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Reinterpreting Corporate Inversions: Non-Tax Competitions and Frictions

ABSTRACT. Corporate inversions have drawn outrage from all segments of society. In an inversion, a company reincorporates abroad to escape its U.S. tax burden. Regulators and academics have typically sought tax law solutions to curb tax inversions. However, the resulting tax regulations have been ineffective, while more radical tax reforms are not politically feasible. This Note argues that inversion is not a tax problem in isolation, but a problem of aligning tax paid with benefits conferred by a given country. By introducing non-tax dimensions into the equation, this Note refines the oft-ignored benefit tax theory. The benefit tax theory proposes that the U.S. corporate tax regime accounts for superior legal and nonlegal benefits that companies enjoy by incorporating or operating in the United States. While paying U.S. tax, corporations receive the benefits of corporate governance, securities regulation, intellectual property law, and other areas of law; furthermore, benefits include many nonlegal business factors such as access to a large consumption market, skilled labor pool, capital markets, and more.

This Note classifies the relevant benefits into three categories: Type I benefits, which corporations enjoy regardless of their place of incorporation or operation; Type II benefits, which corporations enjoy only if they are incorporated in the United States; and Type III benefits, which corporations enjoy by having operations in the United States. Using this classification, this Note builds a novel multi-dimensional regulatory competition model wherein countries compete across various legal and nonlegal dimensions, as opposed to the one-dimensional tax competition model on which inversion scholars have typically relied.

The benefit tax theory and the multi-dimensional competition model illustrate that the problem with inversions is that corporations continue to take advantage of Type III benefits offered by the United States while paying lower tax elsewhere to a non-U.S. country. Inversion is problematic precisely because of the unbundling of certain Type III benefits from the rest of U.S. tax law. Understanding the inversion problem in this way leads to a clear solution: a better bundling of the U.S. tax law with the Type III benefits provided by the United States.

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INTRODUCTION

On November 23, 2015, two pharmaceutical giants—the U.S. company Pfizer and the Irish company Allergan—announced that they had signed a $160 billion merger agreement.[1] The combined company would manufacture many popular pharmaceutical products, including Botox, Viagra, Prevnar pneumonia vaccines, and treatments for Alzheimer's and arthritis, with total annual sales of over $65 billion.[2] The size of this deal alone was noteworthy: in the history of mergers, there have been only six deals larger than $100 billion in size.[3] The deal drew considerable criticism, earning the label of "the biggest ever tax inversion."[4]

A tax inversion is the re-incorporation of a company overseas for the purpose of reducing the tax burden on foreign-source and domestic-source income.[5] Typically, a U.S. multinational corporation—in this case, Pfizer—acts as an "inverting company" and acquires a smaller foreign company—here, Allergan—from a lower tax jurisdiction such as Ireland, Luxembourg, the Netherlands, or the United Kingdom.[6] The combined entity is then incorporated abroad in the target's foreign jurisdiction with a lower tax rate, but almost nothing else changes; the inverting company's operations and management remain largely identical.[7] While the inverted company de facto continues to operate like an American company, it is formally an Irish company that pays tax according to Irish law.

The tax savings can be enormous. Through inversion, Allergan reportedly would have been able to avoid $21.1 billion to $35 billion in U.S. tax with re-

1. *See* Geoffrey Smith & Claire Groden, *Pfizer, Allergan Confirm $160 Billion Merger Deal*, FORTUNE (Nov. 23, 2015, 8:00 AM), http://fortune.com/2015/11/23/pfizer-allergan-merger [http://perma.cc/LY2N-QU3B].

2. *Id.*

3. *See* Himanshu Goenka, *Global M&A Activity in 2015 Worth $4.28 Trillion, Highest Ever*, INT'L BUS. TIMES (Jan. 8, 2016, 3:32 AM), http://www.ibtimes.com/global-ma-activity-2015-worth-428-trillion-highest-ever-2256183 [http://perma.cc/FR2E-SG4K].

4. *See* Smith & Groden, *supra* note 1.

5. *Corporate Inversion*, INVESTOPEDIA, http://www.investopedia.com/terms/c/corporateinversion.asp [http://perma.cc/3CGZ-GVHS].

6. *See* Cathy Hwang, *The New Corporate Migration: Tax Diversion Through Inversion*, 80 BROOK. L. REV. 807, 812 (2015).

7. *See Developments in the Law: Jobs and Borders*, 118 HARV. L. REV. 2170, 2273-74 (2005) [hereinafter *Developments*].

spect to its accumulated retained earnings from foreign operations.[8] Commentators estimate that inversions generally cost the U.S. government billions of dollars of annual tax revenue.[9] For that reason, tax inversions often draw heavy criticism. President Barack Obama described inversions as damaging to the country's finances.[10] He stated, "[S]topping companies from renouncing their citizenship just to get out of paying their fair share of taxes is something that cannot wait."[11] Senator Bernie Sanders called inversions "nothing less than a tax scam,"[12] and then-presidential candidate Donald Trump denounced the Pfizer-Allergan deal as "disgusting."[13] Senator John McCain has labeled Ireland a tax haven, criticizing inversion practices.[14]

In response to the inversion problem, Congress has proposed numerous bills—only one of which became law[15]—and the Department of Treasury and the Internal Revenue Service (IRS) have implemented several regulations that attempt to fight inversion practices. Some of these have had narrow success, but for the most part, this approach has been piecemeal and ineffective.[16] For instance, Treasury and the IRS promulgated joint regulations on April 4, 2016[17] that directly targeted the Allergen-Pfizer merger—without mentioning the parties' names—which broke up the deal on April 6, 2016. However, these regula-

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8. *See* Lynnley Browning, *Pfizer Seen Avoiding $35 Billion in Tax via Allergan Merger*, BLOOMBERG POL. (Feb. 25, 2016, 1:24 PM), http://www.bloomberg.com/politics/articles/2016-02-25/pfizer-seen-as-avoiding-35-billion-in-tax-via-allergan-merger [http://perma.cc/H4H9-4W59].

9. *See, e.g.*, Melissa Lucar, *Corporate Inversions: The Fleeing Notion of an American Corporation*, 15 U.C. DAVIS BUS. L.J. 265, 273 (2015); Sarah A. Wahl, Note, *The Three Legislative Components Necessary To Curb Corporate Tax Inversions*, 19 N.C. BANKING INST. 297, 299 (2015).

10. *See* Press Release, President Barack Obama, Weekly Presidential Address: Closing Corporate Tax Loopholes (July 26, 2014), http://www.whitehouse.gov/the-press-office/2014/07/26/weekly-address-closing-corporate-tax-loopholes [http://perma.cc/TWK8-YH6S].

11. *Id.*

12. Letter from Bernard Sanders, U.S. Senator, to Jack Lew, Sec'y, Dep't of Treasury (Mar. 18, 2016), http://www.sanders.senate.gov/download/sanders-treasury-pfizer-letter?inline=file [http://perma.cc/RVP3-GKXN].

13. Dara Doyle, *Ireland Will Be Just Fine Without Allergan and Pfizer*, BLOOMBERG (Apr. 6, 2016), http://www.bloomberg.com/news/articles/2016-04-06/death-of-pfizer-allergan-mega-deal-no-great-loss-for-ireland [http://perma.cc/8DN9-V4R5].

14. *See id.*

15. *See infra* Section I.C.

16. *See infra* Part I.

17. *See Fact Sheet: Treasury Issues Inversion Regulations and Proposed Earnings Stripping Regulations*, U.S. DEP'T TREASURY (Apr. 4, 2016) [hereinafter *Fact Sheet*], http://www.treasury.gov/press-center/press-releases/Pages/jl0404.aspx [http://perma.cc/J46W-V72A].

tions are hardly solutions to the inversion problem because they are ad hoc, ex post, and narrowly targeted at individual deals.

The bottom line is that there has been a surge of inversions in the past decade,[18] the deals have grown in size,[19] and the tactics have become cleverer. In 2014, several U.S. firms with a combined worth of more than $500 billion announced their intention to invert.[20] And every time a new bill is passed or a new regulation is promulgated to curb inversions, corporations have circumvented the new obstacles by exploiting loopholes and utilizing ingenious inversion strategies.[21] This history of a cat-and-mouse game has led to wider reform proposals by politicians, regulators, and academics to fix the fundamental problems of the U.S. tax system by tightening eligibility criteria for reaping the tax benefits of inversion,[22] moving the country's tax regime to a territorial tax system from a worldwide income tax system,[23] declaring another tax holiday for corporate repatriations,[24] or reducing American corporate tax rates.[25]

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18. *See* Press Release, Ways & Means Comm. Democrats, U.S. House of Representatives, New CRS Data: 47 Corp. Inversions in Last Decade (July 7, 2014), http://democrats-waysandmeans.house.gov/media-center/press-releases/new-crs-data-47-corporate-inversions-last-decade [http://perma.cc/FS8Y-U4YM].

19. *See* DONALD J. MARPLES & JANE G. GRAVELLE, CONG. RESEARCH SERV., R43568, CORPORATE EXPATRIATION, INVERSIONS, AND MERGERS: TAX ISSUES 1-2 (2014) (noting the interest of many high-profile companies in merging with non-U.S. firms).

20. Anton Babkin, Brent Glover & Oliver Levine, *Are Corporate Inversions Good for Shareholders?*, J. FIN. ECON. (forthcoming 2017) (manuscript at 1), http://ssrn.com/abstract=2700987 [http://perma.cc/86EH-2EV5].

21. *See infra* Part I.

22. *See, e.g.*, Stop Corporate Inversions Act of 2014, S. 2360, 113th Cong. (2014).

23. *See, e.g.*, Mihir A. Desai, *A Better Way to Tax U.S. Businesses*, HARV. BUS. REV., July-Aug. 2012, http://hbr.org/2012/07/a-better-way-to-tax-us-businesses [http://perma.cc/UF8Q-DJP3]; Mike Lee, *Economic Growth and Family Fairness Tax Reform Plan*, U.S. SENATE 12 (2015), http://www.scribd.com/document/257656525/A-Pro-Growth-Pro-Family-Tax-Reform-Plan [http://perma.cc/AHM6-MJ57].

24. *See, e.g.*, James Hohmann, *Paul Seeks Corporate Tax Deal with Obama*, POLITICO (Jan. 20, 2015, 7:59 PM), http://www.politico.com/story/2015/01/rand-paul-corporate-tax-deal-obama-114413.html [http://perma.cc/62AH-THLD].

25. *See, e.g.*, N. Gregory Mankiw, *One Way To Fix the Corporate Tax: Repeal It*, N.Y. TIMES (Aug. 23, 2014), http://www.nytimes.com/2014/08/24/upshot/one-way-to-fix-the-corporate-tax-repeal-it.html [http://perma.cc/W8BX-RHJH] (advocating for a zero percent corporate tax rate with a broad tax on consumption). The Obama Administration's 2016 Budget proposed a modest reduction (to twenty-eight percent), along with a flat tax on offshore income. *See* OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2016, at 56-57 (2015), http://www.whitehouse.gov/sites/default/files/omb/budget/fy2016/assets/budget.pdf [http://perma.cc/MV6K-D98Q].

There are indeed fundamental problems with the U.S. international tax system, as it is distortionary and inefficient. And some of the proposals to our tax system have merits and deserve attention. However, focusing solely on the tax dimension and tax proposal is problematic for at least two reasons.

First, it is unlikely that we can radically fix the corporate tax system in the current U.S. context. Democrats and Republicans agree that inversions need to be curbed but disagree on what needs to be done.[26] Republicans typically think the only solution is a full overhaul of the tax system, such as lowering the U.S. corporate tax rate. In contrast, Democrats tend to believe that the focus should be on anti-inversion legislation.[27] Meanwhile, changing the U.S. worldwide income tax regime to a territorial tax regime is a radical idea that is somewhat unrealistic in our current political setting. Facing congressional deadlock and an inability to enact sweeping reforms, the Obama Administration relied on administrative regulations and notices to stymie inversion deals in an ad hoc manner, but these efforts proved too piecemeal and ad hoc to provide a comprehensive solution to the general phenomenon of inversions.

Second, even conceding that tax solutions could be feasible due to the recent change in administration, this approach is still incomplete. For both academic and public policy reasons, we should develop a holistic understanding of inversions as not just a tax problem, but also a non-tax issue. The current proposals focusing on the tax dimension fail to capture the full picture of what is wrong with inversions, limiting the set of tools that are available for addressing the problem.

Given these two premises, I argue that inversions are not simply a tax problem in isolation, but a problem of *aligning tax paid with benefits conferred by a given country*. That is, addressing inversions by overhauling the tax system is one possible solution, but another equally efficient way to realign form with substance and resolve the tension underlying the inversion problem is to look beyond the "cost" side (i.e., tax) to the "benefit" side (i.e., other areas of law) of the equation. This model shows that the inversion problem is not just a cost-side problem but also a benefit-side problem. The case for non-tax solutions is grounded not only in the infeasibility of tax solutions, but more importantly, in the existence of holistic alternative approaches to address the inversion problem.

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26. *See* Wahl, *supra* note 9, at 301.

27. *See* Zachary Mider & Jesse Drucker, *Tax Inversion: How U.S. Companies Buy Tax Breaks*, BLOOMBERGQUICKTAKE (Apr. 6, 2016, 5:15 PM), http://www.bloombergview.com/quicktake/tax-inversion [http://perma.cc/J9HV-65H4].

This Note unpacks this argument in four Parts. Part I provides a descriptive account of the history of inversions, focusing on the cat-and-mouse game between inverting companies and the Treasury. Part II evaluates various arguments for and against inversions and contends that the real reason for curbing inversions should be grounded in the normative view that inverted companies that continue to derive legal and nonlegal benefits from the United States should pay tax corresponding to those benefits. In Part II, this benefit tax theory, previously less explored in the literature, is refined and applied in the inversion context, serving as a guiding principle for the remainder of the Note.

Highlighting the limits of relying on the one-dimensional tax competition model,[28] Part III builds a multi-dimensional competition model where countries compete along legal and nonlegal axes—tax law, securities law, corporate law, bankruptcy law, international treaty protections, other areas of law, and nonlegal business factors—to attract companies. Part III proposes a framework for classifying those benefits into three categories: Type I benefits, which corporations enjoy regardless of their place of incorporation or operation; Type II benefits, which corporations enjoy only if they are incorporated in the United States; and Type III benefits, which corporations enjoy by virtue of having operations in the United States. The problem with an inversion is that it allows the inverting company to cherry-pick the foreign tax regime and Type III benefits offered by the United States, effectively unbundling some Type III benefits from tax law. Under a benefit tax theory framework, companies that continue to enjoy legal and nonlegal benefits offered by the United States should pay tax according to American law for enjoying those benefits. Therefore, bundling tax law with legal and nonlegal business factors is both desirable and necessary to deter inversions.

Part IV discusses the policy implications of the multi-dimensional competition model. Specifically, I contend that bundling can be achieved by subjecting inverting corporations to non-tax "frictions," which attach non-tax costs to abusive tax planning schemes.[29] In this case, the sources of frictions are the denial of Type III or Type I benefits to inverting countries. For instance, companies could face the prospect of being delisted from the New York Stock Ex-

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28. There are very few exceptions to the observation that scholars typically rely on the one-dimensional tax competition model. This Note distinguishes itself from those exceptions. *See, e.g.*, Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573 (2000); Eric L. Talley, *Corporate Inversions and the Unbundling of Regulatory Competition*, 101 VA. L. REV. 1649 (2015).

29. *See, e.g.*, Leigh Osofsky, *Who's Naughty and Who's Nice? Frictions, Screening, and Tax Law Design*, 61 BUFF. L. REV. 1057, 1058-74 (2013); David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1323-38 (2001).

change (NYSE) upon inverting, which would be the equivalent of losing a Type I benefit. The overarching purpose of this Note is to offer various policy levers to regulators and policymakers when their tax lever is unusable or ineffective.

I. HISTORY OF INVERSIONS: A CAT-AND-MOUSE GAME

Most moderately-sized and large corporations are subject to the thirty-five percent marginal tax rate in the United States. Including state corporate taxes, which can range from zero percent to nine percent depending on the state, most U.S. corporations face a marginal tax rate of approximately forty percent.[30] The statutory tax rate has always been higher in the United States than in other countries, and this gap has widened in recent years.[31] As of now, the statutory tax rates for Ireland, the United Kingdom, and the Netherlands stand at 12.5%, 21%, and 25%, respectively.[32] As of 2010, the U.S. effective average tax rate was estimated to be around 29.0%, in contrast to estimates of 10.9%, 22.3%, and 19.4% for Ireland, the United Kingdom, and the Netherlands, respectively.[33]

Corporations invert for two reasons. First, companies want to reduce their tax liability based on income generated *outside* the United States by avoiding both the U.S. worldwide tax regime and the repatriation tax, which they pay upon bringing offshore cash back to the United States.[34] Currently, the total offshore cash that is not repatriated back for tax deferral purposes adds up to more than $1 trillion.[35] Second, companies want to reduce their tax liability

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30. *Corporate Tax Rates Table*, KPMG, http://www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.aspx [http://perma.cc/U4HF-UDR3].

31. Talley, *supra* note 28, at 1660.

32. *See Corporate Tax Rates Table*, *supra* note 30.

33. *See* Kevin A. Hassett & Aparna Mathur, *Report Card on Effective Corporate Tax Rates: United States Gets an F*, AM. ENTERPRISE INST. FOR PUB. POL'Y RES. 6 tbl.2 (Feb. 2011), http://www.aei.org/wp-content/uploads/2011/10/TPO-2011-01-g.pdf [http://perma.cc/RVS8-5BTM]; *see also Global Effective Tax Rates*, PRICEWATERHOUSECOOPERS 3 tbl.1 (Apr. 14, 2011), http://businessroundtable.org/sites/default/files/Effective_Tax_Rate_Study.pdf [http://perma.cc/KD8V-BZMR] (reporting similar figures).

34. The United States adopts a worldwide tax regime—contrasted with a territorial tax regime—where a domestic corporation gets taxed on all its income, whether the income is generated domestically or is from abroad. *See* I.R.C. § 951 (2012).

35. *See* Edward D. Kleinbard, *'Competitiveness' Has Nothing To Do with It*, 144 TAX NOTES 1055, 1055 (2014).

from income generated *within* the United States by engaging in earning stripping[36] and income shifting[37] after inverting out of the country.

These tax motivations have led to a three-decade cat-and-mouse game between taxpayers and the government that is still ongoing. The historical narrative reveals a repeated pattern of ex post inversion regulations, followed by a wave of inversions that exploit loopholes in the preceding regulations.[38]

A. First Wave: McDermott and IRC §§ 1248(i), 163(j)

The first wave of inversions began with the 1983 McDermott transaction, which was the first major inversion to attract scrutiny from the IRS.[39] McDermott, Inc. performed a stock exchange with McDermott International, a Panamanian subsidiary corporation, whereby the Panamanian parent would wholly own McDermott, Inc.[40] McDermott enjoyed about $200 million in tax savings by avoiding repatriation tax and by stripping U.S.-source earnings.[41]

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36. An inverted, now-foreign company would make inter-company loans to its U.S. subsidiary, and the U.S. subsidiary would repay the loan and deduct interest payments from its taxable income to decrease its U.S. tax burden. *See* I.R.C. § 163 (2012).

37. Under the income shifting scheme, a U.S. company would transfer its assets to the inverted foreign parent or related foreign party in the form of a dividend or a sale. When these assets are intangible assets—such as intellectual property, software copyrights, or patents—that generate royalty income and are portable, the transfer of assets in such a related party transaction means shifting income outside of the United States. During the transfer process, valuation is difficult, and so the parties would report the transfer price in the most advantageous way possible to lower taxes. Furthermore, when the right to use such intangible assets is shared between a U.S. corporation and its foreign related party, the allocation of income generated from such intangible assets is difficult due to a valuation problem, and parties would try to lower the income to the U.S. company as much as they could.

38. Essentially, inversions are purely tax-driven. In the landmark case *Gregory v. Helvering*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935), Judge Learned Hand wrote that "one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." However, he ruled against the taxpayer for engaging in a tax evasion scheme involving a reorganization that completely lacked substance. *Id.* at 811. The Supreme Court affirmed Judge Hand's ruling, and the decision gave birth to the substance-over-form doctrine: when the doctrine is invoked, a taxpayer is bound by the economic substance of a transaction where the economic substance varies from its legal form. *See* 293 U.S. at 465-70.

39. *See* Orsolya Kun, *Corporate Inversions: The Interplay of Tax, Corporate, and Economic Implications*, 29 DEL. J. CORP. L. 313, 315-16 (2004).

