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# The Aftermath of a King Renouncing his Citizenship: A Closer Look at Recent Trends of Corporate Inversions in America

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THE AFTERMATH OF A KING RENOUNCING HIS  
CITIZENSHIP:  
A CLOSER LOOK AT RECENT TRENDS OF  
CORPORATE INVERSIONS IN AMERICA

*Gerrard L. Grant*\*

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I. INTRODUCTION

Does it get any more Canadian than Justin Bieber, Drake, or watching fans tirelessly scream the Toronto Raptors' chant, "We the North!" at basketball games? How about hearing that trademark interjection, "eh," when conversing with a true *Canuck*? As a thought, would foodies ever consider a snack consisting of Burger King's Poutine and Tim Hortons' maple doughnuts as the new Canadian specialty? Probably not. Throughout 2014, the world's attention focused on Canada as news media shared an unexplained romanticism with the controversial, yet animated, late Toronto Mayor, Rob Ford.<sup>1</sup> Also during that year, U.S. fast food giant Burger King Worldwide Inc. ("Burger King") made plans to acquire Canadian coffee and donut juggernaut Tim Hortons Inc. ("Tim Hortons"), and move its headquarters to Canada.<sup>2</sup> The publicity surrounding this deal shifted attention away from Mayor Ford to the corporate tax rates of the Great White North. The notion of Canada as a desired location for Burger King, a U.S. multinational corporation ("U.S. MNC"), to lower its tax burden was akin to hitting the jackpot - an easily accessible tax haven. But whether the fast food giant acquired a cash cow by purchasing Tim Hortons, or whether it was part of a master plan to lower taxes, the acquisition raised serious political concerns and provoked public outcry among citizens.<sup>3</sup>

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<sup>1</sup> Michelle McQuigge, *World Media Flock To Cover Latest Rob Ford Scandal*, GLOBAL NEWS, (May 1, 2014), <http://perma.cc/4AW6-CF7E>.

<sup>2</sup> Liz Hoffman & Diana Mattioli, *Burger King May Buy Canada's Tim Hortons to Cut its Taxes*, WALL ST. J., (Aug. 24, 2014), <http://perma.cc/FKM2-YJL6>; See generally, *Industry Minister Champions Canada as Number One Country in the World to Do Business*, GOV'T OF CAN., (Sept. 18, 2014), <http://perma.cc/4ULX-ZPS9>; See also, *Canada Remains Most Competitive Business Tax Environment Worldwide*, KPMG, (Jun. 17, 2014), <http://perma.cc/2ETQ-B3RV>.

<sup>3</sup> Constantine Von Hoffman, *Burger King Could Face Public Backlash Over Deal*, CBS MONEYWATCH, (Aug. 26, 2014), <http://perma.cc/PP9C-WK5F>.

Over the past thirty years, U.S. MNCs have reincorporated overseas by using a strategy known as a corporate inversion to reduce their tax liabilities.<sup>4</sup> According to the Congressional Research Service, in the ten-year period from 2004 to 2013, approximately forty-seven U.S. MNCs inverted compared to the twenty-nine that did so over the twenty-year period from 1983 to 2003.<sup>5</sup> Economists Mihir A. Desai and James R. Hines, Jr. conducted a study on corporate inversions and identified contributing factors influencing domestic firms to relocate. The study revealed that higher corporate tax rates in the U.S. compared to those in other developed nations are a leading factor causing firms to invert.<sup>6</sup> The study also determined that heavily leveraged firms are more likely to invert, as well as those having operations in low tax jurisdictions.<sup>7</sup> But in addition to tax savings that inverted firms enjoy, another factor impacting their decision to relocate was shareholder expectations of increased profitability.<sup>8</sup> Sophisticated deal structuring and tax planning are critical components to improving a firm's bottom-line performance.<sup>9</sup> Post-recession, the inversion dilemma brought worldwide attention

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<sup>4</sup> Deborah L. Paul & Michael B. Love, *A Perfect Storm for Corporate Inversions: Causes and Responses*, 43 TAX MGMT. INT'L J. (BNA) No. 11 at 671 (Nov. 14, 2014), available at <http://perma.cc/Y5LJ-MDB9>.

<sup>5</sup> Gregory Wallace, *More Companies Bail on U.S. for Lower Taxes*, CNN MONEY, (Jul. 7, 2014), <http://money.cnn.com/2014/07/07/news/economy/tax-advantage-inversion>.

<sup>6</sup> Mihir A. Desai & James R. Hines, Jr., *Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions* 3 (Nat'l Bureau of Econ. Research, Working Paper No. 9057, 2002), available at <http://perma.cc/PZN2-C647> (last visited September 26, 2014).

<sup>7</sup> *Id.*

<sup>8</sup> Anne Tucker, *Curbing Corporate Inversions Through Public Pressure for Economic Patriotism*, HUFFINGTON POST, (Aug. 20, 2014), <http://perma.cc/ADT9-2J93>.

<sup>9</sup> CFO Research Services and Deloitte Tax LLP, *What Do Companies Want from the Corporate Tax Function? CFO and Tax Executives' Perspectives on Corporate Tax*, CFO Publishing Corp., November 2006, available at [http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/us\\_tax\\_cfo\\_what\\_companies\\_want\\_1611\\_06.pdf](http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/us_tax_cfo_what_companies_want_1611_06.pdf) (last visited September 15, 2014).

as the global business environment has become exceedingly competitive, especially for domestic firms. U.S. MNCs seeking to expand their international presence are paying closer attention to market trends by strategically aligning operations in the most cost-effective manner possible. For instance, Seattle-based coffee giant Starbucks has a global market capitalization of \$40 billion and is the world's second-largest restaurant chain behind McDonald's.<sup>10</sup> Since 1998, its European subsidiary, Starbucks UK, generated £3 billion in revenues.<sup>11</sup> In the three-year period preceding 2012 and despite having £1.2 billion in revenues, Starbucks UK reported zero profits and paid no taxes.<sup>12</sup> By comparison, McDonald's European division grossed £3.6 billion in revenues and had a £80 million tax liability.<sup>13</sup> Starbucks UK accomplished this by engaging in "tax gimmickry" through housing its intellectual property units in tax havens and then charging their subsidiaries that operate in high tax jurisdictions significant royalty fees that artificially reduced their profits.<sup>14</sup> As British lawmakers became aware of this, Starbucks UK was admonished for engaging in questionable tax practices and was called on the carpet for its failure to act as a moral exemplar throughout the European business community.<sup>15</sup>

Unlike other notable corporate inversions that have occurred, this article focuses on relevant non-tax factors impacting inversion transactions, and the recent and highly publicized Burger King acquisition of Tim Hortons. It also examines political and social considerations regarding this tax saving strategy. Section I provides a general overview of a corporate inversion and tax disparities between domestic and foreign firms. Section II provides insight on political and social factors impacting U.S. firms during

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<sup>10</sup> Tom Bergin, *UK Committees to Examine Starbucks Tax Strategies*, Reuters, (Oct. 15, 2012), <http://uk.reuters.com/article/2012/10/15/us-britain-starbucks-taxidUKBRE89E0EX 20121015>.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> Megan Gibson, *U.K. Slams 'Immoral' Tax Practices of Multinational Companies*, TIME MAG. (Dec. 3, 2012), <http://perma.cc/K3AH-ZSD4>.

pre- and post- inversion phases. Lastly, Section III covers past and current legislative efforts to prevent corporate inversions and their overall effectiveness to curtail such activity.

