'Competitiveness' Has Nothing to Do With It

By Edward D. Kleinbard

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The recent wave of corporate inversions has triggered interest in what motivates these tax-driven transactions now. Corporate executives have argued that inversions are explained by an anticompetitive U.S. tax environment, as evidenced by the federal corporate tax statutory rate, which is high by international standards, and by its worldwide tax base. This report explains why that competitiveness narrative is largely fact free, in part by using one recent articulation of it as a case study.

The recent surge in interest in inversion transactions is explained primarily by U.S.-based multinational firms' increasingly desperate efforts to find a use for their stockpiles of offshore cash (now totaling around $1 trillion) and by a desire to strip income from the U.S. domestic tax base through intragroup interest payments to a new parent company located in a low-tax foreign jurisdiction. These motives play out against a backdrop of corporate existential despair over the political prospects for tax reform, or for a second repatriation tax holiday of the sort offered by Congress in 2004.

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The Competitiveness Narrative

In the movie *Night After Night*, a young and naive coat check girl admires Mae West's jewelry. "Goodness," says the woman, "what beautiful diamonds!" — to which Mae West replies, "Goodness had nothing to do with it."

And so it is with the recent wave of corporate inversion transactions.[1] Despite the claims of corporate apologists, international business competitiveness has nothing to do with the reasons for these deals.

Inversions are economically rational deals as reimagined by Lewis Carroll's Humpty Dumpty. In economic substance, a large U.S. firm acquires a much smaller target domiciled in a tax-friendly jurisdiction (for example, Ireland), but the deal is structured as the foreign minnow swallowing the domestic whale. (In the U.S. domestic consolidated return context, these would be called "reverse acquisitions.") U.S. shareholders of the U.S. firm must pay immediate capital gains tax for the privilege of this upside-down acquisition structure,[2] and the

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[1]For brief summaries of recent deals, see, *e.g.*, Martin A. Sullivan, "Lessons From the Last War on Inversions," *Tax Notes*, May 26, 2014, p. 861; Sullivan, "Short-Term Inversion Fix May Be Necessary," *Tax Notes*, June 9, 2014, p. 1090; Mindy Herzfeld, "What's Really Driving Inversions? Walgreens Revisited," *Tax Notes*, July 28, 2014, p. 393; "Inverse Logic: The Rush of Firms Fleeing America for Tax Reasons Is Set to Continue," *The Economist*, June 21, 2014.

For more detailed descriptions of recent inversion transactions and the underlying issues they raise for the U.S. tax system, see Stephen E. Shay, "Mr. Secretary, Take the Juice Out of Corporate Expatriations," *Tax Notes*, July 28, 2014, p. 473; Bret Wells, "Corporate Inversions and Whack-a-Mole Tax Policy," *Tax Notes*, June 23, 2014, p. 1429; Donald J. Marples and Jane G. Gravelle, "Corporate Expatriation, Inversions, and Mergers: Tax Issues," Congressional Research Service report R43568 (May 27, 2014); and Wells, "Cant and the Inconvenient Truth About Corporate Inversions," *Tax Notes*, July 23, 2012, p. 429.

[2]Laura Saunders, "How a Corporate 'Inversion' Could Raise Your Taxes," *The Wall Street Journal*, Aug. 1, 2014. The technical reason is that reg. section 1.367(a)-3 generally requires shareholders of a U.S. firm who exchange their U.S. target company stock for stock of a foreign acquirer in an otherwise tax-free reorganization to nonetheless recognize gain (but not loss). In turn, the helpful exception to the general rule provided in reg. section 1.367(a)-3(c), which protects U.S. shareholders from current tax in bona fide acquisitive reorganizations by foreign firms, is not available when more than 50 percent of the foreign acquirer's stock is received by U.S. transferors.

U.S. company emerges as the nominal subsidiary of a publicly held foreign corporation.

Current section 7874(b), adopted in 2004, effectively negates so-called self-inversions, in which a foreign shell company is employed as the putative acquirer of a U.S. multinational, by treating the foreign company as a U.S. corporation for U.S. federal income tax purposes. Nonetheless, section 7874(b) characterizes a foreign acquirer in a merger of unequals as a bona fide foreign corporation as long as the former shareholders of the U.S. target own less than 80 percent of the combined firm.[3] This means that a foreign acquirer in a post-2004 inversion transaction can be as small as one-quarter the size of the U.S. target.

U.S.-based multinationals that are pursuing inversion transactions have been quick to wrap themselves in a mantle of simple virtue, forced to take the unpalatable step of inverting into Irish, U.K., or Swiss public companies because their love goes unrequited by a country that cruelly saddles them with both the highest corporate tax rate in the world and a uniquely punitive worldwide tax base. The result, they claim, is that U.S. tax law has rendered them uncompetitive in international business, which in turn explains the sudden wave of inversion transactions.

Heather Bresch, the CEO of Mylan Inc., a pharmaceutical manufacturer that is pursuing an inversion into a Dutch firm, effectively spoke for many other chief executives when she recently gave an interview describing herself as entering into the inversion deal only ''reluctantly.''[4] In her telling, she has abandoned hope that Congress will overhaul the code to make U.S. companies ''more competitive,'' and therefore must pursue a tax-driven redomiciliation in the Netherlands against her patriotic instincts, and even though (and here is a point that Bresch forgot to mention) the merger will subject her firm's taxable owners to capital gains tax.

But all this is a false narrative: U.S. multinationals' competitiveness arguments are almost entirely fact free. My reasoning is laid out in painful detail in my article ''Stateless Income.''[5] Very briefly, sophisticated U.S. firms operate today, not under a worldwide tax system, but rather in an ersatz territorial tax environment, without any of the antiabuse rules that a thoughtful territorial tax system would impose, but subject to a bizarre constraint that they must park their foreign earnings offshore to remain within the ersatz territorial regime. This means that in practice, U.S. firms *do* capture the benefit of operating in lower-tax jurisdictions, both as a cash tax matter and — more importantly — for purposes of U.S. generally accepted accounting principles, which is the lens through which investors and corporate executives measure a firm's performance.

But the story does not end with U.S. firms simply capturing the benefits of actual business operations in lower-taxed countries. Through large investments in aggressive tax planning technologies, and unencumbered by any of the antiabuse rules to which non-U.S. multinationals domiciled in jurisdictions with better designed territorial systems might be subject, U.S.-domiciled multinational firms have become adroit at moving income that as an economic matter is earned in high-tax foreign countries to very low-taxed ones. (This is the essence of what I mean by ''stateless income.'')

Stateless income privileges multinational firms over domestic ones by offering the former the prospect of capturing ''tax rents'' — low-risk inframarginal returns derived by moving income from high-tax foreign countries to low-tax ones. Other important implications of stateless income include the dissolution of any coherence to the concept of geographic source, the systematic bias toward offshore rather than domestic investment, the more surprising bias in favor of *investment* in high-tax foreign countries to provide the raw feedstock for the generation of low-tax foreign *income* in other countries, the erosion of the U.S. domestic tax base through debt-financed tax arbitrage, many instances of deadweight loss, and — essentially unique to the United States — the exacerbation of the lockout phenomenon, under which the price that U.S. firms pay to enjoy the benefits of extremely low foreign tax rates is the accumulation of

[3]Some corporate apologists have tried to limit the term ''inversion'' exclusively to describe the initial pre-2004 wave of self-inversions. These individuals prefer to pretend that the current tsunamis of inversions are just ordinary course cross-border mergers, but this is commercially inaccurate.

[4]Andrew Ross Sorkin, ''Reluctantly, Patriot Flees Homeland for Greener Tax Pastures,'' *The New York Times*, July 14, 2014.

