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Curbing Corporate Inversions:
A Study of National and International Efforts to Establish Corporate Tax Equity

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Fall 2014

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Preface

In his *Discourse on the Origin of Inequality*, philosopher Jean-Jacques Rousseau wrote, “The first man who, after enclosing a piece of ground, took it into his head to say, ‘This is mine,’ and found people simple enough to believe him, was the true founder of civil society.”¹ When I read this quote a week before I traveled to Geneva – the city that Rousseau dedicated the essay in which it appears to, incidentally – I was instantly struck by the uncomfortable notion that the distribution of resources was set in motion long ago in ways that are far from just. Today, the distribution of resources determines nearly everything, and as recent research by notable economists such as Thomas Picketty has shown, this distribution has grown more and more skewed in favor of the so-called “one percent” in recent decades, once again with little, if any, moral justification.² For these reasons, I knew from the beginning that I wanted my own research to focus on one of the factors that exacerbate such inequality – in this case, corporate tax inversions – and examine avenues for reform to the problem on both the national and international levels.

As my host father Walter often says, the matter of whom and what is taxed is often a matter of philosophy. For example, should one be taxed based on one’s income, or rather on what one consumes, or both? Additionally, is it fair for corporations to be taxed? Although these are questions upon which entire books could be written, to proceed with the discussion towards which this paper aims, we must begin with the somewhat philosophical premise that because corporations are an entity made possible by the State, they therefore have an obligation to pay a certain amount of taxes to the State in order to

¹ Jean-Jacques Rousseau. “A Discourse Upon the Origin and the Foundation of The Inequality Among Mankind.” *Amazon Digital Services Inc.*, May 12, 2012.

² See Thomas Picketty. “Capital in the Twenty-First Century.” *Harvard University Press*, March 10, 2014.

allow the State's existence to continue. The practical reasons as to why efforts by corporations to avoid taxation have a negative impact on society will be explained in Part II of this paper, although it is worth observing that in the eyes of the State, the aforementioned premise is quite practical as well.

The criteria used to judge the various policy options discussed in this paper shall be which policies have the greatest benefit to society as a whole. Of course, this is not a very useful criterion if one does not choose which society's interests one is analyzing. For this reason, I will be investigating the issue of corporate inversions particularly as it relates to the interests of the United States throughout the majority of this paper. The perspectives of other countries will be mentioned as well, especially in Part V, which examines the prospects for international solutions to tax base erosion issues, but for the sections focusing on in-depth policy solutions, the recommendations will apply only to the United States.

On a final note, this paper is by no means a complete or final analysis on corporate inversion and taxation issues. In fact, due to recent U.S. policy options and international tax proposals that are currently being debated, parts of this research may soon be outdated. Furthermore, although I am fairly skeptical of the Organization for Economic Cooperation and Development's effort to combat tax base erosion and profit shifting, I hope that it will bring about some amount of tax reform and am excited to see how this debate will progress.

Scott Novak

November 17, 2014
Geneva, Switzerland

Abbreviation List

AJCA	American Jobs Creation Act of 2004
BEPS	Base Erosion and Profit Shifting
CFC	Controlled Foreign Corporation
CBO	Congressional Budget Office
CRS	Congressional Research Service
GDP	Gross Domestic Product
IRS	Internal Revenue Service
OECD	Organization for Economic Cooperation and Development

Abstract

In recent years, the number of U.S. companies trying to merge with a foreign company and thereby reincorporate themselves in countries with a lower corporate tax rate – a practice known as corporate inversion – has skyrocketed. The public outcry in 2014 against corporate inversions led the U.S. Treasury to release a series of new anti-inversion regulations, and more policy changes are in the process of being debated. At the same time as this national discussion on the harmful effects corporate inversions have on the U.S. tax base is progressing, the Organization for Economic Cooperation and Development (OECD) is in the process of working with G-20 countries to develop a Base Erosion and Profit Shifting Action Plan, a plan that aims in part to bring about major international corporate tax reform. In light of these developments, this paper aims to explain the incentives behind corporate inversions and the different policies being discussed on both the national and international level that could discourage this practice. Through the analysis of government reports and interviews with experts, this paper shows that actions on the national level to stop inversions are indeed possible, although the most meaningful actions will probably be carried out by the Administration, not Congress. The OECD effort to create a multilateral tax instrument, however, is much less promising; the governments currently involved have strongly divergent interests when it comes to setting standards for corporate taxation, and developing countries are almost completely left out of the conversation. Based on these conclusions, the paper makes recommendations on measures to curb inversions and advises that the United States not wait for an international solution to its national problem of tax base erosion.

I. Introduction

Earlier in 2014, the U.S. pharmaceutical company AbbVie Inc. announced a \$54.8 billion deal to merge with the U.K.-based Shire Plc.³ On the surface, this might seem like a particularly dry situation with which to start an introduction, but the devil is in the details. The United States has a corporate tax rate of 35%, but because of many loopholes in the corporate tax code, the actual tax percentage many corporations pay is significantly less than this. AbbVie, for instance, currently pays only 22% of its income in such taxes.⁴ However, in the UK, tax rates for AbbVie would be even lower than this. AbbVie's deal with Shire would have allowed the AbbVie to relocate its legal residence to the UK, which would effectively lower its overall tax rate in 2016 from 22% to 13%. While it is true that AbbVie wanted to merge with Shire for more reasons other than just tax incentives – for example, Shire's drugs for attention deficit hyperactivity disorder and rare diseases would have helped diversify AbbVie's portfolio – these tax incentives nevertheless were a primary motivating factor in the deal.⁵

Of course, AbbVie wasn't the only company trying to move overseas this year. Pfizer, another pharmaceutical company, tried to make a \$117 billion offer to buy London-based AstraZeneca Plc. and thereby re-incorporate to London, where the company would enjoy a 21 % corporate tax – a tax which will drop to 20% next year – as well as a 10% tax rate on profits attributed to UK patents (known as the Patent Box

³ Simeon Bennett and Caroline Chen. "AbbVie is Biggest to Quit U.S. in \$55 Billion Shire Deal." *Bloomberg*, July 19, 2014, accessed October 29, 2014, <http://www.bloomberg.com/news/2014-07-18/abbvie-to-buy-shire-for-54-8-billion-asdrug-deals-surge.html>.

⁴ Ibid.

⁵ Ibid.

policy).⁶ The U.S. medical device maker Medtronic Inc. made a \$42.9 billion deal to buy Ireland's Covidien Plc., where it would pay a corporate tax rate of 12.5% once it re-incorporated itself to Ireland.⁷ Chiquita will also move to Ireland once its deal to buy Ireland-based Fyffes is completed.⁸ Even Burger King, a quintessentially American company, is in the midst of confirming a deal to move to Canada, and Walgreens was considering re-incorporating to Switzerland.⁹

These proposed mergers are all examples of corporate tax inversions, which is when a U.S. (in these cases, at least) multinational corporation merges with a smaller foreign corporation so that it can move its legal residence to the lower-tax country of the foreign corporation. This is done primarily for the purpose of paying a lower tax to the new home country instead of paying a higher tax to the United States. Most of the operations of the former U.S. company do not shift to the territory of the foreign country to which it moves – the shift is just a legal one for tax purposes. As Thomas L.

⁶ Jesse Drucker and Zachary R. Mider. "U.S. Treasury Seen Loser in Tax-Avoiding Pfizer Deal." *Bloomberg*, April 28, 2014, accessed October 29, 2014, <http://www.bloomberg.com/news/2014-04-28/u-s-treasury-seen-loser-in-tax-avoiding-pfizer-deal.html>.

⁷ Susan Kelly and Greg Roumeliotis. "Medtronic to buy Covidien for \$42.9 billion, rebase in Ireland." *Reuters*, June 16, 2014, accessed October 29, 2014, <http://www.reuters.com/article/2014/06/16/us-covidien-medtronic-inc-idUSKBN0ER03420140616>.

⁸ David Guelles and Stephanie Strom. "Chiquita Buys Ireland's Fyffes to Go Global in Banana Business." *International New York Times*, March 10, 2014, accessed October 29, 2014. http://dealbook.nytimes.com/2014/03/10/chiquita-to-buy-irish-fruit-and-produce-distributor-fyffes-in-all-stock-deal/?_php=true&_type=blogs&_r=0.

⁹ Richard Rubin. "Burger King Deal Advances Amidst U.S. Inversion Crackdown." *Bloomberg*, September 23, 2014, accessed October 29, 2014, <http://www.bloomberg.com/news/2014-09-23/lew-tries-to-limit-tax-cut-deals-with-inversion-crackdown.html>.

Hungerford puts it, “In essence, the corporations are giving up U.S. ‘citizenship’ to avoid paying U.S. taxes.”¹⁰

Historically, the phenomenon of all of these companies proposing to leave the United States is not a commonplace trend. According to the Center for American Progress, inversions in the United States are now at a record-high level. Over the past 10 years, 47 U.S. corporations have shifted their legal residence to other countries via corporate inversions, and since 2011, there have already been 12 corporate inversions, with 10 more in the process of being completed.¹¹

According to the Joint Commission on Taxation, a nonpartisan congressional research panel, the United States will lose an estimated \$19.46 billion over a decade if most new inversions aren’t stopped with changes to the tax code.¹² This prediction was formulated from estimates made from past inversions and does not take into account deals being made currently. Given the rate at which these inversion proposals have been multiplying and the billions of dollars that are now at stake, engaging in a public dialogue about ways to restrict corporate inversions motivated by the incentive of paying lower taxes is of the utmost urgency.