Evaluating both non-tax and tax costs and benefits of inverting is a complex undertaking. The crux of the inversion dilemma impacting the U.S. is a symptom of a much larger problem - the compelling need to bring meaningful reform to U.S. corporate tax policies. Tax reform should focus on developing policies that build a solid framework to promote a tax friendly environment for domestic firms to compete globally. Whether or not Canada is the “next” tax haven is irrelevant. Further, should a U.S. MNC with tax attributes similar to Burger King obtain Canadian citizenship is also a moot point. An undisputed fact remains, there is a dire need to implement impactful change to U.S. tax laws to deter inversions and prevent further erosion of the corporate tax base. If progressive steps are taken to reform U.S. corporate tax policies, the incidence of domestic firms that relocate overseas should decrease. Alternatively, should a firm explore the option of relocating overseas, then its stakeholders ought to consider the universe of non-tax factors in conjunction with potential tax savings it expects to reap from inverting.

## II. CORPORATE INVERSIONS

### A. Overview

A corporate inversion (an “inversion”) is a transaction, or series of transactions, in which the parent corporation (the “parent”) of a U.S. MNC reincorporates overseas and is replaced by a new foreign parent to avoid taxes.<sup>16</sup> This newly formed entity maintains every aspect of its being prior to inverting, except for its nationality. The Internal Revenue Code (the “Code”) treats an

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<sup>16</sup> U.S. Department of Treasury, Fact Sheet: *Treasury Actions to Rein in Corporate Tax Inversions*, <http://perma.cc/R2ZG-DLCR> (last visited September 22, 2014); Donald J. Marples and Jane G. Gravelle, *Corporate Expatriation, Inversion, and Mergers: Tax Issues*, Congressional Research Service, September 24, 2014, available at <http://perma.cc/XAJ5-QD66> (last visited October 5, 2014).

entity not organized in the U.S. as a foreign person for tax purposes.<sup>17</sup> Tactical mergers between firms worldwide can strengthen the U.S. economy by enabling domestic firms to invest overseas while also increasing domestic capital investment.<sup>18</sup> A firm's corporate growth plans should thrive on genuine business strategies and economic efficiencies, rather than simply relocating to a low-tax jurisdiction.

An inversion is accomplished by using one of the following methods: (1) a stock transaction; (2) an asset transaction; or (3) a combination, known as a "drop down" transaction.<sup>19</sup> For example, in a stock transaction, shareholders of a domestic subsidiary (i.e., the former U.S. parent) exchange stock for shares of a new foreign parent.<sup>20</sup> In turn, the foreign parent acquires stock in the domestic subsidiary.<sup>21</sup> In an asset transaction, assets of a domestic subsidiary are transferred to a new foreign parent, and conversely, the domestic subsidiary's shareholders receive stock in the foreign parent.<sup>22</sup> Lastly, in a drop down transaction, a domestic subsidiary's shareholders receive stock in the new foreign parent in exchange for stock and assets belonging to the domestic subsidiary.<sup>23</sup>

From a practical standpoint, when a firm contemplates inverting, it has an expectation that post-inversion tax savings will handsomely exceed transactional costs.<sup>24</sup> For instance, prior to moving to Bermuda in the mid-1990s, Tyco International Limited

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<sup>17</sup> IRS, *Classification of Taxpayers for U.S. Tax Purposes*, <http://perma.cc/JD2Z-GQYD> (last updated May 28, 2014).

<sup>18</sup> Matthew J. Slaughter, *How U.S. Multinational Companies Strengthen the U.S. Economy*, *United States Council Foundation* (Spring 2009), (at 19-23), <http://perma.cc/YHT7-NB2T>.

<sup>19</sup> Desai & Hines, *supra* note 6, at 9.

<sup>20</sup> James Mann, *Corporate Inversions: A Symptom of a Larger Problem*, *The Corporate Income Tax*, 78 S. CAL. L. REV. 521, 525 (2005).

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> Bernie Pistillo, Joy MacIntyre & Thomas Humphreys, *The Inversion Craze: Will Today's Routine Tax Planning Be Retroactively Outlawed?*, *Morrison Foerster Client Alert* (July 21, 2014), (at 2), <http://perma.cc/GH45-SLMH> (last visited October 1, 2014).

(“Tyco”) projected having net annual tax savings of approximately \$400 million.<sup>25</sup> Domestic firms seeking to reduce their U.S. tax liabilities contemplate the ease of relocating overseas *via*, “paper form,” as a practical means to achieve the desired objective.<sup>26</sup> Executing an inversion strategy could be ideal for a domestic firm that has income attributes similar to their foreign counterparts and a significantly higher tax liability. To illustrate, when comparing corporate tax rates of nations that comprise the Organization for Economic Cooperation and Development (“OECD”), the U.S. ranks in first place with the highest tax rate of 39.1% compared to the average tax rate of 25.5% for other OECD member nations.<sup>27</sup> A closer examination of this disparity reveals the harsh realities influencing the inversion dilemma. Should Congress decide to drastically alter current approaches to combat inversions, which will be discussed later in this article, begs the question of whether the number of U.S. firms that invert would dramatically increase and further erode the corporate tax base. In 2008, the Department of the Treasury (the “Treasury”) estimated that inversions cost the U.S. between \$57 billion and \$90 billion annually in tax revenues, representing 30% of total U.S. corporate revenues and is expected to increase over time.<sup>28</sup>

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<sup>25</sup> Stuart Webber, *Escaping the U.S. Tax System: From Corporate Inversions To Re-Domiciling*, *Tax Notes Int’l*, 63, No. 4, July, 25, 2011, at 277, *available at* <http://perma.cc/BT3T-G2QB> (last visited September 25, 2014); Mann, *supra* note 19, at 526.

<sup>26</sup> Alexandra Thornton, *The Skinny on Corporate Inversions*, CENTER FOR AMERICAN PROGRESS, (Sept. 25, 2014), <http://perma.cc/6QTH-538K>; Scott A. Hodge, *The Countdown is Over. We’re #1*, THE TAX FOUND., (Apr. 1, 2012), <http://perma.cc/6QTH-538K>.

<sup>27</sup> *OECD Corporate Income Tax Rates, 1981-2013*, THE TAX FOUND., <http://perma.cc/C6DJ-J3SB> (last visited August 13, 2014).

<sup>28</sup> Mark P. Keightley, *An Analysis of Where American Companies Report Profits: Indications of Profit Shifting*, CONG. RESEARCH SERV., (Jan. 18, 2013) <http://perma.cc/Z7HT-8DRH>; Kimberly A. Clausing, *The Revenue Effects of Multinational Firm Income Shifting*, *TAX NOTES*, March 28, 2011, at 1580-1586.