[5]Edward D. Kleinbard, ''Stateless Income,'' 11 *Fla. Tax Rev.* 699 (2011). This was the first of three articles studying the phenomenon. Kleinbard, ''The Lessons of Stateless Income,'' 65 *Tax L. Rev.* 99 (2011), extended the analysis to consider the economic efficiency consequences of stateless income and possible policy responses. Kleinbard, ''Through a Latte Darkly: Starbucks's Stateless Income Tax Planning,'' *Tax Notes*, June 24, 2013, p. 1515, was a case study of one well-known firm; in light of Starbucks's business model as a high-street face-to-face retailer, the article concluded that if Starbucks can generate stateless income, anyone can. Condensed versions of the first two articles were published as Kleinbard, ''Stateless Income's Challenge to Tax Policy,'' *Tax Notes*, Sept. 5, 2011, p. 1021; and Kleinbard, ''Stateless Income's Challenge to Tax Policy, Part 2,'' *Tax Notes*, Sept. 17, 2012, p. 1431.

extraordinary amounts of earnings (about $2 trillion, by the most recent estimates) and cash (about $1 trillion) outside the United States.

The problem of stateless income planning is not unique to U.S. multinationals, but we can take a perverse pride in the knowledge that U.S. firms have been world leaders in developing the requisite tax technologies. The situation is now so out of control that in 2012 the G-20 group of countries deputized the OECD to propose, on an extremely accelerated timetable, a concrete set of action plans to address what the OECD calls base erosion and profit-shifting problems.

U.S. firms incur costs to operate their stateless income tax machinery, which is wasteful, but at the same time enjoy an essentially unfettered tax planning environment in which to strip income from high-tax foreign jurisdictions to very low-taxed ones. And this sits on top of transfer pricing, selective leverage of group members, and other devices used to move income that economically is earned in the United States to foreign affiliates.

As a result, whether one measures effective marginal or overall tax rates, sophisticated U.S. multinational firms are burdened by tax rates that are the envy of their international peers. And this is true whether one studies cash taxes paid or — more important in the case of public firms — U.S. GAAP accounting for taxes. *Stateless Image* reviews a raft of data on this point, but to take one more recent example, the Government Accountability Office observed in 2013 regarding cash taxes paid:

> For tax year 2010 (the most recent information available), profitable U.S. corporations that filed a Schedule M-3 paid U.S. federal income taxes amounting to about 13 percent of the pretax worldwide income that they reported in their financial statements (for those entities included in their tax returns). When foreign and state and local income taxes are included, the ETR [effective tax rate] for profitable filers increases to around 17 percent. The inclusion of unprofitable firms, which pay little if any tax, also raises the ETRs because the losses of unprofitable corporations greatly reduce the denominator of the measures. Even with the inclusion of unprofitable filers, which increased the average worldwide ETR to 22.7 percent, all of the ETRs were well below the top statutory tax rate of 35 percent.[6]

It is true of course that the federal corporate tax rate — nominally, 35 percent — is too high relative to world norms, and that the ersatz territorial system requires firms to waste money in tax planning and structuring, but effective marginal tax rates and overall effective tax rates reach the level of the U.S. headline rate only when firms studiously ignore the feast of tax planning opportunities laid out before them on the groaning board of corporate tax expenditures. Moreover, and contrary to the claims of corporate lobbyists, under the usual water's-edge principle of state taxation, the foreign income of a U.S. multinational when repatriated usually is taxed by U.S. states either very lightly or not at all (other than a couple of oddball cases involving income booked in certain tax havens).[7] As a result, and without regard to firms' stateless income tax planning, to claim that U.S. firms face a tax rate approaching 40 percent on their foreign income by virtue of their state tax liabilities is simply false.

To offer just one domestic example, under current U.S. law, the combination of accelerated tax depreciation on new equipment purchases and the deductibility of interest expense on debt incurred to purchase that equipment actually yields a *negative* effective tax rate. This means that we collectively pay companies to make those investments.[8]

In the international arena, U.S. multinational firms have established themselves as world leaders in global tax avoidance strategies, through the generation of stateless income. The result is that many well-known U.S. multinationals today enjoy single-digit effective tax rates on their foreign income, and effective tax rates on their *worldwide* income far below the nominal 35 percent federal corporate tax rate. This is true both as a cash tax and as a GAAP matter.

We can see the payoffs to stateless income tax planning through the evidence presented in a recent study, to the effect that in 2006, controlled foreign corporation subsidiaries of U.S. firms faced a ''cash'' average (that is, effective) foreign tax rate (foreign taxes paid divided by pretax earnings and profits) of only 15.6 percent. With the exception of mining, the most tax-disadvantaged industry for U.S. firms outside the United States was retail trade, in which CFCs faced an average foreign tax rate of 22.5 percent.[9] Leslie Robinson of Dartmouth's Tuck

[6]GAO, ''Corporate Income Tax: Effective Tax Rates Can Differ Significantly From the Statutory Rate,'' GAO-13-520 (May 2013). *See also* Kleinbard, ''Stateless Income,'' *supra* note 5, at 722-724, 737-750.

[7]Special state tax rules not considered in the text can apply to banks and other financial services firms.

[8]Congressional Budget Office, ''Taxing Capital Income: Effective Rates and Approaches to Reform'' (Oct. 1, 2005).

[9]Melissa Costa and Jennifer Gravelle, ''Taxing Multinationals: Average Tax Rates,'' 65 *Tax L. Rev.* 391, at Table 1 (2012).

School of Business recently summarized the academic financial accounting literature in testimony before the Senate Finance Committee as establishing that "there is no evidence that U.S. MNCs face greater tax burdens as a consequence of how foreign profits are taxed, relative to their competitors."[10]

From a GAAP perspective, the magnitude of the tax discounts to which firms have helped themselves is apparent not only by examining their effective tax rate reconciliations in their financial accounting statements, but also by glancing at firms' aggregate foreign earnings designated for GAAP purposes as "permanently reinvested" offshore low-taxed earnings (about $2 trillion), as well as their stockpile of offshore low-taxed cash (about $1 trillion).[11] (I explain the financial accounting terminology immediately below.) In short, no matter what perspective one adopts, the tax burdens imposed on the foreign operations of U.S. firms are far lower than that implied by the nominal U.S. headline rate.

Investors and managers care about GAAP accounting for taxes. They have no direct access to tax returns, have no reason to believe that tax measures of revenue and expense are superior to GAAP measures or are more consistent over time, and further need to understand how much of a company's cash tax rate in any given year reflects timing differences that will reverse in subsequent years. It therefore is worth reminding non-accountants of how a U.S. multinational firm's tax rate looks when viewed through the lens of GAAP.[12]

Financial accounting and tax accounting are quite different, but financial accountants of course think that their worldview is correct, and so differences between actual cash tax liabilities and what the financial accountants would have expected as tax liabilities must be explained. Financial accountants therefore start with the financial accounting measure of earnings before income taxes (EBIT), apply a 35 percent tax rate to it, and then look up and ask, "why isn't that the firm's actual tax bill for the year?"

There are several answers that explain the difference in outcomes, but putting aside audits and potential disagreements as to the interpretation of the law between the firm and the IRS, the answers basically fall into two groups. First, there are temporary differences, for example when the tax rules for depreciation are different from the financial accounting rules for depreciation. These differences theoretically reverse themselves over time.

The financial accountants deal with these timing differences through the deferred tax assets/liabilities accounts. These accounts keep track of all the individual timing differences between when cash taxes actually are due and when under financial accounting principles those taxes would have been due. (Of course, if the firm stays in business, the aggregate balance may never change, as depreciation on new assets replaces reversal of depreciation on old assets, and so on.) Because future cash tax bills will reflect the reversal of these timing differences, the balance of the deferred tax liability (more cash taxes to be paid in the future because "too little" is due this year) or deferred tax asset ("too much" tax actually paid this year relative to what financial accountants believe is the firm's income this year) is shown on the consolidated balance sheet. Temporary differences thus affect cash flow, but not GAAP effective tax rates or financial accounting net income (and therefore earnings per share).

The other accounting differences are "permanent." Interest on tax-exempt bonds is the simplest example. The financial accountants see tax-exempt bond coupons as income and therefore would expect a 35 percent tax bill, but of course no tax will ever be due. So the financial accountants create a second category of book-tax differences that does not appear labeled as such on the face of the balance sheet or income statement, but that is shown in the tax footnote to all GAAP financials. This is the effective tax rate reconciliation table, which lists those items that permanently reduce (or increase) a firm's tax rate from the statutory 35 percent tax rate.

