NOTES

CORPORATE INVERSIONS: A SYMPTOM OF A LARGER PROBLEM, THE CORPORATE INCOME TAX

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I. INTRODUCTION

A corporate inversion is a paper transaction in which an American corporation reincorporates in a foreign nation without moving any of its operations to that country. The principle reason that a corporation will invert is to save money on taxes, in some cases as much as $60 million annually.[1] Politicians, believing these companies are reincorporating in a foreign country to evade taxes, have introduced numerous bills to try to stop these companies from moving overseas.[2] Senator John Kerry, the 2004 Democratic presidential nominee, stated that he plans to stop inversions within 500 days of his election to office.[3] These corporations, however, have demonstrated that they will not give up these tax savings without a fight. Leucadia National Corp., a company that underwent an

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1. Fernando Carneiro & Shirley Westcott, *The Inversion Subversion: Is Wall Street Bermuda-Bound?*, *at* http://www.issueatlas.com/content/menutop/content/subscription/postseasonfiles/bermuda.htm (Sept. 6, 2002) (citing Cooper Industries saving $55 million, Ingersoll-Rand saving $40 to $60 million, Nabors Industries saving $50 million, Stanley Works saving $30 million, and Weatherford saving $45 million).

2. *See* discussion *infra* Part VI.B.

3. *Premier Plays Down U.S. Candidate's Threats to Close Bermuda Tax Loophole*, BBC MONITORING INT'L REP., Jan. 26, 2004.

inversion in 2002, has hired a high-priced lobbying firm to block congressional efforts to stop inversions.[4]

Members of Congress, believing that inverted corporations should be punished for renouncing their citizenship and their executives should be taxed for making this unpatriotic decision, have proposed complex legislation designed to close this tax loophole.[5] Unfortunately, these solutions will not work. In reality, inversions are only a symptom of a much larger problem: American corporations are uncompetitive in foreign nations because of the corporate income tax. Today, the United States taxes corporate earnings at a rate of approximately 35%.[6] Of sixty-nine countries surveyed as of January 2004, only Japan had higher corporate tax rates.[7] These higher tax rates have yielded an inefficient result: some companies have committed transactions with the sole purpose of reducing their tax liabilities.[8]

Thus, the solution to the inversion problem, and consequentially the competitiveness problem, is simple: eliminate the corporate income tax. This might, initially, seem like an unfair shift in the American tax burden onto taxpayers. Economists have long claimed, however, that the corporate income tax is not, in fact, paid by corporations.[9] In practice, a corporation passes its tax liability onto individuals, be they workers, in the form of lower wages; shareholders, in the form of lower rates of return on capital; or customers, in the form of higher prices.[10] Since individuals end up paying all taxes (either through corporate or personal income taxes, or both), eliminating the corporate income tax will not increase the overall tax on individuals, rather, it will only redistribute the tax burden. Because inversions are a product of the U.S. corporate income tax, an in-depth analysis of the inversion phenomenon provides an instructive backdrop to illustrate the negative impacts of the corporate income tax. When the

4. Micahel Isikoff, Holly Bailey & Richard Wolffe, *Looking for Skeletons*, NEWSWEEK, Dec. 15, 2003, at 34, 34.

5. *See* discussion *infra* Part VI.B.

6. PAUL R. MCDANIEL, MARTIN J. MCMAHON, JR. & DANIEL L. SIMMONS, FEDERAL INCOME TAXATION OF BUSINESS ORGANIZATIONS 377 (3d ed. 1999) (stating that the corporate marginal rate structure and applicable phase-outs result in a 35% flat-rate for corporations with taxable income exceeding $18.33 million).

7. INT'L TAX & LEGAL CTR., KPMG INT'L, KPMG'S CORPORATE TAX RATE SURVEY—JANUARY 2004 1–2 (2004), *available at* http://www.kpmg.com.sg/services/intl_tax_pub/corprorate_tax_survey2004.pdf (last visited Jan. 29, 2005).

8. *See* discussion *infra* Parts II & III.

9. Editorial, *Mr. Buffett's Tax Advice*, WALL ST. J., Mar. 9, 2004, *available at* 2004 WL-WSJ 56922265. Economists holding this view include Nobel Prize winning economist Wassily Leontief. *Id.*

10. *Id. See also* discussion *infra* Part VII.

perverse consequences that the corporate income tax imposes on corporations are understood, one comes to the ultimate conclusion that the elimination of the corporate income tax is the best solution.

This Note first introduces the inversion issue and the basic structure of inversion transactions. It then discusses the tax costs and benefits of inversions, followed by a review of the other issues associated with inversions. Next, the incentives that drive inversions, the potential solutions, and the problems that each solution engenders are discussed. This Note concludes by advocating for the elimination of the U.S. corporate income tax, which is supported by the effects of such a solution on inversion transactions, the U.S. tax system, and taxpayers generally.

II. INVERSION TRANSACTIONS

A. DEFINING THE INVERSION ISSUE

Politicians, in their haste to stop the inversion phenomenon, have distorted the inversion issue. Howard Dean, a hopeful in the 2004 Democratic presidential primary, alleged that these inverting corporations are a "symbol of everything that is wrong with George W. Bush's America: wealthy executives who . . . pocket the president's big tax cuts and 'then move their corporations to Bermuda and their jobs offshore.'"[11] Dean, like many others, has confused the inversion issue with two other issues facing corporate America: outsourcing and fraud.[12] Companies invert to reduce tax liabilities, but the company does not change its corporate structure. Outsourcing, on the other hand, changes the corporate structure and can move manufacturing jobs overseas. Additionally, fraudulent and greedy executives are not confined to inverted corporations. Domestic incorporation has hardly prevented corporate scandals from companies such as Enron or Adelphia.[13] The inversion phenomenon is not about greedy executives, moving jobs overseas, or cheating the American public. Simply put, inversions are not about evil executives; inversions are about saving money on taxes. As Judge Learned Hand so aptly noted, "there is

11. Isikoff et al., *supra* note 4.

12. For a recent congressional discussion of the inversion problem, see generally *Corporate Inversions: Hearing Before the Subcomm. on Select Revenue Measures of the H.R. Comm. on Ways and Means*, 107th Cong. (2002) [hereinafter *H.R. Hearing*].

13. *Bringing U.S. Companies Home-Patriotism is No Cure for Fraud*, FIN. TIMES, Mar. 6, 2003, *available at* 2003 WL 14180942.

nothing sinister in so arranging one's affairs as to keep taxes as low as possible." [14]

B. THE INVERSION TRANSACTION DEFINED

"A corporate inversion is a transaction . . . through which a U.S.-based multinational [corporation] restructures its corporate group so that the ultimate parent corporation of the group becomes a foreign entity."[15] These transactions are often accompanied by the transfer of the foreign subsidiaries of the U.S.-based multinational corporation to the new foreign parent, so that these foreign subsidiaries are not exposed to the U.S. Tax Code.[16] Often, there is no change in the operations of the corporation.[17] For a foreign business to incorporate in Bermuda, for instance, the company only needs to complete some paperwork, open a registered office with two representatives, and pay a small fee.[18]

The central issue behind corporate inversions is this: "The U.S. tax treatment of a multinational corporate group depends significantly on whether the top-tier 'parent' corporation of the group is domestic or foreign," which is determined by where the corporation is incorporated.[19] According to the U.S. Chamber of Commerce, since the United States taxes international income—that is, income earned by a domestic corporation from operations conducted beyond the borders of its home country—while many other nations do not, American businesses are at a considerable competitive disadvantage relative to their foreign competitors in foreign markets.[20] These corporations believe that they can increase shareholder value by inverting their corporate structures.[21] After inverting, these companies will not be subject to U.S. taxes on non-U.S. income, which will reduce their tax liabilities. On the other hand, many American politicians

14. Comm'r v. Newman, 159 F.2d 848, 850–51 (2d Cir. 1947) (Hand, J., dissenting).

15. OFFICE OF TAX POLICY, DEP'T OF THE TREASURY, CORPORATE INVERSION TRANSACTIONS: TAX POLICY IMPLICATIONS 3 (2002) [hereinafter TREASURY REPORT].

16. *Id.* at 1.

17. *Id*.

18. Berm. Companies Act of 1981, §§ 130–131 (1989 Revision), *available at* http://www.bermudalaws.bm (last visited Jan. 29, 2005).

19. S. REP. NO. 107-188, at 2 (2002).

20. *See Corporate Inversion: Hearing Before the Subcomm. on Treasury & Gen. Gov't of the S. Comm. on Appropriations*, 107th Cong. 36–37 (2002) [hereinafter *S. Hearing*] (prepared statement of Martin A. Regalia, Vice President for Economic Policy and Chief Economist, U.S. Chamber of Commerce).

21. Yariv Brauner, *An International Tax Regime in Crystallization*, 56 TAX L. REV. 259, 304–05 (2003).

see these inversions as unpatriotic.[22] Additionally, critics claim the corporation is availing itself of all of the services provided by the American government without paying its fair share of the taxes.[23] Before analyzing these viewpoints, though, a brief review of inversion transactions is necessary.