## B. The American Tax System

The U.S. has a worldwide tax system.<sup>29</sup> Under that system, income earned by a U.S. person regardless of its source is subject to tax.<sup>30</sup> The Code provides U.S. taxpayers with a tax credit to offset foreign tax paid to avoid double taxation.<sup>31</sup> In contrast to the worldwide tax system, countries such as, France, Canada, Germany, the Netherlands, and the UK,<sup>32</sup> have a territorial tax system that exempts from taxation income derived from foreign sources.<sup>33</sup> Under the territorial tax system, only income earned within a country's borders is subject to tax.<sup>34</sup> For instance, a French MNC with income earned in Ireland would be subject to the taxing authority in Ireland, and not one in France. Understanding taxing regimes under both systems is critical when showing disparities in tax liabilities incurred by domestic and foreign firms having similar income attributes. For instance, the tax treatment of a domestic firm and foreign firm with U.S. source income would be neutral under both systems. Assuming that both are in the highest tax bracket, each pays a maximum tax rate of 39.1%. On the other hand, when income is earned in multiple jurisdictions with differing tax rates, such tax disparity becomes more apparent.

To illustrate, assume that Domestic is a U.S. MNC and Foreign is a Canadian MNC, both of which sell widgets in the U.S., Ireland, and Bermuda. The maximum tax rates in those countries are 39.1%, 12.5%, and 0%, respectively. Also note that Canada's

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<sup>29</sup> Curtis S. Dubay, *A Territorial Tax System Would Create Jobs and Raise Wages for U.S. Workers*, THE HERITAGE FOUND. (Sept. 12, 2013), <http://perma.cc/ZH9D-ZHMD>.

<sup>30</sup> 26 U.S.C. § 61(a) (2014); Philip Dittmer, *A Global Perspective on Territorial Taxation*, THE TAX FOUND. (Aug. 10, 2012), <http://perma.cc/QDJ9-QS87>.

<sup>31</sup> 26 U.S.C. §§ 164, 901 (2014); IRS Topic 856-Foreign Tax Credit, *available at* <http://perma.cc/JZ3L-G8AT> (last updated August 28, 2014).

<sup>32</sup> PricewaterhouseCoopers, *Evolution of Territorial Tax Systems in the OECD* – Prepared For the Technology CEO Council, April 2, 2013, at 3, *available at* <http://perma.cc/LT33-3KJK> (last visited September 17, 2014).

<sup>33</sup> Dittmer, *supra* note 29.

<sup>34</sup> *Id.*

corporate tax rate is 26.5% and it has a territorial tax system, unlike the U.S.'s worldwide tax system. Further assume that each entity pays the maximum tax rate in each country. Given those facts, Domestic and Foreign each pay tax at 39.1% on income from U.S. widget sales. Domestic pays 39.1% on income from Irish widget sales while Foreign pays 12.5%. However, Domestic can apply a foreign tax credit of 12.5% to offset its U.S. tax liability from tax paid to Ireland, ultimately paying 26.6%. Foreign is not subject to tax on Irish widget sales from the Canadian taxing authority.

Under the territorial tax system, Foreign benefits by paying 0% tax on income from Bermudan widget sales. On the other hand, Domestic still pays tax of 39.1%. In this last instance, Domestic has no foreign tax credit offset from Bermudan widget sales. Overall, Domestic pays an aggregate tax of 117.3% compared to Foreign that pays 51.6%. This simplified illustration shows the tax impact incurred by MNCs subject to the worldwide tax system.

### III. TO INVERT OR NOT, THAT IS THE QUESTION

#### A. Closer Look At The Burger King Transaction

In mid-2014, Burger King made headlines worldwide when it announced plans to acquire Tim Hortons in addition to making Canada the location for its new headquarters.<sup>35</sup> Executives from both firms supported this move, first because Tim Hortons was regarded as a Canadian icon, and second, because Canadian regulators would be more inclined to approve the merger if Burger King was headquartered in Canada.<sup>36</sup> In 1995, another fast food titan, Wendy's Co. ("Wendy's"), purchased Tim Hortons and maintained its corporate headquarters in the U.S. until Tim

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<sup>35</sup> Chris Isadore & Jeanne Sahadi, Burger King buying Tim Hortons, CNN MONEY, (August 27, 2014), <http://perma.cc/N4UJ-2VBS> (last visited September 10, 2014).

<sup>36</sup> Sergio Hernandez, 4 Perspectives on Burger King's Move to Canada, THE WEEK, September 6, 2014, *available at* <http://perma.cc/B5XX-9TD8> (last visited September 16, 2014).

Hortons was sold in 2005.<sup>37</sup> Nearly two decades had passed without any mention of Canadian regulatory issues pertaining to that acquisition. So, the question remains regarding why was Burger King so adamant to seek approval from Canadian regulators when it acquired Tim Hortons in 2014. According to Burger King officials, moving to Canada was a prudent business decision when considering that 80% of its stores would be located there.<sup>38</sup> In addition, this move was very feasible as two-thirds of its revenue source was projected to come from Canada.<sup>39</sup> Nonetheless, aside from rumors labeling the deal as a “classic inversion,” getting different perspectives from key players behind the scenes provides insight regarding Burger King’s motives to relocate.

Chief Executive Officer Daniel Schwartz firmly stated that relocating Burger King’s headquarters would not generate “meaningful tax savings.”<sup>40</sup> Bolstering that claim, Executive Chairman Alexandre Behring stated that, “this is not a tax-driven deal,” and when combined with Tim Hortons, its biggest market was Canada - making it the most logical place for its new headquarters.<sup>41</sup> But regardless of whether news sources confirmed both bosses’ insights on potential tax savings, a study conducted by KPMG suggested that Burger King’s move to Canada would provide it with significant tax benefits.<sup>42</sup> In fact, the KPMG study revealed that overall tax costs for Canadian firms were almost 46.4% lower compared to those for U.S. firms.<sup>43</sup>

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<sup>37</sup> Anupreeta Das and Liz Hoffman, Berkshire, Burger King Deal Draws Criticism Over Taxes, WALL STREET JOURNAL, August 26, 2014, available at <http://perma.cc/B9UC-KCRN> (last visited September 2, 2014).

<sup>38</sup> Isadore and Sahadi, *supra* note 35.

<sup>39</sup> *Id.*

<sup>40</sup> Zachary Mider, *Burger King Claim that Move Won’t Save Taxes Draws Skepticism*, BLOOMBERG BUS., Sept. 3, 2014, <http://perma.cc/59B6-XAKL>; Julie Jargon, *Burger King Defends Plan to Buy Tim Hortons Company Says Global Expansion Ambitions, Not Tax Considerations, Fueling \$11 Billion Deal*; Wall St. J., Aug. 26, 2014, <http://perma.cc/VG54-NAE7>.

<sup>41</sup> Mider, *supra* note 40.

<sup>42</sup> Candice Choi & Michelle Chapman, *Hard to swallow? Burger King may move to Canada* (Aug. 25, 2014), <http://perma.cc/9J4G-5DWY>.