Permanent differences are not liabilities or assets, but they do affect net effective tax rates shown on the face of the firm's income statement (financial accounting tax expense divided by EBIT). This means that for all practical purposes — because GAAP is the lens through which all relevant private parties view a company — a permanent tax difference simply negates the nominal statutory rate. Firms yearn for permanent differences; at healthy firms with strong cash flows, only the corporate treasurer gets very excited about timing differences.

Savvy U.S.-based multinational firms show very low GAAP effective tax rates because they do some actual business in low-taxed jurisdictions and engage in aggressive stateless income tax planning, and because they record the resulting low foreign

[10]Testimony of Leslie Robinson, associate professor, Tuck School of Business at Dartmouth University, before the Senate Finance Committee's hearing titled, "The U.S. Tax Code: Love It, Leave It or Reform It!" (July 22, 2014).

[11]Richard Rubin, "Cash Abroad Rises $206 Billion as Apple to IBM Avoid U.S. Taxes," Bloomberg Business News, Mar. 12, 2014.

[12]Kleinbard, "Stateless Income," *supra* note 5, at 744-750, covers this ground in a slightly more formal fashion than do the next few paragraphs.

tax rates that they pay as a permanent difference between the GAAP measure of tax expense and the nominal 35 percent tax rate. How is this possible, given that corporate apologists keep reminding us that the United States imposes worldwide tax on U.S. corporations?

Under GAAP accounting, a firm presents a worldwide consolidated picture of its operations and results, which therefore includes all of its foreign operations. But the income of foreign subsidiaries of a U.S. firm that are derived from active business operations are not subject to actual tax in the United States until those earnings are returned to the United States as actual dividends or as constructive dividends under section 956 (for example, when a foreign subsidiary lends money to its U.S. parent). This leaves financial accountants in a quandary — U.S. federal income tax will be due only when the active earnings of foreign subsidiaries are repatriated as dividends, but that tax trigger is under the control of the parent company. This fact pattern therefore is not a clear timing difference that will automatically reverse, and it is not a purely permanent difference like tax-exempt bond interest income.

Financial accountants resolve this conundrum by requiring a U.S. firm to record as a liability the U.S. tax bill on the ultimate repatriation to the United States of its foreign earnings, *unless* the firm demonstrates to the satisfaction of its accountants that it has no present intention to repatriate the money and incur the tax.[13] Readers who are financial accountants will, I hope, forgive me when I suggest that the financial accounting profession has not been the sternest of taskmasters when it comes to reviewing a client's claims regarding its plans to redeploy its foreign cash hoard offshore.

Amounts so designated are colloquially referred to as ''permanently reinvested earnings.'' In reality, there is nothing permanent about the designation: Firms do sometimes change their minds, with the permission of their accountants. When eBay Inc. made news recently about repatriating its foreign cash, that is what happened — it changed its mind and told its accountants that perhaps it would repatriate its foreign cash hoard after all; as a result, it was required to provide immediately for the U.S. tax cost for doing so, even though it had not yet actually triggered the tax bill by moving the money.

The reduction from the 35 percent statutory tax rate in a firm's effective tax rate reconciliation in the tax footnote for ''the effect of foreign operations'' or words to that effect thus signals to investors that the company will not in fact pay 35 percent tax on all of its earnings. It is a discount from the U.S. tax that would have been paid if the United States in fact taxed the worldwide income of the firm, attributable to the fact that (1) the overall group's foreign earnings are not currently taxed in the United States (because the earnings are derived by foreign subsidiaries engaged in active business operations), *and* (2) the firm represents to the accountants that its intentions are to permanently reinvest the earnings outside the United States. As far as investors and management alike are concerned, because this item is a ''permanent'' difference for GAAP purposes, it serves as a final discount to the nominal U.S. federal corporate tax rate.

Under U.S. GAAP, a firm's net effective tax rate is presented as a single worldwide rate. If one makes some plausible assumptions about the geographic mix of a company's business, this means that the tax rate actually imposed on a U.S. multinational's non-U.S. income can be much lower than that imposed on the non-U.S. business of a foreign multinational that appears on its face to have the same effective tax rate. In such cases, the competitiveness argument immediately collapses.

For example, imagine that all firms wherever domiciled pay a 35 percent effective tax rate on their U.S. income and lower rates on their non-U.S. income. A U.S. multinational firm earns $1 billion in EBIT, does 60 percent of its business in the United States, and 40 percent abroad. It reports to investors that its effective tax rate is 25 percent. Its tax expense therefore is $250 million. A Freedonian enterprise has exactly the same profile in all respects, except that it earns 40 percent of its income in the United States and the rest abroad.

The U.S. firm's tax expense for its U.S. operations alone would be $210 million (0.35 x $600 million). For the U.S. firm to record a $250 million worldwide tax expense, it must therefore have incurred a $40 million tax expense for its non-U.S. income, which is a 10 percent effective tax rate on its $400 million of non-U.S. income. The Freedonian firm, by contrast, will have an implicit U.S. tax expense of $140 million (0.35 x $400 million), and $110 million of tax expense attributable to its non-U.S. operations, which is an 18.3 percent effective rate. The U.S. firm completely dominates the Freedonian enterprise along the standard competitiveness yardstick.

This example is not entirely fanciful. Consider the February 2014 Form 10-K of Bresch's firm, Mylan. The Form 10-K informed investors and other interested stakeholders that Mylan's *worldwide* GAAP effective tax rate — the taxes it paid or set aside a provision to pay, divided by its worldwide GAAP income — was not 35 percent (the U.S.

[13]*Id.* at 745-746.

statutory corporate tax rate) or some greater rate, but 16.2 percent in 2013, 20 percent in 2012, and 17.7 percent in 2011.[14]

The firm's tax footnote showed a permanent discount for 2013 from the 35 percent statutory tax rate as applied to worldwide income of 13 percentage points, attributable to Mylan's "foreign [tax] rate differential." (The reduction was smaller in 2012 but about the same in 2011.) In other words, Mylan told its shareholders and other stakeholders that, without regard to any other "permanent" differences, the benefit Mylan captured by paying low foreign taxes by itself garnered Mylan a 13 percentage point discount from its nominal worldwide income tax bill (not just for its foreign income — its *worldwide* income) from an "uncompetitive" 35 percent tax rate to 22 percent.

In 2013 Mylan derived about 57 percent of its worldwide revenues (essentially, gross receipts) from the United States; yet, as just noted, told investors that its worldwide effective tax rate was 16.2 percent.[15] Assume, just by way of illustration, that Mylan's taxable profits followed its revenues as allocated for financial accounting (and presumptively, management) purposes — admittedly, a heroic assumption, thanks to stateless income planning internationally, and tax expenditures domestically — and that Mylan, through adroit domestic tax planning, incurred a 25 percent effective tax rate on its U.S. income (federal and state taxes combined). This would imply that Mylan's tax expense for its foreign profits was roughly 4.5 percent.[16]

We would have a clearer window into Mylan's actual foreign effective tax rate if it more faithfully complied with the SEC requirement that it identify in its tax footnote the U.S. tax cost of repatriating its offshore cash (from which one can deduce the quantum of foreign tax credits that would come along with the repatriation), but like the vast majority of companies in this situation, Mylan modestly avers that calculating this number is "not practicable."

AbbVie Inc., another inverting firm, reported in its 2013 annual report's tax footnote an 11.5 percent reduction for 2013 in its global statutory tax rate for "the effect of foreign operations." (The effect of foreign operations was a much greater number in 2011 and 2012.) Again, this means that AbbVie is telling investors and its own managers that it does not operate in a 35 percent tax rate environment at all; to the contrary, AbbVie's effective *global* tax rate for 2013 (again, including U.S. taxes on its U.S. domestic income, where permanently reinvested earnings are irrelevant), after some smaller permanent differences in both directions, was 22.6 percent. This is a permanent tax discount of about one-third off the headline federal rate insofar as AbbVie's investors and management are concerned.