<u>Stock Transaction</u>: Many of the major inversions to date have been stock transactions.[24] In a stock transaction, shareholders exchange their stock in the U.S. entity for shares of the new foreign parent. [25] After the transaction, the shareholders will hold the stock of the foreign parent and the foreign parent will hold the stock of the unchanged U.S. subsidiary. [26]

<u>Asset Transaction</u>: Asset transactions are generally used for smaller inversions.[27] In an asset transaction, the corporation moves assets from the U.S. subsidiary directly under the new foreign parent.[28] Like in a stock transaction, the shareholders will receive stock in the foreign parent.[29]

<u>Drop Down Transaction</u>: Drop down transactions are a mix of stock and asset transactions.[30] In a drop down transaction, the assets of the American corporation that are contributed directly to the foreign corporation will be treated in a similar fashion to assets in an asset transaction.[31] The remaining assets under the U.S. subsidiary will be treated in a similar fashion to the assets in a stock transaction.[32]

<u>Transfer of Foreign Subsidiaries</u>: Under a stock transaction, the foreign subsidiaries are still part of the U.S. group. To reduce the tax liabilities of these foreign subsidiaries,[33] the company must transfer them from the U.S. group to the foreign parent.[34] Once transferred, these subsidiaries will not be subject to U.S. taxes, only to the tax codes of the foreign country.[35]

22. *See S. Hearing*, *supra* note 20, at 1 (statement of Sen. Byron L. Dorgan, Chairman, S. Subcomm. on Treasury and Gen. Gov't).
23. *See id.*
24. TREASURY REPORT, *supra* note 15, at 4.
25. *Id.* at 4–5.
26. *Id.* at 5.
27. *Id.*
28. *Id.*
29. *Id.*
30. *Id.*
31. *Id.*
32. *See id.*
33. *See* discussion *infra* Part III.
34. TREASURY REPORT, *supra* note 15, at 6.
35. *Id.*

III. TAX RAMIFICATIONS OF INVERSIONS

According to statements submitted to the Securities and Exchange Commission ("SEC"), one of the main reasons to invert is to reduce a company's U.S. tax liability.[36] Tyco, for instance, in one year saved over $400 million in taxes.[37] Stanley Works estimated it would reduce its tax liability by $30 million annually (although the company would still annually pay $80 million in U.S. taxes).[38] Executives believe that the U.S. Tax Code causes their companies to be globally uncompetitive.[39] Therefore, they are moving their companies to jurisdictions that they believe will make their corporations more competitive internationally.[40]

It is not just executives that believe the American system of worldwide taxation makes companies uncompetitive internationally. The House Committee on Ways and Means noted, in its summary of House Resolution 5095, that "the inequities and burdens that our tax system imposes on U.S. companies, particularly those operating in international markets, are greater than those imposed by most other nations."[41] The summary further states that these inequalities have led to an increase in the number of American firms purchased by foreign competitors and an increase in the number of inversions.[42]

A. THE CURRENT TAX SYSTEM AND THE POTENTIAL TAX SAVINGS

The main advantage of an inversion is that because the parent is not a U.S. corporation, the income generated from foreign subsidiaries will only be taxed at the corporate rate of the jurisdiction where the income was generated. A U.S. corporation, on the other hand, will be taxed at the U.S. rate no matter where in the world that income is generated. Since most nations have corporate tax rates lower than the U.S. rate, this can mean

36. *See id.* at 1.

37. Rep. Ted Strickland, *Column: To Share Benefits, Corporations Must Also Share Burden*, *at* http://www.house.gov/strickland/AmericanOverseasCorpsCol.htm (last visited Jan. 29, 2005).

38. Jack Lyne, *Stanley's Bermuda Move Scrutinized: Congress Considers Clampdown on Offshore 'Re-incorporations'*, SITE SELECTION ONLINE INSIDER, June 24, 2002, *at* http://www.conway.com/ssinsider/snapshot/sf020624.htm.

39. *Id.*

40. *Id.*

41. SENATE COMM. ON WAYS AND MEANS, 107TH CONG., SUMMARY OF LEGISLATION, H.R. 5095, THE "AMERICAN COMPETITIVENESS AND CORPORATE ACCOUNTABILITY ACT OF 2002" (COMPETITIVENESS - INVERSIONS - TAX SHELTERS), *at* http://waysandmeans.house.gov/legacy.asp?file=legacy/fullcomm/107cong/hr5095/hr5095summary.htm (last visited Jan. 29, 2005).

42. *Id.* (noting that 77% of recent international mergers involving U.S. companies have chosen to retain the foreign company as the parent).

substantial savings.[43] In order to better understand why corporations are compelled to undergo such inversions, this Section briefly discusses how the U.S. tax system deals with multinational corporations.

U.S. Source Income: Inverting corporations pay the U.S. corporate tax rate (about 35% on earnings[44]) on all income generated in the United States.[45] Every business, whether incorporated in the United States, an inverted corporation, or a truly foreign corporation, has to pay U.S. tax on any income generated in the United States.[46] Therefore, an inversion offers no tax advantage for income generated in the United States.

Foreign Source Income: The tax advantages of an inversion result from income generated in a foreign nation with a tax rate lower than the U.S. rate (assuming, of course, that the inverted corporation has transferred its foreign subsidiaries from the U.S. group to the foreign parent[47]). This advantage is exaggerated because the U.S. tax system is based on a capital export neutral, or worldwide, tax system while many other nations utilize a capital import neutral, or a territorial, tax system.[48]

A company incorporated in a worldwide, or capital export neutral, tax system will face the same tax rate in any country in which it operates.[49] In this system, the company's home country taxes all income produced by the company and will generally reduce the taxes owed in the home country by the amount of taxes paid in foreign nations.[50] A company in a territorial, or capital import neutral, tax system will face only the tax rate of the country, foreign or domestic, in which it operates.[51] In this system, companies will always face the same tax rate as their competitors, but different tax rates in

43. *See generally* INT'L TAX & LEGAL CTR., *supra* note 7 (finding that the United States has the second highest corporate tax rate of the sixty-six nations surveyed).

44. MCDANIEL ET AL., *supra* note 6.

45. *See* Samuel C. Thompson, Jr., *Impact of Code Section 367 and the European Union's 1990 Council Directive on Tax-Free Cross-Border Mergers and Acquisitions*, 66 U. CIN. L. REV. 1193, 1209–10 (1998) (stating that foreign corporations are taxed on passive income from domestic sources and income from the conduct of a trade or business within the United States).

46. RICHARD L. DOERNBERG, INTERNATIONAL TAXATION IN A NUTSHELL 17 (5th ed. 1999).

47. *See* discussion *supra* Part II.

48. DOERNBERG, *supra* note 46, at 4–6; Paul R. McDaniel, *The U.S. Tax Treatment of Foreign Source Income Earned in Developing Countries: A Policy Analysis*, 35 GEO. WASH. INT'L L. REV. 265, 267–72 (2003).

49. DOERNBERG, *supra* note 46, at 4; McDaniel, *supra* note 48, at 267–68.

50. DOERNBERG, *supra* note 46, at 4; McDaniel, *supra* note 48, at 267–68.

51. DOERNBERG, *supra* note 46, at 4–5; McDaniel, *supra* note 48, at 272.

different countries.[52] This is the system used in several countries including France, the Netherlands, Germany, and Canada.[53]

The consequences of these different tax systems are best illustrated with an example. Consider an Irish company and an American company, each selling goods in America, Ireland, and a third country with a corporate tax rate of 10%. Sales are made by sales subsidiaries incorporated in the country in which the sales take place. Also, assume Ireland's tax rate is 15% and it has a territorial tax system.[54] On the goods sold in America, both companies pay 35% in tax on earnings (both owe 35% in tax to the U.S. government and 0% in tax to Ireland). On goods sold in Ireland, both companies owe 15% in tax to the Irish government. The American company, however, faces an additional 20% in tax to the American government, so that the company's overall tax rate is 35%. This corporation would owe 35% in tax to the American government, but would receive a foreign tax credit equal to the 15% paid in Ireland for an effective American tax rate of 20%.[55] Additionally, in the third nation, the Irish company will only have to pay the foreign tax rate of 10%, while the American company, again, pays the higher U.S. tax rate. Clearly, the American corporation is at a competitive disadvantage with respect to its business in foreign nations. By inverting, a corporation can remove itself from the U.S. tax jurisdiction. In the example above, if the American corporation inverted to Bermuda it would face the same tax rates across the board as the Irish corporation (35% in the U.S., 15% in Ireland, and 10% in the third country).[56] This is why many observers suggest that inversions could be considered self-help territorial tax transactions because the companies are removing themselves from a worldwide tax system and moving to a territorial tax system.[57]

This analysis, of course, is a vast simplification of the current international tax situation. No country uses a completely territorial or a completely worldwide tax system. Most countries, for instance, believe that

52. DOERNBERG, *supra* note 46, at 4–5; McDaniel, *supra* note 48, at 272.

53. McDaniel, *supra* note 48, at 272.

54. Although in 2004 Ireland's tax rate was 12.5%, this Note uses 15% for simplicity. *See* INT'L TAX & LEGAL CTR., *supra* note 7, at 10.

55. *See infra* notes 63–66 and accompanying text (explaining how the U.S. foreign tax credit system allows a U.S. corporation to take into account the Irish tax).

56. This is true because Bermuda does not have a corporate income tax, making it ipso facto a territorial system. *See* BERM. INT'L BUS. ASS'N, A BERMUDA INCORPORATION: WHY AND HOW 4 (2000), *at* http://bibaproject.northrock.bm/documents/incorp.pdf (last visited Jan. 29, 2005).

57. *H.R. Hearing*, *supra* note 12 (statement of Rep. Jim McCrery, Chairman, H.R. Subcomm. on Select Revenue Measures).

passive income (income derived from real estate and business investments in which the individual is not actively involved[58]) should be taxed on a worldwide basis.[59] Additionally, the U.S. taxes most active income (salaries, wages, fees, and commissions[60]) from foreign operations only when it is repatriated.[61] Some active income, however, will be taxed when earned under the Subpart F rules of the tax code; for instance, goods that are sold to related parties.[62] Generally, passive income, since it is highly mobile, is taxed when earned, while active income is only taxed when repatriated. Therefore, foreign subsidiaries that are actively investing might be able to defer the U.S. tax on their earnings. At some point, however, the earnings must be repatriated and taxed so that shareholders of U.S. parent companies can reap the benefits of the foreign earnings. While these complexities distort the consequences of the international tax system, America still uses a far more capital export neutral system than most other nations, and America employs a higher corporate income tax rate than most other countries.

Returning to the example of the U.S. and Irish companies, if either company purchased stock in a foreign company, the gain would be taxable in its home country. This, of course, still gives the Irish company a competitive advantage because of the higher U.S. corporate tax rate. If the American and Irish companies sell goods in Ireland, both would owe the Irish government a 15% tax on the earnings. The American company would owe an additional 20% tax to the American government. If the American subsidiary reinvests these earnings in the active business, perhaps by producing more goods, the tax could be deferred.

Foreign Tax Credit System: In the United States, corporations are allowed a credit for income taxes paid to foreign governments on foreign source income.[63] The foreign tax credit system was designed to provide a one dollar deduction from a company's U.S. tax liability for each dollar of foreign tax paid.[64] Returning to the above example, the American company

58. InvestorWord.com, *Passive Income*, *at* http://www.investorwords.com/3614/ passive_ income.html (last visited Jan. 29, 2005).

