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Fight or Flight of U.S.-Based Multinational Businesses: Analyzing the Causes for, Effects of, and Solutions to the Corporate Inversion Trend

*Hale E. Sheppard**

I. INTRODUCTION

When a person is confronted by a threat, he or she experiences a psychological and physiological response commonly known as “fight or flight.”¹ In general, this innate survival mechanism causes the body to direct blood to vital areas and to release lactic acid, adrenaline and other chemicals in order to prepare a person to either face the threat or flee immediately.² Multinational corporations based in the United States, likewise, have recently displayed similar fight-or-flight behavior when faced with the threat of high taxes. Unfortunately for the U.S. economy, a growing number of these American corporations have chosen the latter: flight. Frustrated with the perceived complexity and scope of the current U.S. international tax rules, as well as the competitive disadvantage at which these rules supposedly place U.S. businesses operating in the global market, several multinational corporate groups based in the United States have recently restructured themselves in such a way that the parent corporation is relocated to a low-tax or no-tax country such as Bermuda. These so-called “inversions” result in considerable tax savings for the corporate group involved, but arguably do so at the expense of the United States as a whole.

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¹ WAYNE WEITEN, *PSYCHOLOGY THEMES AND VARIATIONS* 68 (5th ed. 2002).

² *Id.*

Accordingly, these inversion transactions have generated a significant amount of controversy and require a viable solution. With this in mind, this article assesses the problem of U.S. corporate inversions and proposes a two-part solution. Part II contains a brief overview of existing U.S. international tax law, focusing on the controversial statutory provisions that many argue are principal causes for corporate inversions. Part III provides a description of common inversion transactions and explains the main tax consequences of and motivations for the recent increase of these corporate maneuvers. One difficulty in resolving the inversion issue is that misinformation and political rhetoric have managed to obscure the real effects of these transactions on the United States. Therefore, Part IV examines the main contentions made by the opposing sides in this area in order to clarify the true ramifications of inversions. Part V then analyzes a multitude of proposed solutions, identifying the strong points of each argument, as well as the pertinent criticism. Finally, extracting ideas from a variety of the proposals submitted thus far, Part VI presents a two-part solution that is designed to both halt inversion transactions immediately and allow for the rectification of the major shortcomings of current U.S. international tax law in the long run.

II. OVERVIEW OF U.S. INTERNATIONAL TAX LAW

The treatment of a multinational corporate group under U.S. tax law depends in large part on whether the parent corporation is considered a "domestic" or "foreign" corporation. According to the Internal Revenue Code ("Code"), a corporation is considered "domestic" if it is created or organized in the United States.³ A "foreign" corporation, conversely, is one that is formed in a foreign nation.⁴ In other words, the place of incorporation determines whether a corporation is treated for tax purposes as domestic or foreign, regardless of other factors, such as the location of a corporation's management activities, employees, officers, shareholders, assets, operations or sources of revenue.

The United States uses a "worldwide" tax system which provides that all of a domestic corporation's income is subject to taxation in the United States, regardless of whether the income is earned in the United States or abroad.⁵ In the case of a foreign corporation, the United States imposes a tax only on income that has a sufficient nexus with the country. In the parlance of tax professionals, U.S. tax applies to income earned by the foreign

³ I.R.C. §§ 7701(a)(3), (4) (2002). In particular, the Code provides that a corporation is considered to be "domestic" if it was created or organized in the United States, or under the laws of the United States or any state.

⁴ *Id.* §§ 7701(a)(3), (5). Defining this term in the negative, the Code dictates that a corporation is deemed to be "foreign" if it is not "domestic."

⁵ *Id.* § 61(a). This subsection provides that, subject to certain exceptions, the term "gross income" means "all income *from whatever source derived*" (emphasis added).

corporation that is “effectively connected” with the “conduct of a trade or business” within the United States.⁶ In addition, a foreign corporation is generally subject to a thirty percent tax when it receives certain passive income derived from sources within the United States, including interest, dividends, rents, royalties, etc.⁷ To avoid having multiple taxes imposed on the same income, the United States generally grants a domestic corporation a credit for the income taxes that it is obligated to pay a foreign government on income that was earned in that foreign country.⁸

In contrast to the “worldwide” tax system used in the United States, certain other countries use a “territorial” tax system under which the majority, if not all, of a domestic corporation’s income that originates from foreign sources is exempt from tax in the corporation’s country of residence.⁹ Stated differently, under a “territorial” tax system, a country primarily alleviates double taxation of the income earned from foreign sources by employing an exemption mechanism, whereas the U.S. system aims to achieve the same result by using a credit device.

With regard to international taxation, the effect of U.S. tax rules applicable to domestic corporations which control business operations in a foreign country depends upon whether the domestic corporation conducts its foreign operations directly (i.e., through an unincorporated foreign branch) or indirectly (i.e., through a foreign subsidiary corporation). For direct foreign operations, the domestic corporation is required to include in its tax return the income that it earned through its foreign branch during the year in which the income is actually earned.¹⁰ For indirect foreign operations, the rules are somewhat more complex. The Code generally dictates that the income earned by a domestic parent corporation from operations conducted by a foreign subsidiary is not taxed in the United States unless and until the foreign subsidiary distributes the income to the domestic parent corporation as a dividend. In other words, until the domestic parent corporation receives a dividend from the foreign subsidiary in its capacity as a corporate shareholder, U.S. tax is not levied on the earnings of the foreign subsidiary. In tax lingo, the general rule is that the imposition of U.S. tax is “deferred” until the income is “repatriated.”¹¹ However, the Code contains certain exceptions to this general tax-deferral rule.

To prevent a multinational corporate group from using this deferral system to unfairly avoid taxes, the Code contains several anti-deferral provisions which can cause the domestic parent corporation to be taxed imme-

⁶ *Id.* § 882(a)(1).

⁷ *Id.* § 881(a).

⁸ *Id.* § 901.

⁹ CHARLES H. GUSTAFSON ET AL., *TAXATION OF INTERNATIONAL TRANSACTIONS: MATERIALS, TEXT, AND PROBLEMS* 14-15 (2d ed. 2001).

¹⁰ *Id.* at 400.

¹¹ *Id.* at 399.

diately on the income earned by the foreign subsidiary in certain cases. For instance, the principal anti-deferral mechanism is set forth in Subpart F of the Code.¹² Enacted in 1962, Subpart F is designed to discourage U.S. taxpayers from using foreign corporations to defer paying U.S. taxes by accumulating income in their foreign corporations located in low-tax jurisdictions. In simplified terms, if a foreign corporation is considered a "controlled foreign corporation" because U.S. shareholders (including domestic corporations) own more than fifty percent of the stock in the foreign corporation, then each U.S. shareholder must immediately include in its tax return its pro rata share of any "Subpart F income" for the year.¹³ In effect, the U.S. shareholder (e.g., the domestic parent corporation) is taxed on its proportional share of the income generated by the foreign corporation that it controls, even though, in reality, the U.S. shareholder never actually receives a dividend during that particular year.¹⁴ Along with Subpart F, Congress has enacted several complicated and partially overlapping anti-deferral regimes designed to prevent perceived tax abuse by U.S. taxpayers (including domestic corporations) who earn income through the use of foreign corporations. Among these anti-deferral regimes are the foreign personal holding company provisions (§551 to §558 of the Code), the foreign investment company rules (§1246 and §1247 of the Code), and the passive foreign investment company provisions (§1291 to §1298 of the Code).¹⁵

III. DESCRIPTION OF CORPORATE INVERSIONS

Recently, several multinational corporate groups have restructured their operations so that the parent of the group becomes a foreign corporation (instead of a domestic corporation) located in a country that has a lower income tax rate than the United States, or, if possible, no corporate income tax whatsoever. To justify conducting this so-called "inversion" or "expatriation" transaction, former domestic corporations claim that the new structure affords them increased operational flexibility, better cash management, and enhanced access to international capital markets.¹⁶ According to the U.S. Treasury Department and other critics of this corporate maneuver,

¹² In the field of international tax, the commonly-used term "Subpart F" refers to § 951-964 of the Internal Revenue Code.

¹³ I.R.C. §§ 951, 952.

¹⁴ For a brief, yet ample, explanation of the operation of Subpart F, *see generally* RICHARD L. DOERNBERG, *INTERNATIONAL TAXATION IN A NUTSHELL* 294-337 (Westgroup, 2001).

¹⁵ GUSTAFSON ET AL., *supra* note 9, at 400.

¹⁶ *See generally* David L. Brumbaugh, *International Tax Provisions of the American Competitiveness and Corporate Accountability Act (H.R. 5095)*, CONGRESSIONAL RESEARCH SERVICE, Sept. 20, 2002.

however, the primary rationale for inverting is to obtain significant tax savings.¹⁷

Ordinarily, an inversion begins with a domestic corporation that is operating both in the United States and abroad.¹⁸ The archetypal stock inversion involves several steps. The domestic corporation first creates a foreign corporation organized in a low-tax or no-tax country such as Bermuda. This Bermudan corporation then forms a corporation in the United States (i.e., a domestic subsidiary corporation) whose sole purpose is to facilitate the inversion. Next, the domestic subsidiary of the Bermudan corporation merges into the existing domestic corporation, with the provisional subsidiary disappearing and the domestic corporation surviving. As a result of this merger, the domestic corporation's character has significantly changed: it is now a domestic subsidiary controlled by the Bermudan corporation. For their part, the shareholders in the former domestic parent (now the domestic subsidiary) receive shares in the Bermudan corporation in exchange for their old shares of stock. In sum, the corporate structure is basically turned upside down, with the newly-created foreign corporation becoming the parent (organized outside the United States so that it is a "foreign" corporation), and the former domestic parent becoming a U.S. subsidiary of a foreign corporation. Hence, the term "inversion."¹⁹ These corporate inversions, however, do not necessarily involve a transfer of economic activity from the United States to the foreign country in which the new foreign parent is located. Indeed, the majority of these transactions are simply "mailbox inversions" accomplished entirely on paper, which do not affect domestic employment, management structure, or the location of production facilities.²⁰

Subsequent to the initial inversion transaction, the multinational corporation may engage in further restructurings designed to maximize tax savings.²¹ For instance, in order to place the business operations of the

¹⁷ *Id.* See also DEP'T OF THE TREAS., OFFICE OF TAX POL'Y, Corporate Inversion Transactions: Tax Policy Implications (May 2002), available at <http://www.treas.gov/press/releases/docs/inversion.pdf> [hereinafter OFFICE OF TAX POL'Y].

¹⁸ The corporation is "domestic" since it is organized in the United States. See I.R.C. § 7701(a)(3) and § 7701(a)(4).

¹⁹ Inversions can be accomplished in various ways. For a technical description and distinctions, see generally John M. Peterson & Bruce A. Cohen, *Corporate Inversions: Yesterday, Today and Tomorrow*, TAXES, Mar. 2003, at 161; David L. Brumbaugh, *Firms That Incorporate Abroad for Tax Purposes: Corporate 'Inversions' and 'Expatriation'*, CONG. RES. SERVICE, May 14, 2003; Joint Comm. on Tax'n, *Background and Description of Present-Law Rules and Proposals Relating to Corporate Inversion Transactions*, (JCX-52-02) June 6, 2002; Hal Hicks, *Overview of Inversion Transactions: Selected Historical, Contemporary, and Transactional Perspectives*, 30 TAX NOTES INT'L 899 (2003).

²⁰ OFFICE OF TAX POL'Y, *supra* note 17 at 5. This report clearly states that while the inversion will have tax consequences to the stockholders and/or to the corporation itself, the inversion transaction "has not [sic] real effect on the operation of the company."

²¹ See Joint Comm. on Tax'n, *supra* note 19 at 3-4.

corporate group beyond the reach of U.S. taxing authority, the domestic corporation may transfer its pre-existing foreign subsidiaries directly to the new Bermudan parent. Consequently, the Subpart F rules that concern "controlled foreign corporations" would no longer be applicable to these foreign subsidiaries since they would now be controlled by a Bermudan corporation, a foreign entity in its own right, instead of by "U.S. shareholders" as required under Subpart F.²² In addition, any profits actually distributed by the foreign subsidiaries to the Bermudan parent as a dividend would be exempt from U.S. taxation since, under the Code, this is a transaction between two foreign entities.²³

The inversion facilitates another type of tax savings known as "earnings stripping," which involves the domestic subsidiary corporation (i.e., the former domestic parent) essentially shifting a portion of its income earned from operations in the United States to the new foreign parent.²⁴ In general terms, the "stripping" occurs when a domestic subsidiary makes payments to its new foreign parent for which it is entitled to take a tax deduction.²⁵ The deductions claimed by the domestic subsidiary reduce the amount of income that is subject to U.S. taxes by essentially shifting a portion of the income to the new foreign parent.²⁶ Since the Code dictates that a foreign corporation is subject to taxes on the income that it earns from actively engaging in a trade or business in the United States, the income earned by the U.S. subsidiary (i.e., the former domestic parent) that is shifted to the Bermudan parent by way of inter-company payments of interest, royalties, etc., basically escapes U.S. taxation.²⁷

Although an inversion likely produces significant tax savings in the long run, the initial transaction may generate tax consequences for both the

²² I.R.C. § 951-964 (2002).

