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YOU CAN'T TAKE IT WITH YOU: BEHAVIORAL FINANCE AND CORPORATE EXPATRIATIONS

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YOU CAN'T TAKE IT WITH YOU: BEHAVIORAL FINANCE AND CORPORATE EXPATRIATIONS

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In 2002, reports of corporate expatriations filled the headlines. These reports come as something of a surprise because the tax rules enacted in the early 1990's should have prevented almost all of these transactions. Various commentators have tried to explain this phenomenon. However, these explanations are not consistent with the empirical evidence. This article proposes a solution to this problem by arguing that corporate managers are exploiting fluctuations in stock prices to expatriate at reduced cost. The article proposes legislation to reduce expatriations consistent with this model.

INTRODUCTION

The sight of people fleeing a country sends a signal to the world that something is wrong in the jurisdiction. When corporations flee, the meaning is less clear. This is particularly true if the corporations can "flee" without significantly changing their operations. Some argue that corporate expatriation is a sign that the U.S. tax system needs to be changed. Others read expatriation activity as a manifestation of excessive corporate greed which must be restrained.

A corporation is, after all a fiction. The idea of a corporation "leaving" a jurisdiction is rather odd but derives from the fact that corporations are considered to be resident where they are incorporated[2] rather than where they actually operate. A corporate expatriation, sometimes called a corporate inversion or "flip" transaction, involves a reorganization in which the parent corporation of a group of related corporations moves

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[2] I.R.C. § 7701 (2002).

from the taxing jurisdiction of the United States to that of a foreign jurisdiction.[3] By moving the parent corporation outside of the United States taxing jurisdiction, many of the U.S. tax rules no longer apply to the group as a whole.[4] What may in substance be little more than a "paper" transaction can significantly reduce the worldwide taxation of the entire group.[5]

Corporate expatriations, which historically have occurred primarily in the insurance and oil and gas industries, are now occurring among a wider distribution of American industries.[6] These expatriations became the focus of congressional debate in the summer of 2002, as industry leaders such as Stanley Tools – America's largest tool manufacturer – made inversion announcements.[7] Notwithstanding the public antipathy for corporate

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[3] Bermuda seems to be the jurisdiction of choice. Tyco International, Ingersall-Rand, and Helen of Troy (which, on December 30, 1993, made the first inversion announcement that alerted the I.R.S. to tax-driven expatriations, leading to the enactment of the 1994 anti-inversion provisions of the Internal Revenue Code), all reorganized to Bermuda.

[4] *See* discussion *infra* Part II.A.3.

[5] *See* discussion *infra* Part II.A.2.

[6] U.S. TREASURY, OFFICE OF TAX POLICY, CORPORATE INVERSION TRANSACTIONS: TAX POLICY IMPLICATIONS, Doc. 2002-12288, reprinted at 2002 TNT 98-49 (May 21, 2002) (hereinafter "Treasury Report") (stating that "there has been a marked increase recently in the frequency, size, and profile of the transactions"). American corporations which have expatriated include: Helen of Troy (Dr. Scholl's) to Bermuda, Tyco International (ADT Security Systems) to Bermuda, Santa Fe International to the Cayman Islands, Fruit of the Loom to the Cayman Islands, Playstar (Internet gaming) to Antigua, Cooper Industries to Bermuda, Ingersoll-Rand (tool and die manufacturer) to Bermuda, and Stanley Works, which announced it's intention to expatriate to Bermuda but reconsidered in the face of overwhelmingly negative publicity Treasury Report at 7, 96 (stating that "[b]oth the recent inversion activity and the increase in foreign acquisitions of U.S. multinationals are evidence that the competitive disadvantage caused by our international tax rules is a serious issue with significant consequences for U.S. businesses and the U.S. economy"). Treasury Report, note 3 at 4 (concluding that "U.S. based companies and their shareholders are making the decision to reincorporate outside the U.S. largely because of the tax savings available"). Treasury Report, note 3 at 19-21 (citing protection of foreign operations from the application of subpart F as justification for the costs associated with expatriation). Expatriation also provides the opportunity to exploit differences in the treatment of equity investments and debt to reduce both U.S. and local-country tax. ROBERT LIPSEY, HOME AND HOST COUNTRY EFFECTS OF FDI (Nat'l Bureau Of Econ. Research, Working Paper No. 9293, 2002). All section references are to the Internal Revenue Code of 1986 (the "Code"), as amended, unless otherwise indicated.

[7] Seven of the Standard and Poor's 500 have either expatriated or made the public inversion announcements and public filings required under state corporate law and federal securities laws. These are Cooper Industries, Ingersall Rand, Nabors, Stanley Works, Transocean, and Tyco International. Inversion announcements in the last eighteen months represent more than $25 billion in market capitalization as of the announcement date. In an March 1999 Senate Finance Committee hearing, Robert Perlman, a former vice-president for tax at Intel testified that "if Intel were to be founded today, I would strongly advise that

inversions following the attacks of September 11,[8] there is every reason to believe that inversion activity is continuing and that non-public corporations are engaging in inversion activity as well.[9]

The increase in inversion activity represents an anomaly. As explained more fully in Parts II and III, if traditional finance theory is correct, the U.S. tax rules operate to impose a cost to expatriate from the United States that generally will equal or exceed the potential tax benefits. Therefore, a decision to expatriate should very rarely be a rational business decision.[10] In the last three years, however, an increasing number of inversions have

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the parent company be incorporated outside the United States.." *Unofficial Transcript of Finance Hearing* 1999 TNT 50-54 (Mar. 16, 1999). Technically, a reorganization comes within the meaning of an "inversion" transaction when a U.S. corporation becomes a subsidiary of a newly-established tax haven parent corporation. Several significant expatriations - the Daimler-Chrysler, BP-Amoco, and AirTouch-Vodafone mergers, for example - have been structured as acquisitions of smaller, preexisting entities, so as to preclude the application of the Code's anti-inversion provisions. Finally, the expatriation of two prominent U.S. multinationals – Accenture and Seagate Technologies - have avoided inversion characterization by strategically structuring their initial capitalization outside the United States.

[8] One need only examine the titles of bills offered in Congress to stem the tide of corporate inversion activity to conclude that expatriations by U.S. corporations are considered "anti-American". The anti-inversion bills offered in the spring and summer of 2002 included the Corporate Patriot Enforcement Act of 2002, the No Tax Breaks for Corporations Renouncing America Act of 2002, and the Save America's Jobs Act of 2002. *See* note 185, *infra*.

[9] The Treasury Department has recently promulgated regulations requiring all corporations which relocate outside the U.S. to notify the I.R.S. within thirty days. This indicates that Treasury believes not only that corporate inversion activity is still continuing, but that it represents a continuing threat to the collection of federal revenues.

[10] For taxable entities, the price of escaping the U.S. tax net is recognition of the appreciation inherent in the assets of the parent corporation, as well as the appreciation in the shares of the parent corporation itself. The second way in which this article adds to the literature is that it proposes a solution to the problem that avoids a moratorium on inversions a which would appear quite drastic and desperate, and might actually be unfair. This tax liability, imposed on the shareholders of the U.S. corporation rather than the corporation, has historically limited the number of corporate expatriations from the U.S. to one or two per year. MIHIR A. DESAI & JAMES R. HINES, JR., EXPECTATIONS AND EXPATRIATIONS: TRACING THE CAUSES AND CONSEQUENCES OF CORPORATE INVERSIONS (Nat'l Bureau of Econ. Research, Working Paper No. 9059, 2002) (hereinafter "Desai-Hines study") (table 1 detailing data on inversion activity among public corporations from 1982 to 2002). In theory, the application of the anti-inversion provisions of the U.S. international tax rules, together with the public notice and filing requirements of state corporate law and federal securities law, should operate to discount any potential tax savings from inversion into the share price of the announcing corporation. RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE (5th ed. 1996) (under the efficient market hypothesis, market prices are "informationally efficient", responding to new information almost instantaneously).

occurred, seemingly undeterred by the imposed or impending tax liability.[11] The academic literature has not yet adequately explained this anomaly. Some commentators have argued that there are other potential tax savings that explain the anomaly of corporate inversions.[12] However, as the article shows, these explanations are not consistent with the evidence. Moreover, neoclassical economics would argue that any potential savings post-inversion are factored into the stock price post-announcement[13] and, as such, subject to immediate taxation.

This article adds to the literature in two ways. First, it proposes a new explanation for corporate inversion activity based upon behavioral finance models. Behavioral finance is an approach to the analysis of financial markets that emerged in the 1980s in response to empirical research which pointed up anomalies in market behavior.[14] This research has documented systematic deviations from classical theories of efficient markets, specifically the efficient market hypothesis, which was widely accepted in the 1970s.[15] This article argues that corporate managers are exploiting imperfections in the market to reduce the cost

[11] Reuven Avi-Yonah, *For Haven's Sake: Reflections on Inversion Transactions*, 95 TAX NOTES 1793 (2002).

[12] Avi-Yonah, *supra* note 11, at 1745; DESAI & HINES, *supra* note 10, at 4. Presumably, though, *any* potential tax savings would increase the price of the shares at the time of the expatriation and hence would increase the cost of expatriation because the cost is based on the value of the shares post announcement, which would mean that these savings are not only taxed by the U.S. but taxed on a current rather than a future basis.

[13] Federal securities laws and state corporate law require public notice and shareholder approval for any corporate reorganization. Robert Hamilton, CORPORATIONS (2000). Moreover, federal securities laws require a detailed filing of the plan of reorganization prior to the shareholder vote. *Id*.

[14] Werner DeBondt and Richard Thaler, *Does the Stock Market Overreact?*, 40 J. FIN. 793 (1985); DeBondt and Thaler, note 21 (empirical work tying theories by Kahneman and Tversky to market behavior); ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE (2000). For Kahneman and Tversky's work on deviations from the standard decision making theory, *see* Daniel Kahneman and Amos Tversky, *On the Psychology of Prediction*, 80 PSYCHOL. REV. 237-51 (1973) (individuals systematically violate maxims of probability theory such as Bayes rule, which holds probabilities follow standard algebraic laws, i.e., if a person does not follow Bayes rules they are behaving as if the probabilities of all events either exceeds or is less than 1), D. Kahneman and A. Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263, 291 (1979) (individuals do not always act rationally with respect to gambles and, more specifically, display an aversion to loss more strongly than a preference for gain).

[15] SHLEIFER, *supra* note 13, at 10.

of expatriation to the point that they deem it profitable for their companies to "leave" the U.S. based on tax considerations alone.

The second way in which this article adds to the literature is that it proposes a solution to the problem that avoids drastic measures such as the Congressionally-proposed moratorium on expatriations,[16] which could have significant negative long-term consequences,[17] but nevertheless prevents corporate managers from abusing the tax system.[18] This article proposes a modification to the current regulations which would ensure that corporate managers will not be able to take advantage of temporary market fluctuations in order to avoid paying their fair share of taxes, by valuing the corporations over a period of time rather than based solely only on market price on the actual day of the inversion. Moreover, the article argues that the inclusion of options in market value will render a more accurate value of the inverting corporation and will serve to deter expatriation activity.

Part I of the article provides a discussion of the international tax rules and the reasons why corporations might wish to expatriate. Part II addresses the issues surrounding corporate expatriation including the tax rules that apply to these transactions. It discusses how corporate inversions can be used to abuse the tax system. It also shows how the U.S. international tax rules are based on traditional finance theory and how this theory is inadequate to explain the phenomena of corporate inversions. Part III proposes a model of the expatriation decision based on the behavioral finance literature and shows how this model can explain the anomaly of corporate inversions. Under this model, corporate

[16] *See* discussion *infra* at Part IV.A.
[17] In addition to potential negative long-term consequences, discussed *infra* at Part IV.A., moratoria could, in some circumstances, be unfair. Legitimate reasons include if the shareholders change so as to avoid the imposition of withholding taxes, and if the U.S. tax rules of the United States are likely or about to change. If the U.S. changes the tax structure, it seems reasonable to allow corporations to pay their taxes and leave.
[18] *See* discussion *infra* Part III.

managers take advantage of temporary downturns in the price of the stock of the corporation to reduce the price of expatriating. Part IV proposes a solution to the problem of corporate inversion based on this behavioral finance model. It argues that the tax price for expatriation should include an ability to take account of changes in market price to derive a more accurate value of a corporation at the time of inversion.

II. THE ANOMALY OF CORPORATE INVERSIONS

A. Background

Any income which arises from cross-border transactions is potentially subject to tax in two or more jurisdictions: the residence country[19] and the source country.[20] It is generally left to the residence country to alleviate double taxation.[21] There are two primary methods of dealing with double taxation.[22] The first is the "worldwide" or "credit" method, in which the residence country taxes foreign source income but provides a credit for taxes paid to foreign jurisdictions. The second is the "territorial" or "exemption" method, under which the residence country cedes all taxing jurisdiction to the source country.

1. Worldwide and Territorial Systems of Taxation

[19] The residence country is the country in which the taxpayer resides, and the source country is the country in which the activities which generate income. *See* Terrence R. Chorvat, *Taxing International Corporate Income Efficiently,* 52 TAX L. REV. 325 (2000).

[20] Double taxation is highly inefficient. If foreign investment is subject to two layers of tax, while domestic investment is subject to only one, the tax system would significantly discourage investment in foreign countries. *See* RICHARD CAVES, MULTINATIONAL ENTERPRISE AND ECONOMIC ANALYSIS 189, 190 (2d. ed. 1996).

[21] PETER HARRIS, CORPORATE-SHAREHOLDER INCOME TAXATION AND ALLOCATING TAXING RIGHTS BETWEEN COUNTRIES 320 (1996).

[22] Alternatively, a country could allow foreign taxes to be deducted from taxable income. A deduction does not eliminate double taxation, but simply reduces the effect of double taxation. Both countries still tax the income. The total tax paid is higher than the tax rate in either country. Fortunately, this is rarely the only method available to deal with double taxation. HARRIS, *supra* note 20.

a. Worldwide Taxation

Under a worldwide system, a country taxes all the income of its residents, irrespective of source.[23] In order to alleviate potential double taxation, the residence country generally permits its taxpayers a foreign tax credit for income taxes paid on income earned in foreign jurisdictions.[24] Under this system, the income earned by a multinational enterprise[25] will be taxed, at a minimum, at the rates set by the residence country.[26]

Almost all countries that use a worldwide system impose a limitation on the foreign tax credit.[27] The foreign tax credit limit is generally equal to the amount of residence country tax on foreign source income.[28] The foreign tax credit limit ensures that the tax rate applicable to foreign source income is the higher of the residence country rate or the source country rate.[29] From the standpoint of the residence country, this ensures that no other country's treasury will be subsidized by credits from the residence country.