59. McDaniel, *supra* note 48, at 272 (stating that even countries that use a territorial tax system tax passive income on a worldwide basis).

60. InvestorWord.com, *supra* note 58.

61. 26 U.S.C.S. §§ 61(a)(7), 1248 (Law. Co-op. 2004). *See also* John M. Peterson, Jr. & Bruce A. Cohen, *Corporate Inversions: Yesterday, Today and Tomorrow*, *in* TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 2003 1050 (Practising Law Institute 2003).

62. 26 U.S.C.S. § 954(d)(1) (Law. Co-op. 2004). *See also* Peterson & Cohen, *supra* note 61.

63. McDaniel, *supra* note 48, at 268.

64. *See id.*

would owe 15% in tax to the Irish government, and 35% in tax to the U.S. government. Without the foreign tax credit, the U.S. company would owe 50% in tax. The company should get a foreign tax credit equal to the Irish tax of 15% that it can deduct from its U.S. tax liability. This 15% reduction means the company only owes 20% in tax to the U.S. When added together, the American company pays 15% to the Irish government and 20% to the U.S. government, yielding an effective overall tax rate of 35%. It should be noted that a territorial tax system does not impose a foreign tax credit system because it does not tax foreign income.

There are three potential distortions in the foreign tax credit system that could cause problems in its implementation. First, if the foreign tax rate is higher than the American tax rate, the dollar for dollar reduction is capped at the American tax rate and the tax credits cannot be used to reduce tax on U.S. operations.[65] This means that U.S. companies could pay a rate higher than the U.S. corporate tax rate, but never lower. Second, when the deferral system is coupled with different foreign tax rates, companies might try to defer the repatriation of income generated in low-tax jurisdictions because it will be highly taxed at repatriation, and could instead choose to repatriate earnings from high-tax jurisdictions to take advantage of the tax credits. This causes unnecessary distortions in capital allocations. Finally, the complexity of the Subpart F rules of the Internal Revenue Code, with its multiple income tax brackets and exclusions, makes it difficult for companies to collect all of the foreign tax credits that are due.[66] This could also lead to companies paying higher tax rates than the U.S. corporate rate.

<u>Interposing a Third Nation</u>: Even after an inversion, funds need to travel from the U.S. subsidiary to the foreign parent to pay shareholders, to pay loans, and to finance international operations.[67] Most no-tax countries, like Bermuda, do not have a tax treaty with the United States. [68] When there is no treaty, all payments from a domestic firm to a foreign firm are subject to a 30% withholding tax in the United States.[69] To get around this 30% tax, inverting corporations will interpose a third corporation in a country with a favorable tax treaty between the U.S. subsidiary and the

65. *Id.* at 268–69.

66. *See* 26 U.S.C.S. §§ 951–964 (Law. Co-op. 2004); David M. Hryck, *Taxation: Saving Money by Moving Offshore*, START-UP & EMERGING COMPANIES STRATEGIST, June 2002, at 7.

67. *See* Hryck, *supra* note 66.

68. *Id.*

69. *Id. See also* Robert L. Sommers, The Tax Prophet, *Questions Concerning Withholding Required on Repatriation of Funds to Non-US Citizens*, *at* http://www.taxprophet.com/foreign/foreign_withholding_memo.shtml (last visited Jan. 29, 2005).

foreign parent.[70] If this third company is in Barbados, for instance, most payments are taxed at only 5%.[71] The company can then transfer money from the U.S. to Barbados to Bermuda and, finally, to the shareholders, without having to pay the 30% tax. This also means that all deductible payments by the U.S. subsidiary to the Barbados company, including interest payments or royalty payments for intellectual property, will be taxed at only 5%.

B. Other Tax Benefits of Inversion Transactions

In addition to the substantial tax savings achieved in foreign nations, inversions provide other avenues for companies to decrease their tax liabilities.

<u>Earnings Stripping</u>: Earnings stripping occurs when a foreign or inverted company lends money from its foreign corporation to its U.S. subsidiary.[72] The interest that the U.S. subsidiary pays to the foreign parent can be deducted from the income earned by the U.S. subsidiary to reduce the income tax owed to the U.S. government.[73] In this way, a foreign company might highly leverage its U.S. subsidiary so that a company with positive operating income would not have to pay U.S. taxes after the interest deduction. To clarify this point, assume a Bermuda corporation lends its American subsidiary $10 million at 10% interest. The interest deduction could reduce its American income by $1 million dollars per year. Using this method, the company can strip earnings from its American subsidiary and reduce its tax liabilities.

<u>Goodwill and Intangibles</u>: Similar to earnings stripping, the foreign parent can loan the American subsidiary something besides money in exchange for payments. For instance, the American subsidiary could pay royalties to the foreign parent for the use of the company name or logo to reduce American income by the amount of the deductible payments.[74] Of course, since the American subsidiary was likely to be responsible for the development of the intangible, these transactions could invite intense scrutiny from the Internal Revenue Service ("IRS").[75]

70. Hyrck, *supra* note 66.

71. LowTax.net, *Double-Tax Treaties*, *at* http://www.lowtax.net/lowtax/html/jbs2tax.html (last visited Jan. 29, 2005).

72. Peterson & Cohen, *supra* note 61, at 1113–15.

73. *Id.*

74. *See* N.Y. State Bar Association Tax Section, *Outbound Inversion Transactions*, 96 TAX NOTES 127, 139 (2002).

75. *Id.*

Artificially Setting Transfer Pricing (with an Eye on Taxes): The United States has a complicated set of transfer pricing rules and regulations designed to keep companies from transferring goods in such a way as to artificially reduce tax liabilities in the United States. A domestic U.S. corporation that transfers goods from its foreign subsidiaries is covered under the transfer pricing rules for FSCs and all profits are taxed as sales to related parties.[76] This eliminates the incentive for domestic corporations to artificially set transfer prices with an eye toward tax reductions.[77] Inverted companies, on the other hand, could engage in aggressive transactions which would put "additional pressure on the already overloaded transfer pricing rules under the code"[78] since they are not covered under the Subpart F rules.

C. TAX LIABILITIES ARISING FROM INVERSION TRANSACTIONS

While an inversion can reduce a company's tax liabilities by millions annually, the transaction itself will trigger an immediate, one-time tax for the company or its shareholders.

Stock Transactions: Normally, a stock-for-stock exchange is a tax-free event if it is between domestic corporations.[79] A stock-for-stock exchange with a foreign corporation is only tax-free if it satisfies the requirements of section 367(a) of the Internal Revenue Code.[80] For a tax-free transaction, the U.S. target must meet the following four standards: (1) shareholders of the U.S. company end up owning less than 50% of the new foreign company, (2) none of the original shareholders hold more than 5% of the new foreign corporation, (3) the active trade or business test is satisfied, and (4) the U.S. target complies with reporting requirements.[81] The stock inversion transactions described above will fail the 50% ownership standard and will therefore be subject to tax.[82] Since the transaction will fail to satisfy section 367(a), the shareholders will have to recognize any

76. 26 U.S.C.S. § 1.925(a) (Law. Co-op. 2004). *See also* Samuel C. Thompson, Jr., *The Non-Wimpy Grassley/Baucus Inversion Bill*, 95 TAX NOTES 1515, 1516 (2002).

77. *See id.*

78. *Id.*

79. Peterson & Cohen, *supra* note 61, at 1052.

80. *Id.*

81. Linda Z. Swartz, *Global Tax-Free Deals: Mergers, Acquisitions and Spins at Home and Abroad*, *in* TAX LAW AND ESTATE PLANNING COURSE HANDBOOK SERIES 259, 398–99 (Practising Law Institute 2002); Thompson, *supra* note 45, at 1222–25.

82. Peterson & Cohen, *supra* note 61, at 1054. *See infra* notes 141–144 and accompanying text.

gain they experienced on their stock since their purchase, but will not be able to deduct their losses.[83]

If an individual bought stock in a U.S. corporation at $10, for example, and the value of the stock was $20 when the company inverts, the shareholder will face an immediate capital gains tax on the $10 gain. One potential issue associated with this tax is that some taxpayers might not have sufficient funds to pay it, particularly retired shareholders.[84] Another issue is that some shareholders who vote for an inversion might not even know that they will owe tax on their gain from the inversion.[85] This has been less of an issue recently because of reduced market values. Many individuals who own stock would not owe capital gains taxes on the transaction if the value of their shares are below their purchase price.[86] In a stock inversion, whether the shareholders pay a tax or not, the corporation will not face a tax liability.

<u>Asset Transaction</u>: In an asset transaction, on the other hand, it is the corporation that faces the tax liability, not the shareholders. In this case, the transaction is organized so that it is outside the scope of section 367(a) of the Internal Revenue Code.[87] To do this, the corporation must transfer its assets to its foreign parent. While the asset transfer would not be a taxable event if the corporation was domestic, the transaction becomes taxable since the American company is transferring assets to a foreign corporation.[88] In this case, the corporation pays a tax on the gain from the assets, but the shareholders do not owe any tax.

<u>Drop Down Transaction</u>: As described above, a drop down transaction is a mix of stock and asset transactions. Similarly, the tax consequences are also mixed.[89] Since only some of the assets are transferred between the parent corporation and its subsidiary in a drop down inversion, corporations are only taxed on the gain from those assets.[90] The rest of the gain is taxable to the shareholders when they exchange their U.S. stock for the stock of the foreign parent.[91]

83. Peterson & Cohen, *supra* note 61, at 1054.
84. *H.R. Hearing*, *supra* note 12 (statement of Richard Blumenthal, Attorney General, Conneticut Attorney General's Office).
85. Jeff A. Schnepper, *When a Company Moves Abroad, Shareholders Pay!*, USA TODAY, May 1, 2003, at 27, *available at* 2003 WL 10887087.
86. *See* Hryck, *supra* note 66.
87. Peterson & Cohen, *supra* note 61, at 1058.
88. *Id.* at 1057–58 (applying sections 361 and 367(a) of the Internal Revenue Code).
89. *Id.* at 1061–62.
90. *Id.* at 1062.
91. *Id.*

Transfer of Subsidiaries to Foreign Parent: While a company might escape a tax liability from an inversion by using a stock transaction, the company still needs to transfer its foreign subsidiaries to its foreign parent to achieve tax savings. This qualifies as an asset transaction with a foreign entity and it is therefore a taxable event for the corporation.[92] In this case, the transferred assets are taxed, similar to an asset transaction. Most recent inversions, however, have been accomplished with minimal tax liability to the corporations.[93] The small tax liability could be attributed to reduced valuations of its foreign subsidiaries (because of reductions in market value) or substantial tax credits from operating losses.[94]

IV. OTHER CONSEQUENCES OF INVERSIONS

Multinational corporations that invert face significantly lower corporate tax rates than their American counterparts. Critics of inversions argue that there are other intangible and tangible costs besides the immediate tax liability associated with this tax savings. For instance, there are important differences between U.S. corporate law and the corporate laws of the countries in which companies invert. These differences in law will have a substantial impact on the rights and duties of the shareholders and corporate officers of inverted companies. This Note will analyze Bermuda and Delaware corporate laws to explain the additional consequences of inversion transactions.

