a corrupt payment to a foreign political entity.[124] To level the international playing field, the United States and thirty-three other countries signed the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions in 1988.[125] Yet tax havens, like Bermuda and the Cayman Islands, are unlikely to have signed onto the OECD Convention.[126] Thus, U.S. corporations can avoid the FCPA's costs by reincorporating in a non-OECD Convention signatory country, delisting in the United States, and not taking actions in U.S. territory when making payments that are subject to scrutiny.

3. Dodd-Frank Wall Street Reform and Consumer Protection Act

Passed in the wake of the subprime crisis and resultant financial meltdown, the Dodd-Frank Act was Congress's response to 8 million lost jobs.[127] The Act creates the Bureau of Consumer Financial Protection, undertakes mortgage reform, creates an orderly liquidation authority for financial institutions, requires derivatives to be cleared over clearinghouses, and enhances regulation of credit rating agencies.[128] The law imposes several costs on financial institutions that they may be able to avoid by reincorporating abroad. First, the Volker rule limits U.S. depository institutions' ability to engage in proprietary trading while prohibiting investment in hedge funds or private equity funds.[129] This may preclude U.S. fi-

124. 15 U.S.C. §§ 78dd-1(a), 78dd-2(a), (h)(1)(B), 78dd-3(a).

125. *Foreign Corrupt Practices Act (FCPA) History*, AM. BUS. (Oct. 12, 2011), http://american-business.org/2986-foreign-corrupt-practices-act-fcpa-history.html.

126. *See* OECD, OECD CONVENTION ON COMBATING BRIBERY OF FOREIGN PUBLIC OFFICIALS IN INTERNATIONAL BUSINESS TRANSACTIONS: RATIFICATION STATUS AS OF 20 NOVEMBER 2012 (2012), *available at* http://www.oecd.org/daf/anti-bribery/antibriberyconventionratification.pdf.

127. U.S. S. COMM. ON BANKING, HOUS., & URBAN AFFAIRS, BRIEF SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (2010), *available at* http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf.

128. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1377, 1380–83, 1385 (2010).

129. *Volker Rule*, FIN. TIMES LEXICON, http://lexicon.ft.com/Term?term=Volcker-rule (last visited Mar. 25, 2012).

nancial service firms from experiencing some economies of scope, rendering them uncompetitive on an international basis. Second, the broad authority of the Consumer Financial Protection Bureau may allow it to impose substantial costs on U.S. financial institutions.[130] Third, the central clearing of derivatives may reduce the ability of U.S. firms to obtain customized financial products, encourage front running, and increase hedging costs, due to the interim cash flows of exchange-traded derivatives. As these rules from Dodd-Frank should not deal with transactions between non-U.S. entities,[131] an inverting U.S. firm could benefit by avoiding these restrictions.

The ongoing efforts to create the regulations required by Dodd-Frank also impose costs on U.S. firms from regulatory uncertainty and compliance efforts. Of the 400 regulatory rulemakings required by Dodd-Frank, only 56.3% have been passed.[132] Given significant corporate efforts to comply with Dodd-Frank's rules, some have even asked whether it might be a job creator.[133] However, as compliance jobs rarely provide much economic value to customers, U.S. firms will be pressured to invert to remain internationally competitive.

4. Other Regulatory Burdens Avoided

Beyond the laws discussed above, other regulatory burdens incentivize corporations to incorporate outside of the United States. In general, the U.S. system of regulatory oversight, involving many regulators at both the federal and state level, may be viewed as inferior to that of other countries, such as the United Kingdom, that provide a single regulator.[134] Additionally, other countries' regula-

130. *See Consumer Financial Protection Bureau: Unaccountable and Costly*, THE HERITAGE FOUND. (July 13, 2011), http://www.heritage.org/research/factsheets/2011/07/consumer-financial-protection-bureau-unaccountable-and-costly.

131. *See* Michael Ouimette et al., *The Dodd-Frank Act Mandates Comprehensive Regulation of Derivatives*, CLIENT ALERT (Pillsbury Winthrop Shaw Pittman LLP, San Francisco, Cal.), July 21, 2010, at 6, *available at* http://www.pillsburylaw.com/siteFiles/Publications/C&S_Dodd-Frank%20Derivatives_7-22-2010.pdf.

132. DAVIS POLK & WARDWELL, LLP, DODD-FRANK PROGRESS REPORT 2 (2012), *available at* http://www.davispolk.com/sites/default/files/files/Publication/5f006bb2-86f9-4318-874c-7b26cc0e0625/Preview/PublicationAttachment/c57275f5-a41e-4759-9a24-7d11f9160705/May2012_Dodd.Frank.Progress.Report.pdf.

133. Kyle Colona, *Is Dodd-Frank a Job Creator?*, COMPLIANCEX (Sept. 12, 2011), http://compliancex.com/is-dodd-frank-a-job-creator.

134. MCKINSEY & CO., *supra* note 24, at 17. Appendix Exhibit 4 shows the large number of U.S. regulators. These regulators can have conflicting views that take months to resolve as "the overall national financial regulatory system is not guided by a common and universally accepted set of consistent principles that di-

tors may be more responsive, less punitive, and less public in their dealings with industry,[135] as U.S. regulators may often be motivated by political concerns.[136] Improved responsiveness may increase innovation, while more private and less punitive actions may decrease executives' hesitancy to bring even minor problems up to regulators.[137] However, U.S. regulators may be more skilled and experienced.[138] Still, survey results show the U.K. regulatory regime to be viewed as preferable to the U.S. system across the board.[139]

A fair and predictable legal market has been found to be the second most important criterion in a financial center's competitiveness.[140] As "the legal risks associated with being a business trailblazer are starting to undermine America's entrepreneurial culture," the legal system may be undermining the United States' role as a center for innovation.[141] To the extent that inverting firms are willing to shift their exchange listings to overseas exchanges, they can avoid "the prevalence of meritless securities lawsuits and settlements in the U.S. [that] has driven up the apparent and actual cost of business."[142] Recent years have seen new highs in the number and value of security class action settlements,[143] while even the threat of securities related litigation may irreversibly damage a company.[144] In addition, inverting corporations may avoid penalties that are viewed as "arbitrary and unfair" given the United States' complex and fragmented legal system.[145] U.S. courts are viewed in this manner because state and federal courts provide different directives and outcomes in suits by "regulators, state and federal attor-

rects the approach to regulation, supervision, enforcement, and approvals." *Id.* at 82–83.

135. *Id.* at 84.

136. Mary E. Deily & Wayne B. Gray, *Agency Structure and Firm Culture: OSHA, EPA, and the Steel Industry*, 23 J.L. ECON. & ORG. 685, 706 (2007) ("The enforcement estimations give qualified support to a model of enforcement decisions based on political considerations.").

137. MCKINSEY & CO., *supra* note 24, at 80, 84–85. Innovation may also be stymied by regulations that hurt small businesses, imposing a cost of $10,585 annually per employee, on average. SBA REPORT, *supra* note 2, at 1.

138. MCKINSEY & CO., *supra* note 24, at 79.

139. *See infra* Appendix Exhibit 5.

140. MCKINSEY & CO., *supra* note 24, at 16.

141. *Id.* at 72.

142. *Id.* at ii.

143. In 2005, total securities settlements cost $3.5 billion, excluding the Worldcom settlement. *See infra* Appendix Exhibit 6.

144. MCKINSEY & CO., *supra* note 24, at 76.

145. *Id.* at ii.

neys general, class actions, and individuals."[146] This unpredictable and severe legal environment imposes significant costs on U.S. entities. However, in some circumstances even non-U.S. entities may be within the scope of U.S. laws and regulations due to their extraterritorial ambit.[147]

Finally, public companies in the United States may face substantial costs of complying with disclosure requirements. Direct financial statement preparation costs, as influenced by SOX, are nontrivial.[148] In addition, there may be substantial indirect costs of disclosure, such as alerting competitors to lucrative geographic and product markets, and to new initiatives.[149] "Issuers may therefore seek to avoid such risks by raising their capital in markets whose disclosure demands do not portend such ominous consequences."[150] Thus, the high regulatory burden of being incorporated or public in the United States—from SOX, the FCPA, Dodd-Frank, and other aspects of the U.S. regulatory system—may encourage corporations to reincorporate abroad and delist from U.S. exchanges.

D. The History of Corporate Inversions and Legislative Responses

To understand what has shaped the tax law surrounding corporate inversions and what is likely to shape future policy, it is instructive to consider the history of corporate inversions and legislative responses. Corporate inversion history has followed a cyclical pattern in which U.S. corporations have inverted under a particular transaction structure, and legislators or regulators have responded with measures intended to discourage the use of that transaction structure.[151] The 1983 corporate inversion by McDermott, Inc., the first inversion to trigger a major policy response, was structured as a share inversion involving a preexisting subsidiary, with shareholders also receiving a nominal amount of cash.[152] Thus, the transaction was taxable to shareholders, most of whom recognized a loss.[153] This transaction was claimed to have resulted in $220 million in

146. *Id.* at 17.

147. Karl T. Muth, *Sarbanes-Oxley Writ Large: Sarbanes-Oxley and the Foreign Commerce Clause*, 8 J. INT'L BUS. & L. 29, 35 (2009).

148. James D. Cox, *Regulatory Duopoly in U.S. Securities Markets*, 99 COLUM. L. REV. 1200, 1215 n.38 (1999).

149. *Id.*

150. *Id.*

151. Peterson & Cohen, *supra* note 8, at 177.

152. *Id.*

153. *Id.*

savings over five years.[154] The IRS's attempt to impose corporate level tax on the transaction by treating the exchange as an imputed dividend failed in *Bhada v. Commissioner*.[155] Congress then added I.R.C. § 1248(i) to the code in 1984, which was intended to tax all unrepatriated earnings of a foreign subsidiary, of which a U.S. parent owned more than 10%, involved in a share inversion.[156] This rule ensured that the repatriation rule's deferral regime was only temporary, as it was under other types of transactions, and could not be made permanent through an inversion.[157]

The next inversion-policy response cycle began with the share inversion of Helen of Troy Corporation. Helen of Troy created a new foreign subsidiary for this transaction.[158] At this time, I.R.C. § 367(a) allowed U.S. stock for foreign stock reorganizations under I.R.C. § 351 and § 368(a)(1)(B) to be tax free to small shareholders, with 5% shareholders needing to file a gain recognition agreement to avoid tax.[159] Thus, this transaction was non-taxable to both shareholders and the corporation.[160] Within two months, the IRS gave notice of its intent to tax this type of transaction.[161] Eventually the IRS issued final regulations that imposed a four-part test for a share inversion to be tax-free for shareholders:

i. U.S. shareholders of the U.S. corporation receive not more than 50% of the foreign corporation's shares by vote and value;
ii. U.S. officers, directors, or 5% shareholders of the U.S. corporation receive not more than 50% of the foreign corporation's shares by vote and value;
iii. the foreign corporation has a value at the time of the exchange at least equal to the value of the U.S. corporation; and
iv. the foreign corporation or a qualified subsidiary must be engaged in an active trade or business outside of the United States for the entire three year period prior to the transaction.[162]

154. *Id.*
155. *Id.* (citing Bhada v. Comm'r, 89 T.C. 959 (1987), *aff'd*, 892 F.2d 39 (6th Cir. 1989)).
156. *Id.* at 177–78.
157. Peterson & Cohen, *supra* note 8, at 178.
158. *Id.*
159. *Id.*
160. *Id.*
161. *Id.*
162. *Id.* at 164–65, 178.

