Corporate America Studies Abroad: An Incentive Analysis of Tax Inversion and the Costs to Consumers

Thomas J K Schick
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"Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant."

-Judge Learned Hand

INTRODUCTION: TAXES TURNED UPSIDE DOWN

Embrouled in legislative and moral arguments, one of the most prominent contemporary political and economic debates revolves around corporate tax inversion. But American consumers cannot be forgotten in this clash between corporate titans and Washington D.C. The effects of tax inversion stretch beyond Wall Street and Pennsylvania Avenue; they have significant impacts on Main Street, as well. This article explores the past and future state of corporate tax inversion with a focus on the effect the practice and potential solutions have and may have on consumers.

Stated most simply, tax inversion occurs when a corporation relocates its legal domicile internationally to lower its tax burden on corporate income. In practice, tax inversions are transactions where the corporation becomes a subsidiary of a new parent company that is

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domiciled outside the United States, usually through a merger or acquisition. The result of the transaction is a multi-million-dollar discount on the inverting corporation’s tax bill.

Losing billions of dollars in corporate tax revenue to mostly overseas tax havens vexes both politicians and ordinary tax-paying consumers. The Obama Administration actively opposed tax inversion and sought to crack down on corporations that invert by closing loopholes and jointly increasing regulation with the Treasury. From the perspective of the United States government, the efforts were worth the potential payout; according to estimates by the Obama Administration, tax inversion would cost the Treasury about $40 billion between 2016 and 2026. The cost of this “loophole,” President Obama said, “[would] come at the expense of middle class families - because that lost revenue could have been used to invest in our schools, make college more affordable, put people back to work building our roads, and create more opportunities for our children.”

Tax inversion is an equally reviled foe to the Trump Administration. In his tax plan, President Trump specifically targets tax inversion and labels it as an “unacceptable . . . symptom” of uncompetitive American corporate tax rates. Further, President Trump has advocated for lowering the repatriation rate—the tax rate on returning cash stashed overseas to the United States. Despite bipartisan support for reform aimed at slowing tax inversion, neither party has achieved the largescale modifications they seek.

Part I of this article provides context to the discussion, outlines

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4 See id. For example, the merger of Omnicom (United States-based) and Publicis moved the entity’s headquarters to the Netherlands which saved it about $80 million in taxes annually.
6 See id.
7 See id.
8 Id.
10 Id.
the systemic factors of the global tax system relevant to inversion, and distinguishes between worldwide and territorial tax regimes. Part II evaluates the legal framework of tax inversion litigation through a seminal case and the recent Treasury regulations aimed at quelling tax inversion. Part III discusses the impact that tax inversion has on consumers. Part IV analyzes the incentives facing business, political, and consumer actors as they pertain to tax inversion, and it assesses both “carrot” and “stick” policies. With this discussion in mind, Part V briefly concludes and highlights several aspects of the proposed solutions.

I. HOW LOW CAN YOU GO? HOW AND WHY CORPORATIONS INVERT

The goal of tax inversion from a corporation’s perspective is to alleviate its tax burden. Two primary tenets of the global taxation system allow corporations to achieve this goal, namely: 1) Disparities in corporate tax rates across the world; and 2) a different system of taxation outside of the United States.

A. Global Tax Rates: A Numbers Game

A primary factor that drives inversions is that corporate income tax rate in the United States is higher than other developed nations. The United States’ corporate income tax rate of 35% is the highest among the thirty-five Organisation for Economic Co-Operation and Development (“OECD”) member nations; compare the United States’ corporate income tax rate (35%) to the corporate tax rates in Switzerland (8.5%), Ireland (12.5%), the United Kingdom (20%), and the Netherlands (25%), for example. Opponents of tax inversion argue that corporations invert because the American corporate tax rate is simply uncompetitive.

Since 1993, the maximum corporate tax rate in the United

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12 See Definition of Tax Inversion, supra note 3.
15 See id.
16 See id.; Capurso, supra note 13.
States has been 35%. The current rate is still 17% lower than the rate’s twentieth century peak of 52% between 1952 and 1963. Many critics—notably President Trump—opine that if the United States lowers its corporate income tax rate to 15%, fewer nations will invert. However, largescale tax reform is unlikely, and if it is achieved, there must be a reasonable plan to recoup the tax revenue that will be lost by cutting the rate by more than half.

