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CORPORATE INVERSION: WILL THE AMERICAN JOBS CREATION ACT OF 2004 REDUCE THE INCENTIVE TO RE-INCORPORATE?

By: Eloine Kim

I. Introduction

Corporate inversions are transactions by which groups of corporations based in the United States are restructured to create new foreign parent corporations for the purpose of obtaining reduced U.S. tax on income from foreign and domestic operations. Over the last few years there was a wave of U.S.-based multinational corporate groups restructuring themselves so that the new parent corporation was located in a low-tax or no-tax jurisdiction. These corporations decided to move offshore for the purpose of remaining competitive in the global marketplace. Such corporations have included Tyco International, Ingersoll-Rand, Cooper Industries, and Fruit of the Loom.

Part II provides an overview of the corporate inversion phenomenon. Part III explains reasons for corporate inversion. Part IV discusses the effects of corporate inversion on the U.S. economy. Part V details the methods that corporations use to undertake inversion transactions, including stock transactions, asset transactions and drop down transactions along with earnings stripping techniques. Part VI examines previous tax treatment of stock and asset transactions and current tax treatment of earnings stripping. Part VII discusses the anti-inversion provisions of the newly enacted American Jobs Creation Act of 2004. Part VIII explains that further measures are necessary in order to balance the need to retain the U.S. tax base while allowing U.S.-based multinational corporations to remain competitive in an increasingly global economy.

II. An Overview of the Corporate Inversion Phenomenon

Corporate inversion is no longer such a hot topic for the press as it once was, but it nonetheless continues to be a problem for the U.S. A corporate inversion transaction occurs where a company moves its headquarters offshore, thus allowing it to avoid paying a substantial amount of taxes which result from being headquartered in the United States. Eloine Kim is a student at Hofstra University School of Law who holds an undergraduate degree from Cornell University. An enormous amount of gratitude is owed to Professor Richard Beck and Professor Marshall Tracht for their invaluable guidance and incredible expertise.

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In certain cases, all that is involved is not much more than a domestic corporation opening a post office box in a low-tax or no-tax jurisdiction such as Bermuda or the Cayman Islands. The company’s employees and operations usually remain in the United States. The types of corporations that engage in corporate inversion transactions are ones that have substantial foreign profits. Corporations that only sell in U.S. markets are unable to lower tax liability through inversion transactions, so these transactions are limited to corporations that compete in international markets.

Many corporations undergo corporate inversion transactions claiming that the new structure allows for increased operational flexibility, better cash management, and access to international capital markets. However, according to the U.S. Treasury Department, these reasons are pretext. The U.S. Treasury Department claims that inversions allow corporate groups to save a considerable amount on taxes, but that this savings comes at the expense of the United States as a whole. By undergoing a corporate inversion transaction which may not be much more than a paper transaction, a multinational corporate group may significantly reduce its worldwide income that is subject to taxation. When the parent corporation is moved out of the U.S. and into a low-tax or no-tax jurisdiction, U.S. tax rules cease to apply to the group as a whole.

Corporate inversion became popular because many U.S.-based multinational corporations in the United States realized that their bottom lines could be significantly improved through considerable tax savings which would be achieved by relocating their foreign subsidiaries so that they were not subject to the taxing jurisdiction of the U.S. Many U.S.-based multinational corporations have decided to diminish the adverse effects that the U.S. tax code has on their profitability and competitiveness by reincorporating in places such as Bermuda, Barbados, the Cayman Islands and other jurisdictions with low or no corporate income tax. This reincorporation is legal under U.S. law since there is no requirement that a company sell or produce anything in its country of residence.

Bermuda is one of the most preferred locations for corporate inversion because of its geographic proximity to the U.S., its stable political system and its legal system which is

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8 Id.
9 2004 WTD 214-10
10 Id.
12 See supra note 1 at 7.
13 See supra note 1 at 9.
14 See supra note 11 at 4.
17 Id.
18 Id.
similar to that of the U.S. There is no income tax or capital gains tax in Bermuda. Also, business in Bermuda is not highly regulated and corporate executive liability is reduced.

Corporate inversion activity is a result of fundamental problems with the U.S. tax rules that govern international transactions. U.S.-based multinational corporations have grown increasingly frustrated with the tax rules that place them at an economic disadvantage and have consequently looked to the corporate inversion transaction to alleviate their tax burdens. These corporations have found themselves faced with the pressure of considering corporate inversion in order to receive more favorable tax treatment that results from reincorporating offshore and thus being treated as a foreign corporation.

The American Jobs Creation Act of 2004 that was recently signed into law by President Bush contains important anti-inversion provisions that will succeed in deterring corporate inversion even though it contains no provisions providing for a solution for the problem of earnings stripping. However, the fact remains that the U.S. is still not an ideal place for a multinational corporation to be headquartered. The U.S. tax system gives better results to foreign corporations and thus needs further revision in order to address the underlying problems that corporate inversion is symptomatic of and to make the U.S. a preferred location for American corporations.