This test provoked criticism for distorting the policy of I.R.C. § 367(a) and for limiting legitimate business combinations due to the size requirements in (iii).[163]

Even after these new regulations, inversions continued to occur in the late 1990s. Inverting companies included "Triton Energy (1996), Tyco International (1996), Everest Reinsurance Holdings (1999), Fruit of the Loom (1999), PXRE Corporation (1999), White Mountain Insurance Group (1999), Xoma (1999) and Applied Power (2000)."[164] Then the early 2000s saw a sharp increase in the frequency, size, and visibility of corporate inversion activity.[165] This was arguably caused by depressed stock prices that reduced shareholders' taxable capital gains on inversions; innovations in tax planning; and new multinational competitors, which increased the competitive cost of U.S. global taxation.[166] High profile inversions included those by Ingersoll-Rand (2001), Foster Wheeler (2001), Nabors Industries (2002), Coopers Industries (2002), Noble Corporation (2002), Weatherford Corporation (2002), APW (2002), and Stanley Works (planned for 2002, but cancelled in response to political pressure and the threat of regulation).[167] Ingersoll-Rand's inversion was projected to save $40 million annually in taxes, and Cooper Industries' inversion $45 million annually.[168] In response to this swell of inversions, corporate inversions became politically unpopular, being called unpatriotic and un-American.[169] This resulted in the passage of I.R.C. § 7874, discussed in Section I(B)(3).[170]

Section 7874 has failed to stop a recent spate of reincorporations overseas, some of which have occurred through the non-inversion methods of mergers and spinoffs.[171] From only a few reincorporations from 2004 to 2008, since 2009 "at least [ten] U.S. public companies have moved their incorporation address abroad or announced plans to do so, including six in the last year or so."[172] These movements overseas are leading to substantial tax revenue losses, with Aon standing to save $100 million annually, Eaton esti-

163. *Id.* at 178.
164. *Id.* at 179.
165. TREASURY REPORT 1, *supra* note 50, at 1.
166. Peterson & Cohen, *supra* note 8, at 179.
167. *Id.*; CRS REPORT 1, *supra* note 7, at 1.
168. Peterson & Cohen, *supra* note 8, at 179.
169. *Id.*
170. *Id.*
171. McKinnon & Thurm, *supra* note 6.
172. *Id.*

mating $160 million in annual tax savings, and Ensco beginning to realize savings of over $100 million a year.[173]

The clustering of recent corporate inversion activity in particular industries suggests that the U.S. tax system is particularly burdensome on these industries.[174] As discussed in Section I(B)(1), Subpart F eliminates the ability of U.S. companies to defer tax on some foreign income under the repatriation rule. "Companies that operate through new [integrated] business models, such as those that rely heavily on shared services, or outsourcing of manufacturing, disproportionately feel the bite of Subpart F,"[175] as it was enacted in a period when foreign subsidiaries were much more likely to operate on a stand-alone basis.[176]

> In addition, Congress has apparently believed that certain industries have such an opportunity to artificially shift income to tax-favored jurisdictions that they have been subjected to special subpart F rules that effectively make deferral impossible for any business income. Industries that face particular pressure under subpart F include the telecommunications sector, the oilfield services sector, and insurance.[177]

Ensco and Rowan, operators of offshore oil rigs, both reincorporated overseas in recent years, following rivals Transocean, Noble, and Weatherford International.[178] Rowan announced its move after investors and analysts questioned its tax strategy, stating that the move would allow it to achieve competitive tax rates.[179] The "anti-competitive effect of current taxation under subpart F" will continue to incentivize a heightened level of inversion activity within those industries most affected by it.[180]

Going forward, given the taxation system that has developed as discussed above, corporate inversions may be more likely when stock prices are depressed, or when corporations have non-taxable shareholders or favorable tax attributes. However, they may also be correlated with competitive pressures caused by globalization and a momentum effect, as once one firm engages in a corporate inversion, the perceived costs of negative publicity fall, stimulating addi-

173. *Id.*
174. Peterson & Cohen, *supra* note 8, at 182.
175. *Id.*
176. *Id.* at 183.
177. *Id.* at 182.
178. McKinnon & Thurm, *supra* note 6.
179. *Id.*
180. Peterson & Cohen, *supra* note 8, at 181–82.

tional inversions.[181] Bermuda and the Cayman Islands should remain popular destinations for corporate inversions, as neither has corporate income taxes.[182]

II. PROPOSED CHANGES TO THE REPATRIATION RULE

A. *President Obama's Proposal*

On May 4, 2009, President Obama released a copy of his plan to alter the corporate tax system for multinational corporations and to raise $210 billion over ten years.[183] President Obama has argued that "for years, our tax code has actually given billions of dollars in tax breaks that encourage companies to create jobs and profits in other countries."[184] President Obama essentially is arguing that the repatriation rule provides tax benefits, allowing a tax rate below 35%, for companies investing and locating operations abroad, or "shipping jobs overseas."[185] To support his plan, the President pointed out that U.S. multinationals paid an effective U.S. tax rate of 2.3% on foreign active earnings in 2004, and that many U.S. corporations had subsidiaries located in tax haven jurisdictions.[186] In fact, almost one-third of U.S. corporations' overseas income in 2003 came from the low-tax jurisdictions of Bermuda, the Netherlands, and Ireland.[187]

President Obama's tax plan makes three changes relevant to the repatriation rule and current system of deferral. First, the plan would ensure that "companies cannot receive deductions on their U.S. tax returns [for expenses] supporting their offshore investments until they pay taxes on their offshore profits," with the excep-

181. CRS REPORT 1, *supra* note 7, at 1–2; TREASURY REPORT 1, *supra* note 50, at 17. An example of the momentum effect is provided by Ensco and Rowan. *See supra* notes 178–79 and accompanying text.

182. CRS REPORT 1, *supra* note 7, at 5.

183. Press Release, Office of the Press Secretary, The White House, Leveling the Playing Field: Curbing Tax Havens and Removing Tax Incentives for Shifting Job Overseas (May 4, 2009), *available at* http://www.whitehouse.gov/the_press_office/LEVELING-THE-PLAYING-FIELD-CURBING-TAX-HAVENS-AND-REMOVING-TAX-INCENTIVES-FOR-SHIFTING-JOBS-OVERSEAS/ [hereinafter President's Plan].

184. *The Send Jobs Overseas Act*, *supra* note 27.

185. Note that a U.S. firm's employment of persons overseas does not mean that it would hire persons inside the United States if it were unable to hire abroad.

186. President's Plan, *supra* note 183.

187. Marie Leone, *Watch Out for the Expense-Deferral Rule*, CFO.COM (May 5, 2009), http://www.cfo.com/article.cfm/13604844/c_2984368/?f=archives.

tion of research and experimentation expenses.[188] As an example, the plan provided for the denial of interest deductions on a loan taken out in the United States, the proceeds of which are invested overseas, until foreign income is taxed.[189] This proposal sought to raise $60.1 billion from 2011 to 2019.[190] Second, President Obama's plan would effectively end the use of foreign tax credits on a country-by-country basis, only allowing foreign tax credits up to a company's average foreign tax rate.[191] This reduces the benefit of the deferral rule by eliminating companies' ability to determine from which jurisdictions income will be repatriated. Companies prefer to repatriate income from high-tax countries so little or no U.S. tax is generated.[192] In conjunction with a measure to restrict the foreign tax credit to foreign taxes paid on income subject to U.S. taxes, this proposal aims to raise $43 billion from 2011 to 2019.[193] Third, the President's plan would seek to end deferral on some foreign income. The proposal would impose U.S. taxes on corporate earnings-stripping transactions, possibly using intercompany loans, designed to move earnings from high tax rate foreign jurisdictions to low tax rate foreign jurisdictions (tax havens).[194] This would eliminate deferral on this income, raising an estimated $86.5 billion from 2011 to 2019.[195] This income is currently untaxed under "check-the-box" rules.[196] It is argued that reduced deferral of corporate income through the President's plan will reduce the incentive of U.S. firms to move operations abroad to real-

188. President's Plan, *supra* note 183.

189. *Id.* This policy change could force highly leveraged companies to give up deferral to save the interest expense deduction. Leone, *supra* note 187. Given the fungible nature of money, it is hard to know how the administration would determine which expenses incurred in the United States are taken to support overseas investments that have not been paying U.S. taxes. Multinationals may be "asked to make 'arbitrary allocations of their otherwise deductible expenses . . . between their domestic and foreign income.'" *Id.* (quoting tax expert Robert Willens). The allocation process could be far ranging, even including Chief Executive Officer salaries. *Id.*

190. President's Plan, *supra* note 183.

191. *See id.*

192. *See supra* note 31 and accompanying text.

193. PRESIDENT'S PLAN, *supra* note 183. Foreign income tax credits were subsequently denied when generated on overseas income not subject to U.S. taxation due to covered asset acquisitions. *President Obama Signs Bill Modifying Foreign Tax Credit*, BLOOMBERG BNA (Aug. 11, 2010), http://www.bna.com/president-obama-signs-n2147485208.

194. President's Plan, *supra* note 183.

195. *Id.*

196. *Id.*

ize lower effective tax rates than are available in the United States.[197]

B. Analysis of Eliminating the Repatriation Rule

The President's plan would not fully eliminate the repatriation rule and deferral. It would make significant strides towards this end. The President's proposal seeks to raise $21.1 billion annually from 2011 to 2019 with the measures discussed above, while the loss to the federal budget from the deferral of active income is estimated to be $14.1 billion annually from 2010 to 2014.[198] To simplify an analysis of the probable economic effects of the President's proposal, this Part will consider the economic impact of the complete elimination of the repatriation rule—taxing companies as soon as overseas profits are earned. Following this analysis, alternative methods of improving the current taxation and regulatory system are suggested and evaluated.

1. Costs of Predicted Corporate Response: Reduced Competitiveness, Sales, and Inversions

In response to removal of the repatriation rule, U.S. firms are likely to lose business to foreign competitors, sell themselves to foreign firms, or engage in corporate inversions.[199] This has happened in the past. Tax reforms in 1986 eliminated the repatriation rule for foreign shipping income, while no other country taxed foreign shipping income, causing U.S. shipping market share and U.S. shipping capacity each to decline by approximately 50% by 1999 and 2004 respectively.[200] In addition, U.S. companies have already rein-

197. ROBERT S. MCINTYRE ET AL., CORPORATE TAXPAYERS & CORPORATE TAX DODGERS 2008-10: A JOINT PROJECT OF CITIZENS FOR TAX JUSTICE & THE INSTITUTE ON TAXATION AND ECONOMIC POLICY 10 (2011), *available at* http://www.ctj.org/corporatetaxdodgers/CorporateTaxDodgersReport.pdf [hereinafter CTJ REPORT].

