

TESTIMONY OF PROF. EDWARD D. KLEINBARD

International Tax Reform Begins at Home

**TESTIMONY PREPARED FOR HEARING ON
“THE GLOBAL TAX ENVIRONMENT IN 2016”**

U.S House of Representatives Committee on Ways and Means

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Chairman Brady, Ranking Member Levin, and distinguished members,

Thank you for inviting me to testify at this hearing. My name is Edward Kleinbard; I am the Ivadelle and Theodore Johnson Professor of Law and Business at the University of Southern California’s Gould School of Law. From 2007-2009 I was privileged to serve as Chief of Staff of the Congress’s Joint Committee on Taxation.

Introduction.

Over the last several years, this committee has worked diligently and productively on corporate tax reform in general, and international tax issues in particular. I have written previously of my admiration for the work underlying former Chairman Camp’s comprehensive corporate tax proposal.¹ But today, the global tax environment in which multinational corporations operate is evolving more rapidly than at any earlier time in my 40 years of work in the area. The question is, what (if anything) must be done, right now?

Pressures seem to be mounting from all directions. Most important for immediate U.S. tax policy and revenues are corporate inversions. In an inversion, a U.S. multinational firm acquires a smaller competitor in a tax-congenial environment, but structures the transaction upside down, so that the foreign minnow as a formal matter

¹ Edward D. Kleinbard, *3 Cheers for Dave Camp*, 138 Tax Notes 619 (Feb. 4, 2013).

acquires the stock of the U.S. whale.² The combination presumptively makes business sense, but the upside down acquisition structure does not, excepting U.S. tax considerations. Closely related to this, we see the problems of earnings stripping, in which a foreign multinational group uses interest paid from its U.S. subsidiaries to foreign affiliates as a device to reduce its U.S. tax bill in respect of its U.S. domestic operations. We see the same phenomenon as well in the overleveraging of U.S. multinationals with large hoards of offshore liquid assets, as I describe below.

Moreover, every Member here is aware that the U.S. statutory corporate tax rate is the highest in the OECD, even if effective (that is to say real-world, after all tax breaks are considered) tax rates are not so out of line. And every Member here also is aware of the so-called overseas “trapped earnings” of U.S. multinationals, amounting to (very roughly) some \$2.1 trillion in offshore assets, which gnaw at the hearts of chief financial officers everywhere. Again speaking very roughly, half of this amount is in cash and other liquid assets, and the other half in real investments in non-U.S. businesses. What might not be as obvious is that, at least by report, some multinational firms are under pressure from their accountants to do something productive with their stockpiles of offshore cash: after all, it is inherently implausible that cash that remains on the balance sheet year after year really is “permanently reinvested” anywhere, which is the test for booking the benefits of tax deferral for GAAP purposes.

From an international perspective, the mounting tax pressures on multinational businesses and tax laws include, first, the successful conclusion of the G20-OECD Base Erosion and Profit Shifting (BEPS) project, which outlined a wide array of new principles of arm’s-length pricing, along with proposed reforms for national governments to

² I here use the term “inversion” to refer to a deal that, in the domestic context, would be called a “reverse acquisition,” in which the smaller foreign firm is the putative acquiror of the larger U.S. one. An inversion in the more technical sense of Code section 7874 requires that former shareholders of the U.S. firm control at least 60 percent of the combined company. A recent article suggests “corporate expatriation” as a catch-all term for all acquisitions of a U.S. firm by a foreign one, regardless of relative size. Stephen E. Shay, J. Clifton Fleming Jr., and Robert J. Peroni, *Treasury’s Unfinished Work on Corporate Expatriations*, 150 Tax Notes 933 (Feb. 22, 2016).

implement.³ The United States, along with every other G20 country, endorsed the final OECD package of BEPS action plans in September 2015.

Second, partially in response to the so-called LuxLeaks scandal, the European Commission has launched a broad inquiry into whether some member states used tax administrative mechanisms – in particular, Advance Pricing Agreements – in effect as a surreptitious means to deliver unlawful government subsidies (that is, “state aid”) to multinational firms, rather than to employ the APA process to determine in good faith the application of arm’s length transfer pricing principles to the facts of a particular multinational firm’s operations.⁴ Third, many countries around the world have radically stepped up their audits of the local operations of multinational firms, and at least in the view of some observers have adopted novel theories of transfer pricing inconsistent with global norms.

In short, like figures caught in an ever-tightening vise, U.S. multinationals are feeling increasing tax pain from every direction. Their squealing, the high statutory U.S. tax rate, and the inversion phenomenon have together inspired a narrative that the U.S. international tax system is “uncompetitive,” and that we need a more multinational-friendly international tax system as soon as possible. U.S. firms have further convinced many observers that they are the victims of unprincipled revenue grabs by foreign jurisdictions looking to raise some money without imposing on their own citizens.

³ For overviews of BEPS, see Jeffrey M. Kadet, *BEPS: A Primer on Where It Came From and Where It’s Going*, 150 Tax Notes 793 (Feb. 15, 2016); Yariv Brauner, *What the BEPS?*, 16 Florida Tax Rev. 55 (2014). The texts of the final package of action plans are available at <http://www.oecd.org/tax/beps.htm>.

⁴ For background on the LuxLeaks scandal, and a scathing analysis of the “substance” of the hundreds of advance tax agreements between Luxembourg and multinational firms that were disclosed through this leak, see Omri Marian, *The State Administration of International Tax Avoidance*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2685642, especially Section IV.B. For a short overview of the scandal and its relationship to the state aid cases, see Jones Day, *Luxembourg Leaks: Potential Risks to Companies Whose Luxembourg Tax Rulings Have Been Released to the Public*, <http://tinyurl.com/jsmfmggr>.