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[23] HUGH J. AULT, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 381 (1997).
[24] *Id*.
[25] A multinational enterprise is defined here as an enterprise that controls and manages business activities in at least two countries. *See* CAVES, *supra* note 19, at 1.
[26] *See* AULT, *supra* note 22, at 381. To illustrate the application of the foreign tax credit, assume that A, a U.S. multinational, earned $100 in Hong Kong and $100 in the United States. Hong Kong will tax the $100 of income earned within its borders at a rate of 17%. The United States will tax A's worldwide income of $200 at a rate of 35%. However, because of the foreign tax credit, A will only have to pay an additional U.S. tax of $53, rather than $70. Because the total amount of tax A will pay is $70, $50 dollars to the U.S. and $17 to Hong Kong, the Hong Kong income and the U.S. source income are both subject to a total tax rate of 35%, which is the rate A would have paid if all the income had been earned in the United States.
[27] For example, limitations are imposed on the foreign tax credits allowed in the United Kingdom, Australia, and Norway. *See* AULT, *supra* note 37, at 388-91; *see also* Joel Slemrod, *The Taxation of Foreign Direct Investment: Operational and Policy Perspectives*, 11, 34-35, in BORDERLINE CASE: INTERNATIONAL TAX POLICY, CORPORATE RESEARCH AND DEVELOPMENT AND INVESTMENT (James M. Poterba ed., 1999).
[28] § 904 (2002). For the United Kingdom rules, *see* AULT, *supra* note 37, at 385-91.
[29] To illustrate the application of the foreign tax credit limitation, assume that A also operates in Italy, where the tax rate is 56%. If A earns $100 in Italy, this income will be subject to $56 of Italian tax. The Italian source income will also be subject to tax in the United States at a 35% rate, but A will receive a tax credit for the taxes paid to Italy. Before taking into account the foreign tax credit limitation, A is eligible for a foreign tax credit of $56, even though the U.S. tax on the income is only $35 dollars. Therefore, A will owe no further U.S. tax. Because the Italian rate of tax is greater than the U.S. rate of tax, A will not pay any tax on this income in the United States. However, the credit is limited to $35 in the U.S. (the

b. Territorial Taxation

Under an exemption or territorial system, such as is employed in Canada, Germany[30], the Netherlands, or France[31], foreign source income generally is not subject to tax in the residence country.[32] The residence country only taxes active business income if it is earned within its borders.[33]

Most exemption systems also tax the passive foreign-source income of their residents, because passive income is viewed as having no natural location.[34] For example, someone who owns shares of a U.S. publicly-traded corporation will obtain the same pre-tax benefits whether he resides in the United States, Bermuda, or Australia. As a result, a multinational group of corporations will have an incentive to shift its passive income to the lowest-taxed jurisdiction in which it operates, in this example in Bermuda. Because this

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amount of U.S. tax on the Italian income) even though the total tax paid on the income is the higher Italian rate of 56%. Generally, if a multinational taxpayer has foreign tax credits that it cannot use on a particular item of income, the taxpayer is permitted to use these credits to reduce U.S. tax on other items of foreign source income. However, the foreign tax credit is subject to many more restrictions and is beyond the scope of this article (and very likely the tolerance of the gentle reader).

[30] Canada and Germany have a worldwide system by statute however, with their tax treaties they have an exemption system. AULT, *supra* note 37.

[31] For descriptions of the Dutch and French exemption systems *see* AULT, *supra* note 37 at 315.

[32] *See* AULT, *supra* note 37, at 381.

[33] *Id*. To illustrate the application of a territorial system, assume that B is a Dutch multinational and has a subsidiary in Hong Kong. B earns $100 in the Netherlands, and the subsidiary earns $100 in Hong Kong. The Netherlands has an exemption system and a 35% corporate rate on income earned in the Netherlands. *See* AULT, *supra* note 37, at 384-85, 87. B will pay $17 in tax to Hong Kong, and will only pay tax in the Netherlands on its Dutch source income. B will not pay any tax in the Netherlands on the Hong Kong source income. Therefore, B will have to pay less in total worldwide tax than A [$52 ($17 + $35) for B versus $70 (35% on $200) for A]. If B had an Italian subsidiary, its income would also be subject to a tax rate of 56%. Under a worldwide system, the higher of the source country rate or the residence country rate applies. Therefore, if the tax rate in the source country is higher than in the residence country, under both a worldwide system and a territorial system, the higher source country rate applies. Thus if A and B both have operations in the same high-tax jurisdiction, A and B will be taxed alike on this income.

[34] For this purpose, passive income includes such items as dividends, interest, and royalties not received from affiliates. The Netherlands, France, and Canada tax these types of income. *See* AULT, *supra* note 37, at 403-06.

shifting of investment activity likely has no economic basis,[35] it is viewed as an abuse of the system, and therefore many exemption systems subject foreign source passive income to tax in the residence country.[36]

c. Comparison of the Two Systems

All things being equal, a multinational enterprise would generally prefer to be considered resident in a territorial system rather than in a worldwide system. Under a territorial system, if a member of the corporate group earns active business profits in a low-tax country, the only tax to which the income will be subject is the low source country rate. On the other hand, if the group is subject to a worldwide system, income eventually repatriated to the parent corporation[37] will be subject to another layer of tax. Therefore, a corporation operating under a territorial system will generally have a lower tax cost associated with operations even in countries with low local tax rates.

2. The U.S. International Tax Provisions

a. The Basic Credit System

[35] Whether, for example, the income is earned by a U.S. or a Bermudan subsidiary, the activities that generated the income do not change, nor are the natural persons enriched by the income any different. Therefore, the shifting of such income between subsidiaries would be viewed as not having economic substance.

[36] *See* AULT, *supra* note 37, at 411-13; *see also* NFTC, THE NFTC FOREIGN INCOME PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY, PART ONE: A RECONSIDERATION OF SUBPART F 57, 156 (1999).

[37] In order for it to be distributed to the shareholders or for reallocation back to other members of the group.

The United States has since 1909 asserted its jurisdiction to tax the worldwide income of domestic corporations, regardless of the source of their income or where they are engaged in a trade or business.[38] Income earned by foreign branches[39] of U.S. corporations is taxed when it is earned abroad. Dividends, interest, rents, royalties, and similar kinds of income received by U.S. persons are also subject to U.S. income tax.[40]

Consistent with a worldwide system, the U.S. tax system alleviates the double taxation of U.S. taxpayers on foreign source income by allowing a limited credit against the U.S. tax which is available for certain income taxes paid to foreign countries.[41] The credit is available only up to the amount of U.S. tax attributable to the foreign income.[42] If the foreign tax is less than the amount of the U.S. tax, the United States will collect any incremental income tax on the foreign income by which the U.S. tax rate exceeds that of the foreign country. If the foreign tax exceeds the amount of the U.S. tax, no portion of the excess credit is available to reduce U.S. tax on income earned in the United States. For a U.S. multinational corporation, this general limitation operates as a "ceiling" on the amount of credit available for each dollar of foreign tax paid.

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[38] BORIS BITTKER AND JAMES EUSTICE, THE FEDERAL TAXATION OF CORPORATIONS AND SHAREHOLDERS (7th ed. 2001).

[39] A foreign branch is a direct operation of a U.S. corporation in a foreign country. A foreign subsidiary is a foreign corporation which is owned by a U.S. corporation. If a multinational chooses to operate in the local jurisdiction in the form of a foreign subsidiary, it must form a foreign corporation to conduct its business. If it chooses a branch, it conducts the business in the foreign jurisdiction directly, without the use of an intervening entity. *See* Slemrod, *supra* note 26, at 12-13.

[40] I.R.C. § 61 (2002).

[41] I.R.C. § 901 (2002).

[42] Congress limits the credit to that portion of the corporation's total U.S. tax liability that equals the ratio of net foreign source income over worldwide income. Because the numerator of the general limitation is described in terms of *net* foreign source income, the limitation is sensitive to formulaic (i.e., non-economic) allocations of expense against foreign source income or, alternatively, inclusion of income as U.S. source which would, in economic terms, be appropriately considered to be foreign source. Congress has incorporated in the international provisions several formulaic allocations of income or expense which serve to disallow credits for foreign taxes paid by U.S. corporations in their foreign operating jurisdictions. Unfortunately for U.S. multinationals, to the extent that these formulaic allocations operate to disallow otherwise creditable foreign taxes, the U.S. corporation is subject to double taxation. Examples may be found in the interest expanse allocation rules, discussed *infra*, and in the rules for allocating income from insurance-related services. Treas. Reg. § 1.861-14T(h); I.R.C. § 904(a) (2002).

The mechanics of the U.S. foreign tax credit limitation are somewhat complex. Many of these rules are designed to prevent taxpayers from using passive income – the paradigmatic low-taxed "mobile" income - to artificially increase the limit and thereby circumvent the purpose of the limit. The operation of the general limitation allows taxpayers to combine the foreign-source income from all non-U.S. jurisdictions in which the U.S. corporation operates. This allows U.S. corporations to average the local tax rates of all non-U.S. jurisdictions over combined foreign source income. To preclude the U.S. taxpayer from averaging the rates from high-tax jurisdictions with low-tax jurisdictions to increase the available limitation (sometimes called "blending" or "cross-crediting"), Congress has imposed separate limitations on certain types of foreign source income. Theoretically, these separate limitations or "baskets" were applied to certain categories of income that were viewed by Congress as more likely to distort the foreign tax credit because they were "mobile" and could be diverted to tax-favored jurisdictions to further the process of cross-crediting.

b. Deferral and Non-Deferral of U.S. Taxation of Foreign Source Income

i. Basic Rule of Deferral

The U.S. tax rules technically apply only to U.S. corporations.[43] As discussed earlier, a corporation is considered a resident in the country in which it is incorporated.[44] It

[43] The U.S. rules also apply to foreign corporations that do business in the United States or own real property here. *See* I.R.C. §§ 882, 897 (2002). However, we will ignore these operations for purposes of this paper because they do not significantly add to the analysis.
[44] I.R.C. § 7701(a) (2002)

is a legal person separate and apart from its shareholders.[45] Under recognized international principles, the United States does not have the right to tax foreign corporations on their worldwide income.[46] It can only tax U.S. resident corporations on their worldwide income. Following this principle, income earned by U.S. corporations through foreign subsidiaries is not subject to tax in the United States until is distributed to the U.S. parent corporation. This allows for significant deferral of the U.S. tax earned by U.S. subsidiaries.[47]

ii. Anti-Deferral Rules

Notwithstanding the separate entity concept, the international provisions of the U.S. tax rules have, since the early 1960s, contained aggressive anti-deferral provisions.[48] The U.S. anti-deferral provisions are found in subpart F of subchapter N of the Internal Revenue Code[49] and are referred to colloquially simply as "the subpart F rules". Under the subpart F rules, a U.S. shareholder[50] of a domestic corporation which comes within the meaning of a controlled foreign corporation[51] or "CFC" is taxed currently on certain earnings prior to the

[45] This separate entity concept is basic to the concept of a corporation and the limited liability of its shareholders.
[46] HARRIS, *supra* note 20.
[47] Terrence R. Chorvat, *Ending the Taxation of Foreign Business Income*, 42 ARIZ. L. REV. 635 (2000).
[48] In fact, tax "legend" has it that, posted on the bulletin board of the infamous "school book depository building" was found a newspaper clipping describing the subpart F anti-deferral regime introduced by the Kennedy administration.
[49] *See* I.R.C. §§ 951-963 (2002).
[50] A U.S. shareholder is any U.S. person who owns or is considered to own 10 percent or more of all classes of stock entitled to vote of the foreign corporation. I.R.C. § 951(b) (2002).
[51] I.R.C. § 957(a) (2002). A CFC is any foreign corporation 50% owned (by vote or value) by U.S. shareholders. Because a "U.S. shareholder" is defined as a U.S. person holding 10 percent or more of the vote or value of a foreign corporation, if a foreign corporation is 100 percent owned by unrelated U.S. persons but no one U.S. person owns 10 percent of the stock of the corporation, it is not a CFC.

actual distribution of those earnings as dividends.[52] These rules prevent deferral of tax by causing certain types of income earned by controlled foreign corporations[53] to be included in the taxable income of the U.S. parent in the year it is earned, even though the income has not yet been repatriated to the U.S. parent. In effect, the Code treats U.S. shareholders as having received a current dividend to the extent of the corporation's subpart F income. Foreign-earned income which is captured as "subpart F income" is usually otherwise mobile categories of income that Congress views as likely retained outside of the U.S. solely for tax avoidance purposes.[54]

In addition to passive income, Subpart F income can also include income referred to as "foreign base company income", which is comprised of various types of *active* foreign source business income. Foreign base company income includes income from (i) the purchase of personal property from a related corporation followed by a sale of that property to anyone, (ii) the sale of personal property to anyone on behalf of a related corporation, (iii) the purchase of personal property from anyone followed by its sale to a related corporation, and (iv) the purchase of personal property from anyone on behalf of a related corporation.[55] Foreign base company income can also include income from services performed by a CFC for or on behalf of a related company that are performed outside of the

[52] I.R.C. § 951(a) (2002). Specifically, a U.S. shareholder of a CFC is required to take into account its pro rata share of the CFC's subpart F income as a constructive dividend, limited, however by the actual amount of earnings from profits which the CFC has generated during the taxable year.

[53] *See* I.R.C. § 957(a) (2002). A controlled foreign corporation is a foreign corporation of which more than 50% of its shares are owned by U.S. shareholders. A U.S. shareholder is defined as a U.S. person who owns 10% or more of the voting stock of the foreign corporation. *See* I.R.C. § 951(b) (2002).

[54] Subpart F income is defined in § 952 to include income derived from the insurance of U.S. risks, the CFC's foreign base company income, international boycott related income plus the sum of the amounts of any illegal bribes, kickbacks or other illegal payments.

[55] I.R.C. § 954(b) (2002)

CFC's home country,[56] shipping income of any kind,[57] or income from the insurance of any U.S. risk.[58] Consequently, non-passive income derived from the active conduct of a trade or business in any taxing jurisdiction other than the U.S. can trigger the immediate recognition of income for U.S. tax purposes, even if it is reinvested in local operations and taxed locally under territorial tax principles.

iii. Effect of the U.S. International Tax System

The existing subpart F rules are considered much stricter than the rules found in similar regimes in other countries.[59] In particular, subpart F counterparts in other countries only apply to passive income.[60] Because the U.S. subpart F rules include various types of active business income such as foreign base company sales and services income,[61] they increase the tax burden on these categories of business income compared to the taxing regimes of other countries.[62]

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[56] I.R.C. § 954(c)(2002)

[57] Foreign base company shipping income is defined to include income derived from, or in connection with, the use or leasing of any aircraft or vessel in foreign commerce or income which arises from the performance of services related to such property or from its sale or exchange, except to the extent that § 954(b)(2) excludes an amount equal to reinvested shipping income. I.R.C. § 954(f) (2002).