III. Reasons for Corporate Inversion

The U.S. international tax system heavily burdens U.S.-based multinational corporations. The rules promulgated by the Internal Revenue Code adversely affect the international competitiveness of U.S.-based corporations in the global economy. What motivates corporations to undertake inversions is the prospect of reducing tax liability. The National Foreign Trade Council conducted a study examining U.S. international tax

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20 Id. A capital gain is the profit that is made from the sale of an investment or an asset. See http://www.taxesindepth.com/capital-gains-tax-laws.html (last accessed March 5, 2005).
21 Veronique de Rugby, Runaway Corporations: Political Band Aids vs. Long Term Solutions, 9 Tax & Budget Bull. 1 (July 2002).
23 See supra note 1, at 29. The U.S. Treasury Department had proposed a multifaceted solution to combating the problem of corporate inversion. The Treasury Department recommended a comprehensive reexamination of the U.S. international tax rules and the economic assumptions underlying them.
24 See supra note 27, at 415.
The study found that the United States is a relatively undesirable location for a multinational corporation's legal domicile and concluded that "a significant modernization of the U.S. rules is necessary to restore competitive balance in the vastly changed circumstances of the global economy of the 21st century." In the 2000 issue of the Economist, William Woods, chief executive of the Bermuda Stock Exchange stated, "Bill Gates would be fabulously wealthier if he had started Microsoft in Bermuda. He may have known a lot about computer programming when he started the company, but his ignorance about tax cost him a fortune. Mr. Gates has not done badly even so, but he knows better now. The new company that he recently co-founded is now incorporated in Bermuda." One of the main reasons that U.S.-based multinational corporations have chosen to invert is that (unlike other countries) the U.S taxes the worldwide income of corporations incorporated in the U.S. as residents, no matter where the corporation is actually managed. Thus, unlike many other countries which assign corporate residence according to place of management, where a corporation is incorporated has enormous tax consequences under the Internal Revenue Code. The U.S. is virtually alone in the world in classifying corporate residence solely by place of incorporation. This has proved to be a highly artificial and unrealistic rule that gives an unjustifiable advantage to U.S. run corporations that are incorporated offshore as well as new corporations that decide to incorporate elsewhere from the start. The worldwide taxation system employed by the U.S. results in corporations being taxed on their worldwide income irrespective of the location of the source of the income. The fiscal arm of the U.S. Treasury reaches around the globe and claims a right to a portion of any income earned by a U.S. corporation anywhere in the world.

Income earned by a U.S. corporation from international transactions is subject to taxation in at least two jurisdictions: the residence country and the source country. U.S.-based multinational corporations pay corporate income taxes on all income generated in the U.S. (U.S. source income) and income earned abroad (foreign source income). Under the worldwide system, U.S. corporations cannot bring income of their subsidiaries back into the U.S. without having to pay taxes on it. U.S.-based multinational corporations end up being double taxed on their foreign earnings because taxes must be paid in the foreign country where profits were earned and in most situations, the U.S. also taxes the same profits regardless of whether they are repatriated to the U.S. If the foreign subsidiary of a U.S. corporation does not have to pay tax on foreign operations for some reason, when it repatriates income to the U.S. as dividends, it is usually taxed on that repatriated income. In addition, a U.S. corporation can also be taxed on certain income earned abroad.

31 Id.
33 Corporate Inversion Transactions, supra, at 1.
34 Id.
35 See supra note 29, at 838.
36 Id. Under the worldwide tax system, a U.S.-based multinational corporation is issued credit for taxes that it pays to the foreign parent country, on its foreign source income, and where the subsidiary is located and the income is derived.
37 See supra note 27, at 414.
38 Id.
earned by its foreign subsidiary, whether or not the income is repatriated to the U.S.\textsuperscript{39} The corporate tax ends up being a double or triple tax on the same income because the original investment is taxed and the dividends and capital gains resulting from corporate income are taxed again.\textsuperscript{40}

In contrast to the worldwide system, under a territorial tax regime, tax is imposed only on income derived in that country. This is known as territorial taxation.\textsuperscript{41} Many foreign competitors of U.S.-based multinational corporations are usually subject to territorial tax regimes. Because of this disparity, U.S. corporations are extremely disadvantaged in terms of tax burdens.\textsuperscript{42} Corporate inversion has thus become a way for U.S.-based multinational corporations to escape the heavy burden of the U.S. worldwide tax regime and instead be subject to a less onerous territorial regime.\textsuperscript{43} For tax purposes, most multinational corporations would prefer to be considered residents of jurisdictions that follow the territorial system rather than the worldwide system.\textsuperscript{44} Under a territorial system, corporations generally have lower tax costs associated with operations; if business profits are earned in a low-tax country, the income is subjected only to the low tax rate.\textsuperscript{45}

A foreign corporation which has a subsidiary in the U.S. must pay taxes to its home government only on the profits that it earned within its home country. Profits earned from operations within the U.S. would already have been taxed by the U.S. The foreign corporation would then be permitted to repatriate its after-tax profits from the U.S. back to its home country without owing any additional taxes to its home government. This differing treatment serves as a significant advantage for foreign corporations.\textsuperscript{46}

The 35 percent corporate tax rate in the U.S. is the fourth highest among the 26 developed countries in the Organization for Economic Cooperation and Development (OECD).\textsuperscript{47} A U.S.-based corporation pays the 35 percent rate plus an average state rate of 5 percent, totaling 40 percent on its income generated worldwide.\textsuperscript{48} Making matters

\begin{itemize}
  \item Id.
  \item Id.
  \item Id. Under a territorial regime, any income that is earned in a foreign country, beyond the borders of the U.S. is not taxed.
  \item See generally Elizabeth Chorvat, You Can't Take It With You: Behavioral Finance and Corporate Expatriation, 37 U.C. Davis L. Rev. 453.
  \item Id.
  \item See Derek E. Anderson, Turning the Corporate Inversion Transaction Right Side Up: Proposed Legislation in the 108\textsuperscript{th} Congress Aims to Stamp Out Any Economic Vitality of the Corporate Inversion Transaction, 16 FLA. J. INT’L L. 267.
  \item Id. Most foreign jurisdictions have corporate tax systems that tax income only in the jurisdiction where the income is earned. Consequently, a foreign parent corporation that has its main office in the foreign parent’s jurisdiction but has a subsidiary in a different foreign jurisdiction will not be taxed by the foreign parent jurisdiction on the income earned by its foreign subsidiary.
  \item Id.
  \item Id.
\end{itemize}
worse, according to the accounting firm KPMG, there is a global trend toward declining corporate tax rates.50 The 40 percent combined federal-state corporate tax rate of the U.S. is higher than that of any other OECD country and is also much higher than the 30 percent average in those developed nations.51 Because of the worldwide system that the U.S. employs, even if another country had the same corporate tax rates as the U.S., corporations in the U.S. would still end up paying more in taxes.52 This high corporate tax rate in conjunction with the worldwide tax system places many U.S.-based multinational corporations at a significant disadvantage.53 Corporations with substantial markets in nations with low corporate tax rates may become susceptible to foreign takeover since foreign corporations that have an advantage over U.S.-based corporations may grow more quickly and gain market share from U.S. competitors.54