40. The transaction was motivated by the desire to repatriate the offshore cash sitting on its Panamanian subsidiary without being subject to U.S. worldwide corporate income tax. Furthermore, the company engaged in earnings stripping to lower the taxable income generated within the United States. *See* Derek E. Anderson, *Turning the Corporate Inversion Transaction*

In response, Congress enacted an anti-inversion provision in Internal Revenue Code (IRC) Section 1248(i), which required ten-percent corporate shareholders of U.S. corporations to recognize gains from the stock exchanges on their individual income taxes.[42] This provision contained a loophole: gain recognition can be avoided by exchanging the U.S. corporation's stock for the stock in a newly formed foreign subsidiary that has no earnings and profits,[43] because a distribution made from a corporation with no earning and profit will not be taxed as a dividend income. Furthermore, Congress enacted Section 163(j) of the IRC to prevent earnings stripping.[44] This anti-stripping provision prohibits deductions of inter-company interest payments made to entities not subject to U.S. taxation.[45] However, there is a way around this provision too, built directly into the rule: when an inverted parent has a U.S. subsidiary with debt-to-equity ratio lower than 1.5 to 1, it can still strip its earnings without violating the anti-stripping provision.

The following Sections will show a repeated pattern of legislative provisions or Treasury regulations prohibiting certain types of inversions ex post, followed by the next wave of inversions exploiting loopholes in those provisions and regulations.

Right Side up: Proposed Legislation in the 108th Congress Aims To Stamp Out Any Economic Vitality of the Corporate Inversion Transaction, 16 FLA. J. INT'L L. 267, 275 (2004).

41. *See* Hal Hicks, *Overview of Inversion Transactions: Selected Historical, Contemporary, and Transactional Perspectives*, 30 TAX NOTES INT'L 899, 904 (2003).

42. *See* I.R.C. § 1248(i) (2012).

43. *See* Joseph A. Tootle, Note, *The Regulation of Corporate Inversions and "Substantial Business Activities*,*"* 33 VA. TAX REV. 353, 365 (2013) (emphasis added).

44. *See* I.R.C. § 163(j)(2). Under the earning-stripping tactic, a now-inverted/foreign parent would issue a lot of inter-company loans to its U.S. subsidiary. Because interest payments on business-related borrowing are deductible, *see* I.R.C. § 163 (2012), the U.S. subsidiary would repay the loan at market interest rates and deduct interest payments from its taxable income to decrease its tax burden. In this scheme, the loan served no business purpose other than to "strip" the taxable income of the borrowing subsidiary that would be subject to the U.S. taxation; tax deductions were made for "interest payments resulting in borrowing from and paying interest to oneself." *Developments*, *supra* note 7, at 2278.

45. *See* I.R.C. § 163(j)(2). It applies when the corporation's debt to equity ratio exceeds 1.5 to 1 and its interest expenses exceed 50% of its adjusted taxable income. *Id.*

B. Second Wave: Helen of Troy and 26 C.F.R. §1.367(a)-3(c)(1)

The second wave of inversions started when Helen of Troy, a U.S. company, inverted into a Bermuda corporation in 1994.[46] Bermuda and the Cayman Islands have no corporate income tax, and so they are attractive destinations for inverting companies seeking to lower their tax liabilities.[47] To avoid the Section 1248(i) gain recognition rule, Helen of Troy exploited the loophole described above by setting up a brand-new paper company in Bermuda that had no earnings and profits.[48]

In response, the IRS promulgated a new regulation under Section 367(a) of the IRC to make "a transfer of stock or securities of a domestic corporation by a U.S. person to a foreign corporation" taxable if (1) the transferors own, in the aggregate, a majority of the inverted foreign corporation, (2) the foreign company has been engaged in an active foreign business outside the United States for 36 months leading up to the transaction, and (3) other technical factors are met.[49] The IRS assumed that, by charging shareholder-level capital gains taxes upon share exchange via Section 367(a), inversions would appear unpalatable to shareholders.[50] Note that this deterrence against shareholders was not an attempt to solve the problem of inversions, but rather, added a small negative incentive against inversions.

C. Third Wave: 1998-2002 Inversions and the Jobs Act of 2004

The Section 367(a) recognition rule promulgated in response to Helen of Troy-type inversions was ineffective. A third wave of inversions came between 1998 and 2002, involving companies like Ingersoll-Rand, Nabors Industries, Noble Drilling, and Cooper Industries.[51] The failure of the existing regulatory

46. *See* Scott DeAngelis, Note, *If You Can't Beat Them, Join Them: The U.S. Solution to the Issue of Corporate Inversions*, 48 VAND. J. TRANSNAT'L L. 1353, 1363 (2015). Unlike McDermott, which had some business relation with Panama before it inverted to Panama, Helen of Troy had no business relationship prior to the inversion, making it the first "pure" inversion ever. Tootle, *supra* note 43, at 366.

47. *See Tax Rates Online*, KPMG, http://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online.html [http://perma.cc/LF52-9DP9].

48. *See* Kun, *supra* note 39, at 318; Tootle, *supra* note 43, at 366.

49. 26 C.F.R. §§ 1.367(a)-3(c)(1) to (3) (2014); *see also* Kun, *supra* note 39, at 316 & n.8 (citing I.R.C. § 367(a)).

50. *See* Hwang, *supra* note 6, at 826.

51. For a full list of corporate inversions up to 2003, see C. Bryan Cloyd et al., *Firm Valuation Effects of the Expatriation of U.S. Corporations to Tax-Haven Countries*, 25 J. AM. TAX ASS'N 87,

deterrence scheme in Section 367(a) was attributable to several factors. First, potential inverters realized the huge benefits of inversions by employing income shifting, transfer pricing, and earning stripping, even if they ran afoul of Section 367(a) and shareholders recognized tax. Empirical studies show that "[third-wave] corporate inversions really made use of intercompany debt to strip earnings from the United States,"[52] and many of them used the 1.5:1 debt-to-equity ratio safe harbor to get around Section 163(j).[53] Second, the capital gain tax imposed on shareholders via Section 367(a) lost its deterrent effect when stock market prices fell in the early 2000s.[54] Because there was no gain to begin with, the gain recognition principle of Section 367(a) became toothless. Third, the taxable nature of the transaction to shareholders via Section 367(a) did not matter to tax-exempt or non-U.S. shareholders.[55]

In reaction to the third wave of inversions, Congress passed the American Jobs Creation Act of 2004, which added Section 7874 to the IRC "to limit inversions to those that are legitimate and not enacted solely for tax purposes."[56] This Code provision remains the centerpiece for how companies structure their inversion transactions.[57]

Section 7874 has two alternative tax regimes for inversions.[58] The first regime applies when the former shareholders of the inverting U.S. company end up owning more than eighty percent of the foreign parent company.[59] In this case, the inverted foreign parent company is treated as a domestic company for taxing purposes, "as if the inversion had *never happened*."[60] The second regime applies when the former shareholders of the inverting U.S. company end up

94 tbl.1 (2003). The study examines data on twenty inversions, seventeen of which were announced from 1998 to 2002.

52. Hwang, *supra* note 6, at 828.

53. Several inverters that inverted in 2001 and 2002 engaged in earnings stripping through intercompany debts to lower effective tax rates. *See* Jim A. Seida & William F. Wempe, *Effective Tax Rate Changes and Earnings Stripping Through Corporate Inversion*, 57 NAT'L TAX J. 805, 806-07 (2004).

54. *See* N.Y. State Bar Ass'n Tax Section, *Outbound Inversion Transactions*, 96 TAX NOTES 127, 130 (2002). Furthermore, often the tax burden is offset by huge share price jumps due to the announcement of an inversion at the prospect of future tax savings. *See* Talley, *supra* note 28, at 1675.

55. *See* Talley, *supra* note 28, at 1674.

56. DeAngelis, *supra* note 46, at 1364.

57. *See* Talley, *supra* note 28, at 1675-76.

58. *See* I.R.C. § 7874(b) (2012).

59. *See id.*

60. *See* DeAngelis, *supra* note 46, at 1364-65 (emphasis added).

owning more than sixty percent but less than eight percent of the foreign parent company.[61] In this case, the parent is treated as a foreign company with additional U.S. tax burdens. In particular, the U.S.-source income over the ten-year period after the inversion is deemed to be at least the "inversion gain,"[62] the inverter's use of certain tax attributes to offset gains in the years after the inversion is limited,[63] and the foreign parent cannot use foreign tax credits or net operating losses to offset any U.S. taxes on gains that apply to transfers of assets to the new entity.[64] On the other hand, if former shareholders of the inverting company end up owning less than sixty percent of the foreign parent company, neither of the regimes in Section 7874 applies and companies can successfully complete inversions without punitive tax consequences.[65]

D. Fourth Wave: Mergers, Notice 2014-52, Notice 2015-79, and April 4, 2016 Treasury Regulations

After Congress passed Section 7874, inversion activities slowed temporarily but picked up again in 2010. The design of Section 7874 made these inversions take the form of mergers. For U.S. assets to be diluted at least forty percent or

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61. I.R.C. § 7874(a).

62. This is measured as the gain recognized on the company's transfer of stock or assets plus certain royalty income from foreign affiliates. *Id.* § 7874(d)(2).

63. *See* Steven M. Surdell, *Inversions 2014—Self-Help International Tax Reform for U.S. Multinationals?*, TAXES, Mar. 2014, at 63, 74-75; *see also* I.R.C. § 7874(d)(2).

64. *See* Eloine Kim, *Corporate Inversion: Will the American Jobs Creation Act of 2004 Reduce the Incentive To Re-Incorporate?*, 4 J. INT'L BUS. & L. 152, 164-65 (2005).

65. Another technical but important feature of Section 7874 is that, regardless of whether an inverting company falls under the first or second regime, if the company already has "substantial business activity" in a foreign country to which it is inverting, the company will be exempt from Section 7874. I.R.C. § 7874(a)(2)(B)(iii). The Treasury issued a series of regulations to define the term "substantial business activity." *See* T.D. 9592, 2012-28 I.R.B. 41; T.D. 9453, 2009-28 I.R.B. 114; T.D. 9265, 2006-27 I.R.B. 1; T.D. 9238, 2006-6 I.R.B. 408. The most recent (and valid as of May 2016) regulation employed a bright-line rule stating that the substantial business activity prong is met when at least 25% of its group employees, employee compensation, group assets, and group income are located or derived in that country. Surdell, *supra* note 63, at 78-79; *see also* Treas. Reg. §§ 1.7874-3(a) to (b)(3) (2015). However, this exemption is rarely met, because "it is unlikely that a significant fraction of a U.S. inverter's ventures will be located in the destination jurisdiction for the transaction." Talley, *supra* note 28, at 1676. "Even some companies that have significant operations abroad may have difficulty meeting the twenty-five percent bright-line rule because the assets of the post-combination company do not include intangible assets in the calculation. Thus, companies with large amounts of assets abroad—but largely comprised of intangible assets—will have trouble meeting the 25% bright-line rule." Hwang, *supra* note 6, at 831 n.123 (citing Surdell, *supra* note 63, at 79).

twenty percent (to pass the sixty percent or eighty percent tests, respectively), U.S. firms need to find merger partners that are big enough to keep the percentage of former-U.S. assets low. These partners are likely to be found in Ireland, Luxembourg, the Netherlands, and the United Kingdom, rather than in Bermuda and the Cayman Islands.

Using the arbitrary sixty percent and eighty percent bright lines as proxies for "economic substance" allows corporations to play games by structuring their inversions to barely escape these formal thresholds. Companies can fall under these thresholds by decreasing the relative size of the inverting company—often the target—and increasing the relative size of the foreign entity—the acquirer. For instance, to decrease its relative size, the U.S. target may pay a "skinny-down dividend": borrowing cash to pay an extraordinary amount of dividends to shareholders in order to reduce its net assets and equity values and make it look smaller.[66] Alternatively, the U.S. target could spin off its divisions to third parties, or engage in "spinversions," where it would move its assets to a newly created foreign subsidiary and then spin off only that foreign subsidiary during an inversion.[67] On the other hand, through a tactic called "cash box," the foreign acquirer can be "puffed up" by aggregating passive assets in retained earnings in order to appear larger before the inversion takes place.[68]

In reaction to the continuing popularity of inversions, legislators in Congress have proposed many bills, none of which have passed the committee stage.[69] In response to Congress's inability to act, the Treasury has acted. Although it could not alter the statutorily set thresholds of sixty percent and eighty percent, the Treasury promulgated Notice 2014-52, Notice 2015-79, and a temporary April 6, 2016 regulation to target the "skinny down," "spinversion," and "cash box" tactics.[70] The April 2016 regulation includes a provision disregarding the bulk-up of U.S. assets by a foreign company in anticipation of a

66. *See* Talley, *supra* note 28, at 1679.

67. *See, e.g.*, Ajay Gupta, *News Analysis: Will PayPal's Spinoff End in an Inversion—or Two?*, 76 TAX NOTES INT'L 188, 193-94 (2014); Michelle Fay Cortez, *Mylan To Add Abbott's Generic-Drug Unit, Cut Tax Rate*, BLOOMBERG BUS. (July 14, 2014, 4:32 PM), http://www.bloomberg.com/news/articles/2014-07-14/abbott-to-sell-generic-drug-unit-to-mylan-for-5-3-billion [http://perma.cc/FT2E-8QUU].

68. *See, e.g.*, William R. Pauls, *Inversion Notice Boxes Out Foreign Insurers and Reinsurers*, 145 TAX NOTES 1259, 1259-61 (2014).

69. *See, e.g.*, Federal Employee Pension Fairness Act of 2014, H.R. 5338, 113th Cong. (2014); No Federal Contracts for Corporate Deserters Act of 2014, H.R. 5278, 113th Cong. (2014); Stop Corporate Expatriation and Invest in America's Infrastructure Act of 2014, H.R. 4985, 113th Cong. (2014); American Jobs for American Infrastructure Act of 2014, S. 2489, 113th Cong. (2014); Stop Corporate Inversions Act of 2014, H.R. 4679, 113th Cong. (2014).

70. *See Fact Sheet*, *supra* note 17.

merger to meet the sixty percent or eighty percent thresholds during the thirty-six months before the inversion. This rule effectively killed the Allergan-Pfizer deal, as Allergan was bulking up to meet the sixty percent test.[71] This latest regulation was motivated in part to specifically kill the Allergan-Pfizer deal in an ad hoc, ex post, and piecemeal manner like the other actions that Congress and the Treasury have taken in this cat-and-mouse game.

E. Ad Hoc, Ex Post, and Piecemeal Approach Is Ineffective

The approaches taken by Congress and the Treasury in reaction to each of the waves of inversions are inadequate for two reasons.

First, the way they are designed—ad hoc and ex post—makes the landscape of international merger transactions uncertain. Companies that try to invert or have legitimate non-tax business purposes in seeking an international merger may worry about the Treasury enacting a regulation that would retrospectively apply to their transaction, sometimes even in between the signing and closing of a deal.[72] Even the Jobs Act, the effectiveness of which is evidenced by its impact on current forms of inversion transactions, has been criticized for not clarifying the line distinguishing legitimate cross-border mergers from inversions.[73] Furthermore, since regulations and Code provisions are reactionary and piecemeal, they add complexity and uncertainty to the law governing inversions and detract from the overarching coherency of the Code.

Second, the recent regulatory solutions have been too piecemeal to solve the issue. The iterative strategies adopted by potential inverters and regulators have shown that companies can devise creative ways to circumvent Code provisions and regulations. Tax scholars agree with this evaluation.[74] Under the current restrictions, for instance, Allergan and Pfizer could simply wait until the thirty-six-month window passes to consummate the merger. Even after the two recent Notices and the April 2016 regulation, far from all loopholes have been closed. Earnings stripping can continue as long as it is not debt financed; trans-

71. Absent this regulation, Pfizer shareholders would have owned fifty-six percent of the combined entity, and Allergan shareholders would have owned forty-four percent of the combined entity. *See* Jordan Flannery, *Allergan: U.S. Treasury Busts the Pfizer Inversion*, SEEKING ALPHA (Apr. 5, 2016, 12:35 AM), http://seekingalpha.com/article/3963134-allergan-u-s-treasury-busts-pfizer-inversion [http://perma.cc/RC65-HQU3].

72. *See Developments*, *supra* note 7, at 2288-89.

73. *See id.*

74. *See, e.g.*, Samuel C. Thompson, Jr., *New Inversions, the 'Joe Frazier Left Hook,' the IRS Notice, and Pfizer*, TAX NOTES 1414 (2014); Bret Wells, *Corporate Inversions and Whack-a-Mole Tax Policy*, 143 TAX NOTES 1429, 1429 (2014).

fer pricing schemes can continue to shift income from the United States to foreign parents; an inversion with continuous below-sixty percent ownership by shareholders of the U.S. company is not scrutinized; and even after the recent regulations, post-inversion income-stripping tactics will continue.[75] "The door remains open."[76]

Commenting more generally on tax reforms, David Schizer has captured the difficulties inherent in the current approach to regulating inversions: "[N]arrow reforms that target specific planning strategies . . . [s]ometimes . . . stop the targeted transaction. But in other cases, taxpayers press on, tweaking their deals just enough to sidestep any targeted reforms. These avoidable measures cannot raise revenue . . . . Instead, end runs consume resources and warp transactions, yielding social waste."[77] Similarly, George Yin has described such a process as a "tax avoidance game," in which a taxpayer makes efforts to evade incremental reform, and identified the resulting inefficiency caused by this process.[78]

The unsatisfactory results of the ad hoc approach suggest that fundamental reform is needed for the U.S. corporate tax system. The source of the problem is that, at its root, the U.S. tax system is inefficient, distortionary, and harsh. Many tax scholars and practitioners have argued that corporate inversion is "merely a symptom of an inadequate tax code."[79] To incentivize U.S. corporations to not invert, common tax reform proposals call for lowering the corporate tax rate,[80] switching the worldwide tax regime to a territorial tax regime,[81]

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75. *See, e.g.*, Joy S. MacIntyre et al., *Latest Treasury Action on Inversions Upends Pending Transactions and Surprises Many for Its Broad Scope and Use of Questionable Authority*, MORRISON & FOERSTER (Apr. 27, 2016), http://www.mondaq.com/unitedstates/x/487014/tax+authorities/Latest+Treasury+Action+On+Inversions+Upends+Pending+Transactions+And+Surprises+Many+For+Its+Broad+Scope+And+Use+Of+Questionable+Authority [http://perma.cc/L977-XFHW].

76. *Id.*

77. Schizer, *supra* note 29, at 1315.

78. George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson from History*, 54 SMU L. REV. 209, 216-17 (2001).

79. *Developments*, *supra* note 7, at 2289; *see also Corporate Inversions: Hearing Before the H. Comm. on Ways & Means*, 107th Cong. 43 (2002) (statement of Gary Hufbauer) ("Corporate inversions are not the fundamental problem . . . ."); Kenneth W. Dam, Deputy Sec'y of the Treasury, Remarks to the Tax Foundation's 65th National Conference (Nov. 14, 2002), http://www.treasury.gov/press-center/press-releases/Pages/po3513.aspx [http://perma.cc/Q8SQ-N4QK] ("[C]hanges to the international provisions of the U.S. corporate tax code in recent decades have ignored [the globalization] trend.").

80. *See, e.g.*, Hale E. Sheppard, *Fight or Flight of U.S.-Based Multinational Businesses: Analyzing the Causes for, Effects of, and Solutions to the Corporate Inversion Trend*, 23 NW. J. INT'L L. & BUS. 551, 571 (2003) ("[I]nversion phenomenon should be viewed as a warning that U.S.

discarding the place-of-incorporation test for a management-and-control test,[82] treating inverted corporations differently,[83] or replacing the corporate income tax with a consumption tax.[84] However, although these reform measures may be possible under the Trump Administration, they remain radical, and practitioners have long argued that they will not be practically feasible soon.[85]

[corporate] rates are too high."); *see also* Eric Tak Han, Note, *Is Capitalism Un-American? An Analysis of Corporate Inversions and Expatriation Proposals in Response*, 27 HASTINGS INT'L & COMP. L. REV. 511, 532-34 (2004); Daniel J. Mitchell, *Job Creation and the Taxation of Foreign-Source Income*, HERITAGE (Jan. 26, 2004), http://www.heritage.org/research/reports/2004/01/job-creation-and-the-taxation-of-foreign-source-income [http://perma.cc/B4EB-TUTS]; Kyler Pomerleau & Andrew Lundeen, *The U.S. Ranks 32nd out of 34 OECD Countries in Tax Code Competitiveness*, FORBES (Sept. 22, 2014, 3:57 PM), http://www.forbes.com/sites/realspin/2014/09/22/the-u-s-ranks-32nd-out-of-34-oecd-countries-in-tax-code-competitiveness [http://perma.cc/WAE8-PWQ6].