198. PRESIDENT'S PLAN, *supra* note 183; JOINT COMM. ON TAXATION, JCX-15-11, BACKGROUND INFORMATION ON TAX EXPENDITURE ANALYSIS AND HISTORICAL SURVEY OF TAX EXPENDITURE ESTIMATES 25 (Feb. 28, 2011), *available at* http://www.us.kpmg.com/microsite/taxnewsflash/2011/Feb/x-15-11.pdf [hereinafter JCOT REPORT]. Note that these numbers are not fully comparable as restricting the foreign tax credit to foreign taxes paid on income subject to U.S. tax does not affect deferral, and income shifted between foreign subsidiaries through earnings stripping transactions may not be considered active in the analysis by the Joint Committee on Taxation.

199. *The Send Jobs Overseas Act*, *supra* note 27.

200. Kenneth J. Kies, *A Perfect Experiment: 'Deferral' and the U.S. Shipping Industry*, 116 TAX NOTES 997, 997–98 (2007) [hereinafter *A Perfect Experiment*]. From 1988 to 1999, the percentage of the world merchant fleet comprised of U.S.-owned, foreign-flag ships, which dropped in number by nearly 50%, fell from 5.6%

corporated overseas in response to the President's rhetoric about limiting deferral.[201] If the repatriation rule is eliminated or substantially eviscerated, repeating the shipping sector experiment with all U.S. companies, service sector industries (e.g., financial services and technology), which contributed 78% of U.S. gross domestic product in 2009,[202] would be most likely to flee the United States as "their emphasis on human capital makes them especially able to pack up and move their operations abroad."[203] For instance, CEO Steve Ballmer has said that Microsoft would move facilities and jobs out of the United States if the President's plan were implemented.[204]

a. Reduced Competitiveness

A former chief of staff of the Congressional Joint Committee on Taxation has written that a way to make U.S. businesses less competitive in the global economy is to "make sure that U.S. companies are subject to higher taxes than foreign-based competitors when they do business abroad."[205] However, due to the United States' worldwide tax regime, U.S. multinationals already often report higher effective tax rates abroad than those faced by foreign competitors.[206] The President's Economic Recovery Advisory Board notes that this reduces the competitiveness of U.S. multinationals,[207] and proponents of the President's plan admit that his plan is not concerned with "the competitiveness of U.S. multinationals in

to 2.9%. *Id.* at 998. In addition, U.S.-owned, U.S.-flag ships decreased in number by nearly 50% and in capacity by over 50% from 1985 to 2004. *Id.* The number of U.S.-owned, U.S.-flag ships declined despite that only U.S. enterprises can engage in domestic shipping, as many U.S. shippers were sold to foreign competitors, reducing the number of potential investors in domestic shipping. *Id.*

201. *See* McKinnon & Thurm, *supra* note 6 (providing Rowan as a specific example).

202. SEC. INDUS. & FIN. MKTS ASS'N, U.S. FINANCIAL SERVICES INDUSTRY: CONTRIBUTING TO A MORE COMPETITIVE U.S. ECONOMY 3 (2010), *available at* http://www.ita.doc.gov/td/finance/publications/U.S.%20Financial%20Services%20Industry.pdf.

203. *The Send Jobs Overseas Act*, *supra* note 27.

204. *Id.* However, note that this would not be a rational response. If the President's plan were implemented, it would be more costly to locate facilities and jobs overseas without selling foreign businesses or reincorporating abroad.

205. Newt Gingrich & Ken Kies, *Our Taxed Expats*, WALL ST. J., June 28, 2006, at A14.

206. PERAB REPORT, *supra* note 19, at 69.

207. *Id.*

foreign markets."[208] It is irrelevant that U.S. companies may have higher effective tax rates abroad than in the United States,[209] as the key metric is the tax rate that a U.S. corporation pays in any particular country, and how that compares to what a foreign corporation pays. As discussed in Section I(B)(1), without the repatriation rule, that rate is the higher of the local tax rate and the U.S. tax rate. On the other hand, foreign firms tend to be taxed on a territorial basis, generally only paying the local tax rate. Thus, when the U.S. tax rate is lower than the local rate, U.S. firms are competitive with foreign firms taxed on a territorial basis. However, when the U.S. tax rate is higher than another country's local tax rate, U.S. corporations are disadvantaged competitively as they must pay U.S. taxes on top of local taxes, while foreign firms only must pay local taxes. This increased tax burden reduces the competitiveness of U.S. businesses abroad[210] by reducing the expected profit on projects, which results in U.S. firms taking fewer projects as some become negative net present value investments.[211] As U.S. firms take fewer projects that are profitable gross of tax, the United States loses as the pie split between those corporations and the U.S. government shrinks.[212] As U.S. firms lose profitable projects, their value will decline, possibly to the point of bankruptcy. The burdens of the U.S. tax system seem to be particularly onerous in certain industries, as discussed in Section I(D). However, decreasing competitiveness and corporate values are not the only expected results of eliminating the repatriation rule and the President's proposal.

b. Less Business Creation in the United States

Firms incorporated in countries operating under territorial taxation regimes do not endure taxes from both their country of incorporation and the country where income is earned. Thus, in comparison to U.S. firms in low-tax foreign countries, foreign firms

208. Seth Hanlon, *Obama's Corporate Tax Plan Points the Way to Reform*, CENTER FOR AMERICAN PROGRESS (Mar. 8, 2012), http://www.americanprogress.org/issues/2012/03/corporate_tax_plan.html.

209. *See* CTJ REPORT, *supra* note 197.

210. Note that even with the repatriation rule U.S. firms face an increased tax burden, as discussed in Section I(B)(1). The deferral of taxes offered by the repatriation rule only serves to reduce the added tax burden borne by U.S. corporations.

211. TREASURY REPORT 1, *supra* note 50, at 19; *see* N.Y. STATE BAR REPORT, *supra* note 89, at 11 (stating that foreign competitors may be willing to pay higher prices for foreign investments, causing U.S. firms to lose opportunities or to overpay and suffer share price declines).

212. TREASURY REPORT 1, *supra* note 50, at 20.

realize a higher net profit from every dollar of operating profit. Therefore, venture capital funds and other sophisticated managers will incorporate new businesses with international ambitions overseas.[213] Similarly, existing unincorporated businesses, such as Accenture and Michael Kors Holdings, can be expected to initially incorporate abroad.[214]

c. The Sale of Domestic Businesses to Companies Incorporated Abroad

Changes to the repatriation rule can be expected to have a greater impact through the response of existing U.S. businesses, given their commanding role in the economy and their ability to amortize the costs of arranging an overseas incorporation.[215] U.S. corporations will benefit from selling foreign subsidiaries to foreign firms if the repatriation rule is eliminated, as foreign firms can realize a greater value from the operations and pay more than they are worth to U.S. corporations due to the tax differential. By eliminating the tax differential, the sold subsidiaries can again become competitive.[216] However, corporations today often experience economies of scale or of scope by operating on an international basis.[217] Thus, by selling foreign subsidiaries a U.S. corporation may make its entire operation uncompetitive with multinational competitors operating in the United States and abroad. To avoid this outcome, a U.S. corporation may realize the full value of its operations plus some of the benefit of the tax differential by selling itself to a foreign firm. Private equity firms have already been engaging in tax arbitrage, "buying American companies with significant foreign operations and reorganizing them as foreign corporations."[218] When moving companies to a territorial tax system, private equity funds still realize the benefits of having access to U.S. capital markets, listing these newly foreign companies in the United States

213. In 2002, the U.S. Treasury stated that it was "seeing start-up companies that envision significant foreign operations making the decision to incorporate outside the United States" to avoid U.S. taxation. *Id.* at 29.

214. Davidoff, *supra* note 39; N.Y. STATE BAR REPORT, *supra* note 89, at 19–20.

215. S&P 500 companies employ 25.6 million people in the United States. CIT, THE POWERFUL IMPACT OF SMALL BUSINESS 1 (2010), *available at* http://www.cit.com/wcmprod/groups/content/%40wcm/%40cit/%40media/documents/fact-sheets/impact-small-business.pdf.

216. *See* Kies, *A Perfect Experiment*, *supra* note 200, at 998.

217. Kerrie Sadiq, *Taxation of Multinational Banks: Using Formulary Apportionment to Reflect Economic Reality (Part I)*, 22 J. INT'L TAX'N 46, 52 (2011); *see* Michael J. Graetz, *The David R. Tillinghast Lecture Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 287 (2001).

218. Davidoff, *supra* note 39.

through IPOs.[219] Thus, the U.S. Treasury stated that "the disparity in tax treatment between multinational companies based in the United States and those based in our major trading partners must be recognized" as a cause of foreign acquisitions of substantial U.S. businesses.[220]

d. Increased Corporate Inversion Activity

The same logic for corporate sales, that non-U.S. operations incorporated abroad are worth more than those incorporated in the United States, could also cause an increase in corporate inversion activity should the repatriation rule be eliminated.[221] Despite changes in U.S. tax law that have made inversions more difficult to implement, as discussed in Section I(B)(3), gifted tax lawyers will be able to craft transactions that meet the law's requirements but no more, minimizing the costs of conducting a corporate inversion. For instance, the taxes that must be paid in an inversion are less costly when corporations have depressed stock prices, non-taxable shareholders, or favorable tax attributes, and the cost of negative publicity may be decreased when other firms have recently inverted.[222] Thus, a study found an average 1.7% increase in share prices in response to inversion announcements.[223] To the extent that inversions are thwarted by anti-inversion legislation and regulations, the result is likely to be more bankruptcies and sales of U.S. firms to foreign companies.[224] In the long term, the incorporation of new U.S. businesses overseas and the inversion, sale, or liquidation of existing businesses will result in a dearth of U.S.-based corporations.

e. Non-Tax Reasons to Locate Businesses Abroad

In addition to the tax differential, there are regulatory benefits of locating abroad, as noted in Section I(C). Bermuda and the Cayman Islands, where many corporations relocate, have "highly developed legal, institutional, and communications infrastructures," with no corporate income tax and "sophisticated financial infrastruc-

219. *Id.*

220. TREASURY REPORT 1, *supra* note 50, at 19 (noting foreign acquisitions of "$90.9 billion in 1997, $234 billion in 1998, $266.5 billion in 1999, and $340 billion in 2000").

221. However, with inversions the tax savings do not need to be split with another corporation.

222. *See* CRS REPORT 1, *supra* note 7, at 1–2.

