CORPORATE INVERSIONS AND EARNINGS STRIPPING: LEGAL LOOPHOLES THAT ARE INCONSISTENT WITH THE GOALS OF CORPORATE LAW

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Corporate inversions, a method by which U.S.-based companies relocate to lower-tax countries, have recently been the subject of heated debate and media coverage.[1] President Obama criticized corporate inversions as one of the "most insidious tax loopholes out there."[2] The President's desire to crack down on corporate inversions was reflected by a new set of Treasury Department regulations that make inversions much less appealing for U.S. companies.[3] The regulations had the desired effect; a merger between Pfizer Inc. and Allergan PLC valued at over $150 billion, which would have been the largest merger in history for the pharmaceutical industry, was called off days after the regulations were announced.[4] Allergan's CEO criticized the Treasury regulations as "un-American" and "capricious."[5]

Although much of the recent coverage and debate has focused on corporate inversions, this commentary posits that corporate inversions are, on their own, relatively consistent with the goals of U.S. corporate law. The related concept of earnings stripping, however, raises a far

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1. Jonathan D. Rockoff, Liz Hoffman & Richard Rubin, *Pfizer Walks Away From Allergan Deal*, WALL ST. J. (Apr. 6, 2016, 5:26 PM), http://www.wsj.com/articles/pfizer-walks-away-from-allergan-deal-1459939739.
2. *Id.*
3. Press Release, Fact Sheet: Treasury Issues Inversion Regulations and Proposed Earnings Stripping Regulations, U.S. DEP'T OF THE TREASURY: PRESS CENTER (Apr. 4, 2016), https://www.treasury.gov/press-center/press-releases/Pages/jl0404.aspx ("Typically, the primary purpose of an inversion is not to grow the underlying business, maximize synergies, or pursue other commercial benefits. Rather, the primary purpose of the transaction is to reduce taxes, often substantially.").
4. Richard Rubin & Liz Hoffman, *New Rules on Tax Inversions Threaten Pfizer-Allergan Deal*, WALL ST. J. (Apr. 4, 2016, 8:28 PM), http://www.wsj.com/articles/u-s-treasury-unveils-new-steps-to-limit-tax-inversions-1459803636?mod=trending_now_4.
5. Jonathan D. Rockoff, *Allergan CEO Saunders Criticizes Treasury Rules That Scuttled Pfizer Deal*, WALL ST. J. (Apr. 6, 2016, 2:34 PM), http://www.wsj.com/articles/allergan-ceo-saunders-criticizes-treasury-rules-that-scuttled-pfizer-deal-1459967644.

more difficult question about the limitations of legal loopholes and inconsistency with the goals of corporate law.

The goal of corporate law is to advance overall social welfare and efficiency.[6] Corporate inversions, and specifically the practice of earnings stripping, are a way of taking advantage of policies and rules that were implemented to advance corporate law in furtherance of that goal. Because some corporations have abused the corporate form through inversion tactics, the law must adjust.

This commentary begins by briefly addressing the goals of corporate law and the way that those goals help shape the legal and regulatory framework in the U.S. The second section will outline the development of, and justification for, the U.S. corporate law landscape that allows companies to engage in actions such as corporate inversions and earnings stripping. By examining the way corporations are taxed on foreign and domestic income, the section will lay the groundwork for understanding precisely how earnings stripping and corporate inversions are a harmful abuse of the U.S. laws. The third section will provide explanations of both corporate inversions and earnings stripping and concludes that, while the former may be a natural extension of the taxation concepts from the second section, the latter is an abusive practice that should be stopped. The fourth section addresses the recent treasury regulations aimed at stopping corporate inversions and earnings stripping and will also examine the Pfizer-Allergan deal that was scrapped after the regulations were issued.

This commentary ultimately argues that corporate inversions, and more accurately earnings stripping, are exploitive abuses of well-intentioned laws and that corporate law must curtail them in a targeted way to maintain the integrity and intention of the laws that led to their creation.

I. THE GOAL OF CORPORATE LAW

As a background for determining the validity and acceptability of corporate inversions and earnings stripping, this section analyzes two competing forces that help shape corporate law: advancement of aggregate social welfare and international competition. The primary

6. John Armour, Henry Hansmann, & Reiner Kraakman, *The Essential Elements of Corporate Law: What is Corporate Law?*, *in* THE ANATOMY OF CORPORATE LAW 1, 25 (2nd ed. 2009).

normative goal of corporate law is to "serve the interests of society as a whole."[7] This goal is appropriate because corporate law affects all members of society, even those who may not have direct contacts with a company.[8] While corporations should not be coerced into becoming eleemosynary institutions, corporate law should aim to prevent corporations from exploiting society. To that end, legislatures and courts typically shape corporate law in ways that pursue the goal of aggregate social welfare, though other forces sometimes influence their decisions.[9] For this commentary, the second relevant goal that helps shape corporate law is international competition.[10] The facilitation of competition is a difficult goal for corporate law to pursue and requires a balance between allowing companies to remain competitive and preventing them from taking advantage of society. Corporate law should encourage and allow domestic companies to compete internationally. At the same time, it is important that corporate law encourages international companies to compete with domestic companies.