The problem of double taxation posed by the worldwide system is dealt with by a system of foreign tax credits, which is purported to reduce the tax burden on U.S.-based multinational corporations.55 Under the foreign tax credit system, credit is issued to a multinational corporation for tax that is paid to a foreign country.56 It follows that since the U.S. corporate tax rate is 35 percent, credit is available up to that amount.57 A corporation ends up paying the same amount as it would have if the income had been generated within the residence country, but it pays tax to both the foreign country and the country of residence.58 The effectiveness of the credits under the foreign tax credit scheme has been limited because the scheme required income to be categorized into baskets whereby the foreign tax credit rules were separately applied to reduce the income that the foreign tax credits could be applied against.59 This situation is also made more complex by Subpart F which may require income from active foreign business operations to be currently taxed although income earned through foreign subsidiary corporations of U.S. parent corporations is generally not taxable until distribution by the foreign subsidiary to the U.S. parent.

If a U.S.-based multinational corporation paid tax to a foreign country for the income it derived from that foreign country, the U.S. would then reduce the amount of tax that the corporation would pay to the U.S. by the amount of tax it paid to the foreign country.60 Despite the fact that the foreign tax credit system was designed to protect against the prospect of double taxation, U.S.-based multinational corporations are still disadvantaged because of having to pay tax on income derived from both domestic

50 Id.
51 Id.
52 See supra note 2.
53 Id.
54 Id.
55 See supra note 42, at 456.
56 Id.
57 Id.
59 Id. Further discussion will ensue in subsequent sections since the American Jobs Creation Act of 2004 modifies this.
60 See supra note 22. In order to mitigate possible double taxation of U.S. taxpayers on foreign source income, limited credit is allowed against the U.S. corporate tax for certain income taxes paid to foreign countries. The credit is only available up to the amount of tax that may be attributed to foreign income. If the foreign tax amounts to less than the U.S. tax, the U.S. collects any incremental income tax on the foreign income where the U.S. tax rate exceeds that of the foreign country.
operations and foreign sources. Foreign corporations are taxed at a 35 percent rate only on the amount of U.S. source income.\textsuperscript{61} The following is a simplified numerical example illustrating this fact:

Ireland has a 12.5 percent corporate tax rate. An U.S.-based multinational corporation would pay 40 percent in taxes on its income earned in Ireland. If the corporation earned $1,000,000 in Ireland, the breakdown of taxes is as follows: The corporation would have to pay 12.5 percent of $1,000,000 ($125,000) to the Irish government. The U.S. government would then credit the corporation for the amount that was paid to Ireland and then proceed to collect the difference between the taxable amount under the U.S. tax rate and the credited amount ($35\% \times \$1,000,000 - 125,000 = \$225,000$). In addition, 5 percent of $1,000,000 ($50,000) would most likely be collected by the U.S. corporation's state of incorporation, bringing the grand total of taxes on income earned in Ireland to $400,000. If the income is earned by a subsidiary incorporated in Ireland, as is usually the case, the subsidiary's earnings will not be taxed in the U.S. until repatriated to the U.S. parent.

In contrast, a country such as Germany that is subject to a territorial system that does business in Ireland would only have to pay 12.5 percent of $1,000,000 ($125,000 total) on its income earned in Ireland.\textsuperscript{62} This simplistic example indicates the disparity in tax treatment that motivates U.S.-based multinational corporations to undertake inversion transactions.\textsuperscript{63}

Undertaking an inversion transaction can be costly because of legal, accounting and banking fees.\textsuperscript{64} Also, shareholders of the original U.S. corporation must, in effect, sell their shares and realize capital gains, which may trigger tax liabilities. They then receive new shares in the foreign corporation exactly equal to their old shares; although ownership doesn't change, the inversion process generates tax liabilities for many shareholders.\textsuperscript{65} Despite the cost, corporations decide to undertake inversions anyway because the tax savings over the long run are considerable.\textsuperscript{66} Economists Mihir Desai and James Hines found a significant increase in stock prices for companies announcing inversions.\textsuperscript{67} Investors realize that their after-tax earnings will be higher and bid up stock prices, thereby compensating shareholders for the taxes they may incur in the process.\textsuperscript{68}

Inversion transactions allow corporations to escape the heavy burden that the U.S. tax system places on the activities of their foreign subsidiaries.\textsuperscript{69} Through inversion transactions, corporate groups may be able to remove some or all of their foreign income from the U.S. taxing jurisdiction, thus potentially allowing them to achieve pure

\textsuperscript{61} Id.
\textsuperscript{62} Id.
\textsuperscript{63} Id. Another simplistic example presented: if a corporation owed a total of $10 of income tax to its residence country (Country A) on the income earned in Country B, but it had already paid $2 in tax on that same income to Country B, then the corporation would only owe Country A $8 in taxes because of the credit received. This credit is limited and usually cannot exceed the tax that would be paid on the foreign-source income in the residence country.
\textsuperscript{64} See supra note 15. See also Paul Tharp. Corporations Heading South-Looking for the Great Tax Dodge, N.Y. POST. Feb. 12, 2002, at 32.
\textsuperscript{65} Id.
\textsuperscript{66} Id.
\textsuperscript{67} See supra note 27.
\textsuperscript{68} Id.
territorial tax treatment. This is the reason that corporate inversions are often referred to as self-help territoriality.\textsuperscript{70}