The disparity between the American corporate income tax rate and the rate of other developed nations has led some of the America’s largest companies to explore more favorable tax domiciles. There is pressure in the C-suite to increase profits; this desire is echoed by investors who want additional return on their investments. The potential tax savings stir up interest outside of the C-suite and lead shareholders to pressure companies to invert. In 2014, Pfizer, the world’s largest drug company, made a $100 billion bid to acquire United Kingdom-based drug giant AstraZeneca. Pfizer’s CEO Ian Read stated that the acquisition “was a way of improving our capital allocation by getting Pfizer’s earnings stream into a competitive tax environment.” Pfizer ultimately discontinued pursuing AstraZeneca, but its attempted inversion illustrates big business’ apprehension towards America’s uncompetitive corporate income tax rate. While an important factor for potential inverters, the corporate income tax rate itself is only half of the calculus.

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18 See id.
19 See Trump’s Tax Plan, supra note 9.
20 See KWALL, supra note 17. Reducing the rate to 15% would represent the single largest change to the rate in the last century. Id.
23 See id.
24 See id.
25 See id. (stating that Pfizer walked away from the deal when “[t]he proposal generated a firestorm of controversy in Congress and the British government [and] [i]nvestors were lukewarm”).
B. Worldwide Taxation: No Shelter from the Tax Flood

The United States' system of corporate taxation is globally unique. While most OECD nations use a territorial tax regime, the United States employs a worldwide system of corporate taxation. A worldwide taxation system taxes all income earned by United States corporations, regardless of whether it is earned within the United States or internationally.

Excluding deductions or exemptions, the worldwide taxation regime can be illustrated as follows: Assume that Acme Corporation—an American corporation—pays a 35% corporate income tax rate and earns $10 million of income domestically, $1 million of income in France, and $1 million in Ireland. As an American corporation subject to the tax laws of the United States, all $12 million of Acme Corporation's income would be taxed equally, regardless of origin.

A territorial tax system, on the other hand, taxes a corporation's income by the country in which it is domiciled, but at the corporate tax rate of the country in which it was earned. Nearly all OECD countries employ a territorial system of taxation. To illustrate this system using the example in the preceding paragraph, Acme Corporation would pay the United States corporate tax rate (35%) on its income earned in the United States, pay the French corporate tax rate (34.43%) on its income earned in France, and the Irish corporate tax rate (12.5%) on its income earned in Ireland, ceteris paribus.

In this illustration and in practice, a territorial system would decrease a corporation's tax bill, and therefore, seemingly reduce its incentive to invert.

Corporations invert to reduce the prohibitive effects of the American worldwide taxation system. This was one McDermott, Inc.'s key motivations when it decided to invert to Panama in the early 1980s. McDermott stated that inverting to Panama allowed it “to retain, re-invest and redeploy earnings from operations outside the

27 See id.
28 See id.
29 See id. at 1661, n.34. The OECD nations that employ a worldwide taxation structure are Chile, Greece, Ireland, Israel, South Korea, and Mexico, Poland, and the United States. Id.
30 See Table II.1. Corporate Income Tax Rate, supra note 14.
31 See Capurso, supra note 13, at 595–96.
33 See id. The McDermott inversion is widely recognized as the first American inversion. Id.
United States without subjecting such earnings to United States income tax."\textsuperscript{34} By successfully inverting, McDermott was able to evade the American worldwide taxation scheme and relieve an estimated $200 million from its tax burden.\textsuperscript{35} Further, McDermott's merger proceeded tax-free.\textsuperscript{36} Opening up the global market for tax domiciles, the McDermott inversion paved the way for future waves of similarly motivated corporate inversions.\textsuperscript{37}

\section*{II. HOW WE ARRIVED HERE: HISTORICAL CONTEXT}

In the context of corporate inversions, innovation and regulation is an ongoing game of cat and mouse between businesses and regulators.\textsuperscript{38} To provide legal context for the upcoming incentive analysis, this article will evaluate two key events that shaped the practice and regulation of tax inversion: 1) The seminal inversion by McDermott, Inc. and the resulting case, \textit{Bhada v. Commissioner};\textsuperscript{39} and 2) the Obama Administration Treasury regulations.\textsuperscript{40} In each illustration, American corporations utilized regulatory loopholes, and the government attempted to counter by closing the loophole to prevent future inversions.

