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## Demanding Corporate Patriotism: A Regulatory Attempt to Curb International Corporate Inversions and Stop Tax Avoidance Schemes

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# DEMANDING CORPORATE PATRIOTISM: A REGULATORY ATTEMPT TO CURB INTERNATIONAL CORPORATE INVERSIONS AND STOP TAX AVOIDANCE SCHEMES

DAVID KHANJYAN

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## I. INTRODUCTION

The popular media often stigmatize corporations that utilize tax loopholes not readily available to individual citizens.<sup>1</sup> Specifically, the term is known as corporate inversions, by which United States corporations are acquired by foreign corporations in order to avoid the United States corporate

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<sup>1</sup> See John D. McKinnon & Damian Paletta, *Obama Administration Issues New Rules to Combat Tax Inversions*, WALL ST. J. (Sept. 22, 2014, 11:52 PM), <http://www.wsj.com/articles/treasury-to-unveil-measures-to-combat-tax-inversions-1411421056>.

tax,<sup>2</sup> which is among the highest in the world.<sup>3</sup> Corporate inversions have become widely popular since 2008 as more corporations move abroad to save taxes.<sup>4</sup> As a consequence, media outlets, everyday citizens, and politicians condemn corporations for abandoning their obligations to the United States while individuals are liable for their respective shares.<sup>5</sup> President Obama has described the practice as “gaming the system,”<sup>6</sup> painting inversions as unpatriotic.<sup>7</sup> Given the current sociopolitical landscape, in which educated masses make daily decisions based on the political consequences of their actions, corporations are sensitive to and, to some degree, influenced by the pressure these masses put on them.<sup>8</sup> While the social pressures may influence some corporations to not undergo the “unpatriotic” tax avoidance route, it is imperative that legislation be enacted to address not only the practice of corporate inversions but also to attack the primary motivation for inversions—the United States tax rate.<sup>9</sup> On September 22, 2014, the Treasury Department released Internal Revenue Service Notice 2014-52 (the Notice) as a preliminary step to address the social backlash against corporate inversions.<sup>10</sup> The Notice was released in the midst of many pending acquisition deals, notably the Tim Hortons acquisition of Burger King and the AstraZeneca acquisition of Pfizer.<sup>11</sup> While the Notice was largely effective in preventing corporate inversions (many pending deals were cancelled with multi-million dollar fees),<sup>12</sup> they were not the reforms the United States needed at the time. Rather,

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<sup>2</sup> *Id.*

<sup>3</sup> See *Corporate Tax Rates 2015*, DELOITTE, <http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-corporate-tax-rates-2015.pdf> (last updated Aug. 2015).

<sup>4</sup> Steven Rattner, *End Corporate Taxation*, N.Y. TIMES, May 3, 2014, at A19, [http://www.nytimes.com/2014/05/03/opinion/end-corporate-taxation.html?\\_r=0](http://www.nytimes.com/2014/05/03/opinion/end-corporate-taxation.html?_r=0).

<sup>5</sup> Ken Wells, Jonathan Allen, & Richard Rubin, *How Inversions Leaped From the Shadows and Doomed Antonio Weiss*, BLOOMBERG (Jan. 14, 2015, 2:00 AM), <http://www.bloomberg.com/politics/articles/2015-01-14/how-inversions-leaped-from-the-shadows-to-doom-treasury-nominee>.

<sup>6</sup> Jeremy Bogaisky, *Obama Administration Moves to Crack Down on Tax Inversions*, FORBES (Sept. 22, 2014, 7:17 PM), <http://www.forbes.com/sites/jeremybogaisky/2014/09/22/obama-administration-moves-to-crack-down-on-tax-inversions/>.

<sup>7</sup> McKinnon & Paletta, *supra* note 1.