This is a false narrative. There is no tax competitiveness crisis in respect of outbound investments by U.S. firms. And if U.S. firms are discomfited by foreign audits and the European Commission's state aid investigations, they are reaping what they themselves have sowed, through years of aggressive tax reduction schemes that routinely have reduced their putative foreign tax rate burdens to single digits. The rule of law has not been abandoned in Europe, and U.S. firms have and will receive the same opportunities to defend their tax planning as is afforded to a European competitor in the same position.⁵

If you are looking for an individual villain to blame for all the tax pain felt by U.S. multinationals, I am your man. I am proud of the contributions that my *Stateless Income* series of articles⁶ have made to a better understanding of how U.S. firms became the world leaders in implementing tax avoidance technologies, and in pointing towards some possible solutions. But I remain a friend to American business, albeit in a Dutch uncle sort of way,⁷ and therefore set out below some recommendations for how this committee can best advance the interests of American businesses, while protecting U.S. tax revenues.

Competitiveness.

The competitiveness narrative is an empty suit pleading for narrow self-interest. I've developed the point in a short article titled *Competitiveness Has Nothing to Do With*

⁵ Jones Day, *European Commission Concludes that Starbucks and Fiat Tax Rulings Constitute Illegal State Aid and Orders Payment of Back Taxes*, <http://tinyurl.com/hpww2oh>, at 3 (describing judicial appeals process).

⁶ Edward D. Kleinbard, *Stateless Income*, 11 Florida Tax Rev. 699 (2011); *The Lessons of Stateless Income*, 65 Tax Law Rev. 99 (2011); *Through a Latte, Darkly: Starbucks' Stateless Income Planning*, 139 Tax Notes 1515 (Jun. 24, 2013).

⁷ I gather that the turn of phrase may betray my age. Wikipedia helpfully explains: "A **Dutch uncle** is an informal term for a person who issues frank, harsh, or severe comments and criticism to educate, encourage, or admonish someone. Thus, a "Dutch uncle" is the reverse of what is normally thought of as avuncular or uncle-like (indulgent and permissive)." https://en.wikipedia.org/wiki/Dutch_uncle.

It, which I've attached to this testimony.⁸ A U.S. firm could be said to face an uncompetitive international tax environment if it paid cash taxes on its international operations at a burdensome rate, if the financial accounting presentation of its international operations inevitably required provisions for future tax liabilities that created the impression of a less profitable firm, or if the costs of maintaining the firm's stateless income machinery, including the cost of financing U.S. operations without touching the cash left abroad, was unduly burdensome. But none of these is true.

As to the first point, we know from a great many sources that the most successful U.S. multinationals pay foreign tax in respect of their foreign operations at derisively low rates. Alphabet (that is to say, Google) enjoyed a 6.3 percent tax rate on roughly \$12 billion of foreign earnings in 2014, through its infamous Double Irish Dutch Sandwich stateless income generator.⁹ Microsoft's effective foreign tax rate is on the same order of magnitude, as can be seen by inspection of Microsoft's tax footnote in its financial statement. In a sense it is unfair to single out these firms, because same is true for dozens of other sophisticated U.S. multinational companies.

But one more example might be instructive. Pfizer Inc. has been the subject of much attention lately, because of its proposed not-quite inversion combination with Allergan PLC.¹⁰ In its 2014 annual financial statements, Pfizer reported to shareholders a worldwide effective tax rate in the neighborhood of 25 percent. (*Competitiveness Has Nothing to Do With It* is useful here in explaining the basic financial accounting presentation of tax liabilities.) Pfizer's Chief Executive Officer, Ian Read, has described the U.S. tax system as requiring that Pfizer compete against foreign rivals "with one hand

⁸ Edward D. Kleinbard, *Competitiveness Has Nothing to Do With It*, 144 Tax Notes 1055 (Sept. 1, 2014). I thank the publishers for permission to redistribute the article.

⁹ Jeremy Kahn and Jesse Drucker, *Google Lowered Taxes by \$2.4 Billion Using European Subsidiaries*, Bloomberg Business, Feb. 19, 2016 (<http://www.bloomberg.com/news/articles/2016-02-19/google-lowered-taxes-by-2-4-billion-using-european-subsidiaries>)

¹⁰ My understanding is that the transaction has been structured such that former Pfizer shareholders will control more than 50 but less than 60 percent of the combined company, thereby avoiding tripping the 60 percent wire of an inversion in the technical tax sense, as defined by Code section 7874.

“tied behind our back,” and has further indicated that a principal driver of the proposed inversion transaction is to reduce Pfizer’s reported effective tax rate.¹¹

A worldwide effective tax rate of 25 percent is roughly congruent with the weighted average of OECD corporate tax burdens. But a careful study of Pfizer’s financial statements suggests that Pfizer’s cash tax liabilities are far lower than this implies, and that Pfizer in fact has paid cash tax bills on its *worldwide* income at a rate on the order of 6 or 7 percent over the last several years.¹² A Pfizer representative essentially acknowledged the accuracy of the analysis in a Wall Street Journal story.¹³ In fact, Pfizer’s financial statements maintain that Pfizer has lost billions of dollars in the United States year after year, notwithstanding that the United States accounts for about 40 percent of the company’s sales and roughly 50 percent of its assets.

Under SEC rules, a firm is obligated to disclose in its tax footnote to its financial statements the U.S. tax cost of repatriating its “permanently reinvested” foreign earnings at the end of each year, unless doing so is “not practicable.” The greater the hypothetical U.S. tax cost that is disclosed to shareholders, the lower the foreign taxes that have been paid on those offshore earnings, because those foreign taxes would be creditable against the firm’s hypothetical U.S. tax bill. Some companies, like Microsoft, comply with this requirement, even when in Microsoft’s case doing so signals that its foreign earnings bear

¹¹ Richard Rubin and Jamie Heller, *Pfizer CEO Says U.S. Tax Regime Pushing Him to Seek Alternative*, Wall St. J., Oct 29, 2015. (<http://www.wsj.com/articles/pfizer-ceo-says-u-s-tax-regime-pushing-him-to-seek-alternative-1446140269>)

¹² Frank Clemente, Americans for Tax Fairness, *Pfizer’s Tax Dodging Rx: Stash Profits Offshore* (Nov. 2015) <http://www.americansfortaxfairness.org/pfizers-tax-dodging-rx-stash-profits-offshore/>. Essentially, Pfizer records each year for financial statement purposes a U.S. tax provision – a reserve, if you will – for the ultimate U.S. repatriation tax on a large portion of its low-tax foreign earnings, even though Pfizer devoutly hopes never to pay any such repatriation tax, at least at the statutory 35 percent rate. This explains the enormous difference between the 25 percent worldwide effective tax rate that Pfizer reports to shareholders and the cash taxes actually paid each year.