\subsection*{A. Legal Background: Bhada Beginnings}

The McDermott, Inc. inversion\textsuperscript{41} is important to illustrate the motivation to escape the worldwide taxation regime. It also serves to illustrate the mechanics of a corporate inversion and the early framework through which courts analyzed the legality of inversions.\textsuperscript{42} The McDermott inversion became the subject of \textit{Bhada v. Commissioner}, a case that considered how the shares received by McDermott’s shareholders in its acquisition should be taxed.\textsuperscript{43}

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\textsuperscript{34} \textit{Id.}; Bhada v. Comm’r., 89 T.C. 959, 961 (T.C. 1987), aff’d, 892 F.2d 39 (6th Cir. 1989).
\textsuperscript{35} \textit{See} Hwang, \textit{supra} note 32, at 822.
\textsuperscript{36} \textit{See id.}
\textsuperscript{37} \textit{See id.} at 821. McDermott’s inversion was upheld by the Sixth Circuit in \textit{Bhada}, 892 F.2d at 40. \textit{See infra} notes 38-59 and accompanying text for a discussion of \textit{Bhada} and the preceding Tax Court decision.
\textsuperscript{38} \textit{See} Hwang, \textit{supra} note 32 (categorizing the history of tax inversion into four “generations of inversions” and subsequent government responses).
\textsuperscript{39} Bhada v. Comm’r., 892 F.2d 39 (6th Cir. 1989).
\textsuperscript{40} \textit{See} Zients & Hanlon, \textit{supra} note 5.
\textsuperscript{41} \textit{See supra} Part I.B.
\textsuperscript{42} \textit{See, e.g.,} Bhada, 892 F.2d at 40.
\textsuperscript{43} \textit{See} Bhada, 89 T.C. at 960.
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Prior to the inversion, McDermott, Inc. was the Delaware-based parent corporation of the McDermott Group and McDermott International, Inc. was a Panama-based subsidiary. In October 1982, McDermott reorganized. As part of the reorganization, McDermott International, Inc. offered cash and its common stock in exchange for shares of McDermott, Inc.’s common stock. Upon the stock sale, McDermott International, Inc. assumed majority control over McDermott, Inc. As McDermott’s prospectus stated, “the principal purpose of the reorganization is to enable the McDermott Group to retain, re-invest and redeploy earnings from operations outside the United States without subjecting such earnings to United States income tax.” Following this transaction, several shareholder-petitioners sought review of the tax status of their shares. The issue before the Tax Court was “whether the shares of International common stock received by petitioners in exchange for McDermott common stock constitute ‘property’ within the meaning of [Internal Revenue Code] section 304(a)(2)(A).”

Section 304(a)(2) of the Internal Revenue Code stated:

(2) Acquisition by subsidiary. -- For purposes of sections 302 and 303, if --
(A) in return for property, one corporation acquires from a shareholder of another corporation stock in such other corporation, and
(B) the issuing corporation controls the acquiring corporation, then such property shall be treated as a distribution in redemption of the stock of the issuing corporation.

The I.R.S. Commissioner argued that the shares received by the petitioners were “property” as defined in Section 304, and thus, the shareholders received a taxable distribution. If the Tax Court classified the shares as “property,” the shareholders would be required to

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44 See id. at 961.
45 See id.
46 See id.
47 See id. at 962.
48 Id. (emphasis added).
49 See id. at 960.
50 Id.; see Hwang, supra note 32, at 822, n.74.
52 See Hwang, supra note 32, at 822, n.74.
pay significant taxes on the distribution they received.\textsuperscript{53}