<sup>43</sup> *Id.*

The infamous sound bite promoted by Burger King that, “this transaction was not driven by tax considerations,” did not end with the firm’s plea attempts to deter rumors that the transaction was heavily tax motivated. Billionaire investor Warren Buffett who agreed to advance \$3 billion of the \$11 billion purchase price insisted that Tim Hortons’ strong Canadian roots was one of the key reasons for its relocation.<sup>44</sup> Throughout the deal’s negotiations, Buffett maintained a low profile avoiding commentary on tax issues for obvious reasons.<sup>45</sup> As one can imagine, the investment mogul was caught between a rock and a hard place. His past statements condemning tax loopholes favoring the wealthy had become synonymous with his namesake coining the term, the “Buffett Rule” - a tax fairness principle advocating for the wealthy to pay more taxes.<sup>46</sup> Despite this predicament that he may have found himself in, it was business as usual for the Berkshire-Hathaway CEO. Notwithstanding efforts to portray the deal as one based primarily on non-tax considerations, Edward Kleinbard, a former partner at the international law firm of Cleary Gottlieb Steen & Hamilton LLP and tax professor at the University of Southern California, commented on the deal’s specs by stating that, “If they don’t see any tax benefits going forward, they are probably not looking very hard.”<sup>47</sup> Other tax scholars chiming in on potential tax benefits reaped by Burger King’s move to Canada shared similar views.<sup>48</sup>

Even across the pond, London news source, Reuters, reported that Burger King’s decision to relocate was consistent with its past efforts to implement an aggressive tax-reduction strategy.<sup>49</sup> This

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<sup>44</sup> Simon Neville, *Burger King buys Tim Hortons: The 'hypocrisy' of Warren Buffett*, *The Independent*, (August 27, 2014), <http://perma.cc/PW7V-QJGE> (last visited September 15, 2014); Jonathan Topaz, *Warren Buffett stands by Burger King deal*, *Politico*, (September 18, 2014), <http://perma.cc/8ZKF-FEFD> (last visited October 22, 2014).

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> Mider, *supra* note 40.

<sup>48</sup> *Id.*

<sup>49</sup> Tom Bergin, *Burger King Has Maneuvered To Cut U.S. Tax Bill For Years*, *Reuters*, September 2, 2014, *available at* <http://perma.cc/Z7YY-GJAK> (last

firm that created its trademark phrase, “Have it Your Way!” had domestic and overseas regulatory filings revealing that it was in the process of making major advances to reduce its U.S. tax liability.<sup>50</sup> In fact, since 2013 it maintained a 26% effective tax rate over the past three years that was significantly lower than other comparable firms, such as, McDonalds, Starbucks, and Dunkin Brands Group, which all had tax rates in excess of 31%.<sup>51</sup> Reuters also cited accounting experts who predicted that Burger King’s move to Canada would further accelerate reduction of its worldwide tax liabilities that would lead to a zero percent tax rate on U.S. sourced income.<sup>52</sup>

## B. Legal Standards Among Jurisdictions

In the landmark case *Gregory v. Helvering*,<sup>53</sup> Justice Learned Hand’s infamous quote that, “[a]nyone may arrange his affairs so that his taxes shall be as low as possible” has been widely accepted by taxpayers. Domestic firms that invert to amply benefit from that principal have become public targets for purportedly lacking patriotism.<sup>54</sup> In fact, within days after Burger King announced plans to relocate overseas, it received public admonishment from notable politicians urging the American public to boycott its stores.<sup>55</sup> However, beyond political and social factors impacting a domestic firm’s decision to invert, potential legal issues are overlooked in the midst of Wall Street hype and intense media frenzies.

In the U.S., more than 50% of publicly traded companies, which

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visited September 18, 2014).

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> *Gregory v. Helvering*, 69 F.2d 809, 810 (2d Cir. 1934), *aff’d*, 293 U.S. 465 (1935).

<sup>54</sup> Mann, *supra* note 19, at 522.

<sup>55</sup> Alan Pyke, *Burger King’s Move To Dodge American Taxes Not Going Over Well*, THINKPROGRESS (Aug 26, 2014), <http://perma.cc/TK8Y-K53P>; Constantine Von Hoffman, *Burger King Could Face Public Backlash Over Deal*, CBS MONEYWATCH (Aug. 26, 2014), <http://perma.cc/U3T7-XUZ3>.

includes 64% of Fortune 500 corporations, are incorporated in Delaware.<sup>56</sup> Under Delaware law, directors of a Delaware corporation are charged with having a fiduciary duty to that corporation and its stockholders when making a business decision.<sup>57</sup> It is without question that deciding to invert is a business decision for directors to consider through exercising professional judgment and discretion.<sup>58</sup> That decision is not intended to have an objective of seeking the Treasury's best interest, or is driven by personal morals and beliefs.<sup>59</sup> Every board has a duty to maximize a firm's value and share price, and therefore, should employ a best efforts approach to accomplish that objective.<sup>60</sup>

To date, most inversions have taken place in Bermuda.<sup>61</sup> Unlike Delaware, Bermuda is a director-friendly jurisdiction that does not impose restrictions against insider trading, and permits shareholder lawsuits in very rare circumstances.<sup>62</sup> Further, Bermudan corporate directors are bound by lower fiduciary standards compared to those in Delaware. For example, in Bermuda, "A director has a duty to act honestly and in good faith with a view towards the best interest of the company."<sup>63</sup> Generally, the difference in director responsibility under both jurisdictions can be summarized as follows: In Delaware, a director

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<sup>56</sup> State of Del., Dep't of State Div. of Corp., <http://perma.cc/DA9A-QRNF> (last visited Sept. 5, 2014).

<sup>57</sup> William M. Lafferty, Lisa A. Schmidt & Donald J. Wolfe, Jr., *A Brief Introduction to the Fiduciary Duties of Directors Under Delaware Law*, 116 PENN ST. L. REV. 837, 841 (2012).

<sup>58</sup> Tyler M. Dumler, *Charging Less To Make More: The Causes and Effects of The Corporate Inversion Trend In The U.S. and Implications of Lowering The Corporate Tax Rate*, 13 U.C. DAVIS BUS. L.J. 88, 90 (2012).

<sup>59</sup> *Id.*

<sup>60</sup> Alfred Rappaport, *Ten Ways To Create Shareholder Value*, HARV. BUS REV., Sept. 2007, available at <http://perma.cc/BMU5-Y968>.

<sup>61</sup> *Corporate Inversions: Hearing Before the SubComm. on Select Revenue Measures of the H.R. Comm. on Ways and Means*, 107th Cong. 2 (2002).

<sup>62</sup> Bermuda Companies Act of 1981 §97 Duty of Care of Officers (1989 Revision), available at <http://perma.cc/HB8F-V2HN> (last visited January 15, 2015); Mann, *supra* note 19, at 536.