[58] I.R.C. § 953 (2002). Section 953(a)(1)(B) is designed to cover attempted avoidance through reciprocal arrangements by which the CFC insures foreign risk under an agreement with an unrelated foreign corporation which takes on the U.S. risk.

[59] NFTC, TERRITORIAL TAX STUDY 12 (2002).

[60] *Id*.

[61] *See* Treasury Study, *supra* note 6 at 10.

[62] In fact, the U.S. Treasury Office of Tax Policy has stated that "[t]he U.S. international tax rules can operate to impose a burden on U.S. based companies with foreign operations that is disproportionate to the tax burden imposed by our trading partners on the foreign operations of their companies ...." Treasury Report, note 3 at 7, 96. The treasury report went on to state for the consideration of "fundamental reform of the U.S. international tax rules, including the merits of the exemption-based tax systems of some of our major trading partners". Treasury Report, note 3 at 98.

The provisions of the U.S. tax code that come in for the most criticism are the U.S. subpart F rules. The controlled foreign corporation rules in subpart F of the Code arose out of the Kennedy administration's desire to reduce the ability of U.S. corporations to (i) defer the domestic taxation of U.S. source income by operating in foreign jurisdictions and (ii) invest passive income in tax-favored or tax haven jurisdictions,

In addition, all income earned by U.S. corporations that is deferred will eventually be subject to U.S. tax. Under a territorial system this extra layer of tax would not exist. This additional layer will affect decisions of when and whether to repatriate and often results in complicated investment arrangements to utilize earnings but avoid the tax on repatriation.[63] Further, this increases the cost of raising additional equity capital for U.S. corporations as compared to those from territorial system.[64] In addition, as described in section II.B.2 *infra*, the limitation on the foreign tax credit often operates to create an even higher rate of tax, by precluding a full credit for foreign taxes paid.[65]

3. Corporate Inversions: Self-Help Territorialism

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rather than repatriating the income to the United States. CHARLES KINGSON, INTERNATIONAL TAXATION, 2000. At the time the rules were adopted, the relative volume of international trade was much lower and the size and reach of multinational corporations was much less than today. In addition, the market dominance of U.S. multinational corporations as compared to those of other nations was unquestioned. Many commentators argue that today that is no longer the case, and the ability of U.S. multinationals to compete with foreign multinationals subject to the lower tax costs of non-U.S. taxing authorities is a real issue. Studies of the international tax regimes of different countries find that the U.S. international tax rules are the most stringent in the world. NFTC, *supra* note 35. In addition, studies of the cost of capital faced by multinationals in different nations consistently find that the cost of capital to U.S. corporations is either the highest or the second highest of those surveyed. Joosung Jun, *The Impact of International Tax Rules on the Cost of Capital* in THE EFFECTS OF TAXATION ON MULTINATIONAL CORPORATIONS 95-120 (Martin Feldstein *et al.* eds, 1996). By avoiding the application of the subpart F rules to foreign operations, U.S. multinationals can reduce their worldwide effective tax rate by achieving deferral of taxation on at least some foreign-generated profits. Further, U.S. multinationals may be able to retain any tax savings that accrue from foreign operations, which otherwise would eventually be subject to a residual U.S. tax on the repatriation of earnings.

Other commentators disagree. They argue that multinational competitiveness should not be the primary goal of a tax system, and even if it is, our system does not actually put these corporations at a very big disadvantage. Robert Peroni, et al. *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income* 52 SMU L. REV. 455 (1999). They argue that the case has not yet been proven and that allowing foreign income to be taxed at a lower rate than U.S. income encourages movement of production facilities and other overseas investment. *See* Avi-Yonah, *supra* note 11.

[63] ROSEANNE ALTSCHULER and HARRY GRUBERT, REPATRIATION TAX, REPATRIATION STRATEGY AND MULTINATIONAL FINANCIAL POLICY (Nat'l Bureau of Econ. Research, Working Paper No. 8144, 2001). For example, dividend payments from one subsidiary to another will be taxed as a repatriation of income but equity investment in other non-U.S. subsidiaries will not come within the meaning of subpart F income. This will complicate the holding company structure and any subsequent transactions involving these entities.

[64] Chorvat, *supra* note 46. Because subpart F increases the tax on capital, the returns to capital are decreased which, in turn, increases the cost of raising equity capital. In other words, a greater return must be offered to attract the same level of capital.

[65] If taxes are paid at to a source country and are not fully created then the rate can exceed both United States and foreign country tax rates, see Harris, *supra* note 20.

Because of the disparity between U.S. and non-U.S. treatment of foreign source income, there can be significant pressure to change the place of incorporation. The determination of whether the multinational group is subject to worldwide or territorial taxation is not where the operations of the corporations are conducted, but rather where the parent is incorporated. If the parent of a corporate group is incorporated in a non-U.S. country with more lenient tax rules, the total tax paid by the group will be less than it would be than if the group were headquartered in the United States.

Corporate inversions or "flip" transactions are reorganizations[66] resulting in the parent of a multinational group moving from the taxing jurisdiction of the U.S. to a foreign jurisdiction. Corporate inversions typically involve two steps to reorganize the structure of the group. The first step is a stock-for-stock swap[67] by the shareholders of the U.S. parent corporation whereby the stock of the parent is exchanged for the stock of a non-U.S. subsidiary, newly incorporated in a tax-favored jurisdiction. Please refer to the Appendix for a graphic description of the steps in an inversion transaction. This taxable exchange[68] results in the non-U.S. company replacing the former U.S. parent corporation as the parent of the multinational group. Although the first step replaces the U.S. corporation with a non-U.S. entity as parent of the group, the operating structure of the group remains vulnerable to

[66] Typically, these transactions are structured as reorganizations. See Treasury Report, *supra* note x.

[67] While steps 1 and 2 would be nontaxable transactions if they occurred in a domestic setting, they are taxable if they occur as cross-border transactions because of the potential loss of taxing jurisdiction over assets or entities.

[68] Step one of the inversion transaction involve the exchange of U.S. corporation (USCo) shares for the shares of a newly-formed foreign corporation (ForCo) by the shareholders of USCo. Under the anti-inversion provisions of the Internal Revenue Code, § 367(a) causes recognition of shareholder-level gain (i.e., taxation to the shareholders of USCo of the gain inherent in the USCo stock) in what would otherwise be a § 368(a)(1)(B) nonrecognition transaction, technically by denying "corporate" status to USCo. The resulting taxation of the inherent gain in the USCo shares is valued by the I.R.S. utilizing the market capitalization method, i.e. relying on the published value of USCo stock.

the application of the subpart F rules unless the U.S. corporation is actually removed from the group.[69] Hence, step two involves removing the U.S. corporation from the group via a taxable liquidation[70] of the U.S. corporation into the new foreign parent of the group. Again, please refer to the Appendix for an illustration of the transaction.

As discussed above, U.S. multinationals engage in this strategic behavior to reduce worldwide taxation.[71] Corporate managers often argue that a reduction in the worldwide effective tax rate of the group is necessary in order to maintain competitiveness. Because the empirical evidence gathered by the U.S. Treasury does appear to indicate that the U.S. rules with respect to foreign source income place U.S. multinationals at a competitive disadvantage, perhaps such a response is understandable. However, basic notions of equity require that an expatriating corporation pay over an appropriate amount of tax on the increase in value which has accrued within the U.S. taxing jurisdiction.

4. Corporate Expatriation: Crime and Punishment

a. The Crime: Why "Flips" Are Taxed

Taxation of expatriating U.S. multinationals[72] is a matter of fairness. In economic terms, U.S. multinationals have earned income while subject to the U.S. tax system, availing

[69] More specifically, the CFCs owned by the former U.S. parent are vulnerable to the application of subpart F.

[70] The § 336 liquidation of the stock of USCo into ForCo triggers corporate-level taxation of the gain inherent in USCo's assets and, under § 331, the former shareholders of USCo (now the shareholders of ForCo) must recognize the difference between the value of USCo's assets and their adjusted bases in the USCo stock. Again, the assets are valued utilizing the market capitalization method, grossed up for the § 336 tax.

[71] Expatriation also provides the opportunity to exploit differences in the treatment of equity investments and debt to reduce both U.S. and local-country tax. LIPSEY, *supra* note 6.

[72] That is to say, the application of the U.S. tax rules at the point of expatriation is a matter of equity. This is distinguishable, however, from suggestions by my academic colleagues such as Reuven Avi-Yonah of Michigan, who suggest that the effect of corporate inversions be denied to U.S. multinationals and that the

themselves of U.S. laws and the U.S. legal system for such benefits as protection of intellectual property rights and limited liability. Moreover, domestic multinationals have benefited from the current U.S. tax system, specifically the deferred recognition of income under the principle timing doctrine of the U.S. Code – the realization doctrine. Under the realization doctrine, the mere appreciation of an asset, whether the asset is tangible or intangible, is not taxed until "realized" in a taxable event. It is generally agreed in the academic literature that the realization doctrine results in slowing the inclusion of income, so that often income is not taxed until well after it is accrued.[73] By contrast, the economic definition of income would include any net increases in the value of assets held by the taxpayer.[74]

The realization doctrine is in place largely to address valuation problems and liquidity concerns.[75] These concerns do not apply as strongly to corporations undergoing corporate inversions.[76] The deferral afforded by the realization doctrine is justified where appreciation will ultimately be subject to U.S. taxation on the later sale or exchange of the asset. However, immediate taxation is required where an expatriating corporation has earned income in a jurisdiction on which it has not yet paid tax.

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§ 11 entity-level U.S. corporate tax be applied to corporations that are "managed and controlled" in the U.S., notwithstanding their country of incorporation. *See* Avi-Yonah, *supra* note 11.

[73] Alan J. Auerbach, *Retrospective Capital Gains Tax* 81 AM. ECON. REV 167 (1991)

[74] *See* Michael Knoll, *An Accretion Corporate Income Tax,* 49 STAN. L. REV. 1 (1996) ; *See also* Joseph Bankman, *A Market Value Based Corporate Income Tax* 68 TAX NOTES 1347 (Sept. 11, 1995).

[75] David Schizer, *Realization as Subsidy* 73 N.Y.U. L.REV. 1549 (1998).

[76] Corporate and securities laws require corporations undergoing reorganizations to value the actual assets owned as well as all equity held by members of the group. *See* WILLIAM CARNEY, MERGERS AND ACQUISITIONS (2000). Measuring changes in value is difficult for most assets without a transfer event to fix value. Without such a transfer event, appreciation does not provide liquidity with which to pay the tax.

Moreover, very likely the expatriating corporation has been able to deduct the costs of increasing the value of its business.[77] However, if the corporation expatriates, it becomes possible that the income from an increase in value of the assets of the corporations might never be taxed again. At that point, there is little reason why this income should not be taxed by the United States at the time of the expatriation.[78]

Under the prevailing "corporation as a nexus of contracts" theory,[79] it is to some degree arbitrary where a multinational corporation is considered to be resident. The initial choice of country in which to incorporate may have little connection with where a corporation eventually does business or where its shareholders reside.[80] However, if a corporation can "earn" income - or, more properly, accrue gain - while under the tax regime of one country, but is not forced to recognize that income because taxation of the income is allowed to be deferred, it is unfair to allow the corporation to leave the taxing jurisdiction of its "home country" without realizing and recognizing this income.

b. The Punishment: The I.R.C. Anti-Inversion Provisions

i. Section 367(a)

Transfers of assets by persons (both individuals and corporations) to a corporation that is controlled by the transferors in exchange for shares of the corporation is generally non-taxable.[81] This is not viewed as an appropriate time for taxation because, in a real

[77] For example, expenses such as deduct advertising, salaries etc. that increase goodwill and going concern value are deductible under I.R.C. § 162.
[78] For an argument that accrual taxation should apply to corporations *see* Knoll, *supra* note 72; *see also* Bankman, *supra* note 72.
[79] For a discussion of the "corporation as nexus of contracts" theory, *see* Hamilton, *supra* note 13.
[80] I.R.C. § 7701(a) (2002)
[81] I.R.C. § 351 (2002)

sense, the taxpayers have not parted with the assets.[82] They still own the corporation which in turn owns the assets.

On the other hand, the transfer of assets from a U.S. person to foreign corporation controlled by the U.S. person has a significant potential for abuse of the tax system. Because the foreign corporation is not subject to U.S. tax rules, the U.S. person could earn income through the foreign corporation without paying U.S. tax on the income. For example, assume that a U.S. taxpayer owns an asset which he wishes to sell. If the U.S. person were allowed to transfer the asset to a foreign corporation in a tax-free transaction, and the foreign corporation were to sell the asset, neither the transferor nor the foreign corporation would pay U.S. tax on the sale.[83] The U.S. person would not pay tax on this gain until the income was repatriated or the shares in the foreign corporation were sold. This would significantly reduce the tax burden on the sale.[84]

In response to this problem, section 367(a) of the Internal Revenue Code prevents the application of provisions that would otherwise defer gains on transfers to related foreign corporations. If shares of stock of a domestic corporation are transferred to a foreign corporation, any inherent gain will be recognized unless the taxpayer complies with very specific regulations.[85] In order to facilitate transfers that occur for legitimate business reasons, the Treasury Regulations permit a number of transfers to remain tax-free, as long as some fairly stringent conditions are met. In particular, the taxpayer must often enter into a gain recognition agreement, under which the shareholder agrees to recognize any gain

[82] Bittker & Eustice, *supra* note 37.
[83] The foreign corporation is not subject to U.S. tax and the sale proceeds might not be subpart F income.
[84] A deferred tax has a significantly lower present value. *See* MYRON SCHOLES ET AL., TAXES AND BUSINESS STRATEGY (2000).
[85] Bittker and Eustice, *supra* note 37.

deferred in the original transfer on a later disposition of the assets acquired in the transaction.[86]

ii. Helen of Troy and Its Aftermath

In 1994, a U.S. publicly-traded corporation, Helen of Troy, caught the attention of both the financial community and the U.S. Treasury when it announced that it was going to become a Bahamas corporation.[87] The IRS and Treasury were concerned, not only because the transaction had the potential of creating a structure specifically to avoid subpart F[88] but because, by relocating to a tax haven, there was a potential that *no* tax would be paid on some of the activities of the group.[89] Perhaps most importantly, the transaction was structured so that neither the shareholders nor the corporation would have to recognize the

[86] Treas. Reg. § 1.367-3(a)(3)(iii).