These two influences, facilitation of international competition and advancement of aggregate domestic social welfare, present some inherent conflicts. An action or policy that gives a company a competitive advantage over international rivals might impose detrimental social costs. For example, if U.S. manufacturing companies were not subject to pollution regulations, they would likely be able to produce goods at much lower costs than other countries. Fortunately, however, U.S. corporate law prioritizes social welfare in this situation and imposes standards on emissions and pollutants produced by manufacturers.

Balancing these sometimes-conflicting interests is at the heart of the debate on corporate inversions. Inversions are, of course, one way corporations avoid taxation. By taxing corporations, social welfare is advanced because the proceeds are used to fund programs and services that benefit society as a whole. On the other hand, tax breaks and deductions reduce the cost of doing business for American companies and makes them more competitive with foreign companies. This delicate balance has produced the U.S. corporate taxation system. The following

7. *Id.* There is merit to the argument that the goal of corporate law should be narrower and should be to "assure that the corporation serves the interests of the shareholders." *Id.* That concept is not so different from the one this commentary ascribes to, since "maximization of shareholder returns is, in general, the best means by which corporate law can serve the broader goal of advancing overall social welfare." *Id.*

8. *See id.*

9. *Id.* at 26. Other forces include historical influence and special-interest constituencies, such as shareholders, managers, and workers. *Id.*

10. *See id.* at 29–30.

examination of some of the various tax avoidance methods used by U.S. corporations will be guided by the desire to optimize both competition and social welfare.

II. TAXATION AND OPTIMIZATION

Corporations exist to increase shareholder value; they can achieve this goal by increasing profits. One way for a corporation to increase profits is to decrease its tax burden. American corporations seeking to increase shareholder value this way face an uphill battle, as the U.S. imposes one of the highest corporate tax rates in the world.[11] This section provides a brief overview of corporate taxation and outlines the legal—and well-intentioned—foundation for a system that allows corporations to lower their tax burdens through practices such as inversions and earnings stripping.

American corporate tax rates are the subject of much debate, and some understanding of the mechanics of corporate tax rates and the surrounding controversies will provide helpful background. By statute, U.S.-based corporations are subject to a maximum federal marginal tax rate of 35 percent.[12] The actual rate that corporations pay, referred to as the "effective rate," is typically much lower.[13] Essentially, the effective rate is the amount a corporation *actually pays* in taxes every year, after accounting for deductions and credits.[14] Specifics aside, the

11. Though this claim will be further explored in this section, it is not controversial to state that the U.S. has one of the highest corporate income statutory tax rates. Jane G. Gravelle, *International Corporate Tax Rate Comparisons and Policy Implications*, CONG. RESEARCH SERV. (Jan. 6, 2014), http://www.fas.org/sgp/crs/misc/R41743.pdf.

12. *2015 Instructions for Form 1120, U.S. Corporation Income Tax Return*, DEPT. OF THE TREASURY, INTERNAL REVENUE SERV. (last visited Sept. 14, 2016), https://www.irs.gov/pub/irs-pdf/i1120.pdf.

13. Gravelle, *supra* note 11. The effective rate reflects tax benefits that lower the taxable income of a corporation and can be determined by "the ratio of taxes paid divided by profits." *Id*.

14. A recent study by the Government Accountability Office found that large, profitable U.S. corporations paid an average effective tax rate of 16.1% in 2012. *Corporate Income Tax: Most Large Profitable U.S. Corporations Paid Tax but Effective Tax Rates Differed Significantly from the Statutory Rate*, U.S. GOV'T ACCOUNTABILITY OFFICE (Mar. 17, 2016), http://www.gao.gov/assets/680/675844.pdf. Some critics have suggested that this study used the profit and tax numbers in a way that made the effective tax rate seem as low as possible and that alternative manipulation of those numbers resulted in an average tax rate of 40.1%. Richard Rubin, *U.S. Corporate Taxes May Be 16% or 40%—It's All How You*

effective tax rate is generally lower than the statutory rate.[15] Although the precise difference between the two is outside the scope of this commentary, understanding *how* the effective rate ends up lower than the statutory rate is crucial to understanding why corporate inversions have become so popular.

Effective tax rates are generally lower than the statutory rate, in large part, due to "tax expenditures."[16] Tax expenditures are essentially subsidies and write-offs delivered through the tax code as deductions, exclusions, and other preferences.[17] Functionally, when a taxpayer undertakes a certain action or meets certain criteria, tax expenditures reduce the amount of taxes owed, resulting in less federal income tax revenue.[18]

The government uses tax expenditures as a method for driving policy initiatives—similar to the way it uses spending or regulatory programs.[19] As an example, an individual taxpayer can reduce his or her taxes by claiming a deduction for the amount spent on mortgage interest.[20] The basic rationale behind such a deduction is that increasing home ownership is a policy goal of the U.S. government, and the tax deduction offers an incentive and reward to individuals who own a home.[21]

Do the Math, THE WALL STREET JOURNAL (Apr. 15, 2016, 7:30 AM), http://blogs.wsj.com/economics/2016/04/15/u-s-corporate-taxes-may-be-16-or-40-its-all-how-you-do-the-math/.

15. For more information on calculating the effective tax rate, see Derek Tsang, *Does the U.S. Have the Highest Corporate Tax Rate in the Free World?*, PUNDITFACT (Sept. 9, 2014, 11:01 AM), http://www.politifact.com/punditfact/statements/2014/sep/09/eric-bolling/does-us-have-highest-corporate-tax-rate-free-world/.