<sup>63</sup> *Id.* at 535.

owes a duty to a Delaware corporation and its shareholders;<sup>64</sup> whereas, in Bermuda, a director owes a duty only to a Bermudan corporation.<sup>65</sup>

Another reason Bermuda has been a sought-after jurisdiction for inversions is because it is a self-governed territory of the UK that does not follow British law.<sup>66</sup> Courts in Bermuda seldom enforce decisions from other jurisdictions.<sup>67</sup> Unlike the Bermudan judicial system, the U.S. judicial system applies the “Full Faith and Credit Clause” of the U.S. Constitution that requires courts in each state to give full faith and credit to judicial holdings from other states.<sup>68</sup>

### C. Political and Social Ramifications of Inversions

In light of the unpatriotic reputation plaguing domestic firms that invert, politicians serve an instrumental role to deter inversions and prevent further erosion of the corporate tax base. When Burger King announced plans to relocate, Senate Majority Whip, Richard Durbin (D., Ill.), stated ominously that, “many of its loyal customers may choose to spend their hard-earned money elsewhere instead of supporting a company that wants all the benefits of America but refuses to pay its fair share to support our nation.”<sup>69</sup> Durbin’s predictions were accurate. Burger King’s Facebook page displayed posts from disgruntled customers threatening to boycott its stores,<sup>70</sup> however, his efforts were futile as Burger King’s share

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<sup>64</sup> *Id.*

<sup>65</sup> *Id.*

<sup>66</sup> *Id.*

<sup>67</sup> Hale E. Sheppard, *Fight or Flight of U.S. Based Multinational Businesses: Analyzing the Causes For, Effects of, and Solutions to the Corporate Inversion Trend*, 23 NW. J. INT’L L. & BUS. 551, 566 (2003)

<sup>68</sup> U.S. Const. art. IV, § 1, cl. 1.

<sup>69</sup> John D. McKinnon, *Liberal Senators Char Burger King Over Inversion Deal*, WALL ST. J., Sept. 11, 2014, <http://perma.cc/3A2B-TPQM>; see also Jim Puzzanghera, *Senators Urge Burger King Not to Move to Lower-Tax Canada*, L.A. TIMES, Sept. 11, 2014, <http://perma.cc/9LB4-ETCA>.

<sup>70</sup> Alexander C. Kauffman & Jillian Berman, *Burger King Fans Call For Boycott Over Tax Dodge*, HUFFINGTON POST (Aug. 25, 2014), <http://perma.cc/V3K4-DXCA>.



price increased by 18.5%, and Tim Hortons's increased by 20%.<sup>71</sup> On average, empirical data suggests that stock prices react positively to a U.S. firm's announcement to invert, appreciating nearly 1.7% over a five-day period following that event.<sup>72</sup> This appreciation is more pronounced for those firms whose stock prices have increased over the previous year and whose shareholders have considerable built-in capital gain appreciation over a lengthy period.<sup>73</sup> Also in 2014, U.S. pharmacy chain Walgreen Co. ("Walgreens") announced plans to acquire Swiss-based pharmacy Alliance Boots.<sup>74</sup> In the final stages of negotiations, Walgreens decided to forego moving forward with the deal amid rampant negative press and fierce public scrutiny.<sup>75</sup> Subsequently after announcing that it would forego using the controversial tax saving strategy, its share price dropped drastically.<sup>76</sup> By deciding not to invert, Walgreens walked away from nearly \$800 million in annual tax savings that would have amounted to \$4 billion over a five-year period.<sup>77</sup>

For board members, the balancing act of maximizing share price while making sound business decisions is a constant struggle. This situation can present individuals tasked with handling those duties with a dynamic, yet sensitive array of potential legal issues. Despite the inevitable stigma that attaches to U.S. firms that relocate abroad, in certain instances, the mere concept of inverting is not as destructive as is conveyed by the media and perceived by the public. Economic gains realized from millions of unspent dollars in tax savings can provide stability in local communities by preserving jobs and encouraging growth in various sectors.

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<sup>71</sup> James Detar, *Video: Why Burger King Isn't Walgreen for Inversion*, INVESTOR'S BUSINESS DAILY (Aug. 25, 2014), <http://perma.cc/7ATW-SJHX>.

<sup>72</sup> Desai & Hines, *supra* note 6, at 3.

<sup>73</sup> *Id.*

<sup>74</sup> Steve Goldstein, *Walgreen's Tumbles on Report it Won't Invert*, MARKET WATCH, (Aug. 5, 2014), <http://perma.cc/H8TM-DVH2>; *See also*, Roger Hickey, *Victory for Americans: Walgreen's Won't 'Invert' to Avoid U.S. Taxes*, HUFFINGTON POST, (Aug. 5, 2014), <http://perma.cc/UTC5-W97S>.

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> Steve Goldstein, *supra* note 74.



Ideally, this can be accomplished by reinvesting capital in blighted localities that would have otherwise been absorbed in paying higher corporate taxes.

In light of those aforementioned factors impacting U.S. firms that invert, when one foregoes moving overseas the potential to regain support from its consumer base is rather apparent.<sup>78</sup> Nevertheless, a firm still suffers great economic loss from declining share prices.<sup>79</sup> An issue that merits discussion is whether or not a board member who supports the decision to forgo inverting is in breach of his or her fiduciary duty.<sup>80</sup> This comes to mind as one would reasonably infer that such board member has failed to capitalize on a sound business opportunity - to increase the firm's value and share price from additional tax savings. Currently, there are no U.S. Court decisions finding a board member, or collectively a board of directors, in breach of their fiduciary duty for lapsing on an opportunity to relocate overseas. Again, by revisiting Walgreens' situation, a conclusion can be drawn that a board's decision to forgo inverting may be popular in Washington, D.C., but not necessarily on Wall Street. The trading day after Walgreens announced that it would no longer acquire Alliance Boots, its share value dropped by 4%, and another 15% the following day.<sup>81</sup>

#### D. The True Economics of Inversions

Each year, Congress is faced with filling the tax gap created by

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<sup>78</sup> See Danny Vinik, *The Burger King Backlash Could Hurt the Republican Party*, NEW REPUBLIC, Aug. 26, 2014, <http://perma.cc/L9FL-RD7W> (last visited December 1, 2014).

<sup>79</sup> Brigid Sweany, *Why Walgreen stayed put*, CHICAGOBUSINESS.COM, Aug. 6, 2014, available at <http://perma.cc/CD2M-BYXK> (last visited Dec. 16, 2014); Agnes Shanley, *Inversions and Identity - Inversions offer tax savings, but hurt corporate identity and culture*, CONTRACT PHARMA, September 8, 2014, available at <http://perma.cc/W3MF-BN3K> (last visited December 10, 2014).

<sup>80</sup> See Vinik, *supra* note 78.

<sup>81</sup> Trefis Team, *The Market May Have Overreacted To Walgreen's Decision Against Tax Inversion*, FORBES (Aug. 8, 2014), <http://perma.cc/YHL2-THP9>; Cynthia Koons & Makiko Kitamura, *Walgreen Stays in U.S. as It Buys Rest of Alliance Boots*, BLOOMBERG BUS. (Aug. 5, 2014), <http://perma.cc/KMS7-6RBF>.

