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Corporate Inversions: Realigning Tax Incentives to Keep Corporations in the United States

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Corporate Inversions: Realigning Tax Incentives to Keep Corporations in the United States

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ABSTRACT

This thesis analyzes the corporate income tax, more specifically related to foreign sourced income, and proposes a solution to reduce the desirability of tax inversions and restore the competitiveness of United States' corporations. The paper introduces the topic and discusses why corporate taxation has returned to the forefront of political discussion. It then addresses early 2000s regulation passed in response to increased inversion activity of the late '90s and how that regulation failed to achieve its intended purpose. Then, the current laws will be introduced with a focus on corporate actions to circumvent these laws in order to reduce tax liabilities. Then, I will propose a solution that emphasizes altering the incentives of corporations as opposed to creating rules to prevent corporate actions.

Introduction

President Obama made the following remarks regarding corporate tax inversions, "They're declaring they're based someplace else even though most of their operations are here... My attitude is I don't care if it's legal -- it's wrong." President Obama made these comments in July of 2014 amidst a flurry of recently completed and proposed corporate inversions. These transactions generally involve a U.S.-based firm merging with a foreign-based firm so that the U.S.-based firm, which is usually the surviving entity, can move its headquarters outside the United States. Once completed, inverted corporations often predict billions of dollars in tax savings. With an increasing aversion to corporate greed, many people become wary when they see corporations lowering their tax bills while they simultaneously achieve record-breaking profits. Fed up with a loss in tax revenue, President Obama and other political figures began to question the substance of these transactions as well as the moral character of corporations willing to invert.

On the flip side, U.S. corporations argue that corporate tax laws are outdated and present an unfair burden, often placing firms in a situation where an inversion makes the most economic sense. At 35% (39.1% when state taxes are included), the United States levies one of the highest corporate tax rates in the world. On top of this, the United States is on a worldwide taxation system. This means the government taxes U.S. corporations on all income regardless of where they earn it. Most other nations use a less burdensome territorial system, in which a nation only taxes income earned within that nation (this is a simplified definition that will be discussed later in the paper). Especially burdensome and unlike their U.S. counterparts, foreign firms face no taxation on their foreign earnings in the United States. Therefore, U.S.-based corporations have a significant tax disadvantage relative to most foreign corporations, who also tend to headquarter in low tax territories.

The two sides of this argument tend to arrive at two different conclusions. The first side concludes corporations are wrong to invert. If they are based in the United States, they should pay their fair share of taxes. They should not be able to engage in a transaction that largely lacks economic substance simply to minimize this obligation. Thus, the United States should alter laws regarding inversions in order to make it more difficult to reap tax benefits from such transactions.

The other side argues the current corporate tax laws have placed an unfair burden on U.S.-based corporations. An identical foreign-based corporation has a clear advantage over its U.S.-based counterpart. This seem contrary the logic of most tax laws. It makes very little sense to have a system that discourages corporations from residing in the U.S. Thus, the United States should alter corporate tax laws and restore the competitive balance for U.S. corporations. Once competitive balance is restored, inversions will naturally fade because the incentive to do so will be gone.

Unfortunately, both conclusions miss important points. The former ignores the competitive disadvantage and assumes stricter rules will work and not open new loopholes. The second ignores the potential loss in tax revenue, and, thus, does not present a solution that the government would realistically consider. However, maybe there is a middle ground that exists, one that restores competitive balance without sacrificing tax revenue. This thesis seeks to find that middle ground.

Chapter I. 1997-2004

The landscape regarding corporate tax inversions changed in 1997. Inversions were not a new concept at this point. McDermott International relocated to Panama in 1983 and Helen of Troy did the same in the early ‘90s, which prompted the IRS to make the built-in capital gains taxable to shareholders upon inversion. However, what made 1997 distinct was that it paved the way for several other companies to invert and caught the attention of the U.S. government on a more significant scale.

In July of 1997 Tyco International Ltd. (Tyco) completed its merger with ADT Limited (ADT). On its surface, Tyco had at least some motivation to merge with ADT beyond tax motivations. In fact, when the Wall Street Journal reported on the proposed merger, it dedicated one sentence to the tax rationale behind the transaction, and the New York Times was no different.[1] The bulk of the articles discussed how ADT, which possessed a strong brand in the home security market, would provide Tyco with cost savings related to the buying of supplies needed to produce alarm systems as well as “expand Tyco's ability to offer homes and offices monitoring services for their fire and burglar alarms.”[2] However, despite the existence of potentially legitimate business reasons, based on the structure of the transaction, it would be difficult to deny that it was largely tax driven.

The terms of the merger dictated that Tyco would merge with a unit of ADT with ADT becoming the parent of Tyco. However, ADT agreed to rename itself Tyco after the merger with the Tyco CEO, Dennis Kozlowski, becoming the CEO of the “new” Tyco,

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[1] Bagli, Charles. "ADT and Tyco Plan to Merge In $5.4 Billion Stock Swap."
[2] "Tyco International to Merge With ADT in Complex Deal."

the "new" board would be controlled by "old" Tyco's board of directors, and "new" Tyco would continue to be operationally headquarted in Exeter, New Hampshire, as it was before the merger.[3] However, as the result of the transaction, "new" Tyco was able to use ADT's place of domicile, which was in Bermuda, despite ADT's operational headquarters being located in Boca Raton, Florida. [4] Tyco created this seemingly odd structure in order to list its place of domicile as Bermuda in order to reap the tax benefits of a Bermuda-based corporation. In 2001 alone, it was reported that Tyco saved around $400 million in taxes because of its merger with ADT.[5]

Most companies knew the tax benefits of inversions. However, most feared that their share price would drop because there was an assumption that a company would have to pay an unreasonably high price to invert, not to mention the potential public backlash surrounding an inversion.[6] Tyco proved this assumption wrong and quelled the fears of other firms, as its stock price improved post-inversion. Thus, the success of the Tyco inversion convinced several other firms to engage in similar deals including Fruit of the Loom (1998) and Ingersoll Rand (2001).[7] By this point, the US government was fed up with the loss of tax revenue from these inversions and sought to close the loopholes being exploited by US-based corporations.

Ultimately, the U.S. government recognized the lack of economic substance present in these transactions. No one truly believed these global corporations had a legitimate business purpose in Bermuda or the Cayman Islands and few would even deny

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[3] Ibid
[4] Ibid
[5] "Corporate Inversion: Senate Hearing"
[6] Ibid
[7] Ibid

it. Therefore in 2004, Congress enacted legislation that largely dictates the current environment.