16. *Policy Basics: Federal Tax Expenditures*, CTR. ON BUDGET AND POLICY PRIORITIES, http://www.cbpp.org/sites/default/files/atoms/files/policybasics-taxexpenditures.pdf (last updated Feb. 23, 2016).

17. Congressional Budget and Fiscal Operations, 2 U.S.C.A. § 622 (Westlaw through Pub. L. No. 93-344) ("[R]evenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."); *see also* CTR. ON BUDGET AND POLICY PRIORITIES, *supra* note 16.

18. CTR. ON BUDGET AND POLICY PRIORITIES, *supra* note 16 ("In fiscal year 2015, tax expenditures reduced federal income tax revenue by over $1.2 trillion, and they reduced payroll taxes and other revenues by an additional $128 billion.").

19. *Tax Expenditures*, U.S. DEP'T OF THE TREASURY: OFFICE OF TAX ANALYSIS (Nov. 11, 2015), https://www.treasury.gov/resource-center/tax-policy/Documents/Tax-Expenditures-FY2017.pdf.

20. 26 U.S.C. § 163(h) (Westlaw through Pub. L. No. 88-9).

21. Tax breaks on owner-occupied housing, which includes the home mortgage interest deduction, were the second largest individual income tax expenditure in 2015. CTR. ON BUDGET AND POLICY PRIORITIES, *supra* note 18. The largest was the provision that allows households to exclude the value of employer-provided health insurance from income. *Id*.

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One of the largest corporate tax expenditures is "deferral of income from controlled foreign corporations."[22] This tax break allows multinational companies to avoid paying U.S. taxes on foreign profits,[23] and reflects the government's desire to help U.S.-based multinational corporations maintain competition with foreign corporations.[24] Firms based in the U.S. are at a disadvantage because the U.S. has a worldwide system of corporate taxation and generally taxes all the income of a corporation regardless of whether it was earned in the U.S.[25] In contrast, many other countries use a territorial system that only taxes income earned in those specific countries.[26] The deferral expenditure does not completely exempt foreign income from taxation, but it does give corporations a tax credit for payments to foreign governments and allows companies to defer paying U.S. taxes on foreign income until the money is repatriated.[27] Essentially, the expenditure allows corporations to defer "the additional domestic tax on foreign earnings . . . which is over and above what is paid abroad . . . as long as the earnings remain invested abroad."[28]

The deferral tax expenditure is in line with both goals of corporate law discussed above: facilitation of international competition and advancement of aggregate social welfare.[29] By allowing companies to

22. U.S. DEP'T OF THE TREASURY: OFFICE OF TAX ANALYSIS, *supra* note 19.

23. This is an over-simplification. The rationale behind this tax expenditure is substantially more complicated than the rationale behind the home mortgage interest deduction.

24. Robert Carroll, *Special Report: The Importance of Tax Deferral and a Lower Corporate Tax Rate*, TAX FOUND. (Feb. 2010), http://taxfoundation.org/sites/taxfoundation.org/files/docs/sr174.pdf.

25. U.S. DEP'T OF THE TREASURY: OFFICE OF TAX ANALYSIS, *supra* note 19.

26. ROBERT CARROLL, TAX FOUND., SPECIAL REPORT: THE IMPORTANCE OF TAX DEFERRAL AND A LOWER CORPORATE TAX RATE (Feb. 2010), http://taxfoundation.org/sites/taxfoundation.org/files/docs/sr174.pdf.

27. Richard Rubin, *Pfizer Piles Profits Abroad*, THE WALL STREET JOURNAL (Nov. 8, 2015, 8:12 PM), http://www.wsj.com/articles/pfizer-piles-profits-abroad-1447031546?alg=y. United States accounting rules dictate that corporations "must include the potential U.S. tax cost in their earnings," though it is possible for the corporation to keep the funds overseas indefinitely, and avoid taxation. *Id.*

28. ALAN COLE, TAX FOUND. CORPORATE VS INDIVIDUAL TAX EXPENDITURES (Apr. 23, 2014), http://taxfoundation.org/article/corporate-vs-individual-tax-expenditures#_ftnref13. For example: If a U.S.-based company earns money abroad and pays a 20% tax rate on it, the company would be taxed 15% on the earnings (assuming a U.S. rate of 35%) if it wants to bring the money back to the United States.

29. Although there does not seem to be any explicit acknowledgement of this justification, the conclusion makes sense.

avoid or delay taxation on profits earned overseas, the government is allowing U.S.-based corporations to stay competitive.[30] The additional tax levied on foreign earnings could put U.S. firms at a disadvantage compared to foreign firms. When U.S. corporate law encourages companies to compete internationally, those companies are less likely to relocate, benefitting society as a whole.[31] Additionally, if the corporation eventually decides to repatriate the money, it will still be subject to taxation in the United States.

Good intentions aside, this U.S. corporate tax system has some adverse consequences and creates incentives that belie the goals the system was intended to pursue. The next section will explain how the U.S. corporate law system's implementation of policies, such as the deferral expenditure, has led to corporate inversions and how inversions and earnings stripping are contrary to the goals of corporate law generally.