¹⁰ Thomas L. Hungerford. “Policy Options to Corporate Inversions: Close the Door Before the Horse Bolts.” *Economic Policy Institute*, September 8, 2014, accessed October 27, 2014, <http://www.epi.org/publication/policy-responses-corporate-inversions/>.

¹¹ Alexandra Thornton. “The Skinny on Corporate Inversions.” *Center for American Progress*: (September 25, 2014), 1, accessed October 29, 2014, <http://cdn.americanprogress.org/wp-content/uploads/2014/09/CorporateInversions-brief.pdf>.

¹² Joseph Walker. “U.S. Stands to Lose Billions from Corporate Inversions.” *The Wall Street Journal*, July 14, 2014, accessed October 29, 2014, <http://online.wsj.com/articles/u-s-stands-to-lose-billions-from-corporate-tax-inversions-1405373537>.

Fortunately, due to mounting public pressure and a U.S. Treasury Notice released on September 22, 2014 that places new restrictions on inversions, most of the proposed mergers mentioned in this introduction have either been canceled or slowed. However, this does not mean that all is now well. More significant reform is needed on both a national and international level to prevent tax bases from further eroding. Moreover, tax base erosion and the “race to the bottom” that corporate inversions and competitive tax codes encourage are harmful to many more governments than just the United States. Therefore, this paper aims to critically evaluate the many different policy options that are currently floating around on how to decrease the occurrence of corporate inversions and protect government tax bases around the world, using the U.S. case as an example.

Before the analysis section begins, however, this paper will present a literature review to familiarize the reader with the most important sources upon which this research is based. It will then briefly review the research methodology used in the research stages of this project. Next is Part II, in which the effects of corporate inversions on a variety of groups is discussed in greater detail. Part III then lays out a brief analysis of U.S. anti-inversion regulations, including the implications of the September 2014 Treasury Notice. Parts IV and V go on to evaluate the measures being discussed in the United States and at the Organization for Cooperation and Economic Development (OECD) on how to deal with corporate inversions and other tax base erosion issues. Finally, Part VI concludes with thoughts on how future inversions can be discouraged in the United States and whether the OECD’s effort to bring about a more equitable international tax system is realistic.

A. Literature Review

This paper relies heavily on research produced by think tanks and government reports. Additionally, as there has been much news around the issue of corporate inversions in the United States during the time in which I wrote this paper, a number of reputable news sources, such as the *Wall Street Journal* and the *New York Times*, are utilized as well.

In Section II, where I discuss the costs and incentives of inversions, the OECD's "Base Erosion and Profit Shifting Action Plan" and reports from the Tax Justice Network helped provide useful explanations as to why corporate inversions and other tax avoidance schemes present serious problems for society. Thomas L. Hungerford's "Policy Responses to Corporate Inversions" report published by the Economic Policy Institute also gave insight into why inversions are so attractive to certain corporations, and statistical data from Alexandra Thornton's "The Skinny on Corporate Inversions" published by the Center for American Progress proved to be quite helpful in illustrating the changes in the corporate share of the U.S. tax burden in recent decades.

In the subsequent sections discussing U.S. corporate tax law, reports from the Congressional Research Service (CRS) assisted me in understanding all the complexities in this topic area and provided a nice summary of current policy options aimed at reforming this particular tax system. Mindy Herzfeld's Tax Analysts report was similarly useful.

As for the latter two sections that have to do with corporate tax policy reform on both national and international levels, it should be noted that there is no agreed upon academic consensus in this area. The most common sources relied on in these sections

are reports from the U.S. government and the OECD. Furthermore, these sections are not an exhaustive list of every different policy option that could produce a more equitable corporate tax system. Instead, their goal is to give a general critique of some of the big, hot-button ideas included in the tax reform debate. Essentially, they aim to open up the discussion as to what future corporate tax reform may look like rather than to conclude it.

B. Research Methodology

A combination of primary and secondary sources was used in the production of this research project. Many of the secondary sources, such as newspaper articles and papers published by various think tanks, have already been mentioned. Primary sources include documents published by governments and multilateral organizations; I also carried out a series of interviews with a number of experts in the field.

The interview part of this research process proved to be the most challenging, as many of the people who are most qualified to talk about corporate tax law – corporate lawyers, for example – refused to discuss this subject with me. However, the sources I did manage to find were all from diverse backgrounds and provided a variety of valuable perspectives on the corporate taxation issues. My interview contacts consisted of a tax advisor from the OECD's Base Erosion and Profit Shifting team, a senior director from the World Economic Forum, a former economist from the United Nations Conference on Trade and Development who is currently a professor at Erasmus University Rotterdam, and a former employee from Deloitte who worked in the company's strategy and human capital consulting practices.

All interviewees were asked permission to be interviewed and informed about the goals of my research project. Because of the sensitive nature of the information the

Deloitte employee revealed and so as not to compromise his professional reputation, he has requested to remain anonymous. He will be referred to as X throughout this paper. One formal interview was conducted with each interview contact. I also held an additional informal interview with X when I first met him in Brussels. Interviews with participants were held in Brussels, Paris, and Geneva.

This project is primarily limited by its scope, as the topic of corporate tax law reform is quite a broad and complex area of study. It is also limited by the one-month timeframe time in which I had to conduct the study. Finally, because there are many developments occurring in the field of corporate tax reform, specifically as it relates to corporate inversions, some of the information in this paper may eventually become outdated.

II. The Costs and Incentives of Corporate Inversions

During X's time at Deloitte, he worked on large finance transformation projects in which companies were reorganizing or building new capabilities within their finance functions. In an email exchange, he wrote, "The reasons that clients undertook these large projects were varied, but I don't think there was a single one in which tax advantages were not a primary motivation... Tax avoidance is as old as taxation, and corporate inversions are just one of the hot new flavors."¹³ Clearly, there are many different methods corporations can use to lower their tax bill, with corporate inversions being just one of many. However, since it is unlikely that we can solve all of the world's corporate

¹³ X. Former Deloitte employee. Interview by the author. Geneva, November 17, 2014.

tax problems in one paper, we will focus specifically on corporate inversions for the purposes of this research.

However, before a discussion is held on ways that corporate inversions might be halted, it is important to understand why society has an interest in halting this form of merger in the first place. In addition, one must also attain a deeper understanding of the reasons corporations pursue inversions.

A. The Costs

As previously stated, the primary incentive of a corporate inversion is to lower the amount of taxes the corporation must pay. However, it is important to note that inversions are just one of the many ways in which corporations attempt to accomplish this goal, and as such, inversions can be grouped into practices called base erosion and profit shifting (BEPS). According to the OECD, “BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profits ‘disappear’ for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low, resulting in little or no overall corporate tax being paid.”¹⁴ Therefore, throughout this discussion, I will talk about the harmful effects of not only inversions, but of BEPS practices as a whole.

When taking into account the costs of inversions and BEPS to society, one should keep in mind that this is *not* about what is legal and not legal. Many corporate inversions and BEPS tactics are perfectly legal as the current law stands, so that is not what this section is primarily about. As the Tax Justice Network so keenly observes, “It is essential to move away from viewing tax compliance merely from a *legal* perspective – whether

¹⁴ OECD. “BEPS – Frequently Asked Questions.” *OECD*, 2014, accessed October 30, 2014, <http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm>.

the corporation has broken the law or not – but from an *economic* perspective: whether it is free-riding off others. If they are not paying their way, they are being irresponsible – and there is a problem that needs fixing.”¹⁵ As such, this section will attempt to frame why BEPS practices are harmful from an economic and moral perspective rather than from a legal one.

First and foremost, BEPS harms governments. Clearly, if corporations make new legal arrangements that allow them to pay little to no taxes to countries in which they have the majority of their operations, then the tax base of those countries will shrink. As mentioned in Part I, the United States could lose close to \$20 billion over the next decade if changes to the tax code aren't made to stop new inversions. However, BEPS is not just an issue for developed countries. As the OECD notes, “In developing countries, the lack of tax revenue [that BEPS causes] leads to critical under-funding of public investment that could help promote economic growth.”¹⁶ (Note that this claim, while partly true, will be further examined and qualified later in Part V.)

Secondly, BEPS harms individual taxpayers. When a company engages in BEPS practices, the government will have less money to spend on promoting the public good. It could also mean that the government will choose to make up the loss in tax revenue by shifting more of the tax burden to individual taxpayers rather than corporations.¹⁷ Laura Stefanelli, a member of the the BEPS team at the OECD, noted in an interview that this

¹⁵ Tax Justice Network. “Tax and corporate responsibility.” *Tax Justice Network*, 2014, accessed October 28, 2014, <http://www.taxjustice.net/topics/corporate-tax/tax-corporate-responsibility/>.

¹⁶ OECD. “Action Plan on Base Erosion and Profit Shifting.” *OECD Publishing* (2013): 8, accessed October 29, 2014, <http://dx.doi.org/10.1787/9789264202719-en>.