¹³ Richard Rubin, *Pfizer Piles Profits Abroad*, Wall St. J. (Nov. 8, 2015) <http://www.wsj.com/articles/pfizer-piles-profits-abroad-1447031546?alg=y> (“The gap between Pfizer’s 25.5% tax rate and the 4.8% reported by Actavis PLC before it changed its name to Allergan is somewhat illusory, an artifact of tax accounting rules and Pfizer’s decisions about how to show the information to shareholders.”).

foreign tax at single digit rates. For reasons that are not clear, however, the majority of large, sophisticated U.S. multinational firms, each which employs dozens or hundreds of tax professionals, are inordinately modest about their tax forecasting abilities in this regard, and profess that it is not practicable to calculate the hypothetical U.S. tax cost of repatriating their foreign earnings. Pfizer falls into this category of confessed tax incompetence, which is doubly puzzling, given that Pfizer has no difficulty calculating this liability for the portion of its low-tax foreign earnings for which it *does* record a U.S. tax provision each year.¹⁴ Pfizer's actual effective foreign tax rate would have been a bit more evident to investors had it worked a bit harder to calculate this one hypothetical tax bill.

Another way of approaching things is to look directly for evidence of profit shifting by U.S. firms. Economists have done just that, in several major studies. In the most recent of these, Kimberly Clausing estimated that base erosion and profit shifting reduced U.S. tax revenues at a rate between \$77 billion and \$112 billion per year in 2012.¹⁵

In another recent and highly technical working paper, three economists from the Staff of the Joint Committee on Taxation closely analyzed nonpublic tax return data of U.S. corporations; they concluded that “there is considerable shifting of profits to lower tax jurisdictions.”¹⁶ Indeed, they found that in 2010, 53 percent of the global earnings of foreign subsidiaries of U.S. multinationals were booked in six tax haven countries.¹⁷ At least as relevant to this hearing, they found that the effective tax rate (the real world average tax rate) paid by U.S. multinationals on their global non-U.S. income was 17 percent; even their income booked in non-tax havens had an effective tax rate of only 18

¹⁴ Pfizer 2014 Financial Statements, note 5, Section C. See also footnote 12, *supra*.

¹⁵ Kimberly Clausing, *The Effect of Profit Shifting on the Corporate Tax Base*, 150 Tax Notes 427 (Jan. 25, 2016).

¹⁶ Tim Dowd, Paul Landefeld and Anne Moore, *Profit Shifting of U.S. Multinationals*, http://papers.ssrn.com/sol3/Papers.cfm?abstract_id=2711968, at 4.

¹⁷ *Id.* at 23.

percent.¹⁸ Other objective studies lead to similar estimates of the revenue hemorrhaging from countries around the world to multinational firms and their shareholders.

In short, U.S. multinationals in general pay non-U.S. tax at rates that are the envy of their foreign competitors. And so long as a firm is able to satisfy its auditors that its offshore earnings will be kept offshore indefinitely, shareholders of the firm see it through territorial-tinted lenses: that is, the firm reports its worldwide profits to investors as if there is no residual U.S. repatriation tax to worry about.

Finally, U.S. firms are not cash starved in the United States by virtue of leaving their foreign profits offshore. The reason is simply that the firms that concern us here are very large, and have easy access to capital markets. This sets into motion a systematic tax arbitrage, in which firms finance U.S. cash needs by borrowing in the capital markets (at historically low rates, as it happens), deducting the resulting interest expense against their U.S. *domestic* income, while their foreign offshore earnings continue to accumulate in a tax-privileged environment.

This is not ivory tower theory: on February 16th, for example, Apple announced a \$12 billion bond offering, the proceeds of which will be used to pay dividends and buy back Apple stock.¹⁹ The interest expense will be fully deductible by Apple, and its enormous hoard of foreign earnings will continue to grow. If the foreign assets held by Apple or any other company engaged in this arbitrage are active business operations, the result is similar to borrowing to invest in tax-exempt bonds – a pure tax-driven arbitrage profit. If the foreign assets are liquid investments, then the income from those investments will be taxable in the United States, which economically will offset the interest expense from the bond offering (plus or minus any interest rate differential). But in that case the *principal* of the bond offering will be the *economic equivalent of a tax-*

¹⁸ Id. at 10. The figures in the paper that are repeated in the text are simple averages; that is, the global non-U.S. average rates are not weighted by the relative amounts of income earned in different countries.

¹⁹ Liz Moyer, *Apple Plans \$12 Billion Bond Sale for Buybacks and Dividends*, NY Times (Feb. 16, 2016) http://www.nytimes.com/2016/02/17/business/dealbook/apple-plans-12-billion-bond-sale-for-buybacks-and-dividends.html?emc=eta1&_r=0

free repatriation – in this case of \$12 billion.²⁰ That is, if the interest rate on the bond offering is offset by interest income from the offshore cash hoard, the net effect is that Apple (in this case) will be in the same position as if it repatriated \$12 billion tax free and distributed the money to shareholders (again subject to any interest rate differentials).

And of course, the “trapped” offshore earnings are not buried in a backyard in Zug: they either are invested in real foreign business assets, or in U.S. dollar denominated financial assets (typically, bank deposits, commercial paper, money market funds and Treasury securities). So in the latter case the money is reinvested in the U.S. economy, it is just not in the pockets of shareholders.

None of this is to excuse the current international tax system as harmless, much less desirable. Operating the stateless income machinery costs money, and offshore cash burning a hole in a CFO’s pockets can lead to a tax-induced incentive to invest in more foreign businesses, just to have something to do with the cash. But of all the faults of the current U.S. tax system, anti-competitiveness is not one.

Inversions.