223. Desai & Hines, *supra* note 51, at 409.

224. Peterson & Cohen, *supra* note 8, at 188.

ture[s]."[225] Firms have claimed that foreign ownership permits "'operational flexibility,' improved cash management, and an enhanced ability to access international capital markets."[226] Michael Kors Holdings ("Michael Kors"), listed on the NYSE and with 95% of sales coming from the United States and Canada, only chose to incorporate in the British Virgin Islands in 2003, despite having been in business since 1981.[227] It did so to "sidestep[ ] higher taxes and substantial regulation in the United States."[228] By organizing abroad, Michael Kors can avoid U.S. taxes on income earned outside of the United States and much of U.S. securities and corporate law.[229] "As a foreign corporation, Michael Kors is under . . . bare-bones reporting requirements under United States securities law" and can provide "minority shareholders . . . limited or no recourse if they are dissatisfied with the conduct of [its] affairs."[230] This is an important cost of sale and inversion activity as U.S. investors may not realize that they are not protected by U.S. securities laws.[231]

Despite the benefits of incorporating overseas, certain benefits of incorporation in the United States may mitigate some of the incentive to engage in a sale process or inversion—for instance, access to skilled regulators.[232] Firms relocating abroad may also face costs from switching to International Financial Reporting Standards ("IFRS")[233] and from foreign political instability, including regula-

225. CRS REPORT 1, *supra* note 7, at 2; Stephen James, *Bermuda: Down To Business - TIEA Now Effective*, MONDAQ (Sept. 8, 2011), http://www.mondaq.com/x/144790/Funds+Financial+Services/Cayman+Canada+Down+To+Business+TIEA+Now+Effective; *see* Rich Miller, *SAVVIS Partners In Bermuda, Caymans*, DATA CTR. KNOWLEDGE (Aug. 8, 2006, 7:34 AM), http://www.datacenterknowledge.com/archives/2006/08/08/savvis-partners-in-bermuda-caymans.

226. CRS REPORT 1, *supra* note 7, at 1.

227. Davidoff, *supra* note 39; Michael Kors Holdings Limited, FORM F-1 at 6 (Dec. 2, 2011), *available at* www.sec.gov/Archives/edgar/data/1530721/000119312511328487/d232021df1.htm. Note that inverted firms can be listed on U.S. exchanges and can remain eligible for inclusion in such indexes as the S&P 500. N.Y. STATE BAR REPORT, *supra* note 89, at 14.

228. Davidoff, *supra* note 39.

229. *Id.*

230. *Id.*

231. *Id.*

232. MCKINSEY & CO., *supra* note 24, at 79.

233. Executives estimate the cost of switching to IFRS at between 0.1% and 0.7% of annual revenue, while the SEC estimates costs at 0.125% to 0.13% of revenue. Sarah Johnson, *Guessing the Costs of IFRS Conversion*, CFO.COM (Mar.30, 2009), http://www.cfo.com/article.cfm/13399306?f=singlepage. However, about 100 countries already use IFRS and many other countries, including the United States, are converging accounting principles with IFRS. Barry J. Epstein, IFRS vs. GAAP,

tory uncertainty.[234] However, many benefits of operating in the United States, such as access to a skilled labor force, are also available to foreign firms that can legally operate here, rendering these benefits irrelevant to this analysis.[235] For instance, international firms also benefit from the positive clustering effect of operating in the United States, as a critical mass of companies in the United States in certain industries has resulted in a concentration of clients, suppliers, and supporting institutions.[236]

f. The Perfect Experiment: The U.S. Shipping Industry

The 1986 removal of the repatriation rule for shipping income provides an example of the incentive to engage in sales and inversions without the repatriation rule. A significant portion of the roughly 50% decline in U.S. shipping capacity after 1986 was caused by the acquisition of U.S. shipping companies by foreign competitors facing lower tax rates.[237] For instance, both the largest overall U.S. shipping company—American President Lines—and the international liner business of the largest U.S. container shipping company—a subsidiary of CSX Corporation—were sold to foreign corporations during this period.[238] However, this trend reversed with the reinstatement of the repatriation rule in 2004. Within one year of the rule's reenactment, New York-based Overseas Shipholding Group (with approximately sixty ships in 2004), whose American flag fleet had previously declined in size, acquired Athens-based Stelmar Shipping with forty ships, reversing the trend of foreign takeovers.[239] Moreover, the firm ordered ten new American-built ships.[240] The ship order was forecasted to "increase Philadelphia's gross economic output by $1.29 billion, labor compensation by $490 million, and average annual employment by

http://www.ifrsaccounting.com (last visited Apr. 22, 2012); *The Move Towards Global Standards*, IFRS, http://www.ifrs.org/Use+around™he+world/Use+around™he+world.htm (last visited Apr. 22, 2012).

234. Uche Ewelukwa Ofodile, *Trade, Empires, and Subjects—China-Africa Trade: A New Fair Trade Arrangement, or the Third Scramble for Africa?*, 41 VAND. J. TRANSNAT'L L. 505, 572–73 (2008).

235. *See* CRS REPORT 1, *supra* note 7, at 2 (stating that most inverted firms keep their headquarters within the United States). Inverting corporations have often stated that they do not expect material changes in their operations, including management, the location of their headquarters, and access to the U.S. capital markets. TREASURY REPORT 1, *supra* note 50, at 15.

236. MCKINSEY & CO., *supra* note 24, at 121.

237. *See* Kies, *A Perfect Experiment*, *supra* note 200, at 998.

238. *Id.*

239. *Id.* at 999.

240. *Id.*

1,217 over the 2005-2010 period."[241] This anecdote demonstrates the potential for the elimination of the repatriation rule to reduce U.S. competitiveness, employment, and business activity, in part by incentivizing U.S. firms to engage in corporate inversions or sales to foreign firms.

g. Reduced Domestic Investment, Employment, and Exports

The U.K. Treasury has stated that "[m]oving towards a more territorial system . . . will allow businesses based here to be more competitive on the world stage supporting [U.K.] investment and jobs."[242] Thus, moving towards a more global system of U.S. taxation, as the President favors, could be expected to reduce U.S. investment and jobs at this time of high unemployment in the United States, before even considering those who have abandoned the search for work.[243] Almost all congressional Republicans, many Democrats, and tax policy experts agree that high-paying executive, research, legal, accounting, and other headquarters-based positions in the United States are likely to be lost if U.S. firms move their

241. *Id.*

242. Kies, *Response*, *supra* note 23, at 1146. *But see* CRS REPORT 1, *supra* note 7, at 2 (providing that inversions apparently do not cause an outflow of U.S. capital or jobs in the short run, as inverted firms typically keep their headquarters within the United States).

243. *See* CRS REPORT 1, *supra* note 7, at 8 (finding that inversions, in the long-term, may cause investment and business operations to be shifted out of the United States). In June 2013, 7.6% of U.S. workers were unemployed. *Labor Force Statistics from the Current Population Survey*, BUREAU OF LABOR STATISTICS, http://data.bls.gov/timeseries/LNS14000000 (data extracted on July 21, 2013). Including in the unemployment rate part-time workers looking for full-time work and individuals who want to work but have stopped looking, the real unemployment rate in June 2013 was 14.3%. Mortimer Zuckerman, *A Jobless Recovery Is a Phony Recovery*, WALL ST. J., July 15, 2013, at A15, *available at* http://online.wsj.com/article/SB10001424127887323740804578601472261953366.html (stating that "the number of people leaving the workforce during this economic recovery has actually outpaced the number of people finding a new job by a factor of nearly three"). Note, however, that the President's proposals would not allow U.S. taxes to make foreign projects appear more attractive than equivalent U.S. projects, achieving "capital export neutrality," although the proposals would result in U.S. firms being uncompetitive with foreign firms for foreign projects, violating "capital import neutrality." CRS REPORT 1, *supra* note 7, at 8–9 (defining and discussing "capital export neutrality" and "capital import neutrality"). "Capital ownership neutrality," or tax policies that do not distort the ownership of capital, may also be violated by the President's proposal. James R. Hines Jr., *Taxation of Foreign Income* 5–6 (Mich. Office of Tax Policy Research, Working Paper No. 2007-4, 2007), *available at* http://www.bus.umich.edu/otpr/WP2007-4.pdf.

headquarters abroad due to corporate inversions or sales.[244] This happened with the sale of shipping companies after the repatriation rule was removed in 1986.[245] In another example, Michael Kors moved its headquarters abroad following its incorporation in the British Virgin Islands.[246] Job losses at corporate headquarters result in lower individual income tax revenues, lost contributions to local communities, and reduced odds that companies will purchase U.S. made goods and services.[247]

Furthermore, the jobs of American expatriates overseas may be lost when U.S. corporations are sold to foreign firms,[248] eliminating the U.S. taxes that these expatriates pay and any U.S. spending supported by their work. Studies show a direct correlation between U.S. exports and the employment of Americans overseas, as American expatriates favor U.S. goods.[249] For instance, a 1980 study predicted that a 10% drop in Americans overseas will result in a 5% drop in real exports, causing an increase in U.S. unemployment and a reduction in U.S. tax revenues.[250] A 1981 study by the General Accounting Office reached similar conclusions.[251] Another report predicted that a 10% increase in investment abroad would increase investment in the investor's home country by 2.6%,[252] which could be explained in part by increased expatriation. Thus, increased sale and inversion activity could hurt U.S. investment due to reduced expatriation.

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244. *See* CTJ REPORT, *supra* note 197, at 11; Sahadi, *supra* note 3. Efforts to reduce the tax incentives for inversions by taxing companies based on where management and control functions are located may exacerbate the move of jobs offshore. *See* Leary, *supra* note 58 (stating that "[f]aced with the mere threat of . . . legislation, Transocean and Weatherford both recently packed up their top brass and shipped them to Geneva").

245. *See* Kies, *A Perfect Experiment*, *supra* note 200, at 998.

246. Davidoff, *supra* note 39.

247. *See* Peterson & Cohen, *supra* note 8, at 184.

248. Kies, *Response*, *supra* note 23, at 1146.

249. COMPTROLLER GENERAL, GEN. ACCOUNTING OFFICE, Report No. 114499, REPORT TO THE CONGRESS OF THE UNITED STATES: AMERICAN EMPLOYMENT ABROAD DISCOURAGED BY U.S. INCOME TAX LAWS 38–39 (1981) [hereinafter COMPTROLLER REPORT], *available at* http://www.gao.gov/assets/140/132160.pdf; Gingrich & Kies, *supra* note 205.

250. Letter from Alliance of Am. Insurers et al. to Sen. Bill Frist (May 21, 2003), *available at* http://www.uscib.org/index.asp?documentID=2608.

251. COMPTROLLER REPORT, *supra* note 249, at 28, 38–39.

252. J. D. Foster & Curtis S. Dubay, *Obama International Tax Plan Would Weaken Global Competitiveness*, HERITAGE FOUND. (2009), *available at* http://s3.amazonaws.com/thf_media/2009/pdf/wm2426.pdf (citing Mihir Desai et al., *Domestic Effects of Foreign Activities of Multinationals*, 1 AM. ECON. J. 181, 181–203 (2009)).

h. National Security Costs

A reduction in the number of companies incorporated in the United States and the number of U.S. multinationals also has negative national security implications. U.S. firms are more likely to fully comply with U.S. government requests, for both patriotic and practical reasons, in both peacetime and wartime.[253] U.S. firms may be required to provide the U.S. government with information about both domestic and foreign operations.[254] In addition, the U.S. government may limit the ability of U.S. corporations to export technology that may be useful for military purposes.[255] The U.S. government may also require U.S. corporations to conduct certain activities. For instance, in peacetime the government has sought the power to unilaterally shut down the Internet in response to cybersecurity threats.[256] In wartime the federal government has gone as far as coordinating economic activity.[257] Thus, there are many ways in which having fewer U.S. corporations harms national security. The loss of U.S. shipping in response to the elimination of the repatriation rule for shipping income in 1986 provides an example. In emergencies, the U.S. military relies on U.S.-owned ships to carry supplies.[258] By 2002, a Massachusetts Institute of Technology study found that a Department of Defense analysis would require more tankers than were available for requisition in certain scenarios, specifically due to the passage of the 1986 tax change.[259]

253. The U.S. government is more capable of taking direct control of a U.S. corporation that does not fully comply with its demands, causing U.S. firms to have higher costs of fighting U.S. government requests.