Chapter II. Recent Changes to the Law

When Congress sought to slow down inversions in 2004, it focused on the rules regarding a corporation's ability to change its corporate headquarters. Prior to 2004, regulation on this matter was either non-existent or ineffective. The relatively unregulated environment permitted corporations to conduct "naked inversions." In a pre-2004 naked inversion, performed by the likes of Tyco and Accenture, "a U.S. firm would form a new holding company in a tax haven country, and the public shareholders of the U.S. firm would become the public shareholders of the new tax haven holding company."[8] Often times no business purpose existed, and the process was relatively easy and painless. Operating headquarters remained in the United States, the stock still traded on U.S. exchanges, and the holding company essentially existed on paper only. [9] Thus, in 2004 Congress enacted Internal Revenue Code (IRC) section 7874 as a part of the Americans Job Creation Act of 2004 (AJCA).

Section 7874 placed restrictions on inversions, in which, the former owners of the acquired domestic corporation owned at least 60% of the stock of the newly formed foreign corporation after the acquisition. There are two levels of restrictions. One in which the ownership level is between 60%-80%, and one in which the ownership level is greater than or equal to 80%. The former situation recognizes the newly formed corporation as foreign, however, imposes "U.S. toll taxes (taxes on gains) that apply to

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[8] Hungerford, Thomas. "Policy Responses to Corporate Inversions."
[9] Ibid

transfers of assets to the new entity, which are not permitted to be offset by foreign tax credits or net operating losses."[10] This special gain recognition requirement would be imposed for a ten-year period following the acquisition.[11] The IRC defined this gain as:

"the income or gain recognized by reason of the transfer during the applicable period of stock or other properties by an expatriated entity, and any income received or accrued during the applicable period by reason of a license of any property by an expatriated entity"[12]

For acquisitions that exceed the greater than or equal to 80% ownership threshold, the recognition of special gains does not apply; however, for purposes of the IRC, AJCA ignores the substance of the transaction and treats the newly formed foreign corporation as a domestic corporation.[13] Thus, AJCA essentially prohibits a corporation from recognizing any tax benefits associated with its inversion. The regulation also included a clause regarding substantial business activity. The law exempted corporations (recognized them as foreign) with substantial business activity in its new place of residence.[14] However, the initial regulation failed to provide guidance as to what constituted "substantial."

Section 7874 effectively addressed the so-called "naked inversions" described earlier. Proving substantial economic activity in the Cayman Islands or Bermuda would be next to impossible, and most of the acquisitions exceeded the 80% threshold.

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[10] Marples, Donald. "Corporate Expatriation, Inversions, and Mergers: Tax Issues." pg 6.
[11] VanderWolk, Jefferson. "Inversions under Section 7874 of the Internal Revenue Code: Flawed Legislation, Flawed Guidance."
[12] "26 U.S. Code § 7874 - Rules Relating to Expatriated Entities and Their Foreign Parents."
[13] VanderWolk, Jefferson. "Inversions under Section 7874 of the Internal Revenue Code: Flawed Legislation, Flawed Guidance."
[14] Marples, Donald. "Corporate Expatriation, Inversions, and Mergers: Tax Issues."

However, the rules did little in the way of slowing down other forms of inversions. Corporations simply found ways around the rules. Post-2004 inversions often fell just under the 80% or 60% threshold, and instead of no-tax regions like Bermuda or the Cayman Islands, corporations inverted to low or territorial tax regions such as Ireland or the United Kingdom, regions where substantial economic activity would be relatively easy to prove.

Recognizing its failures, the IRS and the Treasury have repeatedly attempted to tighten its regulation on inversions since 2004. In 2006, they provided insight as to what constituted substantial business activity by creating a safe harbor threshold and providing factors to be considered in determining “substantial.” The factors included, but were not limited to analyzing the corporation’s historical presence, operational activities (such as property owned, employee performance and services, and sales), management activities, ownership of residents, and strategic actions that existed within the foreign country.[15] The safe harbor exempted corporations so long as the foreign parent accounted for at least 10% of the whole corporation’s total employee head count and compensation, business tangible assets, and sales.[16] However, these changes also failed to stop inversions. Ultimately, the Treasury raised the 10% threshold to 25%. However, corporations still managed, as before, to just meet thresholds imposed by the government allowing inversions to continue on frequently and relevantly.

This past September, the Treasury Department, facing pressure from the media

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[15] VanderWolk, Jefferson. "Inversions under Section 7874 of the Internal Revenue Code: Flawed Legislation, Flawed Guidance."
[16] Ibid

and the President, expanded upon section 7874. The Treasury's actions focused on two basic components of inversions. The first limited a U.S. firm's ability to access the accumulated deferred earnings of its foreign subsidiary, and the second limited a firm's ability to manipulate elements of the transaction in order to qualify for the less than 80% ownership level.[17] With regards to the former limitation, in an inversion a foreign subsidiary of the original U.S. corporation remains a subsidiary of the U.S. corporation; it does not become a subsidiary of the newly formed foreign parent.[18] Therefore, dividends paid to the U.S. firm by the foreign subsidiary should remain taxable. However, corporations use several methods to avoid this tax; three of which the Treasury addressed in September.

Firstly, the Treasury sought to restrict the use of "hopscotch loans. " Hopscotch loans, in this context, occur when the foreign subsidiary of the U.S. corporation issues a loan to the new foreign parent. Then, the foreign parent issues dividends, or a low interest loan, to the U.S. corporation. Since the dividends come from the foreign parent and not the foreign subsidiary, they are not taxed in the United States. The new regulation treats these loans, or any obligation or stock issued between related foreign parties, as taxable U.S. property.[19]

Secondly, the Treasury addressed "decontrolling." Decontrolling occurs when the acquiring foreign corporation purchases the majority of the stock of the foreign subsidiary of the U.S. corporation. Once the purchase takes place, the foreign subsidiary

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[17] Marples, Donald. "Corporate Expatriation, Inversions, and Mergers: Tax Issues." 9.
[18] Ibid
[19] Ibid

seizes to be a Controlled Foreign Corporation (CFC) and, thus, the subpart F income no longer gets taxed in the United States (both these terms will be discussed later but subpart F income generally refers to passively-earned foreign income). Now, the regulation treats the acquisition of stock in the foreign subsidiary as the acquisition of stock in the U.S. corporation, which makes it a taxable transaction.[20]

The last method is not as significant, but it "addresses transactions where the foreign acquiring corporation sells stock of the former U.S. parent corporation to that U.S. parent corporation's CFC in exchange for property or cash."[21] When structured properly, some of the income would have been able to avoid taxation. This transaction is now ignored and the income does not avoid taxation.

As stated earlier, the new Treasury regulations also limit a corporation's ability to fall under the 80% ownership level by restricting a few tax planning techniques. It reduces a corporation's ability to inflate the size of the acquiring foreign corporation by using passive assets such as interest bearing bank deposits; such that, if passive assets represent more than 50% of the foreign acquiring firm's value, then the passive assets are disregarded (these rules do not pertain to banks and financial service companies).[22]

The Treasury rules also prevent a U.S. corporation from reducing its value through paying an unordinary amount in dividends. [23] The Treasury now disregards these dividends and values the corporation as if the dividends never occurred.