81. *See, e.g.*, Ken Brewer, *Treason or Survival of the Fittest? Dealing with Corporate Expatriation*, 26 TAX NOTES INT'L 465, 475 (2002); Karen B. Brown, *U.S. International Tax Administration & Developing Nations: Administrative Policy at the Crossroads,* 35 GEO. WASH. INT'L L. REV. 393, 393 (2003); Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies,* 54 TAX L. REV. 261, 329 (2001); Veronique de Rugy, *Quick-Fix Curbs on Corporate Inversions Mask the Real Problem*, 28 TAX NOTES INT'L 805, 808 (2002).

82. The United Kingdom adopted this standard in 1988. *See* Finance Act 1988, c. 39, § 66, sch. 7 (Eng.).

83. *See, e.g.*, H.R. 5095, 107th Cong. (2002).

84. *See, e.g.*, Chris Edwards, *New Data Show U.S. Has Fourth Highest Corporate Tax Rate*, CATO INST. 2 (Apr. 2002), http://object.cato.org/sites/cato.org/files/pubs/pdf/tbb-0204-3.pdf [http://perma.cc/UW3C-7V6R]) ("[The United States should] mov[e] away from a high-rate [corporate] income tax to a low-rate consumption-based tax.").

85. *See, e.g.*, Talley, *supra* note 28, at 1652 ("[T]he most radical tax reform proposals currently being championed seem overzealous at best, and may even prove counterproductive."); *see also* Candace Carmichael, *Foreign Sales Corporations—Subsidies, Sanctions, and Trade Wars*, 35 VAND. J. TRANSNAT'L L. 151, 206 (2002); Ashley Redd Commins, *The World Trade Organization's Decision in United States—Tax Treatment for "Foreign Sales Corporations": Round Three in the Transatlantic Tax Dispute*, 27 N.C. J. INT'L L. & COM. REG. 363, 387 (2001); Steven H. Goldman, *Corporate Expatriation: A Case Analysis*, 9 FLA. TAX REV. 71, 89-90 (2008); Michael S. Kirsch, *The Congressional Response to Corporate Expatriations: The Tension Between Symbols and Substance in the Taxation of Multinational Corporations*, 24 VA. TAX REV. 475, 586 (2005); Ernest R. Larkins, *WTO Appellate Body Rules Against FSCs: The Search for Alternatives Begins*, J. INT'L TAX 16, 19 (2000); Marc Rosenberg, *How a Taxing Problem Has Taken Its Toll: A Common Person's Guide to an International Taxation Dispute*, 20 B.U. INT'L L.J. 1, 30-31 (2002); John Seiner, *Beating Them at Their Own Game: A Solution to the U.S. Foreign Sales Corporation Crisis*, 11 MINN. J. GLOBAL TRADE 395, 412-15 (2002).

More importantly, while scholars have argued for a tax-centric solution, these approaches fail to comprehend the full scope of the problem.[86] The goal of this Note is to reframe inversions, shifting away from the view of understanding them as solely a tax issue, and to identify non-tax approaches for addressing the inefficiencies underlying the inversion problem. In so doing, I show that the tax-only efforts fail to capture the entire problem; specifically, inversion is not simply a tax problem in isolation, but a problem of aligning tax paid with benefits conferred by a given country.

II. NORMATIVE EVALUATION OF INVERSIONS

Given that corporations technically follow formalities and do not violate any laws when inverting, why should we even bother to police inversions?[87]

To answer this question, this Part develops a normative framework upon which the rest of this Note depends: the benefit tax theory. By looking at the non-tax side of the inversion phenomenon, the benefit tax theory—which the literature has not yet explored in the context of inversions—shows us a holistic picture of what is wrong with inversions: inversion is not simply a tax problem, but a tax problem *in relation to the benefits provided*. That is, if we call the tax issue the "cost side" and call other benefits provided by non-tax laws the "benefit side," the benefit tax theory shows that the inversion problem is not just a cost side problem, but also a benefit side problem. The benefit tax theory

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86. Even if one conceded that radical tax solutions were feasible, there is still a need for correctly understanding the inversion phenomenon, not only academically but also practically to identify non-tax solutions and gain a broader set of tools to address the problem.

87. The corporate tax regime is inherently fraught with form-versus-substance tensions, because corporations are pure legal fictions (e.g., leading to the tension of the place of incorporation versus the place of operation). Reorganizations and place of incorporations are also legal fictions. The tax code, regulations, and cases attempt to structure the formal tax architecture in a way that approximates underlying substance. The tale of the cat-and-mouse game is essentially a story of struggles between form and substance, and companies exploit the tension to push the boundaries as far as they can. One argument for condoning inversions is that the U.S. tax regime is inefficient, where the form it imposes onto multinational corporations fails to approximate the underlying substance. If that is the case, corporations' "abuse" of formality to escape the U.S. tax cannot be condemned, but rather should be applauded as their self-help moves closer to the true substance of avoiding the distortive U.S. international tax. An empirical paper also found that "the additional tax due in the home country upon repatriation of foreign profits has a positive effect on the probability of relocation." Johannes Voget, *Relocation of Headquarters and International Taxation*, 95 J. PUB. ECON. 1067, 1067 (2011). For Congress and regulators to adopt any anti-inversion measures, there should be a strong normative foundation as to why inversions are undesirable.

offers a holistic picture of what is wrong with inversions, in contrast to the traditional lens of efficiency and externalities, which fail in this regard.

As a secondary point, the benefit tax theory captures our intuition and moral outrage upon hearing news about corporate inversions. The popular description of these transactions as "unpatriotic" or "tax scams" seems to reflect the idea that the inverted companies continue to derive their benefits from the United States, but they evade the U.S. taxes. But this moral outrage is more than simply a populist sentiment: it reflects the mismatch between the benefits derived and tax paid by a company that inverts. An analysis of just the efficiency and externality considerations involved in an inversion fails to capture this point.

This Part makes a normative case for the benefit tax theory, one of the justifications for corporate income tax. In particular, I refine the benefit tax theory, apply it in the context of inversions, and establish the normative foundation for a non-tax solution to inversions.

A. *Insufficiency of the Traditional Lens of Efficiency and Externalities*

Under a simple cost-benefit utilitarian framework, if the total cost of inversions outweighs the total benefit of inversions, we have a reason to care about curbing inversions. An efficiency and externality analysis focusing on the benefits and costs of inversions does not seem to give us a clear answer. Inversions benefit companies, but inversions' net effect on shareholders is unclear; and their effect on the public is somewhat negative. Based on this mixed story, it is unclear why we should care about inversions under that efficiency and externality framework. In other words, the framework of efficiency and externality does not explain the underlying condemnation of inversion. This shows the need to look into a different framework to evaluate inversions.

1. *Effects on Inverting Companies*

As discussed, inverting companies can lower their tax liability on foreign source income, tap into foreign offshore cash, and lower their U.S. income by earnings stripping or transfer pricing.[88] Given the inefficiency in the U.S. corporate tax system, inversion may be viewed as a self-help mechanism for corporations, allowing them to avoid burdensome tax. By lowering their tax liability, inverted corporations have higher post-tax earnings and profits.

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88. *See supra* Part I.

2. *Effects on Shareholders*

Inversions may benefit shareholders by increasing the price of their shares. Various studies have proved this empirically true, though the magnitude of increase appears small.[89] The increase in share price captures the expectation that future post-tax earnings will increase due to lower tax liabilities, allowing more dividend payouts to shareholders in the future. On the other hand, despite this benefit, taxation of realized gains in inversions—if § 367(a) applies[90]—can be harmful to shareholders. Which factor weighs most heavily depends on the circumstances.

Another effect on shareholders is the loss of the U.S. corporate governance regime. Delaware has the most popular and best-known corporate body of law in the United States, and many inverting corporations were initially incorporated in Delaware.[91] The superiority of Delaware law comes from the fact that it is characterized by "a modern corporate statute, a specialized corporate judiciary, an extensive body of precedent, and a multitude of practice and scholarly commentaries."[92] As a result, the move away from Delaware to foreign jurisdictions may have adverse consequences for shareholders.

For instance, Delaware law permits shareholder derivative suits,[93] whereas the United Kingdom, a popular inversion destination, limits access to such suits.[94] Furthermore, Delaware has allowed companies to adopt takeover de-

89. *See, e.g.*, Mihir A. Desai & James R. Hines, Jr., *Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions,* 55 NAT'L TAX J. 409, 409, 430 (2002) (stating that "share prices rise by an average of 1.7 percent in response to expatriation announcements"); Jim A. Seida & William F. Wempe, *The Market's Reaction or Nonreaction to Corporate Inversions*, 96 TAX NOTES 1146, 1149 (2003). *But see* C. Bryan Cloyd et al., *Market Nonreaction to Inversions,* 98 TAX NOTES 259, 259-61 (2003) (stating that Seida and Wempe's conclusion is false and that there is no significant positive market reaction to inversions).

90. *See supra* notes 49-50 and accompanying text.

91. *See* Kun, *supra* note 39, at 343 n.141.

92. *Id.* at 345; *see also* Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 241 (1985) [hereinafter Romano, *Law as a Product*] (describing features that assure stability in Delaware corporate law); Roberta Romano, *The State of Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987) [hereinafter Romano, *The State of Competition Debate in Corporate Law*] (discussing Delaware's preeminence in corporate law).

93. A shareholder derivative suit is a way for shareholders to bring claims on behalf of a corporation, lowering the hurdle for shareholders to get over the collective action problem and safeguard their shareholder rights. *See* Ann M. Scarlett, *Investors Beware: Assessing Shareholder Derivative Litigation in India and China*, 33 U. PA. J. INT'L L. 173, 181, 183-84 (2011).

94. *See Companies Act 2006: Directors' Duties, Derivative Actions and Other Miscellaneous Provisions*, SLAUGHTER & MAY (June 2007), http://www.slaughterandmay.com/media/39392/comp fenses such as poison pills[95] and other measures against activist threats.[96] In contrast, under both Irish and British takeover rules, a board of directors cannot take actions that might "frustrate" such an offer for shares once the board "has received an approach that may lead to an offer or has reason to believe that an offer is or may be imminent."[97] Takeover defenses, although sometimes characterized as a management entrenchment tool, have been shown to increase takeover premiums, ultimately benefiting shareholders.[98] Perhaps most importantly, Delaware and other state corporate laws impose the fiduciary duty on directors to consider only the interests of shareholders,[99] while directors in many European countries such as the Netherlands owe fiduciary duties to non-equity actors including employees, customers, creditors, communities, and other stakeholders.[100] In sum, shareholders may lose these corporate governance benefits that Delaware or other states offer when their companies invert to a foreign jurisdiction with fewer shareholder rights.

anies_act_2006_-_directors_ duties_derivative_actions.pdf [http://perma.cc/EHJ2-7CK7] (describing provisions of the Companies Act 2006, which may make it more difficult for shareholders to bring derivative suits); Stuart Pickford & Rani Mina, *Derivative Claims in the U.S. and the U.K.*, MAYER BROWN (Apr. 2009), http://www.mayerbrown.com/files/Publication/d44e695d-fca6-422e-bf0c-73918a8abff3/Presentation/PublicationAttachment/731b55c0-0c92-42b4-9e72-84f930d78b77/ART_PICKFORD_MINA_DERIVATIVE_CLAIMS_APR09.pdf [http://perma.cc/6Q4V-SEMX].

95. *See* Moran v. Household Int'l, Inc., 500 A.2d 1346, 1348 (Del. 1985) (holding that Household's rights plan was a legitimate exercise of business judgment by the company).

96. *See* Hwang, *supra* note 6, at 840.

97. *See* PANEL ON TAKEOVERS & MERGERS, CITY CODE ON TAKEOVERS AND MERGERS 18-24 (12th ed. 2016), http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/code.pdf [http://perma.cc/5QDE-8KDR] (explaining, via Rule 21, the "Restrictions on Frustrating Action"); IRISH TAKEOVER PANEL, IRISH TAKEOVER PANEL ACT, 1997: TAKEOVER RULES AND SUBSTANTIAL ACQUISITION RULES 6.14-6.15 (2013), http://www.irishtakeoverpanel.ie/wp-content/uploads/2014/01/ITP-Takeover-Rules.pdf [http://perma.cc/U9SD-LNZM]; *see also* Hwang, *supra* note 6, at 840 (stating that Britain and Ireland generally prohibit takeover defenses).

98. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180-81 (Del. 1986).

99. *See, e.g.*, Franklin A. Gevurtz, *The Role of Corporate Law in Preventing a Financial Crisis: Reflections on* In Re Citigroup Inc. Shareholder Derivative Litigation, 23 PAC. MCGEORGE GLOBAL BUS. & DEV. L.J. 113, 151 (2010); Spencer Weber Waller, *Corporate Governance and Competition Policy*, 18 GEO. MASON L. REV. 833, 834-35 (2011).

100. *See* Gregory Day, *Irrational Investors and the Corporate Inversion Puzzle*, 69 SMU L. REV. 453, 468-69 (2016); *see also* Ed Silverman, *Has Mylan Labs Been Stichting It to Shareholders? A Lawsuit Says "Yes!*," WALL ST. J.: PHARMALOT (July 28, 2015, 10:05 AM), http://blogs.wsj.com/pharmalot/2015/07/28/has-mylan-labs-been-stichting-it-to-shareholders-a-lawsuit-says-yes [http://perma.cc/C4SX-Q4D5] (describing a lawsuit in which the directors' duties extended to all stakeholders, not just shareholders).

3. *Effects on the U.S. Government and Public*

One might argue that American corporate directors and officers of potentially inverting companies owe no duty to the general public but only to their shareholders. According to that logic, perhaps the normative evaluation of inversions should stop after the preceding section. However, since inversions implicate the American public and economy as well, we must consider the "externalities" imposed on the general public by the corporate directors and shareholders who decide to invert their corporations.

First, inversions reduce U.S. corporate tax revenues. In 2014, the federal corporate income tax revenue was approximately $320 billion,[101] and inversions arguably cost billions annually.[102] Reasonable people may disagree over whether these costs to the government are significant,[103] but there is no doubt that if the number of inversions were to increase, U.S. tax revenues would continue to decrease.[104]

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101. *See Amount of Revenue by Source, 1934 to 2020*, TAX POL'Y CTR. (Feb. 4, 2015), http://www.taxpolicycenter.org/statistics/amount-revenue-source [http://perma.cc/B9LX-G36K].

102. The Joint Committee on Taxation estimated that for the next decade the total tax revenue loss would be $20 billion. That leads to about $1.67 billion in tax loss per year, leading to a 0.5% loss in the corporate tax revenue. Letter from Thomas A. Barthold, Chief of Staff, Joint Comm. on Taxation, to Karen McAffee (May 23, 2014). Even though losing several billion dollars out of $320 billion may seem small in proportion, arguing that inversion should be condoned given this low percentage is not tenable because, on an absolute scale, a couple of billion dollars is still a large figure. Not taking enforcement action against inversions just because they constitute a "small" percentage of the overall corporate income tax revenue is tantamount to arguing that the IRS should not worry about taxpayers and corporations that avoid taxes because the amounts at issue are insignificant. Admittedly there can be a de minimis threshold, but I do not think a couple of billion dollars would fall under a de minimis threshold.

103. *See Corporate Inversion: Hearing Before the Subcomm. on Treasury & Gen. Gov't of the S. Comm. on Appropriations*, 107th Cong. 10 (2002) (statement of Pamela Olson, Assistant Sec'y, Dept. of the Treasury) (mentioning that inversions annually cost the public "billions"); Reuven S. Avi-Yonah, *Commentary*, 53 TAX L. REV. 167, 172 (2000) (referring to recent studies that show a "15% drop in the effective foreign tax rate" of U.S. multinational corporations from 1984 to 1992). *But see* Avi-Yonah, *supra* note 28, at 1597 (stating that the loss of U.S. corporate tax revenue has been small relatively speaking); Martin A. Sullivan, *The U.S. Congress's Inversion Odyssey: Oh, the Places You'll Go*, 27 TAX NOTES INT'L MAG. 150, 151 (2002) ("Using revenue estimates as guides, corporate inversion activity in dollar terms is not even a billion dollar a year issue.").

104. *See* John Kelly, Note, *Haven or Hell: Securities Exchange Listing Standards and Other Proposed Reforms as a Disincentive for Corporate Inversion Transactions*, 14 MINN. J. GLOBAL TRADE 199, 203-07 (2004).

Second, the lost revenue inevitably has to be made up from other sources, furthering the distortion and regressivity of the U.S. income tax regime. When inverted corporations erode the U.S. tax base, the government either has to increase tax rates from other sources or cut programs in order to remain revenue neutral. That is, the tax burden is likely to shift to other domestic corporations and individuals,[105] and the combination of a narrower base and higher tax rates would lead to more distortion. At a more theoretical level, Reuven Avi-Yonah observes that "[b]ecause labor is generally less mobile than capital, a decline in taxes on capital and a [corresponding] rise in taxes on labor . . . tends to render the tax system more regressive."[106] Moreover, because state corporate taxes are based on federal taxable income, a decrease in federal revenues would also translate to a proportionate decrease in state tax revenues.[107]

Tax morale may also drop at the news of multinational corporations using their power and resources to invert to avoid taxes.[108] The U.S. tax system relies on voluntary compliance, and thus "potential lack of public confidence" in the fairness and legitimacy of the U.S. tax system "represents a serious risk" to that system.[109] That is, inversion may lead to negative externalities on the tax compliance of American individuals or corporations.

Another related effect on the public, albeit more abstract and symbolic, is the moral outrage that results from companies being unpatriotic[110] and violating their duties as "American"[111] corporations. The public and their representatives have been extremely critical of inversions for this reason. These critiques view inverting corporations as putting their self-interest above their communitarian duty to the country. Some commentators argue that this is the real reason why Congress attempts to curb inversions and the public perceives inversions as a serious problem,[112] even if the revenue impact is less significant.[113]

105. *See* Sheppard, *supra* note 80, at 563.

106. Avi-Yonah, *supra* note 28, at 1624.

107. *See, e.g.*, Judith Lohman, *Stanley Works Reincorporation Proposal*, CONN. GEN. ASSEMBLY (July 19, 2002), http://www.cga.ct.gov/2002/olrdata/fin/rpt/2002-R-0636.htm [http://perma.cc/853Y-DHTE].

108. *See* N.Y. STATE BAR ASS'N TAX SECTION, REPORT ON OUTBOUND INVERSION TRANSACTIONS 25 (2002); Michael S. Kirsch, *Alternative Sanctions and the Federal Tax Law: Symbols, Shaming, and Social Norm Management as a Substitute for Effective Tax Policy*, 89 IOWA L. REV. 863, 937 & nn.318-19 (2004); Diane M. Ring, *One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage*, 44 B.C. L. REV. 79, 122 (2002).

109. Kun, *supra* note 39, at 372-74.

110. *See, e.g.*, Anderson, *supra* note 40, at 274.

111. Kirsch, *supra* note 85, at 572.

112. *See id.* at 507-19.

Whether or not inversions are problematic from a revenue point of view, the fact that the people and their representatives disapprove of inversions implies that there is democratic legitimacy to condemning them.

In sum, the effect of inversion transactions on the U.S. government and public seems negative, although there is dispute about the significance of the magnitude of this harm.

B. Benefit Tax Theory

The above analysis of the effects of inversions presents a mixed story: inversions clearly lead to lower taxes for companies, but inversions' effect on shareholders depends on the relative magnitude of the monetary benefit compared to the loss of various shareholder protections; and inversions' effect on the public is negative, yet perhaps not of significant magnitude.

The framework of efficiency and externality analysis does not fully capture what is wrong with inversion. Instead of looking only at the effect of inversions, a more comprehensive way to evaluate inversions is to consider the underlying purpose of the corporate income tax and whether inversions align with that mission.[114] To date, this discussion has been scarce in inversion scholarship,[115] since most scholarship has focused on the economic or efficiency costs and benefits of inversion transactions. This Note proposes an alternative approach: the benefit tax theory.

The benefit tax theory offers a strong justification against inversions: inverted corporations continue to derive substantial benefits from maintaining their operations and management in the United States, but avoid the U.S. taxes that could be considered the price of using those benefits. Under this framework, the prohibition against inversions is justified because it ensures that companies pay for the benefits they enjoy as a result of keeping their operations and management in the United States.

As discussed below, these benefits include: (1) real business factors and infrastructure, excluding capital markets, (2) access to capital markets, (3) corporate governance law, (4) securities law, (5) contract law, (6) bankruptcy law,

113. *See* Meagan Clark, *Preventing Inversions Would Save 0.5% of US Corporate Tax Revenue*, INT'L BUS. TIMES (Sept. 25, 2014, 4:04 PM), http://www.ibtimes.com/preventing-inversions-would-save-05-us-corporate-tax-revenue-1695163 [http://perma.cc/2CCD-YHS4].