Another benefit that corporations are able to derive from undertaking inversion transactions is the significant reduction of tax liability by means of earnings stripping.\textsuperscript{71} Tax deductions for interest paid on business debt are permitted by IRC section 163. This has been a primary motivator for corporations to engage in corporate inversion transactions.\textsuperscript{72}

Corporations are motivated to undergo inversion transactions in order to reap the economic benefits that stem from having to pay less tax on foreign source income. Restructuring a U.S.-based multinational corporation through a mere paper transaction that results in the removal of income from foreign operations from the U.S. tax base can save a corporation an enormous amount.\textsuperscript{73} It has been said that under U.S. tax law, a corporation can be considered foreign even if its presence in the foreign country consists of nothing but "a file drawer and a lawyer."\textsuperscript{74} A U.S.-based multinational corporation may avoid having to pay a large amount of taxes by setting up a mail drop in a foreign country.\textsuperscript{75} The mail drop can effectively turn the U.S.-based corporation into one of that foreign country.\textsuperscript{76} When a U.S.-based parent corporation is moved out of the jurisdiction of U.S. taxation, most U.S. tax rules cease to apply to the corporate group as a whole. A mere paper transaction can greatly reduce the worldwide income of the corporation that is subject to taxation.\textsuperscript{77}

IV. The Effects of Corporate Inversion

The phenomenon of corporate inversion has negative implications for the U.S. economy. Corporate inversions erode the U.S. tax base and have adverse effects on other businesses that have not engaged in inversion activities as well as individual taxpayers.\textsuperscript{78} It has been estimated that inversion transactions have eroded the tax base by approximately $70 billion dollars.\textsuperscript{79} According to Congress' Joint Committee on Taxation, corporate expatriates are expected to dodge $4.8 billion in federal taxes over the next 10 years.\textsuperscript{80} The more corporations that undergo inversion transactions, the fewer

\textsuperscript{70} Id.
\textsuperscript{72} Earnings stripping to be discussed in detail in section III.
\textsuperscript{73} See supra note 58. Explanation of how taxable income can be reduced through deductible payments of interest.
\textsuperscript{75} Id.
\textsuperscript{76} Id. Bermuda and Barbados are preferred locations for corporate inversion because they offer favorable conditions for corporate tax regimes and existing U.S. income tax treaties.
\textsuperscript{78} See supra note 42, at 457.
\textsuperscript{79} See supra note 73.
\textsuperscript{80} See supra note 6.
corporations there are paying U.S. taxes.\footnote{See Stanley Works and Corporate Inversion, available at http://www.thunderbird.edu/pdf/about_us/case_series/a06030005.pdf (last accessed Nov. 3, 2004).} This results in the remaining U.S. taxpayers being responsible for a larger portion of taxes. Corporate inversions make the public question and feel resentful towards the U.S. tax system.\footnote{Id.} Taxpayers may become disgruntled and lose confidence in the system.\footnote{Id.} One Congressman aptly stated, "Corporate inversions make average taxpayers feel like chumps; we have to pay more because the big guys are paying less."\footnote{Voting with Their Feet, Richard W. Rahn, National Review Feb. 23, 2004.}

Corporate inversions have the negative effect of pressuring other U.S.-based multinational corporations to invert in order to remain competitive in the global marketplace.\footnote{See supra note 44, at 270.} Corporations that do not join the bandwagon and invert may find themselves at a significant economic disadvantage. Sometimes this pressure is too much for other corporations to resist so they follow suit and choose to undergo international restructuring like some of their counterparts.\footnote{Id.} The amount of taxes which must be paid often dictates the prices corporations set and in turn the profits that can be made. A U.S.-based corporation that inverts and reduces its tax burden will most likely have increased profitability. The increased profitability may be passed to consumers and shareholders by means of lower prices and increased dividends.\footnote{See Tax News and Developments, available at http://www.bakerinfo.com/NR/rdonlyres/ewepnocyjcfj08f6tvzvb43vg52bqwnncedcnzq604tvvhqcmdq3xh6wirdp4ixdu5qjx7vyjdi/ALERT+Mar+15+02+-+lnversions.pdf (last accessed September 15, 2004).} Another negative effect of corporate inversion that has been cited is that it limits shareholder rights.\footnote{See supra note 11 at 3. See also Treasury to Require Information on Corporate Inversion. The United States Mission to the European Union, available at http://www.useu.be/Categories/CorporateGovernance/Nov1302TreasuryCorporateInversion.html (last accessed October 1, 2004).} The legal rights of shareholders are limited in that in some foreign countries, corporate officers and directors cannot be sued. Some foreign jurisdictions refuse to enforce U.S. judgments against officers and directors of corporations. But the prospect of this has not really materialized as a true negative effect because corporate shareholders seem to have been willing to surrender some legal rights for favor of the benefits to be had by the corporation's increased profitability through inversion.\footnote{Id.}

V. Methods of Inversion and Earnings Stripping

There are several methods for achieving corporate inversion through foreign reincorporation. The three primary methods that corporations have used to reincorporate are: stock transactions, asset transactions and drop down transactions.\footnote{See supra, note 58.} Each of these methods will now be discussed in turn but will also be addressed again in the subsequent