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[20] Ibid
[21] Ibid
[22] Ibid
[23] Ibid

Lastly, the Treasury addressed the problem of so-called "spinversions." A spinversion, as the name implies, occurs when a corporation spins-off a portion of its business into a newly formed entity, and then inverts this newly formed entity by merging it with a foreign corporation.[24] Larger corporations generally avoid inversions because doing so is too costly and often result in political fallout. Thus, spinversions allow larger corporations to perform inversions without facing the fallout of inverting the entire business.   Now, the Treasury treats the spun-off company as a domestic corporation essentially eliminating the tax benefits of a spinversion.

These regulations have successfully deterred corporations from inverting, at least in the interim. Shortly after the Treasury released its regulations, U.S. drug maker AbbVie, Inc. reconsidered its $55 billion deal with Irish-based Shire PLC because it lost some of its ability to access its foreign accumulated earnings tax-free. The spinversion rules put the breaks on Mylan Inc.'s proposed takeover of Abbot Laboratories. However, the new regulations did not deter every corporation. Most notably, Medtronic Inc. still intends to acquire Irish-based Covidien Plc., a deal worth $42.9 billion.

The new regulations may have discouraged some proposed inversions; however, it begs the question. Will these rules be effective in preventing inversion in the long term, or are they simply a temporary inconvenience for corporations who still have significant incentives to uncover new techniques to invert?

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[24] Sutherland, Brooke. "Spinversions: How a Mega Co. Can Join In on Tax-Cutting Deals Real M&A."

Chapter III. Corporate Action Post-Inversion

Once inverted, a corporation inherits several tax benefits. It can reduce subpart F income, it can freely repatriate foreign earnings and reinvest it as it chooses, and it can utilize tax loopholes of its new nation to further strip income from the United States.

Although U.S. corporations can defer paying taxes on significant portions of their foreign income, Congress created subpart F income to lessen the revenue effect of income deferral. Subpart F income represents income earned by a U.S. corporation's Controlled Foreign Corporation (CFC) that the U.S. corporation must recognize the year in which it is earned. Therefore, the income is treated as distributed regardless of whether the income is actually distributed.

The IRS defines a CFC as:

"Any foreign corporation in which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned directly, indirectly, or constructively by U.S. shareholders on any day during the taxable year of such foreign corporation or more than 50% of the total value of the stock is owned directly, indirectly or constructively by U.S. shareholders on any day during the taxable year of the corporation."[25]

A CFC should not be confused with a foreign branch, which is not considered a separate legal entity forcing all income to be recognized by the parent corporation. With CFC's, however, only distributed and deemed distributed (Subpart F) income are taxable to the parent.

The U.S. tax code generally permits corporations to defer taxation on foreign

[25] "26 U.S. Code § 7874 - Rules Relating to Expatriated Entities and Their Foreign Parents."

earnings that it actively reinvests in foreign subsidiaries. Thus, the IRS created Subpart F income in order to capture the non-active, passive income of foreign subsidiaries. Once calculated, Subpart F income is deemed distributed and, thus, taxable to the U.S. parent regardless of whether a distribution has actually taken place. IRC Section 952 lists five general categories of income that should be included in subpart F income, and they are: insurance income, foreign-based company income; income from countries subject to international boycotts; illegal bribes, kickbacks, and other similar payments; and income from countries where the United States has severed diplomatic relations.[26] This paper will focus on the second inclusion (foreign-based company income) as it is the most complicated and most easy to manipulate.

Foreign-based company income addresses a couple key aspects of subpart F income. It includes foreign personal holding company income which mostly encompasses passive income such as dividends, interest, royalties, capital gains, certain rents, etc.[27] Also, the IRC recognizes the prevalence of related-party transactions with regards to CFC's and often treats these related-party transactions as subpart F income. [28] However, despite the creation of Subpart F income, inverted corporations manage to earn income passively without recognizing it as Subpart F.

When a corporation inverts outside of the United States, the CFC's of the original U.S. parent remain CFC's, and, thus, the U.S. firm must still recognize subpart F

[26] "26 U.S. Code § 952 - Subpart F Income Defined."
[27] Ibid
[28] Ibid

income.[29] However, in many inversions, the U.S. corporation often converts the CFC into a foreign subsidiary of the new foreign parent allowing it to avoid Subpart F income. And, although the new Treasury regulations largely address this issue, the practice still exists, albeit to a lesser degree. In addition to this, if the new foreign parent creates a foreign subsidiary, then this foreign subsidiary does not become a CFC of the original domestic corporation, thus, allowing the parent to avoid Subpart F taxation.[30] Considering CFC's that create large portions of Subpart F income tend to perform little in the way of actual business operations, it would be relatively easy for the foreign parent to replace CFC's with its own foreign subsidiaries. Moreover, the foreign parent will more easily be able to participate in related-party transactions with its newly formed subsidiary, especially when both likely reside in more lenient tax environments.

The ability to repatriate foreign earnings tax-free represents the other, more obvious, incentive to invert. Prior to an inversion, a U.S.-based firm can opt to reinvest foreign earnings for active business purposes in order to defer recognition of this income in the United States. However, once a firm repatriates foreign profits back into the United States, the income is taxed. So, if firms defer the income long enough, they receive a fairly sizeable discounted tax liability. Moreover, most firms never intend to repatriate and plan to permanently reinvest foreign earnings. When this occurs, the firm hypothetically will never owe taxes to the U.S. on these profits.

However, despite the ability to defer income indefinitely, the system still creates an advantage for foreign firms. Even a hypothetical U.S.-based corporation that

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[29] Ibid
[30] Ibid

permanently reinvests all its foreign profits and earns no Subpart F income would struggle to compete with a foreign-based corporation of the same nature. Regardless of the necessity to repatriate funds, all else being equal, the firm that possesses the ability to freely reinvest foreign earnings into the United States is necessarily advantaged over the firm that does not have this option. Thus, it creates an incentive for firms to invert.

Often in assessing the current landscape, people conclude that the United States should switch to a territorial system. And, in some ways, a territorial system would solve many of the current problems. A territorial system only taxes corporations on their income earned within that territory. Therefore, if the United States adopted this system, U.S.-based firms would no longer owe taxes on repatriated foreign profits, or Subpart F income for that matter, and foreign firms would remain unaffected.[31] Therefore, a territorial system would restore competitive balance for U.S.-based corporations both domestically and internationally.