114. As a secondary point, this unclear, ambiguous answer by the efficiency and externality framework is at odds with the political and moral outrage inversions inspire.

115. There are a few exceptions, such as Kirsch, *supra* note 85; and Mitchell A. Kane & Edward B. Rock, *Corporate Taxation and International Charter Competition*, 106 MICH. L. REV. 1229 (2008).

(7) property law, (8) antitrust law, (9) intellectual property law, (10) diplomatic assistance during trade disputes, (11) treaty protections, and (12) domestic inputs contributing toward foreign source income. By providing these benefits, the U.S. government indirectly participates in the creation of wealth by corporations operating in the United States. Therefore, those corporations should pay proper taxes to the government for the benefits from the United States that they continue to enjoy after inversions.[116] This rough sketch of the benefit tax theory will be refined in this Section and in Part III.

In this Section, I first justify the use of the benefit tax theory in the context of inversions, before delving into an in-depth discussion of the eleven benefits that a company derives from a country through incorporation, operation, or opt-in. In particular, I divide those factors into types of benefits related to domestic-source income and benefits related to foreign-source income. Then, I argue that the benefit tax theory serves as a strong rationale for proscribing inversions even if U.S. tax rates are inefficiently high.

1. *Threshold Question: Why Benefit Tax Theory?*

The benefit tax theory and the ability-to-pay theory have historically dominated discussions of tax equity theories. The benefit tax theory is defined by the principle that "taxes should be considered payments for services rendered by the state to the taxpayers and so proportioned."[117] In contrast, the ability-to-pay theory is defined by the principle that one's tax burden should reflect one's ability to pay, where income is often used as a measure of an individual's ability to pay tax.[118] The progressive income tax system is derived from the ability-to-pay theory, whereas user fees are derived from the benefit tax theory.[119] When it comes to contemporary income taxation scholarship, the ability-to-pay theo-

116. As a qualifying statement, I would like to note that a pure benefit tax regime—where individuals and corporations are taxed in an amount corresponding to the benefits they derive from the government—is not possible. Such a system is simply impossible to administer with precision the benefits each taxpayer receives. Furthermore, some types of the benefits would remain categorically untaxed due to practical and administrative reasons, mentioned below. The application of the benefit tax theory below would depend on proxies for benefits rather than actual benefits themselves, yet I will demonstrate that the benefit tax theory can explain the current U.S. international tax regime quite well, even if not perfectly.

117. *Benefit Theory of Taxation*, MERRIAM-WEBSTER, http://www.merriam-webster.com/dictionary/benefit%20theory%20of%20taxation [http://perma.cc/W94M-SC4U].

118. *See* Alvin Warren, *Would a Consumption Tax Be Fairer than an Income Tax?*, 89 YALE L.J. 1081, 1092-93 (1980).

119. Joseph M. Dodge, *Theories of Tax Justice: Ruminations on the Benefit, Partnership, and Ability-To-Pay Principles*, 58 TAX L. REV. 399, 401-02 (2005).

ry[120] is the dominant mode of thinking and the benefit tax theory is a minority view that has fallen out of favor.[121]

However, the juxtaposition and relative merits of the two theories are usually considered in the context of a domestic, unitary taxation system. The two theories were originally developed in the context of "interindividual equity," which concerns the relative amount of income tax that different individuals pay in a domestic setting.[122] However, in the multijurisdictional context, the relevant concern is "internation equity," not interindividual equity. Internation equity is defined as how taxation revenues on a multinational corporation's income should be shared across different countries. The internation equity concern is a crucial feature of the international tax.[123] For instance, the United States adopts a worldwide income system. Under this system, it taxes all domestic and foreign income by U.S.-incorporated companies, but the tax on foreign-source income is reduced by the amount of tax paid to a foreign country.[124] Assume the U.S. corporate tax rate is thirty-five percent for both domestic and foreign source income.[125] In contrast, the Netherlands adopts a territorial regime whereby it taxes only those incomes earned within its territory, at an effective rate of twenty-five percent.[126] When a U.S. company earns income in its Dutch branch, it will pay twenty-five percent of that income in tax to the Dutch government, and ten percent of that income to the United States. That is, this is an "internation" compromise between the United States

120. The theory has many variations, but all assume that "presumptive fairness within an income tax regime requires taxpayers with larger net incomes in a given year to generally pay more tax than those who have smaller net incomes in the same year." J. Clifton Fleming, Jr. et al., *Fairness in International Taxation: The Ability-To-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299, 301 n.1 (2001).

121. *See* Klaus Vogel, *Worldwide vs. Source Taxation of Income—A Review and Re-evaluation of Arguments (Part I)*, 16 INTERTAX 216, 219 (1988) (referencing "the antiquated benefit principle"); *see also* Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 LAW & POL'Y INT'L BUS. 145, 153, 161 (1998) ("Ability-to-pay theory has found expression in the modern global income tax.").

122. *See* Kaufman, *supra* note 121, at 150, 167-68.

123. *See id.* at 155.

124. *See supra* note 34 and accompanying text.

125. *See* Alexandra Thornton, *The Skinny on Corporate Inversions*, CTR. FOR AM. PROGRESS (Sept. 25, 2014), http://www.americanprogress.org/issues/tax-reform/report/2014/09/25/97827/the-skinny-on-corporate-inversions [http://perma.cc/C64Y-QHJ6].

126. To be more precise, it is the marginal rate of twenty-five percent above €200,000 and the marginal rate of twenty percent below that amount, yet for the purpose of demonstration this is sufficient. *See Taxation and Investment in Netherlands 2015*, DELOITTE (2015), http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-netherlandsguide-2015.pdf [http://perma.cc/8TTZ-N684].

and the Netherlands to share the tax revenue. Meanwhile, if a Dutch company earns income in the United States, it will pay all its taxes to the United States without paying any to the Dutch government. This example illustrates that international tax implicates the internation equity concern: although nothing about the production of income across the world changes for an inverting company as a result of the inversion, the country to which the company pays tax and the amount of tax paid does change.

The benefit tax theory offers an elegant conceptual framework for understanding the internation equity issue, compared to the ability-to-pay theory: a corporation's tax base[127] should be apportioned to different countries relative to the benefits the corporation derives from each of these countries. This framework is also helpful in understanding the problems and inefficiencies underlying inversion. In contrast, the ability-to-pay theory cannot deal with the internation equity concern. The ability-to-pay theory justifies the worldwide income tax on the ground that a U.S. multinational company should pay tax to the U.S. government regardless of the source of income, because the corporate tax is based on its ability to pay measured by its comprehensive income. But the framework cannot provide a more useful metric as to how the tax revenue should be apportioned between the United States and the Netherlands; the company's ability to pay is the same in the eyes of both countries and does not change as a consequence of inversion, aside from the lower tax burden. Thus, the ability-to-pay theory is incapable of evaluating and addressing corporate inversions.[128]

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127. Alternatively, we can focus on the tax amount, depending on which version of the benefit tax theory we adopt.

128. Moreover, the main appeal of the ability-to-pay theory over the benefit tax theory is its relevance in the context of interindividual equity, yet this concern largely disappears in the international taxation context. In a uniform tax system within one country, it is easy to say that two individuals with the same ability to pay should pay the same amount of tax. However, in an international system where each nation adopts different tax rates and features to deal with other countries' taxation (such as foreign tax deductions), and each nation has complete sovereignty over its own tax system, one cannot make a meaningful statement about what interindividual equity should look like. If company *A* and company *B* have the same income, but one is incorporated in the United States while the other is incorporated in the Netherlands, should they pay the same amount of income tax to their respective jurisdictions? Imposing interindividual equity criteria across different jurisdictions with different tax rates and structures does not make much sense, unless all nations give up their sovereignty and impose uniform taxation systems. Interindividual equity loses its force outside of a domestic, unitary context, and so does the ability-to-pay theory. In sum, the benefit tax theory, not the ability-to-pay theory, is particularly relevant in the context of inversion.

The fairness theory—the normative undergird for the ability-to-tax theory—has been applied to the international tax regime, if not inversion, on few occasions. *See, e.g.*, Fleming, In fact, the benefit tax theory offers a strong justification for limiting inversion transactions for the following reasons. First, the benefit tax theory offers a new, more holistic way to look at corporate inversions. Previously, inversions have been framed as problems solely within the tax system. Under the benefit tax theory, however, inversions become a tax problem *vis-a-vis the benefits rendered to these corporations*. It shifts the inquiry from whether a company inverts because it can simply achieve a lower tax rate to whether, by inverting, a company is able to avoid taxes disproportionate to the relative amount of services and benefits it continues to receive from the state. If we call the tax issue the "cost side" and call other benefits provided by non-tax laws the "benefit side," the benefit tax theory shows that the inversion problem is not just a cost side problem, but also a benefit side problem. As a result, a novel way to address the inefficiencies underlying inversion is by tinkering with the benefits continually provided to inverted companies. Our initial reason for looking outside tax was the failure of solutions based solely in the tax system to comprehensively understand inversions, in addition to the disputable difficulty of implementing tax solutions. There are non-tax solutions that may effectively address the inefficiencies underlying inversion—and it is the benefit tax theory that leads to this insight.

Second, the benefit tax theory aligns with our intuition of moral outrage upon hearing news of corporate inversions. Popular descriptions of these transactions as "unpatriotic" or "tax scams" reflect the idea that the inverted companies continue to derive benefits from the United States while evading U.S. taxes. Recall that the framework of efficiency and externality analysis does not capture the reasons for political and moral outrage against inversions. The benefit tax theory fills this gap: combined with the economic effect of inversions on the U.S. government, society, and the public, the benefit tax theory reflects the principle that inversions are undesirable because of the mismatch between the costs and benefits that companies face.

Third, the benefit tax theory resonates with a purpose of corporate income tax. As one commentator noted,

> [T]he true beneficiaries of the public services provided to corporations are the shareholders. And the shareholders generally do not reside in the state—this is especially true of publicly traded and multinational

Jr. et al., *supra* note 120; Graetz, *supra* note 81, at 294, 307 ("[D]eciding to tax income reflects a decision to place issues of fairness at the heart of tax policy debates. That commitment cannot be ignored simply because income traverses national borders."); Kaufman, *supra* note 121. Exploring this is outside the scope of this Note, yet it is worth noting that the benefit tax theory offers a better normative account in understanding inversion transactions.

> corporations . . . . The only way of ensuring that the shareholders will pay for benefits provided by the state is through a corporate income tax.[129]

That is, a corporate income tax scheme may on the surface seem to be taxing a corporation, but in essence it is indirectly taxing shareholders for the income that corporations earned and that would eventually be passed onto shareholders. As the commentator noted, the *only* way of ensuring that some of these shareholders pay for the benefits derived is through a corporate income tax. That is, the concept of corporate income tax is deeply related to the benefit tax theory. In contrast, because essentially all of the corporations at issue in inversions—multinational corporations or companies with large revenues—have hit the top marginal rates, they are subject to the same tax rates. Therefore, where the ability-to-pay theory does not help us better understand inversions, the benefit tax theory provides useful insights.

2. *Benefits Contributing Toward the Creation of Domestic Source Income*

Given these justifications for the use of the benefit tax theory in the inversion context, this Section discusses each of the benefits in more detail. I classify the benefits into two categories: benefits that justify domestic-source income and benefits that justify foreign-source income. This subsection deals with the former; the next subsection deals with the latter.

The benefits relating to the creation of domestic source income include: (1) real business factors and infrastructure (such as skilled labor force, agglomeration benefits, police, fire protection, transportation, access to markets, access to courts), excluding capital markets, (2) access to capital markets, (3) corporate governance law, (4) securities law, (5) contract law, (6) bankruptcy law, (7) property law, (8) antitrust law, and (9) intellectual property law.

Once incorporated, corporations enjoy business "infrastructure" provided by the United States, such as police, fire protection, transportation services, roads, and other infrastructure benefits. Relative to other nations, the United States offers particularly developed capital markets, a skilled labor force, superior infrastructure, and other agglomeration benefits.[130] Furthermore, the

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129. David Brunori, *The Politics of State Taxation: Stop Taxing Corporate Income*, ST. TAX NOTES 47, 50 (July 1, 2002), http://www.in.gov/dor/files/brunoriwhitepaper1.pdf [http://perma.cc/5FE8-2MM3].

130. Reuven S. Avi-Yonah & Omri Marian, *Inversions and Competitiveness: Reflections in the Wake of Pfizer/Allergan* 13 (Univ. of Mich. Pub. Law & Legal Theory Research Paper Series, Paper No. 488, Dec. 14, 2015), http://ssrn.com/abstract=2703576 [http://perma.cc/7XE3

United States has a huge consumption market, and corporations operating in the United States can access this market at lower costs than corporations without U.S. operations.[131]

In addition to those real business factors, operating in the United States entails various legal benefits. For instance, the U.S. antitrust law guarantees that companies are not harmed by the unfair practices of others. Similarly, the country's bankruptcy law ensures orderly, just, and swift dissolution of distressed companies; in fact, it is "generally recognized worldwide that the United States has the most efficient form for restructuring international companies."[132] The U.S. securities regulation regime helps the U.S. financial market function smoothly via disclosure requirements, limits on fraudulent activities, and restrictions on insider trading, thereby contributing to market liquidity and enhancing share values for listed corporations.[133] And property and intellectual property laws ensure that the property and income held by these companies are adequately protected.

3. *Additional Benefits Justifying Tax on Foreign-Source Income*

Note that the benefit tax theory works against those inverted companies that engage in earnings stripping and transfer pricing in order to erode their tax liability on income generated within the United States. Similarly, the benefits argument for taxing companies based on U.S. operations works for foreign corporations operating in the United States;[134] simply put, despite being in-

-RS3R]. Agglomeration benefits are synergistic benefits that companies derive by locating near each other.

131. *See* Tyler M. Dumler, *Charging Less To Make More: The Causes and Effects of the Corporate Inversion Trend in the U.S. and the Implications of Lowering the Corporate Tax Rate*, 13 U.C. DAVIS BUS. L.J. 88, 96-97 (2012).

132. Jacqueline Palank, *Q&A: Foreign Companies Seek Protection of U.S. Chapter 11*, WALL ST. J. (July 25, 2013, 5:20 PM), http://blogs.wsj.com/bankruptcy/2013/07/25/qa-foreign-companies-seek-protection-of-u-s-chapter-11 [http://perma.cc/6M35-76WU].

133. Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 711 (2006).

134. Many articles have "discuss[ed] the role of benefits theory in justifying a source-based [(i.e., U.S.)] income tax" for foreign companies. Kirsch, *supra* note 85, at 565 n.294. As examples, Kirsch cites Michael J. Graetz, which explains that "foreigners, whose activities reach some minimal threshold, should contribute to the costs of services provided by the host government" and that "[o]ne need not thoroughly embrace the benefit theory of taxation . . . to recognize a country's legitimate claim to tax income produced within its borders." Graetz, *supra* note 81, at 298 Kirsch also cites Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021, 1036-37, 1076 n.220 (1997), for its discussion on the extent to which the early scholars of the modern income tax viewed benecorporated elsewhere, these companies derive benefits from the United States by operating within it. Reflecting this normative view, foreign corporations are indeed taxed on income attributable to their trade or business in the United States.[135] However, we need a separate set of explanations for why the benefit tax theory would justify the worldwide taxation of foreign source income if we wish to argue that inversions that *do not* engage in earnings stripping and transfer pricing need to be limited. Otherwise, the benefit tax theory would condone inverted companies that continue to pay U.S. tax on U.S. source income without any earnings stripping or transfer pricing.[136]

The following are the additional benefits provided by the U.S. government to corporations with respect to their foreign-source income: (10) diplomatic assistance during trade disputes, (11) treaty protections, and (12) domestic inputs contributing toward foreign source income.

As to diplomatic assistance, the government may intervene or provide diplomatic assistance on its corporations' behalf during trade disputes or in situations involving political or military instability.[137] As to treaty protections, the United States is a party to various treaties that facilitate international trade and provide protections for corporations. Furthermore, the United States is part of a network of more than three-dozen Bilateral Investment Treaties (BITs) that protect the foreign investments of U.S. investors.[138]

As to the twelfth and final benefit, foreign-source income may be partially derived from inputs made in the United States. Examples include U.S.-manufactured goods sold in a foreign branch of a company, thus generating foreign income. Or, U.S.-developed intellectual properties, software, and other income-generating properties can be (as they often are) transferred to a foreign subsidiary of a U.S. company and generate income to that foreign subsidiary.[139]

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fit tax theory as justifying source-based taxation. *But see, e.g.*, Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 29-30 (1993) (questioning the benefits rationale as a justification for source-based taxation of corporations).

135. *See* I.R.C. §§ 11(d), 882 (2012).

136. The Code's worldwide taxation of income and estates of a U.S. citizen living outside the United States has been justified in a Supreme Court case. *See* Cook v. Tait, 265 U.S. 47, 56 (1924) ("[T]he government, by its very nature, benefits the citizen and his property wherever found."); *see also* Kirsch, *supra* note 108, at 875 n.45 (explaining that U.S. citizens residing outside of the United States still possess a right to vote).

137. *See* Fleming, Jr. et al., *supra* note 120, at 338; Julie Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, 89 GEO. L.J. 543, 588 (2001).

138. *See* Kirsch, *supra* note 85, at 560.

139. *See* Klaus Vogel, *Worldwide vs. Source Taxation of Income—A Review and Re-evaluation of Arguments (Part II)*, 16 INTERTAX 310, 320 (1988) [hereinafter Vogel, *Part II*]; Klaus Vogel, However, this factor ultimately boils down to the benefit factors relating to the creation of domestic source, described in the preceding subsection: for instance, when these companies create or supply inputs from the United States to create foreign source income abroad, they are essentially relying on U.S. business factors and infrastructure to do so. For this reason, the rest of this Note will not treat this twelfth factor as a separate one, and instead focus on the eleven other benefits, assuming that some of those eleven would capture this twelfth factor of domestic inputs contributing toward foreign source income.

In addition, note that the connection between these benefits and foreign-source income is more attenuated than the connection between these benefits and domestic-source income discussed below in Section III.D.2. This observation is somewhat reflected in the foreign income tax credit, where the United States imposes lesser taxes on foreign-source income that is already taxed by a foreign jurisdiction.[140] In other words, the U.S. taxation of foreign-source income is lower than the U.S. taxation of domestic source income. This is not to say that the U.S. taxation of foreign-source income is efficient and perfectly proportional to the benefits companies received; if the benefit theory is applied correctly, the U.S. worldwide tax amount should be a fixed percentage on top of the foreign jurisdiction's source tax, not the difference between foreign source tax and thirty-five percent of the U.S. corporate tax rate.[141]

4. *Benefit Tax Theory and Inefficiently High U.S. Tax Rates*

A critical counterargument to the benefit tax theory approach is that it does not answer the question of whether the current U.S. tax rate is too high relative to the benefits that companies enjoy. According to this line of reasoning, even if we give up on quantifying how much benefit each corporate taxpayer enjoys, it is still impossible to discuss the relative importance of each kind of the benefits. Does this make the benefit theory moot in arguing against inversion? I do not think so: benefit tax theory still works against inversions even with inefficiently high U.S. tax rates.

One can conceivably argue that inversions are justified because, even under the benefit tax theory, the United States is charging too high of a tax for the

Worldwide vs. Source Taxation of Income—A Review and Re-evaluation of Arguments (Part III), 16 INTERTAX 393, 400-01 (1988) [hereinafter Vogel, *Part III*].

140. Roin, *supra* note 137, at 588.

141. This principle was driven by the desire to keep tax neutrality in corporations' decision as to where to do its business internationally, because if the total sum of taxes to the source and the United States is kept at thirty-five percent, corporations would be indifferent as to where to incorporate solely based on tax criteria.

benefits it provides. Consider the United States and a country *Y*, where the United States imposes a higher tax rate than *Y*. And assume that, in an ideally efficient world, both jurisdictions should be charging the same tax rate considering the relative benefits that the jurisdictions offer. Further assume that *Y* is charging the "correct" rate of tax in light of benefits offered, which implies that the United States is mispricing its tax rate. Under these conditions, a U.S. company should be free to seek the correct rate to help itself lower its tax liability, which is available by inverting to the jurisdiction *Y* and subjecting itself to the more efficient tax rate offered by the jurisdiction *Y*. The inverted company will enjoy most of the benefits offered by the United States (except for corporate governance law and diplomatic assistance), and it will pay the "efficient" price in jurisdiction *Y*.

