The New Corporate Migration

TAX DIVERSION THROUGH INVERSION

Cathy Hwang†

INTRODUCTION

Watson Pharmaceuticals was an American success story—until it became an Irish success story.

Taiwanese-American Allen Chao founded Watson in 1983, after cobbling together $4 million in start-up funds from family, friends, and acquaintances.[1] Chao helmed Watson for a decade and a half. By the time he retired in 2007, Watson was the third-largest generic-pharmaceuticals manufacturer in the United States, with annual revenues of $2.5 billion.[2] In 2012, Watson adopted the name Actavis for worldwide operations.[3] The following year, Actavis debuted in the Fortune 500.[4] At the

† Academic Fellow, Stanford Law School, Rock Center for Corporate Governance. I thank Jonathan Abel, Afra Afsharipour, Kelli A. Alces, Douglas G. Baird, Joseph Bankman, Jordan M. Barry, Neil H. Buchanan, Michael J. Caballero, Laura Napoli Coordes, Lynne L. Dallas, Steven Dean, Benjamin P. Edwards, Jared Ellias, Lisa Fairfax, Tom Ginsburg, Joseph A. Grundfest, Sarah C. Haan, M. Todd Henderson, Emily Hite, Thomas J. Hughes, John Patrick Hunt, Sloan G. Speck, Thea Johnson, Cortelyou Kenney, Ruth Levine, Seth Oranburg, Amanda K. Packel, Elizabeth Pollman, Jacob Hale Russell, George Triantis, and participants of the Junior Faculty Workshop at the Center for Law, Economics & Finance (C-LEAF) at George Washington University Law School, the Stanford Law School Fellows' Workshop, and the 2014 Junior Scholars Virtual Colloquium for helpful comments and conversations. Thanks also to the Rock Center for Corporate Governance at Stanford University.

1 Damon Darlin, *Still Running Scared*, FORBES, Sept. 26, 1994, at 127-28 (describing Allen Chao's background and the founding of Watson Pharmaceuticals).

2 Press Release, NexBio, Inc., Dr. Allen Chao, Founder & Former CEO of Watson Pharmaceuticals, Joins NexBio Board of Directors (Jan. 19, 2010), *available at* http://www.prnewswire.com/news-releases/dr-allen-chao-founder—former-ceo-of-watson-pharmaceuticals-joins-nexbio-board-of-directors-82057617.html.

3 Press Release, Watson Pharm., Inc., Watson Announces New Name—Actavis—for Global Operations (Oct. 31, 2012), *available at* http://phx.corporate-ir.net/phoenix.zhtml?c=65778&p=irol-newsArticle&ID=1752588 (announcing that Watson Pharmaceuticals, Inc. would adopt the Actavis name effective in 2013).

4 *Actavis: What It's Like To Join The Fortune 500*, FORTUNE (May 10, 2013), http://fortune.com/2013/05/10/actavis-what-its-like-to-join-the-fortune-500/ (reporting on an interview with Actavis CEO Paul Bisaro at the time Actavis joined the Fortune 500).

end of 2013, Actavis reported annual revenues of $8.6 billion[5] and employed 19,200 people.[6]

In late 2013, Actavis acquired Ireland's Warner Chilcott plc.[7] In doing so, Actavis moved the jurisdiction of incorporation of its parent company to Ireland through a corporate inversion.[8] In a corporate inversion, a corporate group with a common parent incorporated in a domestic jurisdiction[9] reshuffles its corporate structure or acquires a foreign company in order to end up with a common parent incorporated in a lower-tax foreign jurisdiction. In Actavis's case, inverting from Nevada to Ireland was expected to lower its effective tax rate from 28% to approximately 17%.[10]

Corporate inversions are not new. U.S. oil and gas giant McDermott was the first to invert when, in 1982, it inverted to Panama by making one of its Panamanian subsidiaries the corporate group's parent company.[11] Since then, there have been about 75 inversions.[12] In 2014 alone, numerous domestic

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5 Actavis plc, Annual Report (Form 10-K) 57 (Feb. 25, 2014) (disclosing that for the year ended December 31, 2013, Actavis plc had net revenues of $8,677.6 million).

6 *Id.* at 25 (disclosing that as of December 31, 2013, Actavis had approximately 19,200 employees).

7 Actavis, Inc., Current Report (Form 8-K) (Oct. 1, 2013) (announcing the completion of the acquisition of Warner Chilcott plc, a public limited company organized under the laws of Ireland, by Actavis, Inc., which was, at the time of the announcement, a Nevada corporation. As a result of the transaction, both Actavis, Inc. and Warner Chilcott plc would become wholly owned indirect subsidiaries of a newly formed Irish company called Actavis plc).

8 *Id.*

9 The Tax Code classifies taxpayers as "domestic" (for corporations, this means a corporation incorporated in a U.S. jurisdiction) or "foreign." Thus, for the purposes of this article, corporations incorporated in U.S. jurisdictions are generally referred to as domestic corporations. *See* Classification of Taxpayers for U.S. Tax Purposes (May 28, 2014), *available at* http://www.irs.gov/Individuals/International-Taxpayers/Classification-of-Taxpayers-for-U.S.-Tax-Purposes (last accessed Mar. 8, 2015).

10 Actavis Ltd., Amendment No. 1 to Registration Statement (Form S-4) 70 (Jul. 31, 2013) (disclosing that Actavis expected to lower its effective non-GAAP tax rate from approximately 28% to 17%).

11 Hal Hicks, *Overview of Inversion Transactions: Selected Historical, Contemporary, and Transactional Perspectives*, 30 TAX NOTES INT'L 899, 903 (2003); *see also infra* notes 66-70 and accompanying text.

12 Professor Mihir A. Desai at Harvard Law School has compiled the most comprehensive list of inversions to date, and his list includes approximately 75 inverted companies. *See* Colleen Walsh, *Getting a Handle on Inversion: A Q&A with Mihir Desai*, HARVARD L. TODAY (Aug. 15, 2014), http://today.law.harvard.edu/harvard-gazette-mihir-desai-getting-handle-inversion (click "these inversions" in Mihir Desai's first answer). This number comports with other commentators' estimates. *See also* Mihir A. Desai & James R. Hines, Jr., *Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions*, 55 NAT'L TAX J. 409, 418-20 (2002); Andrius R. Kontrimas, Presentation at the 13th Annual International Tax Symposium, 24-25 (Nov. 5, 2010), *available at* http://www.texastaxsection.org/LinkClick.aspx?fileticket=t2ZqNOMHQA0%3D&tabid=59; MARSHA HENRY, *Mergers of Equals: Getting Caught in the § 7874 Corporate Inversion Web—Change the Rules or Change the Game*

corporations, including iconic American brands like Pfizer and Walgreens, publicly contemplated inversions.[13] In the second half of 2014, Burger King announced that it would invert to Ontario, Canada through an $11 billion acquisition of Canadian chain Tim Hortons.[14] Congress's Joint Committee on Taxation has estimated that stopping inversions could result in a total tax revenue gain of approximately $19.5 billion over the next ten years.[15]

Inversions have gained attention from many corners. Professor Steven Davidoff Solomon called last year's inversion activity "a feeding frenzy . . . . Every investment banker now has a slide deck that they're taking to any possible company and saying, '[Y]ou have to do a corporate inversion now, because if you don't, your competitors will.'"[16] Around the same

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36-37 (Dec. 4, 2013) (unpublished research paper, Fordham University), *available at* http://marshahenry.blogs.com/files/corporate_inversions_december_2013.pdf.

[13] *See* David Gelles, *New Corporate Tax Shelter: A Merger Abroad*, N.Y. TIMES, Oct. 9, 2013, at B1 (citing independent tax advisor Robert Willens, who estimated that there had been about 20 inversions in the last year and a half); Ashley Armstrong, *American Companies Target the UK for Tax*, TELEGRAPH (May 3, 2014), http://www.telegraph.co.uk/finance/newsbysector/pharmaceuticalsandchemicals/10806840/American-companies-target-the-UK-for-tax.html (describing the competitiveness of the pharmaceuticals industry and the prevalence of corporate inversion transactions in the industry).

[14] Burger King Worldwide, Inc., Current Report (Form 8-K) (Dec. 12, 2014) (announcing the completion of Burger King's acquisition of Tim Hortons). Through the transaction, Canadian-incorporated Tim Hortons Inc. and Delaware-incorporated Burger King Worldwide, Inc.—the parent company of the Burger King corporate group—would both become indirect subsidiaries of an Ontario, Canada-incorporated corporation and an Ontario, Canada-organized limited partnership. Tim Hortons itself has an interesting incorporation history. Originally a Canadian company, it became part of American restaurant chain Wendy's in 1995. Tim Hortons became a public company incorporated in Delaware after its spin-off from Wendy's in 2006. In 2009, Tim Hortons announced that it would move back to Canada by merging with a newly formed Canadian subsidiary in order to, among other things, take advantage of lower Canadian tax rates commencing in the year following implementation. Tim Hortons Inc., Current Report (Form 8-K) (June 29, 2009) (attaching the company's press release announcing its intention to become a Canadian company through a merger with a newly formed subsidiary); *see also* David Friend, *Tim Hortons Returns Officially to Canada*, TORONTO STAR (Jun. 30, 2009), http://www.thestar.com/business/2009/06/30/tim_hortons_returns_officially_to_canada.html (reporting the company's incorporation history).

[15] Letter from Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation, to Karen McAffee, Democratic Chief Tax Counsel, House Ways and Means Committee (May 23, 2014), *available at* http://democrats.waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/113-0927%20JCT%20Revenue%20Estimate.pdf. Note, however, that while this is a large number, it is not a particularly large percentage of the United States's gross domestic product. According to the World Bank, the United States's gross domestic product in 2013 (the last year for which data is available) was $16.77 trillion. *See United States*, WORLD BANK, http://data.worldbank.org/country/united-states (last visited Apr. 5, 2015).

[16] Mark Garrison, *Corporate Inversion: An Expensive Way to Save on Taxes*, MARKETPLACE (Jul. 15, 2014, 4:14 PM), http://www.marketplace.org/topics/world/corporate-inversion-expensive-way-save-taxes (reporting on recent inversion activity and quoting Professor Davidoff Solomon).

time, Professor Edward Kleinbard, former chief of staff of Congress's Joint Committee on Taxation, predicted that there would be a "sharknado of inversions."[17]

In response to the surge in inversion announcements in 2014, President Obama's administration proposed tightening anti-inversion rules, the Treasury Secretary made a plea to Congress to pass anti-inversion legislation, and bills were proposed in both houses of Congress.[18] In late September of 2014, the Treasury Department and the Internal Revenue Service (the IRS) issued Notice 2014-52, announcing immediately effective promised regulations that reduced some of the tax benefits of inversions.[19] President Obama appears to have discussed inversions again in the State of the Union address in 2015, noting that "lobbyists have rigged the Tax Code with loopholes that let some corporations pay nothing while others pay full freight," and calling for the closing of loopholes "so we stop rewarding companies that keep profits abroad, and reward those that invest in America."[20]

So far, the conversation, especially in the popular consciousness, has been dominated by the tax story: corporations save millions on their tax bills by inverting, correspondingly causing the U.S. government to lose billions in tax revenue. But there is more to the inversion story. This Article considers the collateral effects of inversions, both for corporations and for the public, and proceeds in four Parts.

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[17] Lori Montgomery, *U.S. Policymakers Gird for Rash of Corporate Expatriations*, WASH. POST (Aug. 6, 2014), http://www.washingtonpost.com/business/economy/us-policymakers-gird-for-rash-of-corporate-expatriations/2014/08/05/4898ca5e-18d9-11e4-9349-84d4a85be981_story.html (reporting on the surge of inversions expected to come in late 2014 and quoting Professor Kleinbard).

[18] U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2015 REVENUE PROPOSALS 64-65 (Mar. 2014), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf [hereinafter TREAS., GENERAL EXPLANATIONS] (explaining the current corporate inversion law, the proposed change and the rationale for the change); Press Release, Ways and Means Comm. Democrats, House Democrats Introduce Legislation to Tighten Restrictions on Corporate Tax Inversions (May 20, 2014), *available at* http://democrats.waysandmeans.house.gov/press-release/house-democrats-introduce-legislation-tighten-restrictions-corporate-tax-inversions (providing coverage of H.R. 4679, which mirrors Senator Levin's proposal to tighten existing corporate inversion rules); Steven Davidoff Solomon, *A Merger in a Race With Congress*, N.Y. TIMES DEALBOOK (Jun. 16, 2014, 1:03 PM), http://dealbook.nytimes.com/2014/06/16/a-merger-in-a-race-with-congress (providing coverage of two corporate inversion proposals in the U.S. Senate: Senator Harry Reid's tax holiday proposal, and Senator Carl Levin's proposal to tighten existing corporate inversion rules).

[19] I.R.S. Notice 2014-52, 2014-42 I.R.B. 712 (Sept. 22, 2014).

[20] Press Release, Remarks of President Barack Obama—As Prepared for Delivery State of the Union Address (Jan. 20, 2015), *available at* https://www.whitehouse.gov/the-press-office/2015/01/20/president-obamas-state-union-address-prepared-delivery.

Part I introduces the current discourse about inversions. Overwhelmingly, corporations cite the United States's high statutory corporate tax rate, and the lower tax rates of other countries, as reasons for inverting.

Part II provides a robust overview of previous generations of inversions in the United States, highlighting the evolution of inversions from internal reorganizations to today's complex business-combination transactions. This section provides necessary background for understanding how inversions—and inversion policy—can affect business decisions and the public.

Part III considers how today's complex business-combination inversions can affect inverting corporations themselves and potentially create collateral consequences for the public. To be sure, economists and tax policymakers understand that tax policy, including inversion tax policy, changes behavior in potentially costly ways. This Article considers the specific potential hidden costs of inversions for corporations and the public. For corporations, inverting can change business decisions; for instance, companies may deploy capital in potentially sub-optimal ways in service of chasing tax benefits. For the public, the availability of corporate inversions undercuts tax policy, creates distributional consequences across industries and company sizes, and may drive over-consolidation. To craft sound policy, policymakers need to understand inversions's potential for driving these hidden costs and begin to investigate the magnitude of these effects.

Part IV analyzes potential policy solutions, including a theoretical outright ban on inversions, comprehensive tax reform, and middle-of-the-road or temporary solutions.

I. THE CURRENT DEBATE

The Treasury Department's Office of Tax Policy defines a corporate inversion as "a transaction through which the corporate structure of a U.S.-based multinational group is altered so that a new foreign corporation, typically located in a low- or no-tax country, replaces the existing U.S. parent corporation as the parent of the corporate group."[21] For example, a company that has a Delaware corporation as its

[21] *Corporate Inversions: Hearing Before the H. Comm. on Ways & Means*, 107th Cong. 10-11 (2002) (statement of Pamela F. Olson, Acting Assistant Secretary for Tax Policy, U.S. Department of the Treasury) (providing a primer on the tax policy implications of corporate inversions in conjunction with a previous generation of corporate inversion transactions).

parent company may invert by setting up a new corporation in a tax-friendly jurisdiction like Ireland and engaging in transactions to make that new Irish corporation the company's top parent company. Inverted companies can save tens of millions—if not hundreds of millions—of dollars in taxes through an inversion and the related restructurings that follow it.