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\footnote{Id.}
\footnote{Id.}
\footnote{Voting with Their Feet, Richard W. Rahn, National Review Feb. 23, 2004.}
\footnote{See supra note 44, at 270.}
\footnote{Id.}
\footnote{See supra, note 11 at 3. See also Treasury to Require Information on Corporate Inversion. The United States Mission to the European Union, available at http://www.useu.be/Categories/CorporateGovernance/Nov1302TreasuryCorporateInversion.html (last accessed October 1, 2004).}
\footnote{Id.}
\footnote{See supra, note 58.}
sections of this note since the recently enacted American Jobs Creation Act of 2004 has new implications for such transactions.91

In stock transactions, the stock of the U.S. corporation is exchanged for the stock of the newly formed foreign corporation.92 All this does is convert ownership; the foreign corporation ends up being the owner and the U.S. corporation either becomes a subsidiary or transfers all its property to the foreign corporation. The shareholders of the U.S. corporation receive at least eighty percent of the stock of the newly formed foreign corporation after this transaction. Neither the foreign corporation nor its subsidiaries conduct substantial business activities within the new country of incorporation. The newly formed foreign parent acquires shares of the U.S. corporation. The U.S. parent corporation survives as a subsidiary of the new foreign parent.93

Asset transactions occur where a U.S. corporation directly reincorporates in a foreign country.94 A new foreign corporation is formed and the U.S. corporation merges into the new corporation, just as two unrelated corporations could merge. The result of this transaction is that the shareholders end up holding the stock of the foreign corporation since the U.S. corporation has become a subsidiary of the foreign corporation.95 Stockholders then exchange their shares in the U.S. corporation for shares in the foreign corporation.

Drop down transactions are hybrid transactions that have characteristics of both stock and asset transactions.96 In a drop down transaction, the U.S. corporation transfers its assets to a newly formed foreign parent corporation. Some of those assets are then transferred back to the original U.S. corporation to form the basis of the U.S. subsidiary of the new foreign corporation. The result of this is that the original U.S. corporation does not exist anymore and the U.S. stock gets merged with the stock of the new foreign corporation. Shareholders end up holding the same amount in the new foreign corporation as they did in the now extinct U.S. corporation.97

Depending upon the corporation’s individual tax consequences with regards to its shareholders, each method varies, but all have resulted in the corporate structure being inverted. Each method generally has had no effect on a corporation’s operations but managed to allow the corporation to avoid excess taxation.98

In addition to reincorporating in foreign jurisdictions, corporations may derive further advantages from inverted structures by engaging in earnings stripping techniques

92 See supra note 58.
93 Id. An inversion may be accompanied or followed by further restructuring of the corporate group. With stock inversions, a U.S. corporation might transfer some or all of its foreign subsidiaries directly to the new foreign parent corporation or other related foreign corporations in order to remove income from foreign operations from the tax reach of the U.S. Consequently, the subpart F anti-deferral rules that may apply to controlled foreign corporations no longer apply to those foreign subsidiaries and the U.S. would not impose tax upon any dividends paid by such foreign subsidiaries in the future to the new foreign parent. This allows for the achievement of treatment similar to that which could be obtained under a purely territorial system. Other similar benefits may also be had in connection with foreign operations that may be set up in the future by starting such operations under the new foreign parent corporation instead of under the U.S. corporation.
94 Id.
95 Id.
96 See supra note 48. at 271.
97 Id.
98 Id.
in order to reduce taxable income.\textsuperscript{99} The ability to partake in earnings stripping is one of the main benefits of corporate inversion.\textsuperscript{100} A feature that is common to many inversion transactions is that the reincorporation results in the former U.S. parent being substantially indebted to the new foreign parent or one of its foreign subsidiaries.\textsuperscript{101} Earnings stripping occurs where a significant portion of a corporation’s U.S. generated income is redirected to the foreign corporation so that it becomes non-taxable.\textsuperscript{102} Techniques include having a capital structure that is high in debt and low in equity.\textsuperscript{103} A U.S. corporation can make payments on a loan created by a foreign parent. Loans are not included in gross income and as such the transfer of income disguised as a loan is not taxed.\textsuperscript{104} Under IRC section 163, the interest portion is fully deductible as a business interest expense. After interest is paid, there may hardly be any earnings left to be taxed by the U.S.\textsuperscript{105} Payments of royalties, rents or management service fees to the new foreign parent or other foreign affiliates are also deductible and can thus be a mode of partaking in earnings stripping. Payments by a U.S. corporation to a foreign corporation are usually subject to a withholding tax, but such taxes may be reduced by an income tax treaty, if one exists between the U.S. and that particular foreign country.\textsuperscript{106} It should be noted that apart from earnings stripping, inversion does not help the U.S. parent company’s tax position on its U.S. income or its directly earned foreign income either. Instead, it takes the U.S. parent’s foreign subsidiaries out of carry forward credit status because the foreign subsidiaries will now be owned by a foreign parent. Thus all sorts of tax haven income from carry forward credits will no longer be taxed currently in the U.S. If a dividend is actually paid home to a U.S. owner, though, the income will be taxed in the U.S.

VI. Previous Tax Treatment of Stock and Asset Transactions and Credit Tax Treatment of Earnings Stripping

For the different types of inversion transactions, there were immediate tax consequences to the U.S. corporations or to the U.S. shareholders who were exchanging stock.\textsuperscript{107} For stock transactions, U.S. shareholders who were exchanging stock generally had to recognize gains, but not losses under section 367(a).\textsuperscript{108} Gains were equal to the

\textsuperscript{100} See 36 Tax Notes Int’l 387.
\textsuperscript{101} See id.
\textsuperscript{103} See id.
\textsuperscript{104} See supra note 58. A U.S. parent cannot engage in the same techniques because it files a consolidated return with its U.S. subsidiaries; therefore, interest payments within the same corporate group net out. However, when a U.S. corporation undertakes an inversion transaction, the new foreign parent corporation may then strip earnings out of U.S. subsidiaries. See also I.R.C. Section 163(j).
\textsuperscript{105} See supra note 102.
\textsuperscript{106} See 36 Tax Notes Int’l 341.
\textsuperscript{107} See id. See also I.R.C. Section 367(a).
difference between the fair market value of the shares received of the foreign corporation and the adjusted basis of the shares of the U.S. corporation that were exchanged.\textsuperscript{109}