254. *See* Kathleen Vermazen Radez, *The Freedom of Information Act Exemption 4: Protecting Corporate Reputation in the Post-Crash Regulatory Environment*, 2010 COLUM. BUS. L. REV. 632 (2010).

255. For a discussion of U.S. export controls on military technology, see Jonathan Donald Westreich, *Regulatory Controls on United States Exports of Weapons and Weapons Technology: The Failure to Enforce the Arms Exports Control Act*, 7 ADMIN. L.J. AM. U. 463 (1993).

256. David Kravets, *Internet 'Kill Switch' Legislation Back in Play*, WIRED (Jan. 28, 2011, 6:09 PM), http://www.wired.com/threatlevel/2011/01/kill-switch-legislation. This idea has faced resistance due to censorship concerns, questions about the government's ability to predict a cyber attack, and the fact that operators would likely choose by themselves to disconnect if warned of an imminent attack. *Id.*

257. Frederick B. Chary, *World War II - History of Business in the U.S.*, AM. BUS. (Mar. 28, 2011), http://american-business.org/2813-world-war-ii.html.

258. *See* Kies, *A Perfect Experiment*, *supra* note 200, at 998.

259. HENRY S. MARCUS ET AL., MASS. INST. OF TECH., INCREASING THE SIZE OF THE EFFECTIVE UNITED STATES CONTROL FLEET i–vi (2002), *available at* http://www.dtic.mil/cgi-bin/GetTRDoc?AD=ADA408239&Location=U2&doc=GetTRDoc.pdf.

2. Asserted Benefits of Eliminating the Repatriation Rule

a. The Argument for Increased Jobs and Investment

President Obama has argued that the repatriation rule has made it more expensive for U.S. companies to reinvest overseas profits at home, reducing U.S. job creation and investment.[260] The benefit of tax deferral offered by the repatriation rule has caused an estimated $1.7 trillion of U.S. corporate earnings to be stranded abroad.[261] U.S. capital markets do not nullify the effect of the repatriation rule on investment, as U.S. corporations' external cost of capital can safely be assumed to be higher than their internal cost of capital due to transactions costs and capital market imperfections.[262] If the repatriation rule did not discourage repatriation, these overseas funds could be used to provide U.S. jobs, purchase equipment, engage in research and development, pay shareholders dividends, conduct share repurchases, and make other beneficial investments.[263] All of these activities would help stimulate the U.S. economy. However, increased repatriations may increase the demand for dollars, causing the dollar to appreciate, which may cause declines in exports, partially offsetting any benefit of increased repatriations.[264] In addition, the experience in the U.S. shipping industry showed that the reenactment of the repatriation rule increased domestic investment.[265] This suggests that any increase in investment from repatriations after the removal of the repatriation rule may be more than offset by reduced investment as U.S. busi-

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260. Editorial, *Obama's Global Tax Raid*, WALL ST. J., May 7, 2009, http://online.wsj.com/article/SB124157636504090459.html.

261. *Google's Bermuda Billions*, *supra* note 39.

262. Chul W. Park & Morton Pincus, *Internal Versus External Equity Funding Sources and Earnings Response Coefficients*, 16 REV. QUANTITATIVE FIN. & ACCT. 33, 48 (2001); Kies, *Response*, *supra* note 23, at 1145. *But see* Dhammika Dharmapala et al., *Watch What I Do, Not What I Say: The Unintended Consequences of the Homeland Investment Act*, 66 J. FIN. 753, 782 (2011) (finding that additional repatriations following a tax holiday did not increase domestic investment, employment, or research and development by companies; however, the repatriations did increase payouts to shareholders).

263. *See* Chambers & Catz, *supra* note 36; Kies, *Response*, *supra* note 23, at 1145.

264. DONALD J. MARPLES & JANE G. GRAVELLE, CONG. RESEARCH SERV., R40178 TAX CUTS ON REPATRIATION EARNINGS AS ECONOMIC STIMULUS: AN ECONOMIC ANALYSIS 8 (2011), *available at* http://www.ctj.org/pdf/crs_repatriationholiday.pdf [hereinafter CRS REPORT 2].

265. Kies, *A Perfect Experiment*, *supra* note 200, at 999–1000. However, this result may arguably be inapplicable to other industries as only U.S. firms may engage in U.S. shipping. *Id.* at 998.

nesses move offshore to avoid the immediate U.S. taxation of worldwide income, discussed in Section II(B)(1)(G).

Tax holidays demonstrate that eliminating the U.S. policy of global taxation would also remove the incentive for corporations to keep funds abroad to avoid U.S. taxes, without encouraging U.S. businesses to move offshore.[266] For instance, the Homeland Investment Act, passed in 2004, reduced corporate taxes by 85% on repatriated earnings used for permitted purposes and resulted in about $300 billion in repatriations, 60% to 92% of which was used to return cash to shareholders.[267] Shareholders presumably used these funds for consumption or reinvestment, creating indirect effects on spending, employment, and investment.[268] Shareholder payouts, as opposed to direct corporate investment, may actually be the "economically efficient outcome for many firms" as shareholders can put overseas profits into less mature U.S. companies with more investment opportunities and greater growth potential.[269] In 2005 and 2006, the two years following the passage of the Homeland Investment Act, the United States saw an increase in employment of 5.2 million while the five years of 2003 to 2007 collectively saw only a 9.6 million increase in employment.[270] Thus, the 2004 tax holiday

266. However, the Congressional Research Service makes a strong argument that repatriations are only increased by temporary decreases in the taxes due on repatriation, as the present value of tax due on foreign earnings on repatriation is stable over time with stable tax rates. CRS REPORT 2, *supra* note 264, at 3. This undermines the arguments that either a worldwide system without deferral or a territorial system of taxation would increase repatriations. Yet, a territorial system would likely result in higher levels of repatriation relative to a worldwide system without deferral, or the present system if companies believed that decreases in tax rates on repatriation were possible in the future. This belief is likely, as unrepatriated earnings have increased by 72% since the tax holiday in 2004. *Id.* at 5.

267. Dharmapala et al., *supra* note 262, at 782–83. Appendix Exhibit 7 shows the surge in repatriations following the passage of the Homeland Investment Act. Another study estimated that a more limited 21% of the funds repatriated were returned to shareholders. Jennifer Blouin & Linda Krull, *Bringing it Home: A Study of the Incentives Surrounding the Repatriation of Foreign Earnings Under the American Jobs Creation Act of 2004*, 47 J. ACCT. RES. 1027, 1029 (2009). The Joint Committee on Taxation has estimated that a similar 85% cut in taxes on repatriation in 2011 would have resulted in $500 billion of funds being repatriated that would otherwise be permanently reinvested abroad. Kenneth J. Kies, *A Critique of the CRS Report on Repatriation*, 132 TAX NOTES 737, 740 (2011) [hereinafter Kies, *A Critique*].

268. Dharmapala et al., *supra* note 262, at 783.

269. Blouin & Krull, *supra* note 267, at 1028; Kies, *A Critique*, *supra* note 267, at 742.

270. *Employment Status of the Civilian Noninstitutional Population, 1942 to Date*, BUREAU OF LABOR STATISTICS, *available at* http://www.bls.gov/cps/cpsaat01.pdf (last visited Feb. 5, 2013).

suggests that a move towards a territorial taxation system in the United States could also encourage repatriation without the negative side effects of removal of the repatriation rule, creating "a substantial and beneficial macroeconomic impact."[271]

b. The Fallacy that the Repatriation Rule Encourages "Shipping Jobs Overseas"

President Obama argues that the repatriation rule and deferral regime encourage U.S. corporations to shift U.S. jobs overseas.[272] This is an argument for capital export neutrality, which provides that the U.S. tax code should not favor investments abroad by allowing companies to realize lower corporate tax rates overseas.[273] Essentially, the argument runs that lower foreign tax rates allow U.S. businesses to achieve higher rates of return on foreign projects than U.S.-based projects, encouraging U.S. businesses to invest and create jobs abroad as opposed to in the United States. However, the flaw with this view is readily apparent. Assuming competitive markets, businesses can be expected to bid up the cost of a project's inputs or to compete through price reductions—regardless of the project's location—until expected returns are approximately equal to the businesses's cost of capital.[274] Thus, companies should be indifferent to projects in different locations unless they have unique advantages (disadvantages) that allow them to obtain higher (lower) returns or a lower (higher) cost of capital.[275] U.S. businesses must compete for projects overseas with foreign businesses. With foreign businesses paying lower tax rates abroad, they obtain higher returns than U.S. firms and bid up the cost of foreign projects until expected returns equal their cost of capital.[276] As U.S. firms will realize lower returns with higher taxes, and businesses are only concerned with profits after taxes,[277] U.S. firms will not invest

271. *See* Kenneth J. Kies, *Repatriation Studies Miss the Mark*, 133 TAX NOTES 881, 884 (2011).

272. President's Plan, *supra* note 183.

273. Clifton Fleming Jr. et al., *Deferral: Consider Ending It, Instead of Expanding It*, 86 TAX NOTES 837, 838 n.6 (2000) [hereinafter Fleming et al., *Deferral*].

274. Samuel C. Thompson, Jr., PRACTISING LAW INSTITUTE: MERGERS, ACQUISITIONS AND TENDER OFFERS § 11:5.9[C] (2011); *see* OFFICE OF TAX POLICY, DEP'T OF THE TREASURY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY 27 n.8, 29 (2000), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/subpartf.pdf [hereinafter TREASURY REPORT 2] (arguing that competitive capital markets will result in investments earning the same risk-adjusted rate of return).

275. *See* Thompson, *supra* note 274, at § 11:5.9[C].

276. *See* N.Y. STATE BAR REPORT, *supra* note 89, at 11.

277. *See* MICHAEL A. SPIELMAN, U.S. INTERNATIONAL ESTATE PLANNING ¶ 15.08[1] (2012).

in many foreign projects without the deferral rule as their cost of capital will generally be higher than their expected returns.[278] By contrast, in the United States, where U.S. firms are taxed the same as foreign firms, U.S. firms will be competitive in bidding for projects. Thus, the possibility of perpetual deferral, which is equivalent to a territorial tax system, does not encourage U.S. firms to ship jobs overseas; it simply makes one indifferent between U.S. projects and foreign projects unless it has special advantages or disadvantages for performing certain projects.[279] This encourages projects to be performed by the companies valuing them most pre-tax, encourages economic efficiency, and keeps U.S. firms competitive, as discussed in Section II(B)(1)(A).

c. Fairness Considerations

Another argument for eliminating the repatriation rule is that this would result in a fairer tax system, as it would ensure that all shareholders of U.S. corporations face corporate-level tax at a minimum of the U.S. rate.[280] This view is seemingly supported by the position of the Joint Committee on Taxation, which considers the repatriation rule to be a tax expenditure, or a deviation from normative tax law that results in a revenue loss to the federal government.[281] Thus, the removal of the repatriation rule would not allow a shareholder of a U.S. corporation with significant foreign business to benefit from lower foreign tax rates relative to a shareholder of a U.S.-focused corporation. However, this argument fails because both corporations face the same legal environment and the corporations would be valued on expected net earnings, meaning that both shareholders, if they had purchased shares in the secondary market, would be fairly compensated for their purchase. In fact, the United States' policy of only taxing the worldwide income of U.S. persons, which does not include foreign corporations even if controlled by a U.S. corporation, dates back to the introduction of the

278. *See* N.Y. State Bar Report, *supra* note 89, at 11.