[87] According to Phil Tretiak, former IRS Office of Chief Counsel (International), and author of the § 367(a) regulations, the Helen of Troy expatriation first came to the attention of the IRS and the Treasury as the subject of an article in the Wall Street Journal. Because inversion transactions, like any corporate reorganization, require a filing with the SEC regarding the details of the transaction, Tretiak and his colleagues immediately obtained a copy of the prospectus regarding the inversion transaction. Tretiak has since joked that it was very helpful that, on the first or second page of what might otherwise have been a long and cumbersome document to review, Helen of Troy stated that there was no reason for the transaction other than tax avoidance. ABA Section on Corporate Tax, May 1, 1999 meeting. *See also* Benjamin G. Wells & Philip Tretiak, "The Impact of Section 367 on Outbound Transactions", 549 PLI/Tax 733 (2002).

[88] What has since been called a "Helen of Troy transaction" replaces a structure with a U.S. holding company at the top of a U.S. multinational organizational structure, owning lower-tier subsidiaries in the form of controlled foreign corporations, such that much of the income of the lower-tier subsidiaries is immediately included as U.S. income with a structure with a Bermuda holding company at the top. At the time, the IRS anticipated that the reorganization would be followed by a taxable spin-off to separate some of the controlled foreign operations from the U.S. tax net. *Id*. While the spin-off itself might be taxable under § 311, the future operations of the subsidiaries, which would no longer be 10% owned by U.S. shareholders but rather by a Bermuda corporation, could escape U.S. tax and possibly any tax anywhere in the world. *Id*.

[89] *Id*. They were concerned with earnings stripping , this is discussed in Treasury Report, *supra* note 6, at 15.

gain inherent in the assets transferred outside the U.S. tax net. In fact, neither Helen of Troy nor its shareholders paid any tax price for the expatriation.[90]

Thinking that this type of transaction could significantly harm federal revenues, especially if major domestic corporations such as General Motors or Chrysler ever considered going offshore,[91] Treasury adopted the position that these inversion transactions should be treated as taxable sales, not only to the inverting corporation, but to the shareholders themselves. The Internal Revenue Service issued Notice 94-46, which stated that regulations would be issued which would hold that, if U.S. transferring shareholders as a group received back at least 50% of the value of the new foreign parent corporation, such a transaction would be considered a taxable sale of stock in the U.S. corporation.[92] Treasury followed up with temporary regulations in 1995, adding the requirement that the foreign acquiring corporation had to have been engaged in a "substantial" *active* business prior to the inversion, obviously attempting to preclude the purchase of a domestic corporation by a "shell" corporation located in a tax haven.[93] In 1996, final regulations were issued which included these provisions. The final regulations refined the notion of a "substantial" acquiring business by adding the requirement that, for the transaction to be deemed a tax-free reorganization, the foreign acquirer had to be at least equal in value to the U.S. target corporation at the closing date.[94]

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[90] Ben Wells, ABA Section on Corporate Tax, May 1, 1999 meeting. *See also* Wells & Tretiak, *supra* note 87.

[91] Notwithstanding the expressed preferences of the U.S. taxing authority, the Daimler-Chrysler merger occurred in 1997. Even though the overall parent corporation of the group is a foreign corporation, because Chrysler owned a significant number of subsidiaries before the merger and these subsidiaries remain subject to subpart F.

[92] Tretiak, note 61.

[93] Treas. Reg. § 1.367(a)-3T.

[94] Treas. Reg. § 1.367(a)-3. This requirement served to preclude what is sometimes called "minnows swallowing whales", where what is in truth the acquired corporation purchases the acquiring corporation, because the acquired corporation has desirable property which would have been extinguished had the

iii. The Price of Expatriation

The effect of these regulations is to place a high tax cost on expatriation. Under the final regulations, the price of escaping the U.S. tax jurisdiction is taxation of the built-in gain in the assets of the former U.S. parent corporation[95] plus the appreciation in the shares of the former U.S. parent corporation itself.[96] It is important to understand exactly how the tax cost arises. In step one of an inversion transaction,[97] the shareholders of the original U.S. parent of the multinational group exchange stock in the parent for stock of a foreign corporation, usually newly formed in a tax haven jurisdiction. This results in the former direct shareholders the U.S. parent becoming direct shareholders of a foreign corporation which, in turn, becomes the new foreign parent of the group. Section 367(a) will apply to cause recognition of shareholder-level gain in what would otherwise be a section 368(a)(1)(B) nonrecognition transaction[98] in a purely domestic context, technically by denying "corporate" status to the former U.S. parent.

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property holder not survived the transaction. Absent the section 1.367(a)-3 regulations, these "minnows swallow whales" transactions would occur in order to preserve key tax attributes in the corporate solution of the smaller company. For example, the use of net operating losses in a target corporation post-acquisition is severely limited by section 382. Therefore, if the target purchases what would otherwise have been the acquiring corporation, the net operating losses of the target can be used to offset operating income of the acquirer. If the corporate entity survives, so do the net operating losses. However, the policy behind the substantiality requirement in the section 367 regulations has nothing to do with fish. What is called colloquially the "50%" requirement is intended to preclude the "stuffing" of a group into a tax haven.

[95] The built-in gain in the assets of the former U.S. parent corporation is calculated in the form of a deemed § 338 asset sale as the (i) value of the stock plus (ii) the liabilities of the corporation (debt, trade creditors, judgments).

[96] Please refer to the Appendix for an illustration of the steps in an inversion transaction.

[97] Discussed *supra* at Part II.B.3.

[98] Absent section 367(a), this exchange of U.S. parent stock for foreign corporation stock would come within the meaning of a section 368(a)(1)(B) nonrecognition transaction. Such a stock-for-stock exchange is typically not considered a taxable event because, although the two parties are exchanging shares, they each have a continuing interest in the same assets they held prior to the exchange. This notion of continuity of interest is the rationale for many of the nonrecognition provisions in the Code.

Step one alone, however, will not achieve the desired result. In order to completely avoid the application of subpart F to both current and future foreign operations, the former U.S. parent corporation must be removed from the group.[99] Thus, in step two of the transaction, the former U.S. parent is liquidated into the new foreign parent. Absent the anti-inversion regulations, step two would be a tax-free liquidation under section 336.[100] However, under section 367(a), the liquidation of the former U.S. parent causes immediate taxation of any gain inherent in the foreign subsidiaries of the former U.S. parent. Remember, inversions occur in order to shelter the foreign operations of U.S. multinationals from the application of subpart F, which would cause current inclusion of foreign income and, potentially, double taxation. In addition to the recognition of gain by the liquidating U.S. corporation, the new foreign parent must recognize the difference between the fair market value of assets it receives in the liquidation and its adjusted basis in its stock of the former U.S. parent.[101] Since the new foreign parent's basis in the U.S. corporaiton is established in step one, the value of the U.S. corporation shares and the foreign parent's basis in those shares will usually be equal.[102]

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[99] New capital investments by the foreign parent directly into new or existing foreign operations will be shielded from the application of subpart F. I.R.C. § 951. Income which accrues to existing capital investment, by contrast, will be subject to subpart F unless the subsidiaries are transferred from the former U.S. parent to the new foreign parent. These subsidiaries could be removed from the U.S. chain via taxable section 311 / section 355 spin-offs. Owned directly by FP, the earnings of these foreign subsidiaries would not be subject to U.S. tax. Alternatively, corporations can do a "freeze", whereby the former U.S. parent exchanges its voting stock in its foreign subsidiaries for preferred shares that are limited as to value and dividends, followed by the foreign subsidiaries issuing new common shares to the new foreign parent. Going forward, the foreign subsidiaries would still be controlled foreign corporations for purposes of subpart F, but the amount of subpart F income that would be included currently in U.S. income would be that amount attributable to the preferred shares, which will decline in value over time. Importantly, however, neither of these alternatives removes existing operations from the application of subpart F.

[100] Normally, the liquidation of a subsidiary into a 80% or greater parent corporation is a tax-free transaction, on the theory that economic control has not been altered. I.R.C. §§ 332, 336 (2002).

[101] USCo's assets will be valued using the market capitalization method, discussed *supra* note 15, grossed-up for the § 336 tax. The built-in gain in the assets of USCo is calculated in the form of a deemed § 338 asset sale as the value of the stock plus the liabilities of the corporation (debt, trade creditors, judgments).

[102] When gain is recognized in the first transaction, the basis in the shares is increased to the fair market value. I.R.C. §§ 1011, 1012 (2002).

i.v. Does the Punishment Fit the Crime?

In summary then, in order for a U.S. corporation to leave the U.S. tax system by way of a corporate inversion, the corporation *and its shareholders* have to recognize all the gain which has been deferred by the U.S. tax system at the time of the inversion. While, as described in Part II.A.4.a., there is ample justification for the taxation of built-in gain accrued in the domestic corporation while operating in the U.S., [103] note that the shareholders are also taxed on their built-in gain. One can argue in favor of this layer of tax on shareholders because it is not clear that their gains will ever be taxed, by reason of the step up in basis at death or the application of other non-recognition transactions. Moreover, should the corporation expatriate, there is a concern that it might fail to report to the IRS the amounts of dividends paid to U.S. residents etc. It is possible that this is the last time the IRS will be able to assess tax on these U.S. shareholders.

Of course, the identity of the shareholders can greatly affect the importance of this second tax on the shareholders. Some companies have expatriated and allowed their shareholders to be taxed, knowing that they would not care because they were largely either tax-exempt entities or managed on a pre-tax basis.[104] For example, Triton Energy inverted in 1996, giving its U.S. shareholders an option to keep a share in the U.S. subsidiary rather than being taxed on the inversion transaction.[105] However, Triton announced that they would only offer this "share retention" option if enough shareholders

[103] Note, however, that the corporation will have to recognize gain earned on the assets which are used exclusively in the United States, even though there is no possible improvement in the taxation of these assets from expatriation.
[104] BRYAN CLOYD ET AL, FIRM VALUATION EFFECTS OF THE EXPATRIATION OF U.S. CORPORATIONS TO TAX HAVEN COUNTRIES (Center for International Business Education, Working Paper No. 02-102, 2002).
[105] *Id*.

felt strongly about the taxability of the transaction.[106] As it happened, more than 85% of the shares went voluntarily in a taxable exchange, and the share retention option was dropped.[107] Because the Triton Energy share base was largely composed of tax-exempt entities, the shareholders were not overly concerned with the tax consequences of the transaction. By contrast, if the stock in an inverting company is closely held by individual shareholders, to whom the inversion will trigger large amounts of gain, an inversion probably would not be approved.[108] However, there does not appear to be a statistically significant relationship between tax-exempt ownership and most expatriations.[109]

One other factor for consideration regarding both the accuracy of the taxation of built-in gain and the efficacy of the tax to deter expatriation activity is the measurement of that gain. On might ask whether the market capitalization of an expatriating corporation accurately captures value. Equity is comprised of more than just stock; options are a form of equity.[110] A more accurate measure of value might be achieved by including the value of non-traded securities such as stock options issued to corporate management.[111] A portion of the built-in gain in an expatriating corporation is reflected in changes in value of options held by corporate managers.[112] Corporate managers, as option-holders, should be responsible for that portion of the tax cost of expatriation associated with the change in value of the corporation captured in their employee stock

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[106] *Id*.
[107] *Id*.
[108] *Id*.
[109] DESAI & HINES, *supra* note 10.
[110] Michael S. Knoll, 49 Stanford Law Review 1, 8 (1996); Kenneth M. Morris & Alan M. Siegel, "The Wall Street Guide to Understanding Money and Investing" 124 (1993).
[111] Knoll, *supra* at note 110.
[112] Knoll, *supra* at note 110 (corporate managers commonly receive compensation in the form of options on their employers stock); *see* Myron S. Sholes & Mark A. Wolfson, Taxes and Business Strategy: A Planning Approach, 185 (1992)

options. Moreover, given that accuracy and concerns for fairness support the taxation of options held by corporate managers, such taxation might force corporate managers to make better decisions, since they themselves would share in the tax cost of expatriation.

B. The Anomaly

The toll charge imposed by section 367(a) should be sufficient to prevent these expatriations from occurring in all but the rarest of circumstances. Given the immediate recognition of gain which would otherwise be deferred, and the fact that the price of the expatriation is almost certainly going to exceed the tax savings from the expatriation of the operating companies,[113] why do corporations expatriate? This section explores the explanations of the phenomena so far discussed in the academic literature. This section shows that the purported explanations for inversions are not consistent with the empirical data, which was sometimes gathered by the proponents of the explanations themselves.[114] As discussed below, other commentators accept that expatriations do not make sense considering the costs associated with corporate inversions, but predict that inversions will subside.[115]

1. The Efficient Market Hypothesis and Current Tax Rules

a. The Efficient Market Hypothesis

[113] Wells, *supra* note 90; Cloyd et al, *supra* note 104.
[114] The data from the Desai-Hines study precludes the accuracy of their explanation that savings from avoidance of the U.S. interest expense allocation rules, as explained *infra*.
[115] CLOYD ET AL, *supra* note 104.

Under the standard neoclassical model of behavior, all economic actors act to maximize their utility in a rational manner.[116] This means that individuals will attempt to maximize their profit on their investments. Most models assume that individuals care about two things in connection with their investments: the expected return and the variance or risk of that return.[117] Based on these assumptions, economists have created models of how individuals interact collectively to create a market.