But what about the anti-competitive effects of U.S. domiciled multinationals' "trapped cash?" As readers know, U.S. tax law (but not that of most other countries) effectively induces U.S. multinational firms to keep their surplus low-taxed foreign profits in their foreign subsidiaries because the U.S. parent would be required to pay full U.S. tax on the repatriation of those earnings (less a credit for any foreign income taxes already paid). As a result, U.S. firms now hold about $1 trillion of "permanently reinvested" earnings in cash (usually, U.S.-dollar-denominated short-term debt instruments, like Treasury bills, bank deposits, commercial paper, and money market funds).[17] As explained above, by doing so firms not only minimize their cash tax liabilities but also help themselves to a permanent discount on their GAAP financials from the statutory corporate tax rate charge that would otherwise apply to their pretax GAAP earnings.

It is a great overstatement, popular in the business press, to claim that the cash "trapped" by this rule has large businesses, competitive implications, or that the repeal of current law would lead to a wave of business reinvestment in the United States. This is a vast overstatement. First, a U.S. multinational's offshore cash hoard invariably is invested in the U.S. economy, in the form of investments in dollar assets.

Second, as Apple Inc. demonstrated in 2013, large multinational firms often can access their offshore earnings without incurring a tax cost, simply by borrowing in the United States and using the earnings on the offshore cash to pay the interest costs. (The interest earned on a firm's offshore cash hoard is includable in the U.S. parent's income as subpart

[14]*The New York Times* article cited in note 4, *supra*, appears to have accepted at face value Bresch's recollection that her firm's effective tax rate was "about 25 percent." The February 2014 Form 10-K summarized in the text contains the most recent data released to investors, because quarterly condensed financial statements do not contain an effective tax rate reconciliation. It is a pity that Bresch did not remember with greater clarity the information her firm provided to its owners and the interested public in its audited financial statements.

[15]Mylan Inc. Form 10-K (filed Feb. 27, 2014), note 13 to audited financial statements.

[16]That is, 0.25 (assumed domestic effective tax rate) x 0.57 (presumptive fraction of profits attributable to the United States) = 14.25 percent effective tax rate on global profits attributable to U.S. federal and state taxes. On the foreign side, 0.045 x 0.43 = 1.95 percent additional effective tax on global profits, for a total of 16.2 percent effective tax rate on global income.

[17]*See supra* note 11.

F income, and therefore can be repatriated free of any additional tax cost.) The U.S. parent's income inclusion of the interest earned on its offshore cash offsets the tax deduction for the interest expense on the firm's U.S. borrowing, and the firm is left in the same economic position as if it had simply repatriated the cash tax free (plus or minus a spread for differences in interest rates between the two streams).

Third, we conducted a natural experiment, in the form of a corporate offshore cash tax amnesty in 2004; more than $300 billion over and above the usual level came back to the United States from foreign subsidiaries of U.S. firms. Most studies, however, have concluded that the cash went to prop up stock prices through stock buybacks or dividends, not to invest in productive capacity (as the law nominally required).[18]

If large U.S. multinationals were credit constrained (as is true for many small wholly domestic enterprises), the ''trapped cash'' story might have some modest traction to it, but almost all these firms are not: Their domestic cash flow and their ability to borrow in the U.S. capital markets (economically but not technically secured by their offshore cash) are more than sufficient to fund any domestic investments they wish to make. The meager earnings on the trapped cash are dilutive of earnings per share, but this is not a business competitiveness crisis.

In sum, there is no credible evidence as a matter of cash taxes or as a matter of GAAP accounting that U.S. firms are at a fundamental international business competitive disadvantage under current law. Again, this is not to excuse current law or to hold it up as an exemplar; it is highly distortive and inefficient.[19] But one of the few deficiencies it has avoided is imposing an unfair international business tax competitive burden on sophisticated U.S. multinationals.

If this conclusion seems incredible, ask yourself this: Why is it that following the first rush of self-inversions more than a decade ago, inversions have been so infrequent relative to cross-border mergers and acquisitions activity generally over the last decade (that is, since the introduction of section 7874), until this year?[20] How have most U.S. multinationals managed to compete for the last decade if inversions alone are the economically compelled self-help route to a competitive tax environment? Something else must be going on to explain why U.S. firms believed themselves to be competitive from 2004 to 2013, and only now are scouring the earth for suitable bite-sized merger partners to use as inversion vehicles.

A Competitiveness Fable

Notwithstanding the contrary evidence from their tax returns and GAAP financial statements, U.S. multinationals and their apologists continue to hammer the international business competitiveness narrative to justify inversion transactions. One leading example of this is a recent op-ed published in *The Wall Street Journal* by Walter Galvin, the retired vice chair and CFO of Emerson Electric Co., in which he presents his story of how the U.S. tax system conspired to help Emerson's French arch rival, Schneider Electric, steal American Power Conversion Corp. (APC) from Emerson's grasp.[21] Galvin has offered the same story in testimony before the House Ways and Means Committee, and it has figured prominently in papers authored by the Alliance for Competitive Taxation, a lobbying organization.

As related in a corporate autobiography, *Performance Without Compromise: How Emerson Consistently Achieves Winning Results*,[22] Galvin is a talented financial executive of great personal probity. A close reading of the public record surrounding the APC deal, however, leads to the conclusion that this gripping tale represents a corporate false memory, like the adult recollection of a childhood trauma that never took place.

Here in Galvin's words is the indignity worked on Emerson by the U.S. corporate tax system:

> In 2006, Emerson sought to acquire a company called American Power Conversion (APC). This was a Rhode Island-based company that made more than half of its earnings outside the U.S. Unfortunately, Emerson competed against Schneider Electric, a French company, to acquire APC. Emerson offered more than $5

[18]Dhammika Dharmapala et al., ''Watch What I Do, Not What I Say: The Unintended Consequences of the Homeland Investment Act,'' 66 *J. Fin.* 753 (2011).

[19]These inefficiencies in fact are the true competitiveness costs of the current U.S. tax system, but these costs must be netted against the savings conferred by the unconstrained de facto territorial regime in which U.S. companies operate.

[20]Some summaries overcount here. Bona fide acquisitions by larger foreign firms of smaller U.S. firms are not inversion

(Footnote continued in next column.)

transactions. Neither are redomiciliations of firms from one foreign domicile (*e.g.*, the Caymans) to another (*e.g.*, Ireland) to lock in tax treaty benefits. Of the relative handful that remain on the list, most were small firms by multinational standards; Eaton Corp. was probably the biggest exception to that.

[21]Walter Galvin, ''Why Corporate Inversions Are All the Rage,'' *The Wall Street Journal*, July 27, 2014.

[22]Charles F. Knight (with Davis Dyer), *Performance Without Compromise: How Emerson Consistently Achieves Winning Results* (2005). The author was at the time of publication the chair emeritus of Emerson.

> billion, but ultimately Schneider acquired APC by offering a bid in excess of $6 billion.
>
> Why was Schneider willing to offer more? Schneider outbid us because France's tax code — typical of most OECD countries — exempts 95 percent of foreign-source income from taxation, while the U.S. tax code fully taxes such income. APC's profits were worth more to Schneider because, once absorbed, APC's global profits (net of the taxes paid in the countries where those profits were earned) could be repatriated to Schneider's headquarters in France, where they would be taxed at less than 2 percent.
>
> In contrast, earnings repatriated to the U.S. are subject to a tax rate of nearly 40 percent, with a credit for taxes paid abroad on that income. That dramatic difference made it possible for Schneider to offer more for APC. So what had once been an American company became French.

APC was a U.S. firm with extensive low-cost manufacturing operations outside the United States. APC specialized in manufacturing uninterruptible power supplies (UPS) and other critical power systems, predominantly for smaller commercial customers, and had by far the largest global market share by dollar volume in the UPS markets.[23] Schneider (through its MGE subsidiary) was a major player in the market for larger-scale UPS systems, particularly in Europe. Emerson also had a substantial UPS business through its subsidiary Liebert Corp.; it had about the same share of the global market as did Schneider, but was stronger in North America.