²³ See Joint Comm. on Tax'n, *supra* note 19, at 4. This study explains that the Subpart F anti-deferral rules applicable to controlled foreign corporations are no longer applicable to these foreign subsidiaries, and no U.S. tax would be imposed on the dividends paid by such foreign subsidiaries in the future to the new foreign parent.

²⁴ BORIS I. BITTKER & LAWRENCE LOKKEN, FUNDAMENTALS OF INTERNATIONAL TAXATION 66-39 to 66-48 (2002).

²⁵ I.R.C. § 161 (i.e., interest payments on inter-company loans, royalty payments for the use of intellectual property such as patents and trademarks, lease payments for rental of property, etc.).

²⁶ See generally I.R.C. § 882 (if a foreign corporation conducts a trade or business in the United States, then any income that is "effectively connected" with that trade or business is taxed in the same manner as the business income of a domestic corporation); *but see* I.R.C. § 881 (if no trade or business is conducted, then the United States basically only taxes certain passive investment income derived from U.S. sources at a rate of 30 percent).

²⁷ I.R.C. § 163(j) (limits on the deductions that may be taken for certain types of indebtedness); *see also* I.R.C. § 482 (all transactions between related parties, such as a subsidiary and its parent, be in accordance with the "arm's length" standard, and authorizes the Treasury Secretary to distribute, apportion or reallocate income and deductions "in order to prevent evasion of taxes or clearly to reflect the income of any" of the related parties).

stockholders and the former domestic parent. In its most common form, the inversion forces the U.S. stockholders to “recognize” gain (i.e., report it on their tax returns) based on the difference between the fair market value of the shares of the new foreign parent that they receive and the adjusted basis that they had in the stock of the former domestic parent (i.e., the current domestic subsidiary) that they surrendered in the exchange.²⁸ However, if the value of the former domestic corporation’s shares has decreased instead of appreciated, then this stock exchange will generate little, if any, gain for the stockholders.²⁹ When § 367 of the Code and the corresponding regulations were enacted, lawmakers believed that forcing stockholders to recognize gain would create “an insurmountable barrier” to inversions.³⁰

Yet, this anti-inversion weapon has proven ineffective recently for a number of reasons. For example, a large percentage of the stock of many U.S. multinational groups is owned by financial institutions that worry little, if at all, about the potential tax consequences associated with an inversion because they are tax-exempt (such as pension funds) or tax-indifferent (such as mutual funds).³¹ Moreover, the drastic decline of the New York Stock Exchange and other securities markets during the last few years has left many stockholders with losses in the form of depreciated stock. The potential “toll charge” for inverting contained in § 367 of the Code, which only applies to gains, therefore, provides little deterrence.³² As for tax ramifications to the corporation itself, the transfer of a foreign subsidiary or other assets to the newly-formed foreign parent may force the domestic corporation to recognize gain under § 367 of the Code.³³ However, any income that must be recognized (i.e., included in the corporation’s tax return) as a result of this corporate restructuring may be offset by net operating losses, foreign tax credits, and other tax attributes.³⁴

IV. EFFECTS (LEGITIMATE AND FALSE) OF CORPORATE INVERSIONS

Although considerable uncertainty seems to surround corporate inversions in general, one thing is indisputable: the issue has triggered strong political backlash and an abundance of controversy. Indeed, referring to the fact that inverting corporations are economically weakening the United

²⁸ I.R.C. § 367(a).

²⁹ See Temp. Treas. Reg. § 1.367(a)-1T(b)(3)(ii) (1998) (explaining that the general rule in § 367(a) applies only to gain; loss may not be recognized).

³⁰ Peterson & Cohen, *supra* note 19, at 165.

³¹ *Id.*

³² *Id.*

³³ See I.R.C. § 367 (explaining that when § 367 applies because a U.S. person transfers property to a foreign entity, this provision trumps non-recognition provisions, such as § 351, § 337, § 332 or § 368, by denying corporate status to the foreign corporation involved in the transaction). See I.R.C. § 332; § 337; § 351; § 368.

³⁴ See DOERNBERG, *supra* note 14, at 364-387 (providing a trenchant explanation of international tax-free transactions and the role of § 367 in outbound transactions).

States at a time when the nation is already suffering from a recession and dedicating significant resources to the global war on terrorism, critics of inversions have questioned the morality, patriotism and scruples of corporate directors. For instance, inversion opponents have described these transactions as “immoral,”³⁵ “wrong,”³⁶ “contemptible,”³⁷ “the most blatant example of abusive corporate tax shelters that increasingly plague our country,”³⁸ “outrageous,”³⁹ an “unpatriotic tax dodge,”⁴⁰ “a pure tax avoidance mechanism” that is “very bad public policy,”⁴¹ “a stealth weapon used by management to evade corporate accountability,”⁴² “disgusting,”⁴³ “rotten,”⁴⁴ “reprehensible behavior,”⁴⁵ “awful,”⁴⁶ “one of the ugliest issues that anybody has seen for a while,”⁴⁷ a “crisis” that is reaching “epidemic proportions,”⁴⁸ “troubling from a policy viewpoint”⁴⁹ and “a bad example of corporate tax cheating.”⁵⁰ Along with publicly censuring inversions in gen-

³⁵ Press Release, U.S. Congress, Grassley Announces Bill to Rein in Corporate Expatriation, at <http://finance.senate.gov/press/grassley/prg041102.pdf> (Apr. 11, 2002).

³⁶ *Id.*

³⁷ *Corporate Inversions: Hearing on H.R. 3884 and 4993 Before the House Subcomm. on Select Revenue Measures of the Comm. on Ways and Means*, 107th Cong. 13 (2002) [hereinafter *Corporate Inversions: Hearing on H.R. 3884 and 4993*] (statement of Michael McNulty, Rep., N.Y.) (stating, “At a time when we are asking our Armed Forces to risk their lives in the war against terrorism, I find it contemptible that corporations would renounce their allegiance to this country in order to evade taxes.”), available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_house_hearings&docid=f:81550.pdf (June 25, 2002).

³⁸ *Id.* at 5 (statement of Rep. Lloyd Doggett, Tex.).

³⁹ *Id.* at 28-29 (statement of Rep. James Maloney, Conn.).

⁴⁰ *Id.*

⁴¹ *Corporate Inversion: Hearing on S. 2119 Before the Senate Subcomm. on Treasury and General Government of the Comm. on Appropriations*, 107th Cong. 39 (Oct. 16, 2002) [hereinafter *Corporate Inversions: Hearing on S. 2119*] (statement of William Gale, Senior Fellow and Deputy Director for Economic Studies, The Brookings Institution).

⁴² *Corporate Inversions: Hearing on H.R. 3884 and 4993*, *supra* note 37, at 46 (statement of Richard Blumenthal, Attorney General, Conn.).

⁴³ *Corporate Inversions: Hearing on S. 2119*, *supra* note 41, at 3 (statement of Sen. Byron Dorgan, N.D.) (stating, “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.”).

⁴⁴ *Id.* at 15.

⁴⁵ *Id.* at 28-29 (statement of Robert McIntyre, Director, Citizens for Tax Justice).

⁴⁶ *Id.* at 28.

⁴⁷ *Id.* at 29.

⁴⁸ *Id.* at 28.

⁴⁹ *Id.* at 39 (statement of William Gale).

⁵⁰ *Corporate Tax Shelters: Looking Under the Roof: Hearing Before the S. Subcomm. On Treasury and General Government of the Comm. On Fin.*, 107th Cong. 21 (2002) [hereinafter *Corporate Tax Shelters: Hearing Before the S. Subcomm. on Treasury*] (statement of Sen. Charles E. Grassley).

eral, and the companies that have opted to invert in particular, some detractors have also urged a boycott of products sold by companies that invert.⁵¹ Simply inflaming the inversion debate with such antagonisms tends to obfuscate the true issues and impedes the identification of appropriate solutions. A review of the literature on this issue demonstrates that argumentative commentaries relying upon misinformation have obscured the true effects of inversions on the United States. Accordingly, it is prudent to first clarify the impact that inversions have had or will have on the United States before analyzing the solutions that have been offered thus far.

A. Inversions Decrease U.S. Employment

It has been suggested that corporate inversions harm U.S. workers by sending jobs to those countries in which inverting companies reincorporate. For example, believing (albeit incorrectly) that inversions would occasion significant domestic job loss, one lawmaker even introduced an anti-inversion bill entitled the "Save America's Jobs Act of 2002."⁵² The entire premise for the proposed legislation is unsubstantiated. According to a recent study by the U.S. Treasury Department, although an inversion does require considerable restructuring as a matter of corporate law, the effect on the actual management and operation of the inverted corporation is negligible. In other words, "[w]hile the jurisdiction of incorporation is changed in an inversion transaction, there need not be any change in the location of the corporation's headquarters or its other business operations."⁵³ This position has gained further support from legal practitioners and tax experts, who explain that many members of Congress are under the false impression that inversions entail the dislocation of U.S. factories and jobs when, in reality, they are "purely paper transactions."⁵⁴ Rather than diminish U.S. employment, inversions may actually increase domestic job opportunities. If, for instance, instead of conducting an inversion transaction, which allows the corporation's facilities, employees and officers to remain in the United States, a foreign corporation were to acquire what would be the newly-formed foreign parent, then all of the facilities, employees and officers

⁵¹ *Id.* Senator Charles Grassley, referring to the recent inversion by Ingersoll-Rand in Bermuda, voiced his outrage and urged the public to take economic action: "We have our country at war. We have our country in recession. We have a major, well-respected U.S. corporation going to Bermuda to save 7 percent on taxes . . . I hope people remember this when they shop for products that this company offers."

⁵² Save America's Jobs Act of 2002, H.R. 3922, 107th Cong. (2002).

⁵³ OFFICE OF TAX POL'Y, *supra* note 17, at 15.

⁵⁴ Bruce Bartlett, *Why the Inversion Aversion?*, NAT'L REV., Aug. 12, 2002. Inversions are described as "paper transactions" because, while the inverting does involve significant legal changes and new corporate documentation, the practical impact on business operations is minimal. In other words, an inversion transaction entails a considerable amount of work as a matter of corporate law, but its effect on the actual functioning and management of the inverted entity is limited.

would likely be transferred to a foreign country.⁵⁵ Moreover, while inversion transactions do damage the U.S. economy as a whole by lessening tax receipts, the inverted corporations themselves directly benefit from the tax savings. Corporate tax savings may thus translate into higher wages and more domestic jobs.⁵⁶

B. Inversions Economically Injure Corporate Stockholders

As discussed previously, the initial inversion transaction may cause stockholders to have capital gains (on which taxes must be paid) from the exchange of shares in the former domestic parent corporation for shares in the newly-formed foreign parent.⁵⁷ For this reason, it is suggested that inversions are economically damaging to stockholders.⁵⁸ As logical as this argument may first appear, the evidence proves its invalidity for several reasons. First, tax practitioners emphasize that both stockholders and corporate officers (as stockholders and owners of stock options) have a mutual interest in making the corporation as profitable as possible.⁵⁹

Second, corporations must obtain shareholder approval of inversions before executing them. In obtaining shareholder approval, corporations must adhere to the disclosure laws of the Securities and Exchange Commission ("the SEC") and reveal to shareholders the details of the inversion.⁶⁰ The SEC disclosure requirements, coupled with the corporate voting limitations, thus act as a filter to foolhardy corporate actions. As an example, despite considerable negative media coverage of inversions at the time, over ninety-three percent of the shareholders of Weatherford International, an oil-field services company, approved a corporate resolution in June 2002 to invert from Houston to Bermuda in order to reduce corporate taxes by one-third.⁶¹

Finally, recent studies indicate that, in their role as fiduciaries, corporate officers broach the possibility of inverting only if they believe that the benefits to the shareholders outweigh the costs.⁶² Based on their findings in the studies, experts conclude that corporate directors tend to maximize

⁵⁵ *Corporate Inversions: Hearing on H.R. 3884 and 4993*, *supra* note 37, at 48 (2002) (statement of Steven C. Salch).

⁵⁶ John. S. Barry, *Corporate Inversions: An Introduction to the Issue and FAQ*, Fiscal Policy Memo, available at <http://www.taxfoundation.org/reincorporation.html> (May 30, 2002).

⁵⁷ See I.R.C. § 367(a) (2002).

⁵⁸ Selva Ozelli, *Shareholder Leverage in the Face of Corporate Inversions*, 29 TAX NOTES INT'L 661, 661-62 (2003).

⁵⁹ Peterson & Cohen, *supra* note 19, at 186.

⁶⁰ OFFICE OF TAX POL'Y, *supra* note 17, at 17.

⁶¹ Nelson Antosh, *Weatherford Off to Bermuda*, Hous. Chron., Jun. 27, 2002, at 1.