Recently, corporate inversions have kicked up a storm of interest amongst the press, legislators, and policymakers. President Obama, the Treasury Department, and both houses of Congress have discussed inversions.[22] At the same time, corporate inversions are under-explored in the legal academic literature—a handful of articles form the entirety of the literature, and nearly nothing has been written about the current generation of inversion transactions. This Part provides an overview of current discussions, including a summary of what corporations say drives their inversion decisions.

A. *The Case for Inverting*

Many corporations assert that they invert to take advantage of another jurisdiction's lower statutory corporate tax rate.[23] For instance, in 2014, Mylan, Inc. announced that it would invert to the Netherlands in conjunction with a purchase of a portion of Abbott Laboratories. At the time, Abbott's Chief Executive Officer wrote in *The Wall Street Journal* that, "[i]n terms of global competiveness, the U.S. and U.S. companies are at a substantial disadvantage to foreign companies . . . . Our disproportionately higher tax rate [puts] foreign companies at a huge advantage competitively."[24] The Mylan inversion is expected to lower Mylan's global effective tax rate from 25% to 21% in the first year, and to the high teens over time.[25] This

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[22] *See* U.S. DEPT. OF THE TREASURY, *supra* note 18; *see also supra* text accompanying notes 19-20.

[23] Michael J. Graetz, *Inverted Thinking on Corporate Taxes*, WALL ST. J. (Jul. 16, 2014, 7:46 PM), http://online.wsj.com/articles/michael-j-graetz-inverted-thinking-on-corporate-taxes-1405554359 ("At 35%, [the United States] now ha[s] the highest statutory corporate [tax] rate in the Organization for Economic Cooperation and Development, which has 34 developed countries as members."); *see Hearing*, *supra* note 21 (noting that U.S.-based companies reincorporate abroad to take advantage of tax savings).

[24] Miles D. White, *Ignoring the Facts on Corporate Inversions*, WALL ST. J. (Jul. 17, 2014, 7:06 PM), http://www.wsj.com/articles/miles-d-white-ignoring-the-facts-on-corporate-inversions-1405638376.

[25] Anna Prior, *Abbott Labs to Sell Generic Drug Assets to Mylan*, WALL ST. J. (Jul. 14, 2014, 10:00 AM), http://online.wsj.com/articles/abbott-laboratories-to-sell-developed-generics-business-to-mylan-1405335643 (reporting that, as a result of Abbott/Mylan deal, Mylan would lower its global effective tax rate from about 25% to about 21% in its first year, and even lower in subsequent years).

particular justification for inverting—the desire to chase a lower statutory tax rate—is often viewed as simplistic. While the United States's statutory corporate tax rate is high—at 35%, it is the highest corporate tax rate among developed countries—its effective tax rate is similar to the average of developed countries belonging to the Organization for Economic Cooperation and Development (OECD).[26]

Inverting companies also cite the United States's worldwide tax regime as a driver of inversions.[27] Domestic corporations pay taxes on the entirety of their income, regardless of where it is earned—a worldwide tax regime.[28] At the same time, if foreign-earned income is taxed in the foreign jurisdiction, domestic corporations can claim a foreign tax credit on their U.S. taxes for taxes already paid to foreign jurisdictions on foreign-earned income, which mitigates some of the effect of a worldwide tax regime. When that foreign-earned income is brought back into the United States, however, it is taxed at the higher U.S. rate.[29] In practice, the United States's worldwide tax regime means that no matter where a domestic corporation earns its income, the income will be taxed at the higher U.S. rate once repatriated to the United States. Many other developed countries have territorial, rather than worldwide, tax regimes—that is, only the income a corporation earns within the territory is taxed by that

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[26] The average effective tax rate of OECD countries is approximately 27.7%, and the United States's effective tax rate is approximately 27.1% (both figures are weighted effective tax rates, which are adjusted to account for the size of the economies). Moreover, the United States collects less tax as a percentage of gross domestic product than the OECD average. MARK P. KEIGHTLEY & MOLLY F. SHERLOCK, CONG. RESEARCH SERV., R42726, THE CORPORATE INCOME TAX SYSTEM: OVERVIEW AND OPTIONS FOR REFORM, 13 tbl. 2 (2014).

[27] Stuart Webber, *Escaping the U.S. Tax System: From Corporate Inversions to Re-Domiciling*, 63 TAX NOTES INT'L 273, 277 (2011) (describing that many inverting companies do not articulate any operational benefits generated by their corporate inversions; rather, the rationales for inverting are entirely tax-driven).

[28] KEIGHTLEY & SHERLOCK, *supra* note 26, at 6 ("The United States taxes American corporations on their worldwide income."); Elizabeth Chorvat, *You Can't Take It With You: Behavioral Finance and Corporate Expatriations*, 37 U.C. DAVIS L. REV. 453, 460 (2003) (describing the worldwide tax system); Michael Kirsch, *The Congressional Response to Corporate Expatriations: The Tension Between Symbols and Substance in the Taxation of Multinational Corporations*, 24 VA. TAX REV. 475, 484-85 (2005) (describing the United States's corporate tax system as one that generally taxes worldwide income, regardless of the source of the income).

[29] Chorvat, *supra* note 28, at 459 ("Any income that arises from cross-border transactions is potentially subject to tax in two more jurisdictions: the residence country and the source country.") and at 463 ("[T]he U.S. tax system allows a limited credit against U.S. tax, available for certain income taxes paid to foreign countries, thereby mitigating the double taxation of U.S. taxpayers on foreign source income."); *see* I.R.C. § 901 (setting forth how the taxes imposed by the Internal Revenue Code shall be credited with certain allowances, and the amount of such allowances); KEIGHTLEY & SHERLOCK, *supra* note 26, at 6 (describing that under current tax law, "corporations are allowed a credit, known as a foreign tax credit, for taxes paid to other countries").

territory. By escaping the United States's worldwide tax regime to a jurisdiction with a territorial tax regime, corporations can also save on taxes.[30]

Because the United States taxes income at the higher U.S. rate when it is repatriated, corporations can defer paying U.S. tax by keeping foreign-earned income overseas indefinitely.[31] *Bloomberg* recently estimated that U.S. companies kept about $2 trillion of foreign income overseas in order to avoid paying U.S. taxes upon repatriation.[32] According to commentators, inversions allow corporations to access this cash "trapped" overseas.[33] When American medical device maker Medtronic announced its inversion to Ireland through the purchase of Irish company Covidien, Medtronic's former CEO told *The New York Times* that "[t]he only reason [Medtronic is] doing the inversion is to free up the cash overseas . . . . That money today can't be put to good use right now."[34] Medtronic will use that trapped cash to buy Covidien.[35] In the process, Medtronic will invert to Ireland and also gain access to Covidien's cash flow, which is generated from earnings taxed at the lower Irish rate.[36] That cash will not need to be repatriated to the United States and taxed at the higher U.S. rate. Note that if Medtronic had acquired Covidien in a more traditional, non-inversion

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[30] Chorvat, *supra* note 28, at 460 (describing the two main ways of dealing with double taxation as the "'worldwide' or 'credit' method, in which the residence country taxes foreign source income but provides a credit for taxes paid to foreign jurisdictions," and the "'territorial' or 'exemption' method, under which the residence country cedes all taxing jurisdiction to the source country.").

[31] Chorvat, *supra* note 28, at 465 ("[I]ncome that U.S. corporations earn through foreign subsidiaries is not subject to tax in the United States until the income is repatriated back to the U.S. parent corporation."); Orsolya Kun, *Corporate Inversions: The Interplay of Tax, Corporate, and Economic Implications*, 29 DEL. J. CORP. L. 313, 333 (2004) ("Income earned from non-U.S. operations of foreign corporate subsidiaries of a domestic parent corporation is generally subject to U.S. tax only when distributed as a dividend to the domestic corporation.").

[32] David Welch & Manuel Baigorri, *Offshore Cash of $2 Trillion Sparks Hunt for Tax-Friendly Deals*, BLOOMBERG BUS. (Jun. 16, 2014, 7:01 PM), http://www.bloomberg.com/news/2014-06-16/offshore-cash-of-2-trillion-sparks-hunt-for-tax-friendly-deals.html.

[33] Vanessa Houlder et al., *Tax Avoidance: The Irish Inversion*, FIN. TIMES (Apr. 29, 2014, 5:47 PM), http://www.ft.com/cms/s/2/d9b4fd34-ca3f-11e3-8a31-00144feabdc0.html#axzz37x2JQScc (describing the phenomenon of U.S. companies "shifting their headquarters abroad to protect growing overseas cash piles.").

[34] David Gelles, *In Medtronic's Deal for Covidien, an Emphasis on Tax Savings*, N.Y. TIMES DEALBOOK (Jun. 16, 2014, 8:29 PM), http://dealbook.nytimes.com/2014/06/16/in-medtronics-deal-for-covidien-an-emphasis-on-tax-savings (describing Medtronic's focus on tax savings and accessing trapped cash in its acquisition of Covidien and quoting former Medtronic CEO Bill George).

[35] *Id.*; Lee Schafer, *A Move to Ireland Lets Medtronic Move Its "Trapped Cash,"* STAR TRIB. (Jun. 17, 2014, 5:38 AM), http://www.startribune.com/business/263378681.html.

[36] *Id.*

transaction, Covidien's earnings may have been passed through Medtronic and been used to pay dividends to Medtronic's shareholders. This would have subjected Covidien's earnings to U.S. tax.

According to some commentators and inverting companies, the trapped cash problem has ripple effects on the economy. A domestic corporation may keep and invest its money outside of the United States in order to avoid paying U.S. taxes on that foreign-earned income. As a result, the U.S. economy does not benefit from foreign-earned income being invested back to the United States. However, the extent of the trapped cash problem is disputed. A 2011 study on offshore cash held by large corporations commissioned by Senator Carl Levin found that about 46% of those corporations' tax-deferred offshore funds were actually held in bank accounts in the United States or invested in American assets.[37] In addition, about a third of the companies surveyed "had placed between three-quarters and half of their tax-deferred offshore funds in U.S. assets."[38] These results suggest that a substantial amount of "trapped cash" is already back in the United States and being invested in U.S. assets or held in U.S. bank accounts.

Companies also use inversions to add intercompany debt and "strip earnings" from their U.S.-taxable income. Post-inversion, the foreign parent company loans money to its domestic subsidiary, and that domestic subsidiary takes a tax deduction for interest paid to the parent.[39] One accounting study notes that "[d]espite managements' claims that inversion-related savings will be due to the avoidance of U.S. tax on foreign earnings, . . . most of the tax savings is attributable to avoidance of U.S. tax on U.S. earnings [through earnings stripping]."[40] The Treasury Department also noted in a 2002 report that corporate inversions facilitate earnings stripping, and in a 2007 report that "[i]nversion transactions

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[37] Offshore Funds Located Onshore 4 (2011), *available at* http://www.hsgac.senate.gov/subcommittees/investigations/media/new-data-show-corporate-offshore-funds-not-trapped-abroad-nearly-half-of-so-called-offshore-funds-already-in-the-united-states.

[38] *Id.*

[39] Jim A. Seida & William F. Wempe, *Effective Tax Rate Changes and Earnings Stripping Through Corporate Inversion*, 57 NAT'L TAX J. 805, 806 (2004) (describing the prevalence of earnings stripping among inverting companies).

[40] *Id.* at 807.

provide evidence that the earnings stripping rules are not fully achieving their intended purposes."[41]

B. Government Responses to Inversions

Since a corporation's tax savings is a government's loss, policymakers have taken notice. In response to three previous generations of corporate inversions, legislators and policymakers have imposed a number of rules that make it impossible for corporations to leave the United States only for tax purposes, as they did in earlier generations of inversions. Current rules ensure that companies incorporated in domestic jurisdictions can invert out of the United States only in connection with a foreign acquisition.[42] Despite this rule, inversion activity is once again on the rise. In response to the inversion activity in the past few years, the President, Treasury Secretary, and members of Congress have proposed tax-based policy solutions.

President Obama's Fiscal Year 2015 Budget included a proposal to strengthen and expand current anti-inversion rules.[43] Senator Carl Levin introduced a bill mirroring the President's proposal.[44] In the press release accompanying the proposed legislation, Senator Levin described corporate inversions as "about tax avoidance, plain and simple."[45] Senator Sheldon Whitehouse called the Levin bill a "common sense tax fairness bill" and declared that "[m]ergers should be driven by economics, not tax avoidance."[46] Senator Tim Kaine echoed the sentiments, saying that the bill was about "rooting out flagrant abuse in our system that could lead to billions of dollars of lost

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41 U.S. DEP'T. OF THE TREASURY, REPORT TO THE CONGRESS ON EARNINGS STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES 1-2, 10 (2007), http://www.treasury.gov/resource-center/tax-policy/Documents/ajca2007.pdf.

42 *See infra* Part II.

43 TREAS., GENERAL EXPLANATIONS, *supra* note 18, at 64-65 (describing the current provisions of Section 7874, with a particular focus on the ownership test prong, and outlining the federal budget's proposal).

44 Stop Corporate Inversions Act of 2014, S. 2360, 113th Cong. (2014) (proposing "[t]o amend the Internal Revenue Code of 1986 to modify the rules relating to invert[ing] corporations").

45 Press Release, Senator Ben Cardin, Senators Introduce Bill to Clamp Down on Inversions Tax Loophole (May 20, 2014), *available at* http://www.cardin.senate.gov/newsroom/press/release/senators-introduce-bill-to-clamp-down-on-inversions-tax-loophole (announcing the Stop Corporate Inversions Act of 2014 and quoting Senator Levin).

46 *Id.* (quoting Senator Whitehouse).

revenue."[47] Representative Sander Levin also introduced a companion bill in the House of Representatives.[48]

In July of 2014, Treasury Secretary Jack Lew sent a letter to the House of Representatives' Ways and Means Committee, urging Congress to pass anti-inversion legislation and to enact tax system reform. Secretary Lew noted that "these [inverting] firms are attempting to avoid paying taxes here, notwithstanding the benefits they gain from being located in the United States," and called for "a new sense of economic patriotism, where we all rise or fall together."[49] Later in July, Senator Levin—along with Senator Dick Durbin, and two Democrats in the House of Representatives—introduced another anti-inversion bill: The No Federal Contracts for Corporate Deserters Act.[50] The Levin-Durbin anti-inversion bill aimed to expand existing limitations on awarding federal contracts to foreign corporations.[51] Separately, Senators Harry Reid and Rand Paul advocated for a one-time tax break to allow companies to repatriate foreign-earned income to the United States, which may reduce some corporations' incentives to invert, at least in the short term.[52]

Former Treasury Department official Stephen Shay has also joined the fray, arguing that the Treasury Department is empowered to and should take action—specifically, by reclassifying interest from intercompany debt (which is deductible) as equity (which is not).[53] This may significantly reduce the savings from inversions, much of which comes from post-inversion restructurings that take advantage of interest deductions. Likewise, Senator Charles Schumer's anti-inversion proposal also tackles the intercompany debt and earnings stripping issue by

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[47] *Id.* (quoting Senator Kaine).

[48] Stop Corporate Inversions Act of 2014, H.R. 4679, 113th Congress (2014) (proposing "[t]o amend the Internal Revenue Code of 1986 to modify the rules relating to invert[ing] corporations.").

[49] Letter from Jacob J. Lew, U.S. Treas. Sec'y, to Dave Camp, Chairman, H. Comm. on Ways & Means (Jul. 15, 2014), *available at* http://im.ft-static.com/content/images/89217f94-0ca4-11e4-943b-00144feabdc0.pdf.