¹⁷ *Ibid*, 8.

situation is a moral problem, saying, “If I am a taxpayer and see that companies aren’t paying their fair share, then I could say, why should I pay?”¹⁸

Indeed, this moral problem has presented itself in the United States over the course of just a few decades. U.S. tax statistics from the CRS illustrate this issue:

At its post-WWII peak in 1952, the corporate tax generated 32.1% of all federal tax revenue. In that same year the individual tax accounted for 42.2% of federal revenue, and the payroll tax accounted for 9.7% of revenue. In 2012, the corporate tax accounted for 9.9% of federal tax revenue, whereas the individual and payroll taxes generated 46.2% and 34.5%, respectively, of federal revenue.¹⁹

The report also noted that whereas corporate tax was equal to 6.1% of gross domestic product (GDP) at its peak in 1952, in 2011, the tax was equal to approximately 2.3% of GDP. This significant drop in percentage occurred despite the fact that corporations have been capturing a growing share of the national income from 1946 to 2012.²⁰ In 1946, corporations captured 4.6% of the national income, while in 2012, they took in 11.2% of it.²¹ In this case, a partial shift of the tax burden from corporations to individual taxpayers is clear (See Figures 1.1 and 1.2). However, it should be noted that the lowering of corporate taxes as a result of BEPS and government policy doesn’t hurt *all* taxpayers. When corporate taxes are significantly lower than individual income taxes, the wealthy may shift their income out of the personal tax category and into corporate forms.²² Clearly, this practice further harms the average taxpayer.

¹⁸ Laura Stefanelli. OECD. Interview by the author. Paris, September 26, 2014.

¹⁹ Mark P. Keightley and Molly F. Sherlock. “The Corporate Income Tax System: Overview and Options for Reform.” *Congressional Research Service*: (February 14, 2014), 13, accessed October 27, 2014, <http://fas.org/sgp/crs/misc/R42726.pdf>.

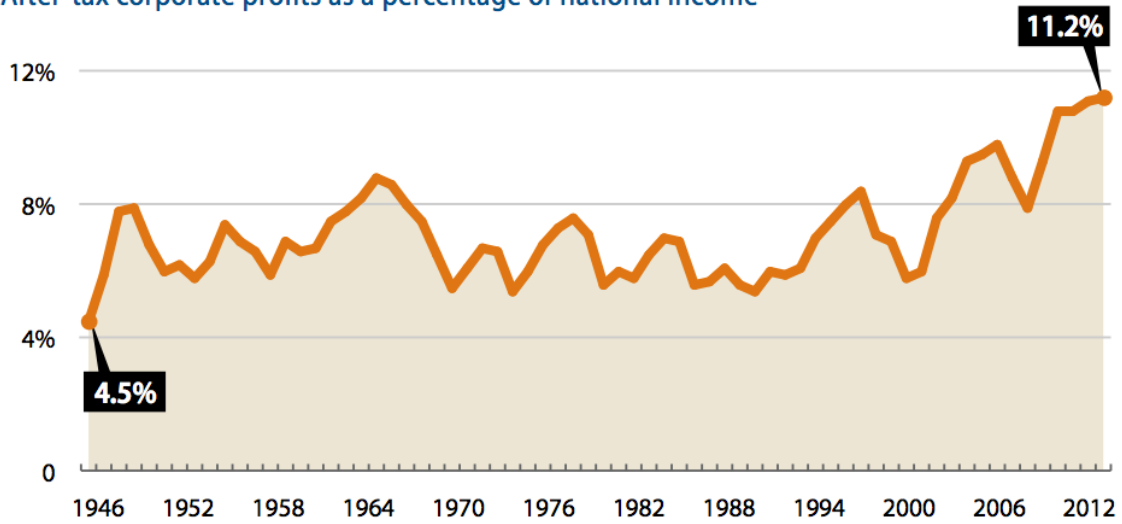
²⁰ Thornton, *The Skinny on Corporate Inversions*, 2.

²¹ For consistency with the CRS, it should be noted that, according to Thornton’s CAP report, the corporate tax rate was 30.2% in 1946, just a few years before its 1952 peak.

²² Tax Justice Network. “Taxing corporations.” *Tax Justice Network*, 2014, accessed October 28, 2014, <http://www.taxjustice.net/topics/corporate-tax/taxing-corporations/>.

Corporations are capturing a growing share of national income

After-tax corporate profits as a percentage of national income

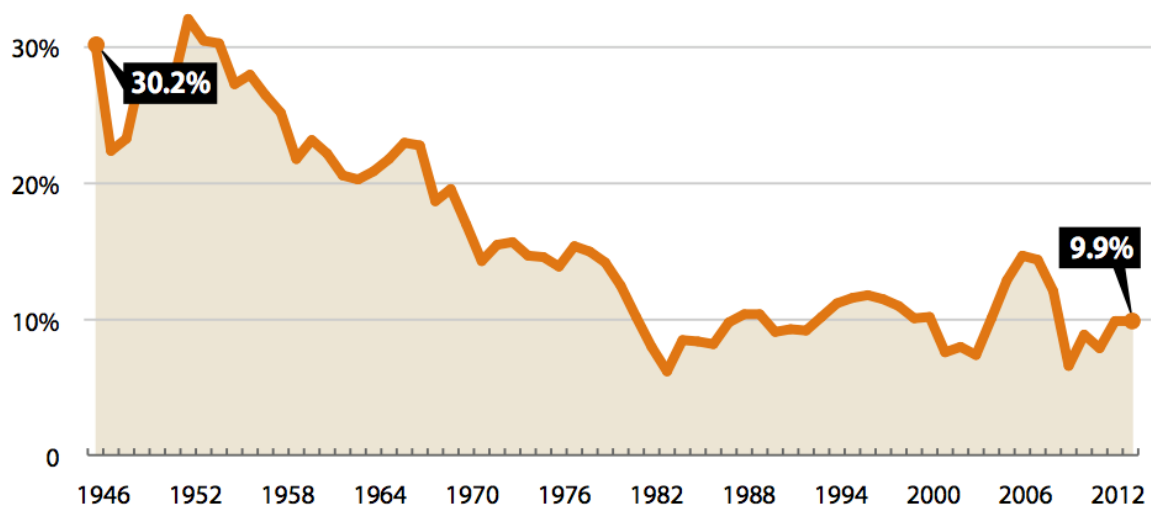


Source: Bureau of Economic Analysis, "National Income and Product Accounts Tables," Table 1.12, available at http://www.bea.gov/iTable/index_nipa.cfm (last accessed September 2014).

Fig. 1.1- Corporations are capturing a growing share of national income (© Center for American Progress, 2014)

Corporate income taxes are a declining share of total federal revenue

Percentage of total federal revenue from corporate income tax



Source: Office of Management and Budget, "Historical Tables," Table 2.2, available at <http://www.whitehouse.gov/omb/budget/Historicals> (last accessed September 2014).

Fig 1.2- Corporate income taxes are a declining share of total federal revenue (© Center for American Progress, 2014)

Finally, businesses are harmed by BEPS as well. Stefanelli explained, “The problem is that an international company can use the tax system to their advantage, putting them at an advantage over a domestic company.”²³ For example, corporations that operate only in the domestic market, such as small family businesses and innovative companies new to the market, may have trouble competing with large multinational corporations that can shift their profits outside of the United States and arrange to be taxed in a country with a significantly lower tax rate.²⁴ Additionally, if a multinational corporation doesn’t take advantage of opportunities to lower its tax burden, then it may be put at a competitive disadvantage when compared to other corporations. There is also

²³ Stefanelli, Interview by the author.

²⁴ OECD, *Action Plan on Base Erosion and Profit Shifting*, 8.

the risk that companies who engage in BEPS practices may face damage to their reputation. This is exactly what happened when Walgreens was attempting to re-incorporate itself to Switzerland by buying Switzerland-based Alliance Boots so that it could enjoy the country's 17.92% corporate tax rate.²⁵ The public outcry over this deal turned out to be so great that Walgreen's soon reversed its decision to re-incorporate itself, at least for now. This past August, Walgreens announced that it will still buy Alliance Boots, but it will keep its legal residence in Illinois.²⁶

Although Walgreens could have saved \$4 billion in taxes over five years by re-incorporating in Switzerland, Greg Wasson, president and CEO of Walgreens, said in a statement that the company is "mindful of the ongoing public reaction to a potential inversion and Walgreens' unique role as an iconic American consumer retail company with a major portion of its revenues derived from government-funded reimbursement programs."²⁷ However, it should be noted that it wasn't only pressure from the public that made Walgreens reverse its decision. In the same statement, Wasson also said that the company "could not arrive at a structure that provided the company and our board with the requisite level of confidence that a transaction of this significance would need to withstand extensive IRS review and scrutiny." This case is a perfect illustration of the power both the public and the government have to halt inversions; such power will become particularly important in later sections of this paper.

²⁵ Americans for Tax Fairness. "Offshoring America's Drugstore." *Americans for Tax Fairness* : (June 2014), 1, accessed October 29, 2014.

<http://www.americansfortaxfairness.org/files/OffshoringAmericasDrugstore.pdf>.

²⁶ Wenxiong Zhang. "Walgreens Resists Tax Inversion by Acquiring Alliance Boots." *The American Lawyer Daily*, August 6, 2014, accessed October 30, 2014,

<http://www.americanlawyer.com/id=1202666066985/Walgreens-Resists-Tax-Inversion-in-Acquiring-Alliance-Boots>.

²⁷ Ibid.

B. The Incentives

The primary incentive for corporation inversions is, of course, to lower the corporation's tax bill. However, an inversion can accomplish this through a variety of methods, often using multiple methods simultaneously. The method that has already been mentioned is re-incorporating to another country in order to enjoy a lower overall corporate tax rate. Inverting corporations argue that in order to stay competitive, they must escape the U.S. statutory corporate tax rate of 35%, the highest tax rate on corporations among developed nations. However, Hungerford points out that "the average *effective* U.S. corporate tax rate—the rate paid after various deductions and credits are applied—is about 27%. This is not much different from the effective tax rate paid by corporations in many advanced industrial countries that are not tax havens."²⁸ (As Section IV will illustrate, sometimes the U.S. effective tax rate is significantly lower than 27% among more profitable corporations.) Of course, many of the countries these corporations invert to, such as Ireland or Switzerland, are considered tax havens, so the tax benefits to moving to these countries are not insignificant. However, Hungerford thinks that there is a much bigger tax-related reason as to why companies want to invert, which brings us to the second method of accomplishing a lower corporate tax bill.