At the time it was acquired, APC had enjoyed strong top-line revenue growth but had struggled to generate comparable net income growth; in fact, its profits for the six-month accounting period ending before the acquisition were down sharply on a year-over-year basis. Compared with industrial giants Schneider and Emerson, APC was a smaller and more specialized company, probably with capital constraints that did not apply to the other two. At the time of the Schneider deal, the *Financial Times* cattily observed that "APC is one of the most shorted stocks, and the least liked by analysts, in the S&P 500."[24]

Schneider paid a 30 percent premium over APC's stock price (which had been performing poorly) to acquire APC. This valuation was universally criticized in the financial press as extremely aggressive, but within a year APC's performance within the Schneider group took some of the pressure off the earlier criticism.[25]

No doubt in response to the blistering criticism among financial analysts and the financial press, Schneider prepared a 49-page slide show to justify the APC acquisition. The word "tax" appears nowhere in the document. The same is true of the unusually long and defensive press release that Schneider prepared that covered much of the same ground.

Schneider's CEO, Jean-Pascal Tricoire, was brand new to the job at the time, and very young by French CEO standards (43). The press described him as eager to make his mark by reorienting Schneider's business to critical power supplies and other "smart" products.[26]

For its part, Emerson had a legendary corporate culture (as reflected in the corporate autobiography referenced above). A 2006 *Financial Tim*es profile, published shortly before the APC takeover battle, described the firm as highly disciplined and "relentlessly profitable," with a "near-unbroken run of earnings increases stretching back 50 years."[27] The article emphasized that Emerson believed its central tasks lay in developing its technology and in grooming its senior executives to take on new responsibilities. The CEO of Emerson closed the profile by saying, "People may call us boring — but if we are, then boring is OK."[28] Emerson had throughout this period a very high GAAP global effective tax rate, close to the statutory 35 percent rate.

APC enjoyed tax holidays in China and India, and booked a large effective tax rate benefit for "foreign earnings taxed at rates lower than the U.S. statutory rate," attributable primarily to its operations in Ireland and the Philippines.[29] (As is typically the case, the annual financial statement does not give sufficient detail to offer any independent judgment on APC's transfer pricing practices or the

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[23]Frost & Sullivan, *World UPS Markets*, Figure 2-19 (2006); Jennifer Levitz, "APC Deal Reflects Demand for Data Protection; France's Schneider Electric Agrees to Pay $6.1 Billion for Emerging U.S. Rival," *The Wall Street Journal*, Oct. 31, 2006.

[24]Lex column, *Financial Times*, Oct. 30, 2006. A parallel story helpfully observed that "margins at APC are under pressure, cash conversion is poor, rising raw material costs pose an ongoing threat, while projected cost synergies [in the Schneider deal] look aggressive."

(Footnote continued in next column.)

[25]Lex column, *Financial Times*, Oct. 23, 2007.

[26]Pan Kwan Yuk, "Schneider Chief Makes His Power Plays Abroad," *Financial Times*, Nov. 21, 2007.

[27]Peter Marsh, "When Boring Beats Buccaneering," *Financial Times*, June 7, 2006.

[28]*Id.*

[29]APC 2005 Form 10-K, at 55. Because APC was acquired in 2006, this is the last annual report that APC filed with the SEC.

like.) APC's GAAP effective tax rates (after removing some extraordinary items) were 26 percent, 25 percent, and 22 percent in 2003, 2004, and 2005, respectively. Schneider's French GAAP effective tax rates for the same period (other than 2003) were a bit higher, in the 28 to 29 percent range. (The French statutory corporate tax rate at this time was essentially identical to the U.S. federal statutory rate.) So to investors, the addition of APC, a U.S. company, to the mix of Schneider businesses might be expected to reduce Schneider's effective tax rate modestly, not because of French tax shenanigans, but because APC's effective tax rate was already somewhat lower than Schneider's. By 2009, by which time APC had been fully digested, Schneider's global effective tax rate was 24.3 percent.

Now we can begin to dissect Galvin's claim that the advantages afforded by France's territorial tax system explained why Schneider outbid Emerson by 20 percent in their battle to take over APC. On its face, this 20 percent price difference in the offers that the two firms made is an implausibly large premium to attribute to tax rate differentials. And in fact, when you think about it for a minute, you realize that the story is precisely backwards.

The key fact is that APC was a U.S. company with some foreign subsidiaries. Schneider's purchase did not miraculously spring APC's CFCs out from under APC. Far from helping APC escape U.S. tax, Schneider became enmeshed more deeply in the U.S. tax web because it now owned a major U.S. subsidiary that in turned owned non-French, non-U.S. subsidiaries. APC's foreign earnings remained inside the U.S. tax system.

As a GAAP matter, if Emerson had bought APC, Emerson would presumably have been able to continue APC's practice of classifying its low-taxed foreign earnings as permanently reinvested outside the United States, thereby obtaining a significant GAAP effective tax rate benefit relative to its very high effective tax rate ex-APC.[30] In other words, Emerson would have gained entree into APC's ersatz territorial tax environment by acquiring that firm; Emerson was never precluded from capturing the benefits of lower foreign tax rates.

As a cash tax matter, Galvin observes that the repatriation to France of APC's earnings through dividends would be subject to only a 2 percent French tax. This ignores the full 35 percent U.S. federal income tax that (in Galvin's telling) would be imposed on APC's domestic and foreign earnings, when those foreign earnings were distributed up the chain, plus a 5 percent U.S. withholding tax on dividends from APC to Schneider (before the 2009 amendment to the France-U.S. tax treaty). It further ignores the fact that dividends from APC to Emerson would have been entirely tax free because APC would have been a member of the Emerson consolidated group.

Where is the tax disadvantage there?

In a March 2014 white paper, the Alliance for Competitive Taxation, a lobbying group, sought to amend and restate Galvin's points here by suggesting that what he meant to have written was that *future* non-U.S. investments relating to the APC business would be structured directly underneath Schneider and therefore would bear a lighter net tax burden in Schneider's hands than they would in Emerson's, once fully repatriated to the parent company (without actually identifying any underlying income tax rate applicable to these hypothetical future investments).[31] The alliance's suggested corporate structure for future investments by Schneider is a presumptively sensible starting place, but the comparison is not.

First, the purchase price paid for APC related to a large extent to the present and future earnings power of APC and its existing foreign subsidiaries (once the supply chain and similar problems identified below were resolved), all of which remained in the U.S. tax net after the Schneider acquisition. Second, had Emerson bought APC, it would presumably have been savvy enough *not* to repatriate APC's low-taxed foreign earnings; to do so would have been a value-destroying move. By not repatriating low-taxed foreign earnings on a current basis, Emerson would have enjoyed for GAAP and for cash tax purposes a quasi-territorial tax environment outcome indistinguishable from that enjoyed by Schneider. Most U.S. multinationals are able to fund their U.S. cash needs without difficulty out of domestic cash flow, domestic borrowing capacity, and judicious repatriations of a steady stream of foreign earnings that bring with them highly concentrated FTCs sufficient to cover the U.S. repatriation tax.[32]

Third, Schneider, with all the advantages of a territorial tax system, in fact reported a *higher* effective tax rate in the years leading up to the merger than did APC, a company burdened by the allegedly uncompetitive U.S. system. Why is it inevitable then that new investments would be

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[30]APC's profits were roughly half the size of Emerson's, so in effect one-third of Emerson's post-acquisition EBIT would have become subject to a tax expense in the low 20s.

[31]Alliance for Competitive Taxation, "ACT Tax Facts, U.S. Tax Code Encourages Foreign Takeovers of U.S. Companies" (Mar. 2014).

[32]For a description of a tax department's "tax distillery" in operation, see Kleinbard, "Stateless Income," *supra* note 5, at 725-727.

subject to light effective tax rates? Emerson's effective tax rate in this period was higher still, but the right question to draw from this is, why was Emerson unable to control its effective tax rate as well as did APC or many other U.S. companies? The U.S. tax system and U.S. GAAP offered discounts of all sorts and sizes from the headline corporate tax rate, and Emerson itself had significant international operations. Emerson's possible frustration with its own tax profile should not be read as proof of a general anti-competitive U.S. tax environment.