Under a territorial system, U.S.-based corporations could freely repatriate and reinvest its foreign earnings into the United States, just as foreign firms do. The system would also allow U.S.-based corporations to better compete against foreign corporations when investing in foreign projects because foreign subsidiaries of a U.S. parent would not have to concern themselves with U.S. taxes. This freedom to invest would have a stimulus effect on U.S. corporations that could potentially benefit the U.S. government and economy as a whole. [32]

[31] Marples, Donald. "Corporate Expatriation, Inversions, and Mergers: Tax Issues."
[32] Ibid

Chapter IV. Proposal

A territorial system has its benefits; however, its drawbacks should not be ignored. A territorial system does little to simplify the already over-complicated tax code. That tax code is so complicated that Americans pay an estimated $0.30 for every dollar they earn simply through the costs of compliance.[33] Also, more complicated regulation often leads to the creation of more loopholes. Corporations pay millions of dollars per year to professional tax advisors whose primary objective is to guide their client into paying as little in taxes as possible. These professionals often have years of experience in analyzing and finding legal ways around specific regulation. The people writing the regulation, however, spend maybe a couple months writing it and are paid far less generously. In other words, the people writing the regulation are far less likely to recognize any loopholes implied by their regulation than the tax professionals hired to do so. "Simple" regulations can still create loopholes, however, the more complicated the regulation, the more difficult it is for the writer to account for every possible loophole.

Often experts argue that a territorial system simplifies the tax code because corporations no longer need to account for foreign income. However, upon closer examination this assumption does not hold. Separating foreign income and United States income can be quite tricky and susceptible to manipulation.[34] The government would struggle to create overarching rules because it would have to address every industry and

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[33]Laffer, Arthur. "The 30-Cent Tax Premium: Tax Compliance Employs More Workers than Wal-Mart, UPS, McDonald's, IBM and Citigroup Combined."
[34] Kleinbard, Edward. "Throw Territorial Taxation From the Train."

sub-industry differently. Finding rules regarding the derivation of income for each industry would be very difficult.

Although these issues still arise and are largely dealt with under the current system, the key difference is the change in incentives. A U.S. corporation, under the current system, has a significant disincentive to shift income outside of the United States due to the taxation of repatriated profits.[35] Therefore, the rules determining U.S. versus foreign income do not need to close every loophole because corporations obtain less value in exposing them. However, in a territorial system the disincentive does not exist. Remove the disincentive and suddenly the quality of the rules will be put the test. The success of the rules up to this point provides no proof that they will continue to work under a new system. Somewhere imbedded in those complicated rules, it would not be surprising for a sizeable loophole to exist. A loophole that avoids exploitation solely because there is no incentive to exploit it. Change the incentive structure, and the previously unutilized loophole will likely be exposed.

In a territorial system, the United States not only becomes susceptible to its own loopholes, but also the loopholes of other nations. It also becomes easier for corporations to expose the loopholes of the nation in which they reside.[36] Thus, it makes sense for corporations to reside in a tax-friendly region. In other words, due to the high rate and strict rules in the United States, under a territorial system, U.S. firms would have an even greater incentive than now to relocate to a more tax-friendly region creating an opportunity to strip more income than ever.

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[35] Ibid

[36] Ibid

Most of Europe, for example, is on a territorial system, so corporations often utilize nations with a more favorable tax environment like Ireland, Switzerland, the Netherlands, and Luxembourg to lower their tax liability. Google, for example, has a entity set up in Ireland that receives significant amounts of income related to interest, royalty payments, and other intangible goods and then funnels that income to an entity set up in the Netherlands, and then the Netherlands funnels that income back to a separate Irish entity that is the subsidiary of a Cayman Islands' entity.[37] This circuitous set of paper transactions leads to Google paying no corporate taxes on that income. Under the current U.S. system, this would be far less likely to occur because the incentive to shift income is far smaller. A territorial system encourages corporations to shift income.

In addition to all of this, achieving a revenue neutral scenario in a territorial system would be a difficult task. The United States government would lose any tax revenue associated with Subpart F income and repatriated income. Also, income stripping would likely impact revenue in a significant matter. Although many argue the United States should not earn revenue off foreign earnings in the first place the loss caused by income stripping should not be dismissed, as it could be quite significant. Just looking at Google alone provides insight into the substantiality of revenue loss caused by income shifting. The chart below shows how much Google saved by exploiting loopholes and taking advantage of the territorial systems of Germany, France, the UK, and the Netherlands:[38]

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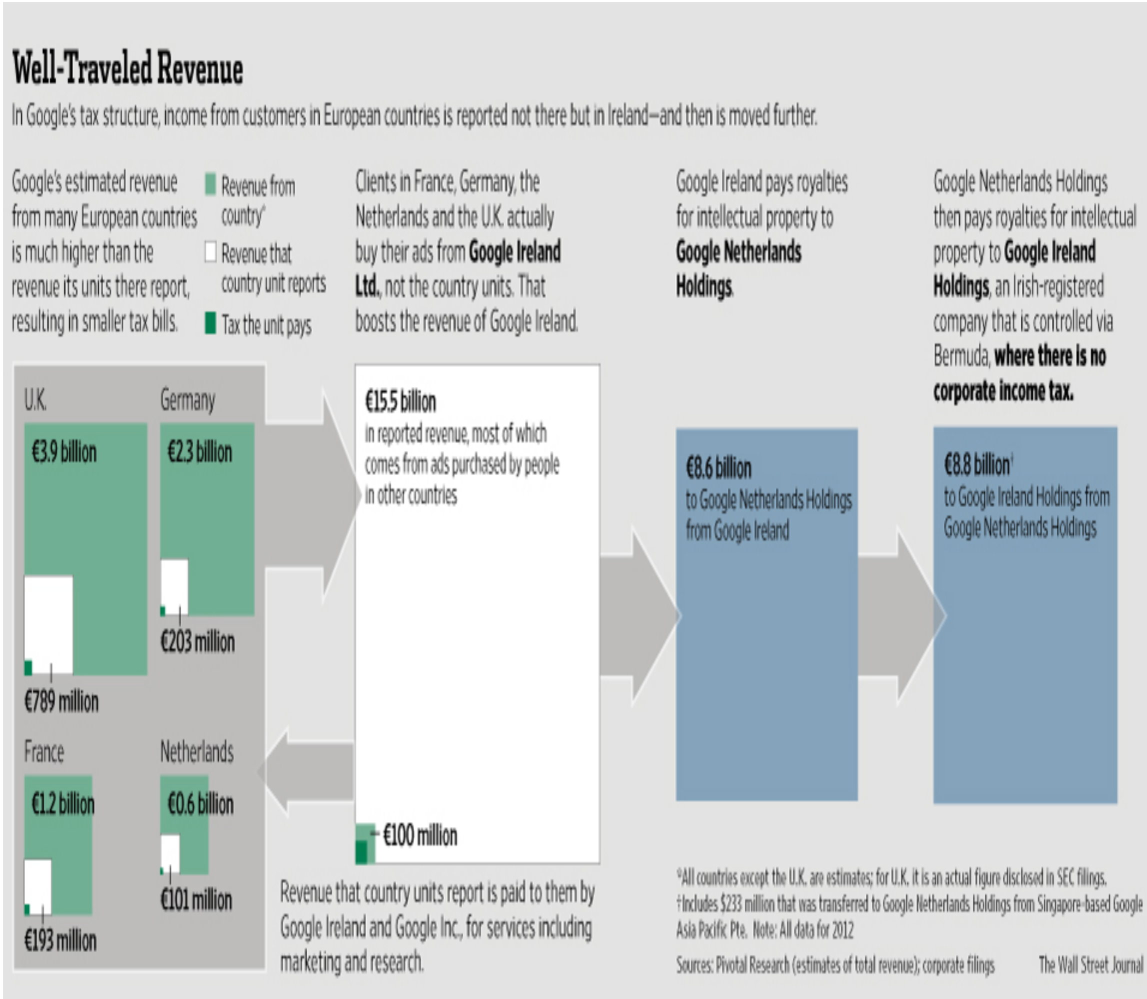
[37] Schechner, Sam. "Google's Tax Setup Faces French Challenge."
[38] Ibid