The second method is a bit less obvious than the first, but just as important. The United States taxes the worldwide income of its corporations, while almost all of the other countries it trades with only tax income earned within their respective territories.²⁹ However, U.S. corporations are allowed to defer paying taxes on their foreign earnings

²⁸ Hungerford, "Policy Options to Corporate Inversions: Close the Door Before the Horse Bolts."

²⁹ Thornton, "The Skinny on Corporate Inversions," 3.

until they reinvest those earnings back into the U.S. company. It is estimated that, right now, U.S. companies are holding at least \$1 trillion in tax-deferred earnings in overseas tax havens.³⁰ However, as law professor Edward D. Kleinbard notes, “The same tax-haven subsidiary of the U.S. firm owns the cash after an inversion transaction as did before the inversion, and therefore the cash cannot directly fund a dividend to the immediate U.S. parent without U.S. tax.”³¹ Fortunately for the corporations, a clever scheme known as “hopscotching” allows them get around this regulation. Hopscotching is when a foreign subsidiary of the former U.S. company – known as a controlled foreign corporation (CFC) – lends its cash to the new foreign parent company created by the inversion at very low interest rates. The foreign parent can then, as Kleinbard explains, “use the cash to fund higher-yielding projects in the U.S., to repay loans used to finance the inversion transaction, or to pay dividends or buy back stock from U.S. investors.” Therefore, the corporation is effectively free from having to pay anything in U.S. taxes on its tax-deferred earnings, and the earnings can still end up in the United States in the end. As Hungerford notes, “This is undoubtedly the primary motivation to invert.”³²

A third method of using an inversion to lower a company’s tax bill is called earnings stripping. Earnings stripping occurs when the U.S. subsidiary of the new foreign parent company takes on heavy intercompany debt through the issuance of an intercompany note.³³ As a result of this intercompany debt, the U.S. subsidiary’s tax bill

³⁰ Edward D. Kleinbard. “Tax Inversions Must Be Stopped Now.” *The Wall Street Journal*, July 21, 2014, accessed October 31, 2014, <http://online.wsj.com/articles/edward-d-kleinbard-tax-inversions-must-be-stopped-now-1405984126>.

³¹ Ibid.

³² Hungerford, “Policy Options to Corporate Inversions: Close the Door Before the Horse Bolts.”

³³ Ibid.

can be dramatically reduced, because the interest payments to the foreign parent company are tax deductible. Although Hungerford notes that there are certain limits on this practice under Internal Revenue Code section 163(j), more regulation is needed. A Department of Treasury report to Congress in 2007 stated, “The data gathered with respect to inverted corporations...strongly suggest that these corporations are stripping substantially all of their income out of the United States, primarily through interest payments.”³⁴ In light of this situation, perhaps section 163(j) could use some strengthening.

When speaking of incentives to invert, the reasons why the number of inversion cases in the United States has spiked in recent years should also be discussed. X believes that tax inversions, like other corporate trends, follow a relatively predictable pattern. He compared tax inversions to a phenomenon in technology adoption called the S curve:

Whenever a new technology comes out, there are certain early adopters who start using it. If they are successful, other actors pay attention and are more likely to adopt the practice themselves, leading to a drastic increase in the rate of adoption. Tax inversions seem to me to be following that trend. After a few large corporations did it and saved ridiculous amounts of money on their tax obligations, and they didn't face significant backlash from the U.S. government or the public, this makes it more likely that peers will imitate the strategy. Accounting, consulting, and law firms (like Deloitte) will start building an expertise in how these work, and they'll literally be selling it to executives of major corporations.³⁵

He also noted that because of the recent public outcry against inversions in the media and recent anti-inversion regulations put out by the government, this trend may be on its way to reversing itself.

³⁴ U.S. Treasury. “A Report to Congress on Earnings Stripping, Transfer Pricing, and U.S. Income Tax Treaties.” *Department of the Treasury*, November 2007, accessed November 17, 2014, 8, <http://www.treasury.gov/resource-center/tax-policy/documents/ajca2007.pdf>.

³⁵ X, Interview by the author.

Additionally, Hungerford theorizes that corporations may have decided that because they have so far failed to gain another repatriation holiday like the one they received in 2004 (see Part III for more details on this), accessing their unrepatriated foreign-sourced earnings via inversions is “a useful complementary strategy to avoid U.S. taxes.”³⁶ Finally, corporations could also be using the threat of inversions as a way to pressure the U.S. government to lower the corporate tax rate, switch to a territorial tax system, or pass another repatriation holiday.³⁷

III. An Analysis of Current U.S. Anti-Inversion Regulations

As Elaine Dezenski from the World Economic Forum noted in an interview, “Companies say, ‘These loopholes [that enable tax avoidance schemes] exist for a reason and we use them.’ It’s a policy deficit.”³⁸ This section aims to give a brief explanation of how U.S. corporate inversion law has managed to close some of these policy deficits in recent years and which loopholes still remain. It will also explain new inversion regulations laid out in the September 2014 Treasury Notice, for in order to discuss reforms to corporate inversions laws in the United States, one must first understand what the current inversion laws are.

A. The Evolution of Corporate Inversion Law

As it was in the Trojan War, the United State’s battle against corporate inversions started with Helen of Troy. However, in 1993, Helen of Troy was not a beautiful woman,

³⁶ Hungerford, “Policy Options to Corporate Inversions: Close the Door Before the Horse Bolts.”

³⁷ Ibid.

³⁸ Elaine Dezenski. World Economic Forum. Interview by the author. Geneva, November 11, 2014.

but rather, a publicly traded U.S. cosmetics company that carried out an inversion to Bermuda, making a newly formed Bermuda shell corporation the U.S. corporation's parent.³⁹ This inversion was tax-free to Helen of Troy and all of its public shareholders. Additionally, there are no corporate taxes in Bermuda. Given these factors, the Internal Revenue Service (IRS) contested that this particular inversion was a completely tax-motivated transaction. In response, the IRS released a notice (Notice 94-96) stating that, "on a prospective basis, U.S. shareholders of a U.S. corporation [will] be subject to taxation in certain inversion transactions."⁴⁰

After this notice came new anti-inversion regulations, which were released in 1996 under section 367(a) of the U.S. Code. These regulations made the transfer of stock or securities of a domestic corporation by a U.S. person to a foreign corporation subject to U.S. tax if all U.S. transferors owned in total 50% or more of either the total voting power or the total value of the stock of the transferee corporation immediately after the exchange.⁴¹ While these section 367(a) regulations would have made Helen of Troy's inversion taxable for its U.S. shareholders, they were not effective in discouraging future inversions.⁴² This is due to the fact that taxable U.S. persons often make up a minority of the shareholders of a U.S. multinational corporation and that such shareholders may have little financial gain in their shares of the U.S. company.

³⁹ Brandon Hayes. "US anti-inversion provisions." *International Tax Review*, March 27, 2013, accessed November 2, 2014, <http://www.internationaltaxreview.com/Article/3181949/US-anti-inversion-provisions.html>.

⁴⁰ Ibid.

⁴¹ Mindy Herzfeld. "News Analysis: What's Next in Inversion Land?" *Tax Analysts*, June 16, 2014, accessed November 2, 2014, <http://www.taxanalysts.com/www/features.nsf/Features/F817995A255AFD2485257CF900427B06?OpenDocument>.

⁴² Hayes, "US anti-inversion provisions."

A few years after a new wave of inversions began in the late 1990's, Congress enacted the American Jobs Creation Act of 2004 (AJCA). This new piece of legislation established section 7874, which states that the new foreign company to which the domestic company has inverted will still be treated as a domestic company under U.S. law if the original U.S. stockholders own 80% or more of the new firm.⁴³ Essentially, this means that the company would not enjoy any tax benefits of the inversion and would be taxed on the combined corporation's worldwide income. In order to compromise with the corporations, the AJCA included a one-year repatriation holiday that allowed multinational corporations to repatriate foreign-earnings at a rate of 5.25% instead of the statutory 35%.⁴⁴ It also included a tax exclusion of 85% of dividends repatriated back to the United States from foreign subsidiaries.⁴⁵ Corporations certainly took advantage of this holiday. For example, the CRS reports that when the repatriation holiday was in effect in 2005, Pfizer repatriated \$37 billion, the largest amount of repatriations of any firm during that time.⁴⁶

The AJCA also set up a new tax regime that applies when there is at least 60% continuity in U.S. shareholder ownership but less than 80%. "In this case," a recent CRS report writes, "the new foreign parent is not taxed like a domestic corporation, but any U.S. toll taxes (taxes on gains) that apply to transfers of assets to the new entity are not

⁴³ Jane G. Gravelle and Donald J. Marples. "Corporate Expatriation, Inversions, and Mergers: Tax Issues." *Congressional Research Service*, September 25, 2014, accessed October 25, 2016, 6, <http://fas.org/sgp/crs/misc/R43568.pdf>.

⁴⁴ Hungerford, "Policy Options to Corporate Inversions: Close the Door Before the Horse Bolts."

⁴⁵ Gravelle and Marples, "Corporate Expatriation, Inversions, and Mergers: Tax Issues," 8.