⁶² Jim A. Seida & William F. Wempe, *Market Reaction to Corporate Inversion Transactions*, 24 INS. TAX REV. 73 (2003).

shareholder wealth instead of stock prices, thereby not participating in inversions unless future tax savings more than compensate for the current capital gains (and corresponding tax liabilities) incurred by shareholders.⁶³ Publicly-traded, inverting corporations' share prices also reflect that inversion will be beneficial to the overall economic position of a corporation. Studies indicate that stock prices of certain inverting corporations increased noticeably shortly after public announcement of their decision to invert.⁶⁴

C. Inverting a Corporation is Unpatriotic

One of the most common criticisms of inversions is that they are "unpatriotic," particularly during a period in which the United States is enduring an economic recession and channeling many of its resources (both human and economic) toward the war on terrorism.⁶⁵ As the adage goes, though, there are always at least two sides to every story. In this case, proponents of inversions justify their actions by making several arguments. For example, despite all of the recent media and political attention given to inversions, it is suggested that the issue has been blown greatly out of proportion. Citing the fact that since 1962 less than thirty companies have actually inverted or announced plans to do so, some commentators absolutely repudiate the proposition that there is a mass "exodus" of domestic corporations as certain politicians would lead the public to believe.⁶⁶ Moreover, corporate directors may have a duty to invert their corporation if doing so is in the best interest of the shareholders. According to the U.S. Chamber of Commerce, irrespective of any ethical issues, inverting is completely legal under current U.S. law. Therefore, as fiduciaries of the corporation that owe a high degree of loyalty to the shareholders, the corporate directors are essentially obligated to maximize profitability and stock value, be it by inverting or otherwise.⁶⁷ Indeed, far from being unpatriotic, the U.S. Chamber of Commerce believes that inverting is simply the "free exercise of

⁶³ See generally Mihir A. Desai & James R. Hines Jr., *Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions*, 55 NAT'L TAX J. 409 (2000).

⁶⁴ Seida & Wempe, *supra* note 62.

⁶⁵ See *Corporate Inversions: Hearing on H.R. 3884 and 4993*, *supra* note 37, at 28-29. (statement of James Maloney); see also Janet Hook, *Democrats Move to Profit from Red Ink*, L.A. TIMES, July 6, 2002, at 8; Jonathan Weisman, *Patriotism Raining on Tax Paradise; Lawmakers Are Chafing at Firms that Exist Offshore Only by Paper*, WASH. POST, Aug. 21, 2002, at E1 (demonstrating that companies which have inverted or are considering such a move find that patriotism and corporate accountability are major issues as a result of the terrorist attacks on September 11, 2001, and collapse of Enron, respectively).

⁶⁶ See, e.g., David Greising, *Investors Pay for Tax Runners' Fun in the Sun*, CHI. TRIB., Aug. 9, 2002, at 1 (explaining that the amount of corporations that have inverted represent merely one-half of one percent of the more than 6,000 companies that are currently listed on the New York Stock Exchange).

⁶⁷ *Corporate Inversions: Hearing on S. 2119*, *supra* note 41, at 34 (statement of Martin Regalia, U.S. Chamber of Commerce).

prudent business decision-making.”⁶⁸ In defense of their decision to invert, others argue that relocating to Bermuda is no different than incorporating a business in Delaware.⁶⁹ Notwithstanding the fact that their assets and management are located elsewhere, thousands of U.S. businesses opt to incorporate in Delaware in order to take advantage of this state’s well-established corporate laws, court system familiar with resolving corporate issues, and the certainty provided by an abundance of legal precedent involving corporations. It is argued that the decision to organize in Delaware is theoretically similar to inverting to Bermuda, thereby making criticisms of either invalid.⁷⁰ Relying more on compassion, other backers of inversion have utilized the don’t-shoot-the-messenger plea, arguing that the recent increase of inversions is simply a manifestation of deeper problems with the Code in general. Specifically, inversions are portrayed as a last, yet necessary, resort in order for domestic corporations to compete internationally.⁷¹ Indeed, far from being unpatriotic, some reputable think tanks suggest that inverting corporations are simply “victims” of poor tax policies, which are truly to blame.⁷² Finally, while acknowledging that the inversion issue is complex and needs to be addressed, others point out that labeling those that opt to engage in this legal transaction as unpatriotic is counterproductive, and therefore the proverbial political cheap-shot.⁷³ Instead of flag-waving and capitalizing on the increased national unity as a result of the recent terrorist

⁶⁸ *Id.* at 35.

⁶⁹ *Flying the Flag*, FIN. TIMES, Aug. 3, 2002, at 22; see also Patti Mohr, *House Majority Leader Defends Corporate Inversion Transactions*, 27 TAX NOTES INT’L 52 (2002) (Richard Arney, House Majority Leader, released a statement defending inverting corporations by claiming that taxing them would be tantamount to punishing a taxpayer from taking the most advantageous tax position such as itemizing deductions as opposed to taking the standard deduction).

⁷⁰ *Flying the Flag*, *supra* note 69 (suggesting that politicians should cease their demonizing of inverting corporations because such an attack could eventually have a broader, unanticipated impact. This article warns, in particular, that if the criticisms do not halt soon “Delaware politicians should start to worry [because] it is not because of the weather and the Wilmington civic center that half of the companies listed on the New York Stock Exchange are incorporated in one state”).

⁷¹ Daniel J. Mitchell, *Corporate Expatriation Protects American Jobs*, HERITAGE FOUND., Exec. Mem. No. 829 (2002) at <http://www.heritage.org/Research/Taxes/em829.cfm> (arguing that inversions allow a domestic corporation to compete in world markets while maintaining its headquarters and jobs in the United States, which is “a combination that advances U.S. interests”).

⁷² *Id.*

⁷³ *Bringing U.S. Companies Home; Patriotism Is No Cure for Fraud*, FIN. TIMES, Mar. 6, 2003, at 12 (opining that patriotism “is the last refuge of the scoundrel”); see also *Flying the Flag*, *supra* note 69 (arguing that the idea that it is unpatriotic for domestic corporations to minimize their tax burdens and maximize their profitability by inverting is “nonsense” while invoking patriotism in the wake of the terrorist attacks in New York is “shameful”).

attacks, other commentators encourage a serious examination of the issue without excessive shenanigans and self-serving rhetoric.⁷⁴

D. Corporate Inversions Erode the U.S. Tax Base

The most compelling and legitimate reason for halting inversions is that this practice erodes the U.S. tax base to the detriment of other businesses and individual taxpayers. In other words, the number of corporations that are paying taxes in the United States decreases as the frequency of inversions increases, thereby making the remaining U.S. taxpayers responsible for a larger portion of the government budget. As one indignant lawmaker put it, “[u]fortunately, while multibillion-dollar companies sidestep income taxes . . . individual taxpayers and U.S. businesses are forced to bear a greater burden.”⁷⁵ Precise statistics regarding decreases in the tax revenue attributable to corporate inversions have not been released; however, the U.S. Treasury Department estimates that these transactions are costing the country “billions” of dollars annually.⁷⁶

E. Inversions Force Other U.S. Companies to Invert in Order to Compete

Prices at which a company may sell its goods and the profits that a company may distribute to its shareholders are impacted, at least in part, by the amount of tax that a corporation must pay. For instance, if a domestic corporation inverts and thereby reduces its overall tax burden, it will likely convey this increased profitability to consumers in the form of lower prices and/or to its shareholders as dividends. A non-inverting domestic corporation, therefore, will find itself at a competitive disadvantage.⁷⁷ As several tax experts have pointed out, this situation leads to the proverbial snowball effect: “once one company does it, rivals feel forced to follow.”⁷⁸ The U.S.

⁷⁴ John S. Barry, *Corporate Inversions: An Introduction to the Issue and FAQ*, TAX FOUND. FISCAL POL’Y MEMO, May 30, 2002 (arguing that while it is “tempting” and “politically easy” to simply criticize and blame the inverting corporations, a better solution would be to focus on a major overhaul of the U.S. international tax rules).

⁷⁵ Richard Neal, *Traitors When It Comes to Taxes*, WASH. POST, April 18, 2002, at A20.

⁷⁶ *Corporate Inversions: Hearing on S. 2119*, *supra* note 41, at 10 (statement of Pamela Olson, Dept. of the Treasury).

⁷⁷ *Corporate Tax Shelters: Hearing Before the S. Subcomm. on Treasury*, *supra* note 50, at 2 (statement by Senator Max Baucus, Chairman, Comm. on Finance) (Sen. Baucus argues that inversions afford certain companies a tax benefit without the recipients reciprocating with a corresponding economic benefit such as technological innovation. This, he argues, could have the “perverse effect” of forcing honest companies to also invert in order not to be placed at a competitive disadvantage).

⁷⁸ Weisman, *supra* note 65, at E1 (Stanley Works considered inverting only after two of its major competitors, Cooper Industries of Texas and Ingersoll-Rand of New Jersey, inverted to Bermuda in 1997). See also *Corporate Tax Shelters: Hearing Before the S. Subcomm. on Treasury*, *supra* note 50, at 2 (Sen. Baucus argues that inversions generate a perverse effect where “perfectly honest companies consider setting up a shelter of their own to avoid being placed at a competitive disadvantage”).

Treasury Department has confirmed this theory, stating in a recent report that inversions used to be merely an "isolated phenomenon." These days, however, the incidence of inversions has dramatically increased and in those industries in which several inversions have occurred, "other companies within the industry may feel competitive pressure to consider the inversion."⁷⁹

Despite claims to the contrary by the U.S. Treasury Department and companies desirous of inverting, certain tax experts argue that the U.S. tax system is not anti-competitive in comparison to tax systems in other countries.⁸⁰ Stated differently, the contention that U.S. businesses operating internationally are at a competitive disadvantage to their foreign counterparts due to the scope and operation of the U.S. tax system is often refuted. From the perspective of certain tax and economic advisors close to the inversion issue, the anti-competitiveness argument is a mere "myth" that has been perpetuated to such an extent that it now possesses a certain degree of truth.⁸¹ Equally numerous are those who sustain that, even if the U.S. tax system is anti-competitive in the global context, corporate inversions are completely unrelated to this issue. According to representatives of a respected Washington-based think tank, "[i]nversions have nothing to do with the lack of competitiveness of our tax system" because the concept of international competitiveness deals only with the effective tax rate on businesses.⁸² The effective tax rate depends on several factors, including the statutory tax rate, depreciation rules, and whether corporate and personal taxes are integrated. The effective tax rate, therefore, does not affect the motivations for inverting.⁸³

On the other hand, inversions are contingent upon the statutory tax rate, and domestic corporations are tempted to shift profits and losses amongst a multinational corporate group due to the relatively high corporate income tax rate of 35 percent.⁸⁴ In support of this position, other tax experts call the anti-competitiveness justification cited by inverting corporations as "misleading" and the "reddest of red herrings" since, in their opin-

⁷⁹ OFFICE OF TAX POL'Y, *supra* note 17 at 17.

⁸⁰ See, e.g., *Corporate Inversions: Hearing on H.R. 3884 and 4993*, *supra* note 37, at 9 (statement by Prof. Samuel Thompson, Center for the Study of Mergers and Acquisitions, University of Miami School of Law) (criticizing the U.S. Treasury Department for making blanket statements about the uncompetitive nature of the U.S. tax system without providing adequate statistics to substantiate such an assertion).

⁸¹ John Buckley & Al Davis, *The ETI/Corporate Inversion Debate: Will Myths Prevail?*, 27 TAX NOTES INT'L 443 (2002).

⁸² William G. Gale, *Notes on Corporate Inversions, Export Subsidies, and the Taxation of Foreign-Source Income*, 27 TAX NOTES INT'L 1495 (2002) (Dr. Gale represents the Brookings Institute).

⁸³ *Id.*

⁸⁴ *Id.*; see also I.R.C. § 11.

ionS, the two issues are completely independent.⁸⁵ Still others argue that while the U.S. international tax rules may or may not be anti-competitive in general, the current system is unquestionably disadvantageous for domestic corporations in specific industries such as telecommunications, oilfield services, and insurance.⁸⁶

F. Inversions Undermine Public Confidence in the Tax System

As comical or ludicrous as it may seem to some people, the U.S. tax system is a "voluntary" arrangement whereby the government expects each taxpayer to willingly disclose certain financial information, complete the requisite forms, and pay the appropriate amount.⁸⁷ If public confidence in this system were to plummet and indignant or rebellious taxpayers decided not to voluntarily comply, serious economic problems for the United States and considerable administrative headaches for the Internal Revenue Service would undoubtedly ensue. Warning of the potential dangers of allowing corporate inversions or other tax shelters to undermine public faith in the system, one Congressman explained that inversions "make average taxpayers feel like chumps; we have to pay more because the big guys are paying less."⁸⁸ The U.S. Treasury Department, likewise, recognizes the deleterious effects of inversions on the integrity of the present tax system, and therefore recommends an immediate response.⁸⁹ Respected bar associations have also agreed with this position, arguing that corporate inversions not only impair the integrity of the voluntary compliance system, but also violate the spirit, if not the letter, of the law.⁹⁰

⁸⁵ *Corporate Tax Shelters: Hearing Before the S. Subcomm. on Treasury*, *supra* note 50, at 24 (statement of Reuven Avi-Yonah, Professor of Law, University of Michigan Law School).

⁸⁶ Peterson & Cohen, *supra* note 19, at 181-83.

⁸⁷ The word "voluntary," as used in publications of the Internal Revenue Service, refers to the U.S. system of allowing taxpayers to determine the correct amount of tax and complete the appropriate returns, rather than have the government determine tax for them. The requirement to file an income tax return, however, is not voluntary and is mandated by I.R.C. §§ 6011(a), 6012(a) and 6072(a).

⁸⁸ *Corporate Tax Shelters: Hearing Before the S. Subcomm. on Treasury*, *supra* note 50, at 1 (statement of Sen. Max Baucus, Mont.).