If tax differences do not on their face explain the big difference in valuations for APC, what does? One explanation, familiar to anyone who has worked on M&A deals, is the difference in corporate cultures — a very young "outsider" CEO at Schneider, anxious to make his mark, competing against a highly disciplined U.S. firm whose internal financial analysts no doubt shared the view universally expressed on the street that Schneider's valuation was much too high.

But Schneider was not reckless. It had a clear strategy, and one that had nothing to do with taxes. Schneider and Emerson were both on acquisition binges because the electric equipment industry (and in particular, the critical power systems segment) was undergoing rapid consolidation. Schneider wanted to move aggressively into "smarter" product lines like critical power systems. Schneider saw great complementarity in geographic penetration and product lines between its MGE business and APC, and further estimated that, as by far the largest player in the world markets in the UPS space following the acquisition, it would be able to radically cut costs and get control over APC's production chain problems.

Schneider's press release for the deal summed all this up, emphasizing that the valuation was justified, among other reasons, because the deal would "generate significant [operational] synergies (including, among other things, purchasing, R&D, support functions, sales, services) estimated at around US$220 million, leverage significant R&D programs and APC's innovative architecture," and "accelerate the profitability improvement of large UPS systems thanks to MGE's strengths in services."[33]

As it happens, history appears to have proved Schneider's judgment to be correct. By the time Schneider published its 2006 annual report, filed with its French securities regulators in March 2007, its CEO reported that:

> APC is now part of Schneider Electric. It is the global leader in integrated critical power and cooling systems, with 2006 revenue of close to $2.4 billion — a 20 percent increase from 2005.
>
> This transaction gives Schneider Electric world leadership in one of the fastest growing areas of electrical distribution. . . . We've created a critical power and cooling services business unit that combines APC's resources with those of Schneider Electric subsidiary MGE UPS Systems. Their people have been brought together under a single management team.
>
> We confirm our synergy target of $220 million. If we meet this target — and we fully intend to do so — the value created will total $3.3 billion.[34]

In addition to this highly credible business case, there was another fascinating back story at work. According to *The Wall Street Journal*, a few months before the APC deal, Schneider itself had been the object of a $25.5 billion takeover bid from a consortium of private equity firms. (Had the deal been consummated, it would have been the largest private equity deal in history to that point.) The article explained that "while the APC purchase has strategic merit, it was also a defensive move to help protect Schneider from another such approach, people close to the matter say."[35]

In short, the tax story on its face is backwards, and the business explanations for Schneider's valuation of APC are plausible and well documented. Yet Galvin's competitiveness narrative reappears whenever corporate apologists are asked to defend inversion transactions, without anyone pausing to ask whether the story possibly makes any sense, or looking at the public record.

But wait, there's more. As Galvin points out, in 2010 Emerson acquired Chloride, a U.K. firm that was arguably the largest remaining independent UPS specialist manufacturer in the world. (It was the fourth largest UPS firm in the world at the time, behind Schneider, Emerson, and Eaton.) Galvin is right that this provided a tax-efficient way to deploy Emerson's offshore cash, but the story is a bit more nuanced than that. Emerson began its takeover attempts in 2008, offering to pay £270 per share for Chloride, which the latter promptly rejected.

[33]Schneider Electric SA press release (Oct. 30, 2006). Unlike documents prepared by tax lobbyists, M&A press releases are not unconstrained puff pieces, since they are filed with securities regulators and relied on by investors.

[34]Schneider Electric SA 2006 Annual Report, at 6.

[35]Jason Singer, "Schneider Got Takeover Approach Before Deciding to Purchase APC," *The Wall Street Journal*, Nov. 4, 2006.

Two years later Emerson returned, and in a move that bemused the financial press, raised its two-year-old offer by £5 per share, to £275. A bidding war broke out, and in the end Emerson prevailed, paying £375 per share. The ironic part is that the underbidder was ABB, the Swiss electric equipment maker, which was itself desperate to get into the UPS business before the continuing wave of global consolidation locked it out. So the U.S. tax system, which allegedly is punitive in its application to U.S. multinationals, did not stand in the way of Emerson acquiring a *foreign* target (unlike APC) and outbidding a rival domiciled in one of the world's great fiscal paradises.

What Really Is Going On?

If the competitiveness story is threadbare, what does explain the sudden tsunami of inversions? Here is my narrative, which I believe to be consistent with the public record and reasonable readings of the tax tea leaves.

The short answer is that the current mania for inversions is driven by U.S. firms' increasingly desperate need to do something with their $1 trillion in offshore cash, and by a desire to reduce U.S. domestic tax burdens on U.S. domestic operating earnings.

The year 2004 is a good place to start, because that year's corporate offshore cash tax amnesty (section 965) had a perfectly predictable knock-on effect, which was to convince corporate America that the one-time never-to-be-repeated tax amnesty would inevitably be followed by additional tax amnesties, if only multinationals would importune their legislators enough.[36] The 2004 law thus created a massive incentive to accumulate as much permanently reinvested earnings in the form of cash as possible.[37] At the same time, the Big Four accounting firms, no doubt chastened by their overzealous selling of risible corporate tax shelter deals, scaled up their educational mission to teach the less savvy U.S.-based multinationals how to generate serious quantities of stateless income.

The convergence of these two phenomena led to an explosion in stateless income strategies and in the total stockpile of U.S. multinationals' permanently reinvested earnings. But U.S. multinationals are now hoist by their own petard. The best of the stateless income planners are drowning in low-taxed overseas cash, which today earns only negligible rates of interest. The meager earnings on the cash drag down earnings per share, while shareholders focus with laser intensity on that cash as more usefully deployed directly in their hands.

It is less than a secret that firms in this position really have no intention at all of ''permanently'' reinvesting the cash overseas, but instead are counting the days until the money can be used to goose share prices through stock buybacks and dividends. The Apple solution (domestic leverage) cannot absorb all this cash, as firms other than Apple with existing debt might find themselves overleveraged if they pursued this solution indiscriminately. And in turn, one hears whispers from time to time that the financial accountants to firms sitting on vast hoards of offshore cash are getting more and more uncomfortable accepting representations as to the use of the offshore cash that fly in the face of financial and commercial logic.

The obvious solution from the perspective of the multinationals would have been a second, and then a third and fourth, one-time-only repatriation holiday, but there are still hard feelings in Congress surrounding the differences between the representations made to legislators relating to how the cash from the first holiday would be used, and what in fact happened. The other *deus ex machina* resolution was thought to be fundamental corporate tax reform, because most observers believe that whatever the precise contours of that legislation, one of its key components will be to reset the clock on permanently reinvested earnings by requiring their inclusion in the income of U.S. shareholders at some discounted rate over some reasonable period of time. But congressional paralysis has led to growing existential despair, and multinationals' representatives and earnest policy wonks alike rightly fret that they may never live to see sensible fundamental corporate tax reform legislation.

Against this desperate backdrop, extraordinary measures can seem almost sensible, and so we see the rush by cash-rich firms to impose tax on all their shareholders, and to merge with less than ideal minipartners, in order to set themselves up as foreign public companies. Doing so does not by itself free the U.S. firm's tax haven subsidiary from the strictures of section 956 or permit the distribution of cash up the chain tax free, but it does open up the possibility to orchestrate what I have described as a ''hopscotch'' transaction.[38]

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[36]The JCT staff in fact took this into account in its revenue estimate for the 2004 holiday, although in retrospect the staff perhaps underestimated the enthusiasm that corporate America would bring to the task. Kleinbard and Patrick Driessen, ''A Revenue Estimate Case Study: The Repatriation Holiday Revisited,'' *Tax Notes*, Sept. 22, 2008, p. 1191.

[37]Thomas J. Brennan, ''What Happens After a Holiday? Long-Term Effects of the Repatriation Provision of the AJCA,'' 5 *Nw. J. L. & Soc. Pol'y* 1 (2010).