The most prominent of the neoclassical models of market behavior is the efficient markets hypothesis.[118] The basic idea behind this is that the actors in the market each have their own information, but that the market as whole has more information than any one of them, and therefore the market can behave more "rationally" than of the actors individually.[119] An efficient market is therefore one where stock prices always incorporate information about fundamental values and, conversely, where prices change only because of such information.[120]

There are three major forms of the efficient markets hypothesis: the strong, semi-strong and weak forms.[121] [122] The strong form of the efficient market hypothesis holds that all information, both public and non-public information is incorporated into prices. Few believe in the strong form of the efficient market hypothesis.[123]

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[116] DAVID FRIEDMAN, PRICE THEORY (1996)
[117] Brealey & Myers, *supra* note 10.
[118] Eugene Fama, *Market Efficiency, Long-Term Returns, and Behavioral Finance* 49 J. FIN. ECON. 283 (1998)
[119] Dhananjay Gode and Shyam Sunder, *What Makes Markets Allocationally Efficient* 112 QUAR. J. ECON. 603 (1997)
[120] *See generally* Robert J. Shiller, *From Efficient Markets Theory to Behavioral Finance*, No. 1385 Cowles Foundation Discussion Papers, Yale University (Oct. 14, 2002); *see also* SHLEIFER, *supra* note 13.
[121] Fama, *supra* note 112
[122] BREALEY & MYERS, *supra* note 10.
[123] Fama, *supra* note 112

According to the semi-strong form of the efficient market hypothesis, asset prices incorporate all available information at any given time.[124] The rationale for the efficient market hypothesis is threefold: (i) investors are rational, (ii) to the extent that investors are not rational, their trades will cancel each other out and (iii) to the extent that investors are irrational in similar ways that create asymmetries between price and fundamental value, rational arbitrageurs in the market will take offsetting positions to arbitrage price to its correct level.[125]

The weak form of the efficient market hypothesis holds that while not all information is incorporated into prices, it is not possible to make money from the inefficient prices that exist.[126] This form holds that because of risks, information asymmetries, etc. full and complete arbitrage is impossible, and so the prices in the market may be inaccurate. However, the inaccuracies are not large enough for someone to consistently be able to make a profit from betting against the market.[127]

According to the strong and semi-strong version of the efficient market hypothesis, at any given time, the stock price of a corporation reflects all available information about the corporation.[128] Even under the weak form, the price is close enough to the correct price that it is not possible to make a profit betting against such prices. The ability of capital markets to adjust price to reflect even publicly-available information is dependent on effective

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[124] *Id.*
[125] SHLEIFER, *supra* note 13, at 2.
[126] Fama, *supra* note 112.
[127] Brealey & Myers, *supra* note x.
[128] MILTON FRIEDMAN, ESSAYS IN POSITIVE ECONOMICS (1953). A paradigm of corporate finance for more than forty years, the efficient market hypothesis holds that, at any given time, the stock price of a corporation reflects all relevant information about the corporation. The semi-strong form of the hypothesis assumes that price only incorporates public information. The strong form of the EMH, which no longer has much support in the literature, would assume that all information – public and nonpublic – is reflected in stock price.

arbitrage.[129] Notice that the efficient market hypothesis does not assume that all investors are rational and knowledgeable. Even if a substantial portion of market traders are irrational,[130] arbitrageurs should not be subject to the psychological biases described in modern financial theory as noise trading.[131] When market price diverges from economic value, arbitrageurs should take the opposite trading position from that of "unsophisticated demand" to bring price back to fundamental value.[132]

b. Application of EMH to the Section 367 "Toll Charge"

The tax rules implicitly assume the validity of some form of the efficient market hypothesis. The valuation of shares of publicly-traded corporations for tax purposes is based on the market price per share of those corporations, multiplied by the number of shares outstanding (the "market capitalization"). In order for this to a fair amount of tax, the prices of the shares must be "correct".

If the market price per share of a publicly-traded corporation accurately reflects all available information, basing the "toll charge" on the market capitalization for the corporation, less the corporation's basis in the transferred assets, should accurately reflect the amount of the unrealized gain. If the efficient market hypothesis is correct, the section 367(a) "toll charge" should be adequate to police corporate inversions.

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[129] SHLEIFER, *supra* note 13, at 13.
[130] BARBERIS AND THALER, *supra* note 135 (arguing that market participants do not always act rationally to arbitrage market price to a correct level due to limits to arbitrage and investor psychology); Lynn A. Stout, *Corporate Finance: How Efficient Markets Undervalue Stocks: CAPM and ECMH Under Conditions of Uncertainty and Disagreement*, 19 CARDOZO L. REV. 475, 478 (1997).
[131] *See generally* Fischer Black, *Noise*, 41 J. FIN. 529, 529-34 (1986); J. Bradford De Long *et al*, *The Size and Incidence of the Losses from Noise Trading*, 44 J. FIN. 681 (1989);); J. Bradford De Long *et al*, *Noise Trader Risk in Financial Markets*, 98 J. POL. ECON. 703 (1990); Andrei Shleifer and Lawrence Summers, *The Noise Trader Approach to Finance*, 4 J. ECON. PERSP. 19 (1990).
[132] SHLEIFER, *supra* note 13, at 13.

As is the case with respect to any business decision, the primary concern of corporate managers with respect to the expatriation decision is the maximization of shareholder wealth.[133] The advantages from inverting are (i) the avoidance of the subpart F rules, which subjects some foreign income to immediate taxation at a rate equal to the U.S. rate less the applicable tax rate of the country in which the income was earned and (ii) for income not subject to subpart F, the ability to avoid the residual U.S. tax upon the repatriation of earnings that eventually must be paid. The cost of repatriating – which is equal to recognizing all built-in gain in assets such as going concern value and goodwill- at both the corporate and the shareholder level, will almost never be less than the benefits to future earnings associated with the perceived tax savings associated with flipping.[134] In other words, the market price of the stock of the expatriating company should reflect the savings that will accrue to the corporation from fleeing the U.S. taxing jurisdiction. But, because the tax "penalty" for inversion is based on the market capitalization[135] of the corporation at the actual date of the inversion, which is *after* the inversion announcement, a

[133] DESAI & HINES, *supra* note 10, at 22 (concluding from the empirical analysis of stock price reactions to inversion announcements that corporate managers, acting to maximize shareholder wealth rather than share price, consider the tax liability to shareholders in making the decision whether or not to expatriate). *See* also Avi-Yonah, *supra* note 11 at 1795.

[134] As demonstrated in footnote 24, *supra*, it would only be rational to flip if the group is facing a negative effective tax rate for its foreign operations. This would occur, for example, if the foreign government is, for development purposes, subsidizing capital investments locally. While this would rarely occur, and would certainly never occur with respect to the entire group, it is conceivable that Bermuda, for example, might subsidize local operations to generate employment for its citizens which would, taken into account with the zero local corporate tax rate, create a negative effective tax rate for that entity. Moreover, the estimated cost of the inversion must include that some of the net present value of the earnings which is included in the asset price will be subject to tax in the foreign jurisdiction when this income is realized the taxes that would be paid in the future would result in a reduction in U.S. tax under the foreign tax credit. However, it the net present value is recognized today, there will be no reduction and no foreign tax credit, because the earnings have not been realized and the foreign tax has not yet been paid. *See* discussion, *supra*, at footnote 24.

[135] Market capitalization, the I.R.S. method of choice for valuing public corporations, is the share price of the U.S. corporation, multiplied by the number of shares outstanding. The "market cap" of a corporation should, under the efficient market hypothesis, equal the present value of all future earnings of the corporation, and should reflect all publicly available information. In the case of an inverting corporation, the stock price should also reflect the present value of all future tax savings from inversion, since state and federal laws require complete public disclosure of the inversion plan.

tax on the market value of the corporation – which should be increase due to the increase in the value of future earnings due to tax savings- should preclude the transaction itself. It will not generally be rational to expatriate if you have pay tax on all inherent gains.[136]

It is highly unlikely that the value of expatriation will equal or exceed the cost of escaping the U.S. tax net when the stock price accurately reflects the fundamental economic value of the corporation. The tax associated with the recognition of all of the built-in gain inherent in an operating corporation – as opposed to a corporation holding passive investments - will almost certainly exceed the value of tax savings associated with the actual or deemed repatriation of income.[137] When one considers the additional shareholder level

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[136] Moreover, on a technical note, the tax cost should clearly exceed the tax savings from inversion because the tax, as applied to the market value of the inverting corporation, does not reflect a *credit* for the foreign taxes paid on future earnings, since the foreign tax credit is only available on foreign taxes already paid. At most, the discounted present value of future earnings could reflect a *deduction* for foreign taxes paid on future earnings, which, if the U.S. tax rate is anything other than 0% or 100%, is less valuable than a credit.

[137] Assuming a basic tenant of corporate finance, that the present value of any asset but, in particular, a corporation, is the discounted present value of all its future income streams, this proposition is basically the corollary of an equivalence theorem commonly used in tax policy that allowing an upfront deduction for the cost of an investment but taxing the income from the investment is the equivalent of denying a deduction for but exempting the income. This is the basis for, for example, the valuation of pension funds and IRAs.

To illustrate, the value of an IRA is $It + I[1 + R]^n - t(I[1+R]^n)$, where I is the investment made, t is the tax rate, R is the rate of return on the investment, and n is the number of periods of the investment. Therefore, the term (It) is the value of the deduction, $I[1 + R]^n$ is the value of earning income without paying tax, and $I(t[1+R]^n$ is the cost of the inclusion in income. (Note that this last term represents future dollars, whereas the first term, It, represents current dollars. If you restate the cost of the inclusion in income, or $t(I[1+R]^n$, in current dollars, by dividing by the rate of return for n periods, since future value equals the present value times one plus the rate of return, then the present value of the cost of the inclusion equals the value of the deduction, or $I(t[1+R]^n)/ [1+R]^n = It$. Hence, the relative value of an IRA is the exemption of income ($I[1 + R]^n$), rather than the deduction. In other words, the value of an IRA is not the current deduction, which doesn't mean anything because it is the mathematical equivalent of the later inclusion, but rather the fact that the income is exempt during the term of the investment. To put it another way, the time value of money is equal to the time value of money**.** *See* SCHOLES ET AL., *supra* note 82 at 45.

The corollary of this proposition (i.e. that the relative value of the IRA is the exemption of income) is that an immediate inclusion of the cost of the investment is the equivalent of taxing income from the investment. Therefore, the tax cost of the inversion has essentially the same present value as the future tax on the future income stream generated by these assets (i.e., all the future income of the corporation). This may lead one to believe that corporations should be indifferent to the expatriation decision; however, this is not true. If the inverting corporation had waited to actually earn the income, it would have received a foreign tax credit for taxes paid in the foreign jurisdiction. If it inverts, it will never receive this credit, because the foreign tax credit is only allowed for taxes that have already been paid. Therefore, the

tax, the situation in which a publicly traded corporation would find it advantageous to invert is difficult to conceive.

This is the anomaly associated with the phenomenon of corporate inversions. If valuation theories based on the efficient market hypothesis are correct, the number of expected corporate inversions per year should be close to zero.[138] However, there has been a significant increase in both public and nonpublic corporations choosing to invert since 1999.[139]

Moreover, the efficient market hypothesis holds that real-world financial markets, such as the U.S. securities markets actually are efficient.[140] Such phenomena are referred to as stock market anomalies.[141] at least for the short to mid-term and, in some cases, for years.[142]

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effective U.S. tax rate imposed now is higher than that which would have been imposed on future income. Therefore, as long as the foreign tax rate is greater than zero, it does not make sense for a corporation to invert (that is, under the standard assumption that price reflects value). When one adds to this analysis the second layer of tax on the shareholders, (remember than the flip transaction itself creates no direct shareholder benefits), it will never make sense to flip.

Assets such as self-created goodwill or going concern value generally have low bases, because the expenses that create them are generally deductible (e.g., advertising, salaries). Therefore, an inversion will generally result in having to recognize the entire value of these assets in income (and, often, most of the value of the corporation is in these assets). Furthermore, because under § 367(a) gains are recognized but losses are not and, under *Williams v. McGowan*, the gain on the transfer of a business must be separately calculated, asset by asset, losses on some assets will not be able to offset gains on other assets.

These valuation issues are explored more fully in CLOYD ET AL, *supra* note 101.

[138] Those which have no gain yet, because they just started are among the companies that might be likely to expatriate.

[139] Desai & Hines, *supra* note 10.

[140] Burton Malkiel, A RANDOM WALK DOWN WALL STREET (1973).

[141] According to the efficient market hypothesis, market participants are rational and the price of securities should equal their fundamental value. NICHOLAS BARBERIS AND RICHARD THALER, *A Survey of Behavioral Finance* in HANDBOOK OF THE ECONOMICS OF FINANCE (published as NAT'L BUREAU OF ECON. RESEARCH, Working Paper No. 9222, 2002). Fundamental value means "true" value, equivalent to the present value of all future cash flows that a market participant expects to earn on an investment asset. BREALEY & STEWART C. MYERS, *supra* note 10.

[142] ROBERT J. SHILLER, IRRATIONAL EXUBERANCE (2000); ADVANCES IN BEHAVIORAL FINANCE (Richard Thaler, Ed. 1992). Consider two examples of asymmetries between price and fundamental value which have continued for years ("persistent mispricing"). The most famous example of persistent mispricing is

2. Empirical Evidence and the Purported Explanations for Increased Inversion Activity

a. The Desai –Hines Study

The only significant empirical study on the causes of inversions has been conducted by Mihir Desai and James Hines. In their study, Desai and Hines undertook an empirical analysis of the economic factors related to expatriations that take the form of corporate inversions and the stock price reactions to inversion announcements.[143] Desai and Hines found correlations between corporate inversions and enterprises that are engaged in (i) foreign operations, (ii) low tax rates in the operating jurisdictions of

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that of the "twin shares" phenomenon. L. Rosenthal and C. Young *The Seemingly Anomalous Price Behavior of Royal Dutch Shell and Unilever NV/PLC*, 26 JOURNAL OF FINANCIAL ECONOMICS 123 (1990); K.A. Froot and E. Dabora, *How Are Stock Prices Affected By the Location of Trade*, 53 JOURNAL OF FINANCIAL ECONOMICS 189 (1999). Royal Dutch Petroleum and Shell Transport are independently incorporated in the Netherlands and England, respectively. SHLEIFER, *supra* note 13, at 29. The current structure emerged from a 1907 alliance between Royal Dutch and Shell Transport in which the two companies agreed to merge their interests on a 60:40 basis while remaining separate and distinct entities. SHLEIFER, *supra* note 13, at 29-30; Richard Thaler, *The End of Behavioral Finance*, FIN. ANALYSTS' J. (Nov.-Dec., 1999). Although Royal Dutch and Shell trade on a total of nine exchanges in the U.S. and Europe, Royal Dutch trades primarily in the United States and in the Netherlands while Shell trades primarily in London. *Id*. According to any rational model of behavior, the shares of Royal Dutch and Shell, making adjustments for foreign currency exchange, should trade in a 60:40 ratio. *Id.* They do not; in fact, the actual price ratio has deviated from parity by more than 35 percent for at least fifteen years, with Royal Dutch exhibiting relative underpricing by 35 percent to relative overpricing by 10 percent. SHLEIFER, *supra* note 13, at 30. Moreover, simple explanations, such as taxes and transaction costs, cannot explain the disparity. SHLEIFER, *supra* note 13, at 30-31.

Another example of persistent mispricing is the phenomenon of abnormal returns that accompany the inclusion of a stock in the S&P 500. Index inclusion should not trigger an increase in price because it does not represent any change in fundamental value. BARBERIS AND THALER, *supra* note 135, at 10. The S&P selects stocks for inclusion that merely represent a cross-section of the U.S. economy, not to convey information about a particular company. *Id*. Nonetheless, stock prices typically jump 3.5% on inclusion, and the increase is usually permanent. J. Wurgler and E. Zhuravskaya, *Does Arbitrage Flattten Demand Curves for Stocks?*, J. OF BUS. (forthcoming, 2002) (studying 236 stocks that were added to the S&P 500 between 1976 and 1996 that were not the subject of any contemporaneously-reported news and finding average share price increases of 3.5%). *The* price of Yahoo actually jumped 24 % the day that it was added to the S&P 500. BARBERIS AND THALER, *supra* note 135, at 10. Like the twin-share phenomenon, this evidence challenges the efficient market hypothesis, which holds that prices react to information and not to non-information. SHLEIFER, *supra* note 13, at 22-23.