III. TAKING ADVANTAGE OF AND ABUSING THE SYSTEM THROUGH CORPORATE INVERSIONS AND EARNINGS STRIPPING

The tax deferral system outlined above serves the goals of corporate law. It avoids placing companies at a competitive disadvantage but still collects tax revenue from corporations when earnings are repatriated. Some companies, however, are not content to benefit from the system on its face. These companies seek to further benefit from the U.S. system by moving their domicile to a foreign country with the goal of decreasing their tax burden even further through corporate inversions and earnings stripping. This section will expand on the above discussion of foreign profit tax deferral and will discuss why corporate inversions have become popular.

The system of tax deferral for foreign profits arguably incentivizes companies to leave money overseas indefinitely to avoid taxation. Some of the largest U.S. companies, such as Apple and Facebook, are often scrutinized by the media for their large offshore cash reserves.[32] The general concept of offshore profit shelters is outside the scope of this commentary and will not be explored at great length. For present

30. CARROLL, *supra* note 26.

31. Corporations provide employment and are a positive force in the economy.

32. Daniel Marans, *America's 50 Biggest Corporations Are Hiding Over $1 Trillion Overseas*, HUFFINGTON POST: BUSINESS (Apr. 14, 2016, 7:43 PM), http://www.huffingtonpost.com/entry/biggest-corporations-hiding-over-trillion-overseas_us_57100f97e4b0060ccda2c625; Robert W. Wood, *Facebook Mirrors Google's Offshore Tax Scheme*, FORBES (Dec. 27, 2012, 10:24 PM), http://www.forbes.com/sites/robertwood/2012/12/27/facebook-mirrors-googles-offshore-tax-scheme/#24ee6c7c4b94.

purposes, it is enough to say that the deferral tax expenditure leaves some companies in a difficult position; they are able to avoid taxation on foreign earnings, but will have to pay taxes on those earnings in order to bring them back to the U.S. and utilize them.[33] Some argue this system constrains U.S. companies because they are unable to return foreign profits to shareholders or reinvest them in U.S. facilities and projects without first paying taxes.[34] Of course, for some companies this is not an issue. Large offshore cash reserves increase a company's book value and may make it a more attractive investment option.[35] Companies that want to utilize foreign cash reserves here in the U.S. are expected to pay the repatriation tax.[36] Presumably, companies would be willing to pay the tax if they needed the additional capital domestically. The root of many corporate inversions is a desire by companies to repatriate those foreign earnings, without paying the deferred income tax.[37]

The following subsection will outline the basics of corporate inversions and earnings stripping. The subsequent subsection will analyze the extent to which those practices directly conflict with the goals of corporate law.

A. Corporate Inversions and Earnings Stripping: How do They Work?

Corporate inversions and earnings stripping are often the result of companies' desire to utilize offshore profits domestically, without paying U.S. taxes on those earnings.[38] Companies typically engage in earnings

33. The tax on those foreign cash reserves is sometimes referred to as a "repatriation tax," but is essentially the end of the deferral.

34. Rubin, *supra* note 27.

35. Philip Elmer-DeWitt, *Congress has its eye on Apple's $158 billion in offshore cash. UPDATE: So does Obama*, FORTUNE (Jan. 31, 2015, 6:13 AM), http://fortune.com/2015/01/31/washington-has-its-eye-on-apples-158-billion-in-offshore-cash/("Apple's overseas cash hoard has grown to $158 billion . . . ."). These large off-shore cash reserves are often the target of Congressional initiatives to increase tax revenue. *Id*. Indefinite deferral entails significant tax planning and administrative costs, but is not the focus of this commentary. *See* Cole, *supra* note 24.

36. *See*, Marans, *supra* note 32 ("But thanks to a tax 'deferral' loophole, U.S. companies only pay domestic taxes on foreign earnings if they 'repatriate' the earnings by bringing them back to the U.S.").

37. *See* Rubin, *supra* note 27 ("Foreign firms have more flexibility than U.S. companies in using intracompany transactions to concentrate deductions in the U.S. and income in low-tax countries.").

38. Press Release, U.S. Dep't of the Treasury, Fact Sheet: Treasury Issues Inversion Regulations and Proposed Earnings Stripping Regulations (Apr. 4, 2016).

stripping after completing an inversion, though not all inverted companies engage in earnings stripping.[39] To understand how a corporate inversion works, it is best to first set aside the issues of earnings stripping and deferred taxation on foreign earnings.[40]

1. Corporate Inversions

Corporate inversions—the heart of this commentary—are complex tax avoidance maneuvers that draw both praise and scrutiny.[41] This section first presents a broad overview of inversions and provides a theoretical example. Next, this section explores the complexities of inversions in light of the recent Treasury Department regulations, which make inversions less appealing due to subtle and nuanced requirements.[42]

At the most basic level, the term "corporate inversion" refers to re-incorporating a company overseas in a country with a lower tax rate and less stringent corporate governance requirements.[43] A typical large corporate inversion—the focus of this commentary—generally involves a large U.S. company and a smaller foreign company.[44] The U.S. company is dissolved through either a merger or acquisition, and the new combined entity is domiciled in the lower-tax country.[45] The company usually retains its presence in the U.S., sometimes as a subsidiary, because the inversion is usually performed solely for tax

39. *Id.*

40. After establishing the essentials of corporate inversions, the concept of earnings stripping as an abuse of the deferred taxation system will make more sense.