In determining that Section 304 was inapplicable, the Tax Court held that, as the term "property" and "distribution" were defined in Section 317(a) of the Internal Revenue Code, "the term distribution . . . does not exclusively refer to a distribution by a corporation to its shareholders with respect to its stock."\textsuperscript{54} As a result, the Tax Court concluded that "[McDermott] International 'distributed' its own stock to petitioners in the December 1982 exchange, and that such stock is not to be deemed property," so Section 304 did not apply.\textsuperscript{55}

Acknowledging that this case was a case of first impression and that the issues were "both complex and confusing," the Sixth Circuit Court of Appeals affirmed the Tax Court's holding.\textsuperscript{56} As victors, McDermott and its shareholders completed the transaction tax free and enjoyed $200 million in tax savings.\textsuperscript{57}

In response to Bhada and the newfound threat that tax inversions posed to corporate income tax revenues, Congress acted to make transactions like McDermott's taxable by adding Section 1248(i) to the Internal Revenue Code.\textsuperscript{58} If it was in place in 1982, Section 1248(i) could have stymied the benefits of McDermott's inversion by treating the foreign corporation's earnings as taxable dividends.\textsuperscript{59} While this Congressional action served to quell one method of tax inversion, the stage had been set for future corporate inversions carved out in the legal ambiguities in the tax code.\textsuperscript{60}

B. 2014–2016 Treasury Regulations: Closing the Loopholes for Good?

The Obama Administration's Treasury regulations serve as a modern example of government action aimed at reducing the incidence of tax inversions.\textsuperscript{61} Enacted between 2014 and 2016, the regulations sought to close loopholes that allowed tax inversions by targeting two notable practices: 1) Using "tricks" to evade the 80% ownership rule;
1. Strengthening the 80% Ownership Rule

When first introduced in 2004, the 80% ownership rule stated that owners who “sold” a United States corporation to a foreign subsidiary must own less than 80% of the resulting, post-inversion entity. Before the 80% ownership rule applies, regulations provide:

“[A]n inverted company is subject to potential adverse tax consequences if, after the transaction: (1) [L]ess than 25 percent of the new multinational entity’s business activity is in the home country of the new foreign parent, and (2) the shareholders of the former U.S. parent end up owning at least 60 percent of the shares of the new foreign parent.”

If both prerequisites are satisfied, then the question becomes whether the former United States parent corporation owns 80% or more of the new entity. If the former United States parent owns more than 80% of the new entity, then it is subject to the American corporate income tax rate, and not the rates of the new foreign parent corporation. The intent of the 80% ownership rule was to end “shifts to tax havens where no real business activity took place” by eliminating the tax benefits of the inversion.

While the 80% ownership rule was a major step in attempting to regulate and slow inversions, it required strengthening to curb “tricks” that corporations used to circumvent the rule. The Treasury

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63 See id.; Donald J. Marples & Jane G. Gravelle, Corporate Expatriation, Inversions, and Mergers: Tax Issues, CONG. BUDGET SERV. 6 (Apr. 27, 2016), https://fas.org/sgp/crs/misc/R43568.pdf; see also 26 U.S.C. § 7874(b) (2012) (stating that “a foreign corporation shall be treated for purposes of this title as domestic corporation if such corporation would be surrogate foreign corporation if subsection (a)(2) were applied by substituting ‘80 percent’ for ‘60 percent’”).
65 See id.; see also 26 U.S.C. § 7874(b) (2016).
66 See 26 U.S.C. § 7874(b) (2016) (stating 80% rule and when “inverted corporations [will be] treated as domestic corporations”).
67 See Marples & Gravelle, supra note 63, at 7.
68 See You Don’t Get to Pick Your Tax Rate, supra note 62.
took corresponding action to eliminate these tricks in 2014.\textsuperscript{69} For example, to bypass the 80\% ownership rule, a corporation could either “[inflate] the size of the foreign merger partner” or “[shrink] the size of the [domestic firm].”\textsuperscript{70} The regulations cracked down on the corporate practice of transferring passive assets to the foreign merging partner to increase its perceived ownership.\textsuperscript{71} Similarly, the regulations targeted the practice of paying huge dividends from the domestic corporation before the merger to decrease its perceived ownership.\textsuperscript{72} The Treasury regulations bolstered the 80\% ownership rule by disregarding passive assets if at least 50\% of the foreign corporation’s assets are passive and disregarding “pre-inversion extraordinary dividends.”\textsuperscript{73}