⁸⁹ *Corporate Inversions: Hearing Before the House Comm. on Ways and Means*, 107th Cong. 8 (2002) [hereinafter *Corporate Inversions: Hearing Before the House Comm. on Ways and Means*] (statement by Pamela F. Olsen, Acting Assistant Secretary for Tax Policy, U.S. Treasury Department) (Ms. Olsen agreed that inversions "have a corrosive effect on the public's confidence in the U.S. tax system."); *see also* John Buckley & Al Davis, *The ETI/Corporate Inversion Debate: Will Myths Prevail?*, 27 TAX NOTES INT'L 443 (2002). These tax and economic experts from the Democratic Party argue that justifying abusive inversion transactions as acceptable responses to shortcomings with current law "threatens to undercut voluntary compliance with our tax laws."

⁹⁰ N.Y. State Bar Ass'n, Tax Section, *Report on Outbound Inversion Transactions*, 1014 TAX NOTES 2 (2002) [hereinafter N.Y. Bar Ass'n Tax Section Rep].

G. Inversions Reduce Shareholder Recourse and Rights

Another concern raised by inversion opponents is that upending the corporate structure and relocating the parent corporation to a low-tax, and perhaps lesser-developed, country will inevitably weaken shareholder rights. In the words of the Attorney General of Connecticut, while the inversion island of choice, Bermuda, may appear to be close geographically and familiar in terms of language and culture, "it might as well be the moon in terms of legal rights and protection for shareholders."⁹¹ This consternation is due to the fact that once the parent of the multinational corporate group is established in a tax-haven country such as Bermuda, the laws of that jurisdiction then govern the rights and obligations of the corporation. As discussed above, prior to engaging in the inversion transaction, a corporation must disclose to the shareholders in accordance with the SEC rules the probable effects of the inversion, and obtain the requisite approval of the shareholders. This disclosure-and-approval safeguard, however, may not adequately protect unsophisticated or naïve shareholders. Those opposed to inversions warn that, although U.S. shareholders are entitled to vote on the inversion proposal and reject it if it is not in their best interest, they often fail to comprehend the legal significance of the intended change because they understand the corporate restructuring to be merely a technical maneuver with only tax implications.⁹²

Despite being aware of this shareholder confusion, some argue that "[m]anagement has been in no rush to clarify the weakening, even eviscerating (sic) of shareholder rights to hold management accountable."⁹³ The major problems with the laws of Bermuda arguably include (i) the general inaccessibility of the law, since court decisions are not collected and publicly reported, (ii) an absence of significant limitations on insider trading, (iii) the fact that prior shareholder approval is not required before a Bermudan corporation enters into major actions such as selling or otherwise disposing of vital corporate assets, (iv) the restriction on shareholder derivative suits, and (v) the fact that a judgment for money damages against corporate officers or directors issued by a U.S. court is not automatically enforceable in Bermuda since the United States has not signed a reciprocal-enforcement-of-judgments treaty with that country.⁹⁴

⁹¹ *Corporate Inversions: Hearing Before the House Comm. on Ways and Means, supra* note 89, at 36 (statement of Richard Blumenthal, Attorney General, Conn.).

⁹² *Id.* at 36-37.

⁹³ *Id.* at 37.

⁹⁴ *Id.* at 32-34 (statement of the American Federation of Labor—Congress of Industrial Organizations).

H. Summary of Arguments against Corporate Inversions

In summary, it appears that the suggestions that inversions either decrease U.S. employment or injure corporate shareholders economically are specious. Moreover, while it is entertaining to a certain degree, the spirited debate concerning whether inversions are “unpatriotic” is counterproductive and simply distracts from the central, legitimate issues. It should, therefore, be ignored in the context of any serious analysis of corporate inversions. However, the literature does reveal that the inversion phenomenon may have several detrimental consequences to the United States, such as eroding the overall U.S. tax base and forcing domestic corporations to invert in order to compete with their competitors who have opted to undergo this international restructuring, undermining public confidence in the voluntary tax system and restricting shareholder rights. Accordingly, sound tax policy dictates the development and implementation of an appropriate solution.

V. AN EXAMINATION OF PROPOSED SOLUTIONS

As with any controversial issue, the inversions debate has yielded numerous proposed solutions, ranging from thought-provoking to outright senseless. Examined below are a variety of these proposals.

A. Shift to a Territorial Tax System

As explained above, the United States uses a “worldwide” tax system in which all of the income of a U.S. person (e.g., a U.S. citizen, resident alien, domestic corporation, etc.) is subject to taxation in the United States, irrespective of the country in which that person actually earns the income.⁹⁵ Many other countries, by contrast, utilize a “territorial” tax system under which tax is imposed on all income that is earned within a nation’s boundaries, no matter who earns it. Under a territorial regime, income that is earned in a foreign country, beyond the borders of the taxing nation, is not taxed.⁹⁶ As a means to prevent inversions, several groups have advocated that the United States join the majority of other developed nations by adopting a territorial system. Embracing this new tax regime, they argue, will enable domestic corporations operating abroad to be more competitive internationally, and thus less susceptible to the pressure to invert.⁹⁷

⁹⁵ I.R.C. § 61(a). This subsection provides that, subject to certain exceptions, the term “gross income” means “all income from whatever sources derived . . .” (emphasis added).

⁹⁶ GUSTAFSON ET AL., *supra* note 9, at 256.

⁹⁷ Mitchell, *supra* note 71. The Heritage Foundation, a respected conservative think tank located in Washington, argues that Congress should either adopt a territorial system so that domestic firms are not tempted to invert or do nothing so that domestic firms continue to invert as a form of do-it-yourself territoriality. Veronique de Rugy, *Quick-Fix Curbs on Corporate Inversions Mask the Real Problem*, 28 TAX NOTES INT’L 805 (2002); Veronique de Rugy, *Runaway Corporations: Political Band-Aids vs. Long-Term Solutions*, TAX & BUDGET BULLETIN NO. 9, (Cato Institute, July 2002); see also CATO INST., CATO HANDBOOK FOR

As well-intentioned as it may be, the idea of the United States adopting a territorial tax system has several flaws. First, the principal champions of this notion have recently backed away from this drastic measure. In particular, the National Foreign Trade Council recently released a study that concluded, among other things, that legislative efforts to improve current international tax rules would be "better spent on reform of our current deferral and foreign tax credit system [rather] than on adopting a territorial exemption system."⁹⁸ Similarly, the U.S. Treasury Department has indicated that the time is not propitious for adopting a territorial system, opting instead to significantly reform the current worldwide regime.⁹⁹ Some speculate, though, that the U.S. Treasury Department will cease to assert this position when conditions are more favorable in the future.¹⁰⁰ In light of this recent loss of political support for territoriality, the proposal becomes less realistic, and thereby, less appealing.

Second, while acknowledging that broad tax reform may be advisable, others argue that territoriality is an inappropriate response to the precise issue at hand: inversions.¹⁰¹ Representatives of the Brookings Institute posit that a territorial tax system normally makes it even more difficult to guard against the erosion of the U.S. tax base, because moving offshore under a territorial system generates larger tax savings than doing so under a worldwide tax regime. Therefore, if the United States were to adopt a territorial system at this juncture, it would simply enhance and legitimize methods of

CONG.: POL'Y RECOMMENDATIONS FOR THE 108TH CONG., 628-29 (2002). The Cato Institute warns that any legislation that simply prohibits inversions is a temporary solution that fails to institute "long overdue business tax reforms." It argues, therefore, that Congress should lower the corporate tax rate and adopt a territorial tax system. *See also Corporate Inversions: Hearing Before the House Comm. on Ways and Means, supra* note 91, at 35 (statement by the Coalition for Tax Competition) (recommending jointly lowering the corporate tax rate and introducing a territorial system). *Cf. N.Y. State Bar Ass'n, Tax Section, supra* note 90, at 63. This legal group does not support a pure territorial system. Rather, it suggests a middle ground such as a limited territoriality of an improved foreign tax credit mechanism.

⁹⁸ National Foreign Trade Council, Territorial Tax Study Group, *Territorial Tax Study Report* (2002). The NFTC is a lobbying group comprised of U.S. businesses engaged in all aspects of international business, trade and investment.

⁹⁹ *Corporate Inversions: Hearing Before the House Comm. on Ways and Means, supra* note 89, at 8 (statement of Pamela F. Olsen, Dep't of Treasury).

¹⁰⁰ Martin A. Sullivan, *Congress's Inversion Odyssey: Oh, the Places You'll Go*, TAX ANALYSTS, TAX NOTES TODAY, July 1, 2002, at 9. This article conjectures that experts from the U.S. Treasury Department realized the shortcomings of tying its desire for a more territorial system on the inversion issue. However, "they did not abandon the argument outright—probably because it might have confused and offended their long-time political supporters." *Id.*

¹⁰¹ *Corporate Inversions: Hearing on H.R. 3884 and 4993, supra* note 37, at 11 (statement of Samuel C. Thompson, Jr., Professor, Univ. of Miami School of Law) (explaining that "[t]here is no sound basis for coupling the examination of the potential move to a territorial system with the inversion problem. They are different problems and should be treated as such.").

tax avoidance.¹⁰² Based on this unanticipated result, members of this respected think tank argue that “[g]oing to a territorial system as a response to corporate inversions is like choosing to reduce the crime rate by legalizing certain crimes.”¹⁰³

Third, designing and implementing any major overhaul to the U.S. tax system, be it territoriality or otherwise, will require numerous years of arduous debate and work. The incidence of inversion transactions, however, is on the rise now.¹⁰⁴

Fourth, the amount of erosion to the U.S. tax base caused by corporate inversions may not justify the enormous costs associated with reconstructing the U.S. international tax rules in their entirety. Citing the fact that inversions have deprived the U.S. Treasury of approximately \$1 billion per year while tax reform necessarily implicates rearranging over \$1 trillion of annual federal revenue, some commentators have characterized the idea that inversions should serve as a catalyst for fundamental tax reform as “absurd” and a case of “the tail wagging the dog.”¹⁰⁵

Fifth, the idea of territoriality may never have been a legitimate proposal in the first place; rather, it simply represented a starting point for the international business community that is truly interested in achieving more practical objectives.¹⁰⁶ When pressed on this issue, certain lawmakers concede that, despite several years of debating the issue of fundamental tax reform, virtually no progress has been made.¹⁰⁷

Finally, the territoriality argument may be untenable in view of the massive resistance that it confronted when recently introduced in another related legislative debate. After losing for a fourth time on the issue in front of the World Trade Organization, the United States was recently instructed to conform its tax rules with international standards by repealing the FSC

¹⁰² Gale, *supra* note 82, at 1495.

¹⁰³ *Id.*

¹⁰⁴ Tim Reason, *Love It and Leave It? Will the Outcry Over Inversions Change the Way Overseas Income Is Taxed?*, CFO MAG., July 2002, at 39 (arguing that any fundamental international tax reform “will take years”).

¹⁰⁵ Sullivan, *supra* note 100.

¹⁰⁶ *Id.* Sullivan states that “nobody should be surprised that territoriality was never seriously on the table” because the business community is eager to accomplish other changes involving the interest allocation rules, definition of subpart F income, and carryover limits applicable to the foreign tax credit. The author of this article cynically, or realistically, or perhaps both, explained that big business has merely one goal: “Whether the principle is free trade or free markets or integration of the corporate and individual income taxes or tax reform or territoriality, these high-minded ideas serve only as the means to the same end: reduction of taxes on business.” *Id.*

¹⁰⁷ *Corporate Inversions: Hearing on H.R. 3884 and 4993, supra*, note 37, at 33 (statement of Rep. Richard E. Neal, Member, House Comm. on Ways and Means) (“[T]he truth is—I think we all would agree on this, at least quietly, we may not be able to agree on it publicly but we would agree on it quietly—we are no closer today to make [sic] any structural changes in the Tax Code than we were then”).

Repeal and Extraterritorial Income Exclusion Act ("ETI Act"), which granted tax-based export incentives to certain domestic corporations operating internationally.¹⁰⁸ Just as in the case of inversions, during the ETI Act debate, various persons and groups suggested that the United States radically change its current tax system by adopting territorial-based taxation.¹⁰⁹ Abandoning the policy of worldwide taxation that the United States has historically used and adopting a system based on territoriality would be an enormous, drastic change.

As such, this proposal in the context of the ETI Act was severely criticized.¹¹⁰ Furthermore, since the benefits provided by the ETI Act represent

¹⁰⁸ For a complete analysis of the issues surrounding the ETI Act, see Hale E. Sheppard, *Rethinking Tax-Based Export Incentives: Converting Repeated Defeats Before the WTO into Positive Tax Policy*, 39 TEX. INT'L L.J. (forthcoming 2003).