[38]''Inverse Logic,'' *supra* note 1.

The idea, which I do not believe can be addressed through regulation or judicial challenge, is that section 956 has a fatal vulnerability in that it applies to loans made by a CFC only to a ''United States shareholder'' of that CFC. The new foreign public parent is not a U.S. shareholder, and as a result the tax haven subsidiary holding the offshore cash hoard can lend the cash directly to the new foreign parent, thereby skipping over the United States entirely. (Alternatively, the CFC could directly buy new foreign parent stock in the market.) From there, the public foreign company can use the cash to buy back ''its'' stock (which in an economic sense is just the old U.S. company's stock by another name), to pay dividends, to invest in real assets in the United States, or to repay the acquisition debt incurred to finance the inversion transaction in the first place. The interest income earned by the tax haven subsidiary is subpart F income, but that also is true today.

Moreover, cash is fungible. The existing cash stockpile alternatively can indirectly fund foreign operations through low-interest loans to foreign affiliates located in the wholly foreign chain, while foreign operations held outside the U.S. chain of companies can fund U.S. domestic operations. The result is to reduce the importance of the offshore cash over time and to hold more and more of the group's assets and income entirely outside the U.S. tax net.

The other reason for the wave of inversions relates to the same existential despair over the failure of Congress to engage with fundamental corporate tax reform, but this time the focus shifts to the tax imposed on U.S. domestic income. Many domestic-centric U.S. firms, particularly those in the services industries — say, a large chain of retail drugstores — actually pay federal corporate tax at effective rates not that far removed from the statutory rate. Companies in this situation have every reason to feel aggrieved that Congress has not addressed the high U.S. statutory rate, which burdens them disproportionately. An inversion transaction does little for those firms regarding their offshore cash, because they typically have little or none in a tax haven kitty, but the creation of an offshore parent located in a tax treaty jurisdiction does permit easy earnings stripping of the U.S. tax base on domestic operating income through newly created internal leverage, up to the ceiling set by section 163(j). But that ceiling is far too high, because it basically allows firms to strip out 50 percent of their earnings before interest, taxes, depreciation, and amortization.[39] After depreciation and amortization reduce what remains, there are slim pickings left for the U.S. Treasury.

These two reasons — hopscotch trades to put offshore cash into the hands of U.S. shareholders, and new avenues for eroding the tax base in respect of U.S. domestic operations — are sufficient to explain the current inversion mania. These motives do not apply with equal force to every firm that has explored an inversion transaction: Walgreens (which has now abandoned its inversion plans) has a large domestic tax base, a 37 percent effective tax rate, and essentially no foreign operations. Other firms have low effective tax rates, and very large stockpiles of offshore cash.

Until very recently, it might have been argued that inversions were naturally limited by the size of interested U.S. firms and the pool of available foreign merger partners. It was generally thought that those foreign merger partners were required to be (1) domiciled in a low-tax jurisdiction with a comprehensive tax treaty with the United States (for example, Ireland, the Netherlands, Switzerland, or the United Kingdom); (2) just the right size relative to an interested U.S. company (not too small to run afoul of section 7874, but no larger than necessary to accomplish the tax agenda that drives the deal); and (3) conducting a business that was at least a reasonably plausible business fit with the U.S. inverting company.

Now, attention has shifted to custom tailoring either a U.S. inverting firm (by spinning out some assets from a much larger U.S. company to a smaller U.S. vehicle suitable for inverting) or its foreign partner.[40] Mylan's inversion, for example, involves a custom-tailored foreign merger partner;[41] AbbVie is itself a recent spinoff from Abbott Labs, although the spin and the inversion are not part of a single transaction. Through such ''spinversions'' and similar tactics, the pool of U.S. assets that might be inverted, and the pool of foreign merger partners, have substantially increased.

One additional motivation for inversions, which is not substantive but certainly accords with my own experience working on Wall Street for three decades, is herd behavior. CEOs find it difficult to be the only gazelle on the veldt that remains in place when all the others madly gallop off in one

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[39]Sullivan, ''The Many Ways to Limit Earnings Stripping,'' *Tax Notes*, July 28, 2014, p. 377.

[40]Brooke Sutherland, ''Spinversions: How a Mega Co. Can Join In on Tax-Cutting Deals — Real M&A,'' Bloomberg News, July 10, 2014.

[41]Stephanie Soong Johnston, ''Mylan to Acquire Abbott Drug Unit for $5.3 Billion,'' *Tax Notes*, July 21, 2014, p. 221.

direction or another. Because this reason sounds in psychology rather than tax policy, I do not consider it further.

Longer term, inversion transactions may open up additional stateless income planning opportunities, if one believes, for example, that over time Ireland will consistently be a more tax-congenial platform than the United States from which to headquarter one's base erosion strategies. (Interestingly, the Irish government may be a net loser in inversion transactions to date. The reason is that Ireland is not picking up significant new tax revenues from these deals, because in fact nothing changes; for example, senior executives in the United States do not pick up and move to the Emerald Isle. But the larger revenues of the expanded Irish parent company are treated as Irish for gross national product purposes, which has the consequence of increasing Ireland's share of EU budget costs.[42])

The usual long-term strategy is to allow the foreign subsidiaries of the old U.S. parent to atrophy, at the same time that revenues ramp up in the entirely foreign chain descending from the new foreign public company. If one is patient, this does not require aggressive transfer pricing, exotic tax-free reorganizations, or the like; simply situating every new business opportunity in the wholly foreign chain, combined if needed with some leveraging of any high-taxed CFCs, does the trick. (Neither the United States nor the OECD treats pure business opportunities as subject to transfer pricing analysis.)

This third explanation has some explanatory power to it, but it is often overstated. The argument essentially is the one offered by Bresch of Mylan. Implicit in her competitiveness explanation for inversions is the idea that firms domiciled outside the United States today have an even easier time than do U.S. firms of generating stateless income, and that it is desirable to encourage an ever-accelerating slide down a slippery slope to negligible tax rates on multinational firms. In many cases, however (for example, the Schneider example discussed earlier), the claim that multinationals domiciled in other jurisdictions are making out even better than U.S. firms is not easily demonstrated, and it ignores anti-base-erosion developments like the OECD's BEPS project or the EU's common consolidated corporate tax base. The second leg to Bresch's argument essentially is analogous to claiming that if one country engages in export subsidies, all countries should. We have gotten past that race to the bottom in trade and in explicit subsidies, and it is time we did so as well for tax mercantilist behaviors by sovereigns. Finally, this argument plainly would lead to economic distortions in markets where multinationals compete with domestic competitors in their own markets, since firms like Mylan already enjoy global effective tax rates lower than those imposed on wholly domestic firms in most of the markets in which these multinationals actually do business.[43]

Regardless of the desirability of export subsidies hidden in the tax code, I view this third reason for inversions as a less powerful motivation than the first two. Savvy U.S. multinational firms already enjoy very low effective tax rates, although of course future U.S. tax regimes are uncertain. Another reason to be skeptical that this reason is a principal motivation is to return to the observation that relatively few genuine U.S. inversion transactions took place in the 2004-2013 period, when measured against the overall volume of cross-border M&A deals. If U.S. firms were running far behind the pack in a race to the bottom, we would have seen many more inversions over this period, but in fact in many cases U.S. firms occupied the pole position.

The final reason to be skeptical is that this sort of strategy requires a long-term perspective. A firm reasonably should be reluctant to impose capital gains tax today on all its taxable owners with unrealized gains against the prospect that its effective tax rates years from now will be materially lower as an Irish rather than as a U.S. company, taking into account the risks that by then the BEPS "actions" may be both delivered and implemented, source countries generally more effective at policing their tax systems against multinational depredations, and the EU's common consolidated corporate tax base may have been implemented.

What Then Should We Do?

It is very important to remove the false narrative of international business competitiveness from discussions about how policymakers should respond to the current wave of corporate inversions, because its continued presence in debates leads people to believe that allowing inversions to continue might be the lesser evil, if the alternative is to condemn U.S. firms to a punitively burdensome operating environment in which they will lose ground to multinationals domiciled elsewhere. I have limited patience for the idea of corporate national champions, but I recognize the idea's rhetorical power.