A. DELAWARE VERSUS BERMUDA LAW

Delaware law will be analyzed because over half of the companies in the Fortune 500 are incorporated in the state (making this discussion relevant to most U.S. multinational corporations that might consider this type of transaction).[95] It will be compared to Bermuda law because most of the companies that have inverted, to date, have done so in Bermuda (over ten out of twenty-five).[96] Other factors that make Bermuda law an ideal candidate for comparison are: Bermuda has no corporate income tax,[97]

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92. *See* Hryck, *supra* note 66.

93. *See id.*

94. *See id.*

95. John L. Reed & Frank E. Noyes, Duane Morris Publications, *Incorporate in Delaware? Yes* (Dec. 1, 2001) (on file with the *Southern California Law Review*).

96. *H.R. Hearing*, *supra* note 12 (statement of Rep. Richard E. Neal, Member, Subcomm. on Select Revenue Measures of the Comm. on Ways and Means).

97. BERM. INT'L BUS. ASS'N, *supra* note 56.

accountants from Ernst and Young suggest companies reincorporate there,[98] and it has been cited as a tax haven by legislators.[99]

Bermuda is a totally self-governed territory of the United Kingdom and no British laws apply there.[100] The country has a parliamentary legislative system and a case law based judicial system very similar to British law.[101] The Bermuda legislature instituted the Companies Act in 1981, which is the controlling document for corporate law in Bermuda.[102] This document provides for the existence of exempted corporations and their governance (which are inverted corporations). [103]

B. SUMMARY OF RIGHTS AND DUTIES AFFECTED BY INVERSIONS

In addition to different taxation regimes faced by companies incorporated in Delaware and Bermuda, there are a number of differences in the laws of the two jurisdictions that could affect the rights and duties of shareholders and directors. This Section seeks to clarify these differences and their effects.

<u>Fiduciary Duty of Directors</u>: Directors in Bermuda have a duty to "act honestly and in good faith with a view to the best interests of the company."[104] This is different from Delaware law in two ways. First, the duty of the directors in a Delaware corporation is to the shareholders and the company,[105] while the duty of directors in a Bermuda corporation is only to the company.[106] Second, directors in Delaware can be held liable

98. DAVID CAY JOHNSTON, PERFECTLY LEGAL 229–30 (2003).

99. *S. Hearing*, *supra* note 20, at 1 (statement of Sen. Byron L. Dorgan, Chairman, S. Subcomm. on Treasury and Gen. Gov't).

100. Keith Archibald Forbes, Bermuda Online, *Bermuda and Great Britain: A Self-Governing British Overseas Territory with Its Own Laws*, *at* http://bermuda-online.org/colonial.htm (last visited Jan. 29, 2005).

101. Keith Archibald Forbes, Bermuda Online, *Bermuda Government from July 30, 2003: Constitution, Executive, Legislature, Judiciary, Voters*, *at* http://bermuda-online.org/bdagovt.htm (last visited Jan. 29, 2005). Bermuda's case law has recently been made available online. LexisOne, *Zimmerman's Research Guide: Bermuda*, *at* http://www.lexisone.com/infopro/zimmerman/#Letterb (last visited Jan. 29, 2005).

102. *See* Berm. Companies Act of 1981, *supra* note 18.

103. *Id.*

104. *Id.* § 97(1)(a).

105. WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS 19 (6th ed. 1998).

106. Berm. Companies Act of 1981, *supra* note 18, § 97; Accenture Ltd., Prospectus Filing under SEC Rule 424(B)(4), Registration No. 333-59194 (July 19, 2001), *available at* http://premium.hoovers.com/subscribe/co/secdoc.xhtml?ipage=1454521&doc=1; State of Wis. Inv. Bd., *SWIB Position Paper - Reincorporation to Offshore Tax Havens*, *available at* http://www.swib.state.wi.us/off_shore.asp (last visited Jan. 29, 2004).

for gross negligence,[107] while Bermuda directors can only be held liable for fraud or dishonesty.[108]

Predictable Legal System: Companies incorporate in Delaware partly because of its predictable legal system.[109] The Delaware chancery court has a long history of published case law that makes the outcome of most disputes in Delaware highly predictable.[110] On the other hand, Bermuda has only recently begun to publish cases.[111] Some lawyers have even suggested that there have not been enough corporate law cases decided in Bermuda to determine how some major disputes might turn out.[112] Therefore, while corporations and shareholders know how the Delaware courts will handle many lawsuits, an action in Bermuda could yield an unexpected result.

Insider Transactions: Bermuda, unlike Delaware and most other American states, does not have explicit restrictions against insider trading.[113] This could be a significant temptation for corporate officers of inverted companies.

Shareholder Approval: Bermuda does not require a vote of the shareholders before a corporation sells a majority of its assets, changes its business structure, or merges with another company.[114] Delaware, on the other hand, requires shareholder approval for these actions.[115]

No Derivative Actions: The reductions in shareholder rights discussed above are further exacerbated by the fact that Bermuda only allows derivative lawsuits in limited circumstances.[116] A derivative lawsuit allows shareholders to directly sue corporate officers for wrongdoing.[117] Some argue that derivative lawsuits are "a profoundly important tool to protect

107. KNEPPER & BAILEY, *supra* note 105, at 47.

108. Berm. Companies Act of 1981, *supra* note 18, § 98(B).

109. Reed & Noyes, *supra* note 95.

110. *Id.*

111. *See* LexisOne, *supra* note 101.

112. Monica Perin, *Nabors Facing Opposition Over Plan to Incorporate in Bermuda*, HOUSTON BUS. J., May 31, 2002, *available at* http://houston.bizjournals.com/houston/stories/2002/06/03/story7.html (last visited Jan. 29, 2005).

113. *H.R. Hearing*, *supra* note 12 (statement of Richard Blumenthal, Attorney General, Conn. Attorney General's Office). *See also* State of Wis. Inv. Bd., *supra* note 106.

114. *H.R. Hearing*, *supra* note 12 (statement of Richard Blumenthal, Attorney General, Conn. Attorney General's Office); State of Wis. Inv. Bd., *supra* note 106.

115. DEL. CODE ANN. tit. 8, § 251 (2004).

116. *See* Accenture Ltd., *supra* note 106. *See also* tit. 8, § 251; State of Wis. Inv. Bd., *supra* note 106.

117. DOUGLAS M. BRANSON, CORPORATE GOVERNANCE 594–95 (1993).

shareholders from the malfeasance and self-dealing by officers and directors."[118]

Enforceability of Judgments: Since the U.S. does not have a treaty with Bermuda, there is no guarantee that judgments against an inverted company in an American court will be upheld by the Bermuda court.[119] If the judgment of the American court is against Bermuda public policy, the Bermuda court can chose not to enforce the judgment.[120] The Full Faith and Credit Clause of the Constitution, on the other hand, ensures that each state must give full faith and credit to the judicial proceedings of every other state.[121] As Richard Blumenthal, the Attorney General of Connecticut, stated, "Bermuda may be not just a tax haven, but also a judgment haven."[122] To date, though, no Bermuda court has overturned an American corporate law decision involving inverted companies.

Potential Mitigating Solutions: One potential solution to the shareholder rights problems would be to amend the corporation's charter to include shareholder protections. Tyco's present CEO, Ed Breen, in response to concerns over reduced shareholder rights, stated that '"[t]here are ways to remain in Bermuda and also provide the protection for shareholders that people are looking for, perhaps by building it into the bylaws.'"[123] Additionally, most inverting firms are part of the New York Stock Exchange and so remain governed by the SEC.[124] The SEC has explicit regulations, for instance, against insider trading, which should prevent insider trading in inverted corporations.[125]

C. OTHER COSTS OF INVERSION TRANSACTIONS

In addition to the tax liabilities of inversion transactions and the potential loss of rights, there are other tangible costs like: (1) inversion transaction expenses, (2) inversion promotion fees, (3) costs of negative

118. *H.R. Hearing*, *supra* note 12 (statement of Richard Blumenthal, Attorney General, Conn. Attorney General's Office).

119. *Id.*; State of Wis. Inv. Bd., *supra* note 106. *See also* Accenture Ltd., *supra* note 106.

120. *H.R. Hearing*, *supra* note 12 (statement of Richard Blumenthal, Attorney General, Conn. Attorney General's Office).

121. U.S. CONST. art. IV, § 1, cl. 1.

122. *H.R. Hearing*, *supra* note 12 (statement of Richard Blumenthal, Attorney General, Conn. Attorney General's Office).