¹⁰⁹ See, e.g., Candace Carmichael, *Foreign Sales Corporations—Subsidies, Sanctions, and Trade Wars*, 35 VAND. J. TRANSNAT'L L. 151, 206 (2002); Ashley Redd Commins, *The World Trade Organization's Decision in United States—Tax Treatment for "Foreign Sales Corporations": Round Three in the Transatlantic Tax Dispute*, 27 N.C. J. INT'L L. & COM. REG. 363, 387 (2001); Ernest R. Larkins, *WTO Appellate Body Rules Against FSCs: The Search for Alternatives Begins*, J. INT'L TAX'N 16, 19 (2000); John Seiner, *Beating Them at Their Own Game: A Solution to the U.S. Foreign Sales Corporation Crisis*, 11 MINN. J. GLOBAL TRADE 395, 412-415 (2002); Marc Rosenberg, *How a Taxing Problem Has Taken Its Toll: A Common Person's Guide to an International Taxation Dispute*, 20 B.U. INT'L L.J. 1, 30-31 (2002); *WTO's Extraterritorial Income Decision: Hearing Before the Comm. on Ways and Means H.R.*, 107th Cong. at 47 (2nd Sess. 2002) (statement of Gary Hufbauer, Senior Fellow, Inst. of Int'l Econ.); Myrna Zelaya-Quesada & Chris Rugaber, *Congress, Administration Vow Cooperation to Resolve Dispute with EU Over FSC/ETI*, DAILY TAX REP., Feb. 28, 2002, at G-5 (stating that the Coalition for Tax Competition, among whose members are many prestigious think tanks such as the Center for Freedom and Prosperity, the Heritage Foundation, the Competitive Enterprise Institute, the Institute for Policy Innovation, and Americans for Tax Reform, advocate a territorial system).

¹¹⁰ See, e.g., *Joint Comm. on Tax'n, Background Materials on Bus. Tax Issues Prepared for the House Comm. on Ways and Means*, TAX POLICY DISCUSSION SERIES, NO. JCX-23-02, at 58 (2002) [hereinafter *Joint Comm. On Tax'n*]. This report includes arguments against the adoption by the United States of a territorial system. For instance, if the United States and other major countries in which multinational enterprises are located were to adopt territorial tax systems, tax competition would intensify and, in the absence of the constraint of some residence-based taxation of foreign-source income, a significant barrier to tax competition would be removed, and the proverbial "race to the bottom" could potentially follow. Moreover, since the United States has an extensive network of bilateral tax treaties that are premised on the fact that the United States has a worldwide tax system, switching to a territorial system now would require that existing tax treaties be renegotiated, which would create enormous uncertainty in taxation of business investments for a substantial period. See also *WTO's Extraterritorial Income Decision: Hearing Before the Comm. on Ways and Means H.R.*, *supra* note 109, at 53-58 (statement of Peter R. Merrill, Principal & Dir., Nat'l Econ. Consulting Group, PricewaterhouseCoopers, LLP, & Consultant, Int'l Tax Pol'y Forum); William G. Gale, Chair of Federal Economic Policy, Brookings Institution, *Hearing on the WTO's Extraterritorial Income Regime, U.S. H.R.—Before the Comm. on Ways and Means, Subcomm. on Select Revenue Measures* (2002).

merely one consideration among many in evaluating the wisdom of instituting a fundamental reform of the entire U.S. tax system, the Joint Committee on Taxation, the preeminent government authority on tax issues, endorses incremental steps as opposed to radical changes.¹¹¹

B. Lower the Corporate Interest Rate

The existing corporate tax rate of thirty-five percent has been identified as a cause of the recent rash of corporation inversions.¹¹² Indeed, some tax organizations suggest that lowering the rate by five percent alone would likely discourage inversions, as well as the practice of earnings stripping associated with these inversions.¹¹³ It is also recommended that, instead of devoting significant time and effort to enacting new legislation to prevent inversions, Congress would be wiser to simply lower the corporate tax rate because the “inversion phenomenon should be viewed as a warning that U.S. [corporate] rates are too high.”¹¹⁴ If the tax rate were decreased by five percent, positive results for the United States could ensue. For example, a corporate tax reduction would arguably (i) make the U.S. tax rate comparable to those of the United States’ major trading partners, (ii) reduce the domestic costs to U.S. exporters, thus making their products more competitive in the global market, (iii) assist small firms desirous of entering the market who cannot because they cannot afford to take advantage of tax deferral and must repatriate profits immediately to finance ongoing operations, (iv) encourage multinational corporations to increase the amount of dividends that they repatriate back to the United States, and (v) serve as an incentive for more foreign direct investment in the United States.¹¹⁵ On the other hand, lowering the corporate tax rate would deprive the U.S. Treasury Department of billions of dollars annually, as well as further exasperate individual taxpayers, who pay a larger portion of the national revenue each year.¹¹⁶

¹¹¹ *Joint Comm. on Tax’n*, *supra* note 110, at 60.

¹¹² I.R.C. § 11.

¹¹³ See Scott A. Hodge, *Tax Found., Fiscal Pol’y Memo*, THE ECON. OF H.R. 5095, at 9-10 (2002); see also RUGY, *supra* note 97, at 805; CATO INST., *supra* note 97 (advocating both adopting a territorial tax system and reducing corporate tax rate from thirty-five percent).

¹¹⁴ See BARTLETT, *supra* note 54.

¹¹⁵ Hodge, *supra* note 113, at 4-8.

¹¹⁶ See Robert S. McIntyre & T.D. Co Nguyen, *Corporate Income Taxes in the 1990s*, INST. ON TAX’N & ECON. POL’Y 10-11 (2000) available at <http://www.itepnet.org/corp00an.pdf>. This report suggests that those parties “los[ing]” from the fact that corporate taxes significantly declined during the 1990s include the general public, disadvantaged companies, the overall U.S. economy, state governments and the integrity of the tax system. In reference to individual taxpayers, this report concludes that this is an “obvious group of losers” from the decrease in corporate taxes because they pay a larger portion, yet receive less public services.

To date, neither Congress nor the U.S. Treasury Department has even addressed this corporate tax reduction proposal. In light of this generalized neglect, this idea seems implausible at this juncture.

C. Do Nothing In Order to Allow Self-Help Territoriality

Next on the list of potential solutions is the prosaic and ungrammatical if-it-ain't-broke-don't-fix-it idea. A multinational corporate group based in the United States that inverts will avoid the application of U.S. taxes with respect to its foreign operations. The foreign operations, however, will continue to be subject to the tax rules of both the country in which they are located and the country in which the newly-formed foreign parent is situated. If the new parent corporation is located in a country with little, if any, income taxes (such as Bermuda, where the corporate income tax rate is zero), then the foreign operations will be subject to tax only where they are located. Since this is similar to the tax treatment that would result when the foreign parent is located in a country that uses a territorial tax system as opposed to a worldwide tax system, inversions are occasionally referred to as "self-help territoriality."¹¹⁷ As explained previously, several different organizations have advocated strongly for the United States to formally adopt the territorial system in order to make the U.S. tax system more harmonious with those of other developed nations, and to allow domestic businesses operating internationally to better compete in the global market. In the alternative, many of these groups suggest that no legislative changes whatsoever should be introduced, so that corporations can proceed to legally invert, thereby opting to take advantage of self-help territoriality.¹¹⁸ More fatalistic perhaps, other tax practitioners sustain that inversions are not a problem, but rather a manifestation of deeper shortcomings of the current international tax rules. In other words, "inversions are an inevitable consequence of our tax system, i.e., inversions represent the means to achieve the end of self-help territorial tax system, and merely demonstrate the need for fundamental reform."¹¹⁹

Inversions generate several problems for the United States, including eroding the overall U.S. tax base, forcing domestic corporations to invert in order to compete, undermining public confidence in the tax system, and restricting shareholder rights. As a result, Congress has held multiple debates on this topic,¹²⁰ the U.S. Treasury Department has conducted a major study

¹¹⁷ OFFICE OF TAX POL'Y, *supra* note 17, at 29.

¹¹⁸ Mitchell, *supra* note 71 (arguing that if the current situation is left undisturbed, then "bad tax law" would still be in effect, but firms could easily circumvent it by inverting offshore as a self-help measure).

¹¹⁹ Peterson & Cohen, *supra* note 19, at 181.

¹²⁰ Congress has held three debates on this specific issue. *See generally Corporate Inversions: Hearing Before the Comm. on Ways and Means, supra* note 89; *Corporate Inversions:*

on inversions and is in the process of developing changes to the Code and regulations to address it,¹²¹ and more than a half-dozen bills designed to thwart inversions have been introduced recently in Congress.¹²² Accordingly, the if-it-ain't-broke-don't-fix-it approach seems to have at least two major problems. One, those in Washington who are charged with drafting and administering tax laws clearly think it is "broke." Two, they seem determined to "fix" it.

D. Pressure Other Countries to Change Their Tax Laws

Perhaps the most outlandish proposal to halt inversions was offered by Senator Max Baucus, former chairman of the prestigious Senate Finance Committee, who suggested that the United States pressure "the Bermudas of the world" so that they "stop this."¹²³ To his credit, Baucus did acknowledge that this recommendation might be somewhat far-fetched.¹²⁴ While the United States is no stranger to applying economic sanctions or enlisting the assistance of its political and/or economic allies in times of need, the idea that the United States can unilaterally obligate Bermuda to relinquish its sovereign right to adopt U.S. tax policies and corporate laws smacks of excessive hubris.

Nevertheless, it appears that market forces, as opposed to international diplomacy, are now forcing Bermudan officials to rethink their position. Local officials were initially indignant about accusations like those of Senator Baucus that Bermuda was acting unscrupulously. The Finance Minister of Bermuda, for instance, emphasized that the country did not make any recruiting pitches to attract U.S. companies to the island, and that the Bermuda Monetary Authority conducted a complete investigation of any company seeking to incorporate there, including a review of criminal and bankruptcy records, and cooperation with the SEC.¹²⁵ The Bermudan leaders do recognize, however, that in today's business and political climate "it

Hearing on H.R. 3884 and 4993, supra note 37; Corporate Inversions: Hearing on S. 2119, supra note 41.

¹²¹ OFFICE OF TAX POL'Y, *supra* note 17.

¹²² See generally American Competitiveness and Corporate Accountability Act of 2002, H.R. 5095, 107th Cong. (2002); Uncle Sam Wants You Act of 2002, H.R. 4756, 107th Cong. (2002); Reversing the Expatriation of Profits Offshore Act, S. 2119, 107th Cong. (2002); S. 2050, 107th Cong. (2002); Save America's Jobs Act of 2002, H.R. 3922, 107th Cong. (2002); Corporate Patriot Enforcement Act of 2002, H.R. 3884, 107th Cong. (2002); H.R. 3857, 107th Cong. (2002).

¹²³ *Corporate Tax Shelters: Hearing Before the S. Subcomm. on Treasury, supra note 50, at 25.*

¹²⁴ *Id.* (this lawmaker said that he was "obviously fishing[,] . . . grasping and trying to find something").

¹²⁵ Elaine Walker, *Politicians Angry at Firms Relocating to Tax-Free Bermuda*, MIAMI HERALD, July 26, 2002.

may be more about perception than reality.”¹²⁶ With this in mind, local business leaders understand that the pervasiveness of the negative press surrounding inversion is imperiling Bermuda’s reputation as a “blue-chip off-shore jurisdiction.” Accordingly, these financial professionals have recommended charging U.S. companies intent on inverting in Bermuda much more than the mere fee of incorporation, which, in itself, may dissuade some future inversions.¹²⁷ Furthermore, local leaders determined to preserve Bermuda’s business image recently traveled to Washington to meet with legislators and other key contacts in order to convey that, although they consider inversions to be strictly a U.S. problem, they are willing to provide U.S. officials with all the factual information that they can pursuant to the stringent banking, corporate, and tax laws in Bermuda.¹²⁸

E. Omnibus Approach: Addressing Multiple Problems Concurrently

Corporate inversions constitute merely one of the various international tax issues that receive considerable attention nowadays. In fact, three related topics are undergoing particular scrutiny: namely tax shelters, inversions, and the overall competitiveness of the U.S. international tax system. Instead of addressing these issues in isolation, efforts have been made to introduce legislation designed to rectify all three simultaneously. In particular, in July 2002, Representative Bill Thomas presented the American Competitiveness Act.¹²⁹ This bill focused congressional attention on these international tax issues; however, its failure was attributable to two principal items.

First, the section of the bill proposing the immediate repeal of the ETI Act in response to the recent loss of the United States before the World Trade Organization met considerable opposition. In late 2002, the Bush Administration announced that rectifying the ETI Act issue was a “priority”¹³⁰ and the White House publicly urged Congress to rapidly address this issue in order to avoid the economic retaliation that was authorized under the decision by the World Trade Organization.¹³¹ Nevertheless, the Ameri-

¹²⁶ *Id.*; see also James Canute, *Home from Home: Corporate Inversions*, FIN. TIMES, Nov. 22, 2002, at 5.

¹²⁷ *Tax-Haven Image Called Damaging to Bermuda*, SEATTLE TIMES, Sep. 13, 2002, at C3.

¹²⁸ *Bermuda: Image Under Attack*, REINSURANCE MAG., Nov. 1, 2002, at 15.

¹²⁹ American Competitiveness and Corporate Accountability Act of 2002, H.R. 5095, 107th Cong. (2002); see also *Joint Comm. on Taxation, Technical Explanation of H.R. 5095*, JCX-78-02 (2002) (hereinafter *Technical Explanation of H.R. 5095*); Alison Bennett, *Thomas Unveils Broad International Tax Bill As Party Tensions Build in Ways and Means*, DAILY TAX REP., July 12, 2002, at GG-1.

¹³⁰ Alison Bennett, *Subpart F, Foreign Tax Credit Rules Priorities, Olson Says*, DAILY TAX REP., Nov. 20, 2002, at G-9 (statement by Pamela Olson, Assistant Treasury Secretary for Tax Policy).