2. Curbing “Earnings Stripping”

In 2016, the Treasury enacted additional regulations that, among other things, targeted a practice known colloquially as “earnings stripping.”\textsuperscript{74} Earnings stripping occurs when a United States corporation takes an internal loan from its foreign parent, allowing the domestic corporation to deduct interest payments from its tax bill and allowing both corporations to “shift” the earnings from the domestic corporation to the foreign parent where the income is reported under the more favorable tax regime.\textsuperscript{75}

The Treasury took aim on this practice by targeting loans that caused large interest deductions and increasing the audit power of the Internal Revenue Service.\textsuperscript{76} The regulations were important because earnings stripping is one of the methods that corporations typically use to invert.\textsuperscript{77} By making it harder to do so, the Treasury made inversions

\textsuperscript{69} See Marples & Gravelle, supra note 63, at 9.
\textsuperscript{70} Id. at 10–11.
\textsuperscript{71} See id. at 10.
\textsuperscript{72} See id. at 11.
\textsuperscript{73} Fact Sheet: Treasury Actions to Rein in Corporate Tax Inversions, U.S. DEP’T OF THE TREASURY (Sept. 22, 2014), https://www.treasury.gov/press-center/press-releases/Pages/jl2645.aspx. “The transfer of properties or liabilities (including by contribution or distribution) shall be disregarded if such transfers are part of a plan a principal purpose of which is to avoid the purposes of this section.” 26 U.S.C. § 7874(c)(4) (2016).
\textsuperscript{74} You Don’t Get to Pick Your Tax Rate, supra note 61.
\textsuperscript{75} Id.; Capurso, supra note 13, at 586.
\textsuperscript{77} See Capurso, supra note 13, at 592.
less desirable to corporations.\textsuperscript{78}

3. Evaluating the Efficacy of the Recent Treasury Regulations

While it is unclear how many inversions were prevented by these waves of Treasury action, there is evidence that several domestic corporations called off mergers in the wake of these regulations.\textsuperscript{79} Most notably, the government earned a major victory against tax inversion when pharmaceutical goliaths Pfizer and Allegan PLC terminated a $160 billion merger that would have inverted Pfizer to Ireland days after the Treasury announced their 2016 regulations.\textsuperscript{80} Time will tell whether the regulations will bring other tax inversions to their knees, but the Treasury’s recent actions put up a strong fight against modern tax inversion methods even while Congress is deadlocked.

III. GETTING THE BILL? HOW TAX INVERSION AFFECTS CONSUMERS

The effects of tax inversion reach beyond business and political elites and touch consumers. While corporations can save millions of dollars through tax inversion, negative externalities pain certain classes of consumers. Consumers, in their roles as taxpayers, small business owners, or shareholders, are not insulated from tax inversion.

A. Do Consumers and Small Businesses Pay or Prosper when Corporations Invert?

In evaluating the effects of tax inversion, especially from the consumer-taxpayer perspective, a primary concern is how the government will replace and manage the loss of billions of dollars in tax revenue abroad.\textsuperscript{81} As stated in the onset, former President Obama opined that the lost tax revenue takes from the coffers of public schools, college financial aid, and public works programs.\textsuperscript{82} President Donald Trump is steadfast in his desire to bring this money back to the United States.\textsuperscript{83}

\textsuperscript{78} Id.
\textsuperscript{79} See Marples & Gravelle, supra note 63, at 9.
\textsuperscript{81} See Zients & Hanlon, supra note 5.
\textsuperscript{82} See id.
\textsuperscript{83} See Trump’s Tax Plan, supra note 9.
It is unclear whether claims that the “average” taxpayer picks up the tab for corporate inverters are political posturing or an ominous warning, but regardless of sentiment, to maintain the current levels of federal expenditures, revenues must be similarly maintained. What is clear, though, is that corporate inversions allow corporations to significantly trim their tax bill, while individuals and small businesses remain bound to the rates in the United States tax code. On the margin, small business owners pay more in corporate income taxes because they continue to pay the existing 35% corporate tax rate, while multinational corporations who can afford to invert can reduce their tax rate considerably by seeking out tax havens.