⁴⁶ *Ibid*, 8.

permitted to be offset by foreign tax credits or net operating losses.”⁴⁷ However, according to the AJCA, if the U.S. domestic company had substantial business activities in the foreign country to which it was re-incorporating, then it could be exempt from these anti-inversion regulations. Most problematically, exactly what the phrase ‘substantial business activities’ consisted of was never defined in the legislation.

Aside from this, there was an additional problem with the wording of the AJCA. Section 7874 states that certain types of stock are ignored in ownership tests when determining whether or not an inversion will be recognized, including “stock of the foreign corporation that is sold in a public offering related to the acquisition.”⁴⁸ Because the language in section 7874 refers only to public offerings, U.S. companies could escape anti-inversion regulation by using private buyouts rather than public ones to invert.

In response to this loophole, the Obama Administration and IRS took action in 2009 to close it. These two government bodies argued that using private equity buyouts to complete inversions violated the intent of section 7874. The Treasury then released a notice (Notice 2009-78, 2009-40 IRB 452) saying that it would “issue regulations interpreting the term ‘public offering’ to include shares issued for cash, marketable securities, or any other property acquired in a transaction with a principal purpose of avoiding the purposes of section 7874.”⁴⁹ Therefore, the intent of section 7874 to discourage corporate inversions overruled, in a legal sense, the statute’s language that referred only to public offerings to include private transactions as well.

⁴⁷ Ibid, 6.

⁴⁸ Herzfeld, “News Analysis: What’s Next in Inversion Land?”

⁴⁹ Ibid.

However, efforts to close ‘the substantial business activities’ loophole did not come onto the scene until later, when the Treasury issued temporary regulations that interpreted the ‘substantial business activities’ exception “to require at least 25 percent of each of the group employees, group assets, and group income to be located or derived in the relevant foreign country,” an increase from what used to be 10 percent.⁵⁰ This action severely limited the U.S. corporations’ use of the substantial business activities exception for inversion purposes, as very few of them met this 25 percent requirement in any single location outside the United States.

B. The September 2014 Treasury Notice: Further Reforms

In response to the numerous attempted inversions being carried out this year, the U.S. Treasury Notice (Notice 2014-52) released on September 22, 2014 laid out further regulatory actions that target two different inversion tactics. The first change limits the access of U.S. firms to the accumulated deferred earnings of foreign subsidiaries by specifically targeting the CFC hopscotching schemes previously mentioned in Part II. The Treasury writes, “Today’s notice removes benefits of these ‘hopscotch’ loans by providing that such loans are considered ‘U.S. property’ for purposes of applying the anti-avoidance rule. The same dividend rules will now apply as if the CFC had made a loan to the U.S. parent prior to the inversion.”⁵¹ In essence, this means that if the CFC makes a loan to the new foreign parent company that is then transferred to the U.S. company, this loan will now be subject to U.S. taxes. The Treasury Notice also prevents a

⁵⁰ Ibid. After the AJCA was signed into law, the Treasury originally interpreted “substantial business activities” as 10% of worldwide activity.

⁵¹ U.S. Treasury. “Fact Sheet: Treasury Actions to Rein in Corporate Tax Inversions.” *U.S. Treasury Press Center*, September 22, 2014, accessed November 8, 2014, <http://www.treasury.gov/press-center/press-releases/Pages/j12645.aspx>.

“de-controlling” strategy corporations use – which is when the new foreign parent buys enough stock to take control of the CFC away from the former U.S. parent to avoid paying U.S. taxes on the CFC’s earnings – by treating the stock the foreign parents buys as stock in the former U.S. parent.⁵² This would make the CFC remain a CFC, and U.S. tax on its profits and deferred earnings would still apply. Finally, the Notice closes a loophole that allowed inverted companies to transfer cash or property from a CFC to the new parent company to avoid U.S. tax. These transactions occurred when the new foreign parents sold its stock in the former U.S. parent to a CFC with deferred earnings in exchange for cash or property of the CFC, “effectively resulting in a tax-free repatriation of cash or property bypassing the U.S. parent.”⁵³

The second way in which the notice targeted inversion tactics was by strengthening the less than 80% ownership requirement that the AJCA established under section 7874. First, the notice prevents firms from attaining this goal “by inflating the size of the foreign merger partner...by use of passive assets (e.g., an interest bearing bank deposit).”⁵⁴ The notice disregards passive assets of the foreign firm in cases where more than 50% of the firm’s value is in passive assets. However, banks and other financial services are exempted from this stipulation. Second, the notice stops U.S. companies from reducing their pre-inversion size by paying out extraordinary dividends in order to meet the less than 80% goal. It does this by simply disregarding these pre-inversion dividends for purposes of the ownership requirement.⁵⁵ Third, the notice prevents

⁵² Ibid.

⁵³ Ibid.

⁵⁴ Gravelle and Marples, “Corporate Expatriation, Inversions, and Mergers: Tax Issues,” 10.

⁵⁵ U.S. Treasury, “Fact Sheet: Treasury Actions to Rein in Corporate Tax Inversions.”

“spinversions”, which is when part of a U.S. company is spun off to create a newly formed foreign corporation, by considering the new foreign company as a domestic corporation.⁵⁶ All of these actions apply to deals closed on or after the day the notice was released, thereby encompassing the attempted inversions mentioned in the introduction of this paper.

While this notice is a step in the right direction, it fails to deal with one of the most important tax avoidance schemes that inversions make possible – earnings stripping. “The tepid response that this [Treasury notice] represents could well embolden companies to believe that Treasury is not going to deal with earnings stripping through regulations,” Bret Wells, a tax law professor at the University of Houston, said to *Bloomberg*.⁵⁷ One of the most direct solutions to earnings stripping would be to reclassify the intercompany debt the U.S. subsidiary receives from its foreign parent as equity “and thereby transform a deductible interest payment into a nondeductible dividend.”⁵⁸ Section 385 of the U.S. Code gives the Treasury secretary the regulatory authority to do this.

Another solution is to lower the current 50% cap on deductions of U.S. taxable income set by section 163(j), thereby making it more difficult for companies to benefit from loading their U.S. operations with debt. However, lowering this cap is not within the Treasury’s power, so Congress would have to enact legislation that accomplishes this – a nearly impossible scenario, at least within the two years, due to the Republican control of

⁵⁶ *Ibid.*

⁵⁷ Iris Dorian. “What About Earnings Stripping?” *CFO.com*, September 24, 2014, accessed November 18, 2014, <http://ww2.cfo.com/tax/2014/09/earnings-stripping/>.

⁵⁸ Stephen E. Shay. “Mr. Secretary, Take the Juice Out of Corporate Expatriations.” *Tax Analysts*, July 28, 2014, accessed November 18, 2014, <http://www.taxanalysts.com/www/features.nsf/Features/76D1FDB318A0435D85257D230050CC38?OpenDocument>.

both bodies of Congress as a result of the recent 2014 elections.

IV. Future Reforms to U.S. Corporate Tax Law

The past decade of anti-inversion regulations have been largely successful in stopping the practice of “naked inversions,”

inversions in which little activity occurs in

the new jurisdiction and the new parent

company is located in a tax haven.⁵⁹

Through further regulations, the U.S.

Treasury has limited corporations’ access to

deferred earnings via inversions and

provided additional requirements regarding

the less than 80% ownership test, among

other actions. However, as the numerous

examples of attempted inversions this year

illustrate, inversions are still possible

through the use of mergers, and there is a

strong lobby of U.S. businesses that, for one

reason or another, no longer want to be

considered U.S. businesses anymore.

Further reforms are needed to prevent future

erosion of the U.S. tax base by both further limiting the ability of corporations to invert

Rank in 2012		Rate in 2012	Enacted or proposed reductions, 2013–2015
1	United States	39.1	
2	Japan	38.0	35.6
3	France	34.4	
4	Belgium	34.0	
5	Portugal	31.5	
6	Germany	30.2	
7	Australia	30.0	
8	Mexico	30.0	28.0
9	Spain	30.0	
10	Luxembourg	28.8	
11	New Zealand	28.0	
12	Norway	28.0	
13	Italy	27.5	
14	Sweden	26.3	22.0
15	Canada	26.1	
16	Austria	25.0	
17	Denmark	25.0	22.0
18	Israel	25.0	
19	Netherlands	25.0	24.0
20	Finland	24.5	20.0
21	Korea	24.2	
22	United Kingdom	24.0	20.0
23	Switzerland	21.2	
24	Estonia	21.0	20.0
25	Chile	20.0	
26	Greece	20.0	
27	Iceland	20.0	
28	Turkey	20.0	
29	Czech Republic	19.0	
30	Hungary	19.0	
31	Poland	19.0	
32	Slovak Republic	19.0	
33	Slovenia	18.0	15.0
34	Ireland	12.5	
	OECD average, excluding U.S.	25.0	

Source: OECD Tax Database (2012). Japan 2012 tax rate, Slovenia 2012 tax rate, and enacted or proposed reductions from current publications.

Figure 4.1- OECD Combined National and Subnational Corporate Tax Rates (© Business Roundtable, 2013)

⁵⁹ Gravelle and Marples, “Corporate Expatriation, Inversions, and Mergers: Tax Issues,” 10.

and making the United States a more attractive place for corporations to stay in the first place. This section will explore some of the current reforms that are on the table suggest which ones might be worth adopting in America's future.