41. "'My attitude is I don't care if it's legal, it's wrong,' Mr. Obama said." John D. McKinnon & Siobhan Hughes, *Obama Urges Quick Action to Stop 'Inversions'*, THE WALL STREET JOURNAL (July 24, 2014, 7:40 PM), http://www.wsj.com/articles/obama-to-urge-quick-action-on-inversions-1406220197; *but see* Bill Archer, *The Obama Uncertainty Principle*, THE WALL STREET JOURNAL (Jan. 27, 2016, 6:53 PM), http://www.wsj.com/articles/the-obama-uncertainty-principle-1453938797 ("The perfectly legal maneuver is a common-sense business response to the absurdly uncompetitive U.S. tax code . . . ."). After establishing the essentials of corporate inversions, the concept of earnings stripping as an abuse of the deferred taxation system will make more sense.

42. *Treasury's New Inversion Rules*, THE WALL STREET JOURNAL: AT A GLANCE (Apr. 5, 2016, 12:21 PM), http://blogs.wsj.com/briefly/2016/04/05/treasurys-new-inversion-rules-at-a-glance/.

43. Marie Beaudette, *5 Things to Know About Inversions*, THE WALL STREET JOURNAL: BLOG (July 8, 2014, 1:54 PM), http://blogs.wsj.com/briefly/2014/07/08/5-things-to-know-about-inversions/.

44. *Id.*

45. *Id.*; *see also* Rubin, *supra* note 27.

purposes.[46] Inversions are fully legal actions and allow a company to further isolate foreign earnings from U.S. taxation.[47]

Corporate inversions make sense for companies that receive a significant portion of their income from foreign sources. As an example, imagine a manufacturing company that incorporated in the U.S. decades ago. At its inception, the majority of the company's revenue came from U.S. sales, but the company expanded and a growing portion of sales now comes from abroad. The income generated in other countries would be taxed where it is earned and again in the U.S. because of the company's U.S. incorporation.[48] If the company changed its domicile and reincorporated in a foreign country, it would be able to bypass the additional income tax not generated in the U.S.[49] This is a basic corporate inversion.

Having laid the foundation for the concept, the specifics of large corporate inversions can now be better understood. In an inversion, two companies undergo a merger and each receives ownership in the new entity consistent with its initial value. U.S. investor's ownership stake in the combined entity is one of the most important aspects of large corporate inversions. As was briefly mentioned above, U.S. companies usually undergo inversions with relatively smaller foreign companies.[50] Although the exact reasons are not relevant here, for an inversion to result in tax benefits, the foreign company's shareholders must receive stock amounting to at least twenty percent ownership of the new entity.[51] If the foreign company's shareholders end up owning less than 20 percent of the merged entity's equity, the entity would still be subject to U.S. taxes, regardless of location.[52] Usually, the U.S. company aims to own between fifty and sixty percent of the new entity.[53] That way, it can maintain majority ownership, and still be considered a foreign

46. *See* Beaudette, *supra* note 43.
47. *See e.g.* McKinnon & Hughes, *supra* note 41.
48. *See* discussion, *supra* Part II.
49. *See* Rubin, *supra* note 27.
50. Beaudette, *supra* note 43.
51. *Id.* For a further discussion of disparate ownership structures, and the problems associated with them, see REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, (2d ed. 2009).
52. Rockoff et. al., *supra* note 1.
53. *Id.*

company, while achieving maximal tax benefit.[54] Suffice it to say, large corporate inversions typically require a great deal of planning to ensure that the ownership percentages are just right.

At this stage, inversions should not seem overtly nefarious. In fact, inversions should not seem very different from the deferral tax expenditure discussed earlier.[55] An inversion is merely a reincorporation to achieve more favorable tax rates on foreign income. Ultimately, the result of an inversion is that a company moves its headquarters outside the U.S. to reduce taxation on foreign earnings.[56] The new, foreign entity retains operations in the U.S., and those operations are subject to U.S. taxation.[57] The more nefarious action, which produces a more significant benefit, comes after an inversion and is known as earnings stripping.[58]

2. Earnings Stripping

For companies that engage in earnings stripping, completing the inversion is just the beginning of the tax benefits.[59] Academics and scholars have suggested that the real tax avoidance of corporate inversions comes from earnings stripping, which is eroding the tax base at an alarming rate.[60] While corporate inversions may be merely another way of achieving deferral on foreign profits, earnings stripping is a way to maximize tax deductions against domestic income.[61]

Earnings stripping occurs after a corporate inversion and further lowers the tax burden of the new entity. The U.S. subsidiary borrows large amounts of money from the newly formed foreign parent company, and pays interest to the parent on that debt. The U.S. tax code allows the interest payment to offset earnings generated by the U.S. subsidiary.[62] Thus, the interest payments, and corresponding deductions, can lower the amount of U.S. taxes owed, and the foreign company pays taxes on the interest payments in the lower tax jurisdiction. This deduction allows the U.S. subsidiary to avoid paying taxes

54. *Id.*
55. This commentary asserts that the effect of the deferral tax expenditure and the effect of a corporate inversion are essentially the same: isolating foreign profits from U.S. taxation.
56. *Id.*
57. *Id.*
58. Steven Davidoff Solomon, C*orporate Inversions Aren't the Half of it*, THE NEW YORK TIMES (Feb. 9, 2016), http://www.nytimes.com/2016/02/10/business/dealbook/corporate-inversions-arent-the-half-of-it.html?_r=1.
59. *Id.*
60. *Id.*
61. *Id.*
62. 26 U.S.C. § 163(j) (2012).