¹³¹ *Id.*

can Competitiveness Act failed to garner the support necessary to proceed down the congressional path, and a working group composed of lawmakers, officials from the Bush Administration, and business leaders was formed to further examine the bill and explore other alternatives.¹³² After this working group's initial meeting, representatives admitted that the American Competitiveness Act was a "good starting point," but cautioned that crafting and implementing an acceptable solution would be a lengthy process.¹³³ In more precise terms, the working group (which made its announcement before the war with Iraq and other major international events that took priority) estimated that it would not issue its recommendations until Spring 2003 at the very earliest.¹³⁴ To date, the group has not issued any such recommendations and the omnibus approach to the problem as set forth in the American Competitiveness Act remains at a standstill.¹³⁵

Second, the provisions of the bill aimed at reducing tax avoidance by corporate groups through "earnings stripping" met significant opposition. This technique of "earnings stripping" is not unique to inverted corporations; it is commonly used by foreign companies that operate in the United States. These foreign corporations employ earnings stripping to significantly lessen the amount of U.S. taxes imposed on the income that the foreign corporation earns from operations in the United States. Domestic companies, however, are unable to take advantage of this tax-reduction approach, thereby finding themselves at a competitive disadvantage.¹³⁶ In the context of inversion transactions, existing tax law limits the ability of a domestic corporation to reduce the amount of U.S. tax imposed on the income that it earns in the United States by first inverting, then obtaining a loan from the new foreign parent, and then deducting excessive amounts for interest payments that it made to the new foreign parent corporation.¹³⁷ Specifically, certain amounts paid by the domestic corporation as interest on

¹³² See Alison Bennett, *Administration Urges Finance Action on ETI; WTO Retaliation Decision Pushed to August*, DAILY TAX REP., July 31, 2002, at G-11 (members of the group include Senator Max Baucus, Chairman of the Senate Finance Committee, Senator Charles Grassley, Ranking Member of the Senate Finance Committee, Robert Zoellick, U.S. Trade Representative, Kenneth Dam, Deputy Secretary of the U.S. Treasury Department, and Representative Bill Thomas, Chair of the House Ways and Means Committee).

¹³³ Alison Bennett, *Make New Law Top ETI Working Group Goal, Dam Says; Thomas Bill Wins Endorsement*, DAILY TAX REP., Sept. 25, 2002, at G-10.

¹³⁴ Alison Bennett, *Aide Says Grassley Sees Long Road in Finding Solution for Export Tax Regime*, DAILY TAX REP., Dec. 17, 2002, at G-5.

¹³⁵ Gary C. Hufbauer, *The Foreign Sales Corporation Drama: Reaching the Last Act?*, PB02-10 INT'L ECON. POL'Y BRIEFS at 9, (2002) (stating "[w]hen Congress adjourned in October 2002, the FSC/ETI debate was at an impasse: a Senate approach [i.e., resolving the dispute by reaching a negotiated settlement with the E.U.], a House approach [i.e., finalizing a legislative solution], discontented exporters, and no winning coalition").

¹³⁶ Bennett, *Thomas Unveils Broad International Tax Bill As Party Tensions Build in Ways and Means*, *supra* note 129, at GG-1.

¹³⁷ I.R.C. § 163(j).

loans may not be deducted if the corporation (i) has a debt-to-equity ratio exceeding 1.5 to one, (ii) the recipient of the interest payments is shielded from U.S. taxation, and (iii) the corporation's net interest expense is more than fifty percent of its adjusted taxable income.¹³⁸ Stated more simply, if a corporation's debt capital (i.e., the money that it received in return for issuing promissory notes or bonds on which it must pay interest to the holders) is greater than 1.5 times its equity capital (i.e., the money that it received in return for issuing stock on which it may pay dividends to the shareholders), then the corporation cannot deduct more than one-half of its taxable income as interest payments to a related, yet untaxed, party.¹³⁹ The disallowed interest deductions can be carried forward indefinitely.¹⁴⁰

The American Competitiveness Act would make considerable changes. First, instead of utilizing a debt-to-equity analysis, the bill would not allow a deduction for interest paid by the domestic corporation to the extent that the domestic corporation's debt-to-asset ratio surpasses the foreign parent's worldwide debt-to-asset ratio.¹⁴¹ Second, the net interest expense allowed is reduced from fifty percent to thirty-five percent.¹⁴² Finally, the disallowed interest payments can only be carried forward for five years, as opposed to indefinitely under current law.¹⁴³ Due to the fact that these changes to the earnings stripping provision will affect not only inversions, but also foreign corporations operating in the United States, many analysts warn that these modifications will severely prejudice foreign investment in the United States. Written complaints to this effect have been submitted by the U.S. Council for International Business,¹⁴⁴ the National Association of Manufacturers,¹⁴⁵ the Center for Freedom and Prosperity,¹⁴⁶ Tax Founda-

¹³⁸ *Id.*

¹³⁹ In justifying the restriction on certain related-party interest payments, Congress explained that

[I]t is appropriate to limit the deduction for interest that a taxable person pays or accrues to a tax-exempt entity whose economic interests coincide with those of the payor. To allow an unlimited deduction for such interest permits significant erosion of the [U.S.] tax base. Allowance of unlimited deductions permits an economic unit that consists of more than one legal entity to contract with itself at the expense of the [U.S.] government . . . [A] limitation on the ability to 'strip' earnings out of this country through interest payments in lieu of dividend distributions is appropriate.

H.R. Rep. No. 101-247, 101st Cong. 1241-1242 (1989).

¹⁴⁰ I.R.C. § 163(j).

¹⁴¹ Technical Explanation of H.R. 5095, *supra* note 129, at 42-43.

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ Daniel A. Nichols & Richard M. Hammer, *Int'l Bus. Council Letter on Corporate Inversions*, 23 INS. TAX REV. 595 (2002).

¹⁴⁵ Letter from Michael E. Baroody, Executive Vice President, National Association of Manufacturers, to Rep. William Thomas, Chairman, House Comm. on Ways and Means (July 11, 2002) at http://www.nam.org/Docs/TBCF/25025_ltr-earnings-strippings-NAM-7-11-02.pdf (last visited Sept. 4, 2003).

tion,¹⁴⁷ the Confederation of British Industry,¹⁴⁸ KPMG Washington,¹⁴⁹ and the Organization for International Investment.¹⁵⁰ According to the Tax Foundation, these proposed legislative changes will lead to higher prices for U.S. consumers, lower wages for employees and decreased earnings for company shareholders. More importantly, perhaps, these modifications could generate a further erosion of the U.S. tax base and retaliation by many trading partners of the United States, who already consider the U.S. rules on inter-company lending to be excessively stringent.¹⁵¹ The Organization for International Investment, a business association representing the interests of U.S. subsidiaries of foreign corporations, also warns that the American Competitiveness Act would have unanticipated, egregious consequences.¹⁵² In the opinion of this organization, changes to the earnings stripping rules “will substantially raise the cost of doing business in the United States for U.S. subsidiaries [of foreign corporations], deterring expansion of existing operations and future new investment in the U.S.—consequences that will be felt in nearly every state and industry across the country.”¹⁵³

While laudable in its ability to trigger productive debate on the issue, the omnibus approach represented by the American Competitiveness Act seems ineffectual because of its breadth (i.e., covering tax shelters, inversions, and international competitiveness in one bill), the continued discord regarding the appropriate manner to address the ETI Act issue, and the reputed harshness of the proposed earning stripping provisions.

F. Re-domestication via New Corporate Residency Rules

Another proposed method to stem corporate inversions is to “re-domesticate” the inverted corporations by introducing new rules to determine the residence of a corporation for tax purposes. The treatment of a multinational corporate group under U.S. tax law depends in large part on whether the parent corporation is considered a “domestic” or “foreign” corporation. Under current law, a corporation is “domestic” if it is created or

¹⁴⁶ Center for Freedom and Prosperity Letter on Proposed Corporate Inversion Moratorium, 23 INS. TAX REV. 595 (2002).

¹⁴⁷ Hodge, *supra* note 113, at 2.

¹⁴⁸ Digby Jones, *British Industry Group Reiterates Concerns Over Earnings-Stripping Provisions*, TAX NOTES TODAY, May 1, 2003, at 12.

¹⁴⁹ Harry L. Gutman et. al., *KPMG Urges Reconsideration of Proposals Regarding Earnings-Stripping Provision*, TAX NOTES TODAY, May 1, 2003, at 13.

¹⁵⁰ Letter from Todd M. Malan, Executive Director, Organization of International Investment, to Rep. William Thomas, Chairman, House Comm. on Ways and Means (July 31, 2002) at http://www.ofii.org/issues/OFIL_201_Letter.pdf (last visited Sept. 4, 2003) (hereinafter Letter from Todd M. Malan to Rep. William Thomas).

¹⁵¹ Hodge, *supra* note 113, at 9.

¹⁵² See ORGANIZATION FOR INTERNATIONAL INVESTMENT, BUDGET PROPOSAL ON RELATED PARTY INTEREST EXPENSE 10-11 (2003), available at www.ofii.org/OFIL_White_Paper.pdf (last visited Sept. 4, 2003).

¹⁵³ Letter from Todd M. Malan to Rep. William Thomas, *supra* note 150, at 1.

organized in the United States,¹⁵⁴ whereas a “foreign” corporation is one that is formed in a foreign nation.¹⁵⁵ In other words, the place of incorporation determines whether a corporation is treated for tax purposes as domestic or foreign, regardless of other factors such as the location of a corporation’s management activities, employees, officers, shareholders, assets, operations, sources of revenue, etc. As explained above, an inversion has the effect of legally relocating the residency of a corporation to a low-tax jurisdiction such as Bermuda, the country in which the new parent corporation is organized or chartered. However, the location of the corporate group’s business operations, employees, and management remains unchanged.

As a way to discourage inversions, some experts suggest scrapping the existing place-of-residency rules and replacing them with a management-and-control test.¹⁵⁶ Under this new standard, the legal residency of the corporation would be based on where the decision-makers (i.e., managers, officers, and directors) of the corporate group are located, as opposed to where the parent corporation is legally organized. This less formalistic, more fact-and-circumstance oriented test, would remove the incentive for domestic corporations to invert, while not requiring a major legislative overhaul.¹⁵⁷ Moreover, this new standard should gain acceptance on an international level since many of the U.S. trading partners already utilize similar concepts in their tax systems.¹⁵⁸ Also, if properly implemented, this test should render accurate results since it is more compatible with the “real” business world.¹⁵⁹

This new management-and-control test raises several concerns. First, the workability of the standard will depend to a large extent on the nature of the criteria employed. If the object of the test is to determine simply where meetings of a company’s board of directors can occur, then the test could be circumvented with ease. On the other hand, if the test requires the analysis

¹⁵⁴ I.R.C. § 7701(a)(3)-(4).

¹⁵⁵ *Id.* § 7701(a)(3), (5).

¹⁵⁶ Lee A. Sheppard, *Preventing Corporate Inversions*, 26 TAX NOTES INT’L 8 (2002); see also *Corporate Inversions: Hearing Before the S. Subcomm. on Treasury and Gen. Gov’t of the Comm. of Appropriations*, 107th Cong. (2002) [hereinafter *Corporate Inversions: Hearing Before the S. Comm of Appropriations*] (statement of William Gale); N.Y. Bar Ass’n Tax Section Rep., *supra* note 90, at 60.

¹⁵⁷ See Buckley & Davis, *supra* note 81, at 454 (explaining that virtually every corporation that has already inverted would be treated as a “domestic” corporation under a management-and-control test, which is “the exact result reached in the anti-inversion bills”).

¹⁵⁸ See N.Y. Bar Ass’n Tax Section Rep., *supra* note 90, at 60.

¹⁵⁹ *Corporate Inversions: Hearing Before the S. Comm of Appropriations*, *supra* note 156, at 25 (statement of Prof. Reuven Avi-Yonah) (stating that if this standard is carefully defined and interpreted, “the managed and controlled test offers the most promising current definition of corporate residency—the one most congruent with business realities and therefore the least open to abuse”).

of a multiplicity of factors, uncertainty will result.¹⁶⁰ Another unsettled issue is the scope of the standard; that is, whether it should apply only to classic inversions where a domestic corporation is relocated to a foreign nation, or also to multinational corporate groups, incorporated abroad, that incorporate structures resulting acquired from a U.S. entity.¹⁶¹ A further fear is that this test could generate unanticipated, and perhaps unwelcome, consequences in other areas of tax and corporate law.¹⁶² Commenting on the danger that a management-and-control test may dissuade management from situating itself in the United States, Rep. Gary Hufbauer has noted that “[I]t’s far more important for the United States to remain the nerve center for multinational corporations than to collect whatever revenue is gathered from the activities of foreign subsidiaries by the cumbersome U.S. system of taxing worldwide.”¹⁶³ Tax havens could seek to facilitate corporations’ illicit avoidance of the spirit of the test.¹⁶⁴

G. Redomestication by Disregarding Attempted Inversions

Several recently-introduced pieces of legislation aim to deny tax benefits to certain inversion transactions by deeming newly-formed foreign parent corporations to be domestic corporations for U.S. tax purposes.¹⁶⁵ Thus, in determining the U.S. tax liability of a typical multinational corporate group and its shareholders, the inversion transaction would effectively be ignored.¹⁶⁶ Proponents of such legislative measures are aware of the existence of more fundamental problems with U.S. international tax law.