A. On Lowering the Corporate Tax Rate

One of the biggest debates concerning corporate tax policy is whether or not to lower the corporate tax rate. As noted in Section I, the United States has the highest statutory corporate tax rate among industrialized nations at 35%, and once state taxes are factored in as well, the total statutory corporate tax rate is around 39.1%.⁶⁰ Fig. 4.1 shows how the United State's tax rate compared to other OECD member countries in 2012. However, there is more to these statistics than first meets the eye. According to 2013 report by the Government Accountability Office, profitable U.S. corporations paid an average effective federal tax rate of 12.6% in 2012.⁶¹ Massachusetts Institute of Technology professor Andrea Louise Campbell explains the reason for this discrepancy in numbers:

Yet as with the individual income tax, the United States applies these statutory rates to a narrower base of taxpayers than other advanced countries do, due to various corporate tax credits and breaks, such as the accelerated depreciation of machinery and equipment and the deferral of taxes on income earned abroad. As a result, according to a report issued by the U.S. Treasury Department, between 2000 and 2005, on average, U.S. businesses paid an effective tax rate of only 13 percent, nearly three percent below the OECD average and the lowest rate among the G-7 countries.⁶²

⁶⁰ Business Roundtable. "Corporate Tax Reform – The Time is Now." *Business Roundtable*, April 15, 2013, accessed November 9, 2014, 2, <http://online.wsj.com/public/resources/documents/BRTStudy.pdf>.

⁶¹ U.S. Government Accountability Office. "Corporate Income Tax: Effective Rates Can Differ Significantly from the Statutory Rate." *U.S. Government Accountability Office*, GAO-13-520, May 2013, accessed November 10, 2014, <http://www.gao.gov/products/GAO-13-520>.

⁶² Andrea Louise Campbell. "America the Undertaxed: U.S. Fiscal Policy in Perspective." *Foreigns Affairs*, September/October 2012, accessed November 10, 2014.

Furthermore, when it comes to corporate taxes as a percentage of GDP, the overall U.S. corporate tax rate stood at 2.3% in 2011.⁶³ This is below both the OECD average of 3% and the median of 2.7%. In 2012, the U.S. corporate tax rate was not much better, standing at only 2.6% of GDP. Such context is essential to take note of if the exercise of comparing the corporate tax rates of different countries is to have any meaning.

Of course, there are still countries with lower effective corporate tax rates than the United States, even if the U.S. corporate tax as a percentage of GDP is below the OECD average. In light of this fact, Republicans in Congress argue that if the U.S. corporate tax rate is lowered, then corporations will be encouraged to invest more in the United States. Along this same line of thought, the Business Roundtable, which represents some of the biggest American companies, writes:

Corporate tax reform to modernize our tax system will enhance US economic growth, increase US investment, and provide for better and higher paying jobs. A competitive corporate tax rate and a more modern and competitive international tax system will provide a level playing field for American-based businesses, increasing the growth of US companies, attracting investment to the United States, and enhancing and sustaining US economic growth and job creation.⁶⁴

Clearly, this is not an unbiased source, as the members of the Business Roundtable would be among the primary beneficiaries of a lower corporate tax rate. Despite this, the above quote is an accurate representation of the main talking points for why the corporate tax rate should be lowered.

<http://www.foreignaffairs.com/articles/137838/andrea-louise-campbell/america-the-undertaxed>.

⁶³ OECD. "Revenue Statistics – Comparative Tables." *OECD StatExtracts*, 2014, accessed November 10, 2014, <http://stats.oecd.org/index.aspx?DataSetCode=REV>.

⁶⁴ *Ibid*, 7.

On the other hand, it should be noted that the money the government receives from corporate taxes does not simply disappear once the government collects it. As Michael Mazerov from the Center on Budget and Policy Priorities writes, “Corporate income taxes are important sources of revenue that states use to fund public services, including services essential to long-term economic growth like education, infrastructure, health care, and public safety.”⁶⁵ Therefore, although higher corporate taxes may discourage investment or the repatriation of foreign earnings to the United States, the collection of corporate taxes in itself does not automatically damage the economy.

The Congressional Budget Office (CBO) and CRS have both come to similar conclusions regarding how effective corporate federal tax cuts are at stimulating economic growth. A 2008 CBO report states that cutting corporate taxes is not a cost-effective method of stimulating business spending. The reason for this, the researchers explain, is that “increasing the after-tax income of businesses typically does not create an incentive for them to spend more on labor or to produce more, because production depends on the ability to sell output.”⁶⁶ While the report also notes that reducing corporate taxes can spur new investment, it points out that there are policy measures that can accomplish this goal more effectively. The primary influence of taxes on a company’s decision to invest depends on the prospective profits from new investments, not on current profits from old investments. However, lowering corporate tax rates

⁶⁵ Michael Mazerov. “Cutting State Corporate Income Taxes is Unlikely to Create Many Jobs.” *Center on Budget and Policy Priorities*, September 14, 2010, accessed November 9, 2014, 1, <http://www.cbpp.org/files/9-14-10sfp.pdf>.

⁶⁶ Robert Dennis, Douglas Hamilton, Kim Kowalewski, John Peterson, and Thomas Woodward. “Options for Responding to Short-Term Economic Weakness.” *Congressional Budget Office*, January 2008, accessed November 9, 2014, 13, <http://corporatetax.procon.org/sourcefiles/cbo-2008.pdf>.

increases the company's returns on past investments more than it increases the attractiveness of new investments from the company. The CBO concludes, "Consequently, a general cut in business tax rates will tend to generate significantly less investment demand for each dollar of revenue than a cut that applies only to new investment."⁶⁷ Likewise, the CRS writes:

Most evidence does not suggest that business tax cuts would provide significant short-term stimulus. . . . This lack of effectiveness may occur because of planning lags [i.e., it takes time to execute major new investments even after the decision has been made] or because stimulus is generally provided during economic slowdowns when excess capacity may already exist. Of business tax provisions, investment subsidies are more effective than rate cuts, but there is little evidence to support much stimulus effect.⁶⁸

Therefore, if investment is what the government is worried about, adopting a cut on the corporate tax rate for new investments or providing some other type of investment subsidy are better policy measures than lowering the corporate tax rate as a whole.

However, President Barack Obama already proposed in 2012 to lower the corporate tax rate to 28%.⁶⁹ At the same time, Obama's proposal would have also closed off some of the loopholes present in the current corporate tax code. This may not entirely have been a bad thing, because at least U.S. corporations could then no longer claim that they must suffer the highest corporate statutory tax rate in the world. Still, the government must ensure that any lowering of the corporate tax rate in the future does not increase the federal deficit and that it comes with a boost in investment that is large

⁶⁷ Ibid, 14.

⁶⁸ Jane G. Gravelle, Thomas L. Hungerford, and Marc Labonte. "Economic Stimulus: Issues and Policies," Congressional Research Service, November 10, 2009, accessed November 9, 2014, 12, <http://fpc.state.gov/documents/organization/132244.pdf>.

⁶⁹ Zachary A. Goldfarb. "Obama proposes lowering corporate tax rate to 28 percent," *The Washington Post*, February 22, 2012, accessed November 9, 2014, http://www.washingtonpost.com/business/economy/obama-to-propose-lowering-corporate-tax-rate-to-28-percent/2012/02/22/gIQA1sjdSR_story.html.

enough to make the lower rates worth it. Furthermore, while it is true that a lower tax rate would reduce the incentives of corporations to invert, it would be quite difficult to get the rate down to the level required to stop inversions, especially given the adverse effect revenue loss would have on the federal budget.⁷⁰ Additionally, the government would have to close corporate tax loopholes if the corporate tax rate was lowered in order to offset the cost of reducing taxes, and even if such offsets were found, they could have their own negative impacts on investment. Finally, as the CRS pointedly notes, “To stop inversions through a reduction in the corporate tax rate would require a U.S. corporate tax rate set equal to the lowest tax rate of a destination company, or zero.”⁷¹ A corporate tax rate of zero is clearly not in the interest of the United States, as it would cause massive budgetary problems. For this reason, more comprehensive policy measures are needed to curb inversions; the U.S. government literally cannot afford to rely only on the popular solution of lowering the corporate tax rate.

B. Worldwide vs. Territorial Tax System

Besides lowering the tax rate, another change that corporations often advocate is shifting to a territorial tax system. Currently, the United States taxes the worldwide income of corporations, as previously explained. Under a territorial tax system, the United States would tax only the income corporations made in the United States. Therefore, foreign earnings would not be taxed at all. Because of the possibility of re-

⁷⁰ Gravelle and Marples, “Corporate Expatriation, Inversions, and Mergers: Tax Issues,” Summary.

⁷¹ *Ibid*, 12.

incorporating to a country with a territorial tax system motivates corporate inversions, adopting a territorial tax system could lessen the incentives for corporations to invert.⁷²

However, despite this benefit of a territorial tax, there exist a number of serious problems within such a system. Research by the CRS has found that territorial tax systems have made possible large profit shifting schemes, and if the United States adopted this form of a tax system, these schemes could become even more prevalent.⁷³ A U.S. territorial tax could also discourage domestic investment and activity. Finally, the CRS notes, “Adopting a territorial tax, as in the case of a rate reduction, would likely reduce corporate tax revenue and add to the current budget pressures unless it is offset by other tax increases.”⁷⁴ Once again, the government cannot afford to adopt this sort of tax reform without taking action to increase another sort of taxes in turn. In light of this, this paper recommends that a greater focus should be put on legal ways to make inversions nearly impossible rather than on the possibility of shifting to a territorial tax system. A discussion of the international equity issues of keeping a worldwide tax system will be saved for Part V.

C. Administrative and Congressional Efforts for Reform

The Obama Administration has released specific policy ideas aimed at making inversions even more difficult to carry out in the Administration’s Fiscal Year 2015 Revenue Proposals. If passed, these proposals would apply to all inversions completed after December 31, 2014.⁷⁵

⁷² Ibid, 12.