[143] DESAI & HINES, *supra* note 10, at 2. The study included a statistical analysis of the factors leading to expatriation and an event study analysis of reactions to expatriations. *Id*.

expatriating multinationals, and (iii) highly-leveraged firms.[144] Desai and Hines also reported that corporate managers acted to maximize shareholder value, inverting when the price of the stock was low, and that corporations whose stock price had dropped recently were more likely to invert than those whose stock price had appreciated.[145] Finally, Desai and Hines concluded that there is a significant increase in share value following an inversion announcement, and that the increase in share price was greater than that which would be warranted by the potential tax savings from subpart F and the elimination of the residual U.S. tax on repatriated earnings.[146]

This last finding is interesting in that it points to a possible secondary anomaly associated with corporate inversions, i.e. that the share price increase in response to inversion announcements exceeds the present value of the tax savings from avoiding the application of subpart F. If this is true, there must be another reason for the additional inference of value by investors. Further, share appreciation beyond the expected benefit of tax savings means that corporate managers that actually follow through with inversions proceed under the assumption that the expected benefits exceed the net costs of the inversion, discounting (i.e., adjusting upward) for the price increase following the inversion announcement, since the tax cost will necessarily be based on the price

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[144] *Id*. at 3.
[145] *Id*. at 3-4.
[146] Note that Desai and Hines also cite avoidance of the U.S. interest expense allocation rules as a rationale for corporate inversions. DESAI & HINES, *supra* note 10, at 10-11, 24. *See* section VI.A. for a description of this theory, the international tax rules that clarify why this cannot be the rationale for corporate inversions, and a discussion of the Desai and Hines data that support the conclusion that avoidance of the interest expense allocation rules cannot be a factor in corporate expatriations. *Id*. at 2-4, 20. Specifically, the Desai-Hines study consisted of an event study of stock market reactions to 19 separate inversion announcements between 1993 and 2002, and concluded that stock prices appreciate on average 1.7% over a five-day window centered on inversion announcements. DESAI & HINES, *supra* note 10, at 3, 20, and 24. While nineteen is a fairly low number of observations to try to obtain statistical significance, it represents the total number of publicly traded corporations that have completed inversions since 1993. Therefore, while the results are not conclusive, they are all that is available, and are not inconsistent with the model proposed in this paper.

following the inversion announcement. Corporate managers would not undertake expatriation if the costs of inversion merely equaled the expected benefit.[147] Therefore, the possibility of a price increase following the inversion announcement adds an additional element of risk to the decision making of corporate managers. [148]

b. Purported Additional Explanations

Because the avoidance of the subpart F rules cannot provide a sufficient motive to incur the large costs of expatriation, some commentators have argued that there are other tax savings that explain the anomaly of corporate inversions.[149] This section examines these additional purported tax savings and shows that they do not have significant explanatory power.

i. Avoidance of the U.S. Interest Allocation Rules

Under the U.S. international tax rules, interest expense is treated as a fungible expense of the group and is allocated between foreign source income and U.S. source

[147] This is especially true since the September 11 attacks on the U.S., which imposed additional non-tax or political costs to corporate expatriations. *See* CLOYD ET AL, *supra* note 101. There are likely to be significant transactions costs from such a inversion and so the two costs are merely equal this will not result in the transactions taking place.

[148] Apart from the Desai-Hines empirical findings with regard to stock price appreciation following inversion announcements, corporate valuation theory would suggest that corporate managers must incorporate the reactions of shareholders to (i) the signal by corporate managers that there are tax savings to be obtained by expatriating and (ii) that there may be shareholder-level gain triggered by the transaction. The response will differ according to the tax attributes of the shareholder. Tax exempt shareholders will be motivated to buy flip shares and taxable shareholders will be motivated to sell. A recent federal reserve study indicated that approximately 40% of the shares of U.S. corporations were held by tax exempt or non-U.S. shareholders. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES 1991-1999 82 (2000) Consequently, the net effect on value will be uncertain because 40% of flip shareholders have a greater perception of value for their shares but 60% may lower their estimation of value for the same shares. Much may depend on the shareholder perception of the signal from corporate managers, and whether the shareholders trust the decision-making ability of the managers.

[149] Others argue that the decision is simply a mistake. *See* discussion *infra* Part II.B.2.b.iii.

income.[150] This is important because the greater the amount of foreign source income, the larger the foreign tax credit limitation. The greater the amount of interest expense allocated against foreign source income the lower is foreign source income. Hence, to the extent the interest expense rules over-allocate interest to foreign source income, they artificially reduce the foreign tax credit limit. The problem with the interest expense allocation rules is that they allocate the interest expense of U.S. members of the group to both foreign and domestic income, based on the distribution of assets which produce each type of income, but do not allocate interest expense incurred by foreign subsidiaries back to U.S. assets.[151] As a consequence, only foreign source income is reduced. Thus, the foreign tax credit limit is reduced below its correct value. The inappropriately-high allocation of interest expense to foreign source income results in the disallowance of earned credits for foreign taxes paid by U.S. multinationals, effectively subjecting U.S. companies to double taxation.[152]

Commentators like Mihir Desai and James Hines argue that this is another justification for inversions, and therefore another potential source of tax savings for inverting U.S. corporations.[153] The problem with this theory is that it is not in accord with the historical data or the empirical evidence collected by Desai and Hines. The interest expense allocation rules are only a problem for "excess credit" taxpayers - those who, on average, pay a higher tax rate than the U.S. rate. If the foreign credit does not affect taxes paid because the amount of tax paid is significantly lower than the U.S. tax on the income, these rules have no effect on tax paid. Data regarding corporate inversions in general, and the Desai-Hines study in particular, indicate that companies that invert are in fact almost

[150] Treas. Reg. § 1.163-8.
[151] *Id*.
[152] *See* I.R.C. § 904(a).
[153] DESAI & HINES, *supra* note 10, at 2-4, 19, 24.

always "excess limitation" taxpayers, that is taxpayers paying an average rate far below the U.S. rate.[154] It would be difficult to argue that the interest expense allocation rules are one of the justifications for corporate inversions, when those companies that do invert are among the least likely to be affected by the interest expense allocation rules.

ii. Earnings Stripping

Another explanation for corporate inversions is that they allow former U.S. corporations to reduce their tax on U.S. source income. This view has been proposed by Desai and Hines,[155] as well as by Reuven Avi-Yonah.[156] The theory is that U.S. multinationals which reincorporate in foreign jurisdictions use interest deductions to "strip" earnings out of the U.S., generating interest deductions against U.S. income and repatriating earnings to a foreign parent which might be taxed at a lower rate in to the foreign parent than they would in the United States. While this is an interesting theory, there are rules in the tax code designed to prevent this behavior, and also there is empirical data that earnings stripping does not provide a reason for expatriation.

The key to this argument is that debt is a tax favored source of capital. This tax advantage results from the fact that interest is a deductible expense while dividends paid to shareholders are not.[157] If a U.S. operating subsidiary pays interest to its parent corporation on corporate debt – rather than dividends on equity – the earnings which make up the interest payments are deductible from the U.S. income of the subsidiary and only taxed in

[154] DESAI & HINES, *supra* note 10, at 3, 19.
[155] DESAI & HINES, *supra* note 10, 24-7.
[156] Avi-Yonah, *supra* note 11, at 1796-7.
[157] I.R.C. § 163.

the country of the parent corporation, rather than in both. If the foreign parent is incorporated in a low-tax jurisdiction, the total worldwide tax has been reduced. Hence, it is often claimed that a justification for inversions is a reduction in U.S. tax on U.S. source income.[158]

One of the key problems with this explanation is there are rules designed to prevent this from occurring. Section 163(j) limits earnings stripping by disallowing deductions for interest paid to a related party (e.g., subsidiary and parent) for loans or guarantees, where the payor of the interest is moderately highly leveraged.[159] Entities which engage in earnings stripping behavior would almost certainly fall within the provisions of section 163(j), because the amount of debt capital has been increased to a take advantaged of the interest deduction. The Desai-Hines data confirms that highly-leveraged firms are more likely to expatriate, demonstrating that these are the very corporations that would be precluded from earnings stripping behavior under the section 163(j) earnings stripping rules.[160] Section 163(j) clearly reduces the ability of these companies from engaging in earnings stripping.

Perhaps a more significant problem is that the empirical evidence indicates that foreign-owned U.S. corporations do not actually engage in earnings stripping. Blouin, *et al*. found no empirical evidence that, when U.S. companies are acquired by non-U.S. companies, they engage in earnings stripping more frequently than do U.S. corporations.[161] They found that foreign owned corporations were not more likely to have high levels of debt than U.S. corporations, and the two groups of corporations were likely to pay the same effective tax rates. The U.S. tax rules appear to prevent earnings stripping out of the United

[158] DESAI & HINES, *supra* note 10, at 24; Avi-Yonah, *supra* note 11, at 1796.
[159] I.R.C. § 163(j)(2). The provision applies to corporations that have debt/equity ratio of greater than 1.5/1
[160] DESAI & HINES, *supra* note 10, at 2-4.
[161] Blouin *et* al, Kenan Flagler School of Business Working Paper (2002) (on file with author).

States from occurring. Therefore, foreign corporate groups do not appear to be engaging in earnings stripping, almost certainly because rules like 163(j) preclude such strategic behavior.

iii. Mistake By Management

Commentators such as economists Bryan Cloyd, Lillian Mills, and Connie Weaver accept the costs associated with corporate inversions likely outweigh the benefits and predict that inversions will subside given the current anti-inversion rules and the antipathy toward corporate expatriation following September 11.[162] They base their analysis on the Desai and Hines data. Their analysis is implicitly based on efficient market theories, in that the price in the market essentially correctly the value of the shares. They argue that the behavior is anomalous and does not on net increase shareholder value. As they point out if one accepts these theories, one cannot explain the corporate inversions and would predict that it is a mistake that this will disappear over time. However, as discussed in section III, there is an alternate explanation of this behavior which can be derived from behavioral finance models.

III. Behavioral Finance and Corporate Expatriations

A. Behavioral Finance

Not all who study the market believe in the efficient market hypothesis. Since the 1980s, behavioral finance research has relied on cognitive psychology decision theory to

[162] CLOYD ET AL, *supra* note 101.

study market anomalies.[163] The literature has developed along the lines of two simple principles. The first is that investors exhibit systematic biases which are identified as individual investor heuristics, that is, mental short cuts that are used in place of purely unbounded[164] rational thinking.[165] These biases can result in incorrect values, in the short to mid-term, for both individual stocks and the market as a whole. The second principle in behavioral finance is that there are limits to arbitrage. In other words, even in markets with both rational and irrational traders, irrational traders can have a sustained impact on prices.[166] Even if rational investors do correctly perceive and analyze the available

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[163] Actually, beginning in the 1970s, Stanford University's prominent cognitive psychologist, Dr. Amos Tversky, and Princeton's Daniel Kahneman, a professor of psychology, challenged the idea of rational market participants as not corresponding to actual human behavior. *See* Daniel Kahneman and Amos Tversky, *On the Psychology of Prediction*, 80 PSYCHOL. REV. 237 (1973); Daniel Kahneman and Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979). Note that behavioral finance does not necessarily imply irrationality to the extent as that put forth in the behavioral economics literature, only that markets may systematically undervalue the price of an individual stock, or even the market as a whole, for the short to mid-term. The theory is accepted by even strong critics of behavioral economics. See Gregory Mitchell, *Taking Behavioralism Too Seriously? The Unwarranted Pessimism of the New Behavioral Analysts of Law*, 43 WM. AND MARY L. REV. 1907 (Apr., 2002).

> "In some cases, group deliberations and collective decision making moderate bias, in some cases they have no apparent net effect, and in some cases they amplify bias. ... [T]he question of whether group judgments and decisions tend to be more or less biased than individual judgments and decisions is enormously complex and defies a simple answer. Accordingly, legal decision theorist should refrain from simple conclusions about the similarity of group and individual decision-making processes and outcomes."

Mitchell at 2004-05 (explaining that, although individuals behave more rationally than would be suggested by the behavioral economics literature, there are particular problems that result in the market's not behaving rationally, even though each individual actor may behave rationally).

[164] The literature on bounded rationality, also called structural uncertainty, relaxes the traditional assumptions of individual rationality. Bounded rationality, for example, would study behavior in which individuals do not act in accordance with Bayes' law, that is, they do not believe that potential outcomes are algebraic or additive. Thus, someone *not* acting in accordance with Bayes law would not understand that, if each of two alternate outcomes of an event were 90% likely to be favorable, that there was more than a 90% chance that the outcome would be favorable.

[165] For example, investors focus more on the risk associated with losses than the potential benefits associated with gains. This risk preference associated with losses is known as the "Prospect Theory." *See generally* Kahneman and Tversky, *supra* note 9. Prospect theory exposed the greater sensitivity to losses than to gains exhibited by individuals choosing between gambles, a feature known as "loss aversion". BARBERIS AND THALER, *supra* note 135, at 15-17.

[166] BARBERIS AND THALER, *supra* note 135, at 2. Rational traders are referred to in financial literature as "arbitrageurs", while irrational traders are known as "noise traders". BARBERIS AND THALER, *supra* note 135, at 4.

information, limits to arbitrage exist such that rational traders are not able to arbitrage the difference between the theoretically "correct" value and the current market price.[167]

Defenders of the efficient market hypothesis generally acknowledge that there are many irrational traders in the market. However, they argue that rational investors will be able to arbitrage between the "irrational" prices set by these irrational traders and theoretically "correct" prices.[168] However, for this correction to occur quickly, and for it to occur at the optimal level, arbitrage must be costless and riskless.[169] Research in behavioral finance has shown that, not only is real-world arbitrage often costly and accompanied by non-diversifiable risk, but it is the most constrained when prices are farthest from the fundamentals.[170]

a. Investor Heuristics

Research by cognitive psychologists has pointed up systematic biases, known as heuristics, which prevent investors from either perfectly perceiving or perfectly processing all available information.[171] These biases can be reflected in underreaction or over-reaction to news such as earnings announcements which, in turn, can lead to mispricing.

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[167] BARBERIS AND THALER, *supra* note 135, at 2.
[168] Eugene Fama, *Efficient Capital Markets*, *A Review of the Theory and Empirical Evidence,* 25 J. FIN 383 (1970)
[169] BARBERIS AND THALER, *supra* note 135, at 2.
[170] *See infra* at note 17.
[171] SHLEIFER, *supra* note 13, at 112-30 (describing heuristics as the examination of failures of individual judgment under uncertainty).