¹⁶⁰ N.Y. Bar Ass’n Tax Section Rep., *supra* note 90, at 66; *see also Corporate Inversions: Hearing Before the S. Comm of Appropriations*, *supra* note 156, at 26 (statement of Prof. Reuven Avi-Yonah).

¹⁶¹ N.Y. Bar Ass’n Tax Section Rep., *supra* note 90, at 66.

¹⁶² *Id.* at 66-67.

¹⁶³ *Corporate Inversions: Hearing on H.R. No. 107-73 Before the Committee on Ways and Means, Subcommittee on Select Revenue Measures*, 107th Cong. 43 (2002) [hereinafter *Hearing on H.R. No. 107-73*].

¹⁶⁴ *See Sheppard*, *supra*, note 156 (stating, “on a tax haven island, you can get an accommodating government to issue any tax ruling you want”).

¹⁶⁵ *See* H.R. 3857, 107th Cong. (2002); Corporate Patriot Enforcement Act of 2002, H.R. 3884, 107th Cong. (2002); Save America’s Jobs Act of 2002, H.R. 3922, 107th Cong. (2002); Uncle Sam Wants You Act of 2002, H.R. 4756, 107th Cong. (2002); S. 2050, 107th Cong. (2002); *see also* Background and Description of Present-Law Rules and Proposals Relating to Corporate Inversion Transactions, JCX-52-02 at 6-7 (2002) (summarizing H.R. 3857, H.R. 3884, H.R. 3922, H.R. 4756, and S. 2050).

¹⁶⁶ H.R. 3857 would apply if, immediately after the inversion transaction, more than eighty percent of the stock of the newly-formed foreign parent is held by the former shareholders of the domestic corporation. Moreover, the test would be lowered to fifty percent if (i) the stock of the foreign corporation is traded on a U.S. stock exchange, (ii) less than ten percent of the foreign corporation’s gross income is earned from activities in the country where the foreign corporation is organized, and (iii) less than ten percent of the foreign corporation’s employees are permanently located in that country. *See* H.R. 3857, 107th Cong. (2002).

However, they insist that halting corporate inversions is a matter of first priority. In the words of U.S. House Representative James H. Maloney, sponsor of one such bill,

We must not wait. Certainly, the tax system needs to be reformed. But there is no reason that fixing the immediate problem needs to be contingent upon reforming the entire system. If your house, which may be in need of remodeling, also has a fire in the attic, you don't do the remodeling first. Instead, you put out the fire immediately, and then move on to the longer range tasks. This is precisely the case here: we need to put out the raging fire of this expatriate tax abuse—and then move on to remodel our tax code.¹⁶⁷

A number of bills designed to deter corporate inversions have been introduced.¹⁶⁸ According to the sponsor a bill that would impose an immediate yet temporary moratorium on inversions, this method is advantageous because it can be enacted and implemented more quickly than a permanent measure.¹⁶⁹ It has further been argued that the effective period of a temporary moratorium will provide lawmakers and the U.S. Treasury Department the time necessary to discuss and craft an appropriate long-term solution, and corporations will be less inclined to invest the time and money needed to attempt to circumvent a moratorium due to its ephemeral nature.¹⁷⁰ Support for a temporary solution has been voiced by the Bush Administration,¹⁷¹ as well as certain influential bar associations.¹⁷²

Those opposing any bill that would ban inversions have referred to such legislative proposals as mere stop-gap “Band-Aids,”¹⁷³ emphasizing that “this is about the tenth fire in the kitchen.”¹⁷⁴ They also argue that it would be wise to examine the problems underlying the inversion issue be-

¹⁶⁷ *Hearing on H.R. No. 107-73, supra* note 163, at 44 (statement by Rep. James H. Maloney).

¹⁶⁸ See generally H.R. 3857, 107th Cong. (2002); Corporate Patriot Enforcement Act of 2002, H.R. 3884, 107th Cong. (2002); Save America's Jobs Act of 2002, H.R. 3922, 107th Cong. (2002); Uncle Sam Wants You Act of 2002, H.R. 4756, 107th Cong. (2002); S. 2050, 107th Cong. (2002).

¹⁶⁹ *Corporate Inversions: Hearing on H.R. 3884 and 4993, supra* note 37, at 15-16, 39-40 (statement by Rep. Nancy Johnson). Representative Johnson introduced the bill on May 16, 2002.

¹⁷⁰ *Id.*

¹⁷¹ Sue Kirchhoff, *Bush Backs Tax-Haven Moratorium*, BOSTON GLOBE, June 7, 2002, at D1.

¹⁷² Andrew N. Berg, *NYSBA Discusses Corporate Inversions*, 26 TAX NOTES INT'L 1195 (2002).

¹⁷³ Sheppard, *supra* note 156 (arguing that the impetus for inversions are the “misguided residence rules” and “ineffectual outbound transaction rules”).

¹⁷⁴ *Corporate Inversions: Hearing on H.R. 3884 and 4993, supra* note 37, at 35 (statement by Rep. Kevin Brady).

fore acting.¹⁷⁵ The breadth of the anti-inversion bills has also been questioned. The U.S. Treasury Department recently highlighted that the negative consequences of inversions can also result when multinational corporations incorporate in foreign countries at their inception or when multinational entities structure cross-border mergers or acquisitions in such a way that the domestic company becomes a subsidiary of a foreign corporation.¹⁷⁶ Any anti-inversion bill that fails to address these other phenomena will be inadequate.¹⁷⁷

H. Comprehensive Approach Presented by the U.S. Treasury Department

Unlike congressional bills introduced thus far, the U.S. Treasury Department advocates a more comprehensive approach, one that not only addresses inversion, but also addresses the phenomena of multinational businesses incorporating at their inception in foreign tax haven states and multinational entities structuring cross-border mergers or acquisitions in such a way that the domestic company becomes a subsidiary of a foreign corporation.¹⁷⁸

The Treasury Department Office of Tax Policy argues that the policy response to corporate inversions should therefore “be broad enough to address the underlying differences in the U.S. tax treatment of domestic corporations U.S.-based companies and foreign-based multinational corporations companies without regard to how foreign-based status is achieved.”¹⁷⁹ Second, an outright ban on inversions would prove futile because, according to high-ranking Treasury officials, any congressional attempt to erect a Berlin Wall around the United States “is unlikely to work and likely to have harmful effects on the U.S. economy.”¹⁸⁰ Finally, simply halting inversions would be tantamount to addressing the symptoms without bothering to examine the disease because, according to the U.S. Treasury Department, the fundamental illness is the outdated international tax rules

¹⁷⁵ *Id.*

¹⁷⁶ OFFICE OF TAX POL’Y, *supra* note 17, at 2.

¹⁷⁷ *Id.* This report warns that measures designed to simply halt inversions may be an acceptable short-term solution, but there is a “serious risk” such narrow solutions may unwittingly encourage a shift to other forms of businesses transactions that would be detrimental to the U.S. economy in the long run.

¹⁷⁸ *Id.*

¹⁷⁹ *Id.* at 20.

¹⁸⁰ *Hearing on H.R. No. 107-73, supra* note 163, at 27 (statement of Pamela F. Olson, Assistant Treasury Secretary for Tax Policy). Olson clearly understands the tax game: “[T]ax lawyers are among the most creative people alive and if you erect some kind of a rule, they will find their way around it.” *Id.*; *see also* OFFICE OF TAX POL’Y, *supra* note 17, at 30.

that place certain domestic corporations at a competitive disadvantage in the world market.¹⁸¹

The broader approach recommended by the U.S. Treasury Department involves several components, including (i) revising the interest-disallowance rules in § 163(j) of the Code concerning the deductibility of interest payments on inter-company loans, (ii) updating the cost-sharing regulations under § 482 of the Code and reviewing cross-border transfers so that they cannot be used to shift income outside of the United States, (iii) evaluating income tax treaties to identify any inappropriate reductions in U.S. withholding taxes that may provide opportunities for shifting income out of the United States, (iv) establishing a new reporting requirement for stock transfers in connection with inversion transactions in order to ensure that shareholders pay the appropriate amount of taxes on any gain, and (v) changing the corporate organization and reorganization rules (such as § 367 and the corresponding regulations) to allow proper taxation in the case of cross-border transactions.¹⁸²

As is predictable with a controversial issue, the U.S. Treasury Department proposal faces considerable criticism. For example, while this multifaceted approach was introduced in mid-2002, progress to date has been notably sluggish. In particular, in late 2002 proposed regulations setting forth the reporting requirements for stock transfers in connection with inversion transactions were issued.¹⁸³ The remaining four components of the proposal, however, have not yet been publicly addressed. A further concern is that tightening the rules regarding the deductibility of interest on inter-company loans under § 163(j) of the Code could be damaging to foreign corporations operating in the United States that have neither participated in, nor benefited in any way from, an inversion transaction. The seriousness of this issue is evidenced by the appreciable amount of complaints that the Bush Administration and the U.S. Treasury Department have already re-

¹⁸¹ Press Release, Pamela Olson, U.S. Treasury Dept., Remarks to the Tax Executives Institute (Dec. 18, 2002) (likening international tax rules, enacted with the 1986 Internal Revenue Code, to teenagers: "They're hard to understand, messy, inconsistent, and display little regard for the real world.").

¹⁸² See Press Release, U.S. Treasury Dep't., Current WTO-Induced Issues in U.S. Taxation of Int'l Bus. (Oct. 8, 2002) (on file with author); OFFICE OF TAX POL'Y, *supra* note 17; *Hearing on H.R. No. 107-73, supra* note 163 (statement of Pamela F. Olson).

¹⁸³ Press Release, U.S. Treasury Dept., Treasury Issues Proposed Regulations on Inversion Transaction Reporting (Nov. 12, 2002). According to Treasury Department officials, these new reporting requirements will increase the Internal Revenue Service's access to information on inversions and remind shareholders that they must report gain from inversions on their tax returns. See also Edward Alden, *HQ Moves Offshore 'Must Be Reported'*, FIN. TIMES, Nov. 13, 2002, at 9; *IRS Seeks to Claim Tax on Offshore Moves: New Regulations Require Filing on Transactions to Help the Agency Track Reincorporations*, L.A. TIMES, Nov. 13, 2002, at 4.

ceived on this issue from lobbyists for foreign-owned corporations,¹⁸⁴ the Swiss-American Chamber of Commerce,¹⁸⁵ Netherlands Chamber of Commerce¹⁸⁶, the Federation of German Industries¹⁸⁷ and representatives from Puerto Rico and other U.S. possessions.¹⁸⁸ The U.S. Treasury Department made a partial concession, recently agreeing to “consider refinements” to its proposed changes to the earnings stripping rules in § 163(j) of the Code.¹⁸⁹ Others are concerned that by not out-and-out repudiating inversions, the U.S. Treasury Department proposal effectively legitimizes these transactions, which will lead to an increase in the transactions in the future.¹⁹⁰ Finally, tax practitioners argue that updating the cost-sharing and transfer-pricing rules under § 482 of the Code is senseless since (i) there is little evidence to support the accusation that inverted corporations are abusing the current rules, (ii) the overwhelming majority of multinational corporate groups already have significant transfer-pricing compliance programs in place, and these companies are unlikely to violate the current rules knowing that they are already under significant scrutiny by the Internal Revenue Service, and (iii) the enactment of stricter rules would simply result in an additional regulatory burden for the companies and a misallocation of resources for the Internal Revenue Service.¹⁹¹

I. Unorthodox Solutions

Along with legislative solutions, a number of unconventional ideas have been proposed to deter inversions. For instance, indignant that several of the corporations that have inverted in order to avoid the payment of U.S. income tax continue to profit from public tax dollars vis-à-vis contracts with government agencies, lawmakers urged Congress to prohibit this prac-

¹⁸⁴ Edward Alden, *U.S. Tax Plans to Hit Foreign Companies*, FIN. TIMES, May 24, 2002, at 9.

¹⁸⁵ Walter Diggelmann, *Swiss-American Chamber of Commerce Criticizes U.S. Treasury's Corporate Inversion Proposals*, 27 TAX NOTES INT'L 676 (2002).

¹⁸⁶ Jan Flinterman, *Netherlands Chamber of Commerce Asks Treasury to Address Corporate Inversions Problem*, 23 INS. TAX REV. 595 (2002).

¹⁸⁷ Pamela F. Olson, *Olson Thanks Writer for Letter on Corporate Inversions Transactions*, 96 TAX NOTES 1326 (Sept. 2, 2002).

¹⁸⁸ Ralph J. Sierra, *Writer Seeks Support for Corporate Inversions*, 96 TAX NOTES 356 (July 15, 2002).

¹⁸⁹ Alison Bennett, *Treasury Willing to Look at Refinements to Earnings Stripping Safe Harbor Proposal*, DAILY TAX REP., March 5, 2003, at G-4.

¹⁹⁰ Sullivan, *supra* note 100 (arguing that eliminating the negative stigma associated with inversions and providing clear guidelines on this issue, the Treasury Department proposal will essentially backfire, and stating, “Treasury’s approach . . . suffers from a major flaw. It may not work.”). See also *Corporate Inversions: Hearing on H.R. 3884 and 4993*, *supra* note 37, at 6 (statement of Rep. Lloyd Dogget) (arguing that the Treasury Department’s decision not to support an outright ban on inversions demonstrates that it does not grasp the seriousness of the problem).