For asset inversions, the U.S. corporation had to recognize gain, but not loss under section 367(a) as if it had sold all of its assets.\textsuperscript{110} However, in asset inversions, U.S. shareholders recognized neither gain nor loss provided that the transaction qualified as a nontaxable reorganization under section 368.\textsuperscript{111} Tax attributes such as net operating losses or foreign tax credits could generally reduce or eliminate the U.S. federal income tax on any gain recognized in an inversion.\textsuperscript{112}

The IRS enacted IRC section 163(j) in 1989 in order to prevent corporations from claiming excessive interest deductions.\textsuperscript{113} Section 163(j) comes into play when the debt to equity ratio of a U.S. corporation exceeds 1.5 to 1, whereupon all interest amounts that are in excess of 50 percent of the corporation's gross income are nondeductible. When a party that is paying interest is moderately to highly leveraged, section 163(j) disallows deductions for interest paid to other related parties such as parents and subsidiaries for loans.\textsuperscript{114} Section 163(j) serves to prevent U.S. corporations from excessively leveraging a corporation in order to reduce its taxable income. But like the other existing IRC sections, 163(j) has not been sufficient to deter U.S. corporations from undertaking inversions. Proposals have been made to deter earnings stripping by applying a stricter debt to equity ratio for corporations that have inverted, but none of the proposals have materialized as of yet.\textsuperscript{115}

VII. American Jobs Creation Act of 2004

On October 22, 2004, President Bush signed the American Jobs Creation Act of 2004 into law. The act amends nearly 600 code sections and makes the most large scale revisions since the 1986 Tax Reform Act.\textsuperscript{116} The new law repeals the U.S. tax code's extraterritorial income exclusion (ETI) which had been ruled illegal by the World Trade
Organization. The ETI is replaced with a nine percent domestic deduction for a range of domestic production activities. The new law has important anti-inversion provisions that set forth U.S. federal tax consequences for domestic corporations that engage in either of two kinds of specifically defined inversion transactions. The first type of inversion that the act defines is a transaction in which (1) a foreign incorporated entity acquires (either directly or indirectly) substantially all of the properties of a U.S. corporation after March 4, 2003; (2) the former shareholders of the U.S. corporation hold 80 percent or more (by vote or value) of the stock of the foreign incorporated entity after the transaction; and (3) the expanded affiliated group of the foreign corporation does not have substantial business activities in the foreign corporation's country of incorporation when compared to the total business activities of the group. For this particular type of corporate inversion transaction, the provision considers the foreign corporation to be a domestic corporation for purposes of the U.S. tax code and the inversion is not acknowledged. The new law would reclassify the corporation as domestic under section 7701.

The second type of inversion that the Act defines is a transaction that would meet the exact definition of aforementioned type of inversion transaction except that the 80 percent ownership threshold would not be met. This type of transaction is referred to as a limited inversion and is subject to milder sanctions than the first type of inversion. In such a case of a limited inversion, the Act states that if at least a 60 percent ownership threshold is met, the inversion will be respected and the corporation will be treated as foreign for tax purposes. However, the corporation will be subject to taxation on any inversion gain, inversion gain being defined as any gain or income recognized in the inversion plus any gain or income recognized during the 10 year period following the inversion by the transfer of stock or other properties, or the license of any property other than section 1221(a)(1) property, by the expatriated entity to a foreign related party. The corporation will also be barred from using tax attributes such as net operating losses and foreign tax credits to offset any such inversion gain.

The new Act includes provisions that aim to reduce the problem of double taxation on U.S.-based multinational corporations, including the reduction of foreign tax

117 See id.
118 See id.
119 See 105 Tax Notes 711.
120 See id explaining that: for purposes of the anti-inversion provisions, the term "expanded affiliated group," means an affiliated group as defined in Section 1504(a) but without regard to Section 1504(b)(3) and by substituting "more than 50%" for "at least 80%." In determining whether each type of inversion transaction satisfies the stock ownership requirement, stock held by members of the expanded affiliated group (for example, "hook" stock held by the inverted U.S. corporation) that includes the foreign corporation, and stock of the foreign corporation issued in a public offering related to the inversion transaction, is disregarded. In addition, if a foreign corporation acquires directly or indirectly substantially all of the properties of a U.S. corporation or partnership during the four-year period beginning two years before the date on which the ownership requirement for an inversion transaction is satisfied, the acquisition is treated as pursuant to a plan and constitutes an inversion.
121 See id.
122 See supra note 116.
123 See id.
124 See id. See also I.R.C. Section 1221(a)(1)
125 See id.
credit baskets from nine to two and allowing foreign tax credits to be carried forward for 10 years instead of only five.126 The anti-inversion provisions of this act trump any current and future U.S treaty obligations. No treaty exemptions from the anti-inversion are available. The provisions apply generally to transactions that took place after March 4, 2004, but they do not apply to transactions that were substantially completed on or before March 4, 2003.127

The repercussions that the new Act has on the 80 percent inversions are likely to discourage these types of transactions.128 Since the act does not acknowledge 80 percent inversions and deems such newly formed foreign corporations to be U.S. corporations for tax purposes, most corporations will probably avoid undertaking these transactions since the intended benefits would be denied.129 Corporations that attempt these transactions would be acting imprudently, for they would be subject to U.S. federal income tax on worldwide income regardless of the transaction. The retroactive effective date of the new Act may also have federal tax consequences for the post-inversion transactions of corporations that completed an 80 percent inversion after March 4, 2003.130

The new law significantly increases the cost for undertaking a 60 percent inversion as well since it denies to the acquired U.S. corporation and related U.S. persons the right to shelter any inversion gains through the use of tax attributes such as net operating losses and foreign tax credits.131 For stock inversions, the new act also imposes a 15 percent excise tax (to be increased to 20 percent for 2009 and subsequent years) on disqualified individuals that hold stock options and other stock-based compensation in the inverted companies. The inverted U.S. corporation is denied deductions for stock compensation paid.132 In the grand scheme, these provisions of the new Act will most likely deter corporations from undertaking inversion transactions.