Probably the most shocking information presented on this chart is the revenue split of Google Ireland Ltd. The chart shows that Google Ireland Ltd reported £15.5 billion of revenue earned outside Ireland while reporting only £100 million in revenue actually earned in Ireland. This ultimately leads to Google sheltering over £8.8 billion in revenue.[39] In other words, under a territorial system the United States government would not only have to consider loopholes created by itself, but also loopholes created by other nations. France alone insists that Google owes it over two billion euros in taxes. When a corporation as massive as Google only reports around 8% of the revenue that it earns

[39] Ibid

within Germany, there is clearly a flaw in the system.[40] One that seems unsustainable and unlikely to convince Congress to enact change.

Based upon all of this, it would make sense for the United States to avoid a territorial system of taxation. There are too many problems associated with it, and it fails to achieve many of the goals it sets out to. That being said, a pure worldwide system has many of is own flaws. Most notably of which being the lack of competitiveness of corporations. Thus, the proposal uses neither model in the strict sense. However, the proposal utilizes components of each while also employing characteristics unique to itself.

The first issue that the United States needs to change is the ability of corporations to defer foreign-sourced income. Congress created this provision in order to allow U.S.-based corporations to compete with foreign-based ones. U.S. corporations would be at a clear disadvantage relative to their foreign counterparts if not for this provision. Their overall global tax rate would be significantly more burdensome than the rate of just about any foreign firm in the world. The deferral regulation achieves its goal relatively well. However, the deferral caveat makes little sense from the perspective of the United States, and there are other means by which to restore competitive balance.

Most firms avoid repatriating foreign funds and often have the intention of indefinitely reinvesting foreign earnings.[41] When a corporation intends to permanently reinvest foreign earnings into active business activities of a foreign subsidiary, it will essentially never owe taxes to the United States on those profits. The incentive structure

[40] Ibid
[41] Rubin, Richard. "Cash Abroad Rises $206 Billion as Apple to IBM Avoid Tax."

presented is clear. The system encourages firms to never reinvest their profits in the United States.

This seems counter-intuitive to the entire logic of the tax code. The tax code should either have a neutral effect (i.e., it raises revenue without changing action), or it should encourage action that benefits the United States (i.e., tax breaks to stimulate the economy). However, the deferral laws offer a tax break to corporations that stimulates the economies of other nations. So, yes, the government should enact regulation that allows U.S. corporations to be more competitive. However, in doing so, they should find a solution that benefits the United States, not other nations.

Thus, corporations should not be allowed to defer the recognition of foreign income. They should be taxed on all foreign income the year in which they earn it. This will ultimately provide dual purposes. First off, it will raise the total amount of taxable income, which increases the likelihood of arriving at revenue neutral situation. Secondly, removing the incentive to store funds abroad will increase investments in the United States and stimulate the economy.[42] The reinvested profits also have the possibility of boosting overall taxable income. Obviously not all foreign profits will be repatriated; however, some, with the possibility of a lot, is certainly better than none.

Ultimately, discouraging the storing of profits abroad is the goal of a territorial system. However, by taxing corporations on their profits as they earn them, the United States achieves the benefits of a territorial system while overcoming its weaknesses. Profits are repatriated while decreasing the incentive to shift income and increasing the likelihood of a revenue neutral scenario. To reiterate the point, the rationale behind

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[42] Desai, Mihir. "Repatriation Taxes and Dividend Distortions."

revenue neutrality is that it becomes a far more realistic option for the government to adopt. In other words, the greater the revenue gap, the less likely the government changes the current system.

The United States should also eliminate the foreign tax credit. The foreign tax credit complicates the tax code and rarely provides corporations with the "one-to-one" credit that people often claim. Determining when foreign tax credits can be used, how many can be utilized from a particular nation in a particular year, and how to properly allocate them can be quite difficult and cumbersome.[43] Of course, if the United States were to eliminate both the foreign tax credit and the ability to defer foreign-sourced income and kept the same corporate tax rate, then the U.S. would be placing an unsustainably high burden on its corporations. All but a few of the more powerful firms would have any chance of competing with foreign-based firms. Therefore, adjustments have to be made to the tax rate structure in order to compensate for this clearly unfair and unreasonable burden.

The United States would benefit from a corporate tax structure, in which, corporations based in the United States pay a lower tax rate on U.S.-sourced income relative to the rate applied to foreign-based corporations. U.S. corporations, however, should also pay a small tax on foreign income the year in which it is earned. Foreign corporations will, of course, continue to pay nothing to the United States on foreign-sourced income. This structure should achieve several goals. First, by taxing foreign income as corporations earn it, it removes the disincentive to keep profits abroad. Second,

[43] Kleinbard, Edward. "Throw Territorial Taxation From the Train."

it restores the competitive balance for U.S. firms. Although U.S. corporations will be taxed on foreign profits, the tax will be small and, to compensate, domestic profits will be taxed at a lower rate compared to domestic profits of foreign firms. Third, it ultimately should not impact tax revenue negatively. Lastly, the system should align incentives so that corporations will accurately decide for themselves where to place their headquarters with the hope that headquartering rules will not be needed.

Before analyzing which rates should apply, Congress should reconsider the current corporate rate. Sitting at 35% (39.1% when the average state corporate tax is added), the United States has the third highest corporate tax rate in the world behind only the United Arab Emirates and Chad.[44] Although the effective rate ends up at around 23% for domestic companies and around 28% for multinational corporations, this still ends up higher in comparison to the effective rates of most other nations.[45] If the effective rate already sits significantly lower, would it not make sense to lower the statutory rate and close many of the credits and loopholes? Since some of the credits and loopholes benefit some firms more than others, doing so would spread the benefits of a lower rate more evenly across all firms.[46] Also, corporations could lower their costs associated with more aggressive tax planning, and this change would have a minimal effect on revenue if structured properly.