⁷³ Ibid, 12.

⁷⁴ Ibid, 12.

⁷⁵ U.S. Treasury. “General Explanations of the Administration’s Fiscal Year 2015 Revenue Proposals.” *Department of the Treasury*. March 2014, accessed October 30,

The first change relates to the current 80% test, which states that the new foreign parent corporation that emerges from an inversion will be treated as a domestic corporation for U.S. tax purposes if the continuing ownership of historical shareholders of the domestic corporation in the foreign acquiring corporation is 80% or more. Instead, this percentage rate would be lowered to 50% or more, and the aforementioned 60% test also established by the AJCA would be eliminated.⁷⁶

Another policy the Administration proposes states that an inversion will be considered to have occurred in the acquisition of a domestic company by a foreign acquiring corporation, regardless of the level of shareholder continuity, “if the affiliated group that includes the foreign corporation has substantial business activities in the United States and the foreign corporation is primarily managed and controlled in the United States.”⁷⁷ Lastly, the Administration would like to amend section 7874 to provide that an inversion can occur if a foreign corporation acquires substantially all of the assets of a domestic partnership or of substantially all of the assets of a trade or business of a domestic partnership.

Certainly, these policies from the Administration aren’t the major reforms that many argue the corporate tax code requires. However, if they are passed, they will succeed in making inversions significantly less attainable for corporations that just want

2014, 65, <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf>.

⁷⁶ Ibid, 65.

⁷⁷ Ibid, 65.

to lower their tax bill. Additionally, these proposals from the Administration are expected to produce a \$17.004 billion reduction in the federal deficit in 2015-2024.⁷⁸

Currently, there are also many inversion-related bills circulating Congress, some of which encompass policy suggestions already discussed. The Stop Corporate Inversions Act of 2014 (H.R. 4679), for example, reflects many of the Administration's proposals.⁷⁹ Others, such as H.R. 1554, H.R. 3793, and S. 268, would treat corporations managed and controlled in the United States as domestic corporations no matter where their legal tax home is. Perhaps one of the best ideas, though, is the elimination of deferral on foreign-earned income, as both H.R. 694 and S. 250 would mandate. This would make the worldwide tax system much more effective while at the same time ending some of the profit shifting schemes that deferral enables. Similarly, the appropriately named Pay What You Owe Before You Go Act (S. 2895) would tax the accumulated deferred earnings of firms that choose to invert.

Of course, given the new Republican control of both legislative bodies of Congress, most of these proposals have little chance of passing into law now. If anything, the U.S. corporate tax rate will almost surely be lowered, since both Republicans and Obama have supported this idea in the past. Unfortunately, this is one of the least cost-effective policy options on the table for preventing inversions and protecting the U.S. tax base if such a policy is enacted in isolation, without closing of any major corporate tax loopholes.

⁷⁸ KPMG. "Tax Provisions in Administration's FY 2015 Budget Proposals." March 2014, 31.

<https://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/taxnewsflash/Documents/fy-2015-budget-booklet-toc.pdf>

⁷⁹ Gravelle and Marples, "Corporate Expatriation, Inversions, and Mergers: Tax Issues," 14.

But even if Democrats controlled Congress right now, because of the widespread influence of corporate donors in elections, prospects for reform might not be much better. As X stated, “Any politician that tries to close a loophole will be fought tooth and nail in the next election by whatever group of corporations that loophole was benefiting. Deloitte would be a much smaller and less profitable corporation if the tax code were simplified.”⁸⁰ Given these factors, the most meaningful actions against inversions that occur in the near future will most likely be carried out by the Administration and Treasury with minimal input from Congress. The September 2014 Treasury notice is already evidence of this trend.

V. The OECD Action Plan

While the United States has been attempting to tackle the issue of corporate inversions domestically, new discussions have been sparked on an international level concerning the topics of tax base erosion and profit shifting. The OECD is leading this discussion with its Base Erosion and Profit Shifting (BEPS) Action Plan, which, if successful, could lead to one of the first major international tax agreements. The following section will examine the BEPS Action Plan in greater detail, particularly as it relates to issues of corporate taxation and inversion. It will also provide a critique of this OECD effort and explain how such a plan may affect U.S. tax policy in the future.

A. The Base Erosion and Profit Shifting Action Plan

At their meeting in St. Petersburg in September 2013, G-20 countries endorsed the BEPS Action Plan developed within the OECD. This document is a 15-point plan that

⁸⁰ X, Interview by the author.

“aims to create a single set of consensus-based international tax rules to address BEPS, and hence to protect tax bases while offering increased certainty and predictability to taxpayers.”⁸¹ A main focus of the plan is to end double non-taxation schemes that multinational corporations currently take advantage of. Ideally, it should ensure “that profits are taxed where economic activities generating the profits are performed and where value is created.”⁸²

Although the plan is primarily between governments, it has received input from other sources as well. Stefanelli said, “We publish drafts every 3 months, 4 months. The drafts receive 3,500 pages of comments from academia, businesses, and other stakeholders. Developing countries are also involved, as corporate revenue is especially important for them.”⁸³

On September 16, 2014, a set of seven reports was released relating to seven of the BEPS Action Plan actions.⁸⁴ More work will be done in Brussels on these actions in 2015, as all 15 actions must be delivered by this year. At the September release, the OECD Secretary-General Angel Gurría gave the following remarks as to what some of these actions entail:

We all know it makes no sense that an investor based in one country, sets up a shell company in another country, to channel an investment in a third country. But this is what happens, because in our efforts to ensure that business doesn't bear the burden of double taxation, the system has left gaps allowing double non-taxation.

⁸¹ OECD, “Explanatory Statement: OECD/G20 Base Erosion and Profit Shifting Project.” *OECD*, 2014, accessed October 25, 2014, 3, <http://www.oecd.org/ctp/beps-2014-deliverables-explanatory-statement.pdf>.

⁸² *Ibid.*, 4.

⁸³ Stefanelli, Interview by the author.

⁸⁴ *Ibid.*

Now we are closing that loophole. All OECD and G20 countries have now agreed that there must be a minimum standard to prevent companies who engage in this “treaty shopping” from taking advantage of benefits that they weren’t intended to have. With this, as well as the measures relating to transfer pricing and other items in the BEPS package, we will finally neutralize cash boxes – which at the moment hold more than two trillion US dollars offshore.⁸⁵

Clearly, although the BEPS plan encompasses much more than just inversion issues, it could nevertheless have an important impact on this topic. Some of the actions that relate to the particular issues of corporate taxation and inversions discussed in this paper are as follows: neutralize the effect of hybrid mismatch arrangements – arrangements that take advantage of differing tax laws in two or more tax jurisdictions in order to lower the corporation’s aggregate tax burden (Action 2), strengthen CFC rules (Action 3), limit base erosion via interest deduction and other financial payments (Action 4), counter harmful tax practices more effectively (Action 5), prevent treaty abuse by multinational corporations (Action 6), and assure that transfer pricing outcomes are in line with value creation (Actions 8-10), among others.⁸⁶ If these actions are successfully carried out on an international level, then many of the incentives that make corporate inversions so attractive to companies – such as the practices of hopscotching and earnings stripping discussed in Part II, as well as the CFC regulations that enable some of these schemes to occur – will be significantly reduced.

⁸⁵ Angel Gurría. Remarks delivered at the Launch of the Base Erosion and Profit Shifting 2014 Deliverables. Paris, France. *OECD*, September 16, 2014, accessed October 30, 2014 <http://www.oecd.org/about/secretary-general/launchofthebeps2014deliverables.htm>.

⁸⁶ OECD, “Explanatory Statement: OECD/G20 Base Erosion and Profit Shifting Project,” 15-20.

B. Creating a Multilateral Tax Instrument: A Critical Analysis

The last action of the plan, Action 15, is to develop what the OECD calls a multilateral tax instrument. If successful, this instrument could be the first major multilateral taxation agreement to emerge to tackle BEPS. During her interview, Stefanelli explained why such an agreement is necessary. “All of the changes [recommended by the BEPS Action Plan] will not be effective until you change the bilateral treaties,” she said. “There are more than 3,000 bilateral tax treaties. If you have to change every single treaty individually, it will be too difficult. Action 15 is to consider an instrument that could change them all at once. An OECD study released in September said that this is possible, that we can modify them all at once.”⁸⁷

However, while such a multilateral agreement may be possible in theory, there exist a number of serious challenges to its success. First and foremost, the outputs of every action in the BEPS Action Plan must be agreed to by consensus by the G-20 and OECD member countries. While consensus may be the only way to establish a multilateral agreement that holds only legitimacy, in the case of corporate taxation, some of the countries involved with the BEPS Action Plan benefit much more from the current international tax systems than others. Therefore, it is not in the interests of all countries to streamline international taxation systems, and these divergent interests will make consensus that much harder to accomplish. For example, although Ireland announced this year that it will end its “double Irish” tax policy – a policy that lets companies with business in the country to lower their tax bill by sending royalty payments to an affiliated firm that is registered in Ireland but has its tax home in another country, such as a tax

⁸⁷ Stefanelli, Interview by the author.

haven like Bermuda – it will create a new tax policy called the Knowledge Development Box, which is similar to Britain’s Patent Box policy.⁸⁸ The Knowledge Development Box tax rate is expected to be even lower than Ireland’s already miniscule corporate tax rate of 12.5%. As an editorial in *The New York Times* points out, “If even G-20 countries cannot resist the temptation to create giant loopholes, how can the international community ever hope to persuade other nations that are tax havens to change?”⁸⁹

On the bright side, such patent box policies have been met with a certain level of outrage from other G-20 countries. Germany has led the criticism against the UK’s policy, and in November of 2014, an agreement was reached between the two countries with the goal of prohibiting corporations from artificially shifting profits to countries with patent boxes.⁹⁰ Only profits made from R&D in the UK can qualify for the patent box tax break, which means that companies would need to move their R&D activities to the UK in order to take advantage of it instead of just registering a patent with the country. As German finance minister Wolfgang Schäuble said, “Preferential tax treatment of intellectual property must be dependent on substantial economic activity.”⁹¹ However, this agreement still does not prevent the race to the bottom that such competitive tax policies inevitably create.