Although the Bush administration targeted earnings stripping as a prime motivation for corporate inversion, the Act does not address earnings stripping but instead directs the Treasury Department to conduct studies and submit reports on this problem.133 Section 424 of the Act requires the Secretary of the Treasury to conduct a study of the effectiveness of the provisions of the Internal Revenue Code of 1986 that are applicable to earnings stripping.134 The study must include an evaluation of the effectiveness of section 163(j) in preventing the shifting of income outside the U.S., whether any deficiencies of earnings stripping provisions place U.S.-based businesses at a competitive disadvantage in comparison to foreign-based businesses, the impact of earnings stripping activities on the U.S. tax base, whether laws of foreign countries facilitate stripping of earnings out of the U.S., and whether changes to the earnings stripping rules would affect jobs in the U.S.135 By June 30, 2005, the Secretary is required to submit to Congress a report of this study including specific recommendations on how

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127 See id.
128 See supra note 119.
129 See id.
130 See id.
131 See supra note 116.
132 See supra note 112.
133 See supra note 119.
134 See 108 P.L. 357, section 424.
135 See id.
to improve the earnings stripping provisions of the Internal Revenue Code. The act also require studies and reports on the effectiveness of transfer pricing and contemporaneous documentation rules, identification of inappropriate uses of income tax treaties due on June 30, 2005. A report of the effectiveness of the act’s corporate inversion provisions is due by December 31, 2006. Earnings stripping is a big problem, but it is only part of a much bigger pattern of shifting income to low-tax jurisdictions, the other huge problem being transfer pricing.

The Act has been criticized and compared to past ineffectual bills for its failure to address the earnings stripping problem that is considered by many to be the ultimate benefit of corporate inversion. The Act has also been criticized for grandfathering corporations that inverted before March 4, 2003 from the changes. However, because of the risk that an inverted corporation may be considered foreign as well as the increased cost of undertaking inversions, the Act will make most U.S. corporations think twice before undertaking inversion transactions. The two specific types of corporate inversion defined by the Act will effectively halt corporations from reincorporating offshore for the time being, but it does not follow that the stemming of corporate inversion indicates that the U.S. is now a favorable place for a multinational corporation to be headquartered. The new anti-inversion legislation is more of a stop-gap measure than a real long term solution. Further measures are necessary to ensure that U.S.-based multinational corporations can remain competitive in a global marketplace.

VIII. Further Measures Necessary

From a pure tax standpoint, few attorneys would recommend the placement of a multinational firm's headquarters in the U.S. because of the drawbacks of being subjected to the worldwide system as well as being denied the advantages of being able to partake in earnings stripping. Further measures are needed to have the U.S. tax system adequately reflect a globalized economy. The goal should be to make the U.S. a preferred location for headquartering a corporation. Closing some of the loopholes that allow for corporate inversion will be effective for the time being, but it may have the unintended effect of encouraging corporations to seek alternative methods to reduce their taxes. For example, new companies may decide to incorporate abroad from their inception.

136 See id.
137 See id. Section 482 requires all transactions between related parties be conducted on terms consistent with an arm’s length standard and permit Secretary of Treasury to reallocate income and deductions among such parties if that standard is not met.
138 See supra note 134.
139 See supra note 116.
140 See id.
141 See id.
143 See supra note 1, at 21. The Treasury Department has stated that measures designed simply to halt inversion activity may address these transactions in the short run, but there is a serious risk that measures targeted too narrowly would have the unintended effect of encouraging a shift to other forms of transactions to the detriment of the U.S. economy in the long run.
Corporate managers often argue that in order to maintain international competitiveness, a reduction of the corporate interest rate would be in order. Some economists postulate that the best way to halt the corporate inversion phenomenon and make the U.S. a friendlier place for multinational corporations to be headquartered would be to eliminate the high corporate tax rate that places these corporations at a significant disadvantage in the international marketplace. But reducing the corporate tax rate would result in a loss of corporate tax revenues in the short run and with the federal deficit expected to rise over the next few years, the government will be reluctant to disregard any revenue sources. The U.S. economy has already lost a lot of tax revenue from corporations that have already inverted and a reduction in the corporate tax rate does not allow for Congress’ goal of retaining the tax base.

Advocates for corporate tax rate reduction argue that such a cut would result in many beneficial effects for the economy. The argument is that a reduction in corporate taxes can benefit consumers, workers and stockholders by ultimately increasing individual income tax receipts. The reasoning is that because prices charged will decrease as a result of a tax cut, wages will be increased, more workers will be hired, more materials will be purchased for production and stockholders’ dividends will increase. Corporate tax cut advocates argue that over the long haul, the loss in corporate tax revenues will be offset by gains in individual tax receipts. However, this corporate tax reduction proposal has not ever been entertained by Congress or the Treasury Department yet.