U.S. firms that invert. As a percentage of U.S. Gross Domestic Product (“U.S. GDP”) corporate income tax represents approximately 2% of U.S. GDP.<sup>82</sup> Policymakers serving in the House of Representatives Ways and Means Committee (the “Ways and Means Committee”) and the Senate Finance Committee (the “Finance Committee”) face an ongoing challenge to minimize erosion of the U.S. tax base.<sup>83</sup> Currently, the U.S. is losing tax revenues to foreign markets that have become more attractive to investors for deploying investment capital.<sup>84</sup>

To frame this issue in a broader context: the federal government collects tax revenues for budget functions, such as, national defense, health, and transportation, even as U.S. firms invert which decreases funds to pay for those services. The decrease in tax revenues collected from inversions is not foregone completely, but rather, is an unforeseen tax burden passed onto other taxpayers.<sup>85</sup> Stated differently, inversions shift the burden among different classes of taxpayers. Politicians have limited options to recoup this loss other than proposing to raise taxes in hopes of absorbing the blow, or reducing government spending and funding for federal programs.<sup>86</sup> Domestic firms that remain in the U.S. can offset this loss by passing the “buck” along to consumers in the form of higher prices to purchase goods and services.<sup>87</sup> Taken from that perspective, this is a no-win situation. Ultimately, this cycle will repeat itself until significant measures are taken, first, to prevent U.S. firms from inverting, and second, to implement legislation making such transactions more costly over the long term.

Another issue to consider when analyzing the inversion dilemma is that intangible costs are oftentimes undetermined. For

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<sup>82</sup> Tax Pol’y Center, *Historical Source of Revenue as Share of GDP* (Feb. 4, 2015), <http://perma.cc/AWR6-DHUU>; Dumler, *supra* note 58, at 94.

<sup>83</sup> *Id.*

<sup>84</sup> Rachelle Y. Holmes, *Deconstructing the Rules of Corporate Tax*, 25 AKRON TAX J. 1, 3 (2010).

<sup>85</sup> Corporate Inversion: Hearing on S. 2119 Before the S. Subcomm. on Treasury and Gen. Gov’t of the Comm. on Appropriations, 107th Cong. 35 (2002); Sheppard, *supra* note 67, at 551, 572-77.

<sup>86</sup> *Id.*

<sup>87</sup> Mann, *supra* note 19, at 522.

instance, market sensitivities can heavily impact a firm's share price causing it to be highly volatile after making public its intent to relocate overseas. To illustrate, in 2002, Stanley Works ("Stanley"), a Connecticut-based tool manufacturer, found itself at the helm of a Securities and Exchange Commission ("SEC") inquiry, and faced attacks by local Congressional members after announcing plans to move its headquarters to Bermuda.<sup>88</sup> During that period, Stanley was regarded as one of the world's largest toolmakers with over 15,000 employees, listed on Standard and Poor's ("S & P") 500 Index, and was the leading U.S. toolmaker with annual revenues in excess of \$2.6 billion.<sup>89</sup> Stanley's motive for relocating was straightforward – to reduce its U.S. tax liability and become more competitive against foreign toolmakers.<sup>90</sup>

Under this proposed deal, a newly formed Bermudan corporation would be managed in Barbados to reap benefits from reduced tax withholdings provided by a U.S.-Barbados tax treaty.<sup>91</sup> When Stanley had announced plans to invert, its share value had increased by \$199 million.<sup>92</sup> During that period, then Connecticut Attorney General Richard Blumenthal ("Mr. Blumenthal") urged the SEC to block Stanley's board's decision, ultimately causing the toolmaker to remain in Connecticut.<sup>93</sup> When news spread on Wall Street that Stanley was no longer moving overseas, its share value decreased by \$252 million.<sup>94</sup> From what seemed as a classic example of "winning a worthy battle" by a noble public servant in his home state to save a struggling American business had resulted in losing an unforeseen war. In fact, it was a big one too. Stanley's decision to forgo moving to Bermuda proved

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<sup>88</sup> Dan Ackman, *Stanley Works Stays Home*, FORBES, August 2, 2012, available at <http://perma.cc/6T9Q-DDLT> (last visited September 2, 2014).

<sup>89</sup> Desai & Hines, *supra* note 6, at 12.

<sup>90</sup> *Id.* at 13.

<sup>91</sup> *Id.*

<sup>92</sup> See the *Corporate Patriot Enforcement Act of 2002*, H.R. 3884, 107th Cong.; the *Save America's Jobs Act of 2002*, H.R. 3922, 107th Cong.; the *Uncle Sam Wants You Act of 2002*, H.R. 4756, 107th Cong.; and the *No Tax Breaks for Corporations Renouncing America Act of 2002*, H.R. 4993, 107th Cong.

<sup>93</sup> Mann, *supra* note 19, at 544

<sup>94</sup> Desai & Hines, *supra* note 6, at 14.

catastrophic as it contemplated terminating 1,000 jobs to keep its doors open.<sup>95</sup> Wearing a different hat this time, Mr. Blumenthal pleaded to Congress to help bail out the Connecticut toolmaker.<sup>96</sup> If there was a moral to this story it would be summarized as follows: obstructing a corporation's board's ability to make prudent business decisions - a duty owed to shareholders - can result in unforeseen consequences that may make a bad situation even worse.

This article does not advocate for U.S. firms to invert as a means to maintain its market share, however, it does acknowledge that those that do so seek to remain globally competitive by minimizing their exposure to U.S. taxation. In many instances, this concept is confused with outsourcing, which is totally different altogether and involves firms seeking to purchase labor in a different country at a cheaper rate.<sup>97</sup> At certain operating thresholds, a U.S. firm will consider relocating to a low tax jurisdiction to become on par competitively with their foreign counterparts, regardless of whether it is done in paper form. This highly suggests that business survival and preserving jobs, rather than simple greed or lack of patriotism, are strong motivators driving U.S. firms to invert.<sup>98</sup>

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<sup>95</sup> Eric Tak Han, *Is Capitalism Un-American? An Analysis of Corporate Inversions and Expatriation Proposals In Response*, 27 HASTINGS INT'L & COMP. L. REV. 511, 529 (2004).

<sup>96</sup> Mann, *supra* note 19, at 544.

<sup>97</sup> *Id.*; See generally, discussion on the Corporate Patriot Enforcement Act of 2002, H.R. 3884, 107th Cong.; the Save America's Jobs Act of 2002, H.R. 3922, 107<sup>th</sup> Cong.; the Uncle Sam Wants You Act of 2002, H.R. 4756, 107th Cong.; and the No Tax Breaks for Corporations Renouncing America Act of 2002, H.R. 4993, 107th Cong.

<sup>98</sup> Mann, *supra* note 19, at 523.

#### IV. MEASURING THE EFFECTIVENESS OF LEGISLATION ON INVERSIONS

##### A. Past and Present Legislative Efforts

In the last fifteen years, more than thirty bills have been introduced by Congress to combat inversions.<sup>99</sup> Though various forms of legislation have been proposed, none are viewed as a holistic approach to deter use of this tax saving strategy.<sup>100</sup> The intent behind past and current legislation addressing inversions appears to be altruistic. Experienced tax professionals are continually developing strategies to exploit nuances in the Code and structure deals with grave complexities in hopes of circumventing tax rules. In the end, the inversion dilemma remains an ongoing problem that is difficult to resolve.