123. Melanie Warner, *Exorcism at Tyco*, FORTUNE, Apr. 28, 2003, at 106 (quoting Tyco's CEO Ed Breen).

124. Carneiro & Westcott, *supra* note 1.

125. Final Rule: Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716-01 (Aug. 24, 2000) (codified at 17 C.F.R. pts. 240, 243, and 249).

publicity, (4) business or transaction modifications, (5) anticipated costs of potential legal challenges, and (6) the possibility of losing the tax savings.[126]

D. PATRIOTISM

Most legislators feel that patriotism is the most important reason to outlaw inversions.[127] These corporations have even been labeled 'Benedict Arnold companies.'[128] Senator Byron L. Dorgan of North Dakota, voicing concerns echoed by numerous members of Congress, stated: "The American people pay their taxes. People who run businesses on Main Street pay their taxes. And frankly, it disgusts me to see corporations decide in their boardrooms that they would like to renounce their U.S. citizenship so they can avoid paying taxes."[129] Many in corporate management, though, note that a corporation is not a citizen but a legal fiction. These corporations have one principle rule: to increase shareholder value.[130] Corporations are increasingly becoming multinational and their patriotic duties are less clear. Kate Barton, a partner at Ernst and Young, noted that "the improvement on earnings is powerful enough that maybe the patriotism issue needs to take a back seat."[131]

V. SUMMARY OF INVERSIONS

There seems to be only one reason to invert: substantial tax savings. On the other hand, there seems to be a number of reasons why shareholders might vote against inversions: patriotism issues, the potential tax liability, a reduction in shareholder rights, other tangible costs, and reduced fiduciary duties owed by their corporate officers. Even with all these negative consequences, over eleven companies, through a vote of their shareholders,

126. Sharp Sorensen, *The Tax Shelter Decision: Setting Aside What Should Be: Dealing with What Is*, *in* TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 2002 1015, 1022–26 (Practising Law Institute 2002).

127. *H.R. Hearing*, *supra* note 12 (statement of Rep. Scott McInnis, Member, House Comm. on Ways and Means).

128. *Congress Fights Offshore Tax Sheltering*, INDUST. DISTRIBUTION, Aug. 1, 2002, at 17 (quoting Rep. Michael McNulty).

129. *S. Hearing*, *supra* note 20, at 4 (statement of Sen. Byron L. Dorgan, Chairman, Sen. Subcomm. on Treasury and Gen. Gov't).

130. STEPHEN A. ROSS, RANDOLPH W. WESTERFIELD & JEFFREY F. JAFFE, CORPORATE FINANCE 15 (6th ed. 2002).

131. JOHNSTON, *supra* note 98, at 231.

inverted in 2001 and 2002.[132] This implies that shareholders believe the tax savings from inversions are so large that they outweigh all of the negative aspects of an inversion. A study by Jim Sieda and William Wempe found that, on average, a firm's share price rises when its inversion is approved by its shareholders.[133] This implies that it is not just the approving shareholders, but the entire market that believes that the costs of inverting are less than the tax savings.

It seems inversions, from a shareholder perspective, are good corporate decisions. Legislators feel that they need to stop inversions because they believe these companies are evading taxes. Most of the government's solutions, however, do not address the fundamental problem that investors believe that the tax structure in the United States makes companies so uncompetitive that they will deal with the negative aspects associated with inversions just for the tax savings.

VI. POTENTIAL SOLUTIONS AND THEIR PROBLEMS

Legislators, in 2002 and 2003, introduced a number of bills designed to stop inversions. Each of these bills, however, has a fundamental flaw. They do not address the underlying issues that cause inversions; they do not make American businesses competitive in international markets. Instead, the bills try to treat the symptoms, rather than the disease. This section first addresses the history of inversions and then discusses each legislative solution and its corresponding problems. Next, it introduces a hypothetically perfect legislative solution and discusses its problems. This is followed by a discussion of the competitiveness issue and how it affects other incorporation transactions. Finally, this section provides one congressional bill that makes sense and a solution that, while inadequate, is a step in the right direction.

132. *H.R. Hearing*, *supra* note 12 (statement of Rep. Richard E. Neal, Member, Subcomm. on Select Revenue Measures of the Comm. on Ways and Means) (listing twenty-five recent inversions).

133. Jim A. Seida & William F. Wempe, *Market Reaction to Corporate Inversion Transactions*, 97 TAX NOTES 1098, 1099, 1100 tbl.1 (2002) (finding that fourteen out of nineteen companies experienced positive returns after shareholders approved inversion transactions). *But see* C. Bryan Cloyd, Lillian F. Mills & Connie D. Weaver, *Firm Valuation Effects of the Expatriation of U.S. Corporations to Tax Haven Countries* 23 (2002), *at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=341141 (finding that only two out of nineteen inverting companies posted statistically significant positive returns).

A. HISTORY OF INVERSIONS

In 1982, McDermott Incorporated completed the first inversion transaction when it reincorporated in Panama.[134] Congress immediately took action against the kind of transaction that McDermott undertook.[135] In 1994, a Texas makeup manufacturer, Helen of Troy, undertook a stock inversion transaction.[136] The government again responded quickly, this time by enacting section 367(a) of the Internal Revenue Code, which made inversions a taxable event to shareholders.[137] Until 1997, when Tyco inverted, investment bankers assumed that a companies share value would decline if it reincorporated in Bermuda.[138] On the contrary, share prices seem to increase after an inversion.[139] The recent increase in corporate inversions from 2000 to 2002 "has been attributed to the increased market acceptance of the transaction."[140]

B. CONGRESSIONAL SOLUTIONS

Legislators introduced over fifteen bills in 2003 designed to stop inversions. The solutions proposed in these bills can be divided into three broad categories.

1. Treat Inverted Corporations Like Domestic Corporations

These bills tax foreign corporations that merge with domestic corporations in inversion transactions as if they were domestic corporations.[141] The acts define an inversion as a transaction in which (1) a foreign corporation acquires substantially all of the properties held by a

134. Robert J. Staffaroni, *Size Matters: Section 367(a) and Acquisitions of U.S. Corporations by Foreign Corporations*, 52 TAX LAW 523, 533 (1999).

135. *See* N.Y. State Bar Ass'n Tax Section, *supra* note 74, at 129.

136. Staffaroni, *supra* note 134, at 534.

137. 26 U.S.C.S. § 364 (a) (Law. Co-op. 2004). *See also* Staffaroni, *supra* note 134, at 535.

138. Anthony C. Infanti, *Eyes Wide Shut: Surveying Erosion in the Professionalism of the Tax Bar*, 22 VA. TAX REV. 589, 593–94 (2003).

139. *Id.*

140. *Id.*

141. Safe, Accountable, Flexible, and Efficient Transportation Equity Act of 2004, S. 1072, 108th Cong. (2004); Jumpstart Our Business Strength (JOBS) Act, S. 1637, 108th Cong. (2003); American Jobs Creation Act of 2003, H.R. 2896, 108th Cong. (2003); Energy Tax Incentives Act of 2003, S. 1149, 108th Cong. (2003); Sales Tax Equity Act of 2003, S. 1436, 108th Cong. (2003); Jobs and Growth Tax Relief Reconciliation Act of 2003, S. 1054, 108th Cong. (2003); To enhance energy conservation and research and development, to provide for security and diversity in the energy supply for the American people, and for other purposes, H.R. 6, 108th Cong. (2003); Energy Policy Act of 2003, S. 2095, 108th Cong. (2003); Dayton Fair Tax Cut Act, S. 135, 108th Cong. (2003); Pension Protection and Expansion Act of 2003, S. 9, 108th Cong. (2003).

domestic corporation; (2) immediately after the transaction, more than 80% of the stock of the acquiring corporation is held by former shareholders of the domestic corporation; and (3) the company does not have significant operations in the country in which it is reincorporated.[142] The acts also create regulations and punishments for corporations that are under the 80% threshold of ownership but above a 50% threshold.[143] Some of these bills differ slightly but, in all of them, the general concept is the same: treat an inverted foreign corporation like a domestic corporation for tax purposes.[144]

The first major problem with this solution is that it does not address the competitiveness issues that underlie inversion transactions.[145] Another major problem with this solution is that, like solutions Congress has proposed before,[146] it is just plugging a hole in a dike. This kind of solution did not stop inversions before, and it is unlikely to stop them now. Lawyers and accountants will find a way around whatever restrictions the government implements if they do not address the underlying issues of why companies choose to invert. This law might stop inversions for a brief time, but lawyers will invent new transactions to circumvent the restrictions. Additionally, there could be other unexpected consequences of these bills that would cause more harm than good.

A simple way to circumvent this legislative solution, for instance, is with stock holding groups. Shareholders of a corporation have to pay tax on their gain if the company commits a stock inversion transaction. The shareholders could sell their stock to a holding group (the shareholders will recognize their gain, but could also recognize any losses on the sale). During the reincorporation, the stock of the foreign company could be sold back to the old shareholders. The holding group would have to recognize the gain on sale of the foreign shares ($0 because they would be sold back at the same price). In this way, the new foreign corporation would have completely different shareholders than when it was a domestic corporation (satisfying the requirements of this legislation so it would not be considered an inverted domestic corporation) and the shareholders would be able to recognize their loss on sale (which they would not be able to do under the section 367(a) regulations). Remember, these companies save millions by

142. S. 1072; H.R. 2896; S. 1149; S. 1436; S. 1054; H.R. 6; S. 2095; S. 9.

143. S. 1072; S. 1637; H.R. 2896; S. 1149; S. 1436; S. 1054; H.R. 6; S. 2095; S. 9.

144. *See, e.g.*, H.R. 6; S.135.

145. *See* discussion *infra* Part VI.D.

146. Peterson & Cohen, *supra* note 61 (discussing the Helen of Troy and McDermott transactions and the accompanying legislative responses).

inverting, so it is naive to assume that these companies will not figure out a way around this kind of legislation.

2. Tax the Stock Compensation of Insiders

These statutes would impose a 20% tax on the gain from any stock compensation to executives, direct or indirect, held at any time during the twelve month period beginning six months before the inversion date.[147] For stock options, this would be the fair market value of the option.[148]

Taxing the compensation of insiders, like taxing inverted corporations as domestic corporations, does not address the underlying issues that drive U.S. corporations to invert.[149] The second major problem with taxing corporate executives is that it would do little to stop inversions. Most executives of multinational corporations seek to increase the value of their corporation for their shareholders. Reducing the company's tax liabilities by inverting the corporate structure would still increase shareholder value even if the executive's stock options are taxed. Executives would still feel that they have to invert their companies for their shareholders.