If U.S. international tax rules are not anti-competitive in the simplistic way that firms describe their predicaments, why the rush to invert? I develop the answers in *Competitiveness Has Nothing To Do With It*, but basically an inversion that threads the needle of the 2014 and 2015 anti-inversion Treasury Notices (as Pfizer – Allergan and Johnson Controls – Tyco are designed to do) opens up three possibilities. First, such an

²⁰ For example, imagine that Apple borrows \$12 billion at 5 percent, and a tax haven subsidiary of Apple has cash investments of \$12 billion also yielding 5 percent. Under subpart F, that offshore interest income is taxable immediately in the United States, and in turn cash equal to that income (\$600 million) can be repatriated to the United States tax-free. Apple’s tax return thus will show \$600 million of interest income by virtue of its subpart F inclusion, and \$600 million of interest expense on its bond issue, for net taxable income in respect of these two items of zero. What is more, the cash yield from the investments held in the tax-haven subsidiary, once repatriated tax-free to the United States, can be used to service the cash interest coupons on the bonds issued by Apple. The result is that Apple has no net cost for raising \$12 billion in cash through the bond offering, just as if it repatriated \$12 billion tax-free. The \$12 billion can then be distributed to shareholders; Apple’s global income goes down by \$600 million/year (because it has a new interest expense and no new assets on its balance sheet, having distributed the bond proceeds to shareholders), but that is the same result as would obtain had Apple actually liquidated some of its offshore income-yielding assets, repatriated the cash tax-free to the United States, and distributed the cash to its shareholders.

inversion enables the surviving firm to get its hands on the U.S. company's offshore cash to fund stock buybacks or dividends, or even to fund the inversion deal itself, through a "hopscotch" loan of the cash directly from the tax haven subsidiary holding it to the new foreign public parent company, jumping over the intermediate immediate U.S. parent.

Second, once a foreign parent company is in place, the wide world of earnings stripping sport opens up. The stock of the U.S. company (now a first tier subsidiary of the putative foreign acquiror) is recapitalized into debt as well as equity, up to the generous limits now provided in section 163(j) of the Code, a large new interest charge appears on the firm's U.S. tax return that is *invisible* to investors (because it is an inter-affiliate transaction eliminated in financial consolidation), and the U.S. tax base on U.S. domestic earnings is thereby depleted. The firm proudly trumpets a lower global effective tax rate, but it has simply engaged in self-help tax reform to deprive the United States of tax on U.S. *domestic* business income, in ways that an entirely domestic U.S. competitor cannot do. This *is* profoundly anti-competitive, but the victims are not the multinational firms who profess that the Internal Revenue Code has driven them to invert, but rather the wholly domestic firms that have been left behind.

Third, inversions offer a long-term congenial tax environment for firms, if they choose their domicile well. But this is very much a long-term agenda item, fraught with all the uncertainty that attends any tax law prediction.

The Treasury has done what it feels it can to restrict inversions through its 2014 and 2015 notices on the subject. But, greatly simplifying, what the notices have done is to create a safe harbor of sorts for combinations that are inversions in a commercial or economic sense, but in which the putative foreign acquiror is large enough that the shareholders of the U.S. firm own more than 50 percent (so that economic control rests with them) but less than 60 percent of the combined company (so that the transaction is not an inversion in the technical sense the word is used in Code section 7874). In this sweet spot, there are no restrictions at all on hopscotch loans, for example.

To be clear, I think it childish to fault companies for inverting. I don't impute much by way of some higher calling to corporate tax patriotism. But I do hold this Committee, and Congress more generally, to a higher standard. The Internal Revenue

Code is a complex model of all of economic activity, written in words rather than math symbols. Congress owns the model, and this Committee is the first line of defense of the model's integrity. If the model yields results that people find troubling, then it is up to Congress to repair it. Patching the model so that it again produces the results that Congress had always expected is not an exercise in "tax hikes" or the like, but rather reflects an appropriate commitment to maintaining the enormous and delicate machine that has been entrusted to this Congress by the 50 Congresses that preceded it.

What Must Be Done Immediately?

Once the reasons for inversions are more clearly understood, and the fuzzy claims of U.S. tax law as systematically anticompetitive in the international setting swept away, then it becomes possible to move forward in a targeted way that stanches the revenue bleeding from inversions without foreclosing or foreshadowing any particular future business tax reform.

Three immediate tweaks are needed. First, lower section 7874's inversion threshold to 50 percent. (The Stop Corporate Inversions Act of 2015, introduced by Mr. Levin and Mr. Doggett, does this in an elegant fashion that distinguishes real business transactions from tax-motivated upside down structures.) Second, recognize that hopscotch loans are simply a tear in the fabric of the Code – a longstanding oversight that leads to the unintended avoidance of the principles of section 956 (the Code section that treats loans to an immediate U.S. parent as a deemed dividend repatriation). Hopscotch loans are relevant whenever a new foreign parent emerges as the owner of a U.S. multinational firm, regardless of the level of continuing ownership of the U.S. target's shareholders; like an impending execution, inversions have simply focused our minds more clearly on them. Section 956 should be amended to treat hopscotch loans as constructive distributions to the immediate U.S. parent.

The same is true of earnings stripping. Earnings stripping is profoundly anti-competitive, because it works to permit foreign-owned U.S. businesses to operate in the United States in an ad hoc privileged low tax environment, to the detriment of wholly domestic U.S. competitors and taxpayers generally. Again inversions have focused our

minds on earnings stripping, but the issue is not in any way limited to inversions.²¹ U.S. domestic business income should be taxed by the United States, and earnings stripping fundamentally violates this core principle. Mr. Levin has recently introduced an anti-earnings stripping bill, and the President in his Fiscal Year 2017 Budget has proposed a thin capitalization variant, which the Treasury Department has estimated will raise \$71 billion in revenue over the next ten years. Again, this \$71 billion does not represent a tax hike on business, but rather the recovery of tax revenue on U.S. domestic business that otherwise is leaking away.

These suggestions leave untouched vitally important issues, from the structure of a new outbound direct investment U.S. tax regime, to anti-abuse rules, to what to do with the existing stockpile of offshore earnings, to the definition of corporate residence. All these must be addressed. The point of my testimony, though, is that the United States is *not* today failing in some global tax competitiveness contest, but it is hemorrhaging tax revenues. Stanch the bleeding first.