Algebraically expressing this idea, let's denote the U.S. tax rate as p_1 and a foreign jurisdiction *Y*'s tax rate as p_y. I choose the notation *p* to reflect the idea that companies pay the price p_1 to enjoy the benefits offered by the United States. Assume $p_1 > p_Y$ and assume that the optimal level of p_1 $-$denoted $p_1^*$$-$is $p_1^* = p_Y$. Then, a U.S. company is justified in inverting to the jurisdiction *Y* and subjecting itself to the more efficient tax rate p_Y.

From an efficiency "market" point of view, such an argument makes sense and the inversion will force p_1 to be driven down to $p_1^*(= p_Y)$ over time due to regulatory competition. However, there are two problems with this argument from the benefit tax point of view. First, as an analogy, assume a store offers two types of sweaters that should be priced the same based on their fabric, design, color, and so forth. However, assume the store chooses to price them differently. That does not justify a customer buying Sweater 1 but paying the price of Sweater 2, no matter how overpriced Sweater 1 is compared to Sweater 2, because the price for Sweater 1 is associated with Sweater 1. In other words, the store bundled Sweater 1 with Sweater 1 price. The efficiency argument can be made for the store to lower the price of Sweater 1, but that does not mean that the customer can unilaterally pay the price of Sweater 2 when purchasing Sweater 1. Second, it matters to whom you pay the price of tax, going to the internation equity concern. In this stylized example, even if we concede that the company is justified in paying the amount of p_Y, it should be paying that amount *to the United States* for the benefit it is deriving from the United States, not to the new jurisdiction *Y* to which it inverted. Presumably it will pay some tax on U.S.-source income, yet with earning stripping and transfer pricing it will erode much of the base. Putting it all together, inversion is not justified under the benefit tax theory.

To sum up the discussion in this Section, the benefit tax theory offers a strong justification for limiting inversions, and it aligns with our intuition and moral outrage upon hearing news about corporate inversions. The popular description of these transactions as "unpatriotic" or "tax scams" seems to reflect the idea that the inverted companies continue to derive their benefits from the United States, but they evade the U.S. taxes. The moral outrage does reflect a deeper tension with the phenomenon of inversions. Combined with the efficiency and externality effects of inversions on the U.S. government, society, and public, the benefit tax theory strongly establishes the principle that inversion transactions are undesirable.

III. MULTI-DIMENSIONAL COMPETITION MODEL

The benefit tax theory suggests that inversion is not simply a tax problem in isolation, but a problem of *aligning the tax paid with the benefits conferred by a given country*. In search for a solution to this problem, the analysis in Part II will serve as the framework for conceptualizing the inversion phenomenon within a multi-dimensional regulatory competition model.

In this Part, I critique the conventional, one-dimensional tax competition model as an insufficient framework for understanding the inversion phenomenon. Then, I build the multi-dimensional competition model and discuss three different types of benefits that companies may enjoy from a country. The model reveals that the problem with inversions is that inverting companies continue to enjoy benefits from their former home country even after inversion, an outcome that is contrary to the benefit tax theory.

A. Inadequacy of the Conventional Tax Competition Model

Before delving into the proposed multi-dimensional regulatory competition model for understanding inversions, this Section explains why the tax competition theory—the current dominant model in inversion and tax scholarship—is inadequate.

The basic premise of the tax competition theory is that countries compete with one another through tax policy to attract business. In a stylized model, competing countries try to make investments within their respective borders relatively more attractive by reducing their tax claims on income generated from such investments.[142] Often this is an iterative process, where countries adjust their tax rates in reaction to each other in order to undercut each other's tax

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142. *See* COMM'N OF THE EUROPEAN CMTYS., REPORT OF THE COMMITTEE OF INDEPENDENT EXPERTS ON COMPANY TAXATION 143 (1992); GARY CLYDE HUFBAUER, U.S. TAXATION OF INTERNATIONAL INCOME: BLUEPRINT FOR REFORM 29 (1992).

rates for more investment,[143] in a game-theoretic manner.[144] Even if not explicitly modeled, various pieces of inversion scholarship and their policy prescriptions implicitly rely on the tax competition model.[145]

This competition model is not merely a theoretical speculation. There is a good deal of evidence showing that tax competition is a real phenomenon.[146] One such piece of evidence is the downward trend of statutory corporate tax rates,[147] which seems to be driven at least in part by corporate inversions. For instance, the United Kingdom recently reformed its tax regime and lowered its corporate tax rates in part because U.K. companies were inverting to Ireland.[148] In addition, when Ensco International Inc. left the United States for the United Kingdom in 2010, it justified the move in part based on the tax benefit of the United Kingdom after the liberalization of its international tax provisions.[149] Ireland lowered its corporate tax rate to 12.5% in 2003 to attract inward invest-

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143. *See* JACOB A. FRENKEL ET AL., INTERNATIONAL TAXATION IN AN INTEGRATED WORLD 206 (1991) ("We conclude that if the two countries are not coordinated with the rest of the world and cannot effectively tax their residents on their income from capital invested in the rest of the world, then competition among the tax authorities leads to a full exemption from tax for the mobile factor . . . ."); HUFBAUER, *supra* note 142, at 31; Bruno S. Frey, *Intergovernmental Tax Competition*, *in* INFLUENCE OF TAX DIFFERENTIALS ON INTERNATIONAL COMPETITIVENESS 87, 89 (1990) ("In equilibrium, the tax rate on capital in each state will be driven to zero because each one will compete for that tax base."); Peggy B. Musgrave & Richard A. Musgrave, *Fiscal Coordination and Competition in an International Setting*, *in* INFLUENCE OF TAX DIFFERENTIALS ON INTERNATIONAL COMPETITIVENESS, *supra*, at 59, 69-70.

144. *See, e.g.*, JACK M. MINTZ & ALFONS J. WEICHENRIEDER, THE INDIRECT SIDE OF DIRECT INVESTMENT: MULTINATIONAL COMPANY FINANCE AND TAXATION (2010); Roger H. Gordon & James R. Hines, Jr., *International Taxation*, *in* 4 HANDBOOK OF PUBLIC ECONOMICS 1935 (Alan Auerbach & Martin Feldstein eds., 2002); Ravi Kanbur & Michael Keen, *Jeux Sans Frontières: Tax Competition and Tax Coordination When Countries Differ in Size*, 83 AM. ECON. REV. 877 (1993).

145. *See, e.g.*, Avi-Yonah, *supra* note 28; Douglas Chiu, *Inversion Subversion: Corporate Inversions and the New Federal Laws Against Them*, 20 FORDHAM J. CORP. & FIN. L. 717 (2015); DeAngelis, *supra* note 46; Dumler, *supra* note 131; Hwang, *supra* note 6; Roin, *supra* note 137; Sheppard, *supra* note 80; James Mann, Note, *Corporate Inversions: A Symptom of a Larger Problem, the Corporate Income Tax*, 78 S. CAL. L. REV. 521 (2005).

146. *See, e.g.*, Michael Devereux et al., *Corporate Income Tax Reforms and International Tax Competition*, 17 ECON. POL'Y 449, 451-52 (2002); *infra* notes 147-157 and accompanying text.

147. *See, e.g.*, Talley, *supra* note 28, at 1660 fig.1; Michael Keen & Kai A. Konrad, *The Theory of International Tax Competition and Coordination* 3 fig.1 (Max Planck Inst. for Tax Law Pub. Fin. Working Paper 2012-06, 2012).

148. *See* Surdell, *supra* note 63, at 63, 76.

149. *See* Hwang, *supra* note 6, at 833 & n.136 (citing ENSCO International Incorporated, Proxy Statement (Schedule 14A) 13, 29 (Nov. 20, 2009)).

ment,[150] and, in 2015, announced the "knowledge development box" where income from intellectual property and patents is taxed at a significantly lower rate of 6.25%.[151] These patent boxes are attempts at attracting pharmaceutical and technology companies, which derive a significant portion of their incomes from intellectual property. Similarly, in 2007, Luxembourg introduced its patent box—setting an effective tax rate of 5.76% for income from intellectual property.[152] The Netherlands introduced its patent box in 2007 and later revised it in 2010 to lower the rate to five percent,[153] making it the lowest patent box rate in the world.[154] The United Kingdom introduced its patent box in 2013 at the level of ten percent.[155] These lowering patent box rates show how countries are strategically competing with each other to attract more investment.[156] These patent box practices have been criticized by other countries that are losing corporations to these tax havens,[157] further confirming the existence of a tax competition dynamic.[158]

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150. *See* AIDAN WALSH & CHRIS SANGER, THE HISTORICAL DEVELOPMENT AND INTERNATIONAL CONTEXT OF THE IRISH CORPORATE TAX SYSTEM 2 (2014), http://www.budget.gov.ie/Budgets/2015/Documents/EY_Historical_Dev_International_Context_Irish_%20Corporation_Tax.pdf [http://perma.cc/HW36-976V].

151. *Knowledge Development Box To Have 6.25% Rate*, RTE NEWS (Oct. 13, 2015, 5:58 PM), http://www.rte.ie/news/business/2015/1013/734525-knowledge-development-box-to-have-6-5-rate [http://perma.cc/UE4Y-8S4Z].

152. *See* Jason M. Brown, *Patent Box Taxation: A Comparison of Four Recent European Patent Box Tax Regimes and an Analytical Consideration of If and How the United States Should Implement Its Own Patent Box*, 46 INT'L L. 913, 918-19 (2012).

153. *Id.* at 921.

154. *Id.* at 927.

155. W. Wesley Hill, *The Patent Box as the New Innovation Incentive for the Several States: Lessons from Intellectual Property-Tax Competition*, 42 AIPLA Q.J. 13, 30 (2014).

156. *See* DeAngelis, *supra* note 46, at 1384.

157. Germany's finance minister Wolfgang Schaeuble has called for a ban on patent box tax treatments as they run counter to EU rules against discriminatory tax rules. *See* Annika Breidthardt, *Germany Calls on EU To Ban "Patent Box" Tax Breaks*, REUTERS (July 9, 2013, 2:59 PM), http://uk.reuters.com/article/2013/07/09/uk-europe-taxes-idUKBRE9680KY20130709 [http://perma.cc/SFA9-SHHQ]. The EU started formal investigations in 2014 on corporate tax regimes in Ireland, Luxembourg, and the Netherlands with regard to whether they struck special deals with Apple, Amazon, Google, and Starbucks to give them special tax deals. *See* Tom Fairless, *EU To Investigate Corporate Tax Codes in Ireland, Luxembourg, Netherlands*, WALL ST. J. (June 10, 2014, 8:27 PM), http://www.wsj.com/articles/eu-to-investigate-corporate-tax-codes-in-ireland-luxembourg-netherlands-1402441870 [http://perma.cc/TX3N-LKPX]. "In January 2015, the EU's antitrust office preliminarily found that Amazon had entered into a tax deal with the Luxembourg government that amounted to unfair state aid." DeAngelis, *supra* note 46, at 1378 (citing James Kanter & Mark Scott, *Amazon's Tax Deal with Luxembourg May Break Rules, E.U. Regulator Says*, N.Y. TIMES (Jan. 16, 2015), Despite the facial appeal of the tax competition model, this framework suffers from key limitations. Perhaps most significantly, the model is limited in assuming that the only way to attract foreign investment is through tax policy, when there are many other tools at the government's disposal to do so. For instance, by making business infrastructure or securities law more business-friendly, governments can attempt to attract more businesses to incorporate and operate in their countries. A holistic understanding of the inversion phenomenon should involve not only the tax dimension but also non-tax dimensions to prescribe a broader set of tools to address the problem. In other words, the tax competition theory, although not incorrect, offers only a limited perspective on the phenomenon of inversion.

B. Multi-Dimensional Regulatory Competition Model

This Section builds a multi-dimensional competition framework that responds to the criticism that the tax competition model does not consider non-tax dimensions of competition. This alternative framework will help refine the benefit tax theory and improve understandings of inversions.

First, this Section categorizes the benefits that companies receive from countries into three categories, based on whether the benefits are available as a result of incorporation or operation in a given jurisdiction. Second, it shows that corporate tax does not and should not reflect one of the three types of benefits. Third, it shows that corporate tax should be closely tied to another of the types of benefits, and the problem with inversions is that inverting companies continue to enjoy this type of benefit when, according to the principles of the benefit tax theory, they should not. The notion that paying tax to the country

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http://www.nytimes.com/2015/01/17/business/amazon-luxembourg-european-commission.html [http://perma.cc/3X2H-UF3C]).

158. From this tax competition model, two camps have emerged with conflicting policy recommendations for limiting inversions. The first camp believes this competition is not healthy and will result in a suboptimally low level of tax rates across countries, leading to government spending cuts and increased reliance on other distortionary revenue sources. *See, e.g.*, Hans-Werner Sinn, *The Case for European Tax Harmonization, in* TAX HARMONIZATION AND FISCAL LIBERALIZATION IN EUROPE 3, 6-7 (Georg Winckler ed., 1992); Avi-Yonah, *supra* note 28, at 1578 (arguing that tax competition may lead countries to "cut the social safety net"). This camp's recommendation is that, because competition leads to a race to the bottom and unhealthy practices like inversion, countries should not lower their tax rates. The second camp thinks that this competition is healthy and will lead to an efficient outcome. *See, e.g.*, A. Lans Bovenberg, *Perspectives on Tax Policy in Small and Open Economies, in* TAX POLICY IN SMALL OPEN ECONOMIES 1, 4 (Torben M. Andersen et al. eds., 1994). At the end of the day, this group argues that inversions are symptoms of the fundamental inefficiency in the U.S. tax system.

that provides a certain type of benefit—bundling—is key to the arguments in this Section.

1. *Setup: Formalizing the Benefit Tax Theory*

Competition need not occur only along the tax dimension. In an attempt to attract business, countries could not only lower the price that companies have to pay to the government (i.e., tax), but also entice them by providing various benefits. Viewed through the lens of benefit tax theory, the tax levied by the United States (or another jurisdiction *X*) on a corporation should correspond to the benefits the company enjoys from the United States (or from *X*).

Consider the United States and another jurisdiction *X*, where *X* offers a lower tax rate, such that U.S. corporations have inverted or are likely to invert there. Each country also offers a set of benefits of (1) real business factors and infrastructure, excluding capital markets, (2) access to capital markets, (3) corporate governance law, (4) securities law, (5) contract law, (6) bankruptcy law, (7) property law, (8) antitrust law, (9) intellectual property law, (10) diplomatic assistance, (11) treaty protection, and (12) domestic inputs. These are the twelve benefits identified in Section II.B. This Section classifies the twelve benefit variables into three categories.

Type I benefits reflect the benefits that companies can enjoy from the United States regardless of their place of incorporation or their place of operation. They include access to capital markets, securities law, contract law, and property law factors, corresponding to items (2), (4), (5), and (7) in the list above.

To derive the benefits of U.S. securities law and access to capital markets, corporations simply need to list their stocks on a U.S. exchange.[159] As long as their stocks are listed on U.S. stock exchanges, such corporations are subject to U.S. securities law and have access to the U.S. securities market, regardless of their place of operation or incorporation. The benefits of U.S. state contract law operate in a similar fashion, because contracting parties can freely opt into the contract law of any state or national jurisdiction. Likewise, the applicable property law is determined by the physical location of a company's property, irrespective of where a corporation is incorporated or operating. In other words, a company with some property in Connecticut will receive the protections of Connecticut property law with respect to that property, even if the corporation's place of incorporation and operations are in another jurisdiction.

Type II benefits are tied to the place of incorporation regardless of the place of operation. They include corporate governance law and diplomatic assistance

159. *See* Kelly, *supra* note 104, at 219-23.

factors, corresponding to items (3) and (10) in the list above. The place of incorporation governs corporate affairs. Similarly, countries often extend diplomatic assistance in circumstances of political instability or trade disputes to corporations incorporated in their jurisdiction. Thus, when a company inverts to change its place of incorporation, benefits in this category are no longer provided by the old jurisdiction and must instead be offered by the new jurisdiction.

Type III benefits represent the benefits that companies can enjoy by having their operations in a given jurisdiction, regardless of the place of incorporation. They include infrastructure and real business factors (excluding capital markets), bankruptcy law, antitrust law, intellectual property law, and treaty protections, corresponding to items (1), (6), (8), (9), and (11) in the initial list.

Assume a U.S. multinational corporation with substantial U.S. operations decides to invert to Ireland. The real business factors and infrastructure (excluding capital markets for now) are some of the most fundamental benefits offered to a company with operations in the United States. Even if a company inverts out of the country, therefore, its U.S. operations will continue to derive these benefits from the United States in the form of the large consumer market, roads, police, fire protection, skilled labor, and so forth.

A similar dynamic applies to the other Type III benefits. To be eligible for Chapter 11 bankruptcy, for example, a company only needs to "reside[] or ha[ve] a domicile, a place of business, or property in the United States."[160] And this property requirement has been construed to include bank accounts in the United States.[161] This is a low bar, which inverting companies that continue to have business and property in the United States will almost certainly pass. The benefits derived from antitrust law and intellectual property law[162] also permit the U.S. operations of a newly inverted company to avoid injury from the unfair practices or copyright-infringing activities of its competitors.

As for treaty protection, the international trade and commercial agreements to which the United States is a party typically focus on the origins of goods, ra-

160. 11 U.S.C § 109(a) (2012).

161. *See* Stephen J. Lubben, *Corporate Bankruptcy Tourists Land in U.S.*, N.Y. TIMES: DEALBOOK (Oct. 31, 2014, 10:06 AM), http://dealbook.nytimes.com/2014/10/31/corporate-bankruptcy-tourists-land-in-u-s [http://perma.cc/JT33-9P6X].

162. U.S. intellectual property law extends only throughout the territory of the United States, and intellectual property law also applies nation by nation in other countries. *See Protecting Intellectual Properties Rights (IPR) Overseas*, U.S. PAT. & TRADEMARK OFF., http://www.uspto.gov/patents-getting-started/international-protection/protecting-intellectual-property-rights-ipr [http://perma.cc/6HJP-2ZSP].

ther than the places of incorporation of the producers and manufacturers.[163] Thus, having an operation in the United States is often sufficient to derive these benefits. In addition, the current draft of the Model BIT "defines an 'enterprise of a Party,' which is entitled to investment protection under the treaty, to mean 'an enterprise constituted or organized under the law of a Party, and a branch located in the territory of a Party and carrying out business activates there.'"[164] That is, the text of the Model BIT implies that the eligibility for investment protection does not depend only on the place of incorporation, but also extends to a U.S. branch/operation of a foreign corporate parent.[165]

The foregoing discussions can be rephrased algebraically. The United States offers a vector of benefits of $\overrightarrow{B_{1,y}} =< i'_{1,y}, i^m_{1.y}, c_{1.y}, s_{1.y}, k_{1.y}, b_{1.y}, pr_{1.y}, ip_{1.y}, a_{1.y}, d_{1.y}, t_{1.y} >$ to a company *y*, where the subscript 1 denotes the United States, the subscript *y* denotes company *y*,[166] and *i'*, i^m, *c*, *s*, *k*, *b*, *pr*, *ip*, *a*, *d*, and *t* denote, respectively, the twelve benefits mentioned above. We can conceptualize the U.S. corporate tax as the price $p_{1,y}$ imposed on corporations enjoying such a vector of benefits $\overrightarrow{B_{1,y}}$.

Assume also that a lower tax jurisdiction *X* offers another vector of benefits $\overrightarrow{B_{x,y}} =< i'_{x,y}, i^m_{x,y}, c_{x,y}, s_{x,y}, k_{x,y}, b_{x,y}, pr_{x,y}, ip_{x,y}, t_{x,y}, a_{x,y}, d_{x,y} >$ to company *y*, while charging a lower tax at $p_{x,y}$; the subscript *x* denotes the lower tax jurisdiction *X*. A high value of *p* would denote higher tax, and high values of *i*, *c*, *s*, etc. would denote greater benefits in those categories.[167] As dis-

163. *See, e.g.*, North American Free Trade Agreement art. 401, Can.-Mex.-U.S., Dec. 17, 1992, 32 I.L.M. 289 (1993); Lan Cao, *Corporate and Product Identity in the Postnational Economy: Rethinking U.S. Trade Laws*, 90 CALIF. L. REV. 401, 462-63 (2002).

164. Kirsch, *supra* note 85, at 560 (quoting U.S. Model Bilateral Investment Treaty, sec. A, art. 1 (2004), http://www.state.gov/documents/organization/29030.doc [http://perma.cc/63NT-UVWM]).

165. *See id.* Kirsch notes that "earlier iterations of U.S. BITs use only a place-of-incorporation rule to define the company eligible for BIT coverage. Thus, under these earlier BITs that are still in force, place of incorporation has some relevance." *Id.* at 560-61 (footnote omitted). However, since the text of the Treaty does not imply so, I interpret it to say that the benefit could extend to a U.S. branch of the inverted company.