⁸⁸ New York Times Editorial Board. “Ireland, Still Addicted to Tax Breaks.” *International New York Times*. October 19, 2014, accessed October 26, 2014. http://www.nytimes.com/2014/10/20/opinion/ireland-still-addicted-to-tax-breaks.html?_r=0

⁸⁹ Ibid.

⁹⁰ Vanessa Houlder. “UK and Germany reach compromise over patent box tax break.” *The Financial Times*, November 12, 2014, accessed November 17, 2014, <http://www.ft.com/intl/cms/s/0/8912f95e-6813-11e4-bcd5-00144feabdc0.html#axzz3JKwO2kQx>.

⁹¹ Ibid.

Furthermore, the BEPS Action Plan's goal of ensuring that profits are taxed where the economic activities that created the profits are performed is directly at odds with the United State's territorial tax system. This brings up important issues of international tax equity, because even though the United States gives companies tax credits on repatriated earnings for taxes they have paid to other countries, companies will still usually have to pay an additional tax on the earnings despite these tax credits, as the U.S. corporate tax rate is higher than the rate of other developed countries. Therefore, companies have to pay taxes on profits earned from economic activities that did not take place in the United States. This tax policy contradicts the international tax standards that the BEPS Action Plan is attempting to establish. From an international perspective, it would be more equitable for the United States to switch to a territorial tax regime. However, given the national interests the United States would have to sacrifice in the process that were discussed Part IV, such a switch seems neither likely nor desirable for the United States.

To complicate things even further, there is the issue of how developing countries will view the BEPS Action Plan. The OECD is trying to frame the issue of BEPS as a problem for developing countries as well, but there exist many problems with this idea. For starters, although China has observer status at the OECD, developed countries in the OECD and G-20 are controlling this discussion on BEPS. While developing countries have been invited to participate in consultations, they are not equal negotiating actors in this diplomatic setting. In effect, the contributions of developing countries in the BEPS discussion have so far remained minimal. Second, contrary to what the OECD says, it may actually be *against* the interests of some developing countries to take action on

stopping BEPS practices and streamlining corporate taxation efforts. Dr. Shigehisa Kasahara, an economist who worked at the United Nations Conference on Trade and Development for nearly 25 years and now teaches at Erasmus University Rotterdam, explained in an interview that easing corporate regulations and making companies pay little to no corporate tax has been a successful way for developing countries to attract investment. He also noted that corporate taxes are not the only source of tax income for governments. “After all,” he said, “if the foreign companies are operating and providing employment opportunities, then the employees can obtain income, and from that personal income, they are also paying government taxes.”⁹² Dr. Kasahara went on to cite Singapore and Hong Kong as examples of successful developing countries that have used low corporate tax policies to spark investment.

Some countries, though, do not need to always pursue such policies if the investment opportunities within the country are attractive enough. As Dr. Kasahara explained:

If you are a very attractive economy in terms of providing productive labor or indispensable raw materials, or have a large local market...then you really do not have to deregulate, and even corporate tax could be maintained at a reasonable high rate. Multinationals will want to join in that particular environment. For example, in the case of China, there are very cumbersome regulations going on, still. But yet, companies line up to get into the environment, because it has a growing economy and large market size.⁹³

But clearly, not all developing countries enjoy the booming growth of China, which is why that even between developing countries, it is very difficult to generalize what their interests are as a group, especially when it comes to issues of taxation.

⁹²Shigehisa Kasahara. Interview by the author. Geneva, November 2, 2014.

⁹³ Ibid.

In addition, sometimes using low corporate tax policies as a way to attract investment can backfire for developing countries. Dr. Kasahara explained that in some countries, “many investors are creating activities that have a high corporate income, but only generate a local economy of so-called ‘jobless growth.’ That means that they aren’t necessarily creating employment opportunities and employees are not necessarily receiving a higher income with which to pay tax.”⁹⁴ Because poor host countries often have inferior positions in terms of bargaining power with foreign direct investors, and such investors are easily mobile, there is no easy solution to this dilemma. One of the only cases in which a poor host country has more power is when that country has particular resources that corporations cannot find in many other places. Of course, not all host countries have such luck.

Notably, these problems of corporate taxation and ‘jobless growth’ for developing countries have not been heavily discussed areas in the BEPS Action Plan. Dr. Kasahara suggested that one way for developing countries to deal with such problems is to form their own regional agreements concerning international taxation policy, but given the divergent interests of developing countries, whether or not the political will exists to make such agreements possible is questionable.

The final major problem with the BEPS Action Plan as it currently stands is that even if all of the OECD and G-20 countries agree to its provisions and future recommendations, the OECD has no enforcement mechanism with which to ensure that all countries adhere to the agreements. It is possible but unlikely that such a mechanism will be created in the future. Dr. Kasahara concurred, saying, “An agreement of the

⁹⁴ Ibid.

OECD is not international law. Bilateral tax treaties are the conventional way of going. If you try to multilateralize [tax treaties] – that’s very complicated.”⁹⁵ For these reasons, while the BEPS Action Plan is a much-needed discussion, the United States and other countries attempting to limit the tax base erosion that corporate inversions exacerbate must not wait for progress on the international level and instead lead the way in comprehensive tax reform by taking action on the national level.

VI. Conclusion

The first conclusion that this paper offers is a determination of which policy options can best prevent corporate inversions and the erosion of the U.S. tax base. The government has little time to waste in reforming anti-inversion regulations due to the recent spike in proposed inversions. Because of this, future policies should be aimed at making inversions instantly more difficult to legally carry out as opposed to trying to convince corporations to stay in the country through a combination of incentives that aren’t legally binding. While lowering the corporate tax rate might entice some corporations to stay in the country, ultimately, the United States cannot compete in this sort of race to the bottom, since the lowest corporate tax rate in the world is 0%. Additionally, as in the case of switching to a territorial tax system, other corporate tax loopholes would have to be closed to make up for the lost revenue. Furthermore, because a switch to the territorial tax system still wouldn’t prevent inversions completely and would exacerbate other BEPS practices, this is not a very good solution, either.

⁹⁵ Ibid.

This paper recommends the following policy options that would legally stop certain types of inversions and harmful inversion-related tax avoidance schemes:

- Use the authority granted to the Treasury secretary under section 385 to reclassify the intercompany debt U.S. subsidiaries often receive from their foreign parent companies as equity. This would help prevent earnings stripping, as it would change a deductible interest payment into a nondeductible dividend.
- Lower the current 50% cap on deductions of U.S. taxable income set by section 163(j) in order to make earnings stripping more difficult.
- Lower the 80% ownership test established by the ACJA, which states that the new foreign parent corporation that emerges from an inversion is treated as a domestic corporation for U.S. tax purposes if the continuing ownership of historical shareholders of the domestic corporation in the foreign acquiring corporation is 80% or more, to 50% or more. By extension, the 60% test established by the ACJA would be eliminated. Many inversions that were proposed in 2014 would not be successful if this policy endorsed by the Administration was enacted.
- Eliminate the deferral of foreign-earned income.
- Tax the accumulated deferred foreign-earned income of U.S. corporations that choose to invert.

Note that there are more options than just these to discourage inversions and tax base erosion. The above policies are only meant to provide a starting point for future discussions. In an ideal world, all of these policies would be enacted, but of course, politics is far from ideal.

Nevertheless, the second conclusion to draw from this discussion on corporate inversions and tax law is that reform is not hopeless. On a national level in the United States, anti-inversion regulations have evolved throughout the years to shut down a variety of corporate tax schemes. Of course, loopholes remain, but the Obama

Administration and the Treasury have the power to close many of them. In fact, this power has already been utilized, as the September Treasury Notice demonstrates.

Additionally, seeing any type of corporate tax reform besides a lower corporate tax rate pass Congress is slim, which is all the more reason for the Administration to do what it can to limit future inversions and other BEPS practices.

On an international level, preventing BEPS practices is much more complicated. The OECD BEPS Action Plan, while it does bring up many points that need to be addressed on a multilateral level, has a low chance of attaining all of its goals. This is because the developed countries involved in the project all have different interests in how the international tax system is changed. The United States, in particular, may have to shift to a territorial tax system as a result of the plan's goal to tax profits where the economic activities that create the profits take place. Even though this may be fairer on an international level, it would certainly damage the U.S. tax base. This situation presents a clear conflict between international tax equity and U.S. national interests, and in the current political climate, the latter is the one most likely to triumph. On the other hand, developing countries have largely been excluded from the OECD discussion. This is unfortunate, because in the long run, it will be necessary for these countries be party to any international tax agreements that are formed. If they aren't, then even if the OECD BEPS Action Plan is successfully implemented among developed countries, corporations can simply move their BEPS operations to developing countries instead.

For these reasons, the United States cannot afford to rely on international efforts to solve its national tax base erosion dilemmas. Fortunately, national solutions are available, as is the political will to proceed with some of them.

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