279. Note that basing the availability of deferral on the competitive circumstances in a country, as supported by some authors, *see, e.g.*, Fleming et al., *Deferral*, *supra* note 273, at 845–46; Fleming et al., *Perspectives*, *supra* note 28, at 1086, would be very difficult to implement in an objective and efficient way.

280. Others may argue that elimination of the repatriation rule is fairer as individuals cannot engage in similar strategies. *See* CRS Report 1, *supra* note 7, at 15. However, the Congressional Research Service discredits this argument by noting that "corporations are not people but agglomerations of stockholders, employees, creditors, and managers." *Id.* at 8.

281. JCOT Report, *supra* note 198, at 2, 25.

modern income tax in 1913.[282] A change in the tax regime eliminating the repatriation rule would decrease the share price of a corporation doing business abroad, disregarding the expectations of its shareholders, while imposing no cost to shareholders of corporations doing business solely in the United States.[283] This violates a fundamental notion of fairness, as shareholders of U.S. multinationals are unilaterally harmed. In addition, when U.S. corporations are not taxed on foreign income (as with perpetual deferral under the repatriation rule), multinational corporations are taxed the same as several smaller businesses operating in individual countries, a strikingly fair result. As stated by the Congressional Research Service, "equity is a difficult concept to apply in the case of the corporate income tax" as "corporations are not people" and "the ultimate repository of the tax's burden is difficult to determine."[284] Finally, commentators including the Joint Committee on Taxation have challenged the treatment of the repatriation rule as a tax expenditure.[285]

d. Increasing Revenue by Eliminating the Repatriation Rule

With the U.S. government currently owing over $16 trillion in debt, or more than 100% of gross domestic product,[286] foreign corporate earnings may be an attractive area for additional taxation as the costs are distributed among many corporations and the negative consequences are delayed and largely unobservable.[287] The

282. TREASURY REPORT 2, *supra* note 274, at 2–3.

283. *Cf.* CRS REPORT 1, *supra* note 7, at 8 (noting that the burden of changes in the corporate tax will fall on shareholders in the short run and on other stakeholders in the long run).

284. *Id.* The Congressional Research Service has noted another source of arguable unfairness from the removal of the repatriation rule—that the resulting inversions may reduce the income tax system's progressivity. *See id.*

285. *E.g.*, JOINT COMM. ON TAXATION, JCX-37-08, A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS 10 (2008), *available at* http://www.jct.gov/x-37-08.pdf (stating that the repatriation rule "would not . . . be classified as a Tax Subsidy under our proposed definition . . . because present law can fairly be said to be ambiguous as to what constitutes the general rule for taxing foreign earnings"); Kenneth J. Kies, *Deferral Not a Tax Expenditure, Former JCT Chief Says*, 131 TAX NOTES 219 (2011).

286. *The Debt to the Penny and Who Holds It*, TREASURYDIRECT, http://www.treasurydirect.gov/NP/debt/current (last visited July 1, 2013); *Federal Debt: Total Public Debt as Percent of Gross Domestic Product*, FED. RES. BANK OF ST. LOUIS: ECON. RES. (June 26, 2013, 8:46 AM), http://research.stlouisfed.org/fred2/series/GFDEGDQ188S.

287. *See* Robert A. Green, *The Troubled Rule of Nondiscrimination in Taxing Foreign Direct Investment*, 26 LAW & POL'Y INT'L BUS. 113, 162 (1994) ("The political desire to engage in tax discrimination might reflect excessive discounting of future

Joint Committee on Taxation estimates that the repatriation rule will cost the U.S. government $70.6 billion between 2010 and 2014,[288] or approximately $14.1 billion annually. Between 1995 and 2009, it is estimated that the repatriation rule cost the U.S. government $51.3 billion.[289] However, as discussed in Section II(B)(1), eliminating the repatriation rule may result in a decline in U.S. business activity, reducing tax revenues and partially offsetting the direct tax benefits from eliminating the repatriation rule.[290] In addition, the Congressional Research Service believes that "the chief near-term economic impact of [increased] inversions is on U.S. federal tax revenues, which are reduced by the reorganizations."[291] However, the opportunity to increase tax revenues remains the strongest argument for eliminating the repatriation rule.

C. *Suggested Alternatives*

If, as President Coolidge is often quoted as saying, "the business of America is business,"[292] then, instead of viewing multinational corporations suspiciously, the United States should follow the United Kingdom's lead and seek to promote the competitiveness of U.S. corporations, increasing job opportunities for U.S. citizens.[293] Therefore, to reduce the rate at which U.S. corporations seek to move work overseas, President Obama should treat the problem's causes: high U.S. tax rates, a global system of taxation, and high regulatory costs.

> [Instead,] Congress [could continue trying] to close [loopholes], but companies that want to lower their taxes will still find a way to incorporate abroad, something made easier by the ability to raise capital through an I.P.O. anywhere in the world.
>
> Perhaps it is time for the United States to adopt a tax system more in line with the rest of the world. This does not

costs, attempts to achieve fiscal illusion, or attempts to benefit narrow interest groups."); Rebecca M. Kysar, *Listening to Congress: Earmark Rules and Statutory Interpretation*, 94 CORNELL L. REV. 519, 530 n.54 (2009).

288. JCOT REPORT, *supra* note 198, at 25.

289. *Id.* at 22–24.

290. *See id.* at 10 (stating that "[t]axpayer behavior is assumed to remain unchanged for tax expenditure estimate purposes . . . . to simplify the calculation and conform to the presentation of government outlays").

291. CRS REPORT 1, *supra* note 7, at 2. However, with the repatriation rule in place, the tax cost of inversions "is not enormous." *Id.* at 9.

292. *Calvin Coolidge*, VIRTUAL VERMONT, http://www.virtualvermont.com/history/ccoolidge.html (last visited Jan. 31, 2012).

293. Kies, *Response*, *supra* note 23, at 1146.

mean pandering to tax havens, but it should incentivize companies to bring their riches to the United States.[294]

Unfortunately, even after the defeat of President Obama's 2009 plan to weaken the repatriation rule, he is still seeking to make the U.S. tax code uniquely uncompetitive internationally with a new "international minimum tax" on overseas profits outlined in 2012.[295]

The President's proposal to weaken the repatriation rule can be predicted to cause U.S. companies to reincorporate abroad or sell themselves to foreign corporations.[296] Shifting to a territorial taxation system would encourage U.S. business activity by eliminating the primary incentive for corporate inversions and the sale of U.S. companies to foreign firms—that U.S. firms are taxed more heavily than foreign firms.[297] Thus, such a change could be expected to increase economic efficiency by allowing the most productive businesses to own capital assets, while also improving corporate finance decisions by removing the disincentive against repatriation.[298] Furthermore, shifting to a territorial system has the potential to increase U.S. production, investment, and employment.[299] This change may not result in an overly sizeable revenue loss, given the effect of the current repatriation rule, and could even result in increased revenues due to various features of the present worldwide taxation system.[300] A territorial system is also arguably fair, despite the fact that individuals are taxed on a worldwide

294. Davidoff, *supra* note 39.

295. President Barack Obama, Blueprint for an America Built to Last 4 (2012), *available at* http://www.whitehouse.gov/sites/default/files/blueprint_for_an_America_built_to_last.pdf. Note that an international minimum tax directly undermines deferral under the repatriation rule by taxing foreign income as it is earned.

296. The President has expressly rejected the territorial approach in his policies. Hanlon, *supra* note 208.

297. *See Obama's Global Tax Raid*, *supra* note 260; PERAB Report, *supra* note 19, at 89. The U.S. Treasury has also suggested that the United States "address the underlying differences in the U.S. tax treatment of U.S.-based companies and foreign-based companies." Treasury Report 1, *supra* note 50, at 2.

298. PERAB Report, *supra* note 19, at 89.

299. *Id.* at 85, 89 (noting that "[r]ecent studies have found positive relationships between both the domestic and foreign employment of U.S. MNCs and between their domestic and foreign investment levels").

300. *Id.* at 90 (referencing findings that "territorial tax systems with expense allocation rules based on the current rules used for the foreign tax credit [could] rais[e] between $40 billion and $76 billion over 10 years"); J. Clifton Fleming, Jr. et al., *Worse than Exemption*, 59 Emory L.J. 79, 84–85 (2009) (stating that the current tax regime gives "U.S. corporations a net advantage, at a significant cost to the public fisc").

basis, because corporations are simply the sum of shareholder interests[301] and corporate shareholders will still be subject to taxation on worldwide income.[302] One downside, however, to territorial taxation is that it might make it easier for companies to shift income to tax havens, avoiding U.S. taxation altogether.[303] Yet, given the incentives under the current system, this effect may be modest.[304]

As an alternative to adopting a territorial tax system, the United States could follow Canada's lead and lower its corporate tax rates. Canada dropped its corporate tax rates from 38% to 15% over the last thirty-two years, with tax revenues fluctuating based on economic growth and not declining with tax rates.[305] In fact, Canada collects 1.9% of GDP in corporate tax revenues with a 15% rate, while the United States only collects 1.6% of GDP with a 35% corporate tax rate.[306] U.S. marginal tax rates are the highest in the OECD.[307] Although some may argue that, due to the effect of credits and deductions, effective tax rates in the United States are competitive internationally even though United States' marginal tax rates are not,[308] it is marginal tax rates that companies use to make investment decisions.[309] These investment decisions are often new

301. Martin Gelter, *Taming or Protecting the Modern Corporation? Shareholder-Stakeholder Debates in a Comparative Light*, 7 N.Y.U. J.L. & BUS. 641, 666 (2011).

302. Some argue that deferral is unfair as corporate taxes should be based on ability to pay. *E.g.,* J. Clifton Fleming et al., *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299, 302, 311 (2001). However, nondeferral is inconsistent with the view that the availability of cash demonstrates ability to pay, as cash is not available until repatriation. *See* GERTZMAN, *supra* note 33, ¶ 3.01[1].

303. Clausing, *supra* note 52, at 1580.

304. PERAB REPORT, *supra* note 19, at 90.

305. *Canada Proves Cutting Corporate Tax Rates Makes Sense*, DCINSIDER (Mar. 18, 2012), http://dcinsider.com/election-2012/canada-proves-cutting-corporate-tax-rates-makes-sense/.

306. *Id.*

307. *See supra* Section I(B)(1).