BEPS and State Aid.

I have devoted very little space to this point to discussing BEPS and the EU state aid cases. I have done so because I believe that U.S. multinational firms' cries of pain are hyperbolic and premature.

²¹ There is some uncertainty in the economic literature about whether earnings stripping is a serious problem outside the context of inverted firms, but no doubt at all that inverted firms generally indulge in earnings stripping as far as section 163(j) allows. U.S. Treasury Department, *Report to the Congress on Earnings Stripping*, <https://www.treasury.gov/resource-center/tax-policy/Documents/ajca2007.pdf> (Nov. 2007) (finding clear evidence of stripping with respect to inverted companies, but not in other cases); Patrick Driessen, *Do Foreign Corporations Really Not Strip the U.S. Tax Base?*, 150 Tax Notes 927, 929 (Feb. 22, 2016) (The view that non-inverted foreign controlled domestic corporations do not engage in earnings stripping “defies intuition”); J. Clifton Fleming, Jr., Robert J. Peroni and Stephen E. Shay, *Getting Serious About Cross-Border Earnings Stripping: Establishing an Analytical Framework*, 93 N.C. L. Rev. 673 (2015).

The BEPS project has concluded by outlining a wide array of proposed reforms for national governments to implement; the United States, along with every other G20 country, endorsed the final OECD package of action plan in September 2015.

The first of the BEPS initiatives to be rolled out on a global basis will be “country-by-country” (“CbC”) information reporting by large multinational enterprises to tax authorities in those countries where a multinational does business. CbC reporting is designed to give tax authorities in one country a better understanding of the business activities that the enterprise conducts elsewhere, and the methods by which it determines the allocation of its gross income, expenses and profits across those countries. The United States Treasury has issued proposed regulations to implement the CbC rules mandated by the G20’s agreement, with a proposed effective date of tax years beginning after the promulgation of final regulations.²²

Whether BEPS succeeds in engendering more principled and more economic tax outcomes to cross-border activity will not be known for some time, but I believe that the United States, as one of the G20 countries that commissioned the project and that endorsed its conclusions, must give BEPS a fair chance. In particular, I am disappointed that CbC reporting is at all controversial. The argument that CbC reporting will lead to trade secrets being leaked to competitors smacks of the sort of argument that lawyers invent when they cannot come up with anything more substantive to complain about. A quick glance at the geographic and business line reporting that the SEC requires today of all public companies, along with industry securities analysts’ reports, will demonstrate how much we know about where the real business of firms is conducted. What is more opaque today are the locations where the income is booked for tax purposes, in which particular affiliate the income is booked, and through what mechanisms.

²² Prop. Treas. reg. section 1.6038-4 (Dec. 2015). For an overview of the CbC and other BEPS action plans, see Jeffrey M. Kadet, *BEPS: A Primer on Where It Came From and Where It’s Going*, 150 Tax Notes 793 (Feb. 15, 2016).

Companies do not have a legitimate claim that stateless income tax planning techniques used to drive down tax rates to single digits somehow constitute protected proprietary information, akin to the formula for Coca Cola. Phrased differently, it is incongruous that firms routinely state that they comply with all local laws, and that their tax planning is entirely above board, but then are unwilling for that tax planning to be transparent to overwhelmed tax administrators in the many countries in which those firms do business.

As noted in the Introduction, the European Commission (EC) has launched a broad inquiry into whether some member states have used Advance Pricing Agreements to deliver unlawful government subsidies (that is, state aid) to multinational firms in return for the multinationals shifting jobs or income to those countries. If a member state has done so, then under EU law the advantaged company is required to disgorge to the member state the value of the advantage it received.²³ The APA process of course is an instrument of tax administration designed to determine in good faith the application of arm's-length transfer pricing principles to the facts of a particular multinational firm's operations.

These state aid cases have elicited a great deal of agitation in the United States, including claims that U.S. firms are being unfairly targeted, but of the first two cases decided by the European Commission, one involved an Italian firm (Fiat) and the other a U.S. one (Starbucks). The analysis in the Starbucks state aid ruling, to the extent it has been made public, has largely mirrored my findings in my case study of Starbucks' stateless income tax planning (*Through a Latte, Darkly*). The recent Belgian "excess profits" ruling by the EC, holding that a Belgian system that gave multinational firms a discount on their Belgian tax bill was illegal, also relied on the idea that the system operated as state aid to induce firms to locate operations in Belgium.²⁴ The majority of

²³ "[T]ax rulings may constitute illegal State aid if they provide favorable tax treatment to specific taxpayers that deviate from the issuing jurisdiction's normal tax rules or tax regimes, and may therefore be viewed as according favorable tax treatment to a specific taxpayer or industry." *European Commission Concludes that Starbucks and Fiat Tax Rulings Constitute Illegal State Aid and Orders Payment of Back Taxes*, <http://tinyurl.com/hpww2oh>, at 2.

²⁴ <http://www.telegraph.co.uk/finance/newsbysector/industry/12092808/Belgian-sweetheart-tax-deals-are-illegal-says-EU.html>

affected firms in that ruling were European. Whether by serendipity or the EC's careful timing, the unfair targeting argument falls of its own weight.