on domestic earnings, essentially pushing income to the foreign country with a lower tax rate. The tax deductions associated with earnings stripping are, of course, available to any foreign company[63] with earnings in the United States.[64]

The tax savings associated with inversions are limited to foreign earnings; but, by engaging in earnings stripping, a company can reduce or eliminate its domestic tax burden as well. A 2004 study of twelve corporate inversions presented evidence that companies engaged in earnings stripping after inverting.[65] Furthermore, the study found that four of the companies had engaged in nearly one hundred percent earnings stripping and cost the U.S. Treasury approximately $700 million over a two-year period.[66] The authors of the study concluded that "most of the tax savings" from corporate inversions were attributable to earnings stripping.[67] A 2007 Treasury study corroborated those results, and concluded there was "strong evidence" that inverted companies were engaging in earnings stripping.[68]

B. *Corporate Inversions Are Permissible, but Earnings Stripping is Not Consistent with the Goals of Corporate Law*

Although both corporate inversions and earnings stripping are presently legal actions, allowing the former aligns with the goals of corporate law, while the latter is an impermissible abuse that lacks balance. Given the impracticality of an outright ban on corporate inversions, the goals of corporate law discussed in this commentary are advanced—or at least abided—by the policies and laws that allow corporate inversions and the tax deferral expenditure. In contrast, earnings stripping takes advantage of those policies and laws, contravening the goals of corporate law. This section demonstrates that

63. The term "foreign company" here is used to indicate companies with foreign domiciles that originate as foreign companies. Essentially, companies that are not the product of an inversion.

64. While these companies are not the focus of this commentary, studies suggest that they do not engage in earnings stripping in the way that inverted companies do. Jim A. Seida & William F. Wempe, *Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion*, 57 NATIONAL TAX JOURNAL 805, 805 (2004).

65. Seida & Wempe, *supra* note 46.

66. *Id*. at 807.

67. *Id*.

68. U.S. DEP'T OF THE TREASURY, REPORT TO THE CONGRESS ON EARNINGS STRIPPING, TRANSFER PRICING, AND U.S. INCOME TAX TREATIES 3 (2007).

corporate inversions are not inherently abusive, and that earnings stripping is the underlying abuse of U.S. corporate law harming society.

Corporate inversions and the deferred income tax expenditure are the two ways U.S. firms mitigate the cost imposed by the U.S. worldwide taxation system. In effect, the two are not very different from each other. Consider a company that is able to utilize the deferred income tax expenditure to exempt all foreign earnings from U.S. taxation: the result is effectively the same as an inversion—none of the company's foreign earnings would be subject to U.S. taxation. Although corporate inversions might not explicitly advance the aggregate social welfare, a complete bar on them would be an impediment to U.S. firms that compete internationally and would stifle investment in U.S. companies and subsidiaries.[69] Thus, allowing corporate inversions is at least consistent with the goals of corporate law. That is not to say that corporate law should idly promote the departure of firms from the United States. Indeed, one of corporate law's attempts to negate the temptation of an inversion is the deferral of income from controlled foreign corporations' tax expenditure.[70]

The deferred income tax expenditure is consistent with the goal of facilitating international competition because it contemplates the encumbrance of the U.S. worldwide tax system, and allows U.S.-based firms to lower their tax burdens without relocating overseas.[71] In the absence of such a provision, firms might leave the U.S. to escape the onerous tax system, which would further decrease tax revenue and in turn would decrease aggregate domestic social welfare.[72] Although that loss of foreign income tax revenue is an exception to the worldwide taxation system, satisfying U.S. firms and keeping them domiciled in the U.S. provides a great benefit to nation. Both actions make firms more competitive internationally without sacrificing the amount of tax collected on domestic earnings. Of course, even with the deferred income

69. Barring corporate inversions and refusing to recognize a company's foreign status would likely have the side effect of imposing additional taxes on foreign companies with operations in the United States.

70. An additional legal preclusion to corporate inversions is 26 U.S.C. § 7874 (2012), which mandates that shareholders of an inverting company own between fifty and eighty percent of the combined entity to benefit from an inversion. If the shareholders of the formerly U.S.-based company own more than eighty percent of the combined entity, all tax benefits are lost and the new entity is subject to U.S. taxation, even if based abroad.

71. If U.S.-based firms were forced to pay income tax on *all* worldwide income—and were not able to deduct funds kept overseas—they would likely be less competitive with international firms not subject to such taxation.

72. While tax revenue is the focus of this commentary, a firm's decision to leave the United States could also result in unemployment and other issues detrimental to the aggregate social welfare.

tax expenditure, some companies opt to leave the U.S. to decrease their tax liability even further—through corporate inversions.[73]

If the deferred income tax expenditure allows U.S.-based firms to decrease the amount of taxes paid on foreign earnings, why are companies still undergoing corporate inversions? As the data in Section III(A)(2) shows, many large-scale corporate inversions are likely motivated by earnings stripping and the potential to decrease the amount of taxes paid on U.S. earnings.[74] Nevertheless, much of the debate concerning corporate inversions and lost tax revenue has ignored earnings stripping. This is in spite of the fact that earnings stripping—unlike corporate inversions and the deferred income tax expenditure—results in a decrease in tax revenue from U.S. earnings.[75] The omission of earnings stripping from the dialogue regarding offshore tax avoidance could be attributable to either ignorance or pragmatism.[76]

The basic argument against the use of corporate inversions is that they allow companies to avoid paying taxes on foreign earnings.[77] Though this is true, the deferred income tax expenditure also allows companies to do that.[78] Instead, the real issue with corporate inversions arises when a company engages in earnings stripping to avoid paying taxes on U.S. earnings, in some cases decreasing tax liability on U.S. earnings to zero.[79] Thus, to correct the truly abusive tax avoidance practice associated with corporate inversions, corporate law should address the problematic issues of earnings stripping.