The potential burden that “ordinary” taxpayers and small business owners bear to offset the cost of tax inversion is not only bad for optics—it risks disproportionately hurting the middle class. Further, tax inversion is a competitive advantage for multinational corporations that compete with small, domestic businesses, and there is a risk that inversions can force small businesses out of a market.

However, on the other hand, consumers may benefit from lower prices that come when an inverting company has reduced its costs by lowering its tax burden. This positive externality of tax inversion exists in theory, but data will be required to confirm whether it is an actual effect of tax inversion or an idealism that only serves to increase a corporation’s bottom line. Specific research should be conducted to quantify the burdens and benefits that tax inversion causes the American consumer and domestic small businesses.

B. Shareholders Lawyer Up

Inverting allows corporations to save millions of dollars because it reduces their tax burdens. But how does this affect the corporations’ shareholders? One of the highest profile inversions of the

85 See id.
86 See Hwang, supra note 32, at 848.
87 See id. (stating that market over-consolidation caused by tax inversion can cause monopolistic markets, meaning public must bear resulting externality of decreased competition).
89 See generally Hwang, supra note 32.
last several years featured a merger between Wisconsin-based Johnson Controls, Inc. (hereinafter, "JCI") and Ireland-based Tyco International.\textsuperscript{90} The benefit to JCI is clear—it estimates that domiciling in Ireland will save the corporation an estimated $150 million in taxes.\textsuperscript{91} But the merger garnered the ire of both 2016 Presidential candidates, and politicians are not alone in their discontent.\textsuperscript{92} The JCI-Tyco inversion left many longtime shareholders feeling “betrayed” by the unexpected tax burden they faced.\textsuperscript{93}

On August 16, 2016, JCI shareholders filed a lawsuit in the United States District Court for the Eastern District of Wisconsin against certain senior executive officers of JCI, all members of the Board of Directors of JCI, JCI itself, and Tyco.\textsuperscript{94} The plaintiff-shareholders allege that for JCI to enjoy the tax benefits of the inversion—which JCI stated would be tax-free to Tyco shareholders and taxable to JCI shareholders—"JCI diluted the stock to a point that any tax liability for reincorporating in Ireland shifted to the shareholders."\textsuperscript{95} The plaintiff-shareholders further allege that public shareholders and shareholders with potential exposure to capital gain taxation are injured by the merger.\textsuperscript{96}

On January 25, 2017, the plaintiff-shareholders moved for a preliminary injunction on their count alleging that “the individual defendants breached their fiduciary duties to the plaintiffs by failing to disclose, or failing to seek advice about, several issues” including potential capital gains consequences.\textsuperscript{97} The plaintiff-shareholders’ motion was denied “because the plaintiffs did not demonstrate that the

\textsuperscript{91} See id.
\textsuperscript{93} Content, \textit{supra} note 90.
\textsuperscript{95} Id. at *3.
\textsuperscript{96} See id.
\textsuperscript{97} Gumm v. Molinaroli, 16-CV-1093-PP, 2017 U.S. Dist. LEXIS 10320, at **5–6 (E.D. Wis. Jan. 25, 2017) ("The motion for preliminary injunction states that all of these alleged breaches of fiduciary duty have resulted in a situation in which the plaintiffs are facing large capital gains tax consequences for the 2016 tax year, which, they argue, constitute irreparable harm to them, and which cannot be reme- died at law.").
monetary damages available as a remedy was inadequate to address the harm they allege. To date, the litigation is still pending.

Similar shareholder-initiated litigation against inverted or inverting corporations has sprung up around the country. Despite the mixed results of these early shareholder lawsuits, the recent emergence of cases shows that corporate inversions may be beneficial to the corporation at the expense of its shareholders. In continuing to assess the effect corporate inversions have on consumers, specifically shareholders, it will be imperative to closely monitor these and other lawsuits, as well as the resulting change in the stock price of corporation following inversion. Litigation and largescale stock sell offs remain important deterrents that shareholders can hold over the heads of inverting corporations if circumstances sour. If litigants earn favorable results against inverting corporations through actions under securities or consumer fraud laws, it is possible that the incidence of tax inversion may slow because of corporations’ interests in reducing their exposure.