The state aid cases are further described by apologists for U.S. multinationals as exercises in bad faith, or extralegal takings, or retroactive changes in tax rules, or as the EU impermissibly meddling in the tax affairs of a member state (which is not permitted under the EU constitution). But I think that the facts – or more accurately the alleged facts – belie the most excited of these claims. As I read the EC's 2014 preliminary report on its state aid investigation of Ireland and Apple, for example, the EC's argument is that these agreements were not tax administration agreements at all – they were shams designed to resemble tax agreements so as to deliver state aid in a manner that would on their face pass muster as confidential tax cases solely within the purview of a member state. As reported by the EC, in its APA process Apple did not produce comparables or propose a transfer pricing methodology so much as it simply negotiated to a number. Apple described how many employees it maintained in Ireland, observed that it was reviewing its worldwide operations, and then negotiated an APA that in part was “reverse engineered so as to arrive at a taxable income of around USD [28-38] million, although [this figure] does not have any economic basis.”²⁵

It may be that that the EC's preliminary allegations are false, or that by the time it releases its actual decision in the Apple and other cases the EC will have refined its argument in some other direction. But regardless, Apple or any other affected firm has the same rights and remedies (including appeal to the European Court of Justice) as does any European company.²⁶ The fact that the EC has not previously made such arguments overlooks the fact that, as best I understand matters, the EC had no notice of the existence

²⁵ State aid SA.38373 (2014/C) (ex 2014/NN) (ex 2014/CP) – Ireland Alleged aid to Apple, Recitals 36, 37, 62 (http://ec.europa.eu/competition/state_aid/cases/253200/253200_1582634_87_2.pdf). See also Omri Marian, *The State Administration of International Tax Avoidance*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2685642 (analysis of Luxembourg APA agreements).

²⁶ See note 5, *supra*.

of these aggressive applications of the transfer pricing process until 2013. Further, restrictions on state aid have been an integral part of the EU treaty for decades.

Like the United States, Europe honors the rule of law. I doubt that the claims in the state aid cases are any more surprising to affected firms than were the reactions of taxpayers and the Internal Revenue Service alike to *Arkansas Best v. Commissioner*, in which the Supreme Court held that decades' worth of settled law on the taxation of business hedges were all based on the misapprehension of an earlier Supreme Court case, thereby changing the operation of U.S. tax law in this area retroactively for all open years.

International Tax Reform Begins at Home.

Finally, I want to return to the important work that this Committee has done on the structure of international tax reform. The more I reflect on matters, however, the more I am convinced that the most important underlying international tax design issues actually are not territorial vs worldwide rules for foreign direct investment, but first and foremost, domestic tax rates, and second, the tax-induced incentives to overleverage U.S. businesses.

The United States is by far the largest exporter of foreign direct investment capital in the world. In 2014, and ignoring the Netherlands and Luxembourg, as artifacts of artificial tax planning as much as real investment, the United States held more than three times as much outbound foreign direct investment as did the second biggest exporter of foreign direct investment, the United Kingdom.²⁷ This is consistent with the theme that outbound international tax reform is a vital priority.

But the United States also is the largest *importer* of foreign direct investment from other countries in the world. Again in 2014 (and with the same caveat) the United States accounted for \$2.9 trillion in inbound foreign direct investment; mainland China was second, with \$2.3 trillion.²⁸ In this respect alone, then, international tax reform

²⁷ International Monetary Fund, Coordinated Direct Investment Survey Database, <http://data.imf.org/?sk=40313609-F037-48C1-84B1-E1F1CE54D6D5&slid=1390030109571>.

²⁸ *Id.*

should involve rethinking the attractiveness of the United States as a *source* country – as a place *in which* to invest, not just a jurisdiction from which to invest.

But of course domestic corporate tax rates are much more important than just this. Lower domestic corporate tax rates make investing in the United States by both foreign investors and by U.S. persons or firms more attractive. And with more investment comes more national income, more jobs, and better paying jobs.

We know that the U.S. statutory corporate tax rate is the highest in the OECD. The first part of this testimony has demonstrated that the statutory U.S. rate is largely *irrelevant* to the foreign operations of U.S. firms (except insofar as it distorts investment decisions, as described below). But it is highly relevant to domestic investments by foreign or domestic investors, because, regardless of tax preferences (other than the domestic manufacturing deduction afforded by section 199), it is the marginal tax rate imposed on successful U.S. businesses, particularly services businesses.

These points attract bipartisan agreement; the President has called for lower domestic corporate tax rates, for example. The United States will never compete with Ireland in respect of its corporate tax rate, but it does not need to. The United States offers access to the world's largest national consumer market and the world's best large economy business environment, when all relevant factors (such as labor flexibility) are taken into account.

I therefore find it odd that the U.S. tax rules for outbound foreign direct investment should attract so much attention, while the rules for inbound foreign direct investment and for investment by domestic investors and firms are asked to play second fiddle. Corporate tax rates inside the United States should be our highest priority for these reasons alone.

But there is still more at stake. High domestic corporate tax rates stoke the corporate flames both to relocate real investments and artificially to shift reported income from the United States to lower tax countries. A lower domestic U.S. tax environment reduces the returns to these noneconomic activities. The U.S. domestic corporate tax rate thus is important even in a territorial tax environment for outbound foreign direct investment, because the rate differential will be one relevant factor in measuring the

relative attractiveness of the United States and a foreign jurisdiction as the site of real business activity, as well as the payoffs to artificial profit shifting. For the same reason, a lower domestic rate reduces to some extent the long-term attractiveness of inversions or stateless income planning, even under current law (because the residual tax burden on repatriations goes down commensurately).

Admittedly, a lower U.S. tax rate by itself will not eliminate base erosion and profit shifting by U.S. multinational firms. The recent working paper by three economists at the Joint Committee on Taxation that I cited earlier emphasizes the nonlinearity of firm responses to tax rates: as a jurisdiction's tax rates approach zero, tax shifting to that jurisdiction ramps up exponentially. But lower domestic rates are directly relevant to firm decisions as to where to site real investment, and can help somewhat to soften firms' hunger for base erosion and profit shifting strategies.²⁹

All these points are redoubled when our overgenerous rules for the deductibility of interest are taken into account.³⁰ First, simply reducing the corporate tax rate without anything more reduces the tax-induced preference for debt financing, because the value of an interest deduction goes down as the the tax rate goes down.

Today, the combination of accelerated depreciation and interest deductibility lead to *negative* effective tax rates on marginal investments in equipment – we *pay* companies to make those investments. This is not a loopy or partisan claim; both the Treasury Department and the Congressional Budget Office came to this conclusion in separate studies during the George W. Bush administration, and the Congressional Budget Office has reaffirmed this point in 2014. So our high statutory tax rate is applied to a narrow

²⁹ Tim Dowd, Paul Landefeld and Anne Moore, *Profit Shifting of U.S. Multinationals*, http://papers.ssrn.com/sol3/Papers.cfm?abstract_id=2711968.