Currently, there are three prevailing approaches to deter inversions.<sup>101</sup> Those are: (1) treating inverted corporations as domestic entities for tax purposes; (2) implementing principles-based rules instead of using prescriptive-based rules; and lastly, (3) lowering U.S. corporate tax rates.<sup>102</sup> Applying the first approach, Congress enacted Section 7874 of the Code under the American Jobs Creation Act of 2004 to tax inversion gains if: (i) a foreign corporation acquires substantially all the assets of a domestic corporation or partnership; (ii) the former owners of a domestic corporation hold at least 60% by vote or value of the stock of a foreign corporation; and (iii) a foreign corporation does

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<sup>99</sup> Joseph A. Tootle, *The Regulation of Corporate Inversions*, 33 VA. TAX REV. 353, 371 (2013); *See generally*, Michael Kirsch, *The Congressional Response to Corporate Expatriations: The Tension Between Symbols and Substance in the Taxation of Multinational Corporations*, 24 VA. TAX REV. 475, 481 (2005).

<sup>100</sup> Mann, *supra* note 19, at 539; Holmes *supra* 84, at FN 65; Jim Puzanghera, *Jacob Lew warns failure to quickly limit inversions imperils tax reform*, LA TIMES, July 28, 2014, available at <http://perma.cc/GEJ3-FWAF> (last visited August 14, 2014); Gordon Gray, *The Underlying Causes of Tax Inversions*, CLEAR POLICY, September 5, 2014, available at <http://perma.cc/L3SF-B6UT> (last visited October 4, 2014).

<sup>101</sup> Dumler, *supra* note 58, at 101.

<sup>102</sup> *Id.*

not have substantial business activity in the foreign country of incorporation.<sup>103</sup> In such instances where former domestic shareholders own 80% or more of a foreign corporation, the Code treats that foreign corporation as a domestic entity for tax purposes.<sup>104</sup>

A major flaw concerning Section 7874 is the difficulty in determining what level of business activity is considered as being "substantial."<sup>105</sup> As one can imagine, that term is open to varying degrees of interpretation for determining the extent of a foreign parent's operations to discern whether it has "substantial business activity" in that foreign country.<sup>106</sup> For example, the American Heritage Dictionary provides six different definitions of the word substantial, the most pertinent of which is, "considerable in importance, value, degree, amount, or extent."<sup>107</sup> The word "considerable" is defined as, "fairly large in amount, extent, or degree."<sup>108</sup> With that line of reasoning, "fairly" is defined as, "moderately," and lastly, "large" is defined as, "of considerable size, extent, quantity, capacity, or amount."<sup>109</sup>

The business activity test analysis under Section 7874 becomes arbitrary because the word, "substantial," remains unclear. In the context of using a safe harbor rule for structuring a multinational deal, the threshold for determining a foreign parent's level of activity is based on its degree of importance, value, and amount.<sup>110</sup> For that reason, more detailed statutory guidance is needed to discern the meaning behind that term for purposes of applying Section 7874. As some tax scholars have suggested, it would be

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<sup>103</sup> I.R.C. § 7874 (2014).

<sup>104</sup> *Id.*; Steven H. Goldman, *Corporate Expatriation: A Case Analysis*, 9 FLA. TAX REV. 71, 110-114 (2008).

<sup>105</sup> Jefferson P. VanderWolk, *Inversions Under Section 7874 of the Internal Revenue Code: Flawed Legislation, Flawed Guidance*, 30 NW. J. INT'L L. & BUS. 699, 710-711 (2010); See Tootle, *supra* note 99, at 388.

<sup>106</sup> *Id.*; Peter Glicklich, Abraham Leitner & Megan J. Grandinetti, *Anti-Inversion Regulations Severely Limit Substantial Business Activities Exception, as Illustrated with Canada*, 41 TAX MGMT. INT'L J. (BNA) No. 08 at 402 (2012).

<sup>107</sup> VanderWolk, *supra* note 105, at 711.

<sup>108</sup> *Id.*

<sup>109</sup> *Id.*

<sup>110</sup> *Id.*

prudent if substantial were interpreted to require a foreign parent's operations to be moderate in size (dollar value) in comparison to the controlled group's total worldwide activities.<sup>111</sup> IRS pronouncements concerning that issue should be provided to lessen this ambiguity in interpreting the Code and inconsistent treatment of transactions involving multinational firms.<sup>112</sup>

The second approach, moving from a prescriptive-based rules approach to a principles-based rules approach is aimed at making U.S. corporate tax laws more adaptable to an ever-evolving and complex global market, and closing tax loopholes by reducing complexity within the Code.<sup>113</sup> Under the principles-based method, courts would invalidate transactions that meet the requirements of the Code but whose substance runs afoul of the spirit of the law.<sup>114</sup> For instance, principles-based rules set forth an explicit general standard that governs the type of conduct that is legally permissible.<sup>115</sup> By contrast, prescriptive-based rules determine before an event (*ex ante*) the specific conduct that is or is not permissible by providing the treatment of all expected factual situations.<sup>116</sup> The benefit of the former approach is that it provides courts more flexibility to determine outcomes of complex transactions specifically designed to circumvent tax rules.<sup>117</sup> In addition, under that approach, courts have the ability to respond to recent practice trends orchestrated by savvy tax professionals structuring deals with multi-layered steps to pass muster as *bona fide* transactions.<sup>118</sup> However, the principles-based rules approach has been vastly criticized.<sup>119</sup> Opponents argue that prescriptive-based rules are much easier to apply and less costly to implement because it directs a specific outcome and does not require an

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<sup>111</sup> *Id.*

<sup>112</sup> *Id.*

<sup>113</sup> Holmes, *supra* note 84, at 7.

<sup>114</sup> *Id.* at 21-22.

<sup>115</sup> *Id.*

<sup>116</sup> *Id.*

<sup>117</sup> Dumler, *supra* note 58, at 103.

<sup>118</sup> *Id.*

<sup>119</sup> *Id.*; See Holmes, *supra* note 84, at 23.



assessment of particular facts to any given principle.<sup>120</sup> Another concern is that varying court interpretations can add complexity and unpredictability under a principle based rules approach, which can adversely affect the holding of cases driven by real economic factors rather than tax considerations.<sup>121</sup>

Lastly, lowering the U.S. corporate tax rate to be on par with other OECD nations would arguably lessen disparities in tax treatment between U.S. firms and foreign firms. By reducing corporate tax rates, it would prevent further erosion of the corporate tax base and deter domestic firms from inverting, thus making them more competitive in an internationally integrated economy.<sup>122</sup> Conversely, lowering corporate tax rates raises legitimate concerns regarding the Treasury's ability to recoup losses from decreased tax revenues collected.<sup>123</sup> Two factors present challenges for lowering the corporate tax rates. First, if revenue neutrality is a goal, there may not be enough base broadening provisions with revenue offsets to counterbalance a reduction in corporate tax revenues; and second, if such offsets are applied, they might have unintended consequences.<sup>124</sup> Thus, if the corporate tax base is reduced it should have a corresponding base broadening plan to prevent any likelihood of incurring significant budget deficits. Academics that advocate for this approach contend that broadening the tax base with a lowered tax rate would reduce the number of U.S. firms considering inverting.<sup>125</sup>

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<sup>120</sup> *Id.* at 25-26.