Thus, it would make sense to lower the overall tax rate to a more reasonable level, one that is more competitive and in line with other nations in the OECD (the corporate

[44] "Corporate Income Tax Rates Around the World"
[45] Ibid
[46] Kleinbard, Edward. "Throw Territorial Taxation From the Train."

tax rate average for OECD nations currently sits at around 25%).[47] Fortunately, despite disagreeing on the exact rate and which loopholes to close, both sides of the political aisle have called for the lowering of the corporate tax rate.

Just as recently as 2012, President Obama recommended lowering the rate to 28% while closing certain loopholes, and more recently others have advocated for plans with even lower rates.[48] Republican politicians, for example, seek a similar change, but want the rate lowered to 25%. Therefore, it looks likely that Congress will ultimately lower the rate; however, there is now way to no when this might happen, or to even guarantee that it will happen. Thus, this paper assumes the rates will remain at the current rate until further notice.

Also, since the proposal attempts to reach a revenue neutral scenario, the proposed rates might seem high given the arguments just made, and people who feel the rate should be lowered might initially dismiss this proposal for that reason. However, the rates are proposed relative to the current rate in order to achieve revenue neutrality. As stated earlier, displaying revenue neutrality is key to making the proposal a realistic option. In other words, the argument for a lower rate should be separated out from this proposal. The focus should be on the ratio of the rates proposed. Since the ratio of proposed rates is tied to the current rate, the proposed rates can be adjusted up or down to whatever someone considers to be the ideal corporate rate. For example, if someone feels that the current corporate rate should be 28%, then the proposed rates will also drop to

[47] "OECD Corporate Income Tax Rates"
[48] Goldfarb, Zachary. "Obama Proposes Lowering Corporate Tax Rate to 28 Percent."

match this. If someone feels the rate should be 40%, then the proposed rates will go up with it.

It should also be noted that the proposal will analyze the statutory rate as opposed to the effective rate. The paper assumes that all credits and loopholes used by corporations will remain the same (with the exception of the foreign tax credit which the paper will address). Not to say that the loopholes and credits are not issues in of themselves; however, the paper simply chooses to focus on tax inversions and the associated problems of corporate taxation of foreign earnings. The proposal seeks to solve this problem without delving into the separate problems of credits and loopholes.

The proposal uses a 35% rate for U.S.-sourced income earned by U.S.-based corporations, a 40% rate for U.S.-sourced income earned by foreign-based corporations, and a 2.5% rate for foreign-sourced income earned by U.S.-based corporations. To reiterate, all foreign earnings of a U.S.-based firm are taxed the year in which they are earned. Corporations no longer possess the ability to defer foreign profits, and corporations will no longer be able to use or receive foreign tax credits. As stated earlier, these rates are too high; however, for the sake of revenue neutrality they will not be changed. If someone feels that the ideal corporate rate is 28%, then the model can easily be adjusted resulting in lower rates across the board.

The foreign rate is not higher in order to achieve revenue neutrality (this could be achieved using a 35% rate), but its purpose is to discourage firms from inverting outside the United States. Any firm that earns one-third or more of its profits will benefit by headquartering in the United States. Any firm that earns less than one-third will benefit from headquartering abroad. In doing this, the proposal aligns incentives so that corporations elect to headquarter based upon the economic reality of the firm. If a firm has over one-third of its business in the U.S., it more likely than not has at least a plurality of its business in the United States. Therefore, it would make sense for that firm to headquarter in the United States. Likewise, it makes more sense for firms performing less than one-third of their business in the United States to headquarter abroad. Also, the more business a corporation has in the United States, the more it benefits from being a U.S.-based corporation, and vice versa, which logically seems how it should be.

The results of the proposal are as follows:[49]

Current Rate	Proposed U.S. Rate	Proposed Foreign Income Rate	Proposed US rate for Foreign firms
35%	35%	2.5%	40%

	2011	2010	2009
U.S. income	$931,874,547	$941,983,728	$815,729,771
U.S. Income less repatriated income	$719,542,059	$671,925,256	$572,874,012
Recognized Foreign Income	$212,332,488	$270,058,472	$242,855,759
Total Foreign Income from U.S. firms	$478,219,608	$444,629,192	$331,941,676
Foreign firm US income	$9,121,201	$9,919,766	$7,012,428
Taxes owed-current	$224,049,882	$218,083,141	$198,540,517
Taxes owed-proposed	$267,443,691	$250,257,476	$211,609,417
Revenue Loss	$0	$0	$0
extra taxable income needed	$0	$0	$0
Rev Gain	$43,393,809	$32,174,335	$13,068,901
Income Cushion	$133,519,414	$98,997,954	$40,212,002
% of total income	11%	9%	4%

[49] Numbers pulled form IRS 1120 and 1120-F tables; http://www.irs.gov/uac/SOI-Tax-Stats-Corporation-Data-by-Type-of-Return

	2008	2007
U.S. income	$910,056,404	$1,129,996,905
U.S. Income less foreign income	$694,673,014	$945,569,634
Recognized Foreign Income	$215,383,390	$184,427,271
Total Foreign Income from U.S. firms	$325,230,390	$283,289,571
Foreign firm U.S. income	$6,403,170	$14,515,113
Taxes owed-current	$223,734,722	$317,822,650
Taxes owed-proposed	$253,827,583	$343,837,656
Revenue Loss	$0	$0
Extra taxable income needed	$0	$0
Rev Gain	$30,092,861	$26,015,006
Income Cushion	$92,593,418	$80,046,173
% of total income	8%	6%

All of these numbers were calculated using the IRS tables provided on its website that aggregate the tax statistics from forms 1120 and 1120-F that corporations filed from 2007-2011. Form 1120 is the form that all U.S.-based corporations must file, and 1120-F is the form foreign corporations file. Unfortunately, the IRS only provides the statistics up to 2011, so more recent years are not provided although it can be assumed that the statistics have not changed drastically since 2011.

The first line item titled “U.S. income” aggregates total taxable income of all U.S.-based corporations, which includes currently recognized foreign income (i.e., subpart F income and repatriated profits). The next line item, “U.S. income less foreign income,” removes the currently recognized foreign income from the initial “U.S. income” total. This calculation isolates income that corporations earn in the United States from income earned abroad.

Next, the “Recognized Foreign Income” states the amount removed from “U.S. Income” when calculating “U.S. income less foreign income.” This total is then added to the total profits actively reinvested abroad creating the “Total Foreign Income from U.S. firms” line item. This item combines the foreign profits corporations intend to defer with the profits it repatriated (including Subpart F) in order to provide the total foreign income that would be taxed at the proposed 2.5% rate.[50] Then, the table provides the total income earned by foreign firms in the United States (“Foreign Firm U.S. Income”), which was pulled from the 1120-F tables.