³⁰ The systemic harms of tax law's biases in favor of debt finance are analyzed in Ruud de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, International Monetary Fund Staff Discussion Note SDN/11/11 (May 3, 2011), available at <http://www.imf.org/external/pubs/ft/sdn/2011/sdn1111.pdf>.

base that, when turbocharged with interest deductions, leads to precisely the opposite result than that which might be expected.

Overgenerous interest deductibility erodes our domestic corporate tax base in at least three more ways. First, as the earlier example of Apple's bond deal showed, U.S. multinationals today can obtain results that effectively amount to tax-free repatriations of offshore cash (or better), by borrowing in the United States and letting foreign profits ride. Second, the domestic base is eroded through earnings stripping, which again is an arbitrage operation designed to bridge the difference between the U.S. domestic tax rate and a foreign rate; lowering the domestic tax rate and restricting interest deductions paid to offshore affiliates work together to keep taxable profits where the income in fact is earned – the United States.

And finally, our overgenerous rules for interest deductibility lead in general to the overleveraging of U.S. domestic corporations, again eroding the U.S. domestic tax base (because many fixed income investors are tax exempt). At least as important for the economy as a whole, the overleveraging of American businesses makes firms more fragile, with all the attendant dislocations that follow when in stressful circumstances many of them fail.

In the end, corporate or business tax reform will require more than “loophole closing” or revoking tax expenditures to make the numbers work. The missing piece is interest deductibility. A real “thin capitalization” law that operates domestically as well as in cross border cases to constrain a firm's total interest deductions relative to its income not only will bridge the missing revenue gap that this Committee will face, but also will constrain all the other pernicious effects of leveraging outlined above.

For the reasons outlined in this testimony, I recommend that this Committee takes as its most urgent responsibility patching the inversion, earnings stripping and hopscotch lending revenue leaks I described earlier, so that there is a corporate tax system left to reform. Moving forward from there, and although my recommendation may seem backwards, I believe that the most important first step in broader international reform is to make the United States a more congenial tax environment for inbound and domestic investment, through a lower domestic corporate income tax rate and general limitations

on interest deductibility, to limit the effects of domestic base erosion.³¹ These moves will not eliminate the need to redesign the outbound foreign direct investment international tax system, but they should come first simply because they are more important to U.S. businesses, and to American taxpayers, taken as a whole.

³¹ I have a more comprehensive idea for fundamental business income tax reform that I believe should gain bipartisan interest, called the Dual Business Enterprise Income Tax, which I would be pleased to discuss with the Committee and its staff.

‘Competitiveness’ Has Nothing to Do With It

By Edward D. Kleinbard



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

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

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The Competitiveness Narrative

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

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

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

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

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

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

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

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

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

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

But all this is a false narrative: U.S. multinationals’ competitiveness arguments are almost entirely fact free. My reasoning is laid out in painful detail in my article “Stateless Income.”⁵ Very briefly, so-

phisticated U.S. firms operate today, not under a worldwide tax system, but rather in an ersatz territorial tax environment, without any of the antiabuse rules that a thoughtful territorial tax system would impose, but subject to a bizarre constraint that they must park their foreign earnings offshore to remain within the ersatz territorial regime. This means that in practice, U.S. firms *do* capture the benefit of operating in lower-tax jurisdictions, both as a cash tax matter and — more importantly — for purposes of U.S. generally accepted accounting principles, which is the lens through which investors and corporate executives measure a firm’s performance.

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

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

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

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

⁵Edward D. Kleinbard, “Stateless Income,” 11 *Fla. Tax Rev.* 699 (2011). This was the first of three articles studying the phenomenon. Kleinbard, “The Lessons of Stateless Income,” 65 *Tax L. Rev.* 99 (2011), extended the analysis to consider the

(Footnote continued in next column.)

economic efficiency consequences of stateless income and possible policy responses. Kleinbard, “Through a Latte Darkly: Starbucks’s Stateless Income Tax Planning,” *Tax Notes*, June 24, 2013, p. 1515, was a case study of one well-known firm; in light of Starbucks’s business model as a high-street face-to-face retailer, the article concluded that if Starbucks can generate stateless income, anyone can. Condensed versions of the first two articles were published as Kleinbard, “Stateless Income’s Challenge to Tax Policy,” *Tax Notes*, Sept. 5, 2011, p. 1021; and Kleinbard, “Stateless Income’s Challenge to Tax Policy, Part 2,” *Tax Notes*, Sept. 17, 2012, p. 1431.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

There are several answers that explain the difference in outcomes, but putting aside audits and

potential disagreements as to the interpretation of the law between the firm and the IRS, the answers basically fall into two groups. First, there are temporary differences, for example when the tax rules for depreciation are different from the financial accounting rules for depreciation. These differences theoretically reverse themselves over time.

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

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

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

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

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

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

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

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

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

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

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

The reduction from the 35 percent statutory tax rate in a firm's effective tax rate reconciliation in the tax footnote for “the effect of foreign operations” or words to that effect thus signals to investors that the company will not in fact pay 35 percent tax on all of

its earnings. It is a discount from the U.S. tax that would have been paid if the United States in fact taxed the worldwide income of the firm, attributable to the fact that (1) the overall group's foreign earnings are not currently taxed in the United States (because the earnings are derived by foreign subsidiaries engaged in active business operations), *and* (2) the firm represents to the accountants that its intentions are to permanently reinvest the earnings outside the United States. As far as investors and management alike are concerned, because this item is a “permanent” difference for GAAP purposes, it serves as a final discount to the nominal U.S. federal corporate tax rate.

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

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

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

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

¹³*Id.* at 745-746.

statutory corporate tax rate) or some greater rate, but 16.2 percent in 2013, 20 percent in 2012, and 17.7 percent in 2011.¹⁴

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

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

We would have a clearer window into Mylan's actual foreign effective tax rate if it more faithfully complied with the SEC requirement that it identify in its tax footnote the U.S. tax cost of repatriating its offshore cash (from which one can deduce the quantum of foreign tax credits that would come along with the repatriation), but like the vast ma-

jority of companies in this situation, Mylan modestly avers that calculating this number is "not practicable."