[50] David Gelles, *New Legislation Targets Inversions from Different Angle*, N.Y. TIMES DEALBOOK (Jul. 29, 2014, 1:09 PM), http://dealbook.nytimes.com/2014/07/29/new-legislation-targets-inversions-from-different-angle/.

[51] Press Release, Office of Congresswoman Rosa DeLauro, Leading Congressional Democrats Introduce The No Federal Contracts for Corporate Deserters Act, (Jul. 29, 2014), *available at* http://delauro.house.gov/index.php?option=com_content&view=article&id=1662:leading-congressional-democrats-introduce-the-no-federal-contracts-for-corporate-deserters-act&catid=2&Itemid=21.

[52] Jonathan Weisman, *Plan to Refill Highway Fund Stokes Conflict in Congress*, N.Y. TIMES, Jun. 10, 2014, at A15 (providing coverage of plans to replenish the Highway Trust Fund, including the tax holiday proposal).

[53] Stephen E. Shay, *Mr. Secretary, Take the Tax Juice Out of Corporate Expatriations*, 144 TAX NOTES 473, 475 (2014).

limiting interest deductions.[54] Senator Schumer's plan "would reduce the amount of deductible interest for inverted [corporations]" and restrict corporations' ability to carry forward deductions to future years.[55]

After months of debate and proposed legislation, in September of 2014, Treasury and the IRS issued Notice 2014-52, announcing planned regulations aimed at reducing the tax benefits of inversions.[56] The promised regulations attempt to combat inversions in three major ways.

First, and most significantly, the regulations eliminate the benefits from so-called "hopscotch loans." Hopscotch loans are intercompany loans that allow domestic corporations to avoid certain taxes. Prior to the Notice, domestic corporations that received loans from their controlled foreign corporations (CFCs) had to treat the loans as if the money had been repatriated to the United States as a dividend, and therefore had to pay taxes on that dividend. Using a hopscotch loan, a corporation avoids those taxes by causing a CFC to make a loan to the domestic corporation's new foreign parent company, rather than to the domestic corporation directly. The promised regulations eliminate the benefits of hopscotch loans by making these loans subject to the same tax that would be owed if the CFC had made the loan directly to the domestic corporation.

Second, the promised regulations reduce the tax benefits of typical post-inversion restructuring strategies. For instance, many post-inversion restructurings cause former CFCs of the domestic corporation to become direct subsidiaries of the new foreign parent—a technique known as "out from under planning." The promised regulations will treat the new foreign parent as continuing to own the CFC indirectly through the domestic corporation. This means that the subsidiary continues to be a CFC subject to U.S. taxation.

Third, the new regulations strengthen existing requirements regarding the size of merger partners. Modern inversions are accomplished through cross-border business combinations, and existing rules specify that shareholders of the U.S. inverter cannot hold more than 60% or 80% of the

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[54] S. 2786, 113th Cong. (proposed Sept. 10, 2014), *available at* https://www.congress.gov/113/bills/s2786/BILLS-113s2786is.pdf (last accessed Jan. 6, 2015).

[55] Richard Rubin, *Schumer Details Interest Deduction Limits in Inversions*, BLOOMBERG BUS. (Aug. 14, 2014, 1:14 PM), http://www.bloomberg.com/news/2014-08-14/schumer-details-interest-deduction-limits-in-inversions.html.

[56] *See* I.R.S. Notice 2014-52, *supra* note 19; *Fact Sheet: Treasury Actions to Rein in Corporate Tax Inversions*, U.S. DEP'T OF TREASURY (Sept. 22, 2014), http://www.treasury.gov/press-center/press-releases/Pages/jl2645.aspx.

stock of the combined company post-combination. (Certain restrictions apply if shareholders hold more than 80% of the combined company's stock, and additional restrictions apply at the 60% threshold.)[57] In order to meet the 60% or 80% thresholds, companies sometimes manipulate the size of the target foreign business partner—for instance, by paying a special "skinny down" dividend prior to the inversion in order to reduce the target's size. The new regulations disregard many of these efforts to manipulate the computation of whether the 60% or 80% thresholds have been met.

The Notice ends with a note that the IRS "expects to issue additional guidance to further limit inversion transactions," and, "[i]n particular, . . . guidance to address strategies that avoid U.S. tax on U.S. operations by shifting or 'stripping' U.S.-source earnings to lower-tax jurisdictions, including through intercompany debt."[58]

The Notice, like several previous generations of inversion policy, is precisely calculated to reduce the benefits of present-generation inversion transactions. Practitioners have noted that the Notice "takes a significant step in eliminating many of the tax benefits that could be derived from post-inversion transactions with the U.S. company's new foreign affiliates,"[59] and "threatens the possibility of future restrictions on [earnings stripping]."[60]

C. *Inversion Scholarship*

While it is clear that policymakers and the press have spilled much ink about corporate inversions, these transactions are under-explored in the legal academic literature. Among the most comprehensive doctrinal articles on corporate inversions is a decade-old student note that explains features of the U.S. corporate tax system that motivate corporate inversions and advances a behavioral finance theory to explain inversion

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[57] *See infra* note 114 and accompanying text.

[58] *Id.*

[59] KIM BLANCHARD & DAVIS BOWER, WEIL GOTSHAL & MANGES LLP, TAX ALERT: IRS ISSUES MORE RULES AFFECTING INVERSIONS (Sept. 29, 2014), *available at* http://www.weil.com/~/media/files/pdfs/tax_alert_irs_affects_inversions_v41.pdf (summarizing key components of Notice 2014-52 in a notice to clients).

[60] MICHAEL L. SCHLER, CRAVATH, SWAINE & MOORE LLP, NEW TAX RESTRICTIONS ON INVERSIONS, *available at* http://www.cravath.com/files/uploads/Documents/Publications/3494991_1.PDF (last access Mar. 22, 2015) (summarizing Notice 2014-52 in a notice to clients).

activity.[61] Another decade-old article compares differences in corporate governance law between the United States and Bermuda (a popular inversion destination for prior-generation inverters).[62] Professor Michael Kirsch also contributed an article in 2005 focusing on Congressional responses to corporate inversions, analyzing the symbolic and social-norm aspects of the responses.[63] On the empirical side, Professors Mihir A. Desai and James R. Hines's article tracing the empirical determinants of corporate inversions, with a focus on the then-in-progress Stanley Works inversion (which was later canceled due to public pressure), is particularly thorough.[64] Professors Jim A. Seida and William F. Wempe's accounting scholarship provides insight into how inverters use intercompany debt to strip earnings during and after inversions.[65]

In contrast to previous work, which generally focuses on individual clusters of inversion activity, this Article considers the development of inversion activity in the United States over several decades. It also contributes an analysis of the tax and non-tax collateral consequences of inversion activity and considers how inversions impact corporations and the public.

II. THE DEVELOPMENT OF CORPORATE INVERSIONS IN THE UNITED STATES

Inversions have collateral consequences for both corporations and the public, and these consequences ought to be considered as policymakers grapple with the next generation of inversion policy. Since the first inversion in the early 1980s, corporations have tried to save on taxes through corporate inversions, and the government has battled inversion activity with tax laws and regulations. The result has been four generations of inversions, in which the hidden costs of inversion policy have risen steadily. Analyzing the history of

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[61] *See generally* Chorvat, *supra* note 28 (arguing that the corporate inversions of the late 1990s and early 2000s may be explained by corporate managers exploiting market imperfections to reduce the cost of inverting to a level that makes it profitable for companies to invert). Chorvat also followed up with a work in progress that argues that policymakers are incorrectly penalizing inversion activity by designing the tax penalty around the stock price at the time of inversion. *See* Elizabeth Chorvat, *"Looking Through" Corporate Expatriations for Buried Intangibles* (University of Chicago, Public Law Working Paper No. 445, 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2309915.

[62] *See* Kun, *supra* note 31.

[63] *See* Kirsch, *supra* note 28, at 483-84.

[64] *See* Desai & Hines, *supra* note 12.

[65] *See* Seida & Wempe, *supra* note 39.

these transactions is critical to addressing future generations of corporate inversion activity. This Part overviews the four generations of corporate inversion activity and government responses.

A. The First Generation

Tax has always been the centerpiece of the corporate inversion conversation. The early 1980s saw one of the first corporate inversions: McDermott Inc.'s move to Panama.[66] McDermott was a Delaware-incorporated, Texas-headquartered public company that provided engineering and other services related to offshore oil and gas operations.[67]

In 1982, McDermott announced that it would invert to Panama.[68] One of McDermott's Panamanian subsidiaries, McDermott International, launched a public tender offer for McDermott Inc.'s shares, offering to buy shares of McDermott Inc. from McDermott Inc.'s public shareholders in exchange for newly issued shares of McDermott International and cash.[69] When the transaction was completed, McDermott International was the parent company, and McDermott Inc. was one of its U.S. subsidiaries.[70]

McDermott enjoyed many tax benefits as a result of inverting to Panama: in its disclosures, McDermott noted that the inversion "enable[d] 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."[71] The company cited mounting global competition as a driving factor

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[66] Reuven S. Avi-Yonah, *For Haven's Sake: Reflections on Corporate Inversion Transactions*, 95 TAX NOTES 1793, 1793 (2002) (describing the McDermott corporate inversion as "[t]he first well-known corporate inversion from the U.S."); Hicks, *supra* note 11 (describing McDermott's corporate inversion as "[t]he first inversion transaction that generated a significant amount of government and tax community attention"); Kirsch, *supra* note 28, at n.1 (describing the "first modern inversion" as having occurred in 1983); Steven Surdell, *Inversions 2014—Self-Help International Tax Reform for U.S. Multinationals?*, 92 TAXES—THE TAX MAG., Mar. 2014, at 63, 64-65 (describing McDermott's corporate inversion as "[o]ne of the earliest and most well-known corporate inversion transactions" and outlining the structure of the transaction).

[67] Surdell, *supra* note 66, at 64.

[68] Because McDermott's shareholders received some cash in the transaction, the corporate inversion was taxable to McDermott's shareholders—however, most shareholders recognized a loss. *See id.* at 64-65; Hicks, *supra* note 11, at 903.

[69] Hicks, *supra* note 11, at 903; Surdell, *supra* note 66, at 65.

[70] After the transaction was completed in 1983, public shareholders owned about 90% of McDermott International's stock, and McDermott International owned most of the stock of McDermott Inc., which was at that point a U.S. subsidiary of McDermott International. *See* Hicks, *supra* note 11, at 903-04.

[71] Surdell, *supra* note 66, at 59.

in its decision, stating that the inversion "will enable the McDermott Group to compete more effectively with foreign companies by taking advantage of additional opportunities for expansion which require long-term commitments, the redeployment of assets and the reinvestment of earnings."[72]

McDermott's corporate inversion kicked off the first generation of inversions. McDermott reveled in its tax savings (estimated to be about $200 million[73]), accomplished through a transaction that was tax-free to the corporation. Congress responded by adding Section 1248(i) to the Internal Revenue Code of 1986 (the Code), making McDermott-like transactions taxable.[74]

Here, we pause to take a deeper dive into some of the technical details of the McDermott transaction. First, how was McDermott able to "redeploy earnings from operations outside the United States without subjecting such earnings to United States income tax" after its inversion?[75] Generally, U.S. companies can defer payment on their foreign-earned income until that income is repatriated to the United States. However, the so-called subpart F anti-deferral rules provide that certain types of mobile subpart F income earned by CFCs are taxed when earned, *not* when repatriated into the United States.[76] Before its inversion, McDermott International was a CFC—it could not defer paying taxes on subpart F income. The inversion allowed McDermott International and its foreign subsidiaries to shed their CFC statuses.[77] As non-CFCs, these foreign companies were no longer subject to subpart F rules, so they did not have to pay taxes in the United States on subpart F income.

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[72] *Id.*

[73] Hicks, *supra* note 11, at 904.

[74] Initially, the government responded by suing McDermott and trying to impose a shareholder-level tax, but that case was unsuccessful. *See* Bhada v. Comm'r, 89 T.C. 959 (1987), *aff'd*, 892 F.2d 39 (6th Cir. 1989). In *Bhada*, the IRS argued that McDermott shareholders received a taxable distribution from McDermott under a Code Section 304(a) transaction, which would have negative tax consequences for McDermott's shareholders. Code Section 304(a) applies when a subsidiary acquires a parent company's stock from parent shareholders in exchange for property. For a detailed discussion of *Bhada*, see Surdell, *supra* note 66, at 66.

[75] Surdell, *supra* note 66 at 65.

[76] Treas. Reg. §§ 1.951-1-1.964-5 (2012). "Subpart F rules" refer to rules under Chapter 1, Subchapter N, Part III, Subpart F (§§ 951-65) of the Code.

[77] McDermott International was, prior to the corporate inversion, a CFC of McDermott Inc. When McDermott International's stock became widely held by the public and fewer than 50% of the company was owned by shareholders who owned 10% or more of McDermott International, McDermott International and the foreign subsidiaries organized under it ceased to qualify as CFCs. Hicks, *supra* note 11, at 904 (describing the mechanism by which McDermott International ceased being a CFC); *see also* I.R.C. § 957(a) (defining a CFC as a foreign corporation if more than 50% of the corporation is owned by U.S. shareholders who each own 10% or more of the company).

Anti-deferral rules explain why McDermott's inversion was not taxable to the corporation. Section 1248 is an anti-deferral rule. If Section 1248 applies to a particular transaction, the income from the sale of stock in the transaction is taxed: specifically, a foreign corporation's earnings are treated as though they were distributed as a dividend to the corporation's U.S. shareholder (in tax parlance, these earnings are "deemed dividends").[78] At the time McDermott inverted, McDermott-like transactions were not subject to Section 1248. The addition of Section 1248(i) ensured that de-controlling transactions like McDermott's were subject to Section 1248. Recall that in the McDermott transaction, McDermott Inc. owned all of McDermott International, and McDermott International bought its McDermott Inc. stock directly from McDermott Inc. Post-Section 1248(i), those types of transactions would be recharacterized, and for tax purposes, the IRS would pretend that two things had happened: (1) McDermott Inc. had first received McDermott International stock, and (2) had then transferred the stock to McDermott Inc.'s shareholders. Thus, McDermott Inc. would need to recognize and pay taxes on dividend income with respect to the previously untaxed earnings and profits of McDermott International under Section 1248(f).[79] In effect, for de-CFC-ing transactions, Section 1248(i) treated that foreign-earned income as repatriated to the United States and taxed it. However, Section 1248(i) did not remove all of the potential tax benefits: the taxable amount is limited by several factors, such as the foreign tax credit position of the former U.S. parent company. In addition, Section 1248(i) does not require the former U.S. parent company to recognize gain in excess of the former CFC's earnings and profits.[80]

Section 1248(i) was the government's first tax-based attack on corporate inversions, but it would not be the last.

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[78] Specifically, if a U.S. person (such as a domestic corporation incorporated in a U.S. jurisdiction, like McDermott Inc.) satisfying certain ownership requirements sells or exchanges stock in a CFC, then the gain recognized on the sale or exchange is included as a dividend in the gross income of the U.S. person, up to the amount of the earnings and profits of the CFC. *See* WILLIAM R. SKINNER, FENWICK & WEST LPP, SECTION 1248 AND DISPOSITIONS OF CFC STOCK (Jan. 18, 2013), *available at* http://content.fenwick.com/FenwickDocuments/Section_1248_Outline.pdf (describing Section 1248 and dispositions of CFC stock thereunder); *see also* I.R.C. § 1248 (2012).