<sup>121</sup> *Id.*

<sup>122</sup> Joshua Simpson, *Analyzing Corporate Inversions and Proposed Changes To The Repatriation Rule*, 68 N.Y.U. ANN. SURV. AM. L. 673, 716 (2013).

<sup>123</sup> Marples and Gravelle, *supra* note 15, at 11-12.

<sup>124</sup> *Id.*

<sup>125</sup> *Id.*



## B. Getting Around the Rules

Since 1982, after McDermott Incorporated completed the first known inversion in the United States,<sup>126</sup> tax professionals have been constantly vying to stay ahead of Congress by exploiting nuances in the Code, in particular, the Code's "Subpart F" rules. Subpart F requires domestic shareholders of a controlled foreign corporation ("CFC") to pay tax on their *pro rata* share of CFC income.<sup>127</sup> Generally, this applies to income of a foreign firm that is controlled, or more than 50% owned by U.S. shareholders with ownership blocks of at least 10% in a firm's stock.<sup>128</sup> Industries that face particular exposure under the Subpart F rules include the telecommunications sector, oilfield services sector, and insurance.<sup>129</sup> Similarly, the Passive Foreign Investment Company ("PFIC") rules were enacted as part of the Tax Reform Act of 1986.<sup>130</sup> Congress passed this provision to impose a tax burden on domestic shareholders of foreign passive investments to minimize the tax disparity between owners of offshore investment funds and those owning domestic investment funds.<sup>131</sup>

Compounding on tax benefits reaped by firms that invert, a foreign parent can further minimize its tax liability on U.S. source income by using a tactic known as "earnings stripping."<sup>132</sup> This strategy is aimed at minimizing taxable income through inter-company transactions. For instance, the purpose of an earnings-stripping transaction is exactly as its name suggests: to "strip" or reduce the earnings of its U.S. subsidiary. Those transactions are arranged by having a U.S. subsidiary make deductible payments to the foreign parent for interest, rents, royalties, and

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<sup>126</sup> Mann, *supra* note 19, at 540.

<sup>127</sup> Subpart F—Controlled Foreign Corporations, 26 U.S.C. §§ 951-965 (2011); Simpson, *supra* note 121, at 698.

<sup>128</sup> *Id.* at 681.

<sup>129</sup> *Id.*; see also 26 U.S.C. § 965 (2014).

<sup>130</sup> Kevin M. Cunningham, *The PFIC Rules: The Case of Throwing The Baby Out With The Bathwater*, 21 VA. TAX REV. 387, 392 (2002).

<sup>131</sup> *Id.* at 406.

<sup>132</sup> Mann, *supra* note 19, at 531.

transfer pricing.<sup>133</sup> The most common form of this scheme is interest stripping. Generally, this involves a foreign parent or another related entity providing a loan to a U.S. subsidiary, and in turn, it repays the foreign parent and takes an interest deduction.<sup>134</sup> To prevent abuse of interest stripping strategies, Congress enacted Section 163(j) of the Code to limit deductible interest expense that a domestic subsidiary can deduct attributable to untaxed interest paid to a related person.<sup>135</sup> Other earning stripping strategies include, but are not limited to, transferring and licensing of intellectual property, sale-leaseback transactions, and management fee arrangements, which have not been specifically addressed by policymakers or stated in the Code.<sup>136</sup>

### C. Legislative Proposals To Reduce Inversions

As part of the White House efforts to curtail inversions, President Obama's FY15 budget proposal planned to broaden the definition of an inversion transaction by reducing the 80% test under Section 7874 of the Code to a greater-than-50% test, which would eliminate the 60% test.<sup>137</sup> Regardless of shareholder continuity, an inversion transaction would be deemed to have occurred if the combined entity had substantial business activities in the U.S. and the foreign firm was primarily managed and controlled in the U.S.<sup>138</sup>

The "Stop Corporate Expatriation and Investment Act in America's Infrastructure Act" (H.R. 4679) was introduced by Congressman Sander Levin (D-MI), a ranking member on the House Ways and Means Committee, to strengthen the Section 7874 rules.<sup>139</sup> Like President Obama's FY15 budget, this bill

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<sup>133</sup> Tootle, *supra* note 99, at 361.

<sup>134</sup> *Id.*

<sup>135</sup> I.R.C. § 163(j) (2014).

<sup>136</sup> Tootle, *supra* note 99, at 361.

<sup>137</sup> Grant Thornton, *Washington Update: Pressure mounts on lawmakers and the Treasury as more inversion deals announced* (Sept. 26, 2014), <http://perma.cc/JM5R-TQX6>.

<sup>138</sup> *Id.*

<sup>139</sup> The U.S. House Ways and Means Committee Democrats, H.R. 4985: *Stop*

proposed to lower the 80% stock ownership threshold to 50% in order to treat a foreign firm as domestic and subject that firm to U.S. tax liability.<sup>140</sup> In addition, these proposed changes would apply retroactively to past transactions that occurred in 2014.<sup>141</sup>

Other congressional proposals do not affect Section 7874 of the Code directly, but have been in place to disincentive inversions. For example, the “Stop Corporate Earnings Stripping Act of 2014,” was also introduced by Levin and has two major objectives: (1) to strengthen Section 163(j) rules limiting interest stripping; and (2) to expand the Section 956 rule to prevent CFC affiliates from making tax-free investments in the United States.<sup>142</sup> The proposed Code Section 163(j) adjustment would eliminate the existing debt-to-equity safe harbor, limit net interest expense to 25% of adjusted taxable income, and repeal any excess carry-forward of unused interest expense deductions.<sup>143</sup> The proposed bill to amend Section 956 of the Code expands the requirement of U.S. shareholders to report their share of foreign group property as income, which includes stock and debt obligations of non-CFC foreign affiliates.<sup>144</sup>

## V. CONCLUSION

Globalization has served as both a gift and a curse for many U.S. firms. The global business environment has intensified significantly over the past decade as firms compete for limited resources and worldwide capital.<sup>145</sup> In today’s rapidly changing economy, firms flirting with the notion of inverting face a backlash of harsh political and social repercussions. Undoubtedly, those that invert are confronted with challenges of public mistrust and

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*Corporate Expatriation and Invest in America's Infrastructure Act of 2014*, <http://perma.cc/9WGG-9DXZ> (last visited Sept. 10, 2014).

<sup>140</sup> *Id.*

<sup>141</sup> *Id.* (The retroactive date the legislation would become effective is May 8, 2014).

<sup>142</sup> See *Stop Corporate Inversions Act of 2014, H.R. 4679*, 113th Cong. (2014).

<sup>143</sup> *Id.*

<sup>144</sup> *Id.*

<sup>145</sup> Holmes, *supra* note 84, at 7.

are tainted with a reputation for lacking patriotism. The general perception of the inversion strategy is that it is simply and profoundly, “unpatriotic” and “un-American.”

As Congress is tasked with engaging in meaningful efforts to resolve the inversion dilemma, much effort is still needed to address underlying issues concerning U.S. corporate tax reform. If this is not resolved in a timely manner, the incidence of U.S. firms that relocate overseas to eliminate tax disparities between themselves and their foreign counterparts will continue and may even increase as time goes on.