After this, the table displays the tax liabilities of all corporations owed to the United States under both the current system and the proposed system. Again, these totals do not reflect actual liabilities, as it does not account for tax credits (other than the foreign tax credit), net operating losses, etc. The proposal simply focuses on corporate taxation of foreign earnings and, thus, assumes all else remains the same. Continuing, the current tax liability multiplies the sum of “U.S. Income” and “Foreign firm U.S. income” by the current corporate rate of 35%, and then this total is subtracted by that year’s foreign tax credit (pulled from the 1120 statistics). The proposed tax liability looks like this: (“U.S. income less foreign income” x 35%)+(“Total foreign income of U.S. firms” x 2.5%)+(“Foreign firm U.S. income x 40%).

As it displays, this model results in a revenue gain for the United States government. The rates in the proposal can be manipulated a bit without sacrificing revenue neutrality. For example, if the proposed U.S. rate was dropped to 32% and the proposed foreign rate was raised to 4% while holding the proposed U.S. rate for foreign firms at 40%, then the United States would still reside in the revenue positive range for

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[50] "Overseas Earnings of Russell 1000 Tops $2 Trillion in 2013."

every year. Or, the same would be true if the proposed U.S. rate were dropped to 33% and the proposed U.S. rate for foreign firms to 38%, while holding the proposed rate at 2.5%. In other words, there is a fair amount of wiggle room in finding the exact rate that the United States should adopt. The table shows that the proposal can be revenue neutral; however, once this is proven, it is the logic behind the model that makes this proposal ideal from the United States' perspective.

The proposal addresses the foreign earnings of U.S. corporations. U.S. corporations currently have around $2 trillion in untaxed foreign earnings. Corporations truly intend to permanently reinvest significant amounts of this total in foreign ventures; however, a sizeable chunk is also being permanently reinvested solely to avoid U.S. taxation. By taxing all foreign earnings of a U.S.-based corporation at a relatively miniscule 2.5%, the United States receives some tax revenue that it normally would not see, and corporations can freely repatriate earnings back into the United States without punishment. Once U.S. corporations lose the disincentive to repatriate, the investments of profits in the United States would likely increase a fair amount.[51] With this in mind, the increased investment activity could potentially increase total taxable U.S. income, thus, raising more revenue.[52] However, since calculating this effect is complicated and largely hypothetical, it was left out of the model. That being said, it is still a thought to keep in mind.

Also, the model should reduce inversions without employing complicated headquartering and anti-inversion rules. Over the past decade, the government provided

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[51] Desai, Mihir. "Repatriation Taxes and Dividend Distortions."
[52] Ibid

stricter rules on this matter and accomplished little in the way of reducing inversions.[53] Instead of placing a Maginot Line-esque barrier that corporations can easily work around, this proposal aligns incentives so as to discourage inversions and encourage firms to headquarter as they should. A firm with one-third of its income inside the United States would have the exact same U.S. tax liability regardless of where it chose to headquarter. The more income that a firm earns inside the United States, the more the system incentivizes them to remain in the United States. On the flip side, as U.S. income goes down, so does the incentive to remain in the U.S. Thus, since the incentives are properly aligned, the system allows firms to elect for themselves to determine where they headquarter.

However, all this being said, corporations should not be able to switch their headquarters from year to year. Thus, it would make sense for firms to elect where they want to headquarter now, and the election must last ten years. Then, after every ten years, corporations can elect to change course. Therefore, if a firm elects to be foreign-based but ultimately earns more than one-third of its income in the U.S., then the U.S. receives more tax revenue. And, if that firm earns less than one-third, then it is headquartered as it should be. The opposite holds true for U.S.-based firms. It creates a win-win scenario for the United States.

The model, however, fails to address the potentially increased incentive to strip income from the United States. Unfortunately, since the 2.5% rate is so low, U.S. firms will generally benefit by shifting U.S.-sourced income abroad.[54] The 2.5% tax does,

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[53] McKinnon, John. "New Tax Rules Will Slow, Not Halt, Inversion Deals
[54] Rubin, Richard. "Cash Abroad Rises $206 Billion as Apple to IBM Avoid Tax."

however, create somewhat of a disincentive and gives the proposal an advantage over a pure territorial system because a territorial system creates no disincentive. That being said, the taxation of repatriated earnings probably creates a greater disincentive than does a 2.5% rate, so the proposal fails to match the current system in that regard.

Fortunately, the proposal generates a revenue positive scenario for the United States. One that is relatively sizeable, which creates a significant cushion that possibly accounts for income stripping. For example, in 2011 the model shows that if U.S. corporations shifted over $130 billion outside of the United States, then the U.S. would still recognize a net gain in tax revenue. In other words, the cushion minimizes, to a certain degree, the impact of income stripping. However, there still exists a few ways in which to minimize the actual act of income stripping.

The IRS, for example, could utilize its enforcement ability and can impose a penalty on income it deems to be stripped out of the United States. For example, the IRS could tax any stripped income at a 40% rate. This would cause the IRS to create rules regarding the definition of income stripping and when corporations can and cannot do it. Although not necessarily ineffective, this solution runs contrary to the theme and logic behind the proposal, which seeks to remove the need for the IRS to create rules and definitions that further complicate the tax code.

Much of this problem can be solved using lower tax rates. Once again, for emphasis, since the current U.S. rate is 35%, it is very difficult to achieve revenue neutrality using significantly lower rates. However, let's assume that recently the U.S. decided to switch to a 25% corporate tax rate. This allows the model to input 25% as the "proposed U.S. rate" while maintaining revenue neutrality. Also, in this new model, the “proposed foreign rate” should be raised to 5%, and the “proposed U.S. rate for foreign firms” should be lowered to 35%. With these assumptions, the model maintains revenue neutrality and maintains the same incentive structure regarding the decision on where to headquarter (the one-third threshold). However, one key difference is that the incentive to strip income decreases significantly.

A 25% rate would make the U.S. corporate rate far more competitive relative to the rates of nations worldwide. That alone decreases the incentive to shift income.[55] The tax savings of shifting income shrinks as the rate shrinks. For one, there would be fewer nations to shift income to simply because there would be fewer nations with lower rates than the United States. Secondly, income that is shifted to lower tax regions would produce smaller tax savings because the difference between the rates would be smaller. Then, add in a 5% rate on all foreign-sourced income and the benefits shrink even more. Although further research would need to be performed, it would not be surprising if this rate structure created a greater disincentive for income stripping than the taxation of repatriated earnings creates in the current system.