73. While some actions may be mandated; in other instances, corporate law can only encourage and incentivize firms to act a certain way. Similar to how the government can incentivize individuals to buy homes but cannot force them to, the government cannot force companies to remain domiciled in the United States. *See* notes 21–22 and accompanying text.

74. *See supra* text accompanying notes 43–46.

75. *See* Solomon, *supra* note 58.

76. For some opponents of corporate inversions, "corporate inversion" may be a blanket term that encompasses earnings stripping, but this commentary seeks to parse those issues.

77. *See* Jeffrey Zients & Seth Hanlon, *The Corporate Inversions Tax Loophole: What You Need to Know,* WHITE HOUSE BLOG (Apr. 8, 2016, 6:39 PM), https://www.whitehouse.gov/blog/2016/04/08/corporate-inversions-tax-loophole-what-you-need-know.

78. *See* U.S. DEP'T OF THE TREASURY: OFFICE OF TAX ANALYSIS, *supra* note 19. In fairness, some groups advocate for the repeal of the deferred income tax expenditure, though this commentary does not address that.

79. Rubin, *supra* note 27; *see* § III(A)(2).

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IV. TREASURY REGULATIONS: TARGETED CRACKDOWN ON LARGE-SCALE ABUSES

On April 4, 2016, the U.S. Treasury Department issued a set of proposed regulations aimed at reducing corporate inversions and earnings stripping as tax avoidance tactics.[80] This section scrutinizes those regulations in light of the analysis above and concludes that the recent Treasury regulations were broad enough to constrain the abusive tax-avoidance actions of multinational, billion-dollar corporations yet narrow enough that they should not disturb other productive economic activities. Shortly after the Treasury Department announced the new regulations, U.S.-based Pfizer Inc. walked away from a pending merger with Ireland-based Allergan PLC.[81] By attacking only the root causes of the most egregious tax avoidance schemes, the new regulations are a model for how corporate law should address abuses without creating undue burdens or sacrificing the goals of corporate law.

The April regulations, the Treasury Department's third foray into corporate inversions in as many years, were the Department's most aggressive attempt to halt corporate inversions. In September 2014,[82] and again in November 2015,[83] the Treasury Department announced guidelines that made corporate inversions more difficult and sought to reduce their economic benefits. Although both actions were highly publicized attempts to stop inversions, they generally amounted to "tinkering on the edges," and failed to halt large inversion deals like the one between Pfizer and Allergan.[84] The actions came up short because they merely tightened and clarified existing restrictions on inversions instead of attacking the heart of the problem: earnings stripping.

80. *Treasury Issues Inversion Regulations and Proposed Earnings Stripping Regulations*, U.S. DEP'T OF THE TREASURY, https://www.treasury.gov/press-center/news/Pages/Treasury-Issues-Inversion-Regulations-and-Proposed-Earnings-Stripping-Regulations.aspx (last updated June 9, 2016).

81. *See* Caroline Humer & Ankur Banerjee, *Pfizer, Allergan Scrap $160 Billion Deal After U.S. Tax Rule Change*, REUTERS (Apr. 6, 2016, 7:47 PM), http://www.reuters.com/article/us-allergan-m-a-pfizer-idUSKCN0X3188.

82. Press Release, U.S. Dep't of the Treas., Fact Sheet: Treasury Actions to Rein in Corporate Tax Inversions (Sept. 22, 2014), https://www.treasury.gov/press-center/press-releases/Pages/jl2645.aspx.

83. Press Release, U.S. Dep't of the Treas., Fact Sheet: Additional Treasury Actions to Rein in Corporate Tax Inversions (Nov. 11, 2015), https://www.treasury.gov/press-center/press-releases/Pages/jl0281.aspx.

84. Liz Hoffman, *'Inversion' Rule Changes Appear Minor*, WALL ST. J. (Nov. 20, 2015, 8:41 PM), http://www.wsj.com/articles/inversion-rule-changes-appear-minor-1448070103 ("But the Treasury stopped short of more far-reaching measures. The guidance doesn't prevent an inverted company from using debt to decrease its U.S. taxable income, a strategy known as earnings stripping.").

The new rules have two main parts, each of which makes it less feasible for firms to benefit from large-scale corporate inversion merger deals, such as the one between Pfizer and Allergan.[85] First, the rules made it more difficult for large U.S.-based companies to find an inversion partner large enough to benefit from an inversion.[86] As discussed earlier, a U.S.-based company needs to merge with a foreign company at least one-quarter of its size for the combined entity to avoid U.S. taxes.[87] For purposes of computing the ownership percentage when determining if a merged firm is a U.S. company, the new regulations "exclude[] stock of the foreign company attributable to assets acquired from an American company within three years prior to the signing date of the latest acquisition."[88] The regulation was targeted at "serial inverters," or companies that engage in increasingly large deals to complete bigger corporate inversions.[89] This portion of the regulations effectively killed the Pfizer-Allergan merger.