IV. CARROT OR STICK: INCENTIVE AND INTEREST ANALYSIS AND POLICY REVIEW

For policies to curb the undesirable effects of tax inversion effectively, they must target the core incentives of the business and political actors. However, no policy decision exists in a vacuum, and the interests of consumers must be carefully considered before any policy recommendation is made. Policy decisions that have distortionary effects on businesses will undoubtedly affect the markets in which consumers transact. Positive or adverse changes to the price of goods and services, employment outcomes, or individual income taxation must

98 Id. at *30.
99 See id.
be measured.

The major proposed solutions to curbing tax inversion are grouped into two categories: "carrots" and "sticks."

A. Rewarding with "Carrots"

For the purpose of this section, "carrots" are policy proposals that seek to incentivize corporations not to invert by making the United States a more attractive location to domicile. Drawing on the discussion in Part I herein of the two primary factors that encourage corporations to invert, this section focuses on how adjusting either the corporate income tax rate or the United States taxation regime incentivizes the actors in a tax inversion.

1. Lowering the Corporate Income Tax Rate

Reducing the United States corporate income tax rate from 35% plays to the purest incentive of an inverting corporation: decreasing its tax burden. As the highest corporate income tax rate in the OECD, the current rate is not competitive. But how much should the rate be reduced? To answer this question, the incentives and interests of both businesses and the government must be analyzed.

To minimize costs, the domestic tax rate must be low enough to incentivize a corporation to remain domiciled in the United States, but this does not mean that the United States should lower the corporate tax rate to a rate lower than that of the most competitive tax haven. Merging with a foreign corporation causes the domestic corporation to incur significant transaction and information costs. The deluge of regulation and public scrutiny aimed at tax inversion means that corporations can no longer shop for the lowest foreign tax rate and simply change their headquarters’ mailing address to enjoy the benefits of inverting.

For an inversion to be efficient, the tax savings must eclipse the transaction and information costs incurred when it inverts. For example, if Acme Corporation can save $50 million on its corporate tax bill annually by inverting to Ireland, but the cost of finding and acquiring a merging partner in Ireland that will satisfy the existing regulations...
costs $200 million, it is probably inefficient for that corporation to invert unless the corporation mitigates its ongoing transaction costs. Notwithstanding, this transaction surely would not be efficient in the short-run.

The recent waves of Treasury regulations targeted this incentive by increasing the transaction and information costs that corporations shoulder when they choose to invert. For example, by adding additional regulatory layers to the existing corporate legal structure, corporations are now forced to expel greater compliance costs. While the government may have incentives to lower the corporate tax rate, it does not want to reduce the corporate tax rate below the efficient level. In other words, if it becomes inefficient for most corporations to invert when the tax rate is 25%, a Congressional reduction of the tax rate to 15% means that there is 10% worth of lost tax revenue that could have been retained. Given the Congressional deadlock that exists, the greater the reduction to the corporate tax rate, the less likely it is that Congress can successfully pass any reduction.

The consumer benefits of lowering the corporate tax rate add an additional wrinkle into the debate as to what rate is optimal for all parties. A 2010 Heritage Foundation study concluded that, if the corporate income tax rate was reduced to 25%, an average of 531,000 jobs would be added to the private sector annually, real gross domestic product would increase $132 billion annually, and the after-tax income for a family of four would increase $2,484 annually. These benefits to consumers may move the needle towards lowering the corporate income tax rates further, as long as the loss of tax revenue and the negative effects therefrom are eclipsed by the benefits. If this administration can facilitate large scale tax reform, as President Trump would like, the optimal rate must be determined by balancing the incentives and interests of the corporate-political-consumer triumvirate.