[79] Hicks, *supra* note 11, at 904; *see generally* I.R.C. § 1248 (2012) (providing the rules under which gain from certain sales and exchanges of stock in certain foreign corporations will be taxed). Additionally, because McDermott "transferred" the stock to its shareholders, the stock issuance to its shareholders would be a transaction that was taxable to McDermott Inc. under Code Section 311. *See* Surdell, *supra* note 66, at 66.

[80] Hicks, *supra* note 11, at 905.

B. The Second Generation

Corporate inversion activity quieted for nearly a decade after McDermott. Along with the addition of Section 1248(i), bad press related to inversions may have also played a role in slowing inversion activity: a failed lawsuit against McDermott by the IRS earlier in the corporate inversion process drew negative attention from the press and public. But in the mid-1990s, Helen of Troy Corporation inverted to Bermuda.

Texas-incorporated Helen of Troy got its start selling wigs in El Paso, Texas in the 1960s.[81] To say that Helen of Troy "grew over the years" would be an immense understatement: today, Helen of Troy calls itself a "consumer products" company,[82] and distributes a variety of everyday products, including products marketed under brands like Dr. Scholl's, Vidal Sassoon, OXO, PUR, Braun, and Vicks.[83]

In 1994, Helen of Troy inverted to Bermuda. Like McDermott before it, Helen of Troy noted in its public filings that the transaction would provide "greater flexibility in structuring its international business activities to minimize its non-U.S. income taxes."[84] The transaction was tax-free to the corporation. To avoid Section 1248(i)'s tax on the earnings and profits of CFCs, Helen of Troy set up a brand-new non-CFC corporation that had no earnings and no profits.[85]

The government, as before, waged its war on tax grounds. In 1996, the IRS issued regulations under Section 367(a) of the Code.[86] Unlike Section 1248(i), which taxed the inverting corporation, the new regulations targeted shareholders by imposing a shareholder-level tax on inversions.[87]

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[81] Vic Kolenc, *Momentum: New Brands Put El Paso Company Helen of Troy on Path to $1 Billion* (May 29, 2011, 12:00 AM), EL PASO TIMES, http://www.elpasotimes.com/business/ci_18162555 (describing Helen of Troy's acquisition of several new brands); Surdell, *supra* note 66, at 67; *Investor Relations—General*, HELEN OF TROY, http://www.hotus.com/investor-relations/general/ (last visited Mar. 6, 2015) (describing Helen of Troy's founding).

[82] *About Helen of Troy*, HELEN OF TROY, http://www.hotus.com/about/ (last visited Jan. 31, 2015) (providing an overview of Helen of Troy's business and products).

[83] *Our Brands*, HELEN OF TROY, http://www.hotus.com/our-brands/ (last visited Jan. 31, 2015) (providing a list of some of Helen of Troy's current brands).

[84] Surdell, *supra* note 66, at 67 (quoting Helen of Troy's prospectus).

[85] Hicks, *supra* note 11, at 905.

[86] The IRS previewed its response in 1994 by issuing Notice 94-46, which announced that new corporate inversion-related regulations would be forthcoming under I.R.C. § 367(a). In the meantime, it issued interim guidance, which was substantially similar to the final regulations. *See* I.R.S. Notice 94-46, 1994-1 C.B. 356.

[87] Hicks, *supra* note 11, at 905; *see* Surdell, *supra* note 66, at 68-70; *see also* Treas. Reg. § 1.367(a)-3(c) (2014). I.R.C. § 367(a) taxed transfers of U.S. stock "outbound" to a foreign corporation and did not apply to U.S. persons who owned less

For readers interested in the technical workings of the Section 367(a) regulation, an understanding of Section 367(a) prior to Helen of Troy is necessary. Under general "non-recognition rules," certain types of corporate transactions can be accomplished tax-free: tax-free liquidations,[88] tax-free transfers of property in exchange for control in a corporation,[89] shareholder tax-free exchanges in a reorganization,[90] and a few others. Section 367(a) overrides the non-recognition treatment afforded to these transactions in cases where a foreign corporation is involved. At the time of Helen of Troy's corporate inversion, Section 367(a) did not apply to transactions like Helen of Troy's—that is, Helen of Troy's type of transaction would have been tax-free. Specifically, Section 367(a) did not apply to U.S. persons who transferred stock to foreign corporations if the U.S. person owned less than 5% of the foreign corporation's stock after the transfer.[91]

After the new Section 367(a) regulations went into effect, avoiding shareholder-level taxation under Section 367(a) became harder: several additional requirements had to be met. First, all of the U.S. persons transferring stock to the foreign corporation must, as a group, own 50% or less of the resulting foreign corporation's stock.[92] This is a big deviation from before the regulation, when a U.S. transferor's individual tax liability was determined based on individual ownership, rather than ownership as a group. Second, certain U.S. insiders cannot, as a sub-group, end up owning more than 50% of both the voting power and the value of the foreign company after the transaction.[93] Third, each individual U.S. transferor must either

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than 5% of the vote and value of the foreign corporation immediately after the transfer. Even those who owned more than 5% of the foreign corporation after the transfer could side-step tax liability by signing a special agreement with the government. So Helen of Troy's shareholders were able to avoid paying taxes on the transfer, even though they had helped transfer stock of a domestic corporation to a foreign corporation, which was helping money leave the U.S. tax net. *See* Hicks, *supra* note 11, at 905; Surdell, *supra* note 66, at 67; and Willard B. Taylor, *Corporate Expatriation—Why Not?* 78 TAXES—TAX MAG. 146, 146-47 (2000) (describing the Helen of Troy corporate inversion and related regulations).

[88] I.R.C. § 332 (2012).

[89] *Id.* § 351 (2012).

[90] *Id.* § 356 (2012).

[91] And to the extent some shareholders ended up owning more than 5%, the government imposed an additional anti-abuse requirement: those shareholders were required to file a gain recognition agreement—an agreement in which the shareholder agrees to recognize some or all of the gain realized on a transfer if certain gain recognition events occur during a certain amount of time following the transfer—in order to avoid taxes. *See* Surdell, *supra* note 66, at 68-69.

[92] Treas. Reg. § 1.367(a)-3(c) (2014).

[93] *Id.*

(a) own less than 5% of the foreign corporation immediately after the transaction or (b) file a gain recognition agreement.[94]

The fourth requirement, colloquially referred to as the "active trade or business test," requires that the foreign company (or qualified subsidiary, or qualified partnership) be engaged in an active foreign trade or business outside of the United States for 36 months prior to the transaction, and have no plans to dispose of or discontinue the business.[95] Helen of Troy's inversion would have been subject to a shareholder-level tax, and Helen of Troy's newly established subsidiary would not have passed the active trade or business test.[96]

Finally, transactions must pass the "substantiality test."[97] Broadly speaking, this test requires that the foreign acquirer must be at least as big[98] as the U.S. target company—no foreign minnows swallowing domestic whales, because minnows swallowing whales are presumably doing so for tax reasons.[99]

The government's tax-based response to Helen of Troy's corporate inversion was meant to halt inversion activity—a shareholder-level tax was meant to make public-company inversions very unpalatable to shareholders. Other factors may have also contributed to the slow-down in inversions. Previous studies, for instance, have cited increased visibility of inversions in the public eye as a factor. Government action may have also raised the profile of corporate inversions, causing corporations to reconsider whether inversions are worth the potential backlash from shareholders, customers, and the public.[100]

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[94] *Id.*

[95] *Id.*

[96] This test is considered the most complicated factor—what qualifies as a "qualified subsidiary," "qualified partnership," and "active trade or business outside of the United States" are all carefully defined in the regulation. Recall that Helen of Troy's corporate inversion skirted section 1248(i), enacted in response to McDermott's corporate inversion, by setting up a brand-new Bermudan subsidiary with no earnings and no profits. *See generally* Treas. Reg. §§ 1.367(a)-3(c)(3)(i).

[97] *Id.*; Hicks, *supra* note 11, at 906.

[98] Size is based on fair market value, which is not carefully defined.

[99] Hicks, *supra* note 11, at 906.

[100] *See* Kirsch, *supra* note 28, at 520-24. Note that after Section 367(a), a few self-inversions went through, using exchangeable shares as a way to defer immediate payment of the shareholder-level tax. Hicks, *supra* note 11, at 907. Exchangeable shares are shares of a corporation with economic entitlements that closely resemble those of another company. For instance, when Triton Energy Corp. decided to invert to the Caymans in 1996, Triton Energy bought its shareholders' shares, and gave shareholders a choice of what they could receive in return: (1) Class-A ordinary shares of the newly formed Triton Cayman or (2) an "equity unit" that consisted of a bit of Triton Delaware preferred stock plus one Class B share of Triton Cayman. Both options were of approximately equal value. U.S. shareholders who chose the first option would have their gains taxed (i.e., Section 367 would apply), but U.S. shareholders who chose the second option would be able to defer a substantial portion of their taxable

C. The Third Generation

The third generation of corporate inversions began in the early 2000s with the self-inversions of Ingersoll-Rand, Nabors Industries, Noble Drilling, and Cooper Industries, and ended with Stanley Works' announced-but-canceled inversion in 2002.

Once again, companies chased the promise of tax savings. Houston-headquartered, Ohio-incorporated Cooper Industries, Inc., which announced its inversion to Bermuda in 2002, was one such company.[101] Brothers Charles and Elias Cooper founded Cooper Industries in Ohio in 1833 and sold plows, hog troughs, kettles, and stoves.[102] By 2002, Cooper Industries had over $4.2 billion in annual revenues[103] and employed over 30,000 people.[104]

Like its corporate inversion predecessors, Cooper Industries cited tax reasons for its corporate inversion: it noted that inverting would improve its global tax position and reduce its effective tax rate from about 35% to 18-23%.[105] In order to invert to Bermuda, Cooper Industries formed a new Bermudan subsidiary, and under it, a domestic subsidiary corporation, U.S. MergerCo. U.S. MergerCo merged into Cooper Industries, and Cooper Industries survived. In the merger process, Cooper Industries's public shareholders received stock in the Bermudan subsidiary, and shares of U.S. MergerCo's stock previously held by the Bermudan subsidiary were converted into shares of Cooper Industries. After the transactions were completed, the public owned the Bermudan company, and the Bermudan company owned Cooper Industries.[106]

Several factors may have worked together to account for the increase in popularity of inversions. First, the early 2000s' dip in stock prices[107] simultaneously made corporate inversions cheaper for shareholders and more important for corporate managers. From the shareholders' perspective, lower stock prices meant that the shareholder-level tax was a smaller

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gain by retaining interest in the U.S. company. *See* Triton Energy Corp., Definitive Proxy Statement (Form 14A) at 2, 35-36 (Feb. 23, 1996).

[101] Cooper Indus., Ltd., Registration Statement (Form S-4), at 2 (Jun. 11, 2001) (offering securities in connection with the formation of a holding company).

[102] *History*, COOPER INDUS. PLC, http://www1.cooperindustries.com/company/company-history.html (last visited Jan. 31, 2015) (providing information on the history of Cooper Industries).

[103] Cooper Indus., Inc., Annual Report (Form 10-K), at 11 (Feb. 20, 2002).

[104] *Id.* at 3.

[105] Cooper Indus., Inc., Registration Statement (Form S-4), *supra* note 101, at 13-14.

[106] Surdell, *supra* note 66, at 73-74.

[107] Hicks, *supra* note 11, at 907.

amount in absolute terms (or even zero, for those shareholders who had losses).[108] Many shareholders were also tax-exempt or tax-indifferent. At the same time, managers felt pressured to increase shareholder value, and inversions could bump up stock prices.[109] Transactional innovation also played a role. Although transfer pricing and intercompany debt helped make second-generation corporate inversions worthwhile, empirical studies show that third-generation corporate inversions really made use of intercompany debt to strip earnings from the United States. In practice, this meant that the new foreign parent extended an intercompany loan to its U.S. subsidiary. The U.S. subsidiary then deducted interest paid on the loan from its taxable income in the United States. Meanwhile, the foreign parent's corresponding interest income was realized abroad, where it was taxed at a low or zero foreign rate and subject to no U.S. tax.[110]

Several public companies announced corporate inversions between 2000 and 2002, but this third generation of corporate inversions abruptly stopped in 2002, a few months after Connecticut-incorporated hand-tool company Stanley Works announced in February of 2002 its plan to invert to Bermuda. Unlike many prior inverters, Stanley Works was an iconic American company and a household name—today, it is known as Stanley Black & Decker, and its products line the aisles of home-improvement stores. After Stanley Works announced its intention to invert, it endured months of press frenzy, public protests at company headquarters, and political pressure to stop the inversion. Finally, in August, before a final shareholder vote[111] could be held, Stanley Works withdrew its inversion plan, stating:

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[108] *Id.*

[109] *Id.* In their 2002 empirical study, however, Desai and Hines found that corporate inversion announcements do not always drive up stock prices. They studied 19 companies that made corporate inversion announcements between 1993 and 2002, and found that only eight of the 19 companies had positive abnormal returns on stock price the day after the announcement, and only 10 had positive abnormal returns on stock price during the five-day window around the time of the corporate inversion announcement. They conclude that "[c]learly, the stock market is concerned in many cases either that the costs of inverting exceed the benefits under current law, or that future tax or regulatory changes might reduce the benefits of inverting." Desai & Hines, *supra* note 12, at 430.

[110] *See* U.S. DEPT. OF THE TREASURY, REPORT TO CONGRESS ON EARNINGS STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES 2 (Nov. 28, 2007), http://www.treasury.gov/resource-center/tax-policy/Documents/ajca2007.pdf; Seida & Wempe, *supra* note 39, at 806-07 (finding that for several inverters that inverted in 2001 and 2002, intercompany debt played a big role in U.S. earnings stripping and contributed to lowered effective tax rates); Surdell, *supra* note 66, at 73.

[111] Stanley Works' shareholders initially approved the transaction in May. However, Stanley Works' board of directors voided the first vote, citing shareholder

> We [Stanley Works] have been asked by the Congressional leadership on both sides of the aisle to support their efforts toward rectifying this situation by enacting legislation that will create a level playing field for companies incorporated in the U.S. We have honored their request, and the ball is now in their court. We sincerely hope that Congress will agree to a solution. Ignoring this problem will not make it go away, but can only accelerate the trend of fewer U.S. headquartered companies.[112]

In its cancelation announcement, Stanley Works called the United States's tax system "archaic" and accused the system of "putting U.S. companies that compete globally in an untenable position."[113]

As it did in response to previous generations of inversions, the government changed the rules in 2004 to disincentivize inversions. Congress added Section 7874 to the Code as part of the American Jobs Creation Act of 2004, making it harder for domestic companies to invert.[114] Under Section 7874, a domestic corporation that engages in a cross-border business combination and that attempts to end up incorporated in a foreign jurisdiction must make sure that after the acquisition, less than 60% of the combined company's stock is owned by the former shareholders of the domestic company by reason of their holding stock in the domestic company.[115] In inversion parlance,

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confusion about the voting procedures. *See* Stanley Works, Prospectus (Form 425) (May 13, 2002) (canceling the initial shareholder vote while citing shareholder confusion about procedures). There was supposed to be a second shareholder vote, but the corporate inversion plan was aborted before it could take place. Dan Ackman, *Stanley Works Stays Home*, FORBES (Aug. 2, 2002, 8:50 AM), http://www.forbes.com/2002/08/02/0802topnews.html.