Since U.S. corporations end up paying higher taxes on income earned in the same global marketplace as their foreign counterparts, it is argued that the worldwide tax regime that U.S. corporations are subject to should be changed into a territorial tax regime that most foreign competitors operate under. Similar to the corporate tax rate cut proposal, it does not seem like an affordable solution at the present moment. Advocates of change to a territorial system argue that the heavy burden that the worldwide system places on U.S.-based multinational corporations will cause these corporations to continually perform worse in both U.S. and overseas markets than their foreign competitors and be subject to foreign takeovers. It is argued that all these factors will eventually cause a drop in corporate tax revenues worse than the loss of revenues that would initially be caused by shifting to a territorial tax regime. However, it must be remembered that our competitors are all or even mostly territorial is overstated by lobbyists. Some European countries have systems not so different than that of the U.S. and all of them have carry forward credit rules to tax foreign subsidiaries currently on their passive income and/or low-tax income from tax havens.

A more progressive approach has been suggested by several experts in order to deal with the huge problem of transfer pricing, which is another part of the pattern of shifting income to low-tax jurisdictions. Experts propose getting rid of the existing

144 See supra note 142.
148 See id. See also supra note 145.
149 See id.
150 See supra note 146.
151 See supra note 22. at 116.
system of separate accounting and replacing it with the formulary system which the states
now use to allocate corporate income by payroll, asset, and sales. Under the formulary
system, a multinational corporation’s actual economic presence in each country
(including employees, assets and turnover) would be used as a proxy to estimate how
much of total worldwide profits should be taxed there. This would eliminate the fiction
that net profits can be located accurately to the penny.

For federal taxation purposes, multinational corporations use a transaction
based approach called separate accounting.\textsuperscript{152} This approach requires all income to be
attributed to its source by tracing all transactions among affiliates.\textsuperscript{153} Internal transactions
must be priced in order to calculate taxable income according to separate accounts
maintained for affiliates in each country.\textsuperscript{154} There is a requirement that the prices
established for their internal transactions with foreign affiliates be set as if the foreign
affiliates were unrelated third parties.\textsuperscript{155} For state taxation, corporations that do business
in multiple states use a formulary system under which they do not separately price each
transaction but rather apportion their total income to each affiliate depending upon the
percentage of total business activity that is located in each state.\textsuperscript{156} This process of using
a formula to assign a portion of the total income of a corporation and its affiliates that
operate in several different locations to each individual location is known as formulary
apportionment.\textsuperscript{157} The affiliates that are located in different states than the parent
corporation are treated as a single entity.\textsuperscript{158}

Proponents of a shift to a formulary system claim that the current separate
accounting method is difficult to enforce and administer in an increasingly globalized
economy and that it perpetuates fiscal myths that corporate income can be precisely
allocated down to the last penny.\textsuperscript{159} The separate accounting system is administered by
means of a complex set of regulations.\textsuperscript{160} A formulary system emulating the ones that the
states currently use would be effective for multinational corporations because of its
simplicity in comparison to the separate accounting method.\textsuperscript{161} Instead of multinational
corporations having to price every transaction that occurs between different nations, a
formulary system would allow corporations to apportion their income by using a
predetermined formula consisting of factors including property, payroll and revenue.\textsuperscript{162}
Because the formulary system taxes a corporation on its total combined income,
corporations would not have much incentive to shift income from one location to another
for tax avoidance purposes.\textsuperscript{163}

\textsuperscript{152} See 2004 WTD 175-15.
\textsuperscript{153} See id.
\textsuperscript{154} See id.
\textsuperscript{155} See id.
\textsuperscript{156} See 1999 WTD 182-23
\textsuperscript{157} See id.
\textsuperscript{158} See id.
\textsuperscript{159} See The Formulary Approach to the Taxation of Transnational Corporations: A Realistic
NU/uploads/approved/adt-NU30020917.133138/public/02whole.pdf (last accessed November 14,
2004).
\textsuperscript{160} See id.
\textsuperscript{161} See supra note 156.
\textsuperscript{162} See supra note 159.
\textsuperscript{163} See supra note 156.
Those who disagree with the formulary system approach think that adopting such a method would introduce a host of new problems.\textsuperscript{164} It is argued that formulary apportionment is arbitrary and ignores market conditions.\textsuperscript{165} Opponents of this approach claim that global economic conditions and the structure of international business have not yet reached the point where the formulary system would be feasible.\textsuperscript{166} The counterargument to this by proponents of a formulary system is that different formulas may be adopted in order to satisfy corporations operating in different types of industries.\textsuperscript{167}

There is a delicate balance to be struck between retaining the tax base and allowing for U.S.-based multinational corporations to remain competitive in the global marketplace. While retaining the tax base is important, it is also imperative to enhance the competitiveness of U.S.-based multinational corporations in order to prevent loss of global market share and foreign takeovers, both of which may result in decreased corporate tax revenues over the long run.\textsuperscript{168}

**IX. Conclusion**

The anti-inversion provisions contained within the American Jobs Creation Act of 2004 will most likely be effective at discouraging most U.S.-based multinational corporations from undertaking corporate inversion for the time being although there are no provisions that prevent the problem of earnings stripping. The higher barrier that the Act constructs will effectively discourage many corporations from considering the types of aforementioned inversion transactions that have been very popular over the last 15 years. In addition, the reduction of foreign tax credit baskets and the allowance of foreign tax credits to be carried forward for five more years serve to help U.S. corporations.

Although corporate inversion will be discouraged by this Act, the fact remains that the U.S. is a relatively undesirable location for a U.S.-based multinational corporation to be headquartered. Corporate inversion is symptomatic of more serious problems that can be attributed to the U.S. tax system that causes U.S.-based multinational corporations to be a competitive disadvantage when compared to its foreign competition. Further measures will be necessary to strike an amicable balance between retaining the U.S. tax base while allowing for U.S.-based multinational corporations to be competitive in an increasingly global economy.

\textsuperscript{164} See id.
\textsuperscript{165} See id
\textsuperscript{167} See supra, note 159.
\textsuperscript{168} See supra, note 146.