2. Shift from a Worldwide to Territorial Taxation Regime

Aligning the United States tax structure with that of most the OECD nations by transitioning to a territorial system is heralded as the
"obvious" solution. Under a territorial taxation system, the United States could continue to tax domestic earnings at 35%, but it would lose taxation power over income earned abroad. For a corporation that earns the lion’s share of its income in the United States, the switch would eliminate the incentive to invert.

Most critics argue that, to be effective, the tax regime switch must be coupled with additional regulation. For example, on its own, the switch to a territorial system does not address earning stripping. Further, the shift would need to be executed through large scale tax reform.

From a consumer perspective, this shift may cause bitterness since individual income earned abroad is taxed “worldwide.” In other words, if Tonya Taxpayer earns $1 million in Spain, she must declare this income on her United States tax return, and the income is subject to American taxation. To ensure equality and protect Congressional interest in satisfying constituents, a similar shift in the individual tax code may deserve consideration.

B. Punishing with “Sticks”

For the purpose of this section, “stick” policies seek to quell tax inversion by punishing companies that have inverted or may invert through punitive measures.

If tax inversion is already widely viewed as undesirable, is there any merit to policies banning or criminalizing tax inversion? While such policies would threaten to punish inverting companies, it is doubtful that the benefits of punitive action would outweigh the costs.

Regarding federal tax inversion bans, three concerns arise. First, defining tax inversion would pose difficulties to legislatures, especially given that the practice is constantly evolving and taking new forms as new laws are passed. Second, given the frequent evolution and creation of new inversion schemes, regulations would need to be


109 See Capurso, supra note 13, at 584.

110 See id. at 595.

111 See id.


113 See id.

114 See Capurso, supra note 13, at 599.
frequently reenacted and revised. Third, a ban threatens to place unnecessary and cumbersome regulation on non-nefarious business alienability and mergers and acquisitions. The cost of frequent legislative catch-up and potential ill effects on legal mergers and acquisitions likely outweighs the benefits that a ban might inspire. Similar issues arise regarding criminalization; the cost to Department of Justice, Internal Revenue Service, or other governmental agencies tasked with prosecuting inversions would be egregious compared to more targeted, incentive-based solutions.

Notwithstanding, legislators have sought to implement other punitive measures. For example, several states have sponsored legislation that would ban state contracts with inverted corporations. Illinois Democratic Senator Dick Durban has proposed similar legislation that bans federal contracts with inverted corporations.

The efficacy of any punitive policy is dependent on balancing the effect on the incentives of business versus the cost to consumers. Based on the foregoing analysis of proposed bans and criminalization of tax inversion, it appears that such measures fail to target the core incentives of corporations, and thus, will be inefficient at curbing tax inversion.

V. TURNING INVERSIONS UPSIDE DOWN

Despite bipartisan opposition of tax inversion, there is no quick fix. When corporations invert, both positive and negative externalities affect American consumers. While the effects are largely negative, generations of reinvention and discovery of new loopholes has led to a system where inverting corporations are always one step ahead of regulatory bodies seeking to stymie the practice. The recent Treasury regulations provided much needed attention to new iterations of tax inversion while Congress remains gridlocked, but only time will tell how effective these rules are at stopping inversions and how consumers are subsequently affected.

The major policy tools—reducing the corporate income tax rate and transitioning from a worldwide to a territorial tax system (the “carrots”)—inspire confidence by addressing some of the key incentives of businesses, politicians, and consumers and boast positive results, but the feasibility of large scale tax reform remains uncertain in the current political climate. In addition to the ongoing Treasury regulations, activism by financial consumers of multinational corporations

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115 See id.
116 See Sheppard, supra note 88, at 585.
117 See Brodwin, supra note 84.
and shareholders may disincentivize inversion. Litigation and other pressure on corporations will not only increase the costs of inversion, but will require these entities to be accountable to their owners, especially when inversions devalue and dilute shares.

The current taxation and regulatory structures incentivize corporations to seek out countries with the lowest corporate tax rates. While consumers may benefit from the resulting lower prices in theory, shareholders, taxpayers, and small businesses bear various costs. Congress must take steps to curb the growing trend of tax inversions, whether by carrot or stick, to prevent massive loss of corporate income tax revenues; in the meantime, the United States Consumer is hurt by these tax inversions.