[112] Stanley Works, Current Report (Form 8-K) (Aug. 1, 2002) (announcing the cancellation of its previously-announced plan to invert).

[113] *Id.*

[114] American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004).

[115] Section 7874 applies when all three of the following criteria are met:

> (1) A foreign corporation acquires a U.S. corporation or partnership (often called the "acquisition test"); and
>
> (2) after the acquisition, at least 60% of the foreign corporation's stock is owned by the former shareholders of the U.S. company by reason of their holding stock in the U.S. company (the "ownership test"); and
>
> (3) the corporate group controlled by the foreign corporation does not have business activities in the foreign corporation's country of incorporation when compared to the total business activities of the group worldwide (the "substantial business activities test." Note that this analysis is done on the activities of the corporate group the year before the acquisition).

See 26 U.S.C. § 7874 (2012).

a company that has less than 60% shareholder overlap is said to have less than 60% "ownership continuity."[116]

Ownership continuity triggers two levels of penalties for an inverting corporation.[117] Inverting corporations with more than 80% ownership continuity will continue to be taxed as domestic corporations. If ownership continuity is between 60% and 80%, Section 7874 imposes a gain recognition requirement, which restricts the inverter in some ways—for instance, by limiting the inverter's use of certain tax attributes to offset gains in the years after the inversion.[118] In addition, the inverting corporation's ability to use net operating losses to reduce taxation of its inversion gain is limited.[119]

The exception to ownership continuity is the "substantial business activities test": if a corporation has substantial business operations in its new foreign jurisdiction, it can invert despite substantial ownership continuity.[120] A corporation has substantial business activities in a country to which it is moving its incorporation jurisdiction if it meets the "25% test":[121]

- at least 25% of its employees are located in the new foreign jurisdiction,
- at least 25% of its employee compensation is attributable to the new foreign jurisdiction,
- at least 25% of the multinational group's asset value is located in that country, and
- at least 25% of the multinational group's total income is derived in that country.[122]

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116 *See* Hal Hicks & Oshan James, *Select Corporate Migration and Combination Considerations in an Ever Changing Environment*, INT'L TAX J., May-June 2014, at 25, 30 (2014).

117 *See* Surdell, *supra* note 66, at 74; Jefferson P. VanderWolk, *Inversions Under 7874 of the Internal Revenue Code: Flawed Legislation, Flawed Guidance*, 30 NW. J. INT'L L. & BUS. 699, 704 (2010).

118 Surdell, *supra* note 66, at 74-75; *see also* 26 U.S.C. § 7874(d)(2).

119 VanderWolk, *supra* note 117, at 704 n.24.

120 This tightening of the rule may have been in response to a number of self-inversions, including Aon Corp's and Rowan Companies Inc.'s, that relied on a previous (and more flexible) "facts and circumstances" test. *See* Bret Wells, *Cant and the Inconvenient Truth About Corporate Inversions*, 136 TAX NOTES 429 (July 2012) (discussing the facts and circumstances test for the substantial business activities test under Section 7874).

121 *See* Surdell, *supra* note 66, at 78-79; Treas. Reg. § 1.7874-3T(a)-(b)(3) (2013).

122 Surdell, *supra* note 66, at 78-79; Treas. Reg. § 1.7874-3T(a)-(b)(3) (2013) (establishing the 25% bright-line test).

D. The Fourth Generation

Although corporate inversion activity slowed for some time after Section 7874, it has picked up again in the last half-decade. Because inverting companies have a hard time escaping Section 7874's applicability through the 25% substantial business activities test,[123] many fourth-generation inverters have focused on making sure that there is not too much ownership continuity between the old U.S. company and the new combined company. In order to have low ownership continuity, fourth-generation corporate inversions are accomplished through business combinations with non-U.S. companies.[124]

Actavis's corporate inversion is a good case study, as it is fairly representative of the current generation of inversions. In May of 2013, Actavis, Inc., a Nevada-incorporated company headquartered in New Jersey, announced its intention to purchase Ireland's Warner Chilcott plc in a stock-for-stock transaction valued at about $8.5 billion.[125]

To complete the transaction, Actavis formed an Irish company (New Actavis) and a number of wholly owned subsidiaries under New Actavis.[126] Then, Actavis merged with and into one of New Actavis's wholly owned subsidiaries, cancelling Actavis's shares and giving its shareholders the right to receive shares of New Actavis.[127] At the same time, New Actavis acquired Warner Chilcott. In the process, Warner Chilcott's shares were also canceled and Warner Chilcott shareholders received the right to a fraction of a New Actavis share for each Warner Chilcott share they previously held.[128] At the end of the transaction, New Actavis was the parent company of both Actavis and Warner Chilcott. Former Actavis shareholders owned 77% of the New Actavis shares, and former

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[123] Even some companies that have significant operations abroad may have difficulty meeting the 25% bright-line rule because the assets of the post-combination company do not include intangible assets in the calculation. Thus, companies with large amounts of assets abroad—but largely comprised of intangible assets—will have trouble meeting the 25% bright-line rule. Surdell, *supra* note 66, at 79.

[124] *Id.*

[125] Press Release, Actavis, Inc., Actavis to Acquire Warner Chilcott to Create Premier $11 Billion Revenue Global Specialty Pharmaceutical Company (May 20, 2013), *available at* http://ir.actavis.com/phoenix.zhtml?c=65778&p=irol-newsarticle&ID=1821961; Actavis, Inc., Current Report (Form 8-K) (Oct. 1, 2013) (noting Actavis's place of incorporation and headquarters location).

[126] Actavis, Inc., Prospectus (Form 424b3) 12-15 (Jul. 31, 2013) (describing and illustrating the pre- and post-transaction structures of Actavis, New Actavis, and Warner Chilcott).

[127] *Id.* at 14.

[128] *Id.* at 13-14.

Warner Chilcott shareholders owned 23% of the New Actavis shares. Because ownership continuity between former Actavis shareholders and New Actavis shareholders was only 77% (and thus did not reach 80%), Actavis successfully inverted out of the United States, although it was still subject to the tightened rules because ownership continuity exceeded 60%.[129]

Like previous generations of corporate inverters, the current generation of inverters cites tax savings, including savings realized by accessing trapped cash, as a key reason for inverting. In public filings, Actavis noted that inverting would lower its effective tax rate from 28% to 17%.[130] Actavis CEO Paul Bisaro also told investors that Actavis expected "substantial operational synergies and some tax synergies and overall tax structure benefits,"[131] and that the acquisition would

> allow us to use our balance sheet and our tax structure to go and get many more of those assets that we were handicapped trying to get before . . . . So if we're looking now at assets that are overseas and we can bring to the U.S., further enhancing our pipeline, we now have a vehicle to do that . . . .[132]

In other words, Actavis's corporate inversion was motivated, in part, by the desire to access cash trapped overseas.

Likewise, when Minnesota-based Medtronic, Inc. announced its decision to invert to Ireland by acquiring Irish company Covidien plc., commentators emphasized that the deal was driven by Medtronic's desire to "bring the amount of [its] 'trapped' offshore cash down to about 40 percent of its total cash, from 60 percent as a stand-alone firm."[133] U.S. companies

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[129] *Id.* at 15.

[130] *Id.* at 70 (noting that "the expected combined company effective non-GAAP tax rate of approximately 17%, as opposed to the current non-GAAP effective tax rate of Actavis of 28%"). Note that Actavis's pre-inversion corporate tax rate was already lower than the oft-quoted 35% U.S. corporate tax rate, because it had already engaged in prior transactions that lowered its tax rate.

[131] Actavis, Inc., Prospectus (Form 425) 2 (May 20, 2013). In response to a question asked during an investor call in conjunction with the deal, Actavis CEO Paul Bisaro stated that, "I think I again would come back to the fact that as we looked at the strategic value of Warner Chilcott in Actavis' hands it became a compelling story for us. It was compelling from a commercial perspective." In the same response, Bisaro stated, "[a]nd then, finally, we will receive the benefit, the combined company will receive the benefit of a better overall tax structure . . . ." *Id.* at 15.

[132] *Id.* at 15. In response to a question asked during an investor call, Bisaro said that the Warner Chilcott acquisition "was the perfect opportunity for that for all the reasons we've already discussed and had the added benefit of being able to deal with something that was always troubling to me, which was the tax structure, and I think we've really found a way to deal with that and make us competitive in a global environment." *Id.* at 20.

[133] Gelles, *supra* note 34.

with a lot of intellectual property, especially, have moved their intellectual property abroad so as to avoid paying high U.S. taxes on the income generated by that intellectual property.[134] By inverting, many companies are able to access trapped cash that they were otherwise unwilling to bring into the United States.

Inverting companies have asserted that tax reforms abroad play a role in driving recent inversions. For instance, the United Kingdom recently adopted tax reforms, including lower corporate tax rates, in part because many U.K. companies were inverting to tax-friendly Ireland.[135] When Ensco International Incorporated left the United States for the United Kingdom in 2010, it noted that

> the U.K. has taken steps to decrease uncertainty about its international tax regime by proposing the liberalization of certain of its international tax provisions to better harmonize them with the foreign dividend exemption system recently implemented in the U.K.[136]

Recent inversions may also be driven in part by the fact that inversions to Europe may be easier to sell to the public and shareholders than inversions to traditional tax havens. Stanley Works's corporate inversion to a traditional tax haven played a big role in drowning its inversion and spurred the addition of Section 7874. Inverting to jurisdictions that are not considered tax havens means that corporations can avoid some public stigma.

President Obama and both houses of Congress proposed anti-inversion actions in 2014. President Obama's 2015 budget

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[134] Jonathan D. Rockoff, *Why Pharma is Flocking to Inversions: Deals Enable Companies to Take Advantage of Lower Tax Rates Overseas*, WALL ST. J. (Jul. 14, 2014, 1:53 PM), http://online.wsj.com/articles/why-pharma-is-flocking-to-inversions-1405360384 ("Even companies that haven't done inversions have used other methods to cut their taxes. Biogen Idec, Celgene Corp. and Gilead Sciences Inc. have 'domiciled' the intellectual property for various drugs outside the U.S. to lower the taxes they pay on sales, according to RBC Capital Markets").

[135] Steven Surdell discusses the "liberalization" that Ensco mentions in its prospectus. Specifically, after seeing several prominent U.K.-incorporated companies reincorporate in tax-friendly Ireland, the U.K. reformed its tax system to lower corporate tax rates and to more closely resemble a territorial system. Surdell notes that

> [t]he activity across the pond was not lost on U.S. multinationals with large U.K. operations. If the U.K. reformed its international tax system to resemble a territorial system and also lowered its corporate rate, U.S. incorporated multinationals could consider unilateral inversions to the U.K. rather than to traditional "haven" jurisdictions like Bermuda or the Cayman Islands.

Surdell, *supra* note 66, at 76.

[136] ENSCO International Incorporated, Proxy Statement (Schedule 14A) 13, 29 (Nov. 20, 2009).

proposal, introduced in March 2014, included a provision to strengthen current anti-inversion rules. Under Section 7874, if there is ownership continuity of 60% or more, tax penalties apply. If there is ownership continuity of 80% or more, the inverting company will not be treated as a foreign company at all after its corporate inversion—the United States will tax it as though it had never left the country. The budget proposes doing away with the 60% to 80% threshold and replacing both with a 50% threshold.[137] Thus, an attempted inverter will still be taxed as a U.S. corporation if there is ownership continuity of 50% or more.

In addition, regardless of the level of ownership continuity, "an inversion transaction [will occur] if the affiliated group that includes the foreign acquiring corporation has substantial business activities in the United States and the foreign acquiring corporation is primarily managed and controlled in the United States."[138] In other words, if a big Irish corporation gobbles up a smaller domestic corporation and the resulting company has substantial business activities in the United States, and the foreign corporation is "managed and controlled" in the United States, this transaction will be considered a corporate inversion, regardless of shareholder continuity. Finally, the budget proposes an amendment to Section 7874 so that a corporate inversion could occur if there is an acquisition of substantially all of the assets of a trade or business of a domestic partnership.[139]

Senator Carl Levin's Stop Corporate Inversions Act of 2014 largely mirrors the budget's proposals,[140] but sunsets in two years, giving Congress two years to consider comprehensive tax reform.[141] Senator Levin's bill proposes to lower the ownership continuity threshold to 50%.[142] It also quantifies the "management and control" sentiment of the budget proposal: a company will continue to be treated as a U.S. company for tax reasons if "either 25% of its employees or sales or assets are located in the United States."[143] On the same day that Senator Levin introduced the bill in the Senate, his brother, Congressman Sander Levin, introduced a companion bill in the House of Representatives.[144]

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[137] TREAS., GENERAL EXPLANATIONS, *supra* note 18, at 64-65.
[138] *Id.* at 65.
[139] *Id.*
[140] Stop Corporate Inversions Act of 2014, S. 2360, 113th Cong. (2014).
[141] *See* Press Release, Sen. Ben Cardin, *supra* note 45.
[142] Stop Corporate Inversions Act of 2014, S. 2360.
[143] *See* Press Release, Sen. Ben Cardin, *supra* note 45.
[144] Stop Corporate Inversions Act of 2014, *supra* note 48.

After the Levins' anti-inversion proposals failed to gain traction, both the executive and legislative branches took further action. Treasury Secretary Jack Lew sent a letter to the House of Representatives, urging anti-inversion legislation and corporate tax reform.[145] Shortly thereafter, Senator Levin co-sponsored a bill with Senator Dick Durbin that would prevent inverted corporations from obtaining federal government contracts.[146]

There were also several proposals targeting trapped cash and earnings stripping. Senators Harry Reid and Rand Paul have also proposed legislation that may deal with the trapped cash problem. They have been "quietly pressing for a one-time tax 'holiday'—a special and lucrative tax deduction—to lure multinational corporations to bring profits home from overseas, producing a sudden windfall."[147] This may also reduce some corporations' incentives to invert, at least in the short term.

Former Treasury official Stephen Shay has also urged regulatory action to reduce the incentive for corporations to invert. Shay argues that the Treasury Secretary has "direct and powerful regulatory authority to reclassify debt as equity and thereby transform a deductible interest payment into a nondeductible dividend," and notes that under Section 385 of the Code, "it is possible and appropriate to identify cases in which the use of related-party debt exceeds thresholds that should be acceptable in a particular case."[148] Shay proposes regulations that would cause inverted corporations to reclassify as equity any intercompany debt issued to a related foreign entity that is not a CFC, up to a certain amount.[149] Since much of the tax-saving value of corporate inversions is derived from earnings stripping by injecting intercompany debt, removing the benefit of that interest deduction takes much of the shine off of inverting. By way of example, Shay notes that, had a rumored Walgreens inversion been completed, Walgreens could have exempted 50% or more of its taxable income from U.S. income tax by injecting intercompany debt, leading to a tax savings of $783 million.[150] Treasury action reclassifying intercompany debt as equity, however, would have reduced

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[145] *See supra* note 49, and accompanying text.

[146] *See* Office of Congresswoman Rosa DeLauro, *supra* note 51, and accompanying text.

[147] Weisman, *supra* note 52.