For example, psychological research has demonstrated that people are overconfident in their judgments.[172] This overconfidence leads to excessive trading without sufficient information, as a result, lower returns.[173] On the other hand, conservatism – the tendency for people to cling to old beliefs in the face of new evidence – has been linked to the underreaction to news such as earnings announcements.[174]

Overreactions to information derive from a different heuristic known as representativeness.[175] Representativeness is the tendency of people to evaluate probabilities in light of broad patterns with which the person is familiar, thus projecting patterns onto random sequences.[176]

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[172] *See* M. Alpert and H. Raiffa, *A Progress Report on the Training of Probability Assessors*, in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES (Daniel Kahneman, Paul Slovic and Amos Tversky, Eds. 1982) (demonstrating that 98 percent confidence intervals assigned to estimates of quantity are correct 60 percent of the time); *see also* B. Fischhoff, Paul Slovic and S. Lichtenstein, *Knowing With Certainty: The Appropriateness of Extreme Confidence*, 3 J. OF EXPERIMENTAL PSYCHOLOGY: HUMAN PERCEPTION AND PERFORMANCE 552 (1977) (finding that events which people thing are certain to occur actually happen only 80 percent of the time while events they believe are impossible happen approximately 20 percent of the time).

[173] B. Barber and T. Odean, *Online Investors: Do The Slow Die First?*, 15 REV. OF FIN. STUD. 455 (2002) (showing that investors that switch from telephone-based trading to online trading demonstrate increased confidence and perform worse); BARBERIS AND THALER, *supra* note 135, at 12, 47-50.

[174] V. Bernard, *Stock Price Reactions to Earnings Announcements*, ADVANCES IN BEHAVIORAL FINANCE (R. Thaler, Ed. 1992) (describing the underreaction of U.S. stock prices to earnings announcements); N. Jegadeesh and S. Titman, *Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency*, 48 J. FIN. 65 (1993) (finding evidence of underreaction and slow incorporation of new information into stock prices);

[175] Overreaction occurs when an investor becomes overly optimistic after a series of positive news announcements, pushing the stock price to unjustifiably high levels. SHLEIFER, *supra* note 13, at 89-120-29.

[176] The best example of the representativeness heuristic comes from the research of Daniel Kahneman and Amos Tversky. Daniel Kahneman and Amos Tversky, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCIENCE 1124 (1974). They show that this tendency to evaluate information in light of perceived patterns can lead to the incorrect assignment of probabilities. *Id.* For example, Kahneman and Tversky presented the following description to a group of individuals of a fictional character, Linda.

> Linda is 31 years old, single, outspoken, and very bright. She majored in philosophy. As a student, she was deeply concerned with issues of discrimination and social justice, and also participated in anti-nuclear demonstrations.

The individuals were then asked to assign probabilities to the following statements.

> Linda is a bank teller, or

A well-known phenomenon in investor behavior is the reluctance of people to sell "losers", that is, stocks trading at a loss.[177] This phenomenon had been linked to both confirmation bias and prospect theory.[178] Investors do not seek out information that challenges previously-held beliefs, even misinterpreting new evidence that may challenge those beliefs.[179] Moreover, in the face of uncertainty, individuals exhibit a greater sensitivity to losses than to gains, a feature of prospect theory known as "loss aversion".[180]

Taken together, the real-world failures of investor judgment under uncertainty contribute to delayed market reactions to new information, precluding efficiency.

b. Limits to Arbitrage

Linda is a bank teller and is active in the feminist movement

The individuals assigned greater probability to the second statement, an impossible result that can be explained by the fact that the description of Linda *sounds* like the description of a feminist. *Id.* Kahneman and Tversky's subjects assigned greater probability to the statement that was most representative, rather than most likely. *Id.* Representativeness is also related to the concept of sample size neglect, which explains the "hot hand" phenomenon, a common misconception in sports. BARBERIS AND THALER, *supra* note 135, at 12-15. Sports fans that demonstrate the "hot hand" phenomenon become convinced that a basketball player who sinks three shots in a row will score again, even though three shots are too small of a sample size from which to make the inference. T. Gilovich *et al*, *The Hot Hand in Basketball: On the Misperception of Random Sequences*, 17 COGNITIVE PSYCHOL. 295 (1985).

[177] H. Shefrin and M. Statman, *The Disposition To Sell Winners Too Early And Ride Losers Too Long*, 40 J. FINANCE 777 (1985). The tendency to hold losers in light of the tax benefits extended to losses leads to curious results. Terrence Odean has shown that, in the month of December (presumably in the context of tax planning), investors prefer to sell losers, but the tendency to hold losers prevails over the rest of the year. Terrence Odean, *Are Investors Reluctant To Realize Their Losses?*, 53 J. FIN. 1775 (1998).

[178] C. Lord *et al*, *Biased Assimilation and Attitude Polarization: The Effects of Prior Theories on Subsequently Considered Evidence*, 37 J. OF PERSONALITY AND SOCIAL PSYCHOL. 2098 (1979) (demonstrating that people do not look for evidence that contradicts existing beliefs and, even when presented with such evidence, are skeptical and misconstrue the evidence as supportive of prior beliefs). For a discussion of prospect theory, *see* note 11, *supra*.

[179] *Id.*

[180] *See* note 11, *supra*.

In actual markets, the uncertainty associated with future events means that all prices are subject to risk and, when arbitrageurs trade for outside investors,[181] there are transactional costs associated with borrowed capital and risks that limit arbitrage the most at the very time when it is needed the most.[182]

There are primarily two types of risk facing rational traders that actually perceive instances of mispricing and have the opportunity to take positions to offset the market and make a profit, in essence, to arbitrage. The first is the fundamental risk associated with the value of a security, that is, that news about the company will drive the stock price up or down.[183] The second relates to investor heuristics, and is called "noise trader risk".[184] Noise trader risk describes the chance that the mispricing will continue or worsen because of investor sentiment.[185] When mispricing continues (or even widens), professional arbitrageurs such as mutual and pension fund managers run the risk that they will lose access to capital, lose the capital that they have already invested or, worse, lose their jobs.[186] These professionals are evaluated on the basis of performance, and must

[181] In the simplest models, arbitrageurs use their own wealth to trade. SHLEIFER, *supra* note 13, at 28-52, 89. However, in real-world financial markets, arbitrage is conducted by highly specialized investors who trade with the capital of others - professional arbitrageurs such as mutual and pension fund managers. SHLEIFER, *supra* note 13, at 89.

[182] Because professional arbitrageurs are judges based on past performance and must borrow to invest, often using their investments as security, arbitrage can be the most constrained when prices are the farthest from fundamentals. SHLEIFER, *supra* note 13, at 89-101. As prices fall, the value of the investments offered as security by a leveraged arbitrageur fall. SHLEIFER, *supra* note 13, at 89. Because professional arbitrage is performance based, outside investors may refuse to provide more capital or withdraw funds already extended. *Id*. As prices move farther from fundamental values, arbitrageurs have the least stabilizing effect, sometimes bailing out of the market entirely. SHLEIFER, *supra* note 13, at 89-101.

[183] BARBERIS AND THALER, *supra* note 135, at 5.

[184] *Id*.

[185] BARBERIS AND THALER, *supra* note 135, at 5-6; SHLEIFER, *supra* note 13, at 89-90.

[186] SHLEIFER, *supra* note 13, at 89-106.

demonstrate positive returns or liquidate their positions, triggering potentially greater losses.[187]

In addition to real-world risks associated with attempts to correct mispricing, there are real-world costs that are not considered in the textbook model of an efficient market. These costs include transactions costs such as commissions, as well as the impact of the bid-ask spread for which the arbitrageur is responsible. For professional fund managers, there are also the costs associated with borrowing, and the potential for large losses if poor performance causes creditors to withdraw capital.

The costs and risks of arbitrage are the highest when prices move farthest from fundamentals.[188] In fact, contrary to the term "arbitrage", which implies a quick and easy profit, attempts to correct mispricing by professional fund managers occur less frequently in stock markets than in bond markets or foreign exchange markets, where it is easier to ascertain value and locate close substitutes, which are essential to limit the risk of taking positions against the rest of the market.[189]

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[187] A. Shleifer and R. Vishny, *The Limits of Arbitrage*, 52 J. FIN. 35 (1997) (calling the phenomenon of professional arbitrage "a separation of brains and capital").

[188] SHLEIFER, *supra* note 13, at 100 (demonstrating with an agency model of limited arbitrage that increased risks accompany extreme mispricing which, in turn, limits arbitrage to the point that, in the face of panics, professional fund mangers will bail out of the market entirely). For related research on fire sales, *see* Andrei Shleifer and Robert Vishny, *Liquidation Values and Debt Capacity – A Market Equilibrium Approach*, 47 J.FIN. 1343 (1992) (showing that, when assets are liquidated involuntarily at a time when potential buyers have limited funds and capital is not readily available, prices fall farther from fundamental value and "noise trader" shock is constant).

[189] SHLEIFER, *supra* note 13, at 100-102. Bond markets and foreign exchange markets have the advantage of offering closer substitutes for cash flows, which are essential to arbitrage. Richard Roll, R^2, J. OF FINANCE 541 (1988). By contrast, perfect substitutes are almost never found in the stock market. Wurgler and Zhuravskaya, *supra* note 8 at 101. To demonstrate the use of a hedge, suppose that a stock is overpriced as compared to its "true" or fundamental value. *See* note 7, *supra*, for a definition of fundamental value. Theoretically, in the absence of additional cost or risk, rational investors would then seize upon the opportunity for a quick profit by selling (or "shorting") the overpriced security and buying a similar (or substitute) security to "hedge" the trade. Thus, the investor has sold the overpriced security and bought the cheaper, substitute security, and should earn a profit. Clearly, then, successful arbitrage depends upon the availability of good substitutes. Moreover, in the real world, as costs and risks increase as mispricing deepens, arbitrage is more and more limited.

c. Implications for the Expatriation Decision

As a result of the costs and risks of real-world arbitrage, temporary price asymmetries can be perceived by market movers and yet remain in place for at least the short to mid-term.[190] Therefore, systematic biases in the market can occur which can be exploited by certain agents not subject to the same constraints as most arbitrageurs. Corporate managers may act as these arbitrageurs.

If corporate mangers are better at perceiving the market situation than the average investor, they might be able to exploit these irrationalities, actually arbitraging the difference between market value and perceived fundamental value. One of the ways corporate managers might exploit a stock price which is perceived by them as undervalued is to accept the tax liability associated with the gain inherent in their corporation and exit the U.S. taxing jurisdiction, expatriating out from under the U.S. tax net at a reduced cost.

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[190] BARBERIS AND THALER, *supra* note 135, at 2. For a further discussion of how risk encountered by individual agents will result in a distorted market, *see* Terrence R. Chorvat, *Ambiguity and Income Taxation,* 32 CARDOZO L. REV. 635 (2002).

IV. Reducing Expatriations

A. Congressional Response to Corporate Inversions

In the absence of adequate explanations for the increase in inversion activity, and concern that somehow this must be damaging the tax revenue collections, several bills have been proposed to prevent corporate expatriation activity which would extend U.S. taxing authority beyond that which is justified under traditional notions of international tax policy. [191] The most prominent proposal in the Senate, the bill proposed by Senators Max Baucus and Charles Grassley, would have banned corporate inversions altogether.[192] In the House, a bill proposed by Rep. William Thomas would have placed a three-year moratorium on corporate inversions, and increased the strength of the earnings stripping rules.[193] Several academic proposals have included provisions to deem foreign corporations with majority U.S. shareholders to be U.S. corporations and tax them accordingly. [194]

There are significant problems with all of these proposals. First of all, a moratorium on inversions creates significant pressures to initially incorporate abroad.[195]

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[191] *See* e.g., S. 2119, Reversing the Expatriation of Profits Offshore Act (Sens. Baucus and Grassley, Apr. 11, 2002); H.R. 5095, American Competitiveness and Corporate Accountability Act (Rep. Thomas, 2002); H.R. 3884, Corporate Patriot Enforcement Act of 2002 (Rep. Neal, Mar. 6, 2002); S. 2050 and H.R. 3857, To Amend the Internal Revenue Code of 1986 to Treat Nominally Foreign Corporations Created Through Inversion Transactions as Domestic Corporations (Sen. Wellstone and Rep. McInnis, Mar. 6, 2002); H.R. 4993, No Tax Breaks for Corporations Renouncing America Act of 2002 (Rep. Doggett, 2002); H.R. 3922, Save America's Jobs Act of 2002 (Rep. Maloney, March 11, 2002); S. 2050 (Sens. Wellstone and Dayton, Mar. 21, 2002); H.R. 4756, Uncle Sam Wants You Act of 2002 (Rep. Johnson, May 16, 2002).

[192] *See* S. 2119, *supra* note 185.

[193] *See* H.R. 5095, American Competitiveness and Corporate Accountability Act (Rep. Thomas, 2002).

[194] Samuel Thompson, *A Critical Perspective on the Thomas Bill,* 96 TAX NOTES 581 (Jul. 22, 2002).

[195] *See* C. BRYAN CLOYD ET AL, WHAT DO TRENDS IN LOCATION DECISIONS FOR INITIAL PUBLIC OFFERINGS IMPLY FOR CORPORATE INVERSIONS? (University of Arizona Working Paper, 2002){on file with the author) (the costs that already been imposed on flip transactions have caused many businesses to initially incorporate abroad). The 2001 incorporations of Seagate Technology and Accenture *ab initio* are representative of the pressures to do so. Seagate is a leading manufacturer of storage drives, and Accenture

As soon as inversions are prohibited, this will only increase the pressure to incorporate initially even for corporations which operate primarily in the U.S. If this should become relatively common, there would be significant tax advantages for these foreign / U.S. corporations to acquire the existing U.S. corporations. Therefore, a simple moratorium is at best a short-term solution, which might significantly distort incentives. One can also make a fairness argument against a moratorium. The initial incorporation decision was based on certain assumptions about how the tax laws operate. If the United States changes or is likely to change these laws significantly, it does seem fair to allow corporations to be able to decide to leave the taxing jurisdiction of the United States, if they pay their deferred taxes. In addition, in some very rare instances, it may actually be profitable from a non-tax perspective to expatriate the corporate group.[196]

Because some academics have understood the problems with such a moratorium, they have proposed treating all corporations which are majority owned by U.S. persons as U.S. corporations.[197] However, this solution has its own problems. Many legitimate foreign corporations are majority owned by U.S. persons. It is generally the case that Seagrams Corporation, a Canadian distillery, is majority owned by U.S. persons.[198] This is often the case for Canadian and Mexican corporations, as well as legitimate Bermudan and other Caribbean corporations.