Another possibility to solve this problem would be to utilize the financial statements of corporations. There would need to be a lot more research on this and probably several more theses to prove anything; however, the logic behind it is worth mentioning. The government can force corporations to include a section in their financial statements that details their income earned within the United States and income earned outside of it. Then, ultimately, the percentage of U.S. income relative to foreign income reported for tax purposes should match the ratio present in the financial statements.

[55] Krauthammer, Charles. "Lower Corporate Tax Rates. Now."

This system would balance the incentives of tax planning and financial reporting. Tax planning generally aims toward lowering income and financial reporting aims to raise income. Thus, when the financial reporting affects the tax planning, a more accurate income total will likely be reported. A firm may decide to alter the ratio so as to benefit tax-wise; however, then it risks showing investors that it underperformed in one the most important markets in the world. More likely than not, however, firms will elect to sacrifice tax-wise in order to benefit in the financial statements. The LIFO vs. FIFO choice provides evidence for this.

Firms can elect to report inventory for financial reporting on a FIFO or a LIFO basis with the caveat that whichever method chosen must also be the method used for tax purposes. FIFO creates higher net income that benefits the financial statements, but it also increases the tax liability. LIFO does the opposite. Most firms elect for FIFO despite the tax advantage of LIFO.[56] Therefore, if corporations had to use the ratio of U.S. vs. foreign income in their financial statements for tax purposes, then the incentive to shift income outside of the United States would likely decrease significantly.

Another common criticism of offering a significant tax discount on foreign earnings is that it would encourage corporations to outsource manufacturing jobs. Vice-President Joe Biden cited a study done saying that 800,000 jobs would be created overseas as the result of such a change.[57] Although Vice-President Biden mistakenly assumed that job creation abroad prevents job creation in the United States, the concerns

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[56] Dopuch, Nicholas and Morton Pincus. "Evidence on the choice of inventory accounting methods: LIFO versus FIFO." 28-59.
[57] Dubay, Curtis. "A Territorial Tax System Would Create Jobs and Raise Wages for U.S. Workers."

are still valid.[58] In deciding where to host a manufacturing plant, all else being equal, a corporation would choose the location with the lowest tax ultimately placing American workers at a disadvantage. However, in practice, “all else equal” rarely holds true, and factors unrelated to taxation generally play a far bigger role in the decision-making process.

In the 90s, U.S. corporations outsourced millions of manufacturing jobs to China. With China’s tax rate being 33%, corporations did so in spite of the absence of significant tax benefits. Then, in the 2000s after China lowered its corporate rate to 25%, the trend started to shift in the other direction.[59] In other words, corporations initially outsourced manufacturing jobs because China possessed a high quantity of cheap labor. However, in the 2000s the labor became more expensive, so the trend shifted despite the tax incentive to do otherwise.

More recently, German auto manufacturers have outsourced manufacturing jobs to the South even though Germany has a far more reasonable corporate tax rate. The German companies instituted this change because they wanted to free themselves from the worker unions of Germany who were driving up the costs of labor. Therefore, they moved to the South where the unions have less power, keeping labor costs low relative to Germany and even the rest of the United States.[60] In other words, taxation consistently plays a minimal role in the relocation of manufacturing jobs.

Also, even with a rate as high as 35%, there appears to be few tax benefits associated with outsourcing jobs. Most "tax havens" throughout the world are too small

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[58] Ibid
[59] Powell, Bill. "The End of Cheap Labor in China."
[60] Sywak, Andy. "The South Rises Again! (In Automobile Manufacturing, That Is)."

to support such a change. They simply do not have an adequate supply of labor. Most nations with a large enough supply tend to have a rate that is relatively in line with the United States or at least one close enough so that non-tax factors play a bigger role in decision-making. Thus, the tax incentive to shift manufacturing jobs is relatively low, and if the U.S. lowered its rate to be in line with the OECD average, the incentive would essentially be eliminated.

Although left unaddressed in the proposal, the profits currently deemed "permanently reinvested" abroad, roughly $2 trillion, should be discussed. Some might argue that these profits should be taxed at the newly proposed 2.5% rate. Some view the "permanent reinvestments" as tax evasion and hold the opinion that the corporations already benefitted by delaying their tax payment by several years. This line of thinking should not be dismissed. However, corporations do not always permanently reinvest profits for tax avoidance purposes. Corporations will likely never repatriate a significant portion of the profits that they earned.[61] Thus, it would be unfair to tax corporations on earnings they never anticipated to pay taxes on, especially when they based this assumption on legal means.

However, some might still argue that firms should be given a break on the profits that they never intended to repatriate, but all other profits they did intend to repatriate should be taxed. However, this would violate the basic assumption of simplicity that this proposal seeks to achieve. Determining a steadfast rule for the true intention of a corporation regarding its foreign profits would almost never work in practice. Therefore, it makes the most sense to allow firms to repatriate, tax-free, all foreign earnings up to the

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[61] Rubin, Richard. "Cash Abroad Rises $206 Billion as Apple to IBM Avoid Tax."

date of the change, especially considering the proposal ultimately creates a revenue gain for the United States.

Conclusion

The current corporate tax system in the United States focuses on preventing corporate actions, but fails to account for the corporate incentives created by the system. In recent years, several notable U.S. corporations have inverted into a foreign company allowing them to move their headquarters outside of the United States. In response to this, the Treasury enacted rules that limit a corporation's ability to change its headquarters post-inversion. However, the anti-inversion rules have done little to deter inversions even as the rules became stricter because the rules did not change a firms incentive to invert.

When corporations possess a strong incentive to invert, it is not surprising they are able to expose loopholes in the rules considering they spend millions on tax advisors whose job is to expose loopholes. Thus, in order to fix corporate taxation, the Treasury must look to realign corporate incentives. Since the United States taxes corporations on their worldwide income at one of the highest tax rates in the world, there is an obvious incentive to become a foreign firm. The ability to defer actively reinvested foreign profits reduces this incentive to some degree but also creates an incentive to not reinvest in the United States, which makes little sense from the perspective of the United States.

Therefore, in reaction to this, many argue that the United States should institute a territorial system of taxation. A territorial system exempts foreign earnings from taxation, thus, it allows U.S. corporations to be more competitive and removes the blockade to the repatriation of earnings. However, a pure territorial system creates an enormous incentive to strip income and makes it difficult to achieve tax neutrality. Therefore, it makes sense to tax foreign earnings, the year earned, at a small rate, while simultaneously raising the U.S. tax rate on foreign firms. This creates a disincentive to shift income and boosts tax revenue. Also, the increased tax rate on foreign firms creates an incentive structure such that corporations will accurately elect for themselves where they should headquarter.

Ultimately, the focus of this proposal should be placed upon the logic behind it, not the exact rates used. As long as the rates remain somewhat in-line with the model, the logic will remain the same. Understanding the motivations and incentives of corporations is key to solving the issues imbedded within the system of corporate taxation. By changing the incentives, the proposal addresses the source of the problem, not the result.

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