A simple way to get around this legislative solution is to have the corporation increase the executive's compensation by the size of the tax liability. In this way, the corporation could just pay the executive's tax. This solution could also lead to an interesting, but obviously unintended, phenomenon. Surveys show that stock prices increase, on average, if a company inverts.[150] This legislation, though, gives executives an incentive to oppose an inversion even if it is clearly advantageous for their companies. The shareholders of a company could potentially file a derivative lawsuit against the directors for ***not*** inverting the corporation, since the executives would be acting in their own best interest rather than in the best interest of the company. Congress would not intentionally force executives into this kind of decision, but passing this bill could lead to these results.

147. H.R. 2896; S. 1149; S. 1436; S. 1054; S. 2095; S. 9.
148. H.R. 2896; S. 1149; S. 1436; S. 1054; S. 2095; S. 9.
149. *See* discussion *infra* Part VI.D.
150. Sieda & Wempe, *supra* note 133, at 1100 tbl.1.

3. Reduce Interest Deductions Through Earnings Stripping and Change Subpart F Rules

These measures reduce the potential for earnings stripping by further limiting deductions for interest on certain indebtedness.[151] Generally, an American subsidiary will only be allowed to deduct interest payments for debts that are equal to or less than the total debt to equity ratio of the entire corporation.[152] This legislation limits the interest expense a company can carry forward from year to year and limits excess related-party interest expenses.[153]

Again, this solution does not address the uncompetitive nature of U.S. corporations in the international environment.[154] Second, this solution only addresses some of the incentives that cause firms to invert. Companies will still face lower tax rates on their foreign operations. As the world economy becomes more globally intertwined, these lower tax rates will become increasingly attractive. Third, this solution uses a general rule to limit deductions for interest. It does not take into account that, for a multinational corporation, business operations in the United States might be different from operations in other nations. This will arbitrarily allow some corporations to strip earnings from their U.S. firms, while other firms that try to set up debt intensive operations in the U.S. will be punished. This bill could have the further unintended effect of pushing debt-intensive operations out of the United States.

C. The Problems with a Perfect Legislative Solution

If the U.S. Congress could develop a perfect solution that stopped all inversions (and only inversions), it could cause more long-term problems than it solves. With all of the negative consequences associated with inversions, perhaps these companies only invert when it is absolutely necessary to do so. If the legislature closes this tax loophole, firms might need to take more drastic measures to be competitive in international markets; measures that could have substantial negative impacts on the U.S. economy.

151. *See* H.R. 2896.
152. *See id.*
153. *See id.*
154. *See* discussion *infra* Part VI.D.

Take, for example, the case of Stanley Tools. Mr. Blumenthal, the Attorney General from Connecticut, fought the Stanley Tools inversion.[155] He even testified in front of a House of Representatives Subcommittee to condemn inversions.[156] He stated that inverting companies should not "dodge" their tax liabilities and that they "ought to pay their fair share."[157] Even though 67.2% of Stanley Tools' shareholders approved the inversion transaction, Blumenfeld asked the SEC to investigate this vote and block another vote.[158] Mr. Blumenfeld eventually applauded Senator Dorgan for embarrassing Stanley Tools and preventing it from moving abroad.[159] Later, Stanley Tools began laying off workers because it was uncompetitive.[160] Mr. Blumenthal again went to the government, but this time he begged for the government's help because Stanley Tools was firing Connecticut workers.[161] As Stanley Tools noted, "if the company is not competitive, there are no taxes and no jobs."[162] Stanley Tools may not have wanted to lay off Connecticut workers, but it had to in order to be competitive. By stopping a paper transaction that would have helped make Stanley Tools internationally competitive, the political pressure forced the company to take more drastic measures. In the long run, stopping inversions may cause the United States to lose more than just tax revenue; it might cost America jobs.

D. COMPETITIVE ISSUES AND CORPORATE STRUCTURES

The major problem with all of these solutions is that none of them addresses the central reason that corporations invert: competitiveness in international markets. As discussed in Part III, if a company inverts its corporate structure, it will be competitive in foreign markets. If it remains a U.S. company, on the other hand, it will be at a competitive disadvantage to foreign firms in foreign markets.[163] As one critic of the legislation noted, American companies have three choices in international markets: (1) watch their market share slip away, (2) become a target for foreign based

155. *H.R. Hearing*, *supra* note 12 (statement of Richard Blumenthal, Attorney General, Conn. Attorney General's Office).

156. *Id.*

157. *Id.*

158. Lyne, *supra* note 38.

159. Press Release, U.S. Chamber of Commerce Holds News Conference on Labor and Economic Issues, FDCH Political Transcripts, Aug. 28, 2003 (comments by Randy Johnson, Vice President of Labor Policy), *available at* 2003 WL 22022722.

160. *Id.*

161. *Id.*

162. Lyne, *supra* note 38.

163. *See* discussion *supra* Part III.

competitors, or (3) reincorporate in a low-tax jurisdiction.[164] Only the inversion, actually keeps jobs in America.[165] A commentator has observed that "[g]lobalization is a deterministic process. It must happen, and ostriches will not be able to maximize their positions."[166] If the United States continues to ignore these competitiveness issues and keeps its head in the sand, the U.S. economy will suffer in the long run.

Inversions are not the only way, however, that companies are incorporating overseas to save money on taxes. There are three other ways that an American business can become incorporated in Bermuda. All three lead to the same tax advantages of Bermuda incorporation, but none of the three will be stopped by the proposed legislation. First, companies can originally choose to incorporate in Bermuda. Second, companies can be taken over by a foreign firm. Third, a company could perform a traditional merger with another company incorporated in Bermuda. Two of the three transactions, a foreign firm takeover and a merger with another company, will likely move the headquarters of the new company out of the United States.

<u>Original Incorporation in Bermuda</u>: Some American companies have chosen to originally incorporate in Bermuda rather than in America. Accenture, for instance, originally incorporated in Bermuda in 2001 when it split from Arthur Andersen, and the company claims that it is not an inverted corporation.[167] As economies become interconnected and corporations begin with a multinational focus, companies will more often originally incorporate in other nations if the U.S. Tax Code remains uncompetitive. Moreover, a benefit of originally incorporating in Bermuda is that shareholders will not face the immediate tax liability associated with the inversion transaction.[168] The legislation designed to prevent inversions, described above, will not stop this trend.

<u>Foreign Firm Takeover</u>: Another potential problem of fighting inversions, without fixing the underlying competitive issues, is that foreign corporations will have a substantial advantage over American corporations when bidding to take over American companies.[169] Consider an American

164. Daniel J. Mitchell, *International Provisions of Tax Bill Undermine U.S. Competitiveness*, HERITAGE FOUNDATION REP. (May 12, 2003), *available at* http://www.heritage.org/Research/Taxes/em878.cfm.

165. *Id.*

166. Brauner, *supra* note 21, at 305.

167. *S. Hearing*, *supra* note 20, at 63–64 (prepared statement of Accenture Ltd.).

168. *See* Hryck, *supra* note 66.

169. *H.R. Hearing*, *supra* note 12 (statement of Steven C. Salch, Partner, Fulbright & Jaworski, L.L.P.).

company (the target) with pretax annual profits of $10 million per year and substantial foreign operations (50% of all profits). Also assume that a Bermuda company and an American company are bidding to takeover this target company. The American firm will have to reduce the entire $10 million of annual profit by 35%, since the United States uses a worldwide tax system, yielding after-tax profits of $6.5 million per year.[170] On the other hand, if the foreign corporation is based in Bermuda and the overseas operations are in a 10% tax jurisdiction, the company will reorganize the operations so that it will pay 35% on its American operations and only 10% on its foreign operations.[171] This would yield after-tax profits of $7.75 million ($4.5 million in foreign income after tax and $3.25 million in U.S. income after tax). Clearly, the foreign corporation, since it sees a higher per year profit potential, will be able to bid higher on the takeover target and is more likely to win the bid. This is how the current American tax system could lead to the exporting of American businesses and, similarly, the exporting of control over American jobs to foreign corporations.

<u>Mergers</u>: When two companies merge, one foreign and one domestic, tax consequences are often taken into account.[172] When Daimler and Chrysler merged, one reason the company became German, rather than American, was the U.S. Tax Code.[173] As one critic noted, "If you're going to produce and sell here, you might as well do it with a foreign parent" because "there's a tax advantage."[174] Congress, too, has taken note of this phenomenon, stating that almost 80% of recent major mergers valued over $300 million involving U.S. companies left the foreign firm intact as the parent entity.[175] By returning to the example of the Irish and American companies in Part III.A, the incentive to leave the foreign corporation as the parent becomes obvious. If the two companies were to merge, and the American corporation became the parent, the tax rates faced by the new corporation would be 35% in America, 35% in Ireland and 35% in any foreign nation. If the two companies merge and the Irish company becomes the parent, the corporation will pay 35% in America, but only 15% in Ireland, and only the foreign tax rate in the other countries. Clearly, there is a benefit to retaining the foreign parent when an American and foreign company merge. None of the congressional solutions deal with this issue.

170. *See* discussion *supra* Part III.A.
171. *See* discussion *supra* Part III.A.
172. *See* Press Release, *supra* note 159.
173. *Id.*
174. *Id.*
175. *H.R. Hearing*, *supra* note 12 (statement by Rep. Michael R. McNulty, Member, House Comm. on Ways and Means).

In fact, those companies that could benefit most from an inversion, because of the substantial tax savings from foreign operations, would also be the most likely to merge with a foreign company and retain the foreign parent.

E. THE ONE SOLUTION CONGRESS GOT RIGHT

Congress, in two bills, expressed that it is "the [s]ense of the Congress that [t]ax [r]eform is needed to [a]ddress the [i]ssue of [c]orporate [e]xpatriation"[176] and found that:

> The tax laws of the United States are overly complex; . . . the tax laws of the United States are among the most burdensome and uncompetitive in the world; . . . the tax laws of the United States make it difficult for domestically-owned United States companies to compete abroad and in the United States; . . . a domestically-owned corporation is disadvantaged compared to a United States subsidiary of a foreign-owned corporation; and . . . international competitiveness is forcing many United States corporations to make a choice they do not want to make—go out of business, sell the business to a foreign competitor, or become a subsidiary of a foreign corporation (i.e., engage in an inversion transaction). . . . It is the sense of Congress that passage of legislation to fix the underlying problems with our tax laws is essential and should occur as soon as possible, so United States corporations will not face the current pressures to engage in inversion transactions.[177]

The American Institute of Certified Public Accountants agrees with this assessment, noting that "an appropriate response should not focus solely on the act of inverting, but on the incentives for U.S.-based multinational corporations to invert."[178]

F. A TERRITORIAL TAX SYSTEM—AN INADEQUATE SOLUTION

A change to a territorial tax system might be one potential solution to the current corporate income tax system that makes companies uncompetitive in foreign markets. Under a territorial tax system, a U.S. firm would face the same tax rates as its foreign competitors in most nations that it did business.[179] This solution would make American

176. To enhance energy conservation and research and development, to provide for security and diversity in the energy supply for the American people, and for other purposes, H.R. 6, 108th Cong. § 44,002 (2003); Tax Relief, Simplification, and Equity Act, H.R. 1308, 108th Cong. § 103 (2003).