Second, there are significant issues of fairness as well as international law which are raised by such proposals. What could justify the United States' imposition of an entity

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is the world's largest management and technology consulting firm and the former consulting arm of Arthur Andersen. While not technically corporate inversions, these foreign incorporations essentially represent U.S. corporate expatriations.

[196] Actually moving the operations, or the owners of the corporation are now non-U.S. corporations

[197] Thompson, *supra* note 185.

[198] Lorance Bravenc, *Connecting the Dots in International Taxation* 97 TAX NOTES 562 (Oct. 28, 2002).

level tax on an entity over which it has no other jurisdiction? This would significantly interfere with the national sovereignty of the other relevant jurisdictions.

Third, the most likely effect of this proposal is it that it will only increase the transactions costs of escaping the U.S. tax net. Those parties which seek to incorporate abroad will find a willing foreign party by which to be acquired and will share the transactions costs and tax benefits appropriately.[199] While this might reduce the amount of inversion activity, those who wish to inversion will discover ways to invert without technically inverting

The proposals to declare what are actually non-U.S. corporations as U.S. corporations would do violence to the concept of the corporation as a separate person from its owners.[200] While this may seem to have an ambiguous effect now this can have bad longer term effects. As the United States becomes relatively smaller in the world,[201] soon many of our corporations may be majority owned by non-U.S. persons. We would probably not consider the possibility of if this happens General Motors may not be a U.S. corporation because the majority of shares were held by non-U.S. persons.

In addition, all such proposals would effectively create an even greater incentive for U.S. persons to invest in foreign corporations. It would reduce the equity capital flowing to U.S. corporations from foreign investors. Furthermore, it will create an even greater incentive for U.S. corporations to escape the U.S tax net via acquisitions by

[199] Perhaps being acquired by a foreign bank, which then issues tracking stock etc.
[200] This principle goes back for centuries in Anglo-American Law. *See* Hamilton *supra* note x.
[201] *See* VITTOTANZI, INTERNATIONAL TAXATION IN AN INTEGRATING WORLD 5 (1996)

foreign corporations.[202] The evidence suggests that it is U.S citizens (workers in particular) who will bear the burden of this tax rather than capital providers.[203]

B. A Behavioral Finance Proposal: A Retrospective Value Standard

1. Capturing The Economic Value Of The Corporation

It is clear that, due to potential market irrationalities, it might be possible for the managers of a corporation to exploit an asymmetry between market value and economic value to leave the U.S. taxing jurisdiction without paying the appropriate amount of taxes. However, absent insider information, the only administratively feasible way to measure the assets of a corporation is to look at market value.

Prior to the 1986 Tax Reform Act, there existed a similar opportunity with respect to transfers of intangible property by U.S. corporations to their foreign subsidiaries. This prompted the imposition by Congress of the commensurate with income standard,[204] under which the reported value of an intangible transferred from a U.S. to a foreign corporation must be commensurate with the value of the income later generated by that intangible.

The "commensurate with income standard" is the only retroactive valuation rule in the income tax rules.[205] When intangible property (i.e., intellectual property) is transferred for a period of more than one year, the price paid for the intangible must be

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[202] Such foreign acquisitions included the British Petroleum-Amoco "merger" and the Daimler-Chrysler "merger".

[203] JOSEPH STIGLITZ , THE ECONOMICS OF THE PUBLIC SECTOR 315 (2000)

[204] U.S. pharmaceutical companies transferred ownership of intangible rights to their self-developed intangibles, i.e. drug patents, to Puerto Rican subsidiaries in anticipation of U.S. F.D.A. approval in order to minimize the value transferred abroad, and therefore the section 367(a) toll charge on domestic-to-foreign property transfers.

[205] The commensurate with income standard does not apply to corporate inversions because they are not transfers of intangibles, but rather the transfer of ownership of the corporation itself, usually via a stock-for-stock swap.

commensurate with the income attributable to the intangible.[206] That is, the value of the intangible is tested not only on the day of transfer, but also two years following the transfer. If, upon examination, the original value is within 80% to 120% of the redetermined value, the original valuation stands.[207] If, on the other hand, the redetermined value gives rise to an additional assessment, the taxpayer is liable for the redetermination, interest, and possibly penalties if substantial understatement or substantial overstatement applies. Conversely, if the redetermined value suggests that the taxpayer might be entitled to a refund, the standard procedural rules will apply to allow for or disallow such a refund.[208]

While the current anti-inversion rules impose a tax or "toll charge" on corporate inversions, this tax is calculated according to the value of the corporation at the date of the inversion. There is no retroactive standard of valuation to capture the actual economic value of the corporation when the market price might be inconsistent with fundamental economic value. Unlike transfers of intangible property, there is no general commensurate with income standard in the U.S. tax law. This paper proposes to modify the Internal Revenue Code to apply the commensurate with income standard to corporate inversions. That is, the market capitalization of the corporation would be determined, not only on the day of transfer, but also two years following the transfer. If, on the basis of

[206] Treas. Reg. § 1.482-4(f)(2)(i). On audit, transfer prices are subject to adjustment by the I.R.S. notwithstanding an arm's length determination in an earlier year, or whether the statute of limitations on assessment remains open for the first year of the transfer. *Id*. The commensurate with income standard of § 482 - often referred to as the "super-royalty provision" - was imported into the transfer pricing rules by the Tax Reform Act of 1986, and was accompanied by parallel amendments in §§ 367(d)(2) and 936(h)(5)(c)(i)(I) relating to transfers of intangibles by a U.S. person to a foreign corporation (in a § 351 incorporation transfer or a § 361 reorganization) or amounts paid by a § 936 U.S. possession corporation for the right to use a manufacturing intangible. ROBERT COLE, PRACTICAL GUIDE TO U.S. TRANSFER PRICING § 13.01[B][2] (2nd ed. 2001); BORIS I. BITTKER & LAWRENCE LOKKEN, FUNDAMENTALS OF INTERNATIONAL TAXATION ¶¶ 68.6.5, 67.2.4. (1998)

[207] Treas. Reg. § 1.482-4(f)(2)(C)(iv).

[208] Generally a taxpayer has two years from the filing of a return to file for a refund. Because of this there is only a very limited ability to seek a redetermination in favor of the taxpayer.

the value two years after the inversion, the original value falls within a specified safe harbor, the taxpayer's valuation would stand and no additional taxes would be assessed. However, if the value fell above or below the original value such that an additional assessment is indicated, the redetermined value should be discounted back to the date of the inversion (to reflect time value of money and other returns), and this redetermined value could be substituted for the value of the corporation on the date of the inversion, in a manner similar to the application of the commensurate with income standard. [209] [210] [211] The addition of the commensurate with income standard to the U.S. anti-inversion provisions would preclude market timing by corporate managers in periods of economic downturn if short to mid-term market failure occurs.

One relatively simple way to accomplish the extension of the commensurate with income standard to corporate inversion transactions would be to treat goodwill and going concern value of the group as separately transferred for purposes of sections 367(d) and 482 in corporate inversion.[212] Most of the value of a corporation is to be found in its goodwill and going concern value, rather than in the tangible assets of the corporation.[213] Currently, section 367(d) does not reach goodwill and going concern value, in these transfer because they generally only in transfer of stock and securities.[214]

This proposal will eliminate the ability of corporate managers to reduce the tax cost of expatriating via a corporate inversion by opportunistically choosing the time of the transaction. Corporate managers will have to bear the risk that stock price will not

[209] Invested capital always requires some compensation for the time value of money. BREALEY & MYERS, *supra* note 10.
[210] The 80%-120% safe harbor is contained in the CWI regulations, discussed at note 208 *infra.*
[211] *See* I.R.C. §§ 482, 367(d) and the regulations promulgated thereunder.
[212] Note that, if § 367(a) applies to a transaction, either § 367(d) or § 482 will apply, *ipso facto*.
[213] *See* MICHAEL J. MARD, VALUATION FOR FINANCIAL REPORTING: INTANGIBLE ASSETS, GOODWILL, IMPAIRMENT COSTS, SFAC 141, 142 (2002)
[214] Treas. Reg. § 1.482-4(b).

increase in the two years following the inversion. "Market timing" would then entail significant risk and should therefore discourage corporations from inverting merely to take advantage of temporary asymmetries between market price and economic value.

One of the significant differences between the proposal of this paper and the current commensurate with the income standard is that corporations should be permitted to prove that, if the value of the corporation has significantly increased after the inversion, the corporation can attempt to show that this increase resulted from actions taken after the inversion transaction. The burden of proving this would rest with the corporation. The default assumption is that the value of the corporation at the time of the inversion was simply a discounted value of what it would be two years (or some other period) later. This is more lenient that the current commensurate with income rules dealing with the transfer of intellectual property, because these rules do not allow for corporations to dispute that the increase in value that occurred later should not be used to derive the early value of the asset.

If the corporations find the value of the corporation is lower two years after the inversion, they should probably not be allowed to be used by the taxpayer to readjust the tax owed. In general under the *Danielson* doctrine, the form of the transaction will be construed against the taxpayer.[215] So here too, if they argued the value of the corporation was a particular amount, they should be held to be stuck with that amount.[216]

If a commensurate with the income standard were applied to all expatriation transactions, it would rarely be the case that the transfer would make good economic

[215] *Danielson v. Commissioner*, 378 F.2d 771 (3rd. cir.1967).

[216] A more precise standard could be based on the corporation's beta with the market. *See* Elizabeth A. Chorvat, *Modern Financial Theory and Transfer Pricing,* 10 GEO. MASON L. REV. 637 (2002), Elizabeth A. Chorvat, *Forcing Multinationals to Play Fair: Proposal for a Rigorous Transfer Pricing Theory*, 54 ALABAMA L. REV. __ (forthcoming, 2003).

sense, just as currently very few intangibles are transferred in a way in which the commensurate with the income standard applies.

This solution will place the risk that the market price returns to what it should be or is in fact greater than the "fair" price on the corporate managers. If the price returns to the "fair" price, there will be no advantage to having inverted and in fact the shareholders and the corporation will have pay interest on the taxes due. This risk should make the managers far less likely to flip in the first place. The only time it would be rational to flip, is if they see adverse changes to the U.S. tax law occurring and want to leave the U.S. tax net ahead of these changes. The price is they have to pay all the taxes that arguably should have been due before[217]. It seems fair to let corporations leave if they think the game is going to change, but only if they pay the amounts we have let them put off paying. Talk about the Haig-Simons definition of income and should probably cite my realization paper.

IV. CONCLUSION

U.S. multinational corporations have significant incentives to try to escape the U.S. international tax rules which are almost universally considered to be the most stringent in the world and harmful to international competitiveness. Since 1994, the current anti-inversion rules have been deemed sufficient to preclude inversion transactions that are not accompanied by an appropriate level of U.S. tax having been paid. However, these rules only operate in this fashion if the stock price truly reflects the underlying economic value of the company and, since 2000 – the beginning of the current

[217] *See* Bankman, *supra* note 72, ; *see also* Knoll, *supra* note 72.

economic downturn – corporate inversions have occurred with increasing frequency and among an ever-widening distribution of American industries. Furthermore, there is every reason to believe that non-public corporations are engaging in inversion activity as well.

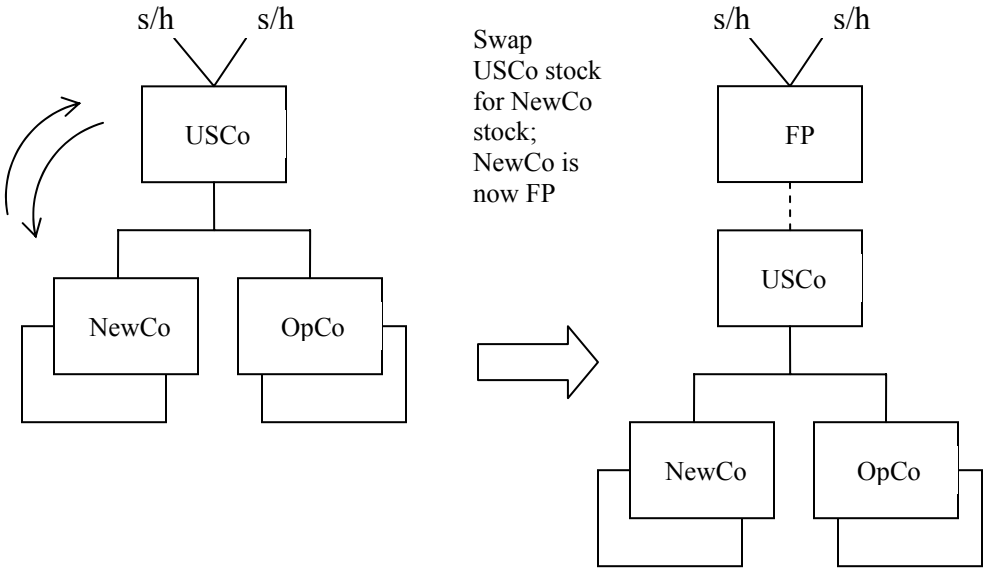
As discussed in the paper, there are significant reasons for believing that the stock prices of corporations which choose to "flip" do not reflect the economic value of these corporations. Therefore, the appropriate response to the corporate inversion "problem" is to adopt more appropriate pricing policies. The simplest and most reasonable way to value the stock and assets of these corporations would be to use retrospective valuation as is currently applied to the transfer of intellectual property through the application of the "commensurate with income standard". One relatively simple way to accomplish the extension of the commensurate with income standard to corporate inversion transactions would be to include goodwill and going concern value in the definition of intangibles for purposes of sections 367(d) and 482. Currently, the section 367(d) definition of an "intangible" does not include goodwill and going concern value. That the commensurate with income standard would be effective to preclude the transfer of most corporate assets outside of the U.S. tax net without an appropriate measure of taxing built-in gain is demonstrated by the fact that the retrospective valuation rules of section 367(d) currently operate to prevent expatriation by firms with large built-in gains in patents, self-created processes, and other intellectual property. This is why, for example, major pharmaceuticals have not seriously considered expatriating.

The proposed solution both prevents the corporations from abusing the U.S. tax system while still allowing individual corporations the freedom to arrange their business

affairs to remain competitive in the international marketplace. Of course longer term solutions to the competitiveness concerns of U.S. multinationals would include considerations of the repeal of subpart F, reform of the formulary methods of apportioning income and deductions, and even the merits of a territorial system of taxation. However, these are beyond the scope of the issues addressed in this paper.

APPENDIX

Flip Transaction Step One: Putting the Foreign Parent in Place



Flip Transaction Step Two: Protecting Existing Operations from Subpart F