Prior to the regulations, the Pfizer-Allergan merger was feasible because Allergan spent the last three years acquiring smaller U.S. pharmaceutical firms.[90] At the time the deal was struck, Pfizer was worth about $200 billion, and Allergan was worth about $120 billion.[91] Thus, shareholders of Pfizer—the U.S.-based company—would have owned around fifty-six percent of the combined entity.[92] Under the new regulations, Allergan's valuation dropped to about $30 billion.[93] At that

85. U.S. DEP'T OF THE TREASURY: PRESS CTR., *supra* note 2.

86. *Id*. ("For the purposes of computing the ownership percentage when determining if an acquisition is treated as an inversion under current law, today's action excludes stock of the foreign company attributable to assets acquired from an American company within three years prior to the signing date of the latest acquisition."). *See supra* note 53.

87. DONALD J. MARPLES & JANE G. GRAVELLE, CONGRESSIONAL RESEARCH SERVICE, CORPORATE EXPATRIATION, INVERSIONS, AND MERGERS: TAX ISSUES 6 (2016), https://www.fas.org/sgp/ crs/misc/R43568.pdf.

88. U.S. DEP'T OF THE TREASURY: PRESS CENTER, *supra* note 3.

89. *See id.* ("today's temporary regulations make it more difficult for companies to invert").

90. *See* Rockoff et al., *supra* note 1. Notable Allergan deals include the $25 billion takeover of Forest Laboratories and the $66 billion combination of Actavis and Allergan.

91. *Id*.

92. *Id*. With a fifty-six percent U.S. ownership, the combined entity would have received maximum tax benefits and would have been recognized as a foreign corporation. 26 U.S.C. § 7874 (2012).

93. *Id*.

valuation, Pfizer investors would own over eighty percent of the combined entity, negating all tax benefits of the corporate inversion.[94]

The second aspect of the new regulations limits earnings stripping.[95] The regulations gave the Treasury Department the authority to scrutinize related-party debt instruments and reclassify them as stock transactions.[96] Stock transactions are not eligible, under the new regulations, for the interest-rate tax deduction that produces the benefit of earnings stripping.[97] In effect, the regulations could revoke the "tax advantages of debt for inverted companies."[98]

The Treasury Department's decision to close this loophole will reduce the tax revenue lost from earnings stripping, although the regulations have drawn criticism for the burden they could impose on foreign companies with ordinary U.S. businesses that want to legitimately invest in the United States.[99] The Organization for International Investment, a trade group of companies based outside the U.S. with operations inside the country, warned that the new regulations "would increase the cost of investing and expanding across the United States for all foreign companies."[100] The Treasury noted, however, that the limitations would only apply to related-party debt and would not apply to debt incurred to fund actual business investments and expansions.[101] Furthermore, the Treasury Department said the rules were designed to avoid "inadvertent side effects," such as the stifling of legitimate foreign investment in the U.S.[102]

94. See *id.*

95. As a refresher, earnings stripping is the process where a corporation undergoes an inversion and later issues debt from the foreign parent to the U.S.-based child company. The resulting interest deduction effectively shifts U.S. income to the lower-taxed jurisdiction of the parent company. *See supra* § III(A)(2). *See also* U.S. DEP'T OF THE TREASURY: PRESS CENTER, *supra* note 3.

96. U.S. DEP'T OF THE TREASURY: PRESS CENTER, *supra* note 3.

97. *See* Rubin & Hoffman, *supra* note 4.

98. *Id.*

99. Saabira Chaudhuri & Ted Mann, *New Inversion Rules Draw Concerns Outside U.S.,* THE WALL STREET JOURNAL (Apr. 6, 2016), http://www.wsj.com/articles/new-inversion-rules-draw-concerns-outside-u-s-1459976748.

100. *Treasury's New Inversion Rules*, *supra* note 42.

101. U.S. DEP'T OF THE TREASURY: PRESS CENTER, *supra* note 3 ("The proposed regulations generally do not apply to related-party debt that is incurred to fund actual business investment, such as building or equipping a factory.").

102. Richard Rubin, *Tax-Rule Changes Ripple Widely*, WALL STREET JOURNAL (Apr. 12, 2016, 8:02 PM), http://www.wsj.com/articles/tax-rule-changes-ripple-widely-1460505777.

V. CONCLUSION

The new Treasury Department Regulations may have caused some concerns, but they seem well calculated to only target abusive and exploitive tax avoidance practices. When transactions are driven by genuine business strategies and economic efficiencies, the U.S. economy grows stronger. When transactions are driven solely by a desire to avoid U.S. taxes—while still taking advantage of the U.S. market—the economy suffers from the decrease in tax revenue. Corporate law should strive to encourage the former transactions, while restricting the latter. Legitimate corporate inversions, imposed to increase efficiency, will still be permissible under the new regulations. Earnings stripping, however, should decrease as the Treasury begins to scrutinize the transactions of inverted companies. Of course, companies may eventually find other ways of avoiding taxation on their U.S. income, but the new Treasury Department regulations are an exemplary use of corporate law that remedies an abusive and exploitive loophole in the tax code, without stifling foreign investment or overly burdening U.S. firms that want to compete internationally.