166. Note that the vector of "benefits" depends not only on a country but also on an individual company. This notation captures the idea that two companies operating in the same country may derive different legal protections from that country, both in magnitude and in kind, possibly because of the companies' differences in size and industry.

167. Before proceeding further, it is important to note that the model does not mean to precisely quantify these variables. Models in general—including this model here—are meant to capture the core essence of a real-life phenomenon. Adding more features and details into models to make them more realistic comes at the cost of losing the core essence of the issue and

cussed above, Type I benefits include i^m, *s*, *k*, and *pr*, Type II benefits include *c* and *d*, and Type III benefits include *i'*, *b*, *ip*, *t*, and *a*.

2. *Type I Benefits: Not Reflected in Corporate Income Tax Rates*

Note that corporations can enjoy Type I benefits no matter where they incorporate or operate. As a result, corporate income tax rates do not—and should not—reflect the Type I benefits provided from that jurisdiction. To see this point, consider the following example.

Putting inversion aside for a moment, consider a Japanese company operating in Russia without *any* ties to the United States, except that its stock is listed on the NYSE and it frequently uses New York contract law in its international trade deals. Note that this company enjoys Type I benefits offered by the United States, such as access to the U.S. capital market, the protections of U.S. securities law, and U.S. contract law. However, because the company is neither conducting any business in the United States nor incorporated in the United States, it would not pay any income tax to the U.S. government under the current U.S. tax regime.

Although a *pure* benefit theory would dictate that any corporation benefiting from the U.S. capital market, securities law, and contract law should be taxed by the United States for those benefits they enjoy, the current corporate tax regime does not function that way. That is, the current state of the U.S. corporate income tax reflects a compromised version of the benefit theory, where corporate tax rates do not account for Type I benefits for several reasons. Even if the U.S. government wanted to collect tax from this hypothetical Japanese company, it would be administratively impossible, for example.

The fact that the current income tax regime does not reflect these Type I benefits enjoyed in the United States by foreign corporations has important implications for treatment of inverting companies. Taxing an inverting company based on these Type I benefits that the company continues to enjoy would in effect treat two similarly situated companies differently. It would be inconsistent to exempt the Japanese company mentioned above from paying tax for

losing their workability by unnecessarily complicating them. Thus, this multi-competition model presents a highly stylized comparison to help understand the core feature of the corporate inversion phenomenon and its solutions. In fact, attempting to find a magic number that reduces the entire body of corporate law into one number *c* is neither meaningful nor possible. As readers will see, not being able to quantify these variables does not matter much for better understanding inversion or devising the solutions proposed below. Because these variables are not quantifiable, they can even be thought of as ordinal values, not cardinal ones, just like modern microeconomic utility functions treat the concept of "utils."

the Type I benefits it enjoys, while also imposing tax on inverting companies for the Type I benefits they receive either before or after inversion. To preserve consistency, then, the corporate income tax *categorically* should not take into account these Type I benefits.

A similar argument can be made for property law. If the same Japanese company above also owned a small piece of land in Connecticut, that state's property tax would presumably reflect the Type I benefits derived from state property law. There is, in other words, no role for the corporate income tax to play with respect to this benefit. Putting it all together, all Type I benefits should be categorically not reflected in the corporate income tax.

Significantly, however, the arguments for decoupling Type I benefits from corporate income tax rates do not apply with equal force to decoupling Type II and Type III benefits from corporate income tax rates. Under the current tax regime, the hypothetical Japanese company derives only Type I benefits from the United States, and so does not pay income tax to the United States. In contrast, Type II and Type III benefits are inevitably tied to the U.S. income tax in a way that Type I benefits are not. Companies enjoying Type III operation benefits from the United States by definition have operations there, and so pay tax on the income generated from these activities. Similarly, companies obtaining Type II incorporation benefits from the United States pay tax on both their domestic-source income and foreign-source income due to the U.S. worldwide tax regime.

In other words, the corporate income tax level is a function of Type II and Type III benefits, but excludes Type I benefits. Formally speaking, $\overrightarrow{B_{1,y}} = < i'_{1,y}, i^m_{1,y}, c_{1,y}, s_{1,y}, k_{1,y}, b_{1,y}, pr_{1,y}, ip_{1,y}, t_{1,y}, a_{1,y}, d_{1,y} >$, yet Type I benefits—$i^m$, s, k, and pr—do not end up affecting $p_{1,y}$. That is, $p_{1,y} = f_{1,y}\left(i'_{1,y}, c_{1,y}, b_{1,y}, ip_{1,y}, t_{1,y}, a_{1,y}, d_{1,y}\right)$. Similarly, $p_{x,y} = f_{x,y}(i'_{x,y}, c_{x,y}, b_{x,y}, ip_{x,y}, t_{x,y}, a_{x,y}, d_{x,y})$.[168]

3. *Competition To Attract Incorporations and Operations*

This model implies that regulatory competitions need not be a race to the bottom as countries compete to lower their lower corporate tax rates. Rather, the multi-dimensional model can account for a race to the top as countries

168. $f_{1,y}$ need not equal $f_{x,y}$. Furthermore, because more benefits (any type) should translate to more tax according to the benefit principle, we can imagine $\partial p_1/\partial i_1, \partial p_1/\partial c_1, \partial p_1/\partial b_1, \ldots \geq 0$ and the same should hold for those of *X*.

compete to offer better Type II and Type III benefits in order to attract corporations to incorporate or operate in their jurisdictions. Numerous scholars have discussed the concept of races to the bottom or the top in different areas, including securities regulation,[169] corporate charters,[170] tax competition,[171] and so forth. What is unique about this Note's multi-dimensional competition model is that it allows competition to occur along many dimensions concurrently, as opposed to along only one dimension. Furthermore, this Note's model can account for the simultaneous coexistence of the tendency to race to the bottom with respect to tax rates and the tendency to race to the top in other areas such as corporate governance or patent protection law.

Moreover, a race need not happen all the way up or down; an equilibrium can be reached in the middle. That is, countries that offer greater Type II and III benefits can efficiently charge companies a higher price, or tax, for those benefits. Countries that offer lesser Type II and III benefits would need to charge a correspondingly lower price. Because the benefits offered by countries are not identical, heterogeneous differentiation of pricing is possible, where the equilibrium does not need to result in identical tax rates across all countries. This outcome of the model is a generalization of a proposition made by Talley that analyzed only corporate law and tax rates as the two dimensions of competition: "When jurisdictions offer differentiated corporate governance regulations, they will in equilibrium split the market and impose differentiated taxes as well . . . ."[172]

This Section makes a highly stylized comparison of the benefit variables between the United States (denoted with subscript 1) and a foreign jurisdiction *X* representing any possible inversion destination (identified with subscript *x*).[173]

In addition, the following stylized comparison considers the *average* benefits provided to the companies and the *average* tax rates imposed on companies

169. *See, e.g.*, Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1997).

170. *See, e.g.*, Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992); Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553 (2002); Romano, *Law as a Product*, *supra* note 92.

171. *See supra* notes 143-146 and accompanying text.

172. Talley, *supra* note 28, at 1708.

173. Each of these factors cannot be satisfactorily covered in this Note for the different countries covered by X—for example, Ireland, Luxembourg, the United Kingdom, and the Netherlands. Nor would it make much sense, because the purpose of this model is to help conceptualize the competition model, not to pin down precisely the relative values of benefits provided by each regime. Therefore, this Section will only point out salient features of the comparisons in order to illustrate how the model functions.

by that country. As mentioned above, a set (i.e., "vector") of benefits, even for the same country, will have different values depending on which company is receiving those benefits. For example, a pharmaceutical company would derive comparatively greater benefit from a given country's intellectual property protection than would a manufacturing company. As another example, a large company hoping to gain market share may be harmed from a robust antitrust regime, whereas an emerging company can benefit from such a protection. In addition, tax rates imposed by a given country may be different for different companies; as mentioned above, Ireland, the Netherlands, and the United Kingdom impose lower tax rates on income from intellectual property,[174] meaning two companies with the same revenue amount may still pay different amounts of taxes based on their revenue structures. To avoid becoming bogged down in these details, this Section focuses on the benefits provided by a country on average, and drops the company-specific subscript. Thus, while normally a corporate law benefit provided by a jurisdiction *X* to a company *y* would be denoted $c_{x,y}$, this Section will consider the corporate law benefit provided by a jurisdiction *X* to companies on average and drop the subscript *y*, resulting in the notation c_x.

The multi-dimensional comparison undertaken in this Section rests on the initial premise that the United States tax rate is higher than that of jurisdiction *X*. This is likely to be true for two reasons: first because the United States has the third highest corporate tax rate in the world,[175] and second because, for the purposes of this discussion, *X* represents one of the countries to which U.S. companies are likely to invert. A direct comparison of respective benefits offered by the United States and *X* should therefore assume that the United States generally offers better benefits than *X*, in order to justify the higher tax rate in the United States.

As discussed above, the United States would most likely have advantages in various market, business, and infrastructure factors—even excluding capital markets—compared to most, if not all, of the countries in the world.[176] Its capital markets benefit is also likely to be greater than that offered by many other countries, as are several other factors identified in the typology set out earlier. Of course, jurisdiction *X* may offer equal or greater benefits in certain instances—the corporate governance regimes in some European countries are highly

174. *See supra* notes 151-157 and accompanying text.

175. *See* Kyle Pomerleau, *Corporate Income Tax Rates Around the World, 2015*, TAX FOUND. (Oct. 1, 2015), http://taxfoundation.org/article/corporate-income-tax-rates-around-world-2015 [http://perma.cc/9L9G-3S6L].

176. *See supra* notes 130-131 and accompanying text.

developed, and thus not necessarily superior to the Delaware regime in the United States, for example. Nonetheless, when viewed holistically, the United States is likely to provide a stronger overall package of benefits than country *X*.[177]

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177. The United States has a huge consumption consumer market to which U.S.-operating companies have direct access. *See* Dumler, *supra* note 131, at 96-97. There are often "good business reason[s] for management to be geographically close to the multinational corporation's most significant customer base," so management being present in the United States could be of immense value. *See* Omri Marian, *Home-Country Effects of Corporate Inversions*, 90 WASH. L. REV. 1, 22 (2015). In addition, the United States has a relatively skilled workforce to support corporate operations, has advanced infrastructure for smooth business operations, and offers other agglomeration benefits: synergetic benefits that companies derive by being located near each other. Furthermore, the United States would most likely provide better capital market infrastructure than most of the countries in the world. The two largest stock exchanges in the world—the NYSE with $18.3 trillion market capitalization and the NASDAQ with a $6.7 trillion market capitalization in 2015—are in the United States. *See* Chief Editor, *2015 Stock Exchange Market Capitalization*, CAPROASIA (Oct. 26, 2015), http://www.caproasia.com/2015/10/26/2015-stock-exchange-market-capitalization [http://perma.cc/4AZK-KGNY]. Listing in U.S. markets can enhance a corporation's "visibility and prestige," and various empirical studies have shown that foreign corporations' shares experience an "increase in value when they cross-list on a U.S. exchange." Kelly, *supra* note 104, at 219; *see also* Gordon Alexander et al., *Asset Pricing and Dual Listing on Foreign Capital Markets: A Note*, 42 J. FIN. 151 (1987); Gregory B. Kadlec & John J. McConnell, *The Effect of Market Segmentation and Illiquidity on Asset Prices: Evidence from Exchange Listings*, 49 J. FIN. 611 (1994). One possible explanation for why share price increases is that shareholders recognize the benefits of stricter corporate governance standards and disclosure requirements demanded by U.S. exchanges. *See* John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications,* 93 NW. U. L. REV. 641, 674 (1999). However, securities market access is a Type I benefit and thus would not factor into the competition to attract corporations to incorporate or operate in the United States.

Given the superiority of the U.S. corporate governance regime—relative ease of shareholder derivative suits, allowance of poison pills that raise takeover premiums and benefit shareholders, the principle of shareholder primacy, the expertise of Delaware courts, the predictability of Delaware law and other aspects of the generally superior Delaware regime—the corporate law benefits offered by the United States would likely be greater than the ones offered by another jurisdiction *X*. Yet the degree of this difference may be insignificant or the sign may be flipped. Some of the European countries that are popular inversion destinations have highly developed corporate governance systems as well. For instance, Ireland offers a "corporate government structure [that] protects shareholders," and that was scored "the highest on [Governance Metrics International] Rating's corporate governance scale." Day, *supra* note 100, at 489 & n.236. If this is the case, the corporate law benefits offered by the United States would not be more than the ones offered by jurisdiction *X*.

Lastly, as to the bankruptcy law, it would be fair to say that the United States offers more bankruptcy benefits than many of the other foreign countries represented by *X*, based on foreign companies' general preference for seeking bankruptcy proceedings in the United States. For instance, the United States is generally recognized worldwide as having "the

Algebraically, $p_1 > p_x$ would hold, and many of the following eight inequalities—$i'_1 > i'_x$; $i^m_1 > i^m_x$; $c_1 > c_x$; $b_1 > b_x$; $ip_1 > ip_x$; $t_1 > t_x$; $a_1 > a_x$; $d_1 > d_x$—if not all, should be true. The previous paragraphs discussed the capital market infrastructure factor (that $i^m_1 > i^m_x$ would hold very easily), the corporate governance law factor (that $c_1 > c_x$ may hold for a lot of countries *X*), and the bankruptcy law factor (that $b_1 > b_x$ for most *X*).

4. *Interpreting Inversion Through the Competition Model: A U.S.-Outbound Inverted Company Continues To Enjoy U.S. Type III Benefits*

The discussion so far has suggested that companies do not belong to any jurisdiction a priori and thus weigh the costs and benefits of each jurisdiction when deciding where to incorporate. This may be true for companies that are incorporating for the very first time in their history. However, in the context of inversion, the model needs an additional feature. For inverting companies, the source of some benefits they receive will change from the United States to the new jurisdiction. They may also incur transaction costs during the inversion.

most efficient forum for restructuring international companies," Palank, *supra* note 132, and is known worldwide for "its long history of corporate reorganization." Oscar Couwenberg & Stephen J. Lubben, *Corporate Bankruptcy Tourists*, 70 BUS. LAW 719, 719 (2015); *see also* Stephen J. Lubben, *Railroad Receiverships and Modern Bankruptcy Theory*, 89 CORNELL L. REV. 1420 (2004). Furthermore, the United States has extensive experience in restructuring bond debt and complex capital structures, whereas "by and large European jurisdictions, even the United Kingdom have relative little experience." Couwenberg & Lubben*, supra*, at 720.

By way of demonstration, the model may be used to compare the United States and Ireland, where the magnitude of difference in the benefits offered may not be too different. The latter country is a common inversion destination that offers a strong corporate governance structure and a robust intellectual property law regime. Perhaps even more importantly, Ireland has access to the E.U. market and is a hospitable, cost-competitive climate for doing business thanks to "a skilled and productive labor force" and "stable and sensible regulation." Ramesh Maharaj, *IP in a Financial Center: Ireland vs. Cayman Islands*, LAW360 (Aug. 21, 2014), http://www.law360.com/articles/567590/ip-in-a-financial-center-ireland-vs-cayman-islands [http://perma.cc/WW9Z-B584]. Expressed in terms of the factors identified here, its infrastructure and business factor (excluding securities market) may not be much lower than that of the United States. At the same time, Ireland offers one of the lowest corporate tax rates of any developed country. *See* Hwang, *supra* note 6, at 814-15. And this rate is even lower for income derived from intellectual property due to its patent box regime. *See* DeAngelis, *supra* note 46, at 1367-71. Putting together the low cost and high benefits of incorporating in Ireland, a company's desire to incorporate in Ireland makes sense, whether it is seeking to incorporate for the first time or to invert from another jurisdiction. Indeed, "[Ireland] is home to 15 of the top 25 global medical devices companies, eight of the top 10 global technology companies and eight of the top 10 global pharmaceutical companies." Maharaj, *supra*.

Thus, the model must take these changes into account.[178] This Section therefore tries to focus on not only the country-level characteristics of the regulatory regimes described above, but also on the cost-benefit calculation of a "rational actor" U.S. company that is considering whether to invert.

Prior to inversion, an American corporation enjoys Type I, Type II, and Type III benefits offered by the United States, and pays taxes to the United States based on the Type II and Type III benefits it receives. When that company inverts to lower tax foreign jurisdiction *X*, it takes advantage of *X*'s Type II incorporation benefits and continues to enjoy Type I and Type III benefits offered by the United States. However, after the inversion, the company would pay tax to *X*, at the *X* rate based on both the Type II and Type III benefits offered by *X*. Note that only Type II incorporation benefits—namely the corporate law and diplomatic assistance factors—change from the old jurisdiction to the new jurisdiction,[179] yet the company pays the lower tax to *X* as if its source of Type III operation benefits *also* changed, even though these continue to be provided by the United States.

Formally speaking, an inverting company *y* previously enjoyed benefits expressed as $< i'_{1,y}, i^m_{1,y}, c_{1,y}, s_{1,y}, k_{1,y}, b_{1,y}, pr_{1,y}, ip_{1,y}, t_{1,y}\ a_{1,y}, d_{1,y} >$ and paid $p_{1,y}(i'_{1,y}, c_{1,y}, b_{1,y}, ip_{1,y}, t_{1,y}, a_{1,y}, d_{1,y})$. After inversion, the company enjoys a set of benefits $< i'_{1,y}, i^m_{1,y}, c_{x,y}, s_{1,y}, k_{1,y}, b_{1,y}, pr_{1,y}, ip_{1,y}, t_{1.y}, a_{1,y}, d_{x,y} >$ but pays the post-inversion tax of $p_{x,y}\left(i'_{x,y}, c_{x,y}, b_{x,y}, ip_{x,y}, t_{x,y}, a_{x,y}, d_{x,y}\right)$.

To make this model more realistic, it needs yet one more feature. Inverted companies do not avoid taxes to the United States altogether as they relate to Type III benefits, because they continue to pay U.S.-source tax based on their operations in the United States. Thus, the model needs to distinguish Type III benefits that are related to U.S.-source income[180] from those that are related to foreign-source income.[181] This distinction highlights the fact that an inverted company would pay tax to the United States only on its U.S.-source income, while continuing to enjoy the Type III benefits provided by the United States

178. Some inversion articles focusing on regulatory competitions fail to characterize inversion from the point of view of a company that already belongs to a certain jurisdiction. *See, e.g.*, Talley, *supra* note 28.

179. *See supra* Sections III.B.1, III.B.2.

180. These include infrastructure and real business factors (excluding capital markets) that contribute to domestic wealth generation, as well as bankruptcy law, intellectual property law, and antitrust law.

181. These are the U.S. infrastructure and real business factors (excluding capital markets) that contribute to foreign income generation as well as treaty protections.

that are related to foreign-source income without paying the corresponding tax to the United States. Even worse, the company can further erode its domestic-source income through practices such as transfer pricing, earnings stripping, or income shifting, thereby reducing the tax it pays to the United States for the enjoyment of even the Type III benefits that are related to U.S.-source income. In other words, an inversion creates a mismatch where companies continue to enjoy all of the Type III benefits provided by the United States but stop paying the corresponding tax for some, if not most, of those Type III benefits.

A company contemplating inversion would compare the benefits of inversion—the net present value of all future tax savings by inversion—with the costs of inversion: the relative difference between Type II benefits offered by the United States and Type II benefits offered by *X*, in addition to transaction costs.[182] After performing the cost-benefit analysis, those companies for which the benefits outweigh the costs of inversion will invert.