¹⁹¹ Peterson & Cohen, *supra* note 19 at 161, 185.

tice.¹⁹² Although government studies cast considerable doubt on the validity of this contention,¹⁹³ measures were recently taken in Washington to prevent inverted corporations from obtaining contracts with the Department of Homeland Security, except in limited circumstances.¹⁹⁴ A second method to discourage inversions is to exert various forms of economic and market pressure. As an example, one lawmaker recently urged the public to boycott the products of inverted corporations.¹⁹⁵ Economic pressure has also been generated by an advertising campaign launched in April 2003 that is designed to raise awareness of corporate inversions and their cost to the average U.S. taxpayer. Sponsored by the so-called "Bermuda Project," these television messages blame the Bush Administration for its alleged complicity with corporate America, and juxtapose images of U.S. soldiers in Iraq with those of businessmen lighting cigars with burning cash in order to provoke the audience.¹⁹⁶ California's state treasurer recently employed monetary coercion when he announced that his office refuses to engage in business with inverting companies.¹⁹⁷ As a result, the treasurer is unable and unwilling to invest in any inverting company with funds from the state's \$45 billion investment account.¹⁹⁸

¹⁹² *Corporate Tax Shelters: Hearing Before the S. Subcomm. on Treasury*, *supra* note 50, at 28 (statement of Sen. Charles Grassley) (explaining that "we have corporations on the one hand evading U.S. taxes, and on the other hand making profits off of the taxes that people are paying because they are not leaving the country, the middle class Americans. . .").

¹⁹³ U.S. G.A.O., *Information on Federal Contractors That Are Incorporated Offshore*, Report GAO-03-194R (Oct. 1, 2002). Upon the request of Congress, the General Accounting Office ("GAO") conducted an investigation to determine which, if any, of the one hundred largest publicly-traded federal contractors are incorporated in a tax-haven country or have been engaged in an inversion transaction. The GAO report found that only four percent were incorporated in tax havens, and a mere three percent had engaged in an inversion.

¹⁹⁴ Mike Madden, *Senate Approves Wellstone Provision Denying Contracts to Corporate Tax Evaders*, GANNETT NEWS SERVICES, Sep. 6, 2002 (available at LexisNexis). While the Department of Homeland Security would generally be barred from contracting with any U.S. company that inverted after November 2002, exceptions exist if contracting is necessary in the interest of national security, to protect domestic jobs, or to prevent the government from incurring additional costs. See Katherine M. Stimmel, *Senate Approves Amendment to Tighten Limits on Contracts to Inverting Companies*, DAILY TAX REP., Jan. 24, 2003, at G-5; see also Susan Milligan, *Senate Takes Aim at Offshore Tax Havens: Firms Would Lose Defense Contracts*, BOSTON GLOBE, Aug. 1, 2002, at A6.

¹⁹⁵ *Corporate Tax Shelters: Hearing Before the S. Subcomm. on Treasury*, *supra* note 50, at 21 (statement of Sen. Charles Grassley) (labeling companies that invert "tax cheats," and stating his hope that "people remember this when it comes to shop for products that this company offers [because] [w]e ought to be able to expect American companies to have their heart in America").

¹⁹⁶ Constance Parten, *TV Advertising Campaign Launched to Push Corporate Expatriation Legislation*, DAILY TAX REP., Apr. 10, 2003, at G-4.

¹⁹⁷ Laura Mahoney, *CALPERS Calls on Expatriate Companies to Return Incorporation to United States*, DAILY TAX REP., Nov. 20, 2002, at G-5.

¹⁹⁸ *Id.*

On a more radical note, some officials have threatened to impose criminal charges on the executives of inverting corporations. In June 2002, taking advantage of the public's disgust with corporate executives in the wake of the Enron collapse, the district attorney in New York City warned that he would attempt to prosecute for tax evasion those business leaders who opt to invert.¹⁹⁹ While this maneuver has been criticized for improperly blurring the line between legitimate tax avoidance and illegal tax evasion, it undoubtedly produced the desired effect: "The message to other corporate executives with companies based in New York could not be clearer: those who try to save taxes for their shareholders by reincorporating abroad run the risk of going to jail."²⁰⁰ Pressure against inverting has also been applied by the owners of the corporations themselves; that is, the stockholders. For example, although Tyco International has considerably reduced its tax burden after it inverted to Bermuda in 1997, the company is now "taking a fresh look" at reincorporating in the United States because of shareholder pressure to do so.²⁰¹ Likewise, McDermott International, a corporation that is currently based in Panama, has agreed to put the issue of reincorporation to a shareholder vote in 2003.²⁰² Finally, in addition to facing pressure at the federal level, inverted corporations have come under criticism from various states. Among others, Massachusetts, Pennsylvania and Texas are sponsoring legislation that would impose an outright ban on state contracts with inverted entities.²⁰³

VI. A NECESSARY COMPROMISE

Disregarding claims that corporate inversions are "unpatriotic" as well as other arguments without merit, it is still evident that these transactions have several harmful effects on the United States, such as diminishing the overall U.S. tax base (thus forcing individual taxpayers to pay a higher portion of taxes), obligating domestic corporations to invert in order to compete with their competitors, subverting public confidence in the voluntary tax system and lessening shareholder rights. Sensible tax policy, therefore, demands the identification of a suitable solution. The majority of the pro-

¹⁹⁹ See Bruce Bartlett, *Inversions, Not Evasions*, NAT'L. REV. ONLINE, June 12, 2002, at http://www.nationalreview.com/nrof_bartlett/bartlett061202.asp.

²⁰⁰ *Id.*

²⁰¹ Andrew Hill & Andrew Parker, *Tyco Considers HQ Move to End Doubts*, FIN. TIMES, Oct. 7, 2002, at 18.

²⁰² Laura Mahoney, *McDermott Will Weigh Move Back to U.S. Under Agreement With CALPERS, AFSCME*, DAILY TAX REP., April 2, 2003. (reporting that significant company shareholders, such as the California Public Employees Retirement System and the American Federation of State, County, and Municipal Employees, are spearheading the reincorporation campaign).

²⁰³ Andrew Hill, *Offshore Companies Urged to Rally to U.S. Flag*, FIN. TIMES, Mar. 5, 2003, at 18.

posals submitted to date are economically or politically implausible. For the reasons set forth above, it is highly improbable that the inversion issue can be resolved by adopting a territorial tax system, significantly lowering the corporate tax rate, refraining from action in order to allow self-help territoriality, pressuring tax haven countries into altering their tax or corporate laws to the benefit of the United States, adopting an omnibus bill that encompasses multiple international tax issues (i.e., inversions, tax shelters, and international competitiveness) or by re-domesticating inverted corporations through the adoption of new corporate residency rules centered on management-and-control.

Unfortunately, instead of working jointly to resolve the issue, it seems that Congress and the U.S. Treasury Department have taken divergent paths and find themselves at somewhat of an impasse. On one hand, the bills introduced in Congress thus far would generally eliminate all the tax benefits of any transaction that falls within its definition of "inversion" by deeming the top-tier foreign corporation a domestic corporation for tax purposes.²⁰⁴ Moreover, congressional leaders emphasize that permanent legislation covering the singular issue of inversions should be enacted immediately.²⁰⁵

On the other hand, the U.S. Treasury Department would apply its provisions to a broader set of transactions, including classic inversions where the corporate group is originally organized in the United States and then reincorporates overseas, the situation where a corporate group is formed in a tax haven country from the outset and international mergers that result in the domestic company becoming a U.S. subsidiary of a foreign corporation.²⁰⁶ Additionally, the U.S. Treasury Department believes that a delayed decision on this issue is preferable because any drastic moves would prove fruitless in the long run and detrimental to the overall U.S. economy.²⁰⁷

In light of this continuing discord, perhaps a compromise (a term with many negative connotations in Washington) represents the most feasible method of resolving the issue. As a short-term solution, members of Congress and representatives of the U.S. Treasury Department should collabo-

²⁰⁴ See Joint Committee on Taxation, *Background and Description of Present-Law Rules and Proposals Relating to Corporate Inversion Transactions* (2002). The bills include (i) H.R. 3857, introduced Mar. 6, 2002; (ii) Corporate Patriot Enforcement Act, introduced Mar. 6, 2002; (iii) H.R. 3922, Save America's Jobs Act of 2002, introduced Mar. 11, 2002; (iv) H.R. 4756, Uncle Sam Wants You Act of 2002, introduced May 16, 2002; and (v) S. 2050, introduced Mar. 21, 2002.

²⁰⁵ See *Hearing on H.R. No. 107-73, supra* note 163, at 44 (statement of Sen. James H. Maloney).

²⁰⁶ OFFICE OF TAX POL'Y, *supra* note 17, at 2.

²⁰⁷ See *Corporate Inversions: Hearing on S. 2119, supra* note 41 (statement of Pamela F. Olson, Dep't of Treasury) (warning that a rapid response would consist of a ban on inversions, which, in her opinion, is akin to treating the symptoms while ignoring the true disease. In such a case, "the disease would live on and manifest itself in alternatives that achieved the same result with equally—or more—unfortunate consequences for the economy.").

rate to draft and enact a piece of legislation that would serve to halt the recent outbreak of inversions. With the aim of ensuring that the U.S. Treasury Department does not fall victim to organizational apathy immediately thereafter, this legislation should contain one provision specifying that the law would remain in effect for only a relatively brief period (e.g. two years), and another provision explicitly requiring the U.S. Treasury Department to continue to conduct in-depth studies and to present precise legislative recommendations for changes to existing U.S. international tax rules within that two-year period.²⁰⁸ Although this initial legislation would ideally apply in a just manner to all three relevant situations (i.e., inversions, foreign start-ups, and international mergers where the domestic parent becomes a subsidiary), rules germane to only the first two would still be acceptable for several reasons. For example, despite claims to the contrary, little evidence exists that avoiding the application of the anti-deferral regimes of U.S. international tax law motivates cross-border mergers or acquisitions.²⁰⁹ It is further suggested that the idea that foreign takeovers of domestic companies are attributable to flaws in the U.S. tax system may simply be a "myth." Indeed, many of these international mergers are just part of a worldwide trend of consolidations in which the stronger foreign company survived for purely business reasons.²¹⁰ Also, passing any anti-inversion legislation that would inadvertently lessen foreign direct investment in the United States would be damaging to the national economy.²¹¹ With the enactment of this provisional legislation and the media attention that it will undoubtedly trigger, inversions will be effectively halted, at least for a certain period.

Meanwhile, the desirability of inverting should continue to decline as the variety of market mechanisms begin to take effect. One may speculate, for instance, that depriving inverted corporations of the ability to contract with certain federal and state agencies will render this transaction less appealing.²¹² Television campaigns harshly criticizing inversions and the threat of criminal prosecutions of corporate directors should further dissuade several of these corporate restructurings.²¹³

As a long-term solution, the U.S. Treasury Department should proceed with its project of (i) revising the interest-disallowance rules in § 163(j) of the Code, (ii) updating the cost-sharing regulations under § 482 of the Code

²⁰⁸ See N.Y. Bar Ass'n Tax Section, *supra* note 90, at 3-4; see also *Corporate Inversions: Hearing on H.R. 3884 and 4993*, *supra* note 37, at 10.

²⁰⁹ See *id.*

²¹⁰ See Buckley & Davis, *supra* note 81.

²¹¹ See Current WTO-Induced Issues in U.S. Taxation of International Business Section, *supra* note 182. Deputy Secretary of the Treasury Dep't Kenneth Damk explained that a comprehensive solution to the inversion problem necessarily involves fostering foreign direct investment, which is beneficial for the U.S. economy in general.

²¹² See *supra* Part V(1).

²¹³ *Id.*

and reviewing cross-border transfers so that they cannot be used to shift income outside of the United States, (iii) evaluating income tax treaties to identify potential inappropriate reductions in U.S. withholding tax facilitated by income shifting, (iv) establishing a new reporting requirement for stock transfers in connection with inversion transactions, and (v) changing the corporate reorganization rules (such as § 367 and the corresponding regulations) to allow proper taxation in the case of cross-border transactions.²¹⁴ During this process, the U.S. Treasury Department should regularly interchange ideas with politicians, tax gurus, legal experts, policy advisors, etc., to identify practical, and perhaps novel, solutions. It should, moreover, urge Congress to hold multiple hearings on the issue in order to gauge progress and identify additional ideas. Then, before the two-year tenure of the legislation expires, the U.S. Treasury Department should formally present its ideas, which Congress will hopefully transform into new international tax law.

Throughout this process, all parties involved should endeavor not to punish those corporations that legally inverted in the past, but rather to modernize the U.S. international tax rules in such a way that multinational corporate groups consider the United States a model country in which to organize, manage and operate.²¹⁵ This, without any doubt whatsoever, would be beneficial to the nation as a whole.

²¹⁴ See e.g., Current WTO-Induced Issues in U.S. Taxation of International Business Section, *supra* note 182; see also *Hearing on H.R. No. 107-73*, *supra* note 163.

²¹⁵ See Press Release, U.S. Treasury Dep't, U.S. Assistant Treasury Sec'y for Tax Pol'y, Pam Olson: Remarks to the Tax Executive Institute (Dec. 18, 2002) (on file with author) (this high ranking treasury official seems willing to make the requisite changes. As Olson explains, the current international tax system is so complicated that it has undermined public confidence, and it is held together by "chewing gum" and "chicken wire." Thus, in her opinion, "[i]t is time for us to clean house.").