[148] Shay, *supra* note 53, at 474-75 (arguing for regulatory action to reduce the benefits of corporate inversions).

[149] *Id.* at 475.

[150] Shay, *supra* note 53, at 474.

that savings "by hundreds of millions of dollars . . . chang[ing] the calculus of a decision to expatriate."[151]

Like Shay's proposal, Senator Charles Schumer's proposal also tackles the earnings stripping problem by limiting interest deductions.[152] In addition to other technical aspects, Senator Schumer's proposal reduces an inverted corporation's permitted net interest expense from 50% to 25% of its net adjusted taxable income. The proposal also repeals the corporation's ability to carry forward excess interest deductions into future years, which is currently allowed. Additionally, an inverted corporation will need to obtain IRS pre-clearance on transactions with its parent company for 10 years after the inversion, which would possibly allow the IRS to limit the amount of intercompany debt injected, and therefore the amount of earnings stripping that occurs.[153]

As with previous generations of inversions, the government continues to wage war on tax grounds. Once again, corporations have stated that they invert for tax reasons: to lower tax rates, to access trapped cash, and to inject intercompany debt in order to further reduce tax burdens. And, as before, the government has responded on tax grounds: it has proposed tightened tax-based restrictions and introduced the "management and control" concept in order to make it even harder for corporations to escape the U.S. tax net.

From the perspective of both parties, the war is a zero-sum game. For corporations, increasing global competition against companies that have smaller tax burdens makes inverting out of the United States an attractive way to lower taxes and access cash trapped overseas. For the government, every dollar of a corporation's tax savings is a corresponding loss in government tax revenue. As a result, the government has implemented a series of policies that lower the tax benefits of inverting and make inverting complicated and difficult. But the Code is complicated, and corporations are nimble. Whenever a new generation of anti-inversion policy is enacted, it is only a matter of time before corporations find a way to invert. And while comprehensive tax-system overhauls like the United Kingdom's—including a move to a territorial system or

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151 *Id.* at 475.

152 Rubin, *supra* note 55.

153 Siobhan Hughes, *Q&A: Schumer's Proposal to Strip Benefits of Corporate Earnings Stripping*, WALL ST. J. (Aug. 14, 2014, 4:50 PM), http://blogs.wsj.com/washwire/2014/08/14/qa-schumers-proposal-to-strip-benefits-of-corporate-earnings-stripping/ (reporting on Senator Schumer's proposal to cap interest deductions).

lowering the corporate tax—have been proposed in the United States and may work in theory, they may be too politically fraught to be practicable or realistic. In the best of times, a comprehensive overhaul of the corporate tax system requires Herculean Congressional effort. And with today's gridlocked Congress, many commentators have noted that even the Levin brothers' relatively middle-of-the-road proposal is unlikely to find support on both sides of the political aisle.[154]

III. CORPORATE INVERSIONS' HIDDEN COSTS

The reality that corporations can use inversions to save on taxes changes corporate behavior, which has non-tax consequences for the corporation. Inversions also cause negative externalities—costs borne by the public. These consequences for the corporation and for the public are exacerbated by the complexity of modern business-combination inversions. This Part begins to consider some of the hidden costs of inversions both for inverting corporations and for the public. In doing so, this Part reveals a range of under-considered factors that are relevant to the inversion discussion and begins to consider whether and to what extent these factors should be considered in future policy decisions.

Ultimately, while inversions create costs for corporations, the non-tax hidden costs may not, for each individual inverter, be sufficient to outweigh an inversion's tax benefits. However, the cumulative costs of inversions for the public are worthy of further research.

A. Costs to the Inverting Corporation

Tax laws—like all laws and regulations—often have unanticipated consequences. In this case, the current corporate-inversion-related legal and regulatory landscape, combined with

[154] *See* Wendy Diller, *Congress And Tax Inversions: A Wall Streeter's Take On 2014*, FORBES (Jul. 16, 2014, 6:23 PM), http://www.forbes.com/sites/wendydiller/2014/07/16/congress-and-tax-inversions-a-wall-streeters-take-on-2014/ (opining that "hardliners" are unlikely to support the Levins' proposal, instead preferring to hold out and pass comprehensive tax reform when there is a Republican majority in both houses of Congress); Gelles, *New Legislation Targets Inversions From Different Angle*, *supra* note 50 (noting that the Levins' bill "failed to gain traction"); Danny Vinik, *U.S. Corporations Are Exploiting a Huge Tax Loophole, but The GOP Doesn't Want to Close It*, NEW REPUBLIC (May 21, 2014), http://www.newrepublic.com/article/117843/levin-brothers-want-end-tax-inversion-gop-refuses (opining that although the Levins' bill "has 13 Democratic co-sponsors in the Senate and nine in the House, [it] is unlikely to find much support among Republicans").

the corporate inversions that are executed because of it, creates costs for inverting corporations. This sub-Part unpacks some of the ways that inversions and inversion policy can change corporate behavior, revealing factors that are under-discussed. While these non-tax factors may not be sufficient to outweigh inversions's tax benefits, they are worth discussing and certainly worthy of consideration by potential inverters.

1. Transition Costs

Currently, corporations can leave the United States for lower-tax jurisdictions by inverting. For some corporations, a desire to lower their tax bills may be the primary driver of a re-incorporation decision. The act of reincorporation abroad, however, comes with transition costs.

These transition costs include the costs associated with learning a new corporate law and corporate governance regime. A corporation that has spent decades incorporated in Delaware is already familiar with the nuances of Delaware corporate law. A corporation that inverts to Ireland or the United Kingdom incurs the cost of learning a new body of law, and the differences may be substantial.

In the everyday governance context, for instance, there are material differences between dividend payout rules in Delaware and in Ireland. Under Delaware law, a corporation can pay out dividends if it has surplus—a fairly squishy concept that allows a corporation a great deal of leeway in dividend payments.[155] In contrast, under Irish law, dividend payouts are based on the concept of distributable reserves.[156] Capital reduction is one way to create distributable reserves, but capital reduction requires shareholder approval and approval by the Irish High Court.[157] While this approval may be a rubber-stamp process, it is still an additional restriction to dividend payments that is not imposed on a Delaware corporation.

Shareholder derivative suits are also handled substantially differently in the United Kingdom. Shareholder derivative suits—lawsuits in which a corporation's shareholder sues (often a corporation's management) on behalf of a

[155] DEL. CODE ANN. tit. 8 § 170 (providing for the distribution of dividends of Delaware corporations).

[156] Companies (Amendment) Act of 1983, § 45 (1983) (providing restrictions of profits and assets).

[157] Companies Act of 1963, § 74 (1963) (describing the process by which the court approves a capital reduction).

corporation—are common in the United States.[158] In the United Kingdom, there is relatively limited access to such suits. Until the passage of the Companies Act 2006, shareholder derivative suits were governed by complex common law and were therefore rare.[159] The Companies Act 2006 established a new two-stage procedure to obtain court permission to continue derivative actions, eradicating the common law procedures for bringing a shareholder derivative suit. This change was thought to make shareholder derivative suits slightly easier to sustain,[160] although the two-stage court-permission process is still cumbersome relative to the United States's process. In the United States, a shareholder need only first demand that management bring a suit, and can then sue if management refuses.[161] Evidence from the years directly after the U.K. laws went into effect also did not indicate a great uptick in the number of shareholder derivative suit opinions reported.[162] The United Kingdom's relatively cumbersome shareholder derivative suit rules, combined with the relatively low numbers of derivative suits reported, suggests that shareholders of corporations that have inverted to the United Kingdom may have less access to derivative suits than if the corporations had stayed in the United States. On the other hand, evidence also suggests that many U.S. derivative suits are dismissed early, and a very small percentage of these suits—around 1%, or much lower, depending on the type of company involved—generated a judicial opinion.[163] Thus, while shareholders may find it less cumbersome to file derivative suits in the United States, the shareholder's probability of litigating a case to opinion-generation in the United States is also very low.

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[158] Ann M. Scarlett, *Investors Beware: Assessing Shareholder Derivative Litigation in India and China*, 33 U. PA. J. INT'L L. 173, 178-79 (discussing the frequent use of shareholder derivative suits in the United States).

[159] *See* SLAUGHTER & MAY, COMPANIES ACT 2006: DIRECTORS' DUTIES, DERIVATIVE ACTIONS AND OTHER MISCELLANEOUS PROVISIONS (June 2007), *available at* http://www.slaughterandmay.com/media/39392/companies_act_2006_-_directors_duties_derivative_actions.pdf (describing provisions of the Companies Act 2006).

[160] John Armour et al., *Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States*, 6 J. EMPIRICAL L. STUD. 687, 695 (2009).

[161] Thomas P. Kinney, *Shareholder Derivative Suits: Demand and Futility Where the Board Fails to Stop Wrongdoers*, 78 MARQ. L. REV. 172, 173 (1994).

[162] *See* STUART PICKFORD & RANI MINA, MAYER BROWN, DERIVATIVE CLAIMS IN THE US AND THE UK: THE STORY SO FAR (Apr. 2009), *available at* http://www.mayerbrown.com/files/Publication/d44e695d-fca6-422e-bf0c-73918a8abff3/Presentation/PublicationAttachment/731b55c0-0c92-42b4-9e72-84f930d78b77/ART_PICKFORD_MINA_DERIVATIVE_CLAIMS_APR09.PDF.

[163] Armour, et al., *supra* note 160, at 706.

There are also substantial differences between U.S. law and foreign law in the mergers and acquisitions context, and, specifically, in the takeover protection and deal protection contexts, which can add to deal cost and deal uncertainty.

Many U.S. states, including Delaware, have long allowed companies to adopt takeover defenses, like stockholder rights plans (commonly called poison pills).[164] A typical stockholder rights plan may be triggered if a certain event, like a hostile takeover, occurs—for example, when one shareholder buys up 30% of a company's shares. When the plan is triggered, the other shareholders will have the right to buy newly issued shares of the company at a discount, which dilutes the 30% holder's shares and makes the takeover more expensive. In *Moran v. Household International*,[165] the Delaware Supreme Court upheld the validity of a stockholder rights plan as a takeover defense mechanism. The Delaware Court of Chancery has also recognized stockholder rights plans as acceptable responses to activist shareholder threats.[166] In contrast, both Ireland and Britain generally prohibit takeover defenses and expect companies to "fight these bids by lobbying shareholders directly."[167] Under both Irish and British takeover rules, subject to certain exceptions, a board of directors cannot take any action that might "frustrate" an offer for shares once the board of directors has received an approach that may lead to an offer or has reason to believe that an offer is or may be imminent.[168] And while some Irish corporations listed in the United States

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164 Steven Davidoff Solomon, *Elan Finds Creative 'Poison Pill' to Defend Against a Hostile Bid*, N.Y. TIMES DEALBOOK (Jun. 6, 2013, 6:57 PM), http://dealbook.nytimes.com/2013/06/06/elan-finds-creative-poison-pill-to-defend-against-a-hostile-bid/ (noting that "the states where American companies are organized freely allow companies to adopt takeover defenses, like a poison pill," and that "Ireland, like Britain, takes a different approach. Takeover defenses are generally prohibited. Instead, companies are exposed to a hostile takeover and are forced to fight these bids by lobbying shareholders directly").

165 500 A.2d 1346 (Del. 1985) (holding that Household's rights plan was a legitimate exercise of business judgment by the company).

166 *Third Point LLC v. Ruprecht*, No. 9469-VCP, 2014 WL 1922029, at *1 (Del. Ch. May 2, 2014) (refusing to enjoin Sotheby's annual meeting based on claims from activist Third Point that Sotheby's board breached its fiduciary duties by adopting a shareholder rights plan).

167 Davidoff Solomon, *supra* note 164.

168 THE PANEL ON TAKEOVERS AND MERGERS, THE CITY CODE ON TAKEOVERS AND MERGERS, rule 21 (11th ed., 2013), *available at* http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/code.pdf (providing rules that govern takeovers and mergers in the United Kingdom); IRISH TAKEOVER PANEL, IRISH TAKEOVER PANEL ACT, 1997: TAKEOVER RULES AND SUBSTANTIAL ACQUISITION RULES, rule 21 (2013), *available at* http://irishtakeoverpanel.ie/wp-content/uploads/2014/01/ITP-Takeover-Rules.pdf (providing rules that govern takeovers and substantial acquisitions in Ireland).

have adopted shareholder rights plans, the validity of these plans has yet to be tested in Irish court.[169]

Break-up fees are also handled differently in the United States than in the United Kingdom and Ireland. A break-up fee is a fee that a target company pays to a buyer if the deal is canceled under certain circumstances specified in the acquisition agreement.[170] For instance, if a topping bidder offers a larger sum to the target company and causes the target to terminate a previous agreement, the target will need to pay the previous buyer a break-up fee. In practice, the break-up fee increases the cost of the deal for the topping bidder, since the topping bidder will need to cover the target's payout of the break-up fee—this provides a level of deal protection to the original buyer.[171] In Delaware, there is no bright-line rule about what size break-up fee is reasonable, but generally, fees in the 3% to 4% range have passed muster.[172] Both British and Irish takeover rules are stricter about the use of break-up fees. British takeover rules specify that a break-up fee needs to be approved by the British Takeover Panel and can be used only in limited circumstances.[173] Under Irish takeover rules, break-up fees also require prior approval by the Irish Takeover Panel, and are capped at not more than 1% of the value of the offer.[174] The restriction on break-up fees can reduce deal certainty: for instance, parties subject to British or Irish takeover rules cannot agree to a relatively high break-up fee in order to protect the deal and ensure certainty.

However, while inverting corporations face certain transition costs, even a corporation that does not invert faces potential changes to corporate laws and rules in its jurisdiction of incorporation, which must be learned on an ongoing basis. Moreover, both inverted and non-inverted corporations are able to engage sophisticated counsel or employ relevant experts to help them navigate and comply with local laws. The cost of engaging those experts is likely outweighed by the enormous tax

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169 Finnerty & McLaughlin, *infra* note 184, at 77.

170 DAVID FOX ET AL., BREAKUP FEES—PICKING YOUR NUMBER, KIRKLAND & ELLIS LLP (Sep. 6, 2012), *available at* http://www.kirkland.com/siteFiles/Publications/MAUpdate_090612.pdf (describing the range of break-up fees).

171 *Id.*

172 *Id.* (referencing the decisions in *In re Cogent, Inc. S'holder Litig.*, 7 A.3d 487 (Del. Ch. 2010), *In re Toys "R" Us S'holder Litig.*, 877 A.2d 975 (Del. Ch. 2005), and *In re Topps Co. S'holders Litig.*, 9216 A.2d 58 (Del. Ch. 2007), which held that 3%, 3.75%, and 4.3% break-up fees were reasonable).

173 THE PANEL ON TAKEOVERS AND MERGERS, *supra* note 168, at Rule 21.

174 *Id.*

savings of inverting. Finally, while commentators of previous generations of inversions worried about shareholders' inability to understand inversion-related changes to governance—one commentator noted that "few American shareholders possess a sufficient understanding" of the inverted-to jurisdiction's laws[175]—modern-day shareholders, including institutional and activist investors, are more engaged with governance matters.[176] Thus, the concern that shareholders will be blindsided in the governance context by a move is also mitigated.