308. *E.g.*, Bruce Bartlett, *Are Taxes in the U.S. High or Low?*, N.Y. TIMES, May 31, 2011, http://economix.blogs.nytimes.com/2011/05/31/are-taxes-in-the-u-s-high-or-low/. Effective tax rates hit their lowest point in forty years in 2011, at 12.1%, much lower than the average of 25.6% from 1987 to 2008. Damian Paletta, *With Tax Break, Corporate Rate Is Lowest in Decades*, WALL ST. J., Feb. 3, 2012, http://online.wsj.com/article/SB10001424052970204662204577199492233215330.html?mod=WSJ_business_whatsNews. Note the humor inherent in this argument, as the tax code is praised for being so complex that it is difficult to administer and is inefficient at collecting revenue, leading to low effective tax rates despite high marginal rates. *Obama's Global Tax Raid*, *supra* note 260.

309. Kenneth Rapoza, *Are US Companies Paying Too Much Taxes?*, FORBES (Sept. 9, 2011), http://www.forbes.com/sites/kenrapoza/2011/09/09/are-us-

corporate projects,[310] which may require the creation of new jobs. High corporate tax rates have been shown to increase the size of the informal economy and have large adverse effects on investment, foreign direct investment, and entrepreneurship.[311] Even President Obama's Economic Recovery Advisory Board stated that "[t]he high effective tax rates that apply to corporate investments result in significant economic distortions and a lower tax rate on corporate investments would result in desirable changes in a number of areas."[312] For instance, lowering the U.S. corporate tax rate could increase the competitiveness of the United States in attracting business activity.[313] Many proposals suggest lowering tax rates in a revenue-neutral fashion by broadening the corporate tax base.[314] There are also many arguments that this is a fair outcome, one being that shareholders are already taxed on the income received from corporations.[315] As lower rates also have the advantage of decreasing the incentive for corporations to shift income abroad, they could mitigate the problems created by a shift towards a territorial tax system.[316] Income shifting was estimated to cost the U.S. government $90 billion in 2008 alone, or 30% of corporate tax reve-

companies-paying-too-much-taxes/; *see* ASWATH DAMODARAN, APPLIED CORPORATE FINANCE 137 (3d ed. 2011).

310. Thus high tax rates are often associated with lower amounts of investment in a country. For the intuition, see TREASURY REPORT 2, *supra* note 274, at 29.

311. Simeon Djankov et al., *The Effect of Corporate Taxes on Investment and Entrepreneurship*, AM. ECON. J.: MACROECONOMICS 31, 31 (July 2010), *available at* http://pubs.aeaweb.org/doi/pdfplus/10.1257/mac.2.3.31.

312. PERAB REPORT, *supra* note 19, at 69. Several economic distortions associated with high corporate tax rates are provided in the PERAB REPORT at 65; DEP'T OF THE TREASURY, A RECOMMENDATION FOR INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS 1 (1992), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/recommendation-for-integration.pdf.

313. PERAB REPORT, *supra* note 19, at 70; Kenneth Hamner, *Comparing the Legal Structure and Business Climate of the Commonwealth Caribbean and the People's Republic of China for Foreign Direct Investment*, 2001 FLA. ST. U. BUS. REV. 195, 197 (stating that "government incentives, such as low corporate tax rates on International Business Companies attract foreign direct investment to the Caribbean"); Susan C. Morse, *Revisiting Global Formulary Apportionment*, 29 VA. TAX REV. 593, 629 (2010).

314. *E.g.*, PERAB REPORT, *supra* note 19, at 72. This has been a goal of tax reform since the 1970s. DEP'T OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 1–2 (1977), *available at* http://www.treasury.gov/resource-center/tax-policy/Pages/blueprints-index.aspx [hereinafter TREASURY REPORT 3]. Even the President has called for broadening the tax base to lower rates. Jackie Calmes, *Obama Offers to Cut Corporate Tax Rate to 28%*, N.Y. TIMES, Feb. 22, 2012, at B1, *available at* http://www.nytimes.com/2012/02/22/business/economy/obama-offers-to-cut-corporate-tax-rate-to-28.html?_r=3&ref=Business&nl=Business&emc=dlbka35.

315. *See* TREASURY REPORT 3, *supra* note 314, at 68.

316. Clausing, *supra* note 52, at 1580.

nues.[317] Thus, ideally a territorial tax system with lower tax rates would be implemented to enhance U.S. competitiveness and support growth, as OECD analysis has found that "corporate taxes are the most harmful type of tax for economic growth."[318]

As discussed in Section I(B)(3) and I(D), Congress has often taken actions to make corporate inversions more difficult in response to periods of high inversion activity. In effect, Congress is seeking to create barriers to exit for U.S. companies. The unrecognized cost of these actions is that high barriers to exit discourage entry, as potential investors in U.S. corporations realize that they will be forced to make a substantial and lengthy commitment to the United States despite changing business conditions and regulatory regimes.[319] By restricting capital flows, anti-inversion legislation results in an inefficient allocation of resources. Thus, a better U.S. policy would freely allow corporate inversions, encouraging the creation of businesses incorporated in the United States. This policy would also be beneficial as inversion activity could then provide lawmakers and the public with indicia of the competitiveness of U.S. policies and business regulation internationally.[320]

Another suggested alternative is to streamline U.S. regulations, which would support territorial taxation and lower tax rates in reducing the incentive for corporate inversions. Some targets for modification may include SOX, the FCPA, Dodd-Frank, the securities litigation system, and other regulations mentioned in Section I(C). Performing a cost-benefit analysis on the controversial provisions of existing laws and regulations may provide a means for assessing the desirability of changing the existing regulatory structure and for setting priorities for legislative action.

317. *Id.*

318. CTR. FOR TAX POLICY & ADMIN., OECD, TAX POLICY STUDY NO. 20 - TAX POLICY REFORM AND ECONOMIC GROWTH 10 (2010), *available at* http://www.oecd.org/ctp/tax-policy/46617652.pdf.

319. *See* Ignacio Mas, *Transforming Access to Finance in Developing Countries through Mobile Phones: Creating an Enabling Policy Framework*, 27 BANKING FIN. L. REV. 285, 296 (2012).

320. For instance, in 2002, before the anti-inversion American Jobs Creation Act of 2004, the U.S. Treasury stated that "the recent inversion activity and the increase in foreign acquisitions of U.S. multinationals are evidence that the competitive disadvantage caused by our international tax rules is a serious issue with significant consequences for U.S. businesses and the U.S. economy." TREASURY REPORT 1, *supra* note 50, at 2.

CONCLUSION

The United States is an outlier internationally with high tax rates and global taxation of domestic firms.[321] Corporate inversions are a self-help method for U.S. corporations to avoid these tax burdens and to reduce regulatory costs to a more competitive level internationally.[322] Thus, waves of corporate inversions receive policy responses that tend to slow or stop inversions until market conditions or structural innovations create renewed interest.[323] However, a 2002 Treasury report provided that:

> [T]he policy response to . . . corporate inversion activity should . . . address the underlying differences in the U.S. tax treatment of U.S.-based companies and foreign-based companies, without regard to how foreign-based status is achieved. Measures designed simply to halt inversion activity may address these transactions in the short run, but there is a serious risk that measures targeted too narrowly would have the unintended effect of encouraging a shift to other forms of transactions to the detriment of the U.S. economy in the long run.[324]

President Obama's proposal to reform the repatriation rule not only ignore the Treasury's conclusion, but actually exacerbates the differences in tax treatment between U.S.- and foreign-based companies. Through an analysis of the natural extension of the President's plan, the elimination of the repatriation rule, the plan appears likely to lessen the competitiveness of U.S. firms and to lower their valuations; to increase corporate inversions and sales of U.S. firms to foreign corporations; to decrease exports, investment in the United States, and employment; and to damage U.S. national security. Many of these anticipated results were realized in practice after the repatriation rule was removed for the U.S. shipping industry in 1986.[325] As arguments concerning increased U.S. investment and improved fairness in the tax code are flawed, the only strong argument for the elimination of the repatriation rule and the Presi-

321. PERAB Report, *supra* note 19, at 84 ("The United States is the only major developed country economy that uses a worldwide (with deferral) approach to the taxation of corporate income . . . . Additionally, all of the developed countries . . . have a lower statutory corporate tax rate than the United States."). In addition, the U.S. Treasury has stated that "no country has rules for the immediate taxation of foreign-source income that are comparable to the U.S. rules in terms of breadth and complexity." Treasury Report 1, *supra* note 50, at 28.

322. Earnings shifting strategies are another self-help method.

323. Peterson & Cohen, *supra* note 8, at 188.

324. Treasury Report 1, *supra* note 50, at 2.

325. Kies, *A Perfect Experiment*, *supra* note 200.

dent's proposal, besides scoring political points, is to benefit the public fisc.[326] Yet, from 2010 to 2014, incremental tax revenues without the repatriation rule were only expected to be $14.1 billion annually, not considering any associated declines in tax revenues from reduced business activity.[327] Thus, a more attractive alternative may be to streamline regulations, and shift to a territorial tax system with decreased corporate tax rates. However, if, instead of implementing the economically rational solutions of removing regulatory costs and creating a competitive tax system, the United States decides to diminish the benefit of the repatriation rule solely for tax revenues at the expense of future economic growth, the road to economic recovery looks long and arduous indeed.

326. A system of worldwide taxation may also be beneficial for simplification, compliance, and enforcement. PERAB REPORT, *supra* note 19, at 93.

327. JCOT REPORT, *supra* note 198, at 25.

APPENDIX

Exhibit 1: Corporate Income Tax Rates by Country.[328]

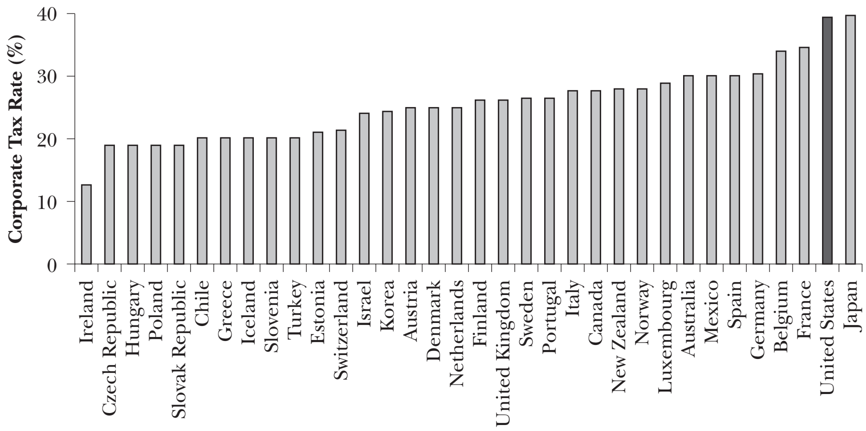
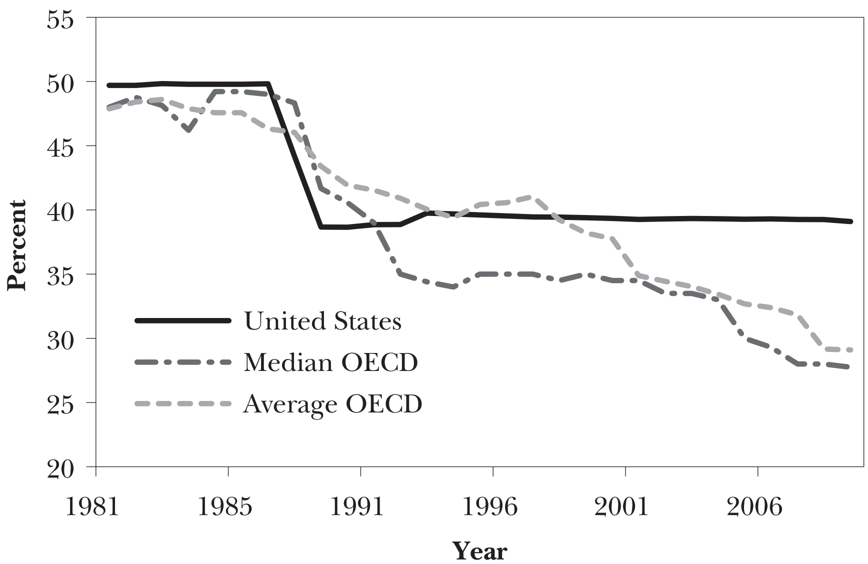