What the model developed here suggests is that, for those companies choosing to invert, the cost of pursuing inversion as outlined above *is, according to the benefit tax theory, too low*. Inverting companies face only the cost of losing U.S. Type II benefits (in exchange for obtaining these from *X*) and transaction costs. Excluded from the current calculation is the cost of also losing some of the U.S. Type III benefits (in exchange for getting those from *X*), where a benefit tax framework would dictate these costs should be included. *That is, the core*

182. These transaction costs involve the following: (1) tax recognition of built-in gains on share exchanges, *see* I.R.C. § 367(a) (2012); *see also supra* notes 49-50 and accompanying text; (2) uncertainty as to the success of the deal due to retrospective Treasury measures, *see supra* Part II; (3) reduced local influence due to "small footprints in their new foreign jurisdictions," Hwang, *supra* note 6, at 843; and (4) unfamiliarity with the new corporate governance law and the cost of learning. As to the reduced local influence effect, for instance, Tyco International inverted to Bermuda in 1997 and inverted again to Switzerland in 2013. In 2013, Switzerland passed a voter referendum that required a binding shareholder vote on compensations for the executive officers of Swiss public companies. Tyco could not influence these laws or regulations and had to invert out to Ireland. *Id.* In contrast, a company like Boeing was given various tax breaks by the state of Washington over sixteen years so that it would not leave the state, and the state of New York also gave Alcoa various tax breaks over thirty years for the same reason. *Id.* at 844. As to the unfamiliarity with the new corporate governance law, for instance under Delaware law, dividend payments are largely up to the discretion of the directors and depend on the notion of earnings and profits account; in contrast, under the Irish law, dividend payments depend on the concept of "distributable reserves," where the process of creating distributable reserves may be a little onerous, for instance in the case of capital reduction that "requires shareholder approval and approval by the Irish High Court." *Id.* at 838 (citing the Companies (Amendment) Act of 1983, § 45 (1983) and the Companies Act of 1963, § 74 (1963)). Furthermore, corporate law in mergers and acquisitions is different between the United States and the United Kingdom, in the area of takeover defense, break-up fees, etc. *See id.* at 840-41.

concern with inversions is the unbundling of some Type III benefits—all Type III benefits that relate to foreign-source income and other Type III benefits that relate to domestic-source income to the extent that a company engages in transfer pricing, income shifting, and earnings stripping—offered by a certain jurisdiction from the tax owed to that jurisdiction. Inverting companies can cherry-pick Type III benefits from one country and pay tax in another jurisdiction, when a benefit tax perspective would instead counsel that a jurisdiction's corporate income tax should be based on both the Type II and Type III benefits it offers (i.e., benefit tax theory dictates that corporate tax be bundled with Type II and Type III benefits offered). Thus, there are two problems with inversion: (1) inverting companies pay lower tax to *X* while still enjoying presumably superior Type III benefits from the United States, and (2) even if the U.S. tax rate is overpriced relative to the Type III benefits offered, inverting companies fail to pay the full price to the United States for the Type III benefits that the United States nonetheless provides.[183]

IV. IMPLICATION OF THE MULTI-DIMENSIONAL COMPETITION MODEL: FRICTION

The insight the benefit tax theory provides to a country hoping to curb inversions, such as the United States, is simple: bundle *all* Type III benefits provided with the country's tax. A company should be allowed to enjoy Type III benefits from the United States if and only if it pays the corresponding U.S. tax. A company that does not pay any U.S. tax on the Type III benefits it enjoys either should be made to pay U.S. tax or should be denied those Type III bene-

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183. Note that, from the point of view of a country attempting to limit inversions, the two identified problems with inversion do not depend on individual companies' characteristics. Individual companies' characteristics affect the relative magnitude of benefits derived. The problem in (2) deals with a threshold question—whether a company should pay a tax to the United States, rather than whether the right amount of tax is paid—and does not depend on individual companies' characteristics that affect its tax. All inverting companies, regardless of their characteristics, avoid paying tax to the United States for some of the Type III benefits derived. As to the problem in (1), from the point of view of a country attempting to limit inversions, only those companies whose benefits of inversion—tax savings—are large enough to outweigh costs of inversion—differences in Type II benefits, in addition to transaction costs—would invert. In other words, no matter the individual company's characteristics that affect the relative amounts of benefits they derive, the only companies that end up inverting are the ones that end up violating the benefit tax theory. Therefore, a country attempting to limit inversions can be confident that such a self-selection means inverting companies are violating the benefit tax theory and need not worry about taking into consideration individual company characteristics.

fits. In some respects, the enactment of IRC Section 7874, IRS Notice 2014-52, IRS Notice 2015-79, and the recent April 6, 2016 temporary regulation discussed in Part II are attempts at realizing this result by making these inverted companies, which continue to enjoy Type III benefits, continue to pay U.S. tax.

Another way to bundle the benefits received with the tax paid is to simply deny Type III benefits that inverting companies avoid paying tax on. That is, the multi-dimensional model offers a more comprehensive diagnosis of the tax problem—because it also implicates non-tax laws—rather than viewing inversion solely through the tax lens. By doing so, it also helps eliminate the tension between form and substance (i.e., addressing inefficiencies underlying corporate inversions) in the inversion context.

Given the importance of bundling, this Part proposes tax friction as a way to bundle better and deduces from that friction framework three possible proposals to curb inversions. The Part then identifies the unexpected collateral consequences of its proposals and compares these non-tax friction approaches to the historical tax solutions discussed in Part I.

These three possible proposals are by no means exhaustive. Instead, they serve as examples of what insights the multi-dimensional competition model may provide going forward. This Note leaves it to future scholars to more fully develop other proposals that could be derived from this model.

A. *Friction as a Way To Bundle*

Tax friction refers to the idea of adding *non-tax* costs to constrain the abusive tax-planning behaviors.[184] This additional cost is called "friction." David Schizer notes that "narrow reforms that target specific planning strategies" lead to "taxpayers press[ing] on, tweaking the deal just enough to sidestep the reform . . . ."[185] He further states that "[t]hese avoidable measures cannot raise revenue or increase the tax burden on wealthy taxpayers. Instead, end runs consume resources and warp transactions, yielding social waste."[186] Although his article focuses on other areas of tax such as the constructive sale rule[187] and

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184. *E.g.*, MYRON S. SCHOLES & MARK A. WOLFSON, TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH 7 (1992) ("By frictions we mean transaction costs incurred in the marketplace that make implementation of certain tax-planning strategies costly"); Marian, *supra* note 177, at 22; Schizer, *supra* note 29, at 1315.

185. Schizer, *supra* note 29, at 1315.

186. *Id.*

187. I.R.C. § 1259 (2012).

the constructive ownership rule,[188] Schizer's observation is equally applicable to inversion, because the history of inversion has been a cat-and-mouse game where tax remedies are sidestepped by taxpayers who develop ingenious ways to skirt the law.[189]

Professor Schizer notes that tax policies are successful when there are enough frictions, and not as successful when there are no such frictions. Therefore, the "answer [to constrain tax avoidance behaviors] lies outside the tax law itself."[190] He then offers examples of non-tax frictions that may apply generally: legal and accounting constraints (e.g., substantive preconditions, agency costs, credit risk), state of technology and markets, taxpayer preference regarding business activity, regulatory and financial accounting, and so forth.[191] In the inversions context, there are two possible candidates for tax frictions: the reduction of U.S.-provided Type III benefits to inverting companies, and the reduction of U.S.-provided Type I benefits to inverting companies.

B. Proposal 1: Reducing Type III Benefits to Inverting Companies

The logic of this proposal is simple: if a U.S. company inverts, they will no longer be allowed to enjoy the same amount of Type III benefits from the United States because they are not paying the corresponding tax to the United States for enjoying those benefits. This proposal raises the cost of inversion and essentially converts some of the Type III benefits into Type II benefits. In an ideal world, this proposal would entail denying inverted companies the Type III benefits that they avoid paying tax on—namely all Type III benefits that relate to foreign-source income and other Type III benefits that relate to domestic-source income to the extent that a company engages in transfer pricing, income shifting, and earnings stripping. This approach would be most consistent with the benefit tax theory.

However, denying all of these Type III benefits is likely not possible. It may not be worth the effort to try to bundle some of these benefits because of the resulting distortions that may occur in other legal realms. Thus, there is a need to prioritize, perhaps by focusing on Type III benefits that relate to foreign-source income (and on other Type III benefits that relate to domestic-source income to the extent that a company engages in transfer pricing, income shifting, and earnings stripping). Only empirics can conclusively determine the

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188. *Id.* § 1260.

189. *See supra* Part II.

190. Schizer, *supra* note 29, at 1315.

191. *See id.* at 1326-34.

effectiveness of a denial of individual Type III benefits, but some outcomes seem more plausible than others. Consider bankruptcy law: these inverting companies, often with high revenues and correspondingly high tax liability, are typically bankruptcy-remote and thus less likely to use the U.S. bankruptcy law regime. Thus, it may not be worth the effort to change the bankruptcy law regime solely to address the inversion problem. Similarly, the benefits derived from U.S. antitrust law—namely, benefiting from a competitive market structure and not being harmed by anticompetitive practices—may be too diffuse and abstract to have a significant effect.

In contrast, other benefits arguably can be reduced for inverting companies. For example, patent law protection can be diminished for inverting companies by lowering the years of protection, although this is admittedly a radical idea. Instead of trying to be comprehensive, the remainder of this Section focuses on two specific approaches: the reduction of BIT/treaty protection, and the reduction of some real business factors by denying government contracts.

1. *Example 1.1: Reducing U.S. BIT/Treaty Protection*

The international trade and commercial agreements to which the United States is a party typically focus on the origins of goods rather than the places of incorporation of producers and manufacturers.[192] It would be difficult to change these preexisting treaty provisions, and it may be costly to change them solely with the goal of tackling inversion problems. However, in future agreements, it may be worthwhile to consider making the place of incorporation play a bigger role in determining the applicability of the trade protections. That way, a company inverting out of the United States would not be able to enjoy as much of the treaty protection benefits as it did before inversion. This is already occurring, for instance, in deciding eligibility regarding cross-border services under NAFTA,[193] where an enterprise of a Party eligible for NAFTA benefits in other countries is determined by the location of incorporation.[194] Under this scenario, a Bermuda corporation, say, would not qualify for NAFTA bene-

192. *See, e.g.*, North American Free Trade Agreement, *supra* note 163; Cao, *supra* note 163; *Proceedings of the Seventh Annual Conference on Legal Aspects of Doing Business in Latin America: Adapting to a Changing Legal Environment*, 9 FLA. J. INT'L L. 1, 33 (1994).

193. Kirsch, *supra* note 85, at 558-59.

194. *Id.* at 559 n.272. For more information, see Eric Leroux, *NAFTA and the Financial Services Sector*, *in* 1 NORTH AMERICAN FREE TRADE AGREEMENTS COMMENTARY C.19, 16 n.88 (James R. Holbein & Donald J. Musch eds., 1998); and Linda Powers, *NAFTA and the Regulation of Financial and Other Services*, 1 U.S.-MEX. L.J. 65, 68-69 (1993).

fits.[195] Prospective treaties could also include this kind of reference to and emphasis on the place of incorporation.

In addition, the United States has concluded more than three dozen BITs that are playing increasingly important roles in international trade.[196] The primary benefit to corporations under these agreements is that they are afforded the same protections they would receive from the United States when they invest in a foreign country that signed a BIT with the United States. As discussed earlier, according to the current draft of the model BIT, the definition of an "enterprise of a Party" entitled to investment protection under the BITs can include a U.S. branch of a foreign corporate parent.[197] That is, an inverted company—now with a foreign parent—would fall under the definition of an "enterprise of a Party" solely by virtue of continuing to have operations in the United States. This definition in the model language of "an enterprise constituted or organized under the law of a Party, and a branch located in the territory of a Party and carrying out business activities there,"[198] can be modified to "an enterprise constituted or organized under the law of a Party" to make the place of incorporation the only relevant factor in extending the benefits of protection offered by the BITs.

For future treaties and BITs to be signed by the U.S. government, drafters and negotiators could implement this idea. The proposed "tweak" to U.S. BITs is unlikely to provoke political deadlock, because the drafting language can be shaped and determined by executive branch officials, and even at the Senate ratification stage, the proposed modification is narrowly tailored to address the inversion problem, as opposed to pushing for more comprehensive reform.

2. *Example 1.2: Reducing U.S. Business Benefit Factors by Denying Government Contract Privileges*

Because the infrastructure and business benefits are important, the problem of not paying tax to the United States for those benefits seems significant. However, a complete denial of access to the U.S. infrastructure and business factors—such as prohibiting access to the consumption market, labor market, roads, police and fire services, and so forth—seems impractical. Perhaps an angry public can choose not to purchase products from the inverted company or the media can publicize egregious inversion deals; however, government denial

195. *See* Kirsch, *supra* note 85, at 559 n.272.

196. *See supra* notes 164-165 and accompanying text.

197. *Id.*

198. U.S. Model Bilateral Investment Treaty, art. 1 (2004).

of access to the U.S. market for these inverted firms sounds oppressive and contrary to the paradigm of free-market capitalism. Yet, while a complete denial of business benefits is impracticable, one way to partially reduce the business benefits offered by the United States is to restrict the ability of inverting companies to obtain federal, state, or local government contracts.

In 2014, inverted companies were found to be making more than $1 billion a year from the federal government.[199] As of now, there are few restrictions on contracting for inverted companies. Section 835 of the Homeland Security Act of 2002 prohibits the agency from contracting with any "foreign incorporated entities" that meet the definition of an inverted domestic corporation given by the Act.[200] Unfortunately, the provision "still has only limited instrumental impact."[201] Two other subsequent laws imposed similar prohibitions on other agencies, yet the restrictions apply "only as to funds appropriated or otherwise made available under specific acts of Congress"[202] and the relevant provisions do not "impose any restrictions on contracting with inverted domestic corporations that do not have a basis in statute."[203] That is, these measures are limited only to few agencies and are very limited in scope. Furthermore, some commentators have noted that inverted companies often find loopholes to continue contracting with the federal government.[204] At the state-level, in 2003, California enacted a law stating that "a state agency shall not enter into any contract

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199. *See* Zachary R. Mider, *Tax Runaways Win Billions in U.S. Contracts Despite Bans*, BLOOMBERG (July 8, 2014, 12:01 AM), http://www.bloomberg.com/news/articles/2014-07-08/tax-runaways-win-billions-in-u-s-contracts-despite-bans [http://perma.cc/XKD8-V9AB] ("[Ingersoll-Rand, an inverted company, can] garner contracts that aren't funded by annual congressional appropriations, [and received] contracts during periods when the ban had temporarily expired.").

200. 6 U.S.C. § 395(a)-(c) (2012); *see also* KATE M. MANUEL & ERIKA K. LUNDER, *Contracting with Inverted Domestic Corporations: Answers to Frequently Asked Questions*, CONG. RESEARCH SERV. 9 (May 11, 2015), http://www.fas.org/sgp/crs/misc/R43780.pdf [http://perma.cc/34JE-N2YQ].

201. Kirsch, *supra* note 85, at 498-99.

202. MANUEL & LUNDER, *supra* note 200, at 1 (citing 6 U.S.C. § 395(d)).

203. 5 U.S.C. § 395(b); 48 C.F.R. § 9.108-1 (2016); *see also* Consolidated Appropriations Act, 2012, Pub. L. No. 112-74, § 738, 125 Stat. 786, 938-39 (2011); Transportation, Treasury, Housing and Urban Development, the Judiciary, the District of Columbia, and Independent Agencies Appropriations Act, 2006, Pub. L. No. 109-115, § 724, 119 Stat. 2396, 2494 (2005); MANUEL & LUNDER, *supra* note 200, at 3; KATE MANUEL ET AL., *The Federal Acquisition Regulation (FAR): Answers to Frequently Asked Questions*, CONG. RESEARCH SERV. 3 (Feb. 3, 2015), http://www.fas.org/sgp/crs/misc/R42826.pdf [http://perma.cc/K2WN-HG8D].

204. *See, e.g.*, Zachary R. Mider, *Ingersoll-Rand Finds Escaping U.S. Tax Carries No Penalty as Contracts Flow*, 102 FED. CONT. REP. (BNA) 67 (2014).

with an expatriate corporation or its subsidiaries."[205] North Carolina enacted a similar bill.[206] Philadelphia is currently considering such a proposal, but no locality in the United States has yet adopted such a measure.[207] In sum, except for rare circumstances, inversions do not currently prevent inverted companies from continuing to obtain contracts with federal, state, or local governments.

To reduce the Type III benefits to these inverting companies, governmental contracts can be denied more categorically and more broadly across federal agencies, state governments and agencies, and local governments. Bidding would be denied to those companies that are deemed to have inverted out of the United States, according to some pre-established standard that could be coordinated among agencies. For flexibility, exceptions can be made: a presidential waiver could override the ban in the case of a national security interest, and a case-by-case exception could be made for those entities determined by the Secretary of the Treasury to have inverted for reasons other than the purpose of avoiding federal income taxation.

Implementing this proposal could happen at the federal, state, and local levels. Legislatures at all levels can pass bills that prohibit federal, state, and local agencies from contracting with inverting companies.[208] The legislative solution here is different from the legislative solution discussed at the beginning of the Note that attempted to fix the tax system. That is, a legislative solution that fundamentally reforms the tax system does not only narrowly target the inversion problem but also targets many other features of the U.S. tax system. This breadth makes it much more difficult to gain consensus and implement the fix. In contrast, a legislative solution to deny government contract privileges is narrowly tailored to address inverting companies. While some of the more comprehensive bills banning government contracts for inverted companies have not passed at the federal level,[209] that does not mean this solution is not possible.

205. California Taxpayer and Shareholder Protection Act of 2003, CAL. PUB. CONT. CODE § 10286.1(a) (West 2004).

206. N.C. GEN. STAT. § 143-59.1(a)(2) (2004).

207. *See* Leslie A. Pappas, *Proposal: No Philadelphia Contracts for Inverted Companies*, DAILY TAX REP. (Mar. 29, 2016), http://www.bna.com/proposal-no-philadelphia-n57982069150 [http://perma.cc/3AZ5-ZCLS].

208. Another possibility is that agencies can adopt these measures by themselves through regulations. This can stem from executive orders or state- and local-level equivalents from the executive branches.

209. Reclaiming Expatriated Contracts and Profits Act, S. 3120, 107th Cong. (2002); *see also* Amy Hamilton, *Finance Asks: Is Accenture an Expatriate?*, 98 TAX NOTES 894, 894-95 (2003) (discussing lobbying efforts to fight anti-inversion legislation).

As the examples from California and North Carolina show,[210] it is feasible, if not easy, to pass these bills, and there is huge public support for such measures.

C. Proposal 2: Reducing Type I Benefits to Inverting Companies

The goal of bundling should be to tie back Type III benefits with tax, and the most direct way to achieve this end is to make Type III benefits unavailable to inverting companies. Alternatively, and less ideally, an indirect way to accomplish the same goal is to deny Type I benefits to inverting companies in order to raise the costs of inversions. Conceptually, this approach is identical to converting Type I benefits, which are currently not reflected in the tax rate, into Type II incorporation benefits. This proposal can be implemented in conjunction with or independent of the above proposals.

1. Example 2.1: Reducing Access to the U.S. Capital Market, Delisting

The stocks of inverted companies continue to be listed on U.S. exchanges, and this continued listing guarantees them continued access to capital even after inversion. Given the enormous benefit of being listed in a U.S. exchange—liquidity, volume, stability, prestige and other characteristics[211]—delisting could pose a significant deterrent force for corporations that want to invert. John Kelly first proposed this solution,[212] but this Section will expand upon and slightly modify his proposal.

Listing requirements are set by the exchanges with the approval of the SEC.[213] There are two issues here.[214] First, would the exchanges be incentivized to delist inverting companies? Delisting could not be the best public relations move for the exchanges, and they would not have much of an incentive to help the U.S. government collect more tax revenue.[215] Inversion is more of a problem for the U.S. government, not for securities exchanges. On the other hand, exchanges do care about how they are perceived by the public,[216] and unpatri-

210. *See supra* notes 205-206 and accompanying text.

211. *See supra* note 177 and accompanying text.

212. *See* Kelly, *supra* note 104, at 220-23.

213. Securities Exchange Act § 19(b)(1), 15 U.S.C. § 78s(b)(1) (2012).

214. *See* Kelly, *supra* note 104, at 221-23.

215. *Id.* at 221.

216. *See, e.g.*, Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 699 (1986) (discussing how the NYSE's decision to preserve a voting rights rule was motivated by "concern about public opinion").

otic connotations of inversion could incentivize exchanges to treat inverters harshly,[217] although this may be a stretch. Most likely, there would not be enough of an incentive for exchanges to act on their own to implement delisting provisions, so the SEC will need to push for them. That said, the SEC has plenty of influence over exchanges, as evidenced by its past prodding of exchanges to implement corporate governance standards as part of their listing requirements.[218]

Another issue, as Kelly notes, is whether delisting would violate Section 6(b)(5) of the Securities Exchange Act, which mandates that listing standards should not allow "unfair discrimination" against issuers.[219] As Kelly notes, it would be difficult to argue that punishment against issuers who are evading U.S. tax would be "unfair discrimination."[220] Furthermore, one of the Securities Exchange Act's purposes is "to protect . . . the Federal taxing power" as stated in section 2 of the Act,[221] and this adds more weight to the creation of listing requirements that include punitive measures against inverting companies.

Kelly's proposal demands automatic delisting, but this automatic delisting is likely too harsh of a measure. There may be many borderline cases that may or may not be considered inversions, and imposing a bright line rule involving such a harsh punishment may be unwise. Denying a Type I benefit is harsher than denying a Type III benefit, because Type I benefits are typically enjoyable by any company regardless of where it is incorporated or operates, whereas delisting Type III benefits is more fitting for the inverting companies that avoid paying tax for the Type III benefits they continue to enjoy.