2. Reduced Local Influence

Another related concern for an inverted corporation is that if the laws of its new jurisdiction change, an inverted corporation may lack the necessary local influence to protect itself. Both management and shareholders may have incomplete pictures of how foreign corporate laws play out. For instance, how do local courts interpret the boundaries of the laws? How do the texts of the laws interact with the local political, economic, or social climate?[177]

Tyco International recently learned that local political and social climate can have a real and potentially negative impact on the corporation, its shareholders, and its managers. Tyco was a U.S. company that inverted to Bermuda in 1997, and later inverted portions of the company from Bermuda to Switzerland.[178] In 2013, Switzerland passed a voter referendum

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[175] Kun, *supra* note 31 at 343-44. Public companies file proxy statements in conjunction with corporate inversions, and these disclosures provide an item-by-item comparison of corporate laws in their original jurisdictions and the foreign jurisdictions to which they are inverting.

[176] *See generally* Roberta Romano, *Less is More: Making Institutional Investor Activism A Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174 (2001).

[177] Of course, there is an argument to be made that U.S. shareholders have a less-than-complete picture of U.S. corporate laws, too—after all, many shareholders may lack the legal and technical ability to understand U.S. corporate laws and how they interact with the United States's political, economic, and social climate. However, there are many reasons to believe that U.S. shareholders have a better understanding of U.S. law than foreign law. U.S. shareholders are more likely to be invested in more than one U.S. company, so they can at least compare one company's corporate practices against that of another. U.S. shareholders are also exposed regularly to U.S. news, and therefore should have a better understanding of the United States's political, economic, and social climate than they would have of a foreign jurisdiction's. And finally, U.S. shareholders have easier access to U.S. counsel.

[178] Stuart Webber, *Inverted U.S. Firms Relocate Headquarters to Europe*, 64 TAX NOTES INT'L 589, 590-91 (2011) (noting that Tyco inverted to Bermuda in 1997, split into three companies, and then inverted two of them from Bermuda to Switzerland in 2008 and 2009).

called the Minder Initiative.[179] Among other things, the Minder Initiative requires a binding shareholder vote on executive pay for Swiss public companies and bans signing bonuses and golden parachutes, among other forms of compensation.[180] Swiss voters also considered another executive pay proposal: the 1:12 Initiative for Fair Pay, which, if passed, would have capped the salaries of top-level Swiss executives at 12 times the wages of their lowest-paid employees.[181] These proposals caused concern to management of Tyco and other Swiss companies.[182] For managers especially, executive compensation caps are considered negative: they make it harder for companies to hire the best managers (who, in theory, require the highest compensation), and threaten managers' personal bottom lines. In May 2014, Tyco announced its intention to invert from Switzerland to Ireland, citing "[r]ecent changes in Swiss law impacting regulatory environment" as matters "of great concern to [Tyco]."[183]

Tyco's experience with Switzerland's executive pay reforms is just one example of how inverting corporations may be affected by unfavorable changes in the corporate laws of their new jurisdictions of incorporation. Because inverted corporations may also have small footprints in their new foreign jurisdictions—they may have few employees and little in the way of operations in their new foreign home[184]—they also

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179 Catherine Bosley, *Swiss Voters Approve Limits on "Fat Cat" Executive Pay*, BLOOMBERG (Mar. 3, 2013, 7:38 AM), http://www.bloomberg.com/news/2013-03-03/swiss-voters-set-limits-on-ceo-paychecks-sf1-projections.html (reporting on the Swiss voters' approval of the executive pay referendum); Neil MacLucas, *Swiss Voters Reject High-Pay Initiative*, WALL ST. J. (Nov. 24, 2013, 12:34 PM), http://online.wsj.com/news/articles/SB10001424052702304011304579217863967104606 (reporting on the outcome of the vote on Switzerland's executive pay referendum).

180 MacLucas, *supra* note 179.

181 John Lichfield, *Swiss Voters Reject '1:12' Proposal to Cap Top Executives' Pay in Latest Referendum*, INDEPENDENT (Nov. 24, 2013), *available at* http://www.independent.co.uk/news/world/europe/swiss-voters-reject-112-proposal-to-cap-top-executives-pay-in-latest-referendum-8960669.html.

182 MacLucas, *supra* note 179.

183 *Tyco to Move to Ireland as Swiss Tighten Laws on CEO Pay, Immigration*, REUTERS (May 2, 2014, 1:40 PM), http://www.reuters.com/article/2014/05/02/tycointernational-ireland-idUSL3N0NO41K20140502.

184 This is especially true for corporations that, for example, invert to Ireland by purchasing a Canadian company. Domestic corporations that invert to Ireland by purchasing an Irish company may acquire Irish operations as a result of the acquisition. Domestic corporations that invert to Ireland by purchasing a non-Irish company may truly have very little Irish operation in Ireland, since both the domestic corporation and its non-Irish target may have little previous operation in Ireland. *See* Ailish Finnerty & Christopher McLaughlin, *Inversions to Ireland*, PRAC. L.J. (Apr. 2014), at 74-75, *available at* http://www.arthurcox.com/wp-content/uploads/2014/04/

have relatively little influence in their new foreign jurisdictions. In contrast, when faced with unfavorable circumstances, a large corporation with a substantial local footprint can influence laws and regulations to change their circumstances. For instance, Washington state has given $8.7 billion in tax breaks over sixteen years to keep Boeing from moving away, and New York state granted aluminum company Alcoa $5.6 billion in tax breaks over thirty years for the same reason.[185] In contrast, inverted corporations that have little operational connection to their new jurisdictions of incorporation have less leverage when unfavorable legislation is on the horizon. In the context of inversion-specific legislation or regulation, the lack of influence becomes particularly interesting: there is no guarantee that popular inversion destinations will not come up with anti-inversion laws that make inverting out of those jurisdictions a cumbersome and costly process.

However, social changes in the United States also occur rapidly, and may cause concern for U.S. corporations. For example, a few years before Tyco was concerned about the Minder Initiative in Switzerland, many U.S. corporations were probably likewise concerned about how 2011's Occupy Wall Street movement would affect the domestic corporate and economic landscape. In addition, an argument can be made that corporations actually *increase* their political influence by inverting. For instance, a mid-market domestic company may invert from the United States to a smaller economy. In the smaller economy, the inverter's taxes generate a proportionally larger chunk of the smaller economy's total tax revenue. As a result, the inverter, through its footing of a larger share of its new home country's tax bill, has a proportionally larger share of influence than it did in the United States, where it footed a smaller percentage of the United States's total tax revenue.

3. Opportunity Costs of Acquiring a Foreign Business in Service of an Inversion

Modern inversions can be executed only through substantial cross-border business combinations, and most companies invert to their new jurisdictions by acquiring

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April2014_SpotlightOn.pdf (providing an overview of U.S. inversions to Ireland from an Irish law firm's perspective).

[185] Danny Westneat, *Tax Breaks for Boeing: We're No. 1*, SEATTLE TIMES (Nov. 12, 2013), *available at* http://seattletimes.com/html/localnews/2022245449_westneat13xml.html.

companies in that new jurisdiction.[186] In choosing to deploy its capital to buy a particular foreign business in a tax-friendly jurisdiction, an inverting corporation may lose out on other growth opportunities.

The opportunity cost of purchasing a particular foreign business in order to invert may be substantial. If Burger King's acquisition of Tim Hortons had been entirely driven by a desire to invert, for instance, Burger King would have tied up $11.0 billion in order to invert.[187] Tying up a significant amount of a company's capital in a substantial foreign acquisition could affect an inverting company's future creditworthiness, causing cash flow issues. On the other hand, if the result of a foreign acquisition is that cash on the assets side of a company's balance sheet is simply converted to a non-cash asset—a foreign company—there is less cause for concern.

The fear that an inverting corporation may forgo other foreign growth opportunities purely to chase an inversion is also somewhat mitigated by recent deals. Pennsylvania company Mylan recently announced its corporate inversion to the Netherlands through the acquisition of a foreign division of Illinois corporation Abbott Laboratories.[188] Applied Materials' recent inversion to the Netherlands, too, was accomplished through the acquisition of Japanese target Tokyo Electron.[189]

4. Costs to Inverting Corporations, Evaluated

Corporations assert that they invert to save on their tax bills. This single-minded focus on tax savings may change corporate behavior, causing corporations to incur, among other things, transition costs, the costs of being incorporated in a foreign jurisdiction in which it has relatively little influence, and opportunity costs when the inverting corporation deploys its capital to acquiring a particular foreign business. In many of these cases, inverting injects risk. However, many of these hidden costs to corporations of inverting can be and are mitigated—and the cost of mitigation may be but a small portion of an inverting corporation's huge tax savings.

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[186] *See* Professor Desai's data on inversions, *supra* note 12 (showing that most recent inversions are accomplished through a cross-border business combination transaction with a company already domiciled in the combined company's ultimate tax domicile).

[187] *See supra* note 14.

[188] Mylan, Inc., Current Report (Form 8-K) (Jul. 14, 2014) (announcing its proposed acquisition of Abbott and planned subsequent inversion to the Netherlands).

[189] *New Corporate Tax Shelter: A Merger Abroad*, *supra* note 13.

Moreover, while not inverting carries similar risk (for instance, that the relevant corporate law may change), the risk of inverting may be higher. On the whole, then, it appears that these costs and risks may, for a corporation, take a back seat in the face of enormous tax savings.

B. *Inversion Costs Borne by the Public*

In addition to creating costs for corporations, inversions may also create costs that are borne by the public. These negative externalities are not accounted for by inverters.

1. Inversions Driving Industry Over-Consolidation

Modern inversions require inverting companies to engage in substantial cross-border business combinations, so the availability of inversions may drive over-consolidation in some industries. For instance, in conjunction with Pfizer's proposed inversion through the acquisition of AstraZeneca, Professor Victor Fleischer observed that "[w]e don't know if Pfizer is pursuing AstraZeneca because the combined firm will be more efficient or because of the tax savings."[190] He notes that:

> Coase argued that the boundaries of the firm depend on what is known as the make vs. buy decision. If the costs of making a product inside the firm are less than the costs of contracting out, the company will make the product, not buy it . . . . The boundaries of the firm are set at the point where the benefits of [buying from] the market are outweighed by [the] transaction costs [associated with buying from the market].[191]

However, when buying from outside—that is, buying another company—is associated with a tax break, the make vs. buy decision is distorted. Companies begin to think about the make vs. buy decision based in part on whether buying will garner a specific tax benefit. Buying is now a necessary part of inverting. Thus, inverting companies may choose to buy more than to make in order to take advantage of inversions' tax benefits. For companies, this has a potentially negative side effect: they may grow larger than would have been efficient in the absence of inversions' tax benefits. On the other hand, a

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[190] Victor Fleischer, *How Tax Laws Distort the Pfizer Deal*, N. Y. TIMES DEALBOOK (Apr. 29, 2014, 3:56 PM), http://dealbook.nytimes.com/2014/04/29/how-tax-laws-distort-the-pfizer-deal/ (discussing, in the context of Pfizer's proposed inversion via an acquisition of AstraZeneca, the distortionary effects of current U.S. tax laws).

[191] *Id.*

particular inverting company's tax savings may still outweigh any inefficiencies that result from buying when it should have been making, so inverters may still come out ahead as a result of an inversion.

On a systemic level, however, multiple inverters engaging in inversion-related business combinations may have a negative effect for the public. Multiple business combinations almost necessarily lead to increasing consolidation within a particular industry. That is, a life sciences company that needs to buy another company in order to invert is likely to choose another life sciences company as a target, rather than, for example, a hotel chain. When multiple life sciences companies invert, they buy up many of the other life sciences companies in the market. Over time, industries may over-consolidate as many companies begin to choose to buy rather than to make in order to take advantage of the tax benefits of inverting.

Many have commented on the detriments of over-consolidation and the resulting monopolistic markets. For instance, scholars have noted that monopoly inhibits innovation.[192] This lack of innovation creates a negative externality that the public must bear. Many recent inversions have involved companies in the life sciences industry. In the life sciences industry, over-consolidation may lead to fewer drugs being developed. Pfizer's former President of Global Research and Development, John LaMattina, has called pharmaceutical-industry consolidation "devastating."[193] In a *Forbes* op-ed about Pfizer's bid for AstraZeneca, LaMattina noted that industry consolidation can lead to reduction in R&D projects: "While done with the best of intentions, the fact is that you can never be sure that you haven't dropped what would have been a major new advance to treat brain cancer . . . . [T]he major outcome for R&D in mergers is that

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[192] *See, e.g.*, Mark A. Lemley, *Industry-Specific Antitrust Policy for Innovation* 2 (Stanford L. & Econ., Olin Working Paper No. 397, Sept. 1, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1670197 (noting that "there is substantial economic evidence suggesting that competition itself may act as a greater spur to innovation than monopoly," and citing Kenneth J. Arrow, *Economic Welfare and the Allocation of Resources for Invention*, in NATIONAL BUREAU OF ECONOMIC RESEARCH, THE RATE AND DIRECTION OF INVENTIVE ACTIVITY: ECONOMIC AND SOCIAL FACTORS, 609, 615 (1962)).

[193] John L. LaMattina, *The Impact of Mergers on Pharmaceutical R&D*, 10 NATURE REV. DRUG DISCOVERY 559 (Aug. 2011), *available at* http://www.nature.com/nrd/journal/v10/n8/full/nrd3514.html?WT.ec_id=NRD-201108 (describing the negative impact of mergers on research and development at Pfizer).

there will ultimately be fewer scientists in R&D and fewer ideas being pursued."[194]

The only factor that mitigates industry over-consolidation may be that, as a public-relations matter, huge, iconic companies like Stanley Works, Walgreens, and Pfizer have more trouble inverting. If public relations can successfully limit the number of large companies inverting, over-consolidation may be somewhat mitigated.

2. Inversions Exacerbating an Already-Regressive Corporate Tax Rate

In addition to contributing to over-consolidation, inversions also change the corporate tax rate structure. The U.S. corporate tax rate is fairly flat: all but the smallest businesses are subject to a 35% statutory rate.[195] When large corporations are able to invert, however, they are able to take advantage of a much lower foreign tax rate, while smaller businesses continue to be subject to the 35% rate.

Inversions are expensive transactions with high upfront costs. For example, for its acquisition of Warner Chilcott, Actavis paid $20.5 million to its two financial advisors, Merrill Lynch and Greenhill.[196] When Forest Labs inverted in 2014 (through a business combination with Actavis), it paid its financial advisor, J.P. Morgan, $5 million for the delivery of its opinion, and approximately $50.9 million when the deal

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[194] John LaMattina, *Biopharmaceutical Industry Consolidation Diminishes Future Drug Discovery*, FORBES (Jun. 10, 2014, 8:01 AM), http://www.forbes.com/sites/johnlamattina/2014/06/10/biopharmaceutical-industry-consolidation-diminishes-future-drug-discovery/. LaMattina said the same in 2011, when Pfizer merged with Wyeth:

> From a business perspective, mergers and acquisitions are often considered attractive as they remove duplication, reduce costs and produce synergies . . . . [But i]n major [pharmaceutical] mergers today, not only are R&D cuts made, but entire research sites are eliminated . . . . After a major merger, the rate of progress of compounds in the development pipeline seems to decrease. For example, comparing data from Pfizer's pipeline updates . . . before the Wyeth merger in February 2008, and in February 2011, reveals that 40% of the compounds (not including those from Wyeth) have been in Phase II development for more than 3 years, which is below the industry average.

See John L. LaMattina, *supra* note 193, at 559-60.