177. H.R. 6; H.R. 1308.

178. Pamela J. Pecarich, *AICPA Comments on Corporate Inversion Transactions*, 96 TAX NOTES 356 (2002).

179. *See* discussion *supra* Part III.

companies competitive in foreign countries and it would eliminate the main incentive to invert: tax savings.

A move to a territorial tax system, however, has one major flaw. Since the U.S. tax rate is one of the highest in the world,[180] U.S. firms will face a lower tax rate in foreign nations than they do at home. Therefore, a territorial tax system provides a significant incentive for U.S. firms to invest in foreign nations rather than in the U.S. Returning to the Irish and American company example, in a worldwide tax system, a U.S. company pays 35% in tax if goods are sold in either Ireland or the U.S., after the foreign tax credit. Under a territorial tax system, the American corporation will owe 15% in tax on goods sold in Ireland and 35% in tax on goods sold in the United States. Clearly, if an American company has two identical opportunities, it will choose to invest in the foreign nation. Any solution to the inversion problem, which seeks to keep companies in America, should not provide incentives for those companies to invest elsewhere.

VII. THE SIMPLE SOLUTION—ELIMINATE THE CORPORATE INCOME TAX

Eliminating the corporate income tax would make companies competitive internationally and would give them an incentive to invest in America. The goal of many congressional representatives, however, is to maintain the current corporate tax base so that taxes on individuals do not have to increase.[181] Is eliminating the corporate income tax just helping big business and hurting the American public? The answer is no. Why?

The corporate income tax is really just another tax on individuals.[182] Corporations are a legal fiction made up of two groups of people: labor or wage earners and capital or shareholders.[183] As Nobel Prize winning economist Wassily Leontief noted over twenty years ago,

> Corporate income taxes fall ultimately on people. Economists have tried but have never succeeded in finding out how the weight of these taxes is ultimately distributed among different income groups. There can be little

180. *See generally* INT'L TAX & LEGAL CTR., *supra* note 7 (comparing the corporate tax rates of sixty-six countries).

181. *See H.R. Hearing*, *supra* note 12 (statement of Rep. Michael R. McNulty, Member, Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means).

182. John K. McNulty, *Corporate Income Tax Reform in the United States: Proposals for Integration of the Corporate and Individual Income Tax and International Tax Aspects*, 12 INT'L TAX & BUS. LAW 173–74 (1994).

183. *Id.*

> doubt that elimination of corporate income taxes would simplify our tax system and limit its abuse.[184]

The key is that taxes are not paid by corporations. As one critic notes, the corporate income tax is a "fraud perpetrated on the American public."[185] Essentially, the corporate income tax reduces the wages of workers, reduces the return to investors, or increases the price of products to consumers. The question of which group bears the larger burden is beyond the scope of this Note, but it is generally assumed that the three groups share that burden.

Paul O'Neill, President George W. Bush's Treasury of the Secretary in 2001, has suggested that abolishing the corporate income tax would greatly promote job creation and economic growth,[186] stating that it is simply "an inefficient tax."[187]

A. THE INCIDENCE OF THE CORPORATE INCOME TAX

Before discussing the costs and benefits of eliminating the corporate income tax, a brief discussion of how individuals pay the tax is necessary. Economists have proposed two models to explain the incidence of the tax on labor, capital, and consumers.

One view is that in the short run, the supply of capital is relatively fixed.[188] Therefore, an increase in tax will be borne by owners of capital, or the shareholders.[189] In the long run, capital will flow out of the market (since long term capital is highly elastic) until the return on capital is the same as before the tax.[190] This implies that the incidence of the tax will be borne by labor or consumers in the long run. The interesting case is in the intermediate term, when total capital is fixed but can be shifted between sectors.[191] In this case, an increase in corporate tax rates will decrease investment in the corporate sector and increase investment in the unincorporated sector. [192] In the intermediate term, only part of the tax will be borne by capital. The rest of the tax must be borne by either labor or

184. Editorial, *supra* note 9.

185. *See* Edward J. McCaffery, *Manager's Journal: Remove a Major Incentive to Cheat*, WALL ST. J., July 9, 2002, at B2.

186. *See* John Maggs, *Slow Burn*, NAT'L J., Jan. 9, 2003, *available at* 2003 WL 5140531.

187. *Id.*

188. JOSEPH E. STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR 565 (2d ed. 1988).

189. *Id.*

190. *Id.* at 565–67.

191. *Id.* at 567–70.

192. *Id.*

consumers. Even if the rest of the tax is borne completely by consumers, through higher prices, this will still lead to a decrease in real wages (defined by wages over prices), which results in a decrease in purchasing power for labor.

Economists who disagree with this proposition[193] believe that in the short term, the incidence of the tax is shifted to consumers as an increase in the price of goods.[194] They believe most corporations do not maximize profits.[195] When taxes increase, these corporations just increase their prices to maintain the same level of profit.[196]

While the two models are slightly different, the adverse effects of the corporate income tax can best be understood with an example. Suppose there is a tax-free economy with a single corporation that sells a widget for $1000. To produce the widget, the corporation incurs certain costs. Suppose the company pays $400 for materials and $400 for labor to produce the product. This leaves $200 in profit, which is then paid to shareholders as the cost of capital. Also, assume that the shareholders provided $1000 in capital so that their return on capital is 20%.

Now assume that the corporation has to pay a corporate income tax. Economist who believe that in the short run, the supply of capital is relatively fixed would argue that the entire tax is borne by the shareholders. In that case, all of the costs would remain the same, but the pretax profits of the corporation would have to be split between the shareholders and the government. Assuming a 35% tax, the corporation would pay $70 in tax, and the shareholders would receive only $130, resulting in a 13% return. It is generally assumed, though, that in the longer term capital is relatively mobile. In other words, the shareholders might choose to invest in other investment vehicles that would provide higher returns, perhaps in another nation, or in the noncorporate sector. Of course, corporate officers realize that if after-tax profits decline, share prices will decline. To retain share prices and profit margins, corporate officers will try to reduce the incidence of the corporate income tax on shareholders.

This can occur in one of two ways. The corporation can increase its price, say to $1020, or it can reduce its costs by paying less for materials and labor. Assume the company now pays only $380 for materials and labor. Now the pretax profit is $260, the tax is $91, and the return to

193. McNulty, *supra* note 182, at 259.
194. *Id.*
195. *Id.*
196. *Id.*

investors is $169, or a 16.9% return on investment. Under this plan, each group pays some of the corporate income tax. The higher price, after taxes, has two additional consequences. First, higher prices in the market lead to reduced demand, which implies reduced output. Second, higher prices will lower real wages. While this is a simplified economy, the example still shows how each group can be affected adversely by corporate income taxes.

B. JUSTIFICATIONS FOR THE CORPORATE INCOME TAX

Since it seems shareholders, labor, and consumers could all be adversely affected by the tax, it seems there must be some compelling justification for its use. Proponents of the corporate income tax state that corporations are taxed separately from their shareholders because they are distinct entities in the eyes of the law.[197] Originally, Congress never intended the corporate income tax to be a double tax on corporate profit.[198] Instead, it was used simply as a substitute for taxing shareholders directly because few individuals filed tax returns and tax evasion was rampant.[199] In fact, shareholders could originally exclude corporate income taxes from their personal income taxes.[200] Today, most Americans file corporate income taxes and the IRS has become a fully functional government organization so the original justifications for taxing corporations directly are no longer applicable.[201]

197. *See* Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 WM. & MARY L. REV. 447, 465–66 (2001).

198. *Id.* at 453–54.

199. *See id.* at 452.

200. *Id.* at 454.

201. Herwig J. Schlunk, *I Come Not to Praise the Corporate Income Tax, But to Save It*, 56 TAX L. REV. 329, 337 (2003). Some scholars argue that the corporate income tax is a payment for the benefits of participating in a corporation. *Id.* at 338–49. Academics argue that the income tax generally pays for three benefits of corporate organization. First, the corporate income tax could be a payment for the shareholders' limited liability. *Id.* at 338–42. The emergence of limited liability companies, which do not pay corporate income taxes, implies that the corporate income tax does not pay for limited liability. *Id.* at 341–42. The second benefit corporations might be paying for is access to liquid capital markets. *Id.* at 343–47. The existence of the debt markets, which are liquid but not subject to an entity level tax, shows that access to liquidity is not what the corporation is paying for. Moreover, tax is paid even if the firm is not publicly traded. Finally, the corporation might face lower agency costs, associated with contracting within the entity structure. *Id.* at 347–49. The problem is that publicly traded corporations have no choice but to be taxed even if their agency costs are low, which implies that high entity costs are not the reason for the corporate income tax.

C. THE TAX RAMIFICATIONS OF ELIMINATING THE CORPORATE INCOME TAX

Eliminating the corporate income tax will have a minimal impact on the tax rates faced by the average U.S. taxpayer. In 2002, for instance, individuals paid $831.2 billion in personal income taxes while corporations paid $143.4 billion.[202] If the corporate income tax is eliminated, individuals would have to contribute $974.6 billion dollars to produce the same tax receipts. This equates to a 16% increase in tax receipts from personal income, which implies a maximum increase of 16% in personal tax rates. In other words, the highest tax bracket's rate would increase from 35% to 40.5% and the lowest bracket's rate would increase from 10% to 11.6%. These rates are not extraordinarily high.