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

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

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

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

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

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

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

¹⁷See *supra* note 11.

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

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

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

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

If this conclusion seems incredible, ask yourself this: Why is it that following the first rush of self-inversions more than a decade ago, inversions have been so infrequent relative to cross-border mergers and acquisitions activity generally over the last decade (that is, since the introduction of section 7874), until this year?²⁰ How have most U.S. multi-

nationals managed to compete for the last decade if inversions alone are the economically compelled self-help route to a competitive tax environment? Something else must be going on to explain why U.S. firms believed themselves to be competitive from 2004 to 2013, and only now are scouring the earth for suitable bite-sized merger partners to use as inversion vehicles.

A Competitiveness Fable

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

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

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

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

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

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

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

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

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

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

(Footnote continued in next column.)

billion, but ultimately Schneider acquired APC by offering a bid in excess of \$6 billion.

Why was Schneider willing to offer more? Schneider outbid us because France's tax code — typical of most OECD countries — exempts 95 percent of foreign-source income from taxation, while the U.S. tax code fully taxes such income. APC's profits were worth more to Schneider because, once absorbed, APC's global profits (net of the taxes paid in the countries where those profits were earned) could be repatriated to Schneider's headquarters in France, where they would be taxed at less than 2 percent.

In contrast, earnings repatriated to the U.S. are subject to a tax rate of nearly 40 percent, with a credit for taxes paid abroad on that income. That dramatic difference made it possible for Schneider to offer more for APC. So what had once been an American company became French.

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

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

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

²⁴Lex column, *Financial Times*, Oct. 30, 2006. A parallel story helpfully observed that "margins at APC are under pressure, (Footnote continued in next column.)

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

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

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

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

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

cash conversion is poor, rising raw material costs pose an ongoing threat, while projected cost synergies [in the Schneider deal] look aggressive."

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

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

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

²⁸*Id.*

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

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

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

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

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

As a cash tax matter, Galvin observes that the repatriation to France of APC's earnings through dividends would be subject to only a 2 percent French tax. This ignores the full 35 percent U.S. federal income tax that (in Galvin's telling) would be imposed on APC's domestic and foreign earnings, when those foreign earnings were distributed

up the chain, plus a 5 percent U.S. withholding tax on dividends from APC to Schneider (before the 2009 amendment to the France-U.S. tax treaty). It further ignores the fact that dividends from APC to Emerson would have been entirely tax free because APC would have been a member of the Emerson consolidated group.

Where is the tax disadvantage there?

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

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

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

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

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

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

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

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

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

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

As it happens, history appears to have proved Schneider's judgment to be correct. By the time

Schneider published its 2006 annual report, filed with its French securities regulators in March 2007, its CEO reported that:

APC is now part of Schneider Electric. It is the global leader in integrated critical power and cooling systems, with 2006 revenue of close to \$2.4 billion — a 20 percent increase from 2005.

This transaction gives Schneider Electric world leadership in one of the fastest growing areas of electrical distribution. . . . We've created a critical power and cooling services business unit that combines APC's resources with those of Schneider Electric subsidiary MGE UPS Systems. Their people have been brought together under a single management team.

We confirm our synergy target of \$220 million. If we meet this target — and we fully intend to do so — the value created will total \$3.3 billion.³⁴

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

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

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

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

³⁴Schneider Electric SA 2006 Annual Report, at 6.

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

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

What Really Is Going On?

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

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

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

The convergence of these two phenomena led to an explosion in stateless income strategies and in the total stockpile of U.S. multinationals' permanently reinvested earnings. But U.S. multinationals

are now hoist by their own petard. The best of the stateless income planners are drowning in low-taxed overseas cash, which today earns only negligible rates of interest. The meager earnings on the cash drag down earnings per share, while shareholders focus with laser intensity on that cash as more usefully deployed directly in their hands.

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

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

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

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

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

³⁸"Inverse Logic," *supra* note 1.

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

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

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

preciation, and amortization.³⁹ After depreciation and amortization reduce what remains, there are slim pickings left for the U.S. Treasury.

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

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

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

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

³⁹Sullivan, “The Many Ways to Limit Earnings Stripping,” *Tax Notes*, July 28, 2014, p. 377.

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

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

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

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

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

This third explanation has some explanatory power to it, but it is often overstated. The argument essentially is the one offered by Bresch of Mylan. Implicit in her competitiveness explanation for inversions is the idea that firms domiciled outside the United States today have an even easier time than do U.S. firms of generating stateless income, and that it is desirable to encourage an ever-accelerating slide down a slippery slope to negligible tax rates on multinational firms. In many cases, however (for example, the Schneider example discussed earlier), the claim that multinationals domiciled in other jurisdictions are making out even better than U.S. firms is not easily demonstrated, and it ignores anti-base-erosion developments like the OECD's BEPS project or the EU's common consolidated corporate tax base. The second leg to Bresch's argument essentially is analogous to claiming that if one country engages in export subsidies, all countries should. We have gotten past that race to the bottom in trade and in explicit subsidies, and it is

time we did so as well for tax mercantilist behaviors by sovereigns. Finally, this argument plainly would lead to economic distortions in markets where multinationals compete with domestic competitors in their own markets, since firms like Mylan already enjoy global effective tax rates lower than those imposed on wholly domestic firms in most of the markets in which these multinationals actually do business.⁴³

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

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

What Then Should We Do?

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

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

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

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

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

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

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

The second component, which has very recently gained traction among some members of Congress, is to lower the excessively generous ceiling that section 163(j) sets on the quantum of U.S. corporate tax base erosion that we will tolerate regarding U.S. domestic earnings. Martin A. Sullivan recently published a description of 10 different proposals to bolster section 163(j) that have been offered to Congress since 2002.⁴⁴ Congress should choose one already and just do it.

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

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

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

⁴⁴Sullivan, *supra* note 39.

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

⁴⁶*Id.*

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

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

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

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

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

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

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