[42]Maureen Farrell, "Ireland: U.S. Tax Inversions Aren't Helping Us Much Either," *The Wall Street Journal*, July 8, 2014.

[43]Kleinbard, "The Lessons of Stateless Income," *supra* note 5, discusses these issues in much greater detail.

Once one understands, however, that U.S. multinational firms today operate in a tax environment that essentially is one of ersatz territoriality, with none of the safeguards of a well-designed territorial system, but with an odd balance-sheet-bloating (and admittedly generally stupid and inefficient) rule for where the fruits of offshore base erosion and profit shifting must be stored, the case for inaction essentially dissipates.

From the other direction, the case for action is urgent, both to protect the U.S. domestic tax base and to preserve existing law's premises of how the international tax system is supposed to operate. Inversions are an immediate threat to fiscal stability because they enable inverted firms to strip their U.S. *domestic* corporate tax base, and to use existing offshore cash to fund dividends or stock buybacks to U.S. shareholders, which today cannot be done without paying U.S. tax. (I briefly discuss the risk of tax revenue hemorrhaging below.) And once a company has inverted, it is gone: The United States will find it difficult to undo the damage to the tax base in subsequent corporate tax reform.

In my view, the necessary responses require legislation rather than Treasury regulations, but the measures that I suggest below rest on firm policy grounds and are properly constrained in their application to address the faults in the code's architecture that inversion transactions have made so salient. While large-scale corporate tax reform is necessary, the legislative solutions offered here do not in any way foreclose the shape of that reform; to the contrary, the more plausible prediction is that they will be integral components of any future tax reform legislation. For this reason, there is no reason to wait until a major tax reform bill can work its way into law, and every reason to act now.

The first component of the necessary legislative package is the most obvious: Revise section 7874 so that it parallels domestic law's consolidated tax return principles, by treating a reverse acquisition of a U.S. firm by a smaller foreign firm as a continuation of the U.S. firm for U.S. tax purposes. All that is required is to drop the operative rule of section 7874(a) as surplusage and to change the specified fraction in section 7874(b) from ''80 percent'' to ''more than 50 percent.'' This is a simple application of commercial and economic common sense: In a world without tax advantages bestowed for thinking backwards, minnows do not swallow whales, or catfish swallow dolphins. The idea to reorder which is the acquirer and which the target in reverse acquisitions is completely noncontroversial in the domestic context for this reason, and its extension to the international arena not only helps to protect the U.S. tax base but ends a policy that rewards tax perversity over commercial reality.

The second component, which has very recently gained traction among some members of Congress, is to lower the excessively generous ceiling that section 163(j) sets on the quantum of U.S. corporate tax base erosion that we will tolerate regarding U.S. *domestic* earnings. Martin A. Sullivan recently published a description of 10 different proposals to bolster section 163(j) that have been offered to Congress since 2002.[44] Congress should choose one already and just do it.

A bulked-up section 163(j) would not be limited to inversion cases, nor should it be. It would apply whenever the United States is the source country rather than the residence in a cross-border relationship, and it would ensure that the source country income that economically is generated here is taxed here. For those policymakers who look over their shoulders at international norms, the theme that source countries (in an economic or commercial sense) are systematic losers to stateless income stratagems is the reason behind the OECD's BEPS project, and is a major reason for the thin capitalization statutes that many countries with territorial tax systems have adopted.[45] Protecting one's source country tax base from easy depredations by foreign investors, where the income side may be taxed nowhere, and certainly not where it economically was earned, is what functional governments do.

Section 163(j) is intended to prohibit easy domestic base erosion through internal leverage. It has been suggested that the same principle should be extended to other deductible payments made by a U.S. company to its foreign parent, such as royalties. The idea is intuitively attractive but conceptually is more difficult than it seems at first blush.[46] Moreover, such an extension is not consistent with world norms (or arguably with some of the positions staked out by Treasury in negotiations over the BEPS action plans), when arm's-length transfer pricing requirements are still the operative instrument for limiting excessive zeal in this area. For both reasons, I would limit our ambitions today to section 163(j) intragroup interest expense cases.

The final necessary component of any legislative response to inversion transactions is an antihopscotch rule. Here the idea is to recognize that the existing offshore cash held by CFCs of U.S. firms was accumulated under an explicit premise that it would one day be taxed by the United States, when the cash was directly made available to the U.S. group through a dividend, or indirectly through a

[44]Sullivan, *supra* note 39.

[45]Kleinbard, ''The Lessons of Stateless Income,'' *supra* note 5, at 140-144.

[46]*Id.*

loan to a U.S. affiliate, an investment in U.S. tangible assets, etc. Hopscotch low-interest loans that skip over a CFC's U.S. parent to go directly from the CFC to a new (or old, for that matter) foreign ultimate public company can be used to put value directly into the hands of former shareholders of the U.S. firm, or perhaps even into the CFC's immediate U.S. parent (through a downstream infusion from the new foreign ultimate parent); those loans can also be used to finance the upside-down merger itself. All these fit badly with the larger apparatus of subpart F. (With some care, the hopscotch loan from the CFC to the ultimate foreign parent can in turn be used to fund loans from the foreign parent to the U.S. group, to facilitate earnings stripping as well.) And because under section 482 intragroup loans can bear a low rate of interest, over time the effect is to drain untaxed earnings out from the subpart F net, as higher returns on the cash so lent accumulate outside the U.S. subgroup.

Like earnings stripping, the hopscotch loan phenomenon is not necessarily limited to true inversion cases, and neither should be the response. Again, the idea should be that whenever a U.S. firm has low-taxed offshore earnings, the indirect distribution of those earnings to or for the benefit of U.S. shareholders or the U.S. immediate parent should be tested under section 956 principles.

Section 956 therefore should be extended to address the problem of hopscotch trades. Legislation should include as section 956 income of a U.S. shareholder its CFC's loans to, or purchases of stock from, non-U.S. persons that either (1) control the U.S. shareholder or (2) are not U.S. corporations and are not themselves CFCs as to the U.S. shareholder but are controlled by the controlling non-U.S. shareholder of the U.S. shareholder. The second thought is meant to pick up the new entirely foreign chain of companies that join the U.S. chain in the merger. This rule would apply even to a non-inverted group (that is, a bona fide acquisition by a foreign company of a smaller U.S. target). It also would not change the current reach of section 956 within the U.S. subgroup of CFCs, so that loans from one CFC to another would not trigger 956.

Again, the solution is designed to be surgical, and to address a problem that was brought to the fore by inversions, but which ultimately is a fault in the code's architecture that logically should not be so limited. As a result, and like the bulking up of section 163(j), it is not intended as a punishment for inverting so much as it is the protection of the U.S. tax base through preserving the premises underlying current law.

In May 2014 the Joint Committee on Taxation staff estimated that a bill incorporating only the first of these three suggestions (the revision to section 7874's threshold from 80 percent to 50 percent) would raise about $19.5 billion in revenues, compared with current law.[47] This estimate was delivered before the pace of inversion transactions intensified even further and variants like ''spinversions'' were widely discussed. I believe that legislation incorporating not only this proposal but also lowering the section 163(j) ceiling and an anti-hopscotch rule would, if analyzed today, carry with it a much higher revenue estimate.

These three proposals are targeted, economically and commercially neutral, and consistent with both current law and the probable shape of any future reform legislation. I would not go further, as for example by rethinking the definition of corporate residence, because such an initiative is not necessary today, and because the topic more fairly does belong in a larger conversation about a new international corporate tax system (similarly, broaden anti-decontra/legislation in respect of controlled foreign corporations properly belongs in comprehensive reform legislation). I have views as to whether this targeted legislation should be mildly retroactive or fully prospective, and temporary or nominally permanent, but these questions are politically charged, and at this point will be resolved through entirely political negotiations.

[47]Memorandum dated May 23, 2014, from JCT Chief of Staff Thomas Barthold to Karen McAfee.