[195] KEIGHTLEY & SHERLOCK, *supra* note 28, at 2.

[196] Actavis Ltd., Amendment No. 1 to Registration Statement (Form S-4), *supra* note 10, at 85, 96 (disclosing that Actavis agreed to pay $10.5 million and $10 million to Merrill Lynch and Greenhill, respectively).

closed.[197] Lawyers' fees for a public company deal—for negotiation, drafting, diligence, and filing of public disclosure, among other tasks—can also easily cost millions of dollars.[198]

For larger corporations, millions in upfront cost is doable: recent announcers include Applied Materials (with a market cap of $25.5 billion[199]) and Pfizer (with a market cap of $178.0 billion[200]). But this cost is harder for smaller corporations: a smaller company, like hip New York subscription cosmetics start-up Birchbox, has estimated annual revenues of about $125 million.[201] A $10 million inversion cost would be 8% of its annual revenues. Although smaller companies may hire less expensive counsel who spend less time on the smaller companies' less complicated inversions, evidence from previous generations of inversion activity supports the theory that only larger companies invert: in Professors Desai's and Hines's survey of third-generation inverters, even the smallest inverters had nine-figure market valuations.[202] Moreover, smaller companies where stock ownership is concentrated with a few founders are more likely to be affected by the shareholder-level taxes imposed by Section 367(a), adding an additional reason for small companies not to invert.

Scholarship on regulatory arbitrage supports the observation that large companies invert while small ones do not.[203] The conventional scholarly wisdom is that contracts, like the ones used in big business combinations, are designed to minimize transaction costs, including upfront drafting and negotiation costs.[204] But some deals that increase upfront transaction costs, like inversions, exist. Regulatory arbitrage theorizes that there is tension between regulatory costs and upfront transaction costs—some transactions that are costly

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[197] Actavis plc, Amendment No. 1 to Registration Statement (Form S-4) at 97 (May 2, 2014).

[198] One report published in 2013 estimated that the average billing rate for big-firm partners was over $700 an hour, and for law-firm associates generally was about $370 an hour. *See* Debra Cassens Weiss, *Average Hourly Billing Rate for Partners Last Year Was $727 in Largest Law Firms*, ABA J. (Jul. 15, 2013), *available at* http://www.abajournal.com/news/article/average_hourly_billing_rate_for_partners_last_year_was_727_in_largest_law_f/ (reporting on the billing rates of partners at large firms).

[199] *Applied Materials, Inc.* (AMAT), Yahoo! Finance, http://finance.yahoo.com/q?s=AMAT (as of Aug. 12, 2014).

[200] *Pfizer, Inc. (PFE)*, Yahoo! Finance, http://finance.yahoo.com/q?s=PFE (as of Aug. 12, 2014).

[201] Erin Griffith, *Exclusive: Birchbox Banks $60 Million*, FORTUNE (Apr. 21, 2014), *available at* http://fortune.com/2014/04/21/exclusive-birchbox-banks-60-million/ (reporting on Birchbox's Series B round and providing an estimate of Birchbox's annual revenues).

[202] Desai & Hines, *supra* note 12, at tbl. 1.

[203] *See generally* Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227 (2010).

[204] *Id.* at 230-31 (citing Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 255 (1984)).

upfront are perfectly rational if they are designed to minimize regulatory costs and if those regulatory cost savings outweigh the upfront transaction costs.[205] In the case of a corporate inversion, corporate inverters are engaged in the perfectly rational behavior of taking on huge one-time upfront transaction costs in order to save on ongoing regulatory costs. Those regulatory costs saved are expected to more than make up for the millions in upfront fees.

It is worth noting here that although the conventional wisdom in corporate finance is that worthwhile projects can be financed with debt, this may not be the case in practice. Thus, even if a corporate inversion would be rational for a small corporation to undertake, the small corporation may not be able to find the $10 million upfront funding needed.

The phenomenon of big businesses inverting while small businesses do not has important implications. When big businesses invert and small businesses do not, the corporate tax rate starts to look regressive. To be sure, large, profitable corporations may already pay taxes at a significantly lower rate than the statutory rate,[206] but the ability to invert abroad exacerbates that problem.

3. Inversions Benefit Some Industries More Than Others

Inversions also affect industries within the United States differently. Consider, for instance, two large companies incorporated in Delaware: Domestic Corp. is a U.S.-based service provider with no overseas operations or sales, and International Corp. is a U.S.-based software company with extensive overseas operations and sales. A corporate inversion is worthwhile for International Corp., because multinational corporations can use corporate inversions to undo CFC classifications, access cash trapped overseas, and inject intercompany debt. On the other hand, corporate inversions are of less help to domestic corporations that do not otherwise intend to expand overseas:

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[205] *Id.* at 231 (noting that "deal lawyers face a tension between reducing regulatory costs on the one hand and increasing Coasean transaction costs on the other," that "[d]eal lawyers routinely depart from the optimal transaction-cost-minimizing [deal] structure," and that "[s]o long as the regulatory savings outweigh the increase in transaction costs, such planning is perfectly rational").

[206] *Corporate Income Tax: Effective Tax Rates Can Differ Significantly from the Statutory Rate*, U.S. Gov't Accountability Office 14 (May 2013), *available at* http://www.gao.gov/assets/660/654957.pdf (finding that for the 2010 tax year, large profitable domestic companies "paid U.S. federal income taxes amounting to 12.6 percent of the worldwide income that they reported in their financial statements").

Domestic Corp., for instance, may not have any CFCs it wants to declassify or any cash trapped overseas that it needs to access. Thus, the availability of corporate inversions as a tax-saving mechanism favors some industries over others: corporations in industries that are very domestic cannot take advantage of an inversion's tax-saving features, while corporations in more multinational industries can and do invert to save on taxes. That said, Walgreens' recent contemplated inversion shows that even businesses with primarily a domestic footprint may find inversions worthwhile. However, domestic companies of a certain type—for instance, domestic telecommunications providers—that find it harder to find suitable foreign business combination partners may still be disadvantaged compared to corporations in industries with many suitable combination partners.

The distributional effect across industries is important. It amplifies the effects already observed across different corporation sizes: even within the subset of very big corporations, corporations in certain industries can more readily take advantage of corporate inversions' benefits, while corporations in other industries cannot. To the extent that the U.S. government cares about developing certain industries domestically for non-tax policy reasons, it may be of some concern that inversions essentially change the rate at which different industries are taxed.

IV. MOVING FORWARD

Corporate inversions have sparked debate from all corners: from the Oval Office, on both sides of the political aisle, and in the press.

Current policy responses fall into two broad categories. The first is to build higher fences, thereby making it harder for domestic corporations to avoid paying U.S. taxes by inverting. Notice 2014-52 and recent proposals from the Obama administration and Senator Levin are examples of this strategy.[207] Stephen Shay's and Senator Schumer's proposals are also higher-fence proposals: they reduce the most enticing benefits of inversions. The second category is centered on comprehensive tax system reform that would motivate domestic corporations to stay in the United States.[208] These proposals call

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[207] Vinik, *supra*, note 154 (providing coverage of recent anti-inversion bills and related political background).

[208] *Id.*

for lowering the corporate tax rate, moving toward a territorial tax regime, simplifying the Code generally, or a combination of some or all of these.

These proposals are not mutually exclusive: Senator Levin's proposal, for instance, contemplates making inversions much harder to execute for two years, which is meant to give Congress enough time to enact comprehensive tax reforms.[209] And Senator Levin's moratorium concept could be supplemented by Shay's or Senator Schumer's proposals, which would make inversions during the moratorium period even less likely.

This Article has argued that inversions create costs for the inverting company and also generate negative externalities that are borne by the public. This Part suggests several starting points for thinking about future inversion policy.

A. *Outright Ban on Inversions*

In theory, one policy solution is to ban inversions outright. This can be accomplished through, for instance, a law that requires all cross-border business combinations be examined by a government body to ensure that they are not inversions. This policy, combined with perfect enforcement, could eliminate many of the costs discussed in this Article. For instance, to the extent inversions exacerbate the problem of large corporations paying taxes at lower rates, that problem will be reduced. Moreover, if using a cross-border business combination to leave the United States is not an option, corporations' managerial or operational behavior may be less motivated by a desire to chase lower taxes.

An outright ban, however, comes with many line-drawing and logistical concerns. Differentiating between tax-driven transactions (inversions) and business-driven transactions that happen to result in re-incorporation abroad will always be a problem. In addition, companies highly motivated to invert have, several times before, invented creative structures to sidestep rules meant to thwart inversions. Section 7874 already attempts to ban inversions and successfully banned the purely paper transactions of earlier generations. Corporations have inverted nonetheless by coupling an inversion with a large cross-border transaction. Even an outright ban coupled with government pre-clearance of all cross-border transactions to ensure that they are not inversions is unlikely to be unchallenged by

[209] Stop Corporate Inversions Act of 2014, *supra* note 44.

transactional innovations that make inversions, in some form or another, possible.

B. *Comprehensive Tax Code Overhaul*

A complete overhaul of the Code may also reduce inversions' negative effects, address some tax revenue loss concerns, and reduce many of the hidden costs identified in this Article. While specific prescriptions for a Code overhaul are outside the scope of this Article, this Article can consider the theoretical impacts of a Code overhaul.

Suppose, for instance, that after a comprehensive overhaul of the Code, the United States's corporate tax system becomes identical to Ireland's. Under those circumstances, U.S. companies have little reason to invert to Ireland for tax reasons. In fact, an inversion under such circumstances would cost the corporation in transaction and transition costs, but not provide the tax benefits of moving to a lower-tax jurisdiction. A Code overhaul would thereby ensure that when domestic corporations leave the United States, they are not leaving for tax-savings reasons, but for other reasons—for instance, to take advantage of corporate laws that may improve value for shareholders.[210]

On the other hand, a complete overhaul of the Code, like a complete ban with perfect enforcement, brings its own logistical problems. A complete overhaul requires substantial political cooperation—a feat that is difficult in the best of times, and particularly challenging with today's fractured Congress. Moreover, it is hard to know ex ante whether a complete Code overhaul can begin to address the inversion issue. Surely, a Code overhaul cannot and will not be driven solely by the desire to disincentivize inversion activity. A Code overhaul could solve many issues, but it may not address inversions adequately or at all.

C. *Middle-of-the-Road Solutions*

Policymakers can also consider other solutions—or perhaps solutions that combine several proposals—to address inversion activity.

For example, there may be merit in combining Senator Levin's moratorium idea with an attempt at tax reform. A

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[210] *See, e.g.*, Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001) (comparing the firm value of Delaware and non-Delaware corporations in the 1980s and 1990s, and finding that Delaware corporations generally have higher firm values).

temporary moratorium puts an immediate stop on tax revenue loss from inversions and also limits the hidden costs identified in this Article. Moreover, a temporary moratorium may have the benefit of setting a deadline for reform, since inversions can return to popularity at the end of the moratorium if more comprehensive change is not implemented. However, previous Congressional promises to reform tax laws have borne limited fruit, and with today's Congress, reform seems even less likely. Moreover, many parties do not stand to lose at the end of the moratorium. Legislators who favor inversions, for instance, may be motivated to wait for the moratorium to end and for today's status quo to return, making inversions once again possible. In the absence of a real chance at comprehensive reform, any temporary moratorium is only a short-term, stop-gap measure.

Other creative solutions exist. Since a desire to access "trapped cash" overseas is one of the most oft-cited reasons for inverting, solutions can target the trapped cash issue. A temporary holiday that grants tax-free or low-tax repatriations to the United States of offshore income could help curb some inversion activity. In the alternative, ending deferred taxation of foreign-earned income may also work. Both cases could be better for the government's bottom line than the status quo. A tax holiday allows the government to collect *some* tax revenue on cash trapped offshore. Eliminating deferred taxation on foreign-earned income ends the incentive for cash to be trapped offshore at all.

A more tailored version of the tax holiday concept is to target only certain industries with a tax holiday. For instance, the government could offer tax holidays to life sciences companies, many of which have inverted, as a way to stem a temporary inversion interest in that industry. States have implemented similar plans. For example, Washington has given $8.7 billion in tax breaks over sixteen years to keep Boeing from moving away, and New York granted aluminum company Alcoa $5.6 billion in tax breaks over thirty years for the same reason.[211] These temporary, industry-specific breaks help ease potentially unobservable growing pains these industries are going through and may be enough to deter inversion.

A tax holiday, however, presents many challenges. First, it depends on the assumption that cash really is trapped

[211] Westneat, *supra* note 185 (reporting on recent tax breaks for Boeing by Washington state).

offshore—a fact that is often disputed.[212] If foreign-earned cash is not trapped abroad, and the ability to access trapped cash is not actually a significant driver of inversion activity, then a tax holiday that allows corporations to bring trapped cash back to the United States will have a substantially diminished effect on slowing the rate of inversion activity. Moreover, if the tax holiday is not sufficiently narrowly tailored, corporations that were not otherwise considering inversions may also use the opportunity to repatriate trapped cash. Worse, using tax breaks as a way to stem current inversion activity could motivate corporations to threaten to invert in order to trigger future tax holidays. In that case, a tax holiday may actually have a negative effect on revenue. Finally, temporary tax holidays may, like temporary moratoriums, be useful only for a limited time. At the state level, there is evidence to suggest that temporary breaks given to certain companies do not have a lasting effect in keeping a company within a certain jurisdiction. For example, despite the fact that Washington state has given Boeing many tax breaks, the company is constantly on the lookout for better deals out of state.[213]

D. Optimal Policy?

Anti-inversion policies enacted thus far have been piecemeal solutions to a fractured tax system that seems out of sync with international norms. Notice 2014-52, while tailored to reduce some of the most enticing benefits of inversions, is another Band-Aid. Like many solutions before it, Notice 2015-52 reduces some of inversions' benefits—for example, it reduces the benefits of hopscotch loans and some post-inversion restructurings. On the other hand, more comprehensive tax reform—whether that be a revamp of the U.S. tax system to more closely resemble that of other developed countries or not—also seems unlikely, given political realities.

The most sensible yet practicable solution, therefore, may be a temporary moratorium that buys time for reform to be considered. A relatively short moratorium on inversions may allow enough time for legislators and policymakers to consider more comprehensive reform, and the short timeframe may also

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[212] *See supra* note 37 and accompanying text.

[213] Kirk Johnson, *Boeing Looks Around, and a State Worries*, N.Y. TIMES (Dec. 10, 2013), http://www.nytimes.com/2013/12/11/us/washington-state-not-ready-to-ponder-future-without-boeing.html?pagewanted=all&_r=0 (reporting on Boeing's interest in moving to other states).

motivate policymakers to work quickly. In any case, only with proper consideration of the whole story—including the hidden costs noted here—can appropriate policy be crafted.

CONCLUSION

In recent years, many domestic corporations have left the United States for tax-friendly foreign shores through cross-border business-combination inversion transactions. While inversions have gained significant attention from policymakers and the press, they have received little attention in the academic literature. This Article identifies and examines the tax issues that motivate inversion transactions and introduces to the discourse a variety of other factors that should be considered in companies' inversion decisions and the government's response to inversions. In particular, while individual corporations' tax benefits dwarf some of inversions' corporate-level, non-tax downsides, this Article identifies how systemic corporate exodus, especially in a few concentrated industries, may create negative externalities for the public. The magnitude of potential public harm, and the extent to which the current generation of anti-inversion policy can mitigate that harm, is an area ripe for further research.