Additionally, the necessary increase in tax rates will be less than 16% because many other factors will increase personal income, and thereby increase personal tax receipts. For instance, the elimination of the corporate income tax increases returns to investors, raises wages for workers, and lowers prices for consumers.[203] For wealthier workers, the increase in income will lead to higher tax receipts. While economists have argued about how a reduction in corporate income tax will be divided between shareholders, workers, and consumers,[204] if we assume that 25% of the $130.2 billion is distributed to wealthier workers, they will receive $32.6 billion in additional income and will pay $11.4 billion in additional taxes (at the 35% tax rate).[205] This implies that the new shortfall from eliminating the corporate income tax would be $118.8 billion and the government would only need to increase tax rates 14% to meet the same tax receipts.

There are other benefits as well. Any increase in pay for relatively poorer workers will also increase tax receipts and reduce the necessary rate increase. An additional benefit is that, if lower wage workers pay only 10% in personal income tax, they will retain more of the incremental benefit on

202. Bureau of Economic Analysis, U.S. Department of Commerce, *Interactive Access to National Income and Product Accounts Table: Table 3.2. Federal Government Current Receipts and Expenditures*, *at* http://www.bea.doc.gov/bea/dn/nipaweb/TableView.asp#Mid (last visited Jan. 29, 2005) (providing the 2002 national income and products account table).

203. *See* discussion *supra* Part VII.A.

204. *Id.*

205. The 25% distribution of the benefits of eliminating the tax to wealthy workers is only an assumption to illustrate the income effect on tax receipts. Since economists cannot determine the incidence of benefit for a reduction in tax rates between labor, capital, and consumers, determining the incidence of benefit for wealthy workers is beyond the scope of this Note.

a dollar for dollar basis than wealthier workers. Moreover, the elimination of corporate income taxes will lead to lower prices for all consumers.[206] Since lower income individuals generally spend a greater percentage of income on consumption than wealthy individuals, the lowering of prices is a relatively progressive policy.

Finally, the elimination of the corporate income tax will have two positive macroeconomic effects on the economy that should raise tax receipts. First, the lowering of prices will increase individual's purchasing power (but this increase could be offset by the increase in personal income taxes). Second, the elimination of the corporate income tax will increase investment in the United States by both foreign and domestic firms, which will shift the supply of goods to the right. In other words, an increase in the supply of goods produces an increase in output, which should lead to higher income for individuals and higher tax receipts for the government.

All of these factors minimize the necessary increase in tax rates to retain the same overall tax receipts. Additionally, the percentage increase in tax rates does not need to be identical for each economic group. Depending on Congress, the lower tax rate could remain at 10% and the 35% tax rate could be increased to make up for the shortfall. Choosing the correct tax rate for each economic group is beyond the scope of this Note. Eliminating the corporate income tax, though, provides a number of benefits, like increased investment in the United States and lower prices for consumers, all at a relatively low cost.

D. ADDITIONAL BENEFITS OF ELIMINATING THE CORPORATE INCOME TAX

There are many additional costs and benefits associated with eliminating the corporate income tax. A detailed review and a complete cost-benefit analysis are beyond the scope of this Note. But a brief survey of these costs and benefits will show that eliminating the corporate income tax provides many more benefits than keeping it.

Eliminating the corporate income tax solves many tax related problems. Without a corporate income tax firms will be competitive in international markets. Additionally, there will be no incentive to reduce financial statement earnings with an eye toward tax. Therefore, corporations will have no reason to invert, strip earnings from the United

206. *See* discussion *supra* Part VII.A.

States, abnormally price transfers with an eye toward limiting tax liabilities, or loan intangibles to their American subsidiaries.

Since the elimination of the corporate income tax makes American firms more competitive in foreign markets, it will only stimulate the U.S. economy because U.S. companies will be able to return higher after-tax profits to their shareholders. As the world economy grows more intertwined, potential areas of growth for American companies will be in international markets. By helping American companies grow internationally, the U.S. economy will improve.

Third, this solution will actually create U.S. jobs because investing in America will become more attractive to both American and foreign companies. All other solutions, because they don't address the underlying issues, are likely to eliminate jobs in the long term. As Nancy Johnson, a Congressional Representative from Connecticut, stated that any solution to the inversion problem needs to "keep jobs in America. Any proposal that does less is unacceptable."[207] This solution not only keeps jobs; this solution creates jobs. Returning to the Irish and American company example from Part III.A, assume there are two identical projects, one located in Ireland and the other located in America. Without the corporate income tax, both the Irish and American companies will invest in the United States because both companies would rather pay 0% in tax on their U.S. investment than 15% in tax on their Irish investment.[208] The increased after-tax return from investing in the U.S. will attract capital, which will increase output and create new jobs.

Fourth, complying with the corporate income tax is an inefficient use of resources within the corporate structure. Compliance with the corporate income tax codes is a major cost for small corporations.[209] The Tax Foundation has found that "small businesses spend $724 to comply with the income tax for every $100 they pay in tax."[210] Additionally, 90% of all corporations in the United States are small corporations with less than one million in assets.[211] By eliminating the corporate income tax, these inefficient costs can be reduced for all corporations.

207. *H.R. Hearing*, *supra* note 12 (statement of Rep. Nancy Johnson, Member, House Comm. on Ways and Means).

208. *See* discussion *supra* Part III.A.

209. Laura Dale, *The Economic Impact of Replacing the Federal Income Tax with a Federal Consumption Tax: Leveling the International Playing Field*, CURRENTS: INT'L TRADE L.J., Winter 2000, at 47, 52.

210. *Id.*

211. *Id.*

Fifth, the time legislators, accountants, lawyers, and corporate executives spend trying to reduce or eliminate corporate income taxes each year could be spent in more productive ways. The corporate income tax codes have gotten incredibly complex.[212] The reason for the complexity is because companies continue to hire accountants and lawyers to get around the band-aid solutions Congress provides for fundamental problems in the corporate income tax code. Eliminating the corporate income tax reduces this inefficient use of time.

Sixth, under the existing system, it is impossible to determine who actually pays the corporate income tax. Therefore, by eliminating the corporate income tax, it will become clear how much individuals are actually paying in taxes. This could be important to members of Congress, since their job is to set the tax rate that each individual pays. By better understanding the actual incidence of taxes on each economic group, they should be more informed about the effects their decisions will have on citizens.

Finally, without the corporate income tax, U.S. companies no longer need to defer the repatriation of their income. The entire reason to defer repatriation of income is to defer the taxes on that income. If no taxes are owed on the income, the company will repatriate its foreign earnings. If companies can repatriate their income without it being taxed, rather than defer it, they can use the earnings to invest in the U.S. or to return dividends to shareholders.

E. ADDITIONAL PROBLEMS WITH ELIMINATING THE CORPORATE INCOME TAX

The major problem with eliminating the corporate income tax is that people and politicians do not understand that individuals are paying this tax already. Most believe that, if corporations pay more in tax, individuals will have to pay less. They do not understand that it is the individuals that end up paying this tax anyway. In two lengthy congressional hearings about inversions, the incidence of the corporate income tax was clearly misunderstood.[213] This misunderstanding, of course, is not a reasonable justification for keeping the tax.

212. *See* Michael S. Powlen & Raj Tanden, *Corporate Tax Shelters or Plus Ça Change, Plus C'est La Même Chose*, *in* TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 2003 1189, 1266–71 (Practising Law Institute 2003) (listing the numerous complexities that have entered the tax code because of tax havens).

213. *See H.R. Hearing*, *supra* note 12; *S. Hearing*, *supra* note 20.

Perhaps Congress understands the burden of the corporate income tax, but believes shareholders are generally wealthy.[214] In that case, the corporate income tax would progressively tax the wealthy. However, statistics show that many shares are held by low- or middle-income individuals.[215] Why should these individuals be taxed at higher rates when rich bondholders are not taxed at higher rates? If a progressive tax is the goal, it would be more effective to eliminate the corporate income tax and increase the personal income tax for wealthy individuals. Perhaps the corporate income tax influences macroeconomic factors, slowing the economy (by taxing at high rates) when there is more income and speeding up the economy (by taxing at lower rates) when income is down.[216] Personal income taxes, however, would be much more efficient at influencing these macroeconomic factors since they are on a variable scale (increasing as income increases) while corporate income taxes are relatively constant.[217] In actuality, the corporate income tax probably exists simply to generate money from an unidentified source.[218] Individuals do not fight increases in corporate income taxes because they do not understand that they are paying it. With the corporate income tax, the legislature has found a way to tax the American public without the psychological pain associated with increasing personal tax rates. While this is an important point for a politician, this is not a valid justification for the tax. Whether politicians understand the incidence of the tax or not, there is no economic justification for keeping the corporate income tax, rather than just eliminating it and slightly increasing the personal income tax.

VIII. CONCLUSION

Corporations invert to save millions in taxes each year. Moreover, inversions have additional costs for society, like market inefficiencies and a decrease in shareholder rights. Legislators see these "unpatriotic" corporations as the problem. The real problem, though, is not these inverting companies but the U.S. corporate income tax. These companies state that the high corporate income tax rates, coupled with the worldwide taxation of their income, make them uncompetitive in foreign markets.

Legislators have tried to solve this problem by "putting their finger in the dike." The only solution that is likely to work, though, must deal with

214. McNulty, *supra* note 182, at 174.
215. *Id.*
216. *Id.* at 176.
217. *See id.*
218. *Id.* at 174.

the competitiveness issues of U.S. companies in foreign nations. The only solution that ultimately solves these issues is eliminating the corporate income tax.

Clearly, there are many benefits to eliminating the corporate income tax. These include a more competitive environment for U.S. businesses abroad, reduced inefficiencies from applying the tax code, and increased stimulus for the economy. All these benefits come at a relatively low cost. Since individuals pay all of the corporate income tax anyway, the tax burden will only be redistributed. Additionally, the increase in personal income tax rates would be minimal, especially when one considers the higher wages, increased output, and lower prices that would accompany the elimination of the corporate income tax.

The corporate income tax generates a relatively small percentage of the total U.S. tax receipts and corporations waste millions to reduce and eliminate their tax liabilities. Eliminating the corporate income tax might seem like a drastic measure designed only to help businesses. In reality, eliminating the corporate income tax provides a wide variety of benefits to the entire economy, not the least of which is removing the incentives for corporations to invert.