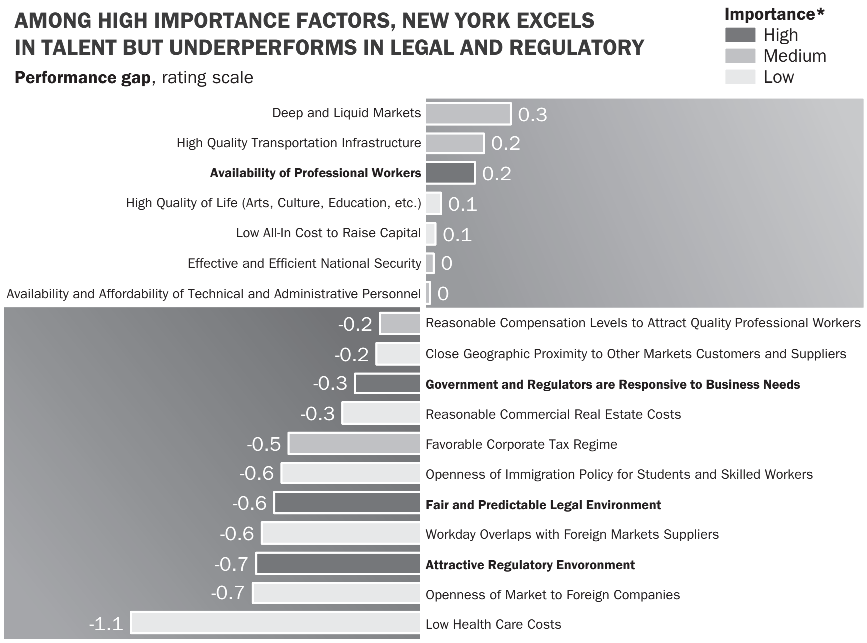
Exhibit 2: Top Statutory Corporate Tax Rates.[329]



328. Author-generated table. Data from *OECD Tax Database*, OECD, http://www.oecd.org/tax/tax-policy/oecdtaxdatabase.htm (follow "Basic (non-targeted) corporate income tax rates" hyperlink) (last visited Jan. 2012) (used combined corporate income tax rate). Note that the U.S. combined corporate rate includes a weighted average of state corporate income tax rates. *Id.*

329. PERAB REPORT, *supra* note 19, at 68 fig.4.

Exhibit 3: Analysis of New York's Relative Competitiveness in Key Areas to Financial Service Firms.[330]

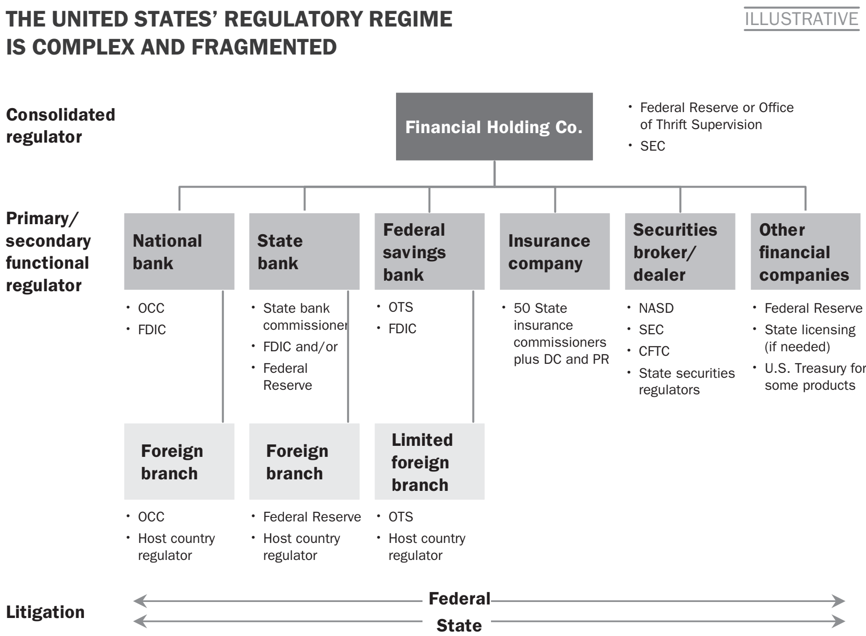


* High importance factors were rated between 5.5-6.0 on a 7-point scale; medium between 5.0-5.4; low were less than 5.0

Source: McKinsey Financial Services Senior Executive Survey

330. McKinsey & Co., *supra* note 24, at 15.

Exhibit 4: Regulators in U.S. Corporations' Corporate Structures.[331]



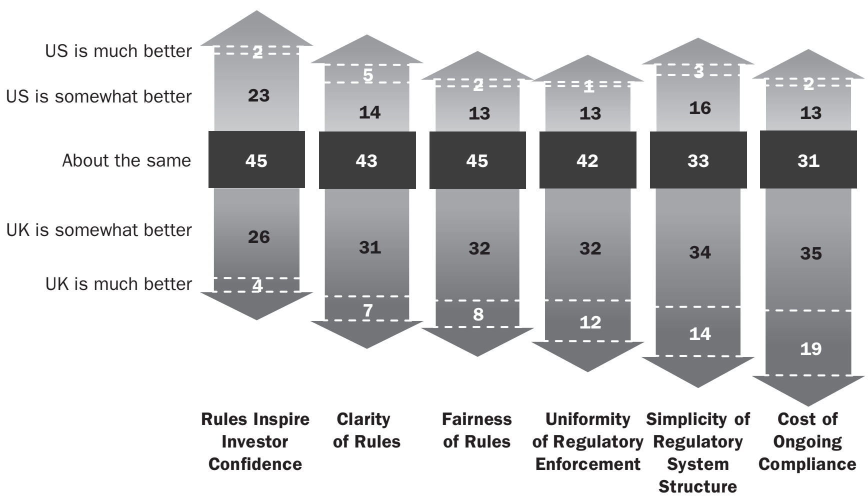
331. *Id.* at 81.

Exhibit 5: Preference for U.S. versus U.K. Regulatory System by Category.[332]

UK IS PREFERRED ACROSS MANY REGULATORY DIMENSIONS
BUT IS MOST DISTINGUISHED IN COST AND SIMPLICITY OF REGULATIONS

Ranking by response, Percent

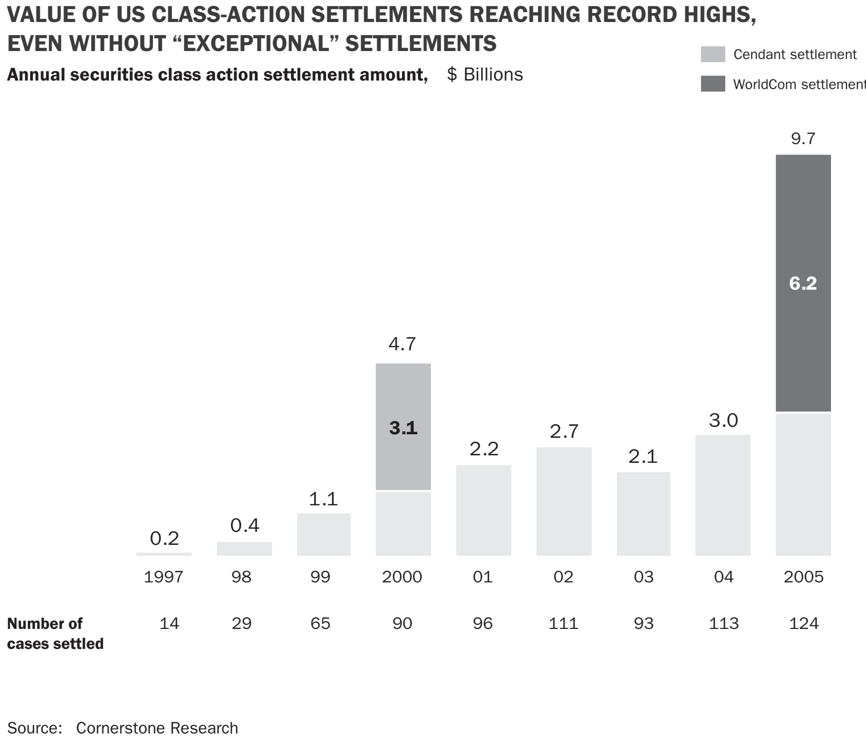
Which regulatory environment is more business-friendly?



Source: McKinsey Financial Services Senior Executive Survey

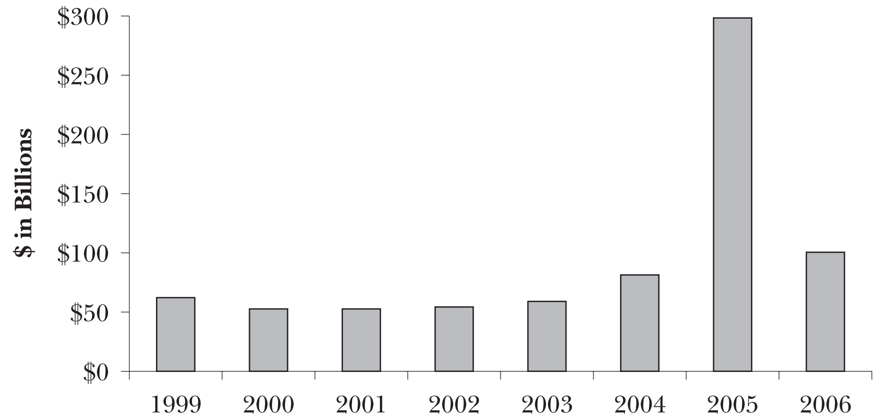
332. *Id.* at 86.

Exhibit 6: Value of U.S. Class Action Settlements.[333]



333. *Id.* at 75.

Exhibit 7: Funds Repatriated by U.S. Multinational Corporations.[334]



334. Author-generated table. Data from *International Data*, U.S. Dep't of Commerce, Bureau of Econ. Analysis, http://www.bea.gov/iTable/iTable.cfm?ReqID=6&step=1 (from Line 3 ("Distributed Earnings") of Table 7a) (last visited Nov. 4, 2012).