Furthermore, the automatic delisting approach could, in attempting to solve an inversion problem, have the unintended consequence of triggering capital and issuer flight from the U.S. market. This problem would likely be exacerbated by the fact that competition among exchanges is getting fiercer over time, and issuers may choose to go to foreign exchanges. Issuers may also opt out of public exchanges in favor of alternative trading systems such as dark pools that do not have listing standards.[222] This is not to say that all issuers would exit, because there is enormous benefit to being a public company listed in the U.S. exchanges as mentioned above. Yet the automatic delisting is a

217. Kelly, *supra* note 104, at 222.

218. *See, e.g.*, Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law, and Federal Regulation*, 38 WAKE FOREST L. REV. 961, 977-81 (2003).

219. 15 U.S.C. § 78f(b)(5) (2012).

220. Kelly, *supra* note 104, at 221.

221. 15 U.S.C. § 78(b).

222. *See* Kelly, *supra* note 104, at 222.

harsh measure that will likely have a non-negligible effect on the capital market.

As an alternative, discretionary delisting—with the joint authority of the Commissioners of the SEC and the Secretary of the Treasury (with the IRS Commissioner's input)—may reflect a more sensible and balanced approach. Having a standard in place that can be applied at any time may also serve as a significant deterrent. After all, symbolic threats can go a long way to affect ex ante incentives.

Because the heads of two agencies would implement this proposal, the barriers to the tax reform legislative proposal mentioned above would not exist. That is, in contrast to the tax reform legislative approach that is nearly impossible in the current political context, these policy measures can be easily implemented as they are more discretionary. In addition, compared to the IRS's ad hoc approaches, by foregrounding the threat of delisting, the proposal here would not lead to the cat-and-mouse game of having to constantly adjust the scope of application in reaction to newly-developed methods of inversion.

D. Potential Collateral Consequences of the Proposals

One of the measures of an effective friction mechanism is that it does not impose costs on corporations who are not supposed to be targeted.[223] Therefore, the anti-inversion proposals outlined above must address two potential collateral issues.

First, the proposals should not apply to companies that are engaged in foreign mergers but not in "inversion transactions." That is, they should not apply to corporations whose mergers do not violate the spirit of the benefit tax theory. Reducing Type I and Type III benefits can be a harsh measure, and it is important that these measures apply only to inverting corporations. The question that then arises is what kind of trigger standard should be established to make sure that the tax frictions discussed above are tailored narrowly to reach only those companies violating the spirit of the benefit tax theory. Especially if the reduction of government grant benefits standard is applied, having consistent criteria that can be employed by various actors—federal, state, and local governments—would likely be crucial.

Second, even if the criteria can be perfectly designed to narrowly target only those companies that are "truly" inverting, the proposals should not cause any other collateral effects on entities not engaged in foreign mergers. For instance, raising the costs of inversion could affect the ex ante incentive of newly incor-

223. *See* Osofsky, *supra* note 29, at 1073-74.

porating companies that are considering incorporation in the United States. Companies may also choose to move their operations, as opposed to simply their place of incorporation, when the United States implements policies combating inversions.

The following subsections address these issues in turn.[224]

1. *When To Pull the Trigger? Defining the Narrowly-Tailored Criteria*

The most ideal trigger standard would target only those companies that invert and continue to enjoy Type III benefits provided by the United States. It should target inverting companies that continue to have "substantial" opera-

224. One additional potential collateral consequence is not at the company level, but at the global and country level. For instance, in response to the U.S. government applying a harsh measure against inverting companies, other countries that suffer from inversions may also employ similar tactics to curb inversions out of those countries. In response to this increasing cost of inversion, countries that are inversion destinations may induce companies to invert more by offering more benefits—lowering tax rates and/or raising other legal and nonlegal benefits. I would like to make three observations with regard to this international consequence of the U.S. anti-inversion policies.

First, the international consequence would not necessarily be in the direction of a mercantilist system. Some countries like the United States and other jurisdictions with higher tax rates may stand to lose, so they may adopt approaches that make it tougher to invert out of those countries. However, as stated above, countries that stand to gain from inversion would adopt policies in response that make inversion transactions more palatable.

Second, the countries are already engaged in international game-theoretic approaches to the phenomenon of inversions—those developed countries generally have been engaged in attempts to "collude" to stop inversions outside of their countries, as evidenced by the BEPS agreement mentioned in this Note. Thus, in a way, countries outside of the United States are already engaged in anti-inversion measures, so the potential global consequence of the proposals here is not completely new.

Third, one thing to note is that all the analyses of international consequences can only be speculative. Other countries may respond in the way described in this footnote, but they may also not react at all if the United States adopts a new harsh policy against inversion. In addition, the global collateral economic effects of, for instance, delisting companies, is hard to foresee. On the one hand, those companies that want to invert may be harmed by not being able to invert without incurring significant costs. On the other hand, as a result of using anti-inversion measures to uphold the benefit tax theory, there may be other collateral benefits to such measures, such as better upholding the integrity of the capital market, more tax revenue collection, more tax compliance, and so forth. Determining whether the positive effects of the proposals outweigh the negative effects is speculative.

The speculative nature of the prediction makes this analysis less meaningful for the purpose of this Note. Furthermore, to faithfully execute the analysis of such a future prediction, empirical tools, rather than qualitative arguments, would likely be much more fruitful. Therefore, in this Note, I merely suggest possible outcomes, rather than pin down exactly what is going to happen.

tions in the United States. To add bite to this "substantial" language, but without losing sight of the fact that the determination of whether inversion happened will be highly fact-intensive and context-dependent, this Section proposes the following multi-factor test with two sets of safe harbors.

The factors to consider are whether there has been (i) a meaningful change in physical location of the company's manufacturing or operations outside of the United States, (ii) a meaningful reduction of its U.S. employees, (iii) a meaningful change in its management and control locations away from the United States, *and* (iv) a meaningful shift away from the United States as its territorial source of income. Criterion (i) reflects the source of the Type III benefit of physical infrastructure changing from the United States to a foreign country. Criterion (ii) reflects the source of the Type III benefit of workforce changing from the United States to a foreign country, and a similar analysis applies to Criterion (iii). The standard for determining where the management of the company is located should not be where the board meetings are held. The example of the United Kingdom, which previously adopted the board meeting standard,[225] shows us that companies hold board meetings at jurisdictions irrelevant to their actual management and control to freely select the governing tax jurisdiction.[226] Rather, criterion (iii) should reflect the location where the *daily* management and control occurs because, for companies with pure inversion motives, it would be costly for them to move their main officers abroad just to satisfy this test.[227] Criterion (iv) is intended to be a consequential factor. The preceding factors (i)-(iii) may not exhaustively capture all the possible ways a company can bring about a substantial change in its operations, so a consequential factor like criterion (iv) can serve as a catch-all factor.

Inverting companies would, by default, be considered "inverted" for the purpose of this test, unless they overcome the burden of proof to show that some of these factors are met. Because multi-factor tests like this tend to generate uncertainty, provisions delineating a set of safe harbors should be set for each factor. For instance, a thirty percent change in worker composition would be deemed to satisfy (ii); a twenty percent change in the territorial source of income as a percentage of total income from the United States to a new jurisdiction would be deemed to satisfy (iv).[228] An additional safe harbor criterion

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225. *See* Finance Act of 1988, c. 39, § 66, sch. 7 (Eng.).

226. *See* John M. Peterson, Jr. & Bruce A. Cohen, *Corporate Inversions: Yesterday, Today and Tomorrow,* 81 TAXES 161, 184 (2003); Sheppard, *supra* note 80, at 578.

227. *See* Reuven S. Avi-Yonah, *For Haven's Sake: Reflections on Inversion Transactions*, 95 TAX NOTES 1793, 1797 & n.37 (2002).

228. These numbers are meant to be merely demonstrative.

should be given in order to tie the factors together, such as providing that satisfying two out of four factors would be deemed sufficient.

The factors are meant to capture as much of Type III benefits of infrastructure and business factors as possible. Ideally, the test would be a proxy for how much the company is still enjoying *all* Type III benefits, not just the business factors, from the United States. However, when it comes to other Type III benefits, such as antitrust law and intellectual property law, it is much harder to sensibly "measure" the amount of protection that companies derive from them. Therefore, in devising the multi-factor test, the focus is almost exclusively on, among the Type III benefits, the infrastructure and business factors that are easily cognizable and measurable compared to other Type III benefits.

2. *Collateral Consequences to Entities Not Engaged in Foreign Mergers*

Another possible concern is that companies that have not yet incorporated may have more incentives to avoid incorporating in the United States once the anti-inversion proposals are adopted. Because of the heightened costs of changing places of incorporation out of the United States, they may prefer not to incorporate in the United States a priori. Only empirics would precisely determine the magnitude of this effect, but given the significant non-business and business benefits offered by the United States, it is perhaps unlikely that it would be large. When companies think about places to incorporate, they likely do not have in mind the long-term view of later inverting out of the original incorporation jurisdiction; instead, they incorporate where it makes the most sense for the success of their business. Relevant factors in this determination include access to capital, consumption markets, labor, adequate legal regimes, and so forth. If a pharmaceutical company thinks Ireland is a better jurisdiction than the United States in which to incorporate, then the company would choose Ireland to incorporate, whether or not the proposals here are adopted. Thus, the proposals made in this Note are unlikely to have any significant ex ante effect on incentives for companies that choose not to incorporate in the United States.

Another possible concern is that anti-inversion policies may drive companies to move their *operations* to other countries with friendlier regulatory regimes. If no operations change, companies merging outside of the country are more likely to be seen as inverting. Thus, by shifting their operations abroad, these companies could be deemed less likely to be inverting. Although this is a real concern, there are several factors mitigating against this problem. Shifting operations abroad is a huge endeavor that entails huge costs. Changing the location of manufacturing plants or research centers, or relocating a huge number of employees for the sake of shifting operations abroad, would incur huge costs. Second, shifting operations abroad assumes that these companies can enjoy a comparable quality of Type III benefits abroad as they previously did in the United States. This may not hold for most other countries. Third, if companies do choose to shift their operations abroad, then that should be allowed: it is not the realm of the U.S. government to force companies to change the way corporations run their businesses. The problem identified in this Note is that companies are enjoying benefits from the United States by having operations here without paying the corresponding tax. However, if companies choose to move their operations abroad and forgo Type III benefits offered by the United States, they should be allowed to avoid U.S. taxes on the Type III benefits that they no longer enjoy. For these reasons, the concern as to whether the anti-inversion policies would drive companies' operations abroad is significantly mitigated.[229]

Lastly, each of the three proposals above has its own polycentric problem in using non-tax means to address the tax problem. Solving a tax problem with a purely tax tool is the most ideal solution in terms of avoiding such collateral consequences. Because these proposals employ non-tax means, there may be unintended consequences in non-tax spheres, which policymakers must consider in implementing these proposals. For instance, regarding the proposal to deny trade protections,[230] putting more emphasis on the places of incorporation rather than the origins of goods can lead to a scenario where a company with no trade ties to the United States and with none of its goods originating in the United States could obtain U.S. treaty protection by being incorporated in the United States. That is, the treaty provision could protect companies that are not meant to be protected. Thus, if protection is to be afforded more based on places of incorporation rather than origins of goods, it may be necessary to implement supplemental provisions prohibiting companies with no commercial ties to the United States from taking advantage of this new provision by simply

229. In addition, note that there would be no effect on foreign businesses operating in the United States as a result of these policies; these policies only target those companies that are changing their place of incorporation from the United States to a foreign country, meaning those companies that are already non-U.S. companies would not be hurt by these policies.

230. One may think that another collateral effect of the first proposal to deny trade and BIT protections to those companies that invert would be hurting investors and workers by changing companies' calculation in selecting their place of incorporation. However, any inversion attempts would benefit investors and workers—through tax savings, they can give larger returns to shareholders and possibly pay higher wages to workers—and any measures to curb inversion attempts would thus deny those benefits to investors and workers. An argument against inversion is inevitably an argument against these investors and workers that are, in addition to the inverting corporation, "unjustly" benefiting from lower taxes in violation of the benefit tax theory (as well as at the expense of the public fisc).

incorporating in the United States. Or, at the very least, policymakers should be aware of this collateral cost of the first proposal.

Similarly, the other two proposals have their own polycentric problems. For example, it is possible that in denying government contracts to inverting companies, the government could lose out on the highest quality services and be forced to award contracts instead to less competent companies that are not inverting.

Precisely pinning down what the collateral effects would look like is speculative and difficult, but this Note discusses some possible outcomes and argues that policymakers must be aware that such collateral costs can exist. Overall, however, with careful targeting and consideration, many of these collateral costs can be mitigated.

E. Drawing the Boundaries of the Proposals

This Note's proposals would not apply to foreign-incorporated companies, even if they were similarly situated as U.S. companies that invert, because of the divergent history between those two types of companies and because of the necessity of drawing a line between impermissible inversions that could be practically regulated under a benefit tax regime and foreign companies that could not be regulated.

For illustrative purposes, consider two companies, *A* and *B*. Both have substantial U.S. operations, including management offices, product development labs, and production facilities, and both are incorporated in the Netherlands. The only difference between *A* and *B* is that, while *A* has been a Dutch-incorporated company from the beginning, *B* used to be incorporated in the United States and inverted out to the Netherlands to take advantage of its lower tax rate. Assume both companies engage in transfer pricing, income shifting, and earnings stripping to minimize the tax on U.S.-source income. In other words, *B* exhibits the behavior that this Note seeks to address.

Post-inversion, *A* and *B* are in functionally identical positions: both derive Type I (if any) and Type III benefits from the U.S. without a tax burden that accurately reflects these benefits. This Note's prescriptive solutions are tailored to target only *B*, not *A*. In an ideal system, if we are completely faithful to the benefit tax theory, this Note's prescriptive solutions should also apply to companies like *A* to the extent that the benefits they derive are out of proportion in relation to the U.S.-source tax those foreign companies pay due to techniques like transfer pricing, income shifting, and earnings stripping. Under the benefit tax theory, which seeks to align tax rates with the benefits derived, what justifies the disparate treatment of *A* and *B*, given their functional equivalence? This Note provides two rationales.

First, although *A* and *B* may seem identical after the inversion, their divergent histories do matter. *B* has been subject to the U.S. worldwide tax system, whereas *A* has been subject to the Dutch territorial tax system. *B*'s inversion is motivated not only to lower tax liabilities on *future* income—if this was the only goal of *B*'s inversion, then the argument for an equal treatment of *B* and *A* has more force—but also to avoid taxes on non-repatriated offshore cash from *past* Dutch-source income that some of the U.S. benefits contributed to creating. *A* would have no equivalent of avoided taxes on past Dutch-source income; in fact, because *A* has never been subject to the U.S. worldwide tax income, it had no U.S. tax to avoid. Then, can the benefit tax theory justify the fact that, prior to inversion, *B* and *A* had to pay the same amount of tax to the Dutch government on their Dutch-source income, but *B* had to pay additional tax to the U.S. government on its Dutch-source income? One possible response is that *B* enjoyed U.S. Type II benefits before the inversion, whereas *A* has enjoyed Dutch Type II benefits, and that distinction should matter.[231] For these reasons, the divergent histories of *A* and *B* do matter for treating these two companies differently, even if their profiles after the inversion may seem similar.

Second, even if this Note concedes on that point, practical concerns raise the need to draw lines and limit the applicability of the benefit tax theory-based proposals only to inverting companies. Inversion demarks a salient, conspicuous moment that can actually function as the basis for applying these policy measures, without concern as to whether these proposals should also apply to foreign companies like *A*. There is no equivalently salient, conspicuous moment to which one can point to impose the punitive measures depriving these foreign companies of benefits. From the point of view of implementation, drawing the line at inverting companies appears practical.

F. The Proposals in Relation to the IRS Approaches

Whether each of the proposals would be more effective than the IRS's ad hoc regulations and notices depends on the potential inverter's industry. For instance, the proposal denying government contract privileges would work effectively against a company that relied heavily on contracts with the U.S. government, but not as well for companies with no commercial relations with the U.S. government. Similarly, the denial of treaty and BIT protections would be

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231. Another possible response is that, even if Type II benefits offered by both countries are identical, we should accept as given the tax systems that each government adopted. To the extent that *B* has been avoiding paying tax on Dutch-source income, when there is no such avoidance on *A*'s part, it is justifiable to treat *A* and *B* differently.

more effective against those companies engaging in significant amounts of international trade and investment than those that do not.[232]

More importantly, however, the three proposals here and the IRS approach need not be mutually exclusive. They can and should work in conjunction with one another to raise the costs of inversion. In fact, both the previous IRS approaches and the three proposals here are all attempts at better bundling. If an inverting company is not paying any U.S. tax on the Type III benefits it enjoys, either (1) it should be made to pay U.S. tax, or (2) it should be denied Type III benefits. In a way, the enactment of IRC Section 7874, IRS Notice 2014-52, IRS Notice 2015-79, and the recent April 6, 2016 temporary regulation discussed in Part II are attempts to take approach (1); yet, the story of the cat-and-mouse game shows that those tax approaches have not effectively achieved the goal of approach (1). The multi-dimensional competition model allows us to realize that approach (1) is not an exhaustive solution; another way to bundle, approach (2), is available, where the United States can simply reduce some of its Type III benefits (or even more radically, Type I benefits). Therefore, the IRS approach and the three proposals are meant to complement each other.

And this point—that the IRS approach and the three proposals are two sides of the same coin attempting to bundle better—is the main contribution of this model. After all, inversion is not simply a tax problem in isolation, but a problem of aligning tax paid with benefits conferred by a given country. Amending tax law provisions directly addresses the problem of inversions in part, but adjusting benefits through the lens of benefit tax theory is another, more comprehensive way forward. Indeed, the holistic nature of this model permits policymakers to better address the form-substance gap associated with inversions.

CONCLUSION

The cat-and-mouse game between inverting companies and the Treasury regulations show how piecemeal regulatory actions are ineffective and insufficient. We need a fundamental tax reform, and perhaps it could be possible. Anti-inversion proposals that focus solely on the tax dimension fail to capture the full picture of what is wrong with inversions and thus limit the set of tools that are available to address the problem. In order to combat inversions using a

232. Another comparison between the two approaches is that the IRS regulations and notices are bound by the twenty percent and forty percent dilution framework, where the only factor to consider in determining whether an inversion occurred is the share dilution ratio. In contrast, the trigger criteria proposed in this Note depend on various other factors that are meant to serve as proxies for inversion.

more holistic approach, regulators should consider methods outside of the tax law to address this tax problem.

Looking outside of the tax law allows us to build a multi-dimensional competition model to resolve the tensions underlying the inversions problem differently. This Note's multi-dimensional competition model is rooted in the benefit tax theory that has been heretofore largely ignored by the literature. The model identifies the source of the inversion problem as the decoupling of certain Type III benefits offered by the United States from the U.S. tax regime. This model further reveals that bundling Type III benefits to tax is necessary. This outcome can be achieved by adding non-tax frictions to inverting actors, where the sources of frictions are Type I and Type III benefits. The overarching purpose of this Note is to build this model to offer holistic policy levers to regulators and policymakers when their tax lever is unlikely to be utilized or effective. And these alternative policy levers outside of tax are just as good at addressing inefficiencies underlying corporate inversions as the tax solutions.

The inversion issue is extremely complex and raises many tough questions inside and outside of the realm of tax law. Inside tax law, inversions raise thorny questions about the purpose of the corporate income tax. Outside of tax law, in the era of globalization, corporate personhood, and some of the traditional concepts of place of incorporation and territoriality elements, may need to be reconsidered to fit within this new reality. On one extreme, governments could adopt a fully elective regime, where companies can pick whichever tax, corporate, and other legal jurisdictions to be governed under, and pay tax however they want.[233] In a way, this regime already exists for contract law. But something about extending this logic to inversion transactions and consequent taxation is intuitively troubling to many. The benefit tax theory and the multi-dimensional competition model attempt to explain where this trouble comes from, even though inversion transactions have not caused a substantial amount of corporate tax revenue loss to the U.S. government so far.[234] This rejection of inversions reflects the intuition underlying the benefit tax theory and shows that the territoriality principle holds no matter how mobile companies are.

Without reform, the problems of inversions may only be exacerbated by increasingly intense regulatory competition, lower tax rates and more tax breaks abroad, and globalization. And in a world of multinational corporations, tax jurisdictions, comparative regulatory environments, and business factors are

233. A parallel, if remote, idea exists in different fields where scholars advocate for companies to freely choose which legal jurisdiction to be governed by, with one example in the realm of securities registration. *See, e.g.*, Choi & Guzman, *supra* note 169.

234. *See supra* notes 101-102 and accompanying text.

inexorably intertwined. In light of this context, analyzing a tax phenomenon within a broader context of various areas of law and other nonlegal business factors is indispensable.