<sup>8</sup> See Richard Trumka, *Let's Call 'Corporate Inversions' for What It Is: A Gaping, Unpatriotic Tax Loophole*, HUFFINGTON POST (Sep. 28, 2014, 5:59 AM), [http://www.huffingtonpost.com/richard-trumka/lets-call-corporate-inver\\_b\\_5629936.html](http://www.huffingtonpost.com/richard-trumka/lets-call-corporate-inver_b_5629936.html).

<sup>9</sup> See Kimberly A. Clausing, *The Future of the Corporate Tax*, 66 TAX L. REV. 419, 440 (2013).

<sup>10</sup> See *infra* Part V.

<sup>11</sup> See *infra* Part V.

<sup>12</sup> See Chipp Cummins, *Salix, Cosmo Cancel Merger Agreement: Move Comes Amid Crackdown on Inversion Deals*, WALL ST. J., <http://www.wsj.com/articles/salix-cosmo-cancel>

a better approach to corporate tax reform would be to develop a less prohibitive system that incentivizes corporations to repatriate their profits, through either changes to the tax rate and base provisions of the code<sup>13</sup> or through the adoption of a modified territorial system.<sup>14</sup> With an alternative, simpler approach that addresses the discrepancies between the United States laws and those of foreign countries, the problem with collecting tax revenue from big corporations and their tendency to conduct corporate inversions would be remedied.

This paper will discuss the current structure of international tax, the need for reform, and the Notice by the Treasury Department.<sup>15</sup> Part II discusses the general landscape of international tax and how the United States differentiates domestic corporations and foreign corporations.<sup>16</sup> It also compares the different corporate tax rates of the developed countries, which lends itself to the natural incentives U.S. corporations face to conduct inversions and avoid taxes.<sup>17</sup> Part III evaluates the Internal Revenue Code sections prior to the Internal Revenue Service Notice 2014-52 of September 22, 2014.<sup>18</sup> It explains the loopholes corporations routinely utilize to avoid paying U.S. corporate tax on foreign profits.<sup>19</sup> Part IV introduces Notice 2014-52 and discusses how the provisions therein address the faults of the pre-Notice law.<sup>20</sup> Part V analyzes the practical effects of the Notice thus far and the problems that arise as a result of the provisions.<sup>21</sup> Part VI presents some alternatives that better address the corporate tax issues than the proposals in the Notice.<sup>22</sup> The paper then concludes that, while the purpose of the Notice to prevent corporate inversions was met, the provisions in the Notice do not serve the best interest of the United States or of multinational corporations, and in and of themselves, are not sufficient to solve the corporate tax issues that plague big business.<sup>23</sup> While there is difficulty in weighing the interests of U.S. corporations against the interests of the United States, as well as in considering the pressures made

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merger-agreement-1412319533 (last updated Oct. 3, 2014, 4:22 AM).

<sup>13</sup> See *infra* Section VI.A.

<sup>14</sup> See *infra* Section VI.B.

<sup>15</sup> See *infra* Parts II, III, IV, V, VI and VII.

<sup>16</sup> See *infra* Part II.

<sup>17</sup> *Id.*

<sup>18</sup> See *infra* Part III.

<sup>19</sup> *Id.*

<sup>20</sup> See *infra* Part IV.

<sup>21</sup> See *infra* Part V.

<sup>22</sup> See *infra* Part VI.

<sup>23</sup> See *infra* Part VII.

by individual people, the current law makes that conflict too polarized.<sup>24</sup>

## II. INTERNATIONAL TAX AND TAX REFORM

To understand how corporate inversions work, one must first understand the landscape of international tax. Pursuant to the Internal Revenue Code, U.S. corporations are treated differently than foreign corporations.<sup>25</sup> Particularly, U.S. corporations that have over \$10,000,000 in income are taxed at 35%.<sup>26</sup> On the other hand, foreign corporations are only taxed this rate for income derived in transactions “connected with the conduct of a trade or business within the United States” or “income . . . derived from sources within the United States.”<sup>27</sup> Relative to the tax rate of other developed countries, the tax rate of the United States is among the highest.<sup>28</sup> Therefore, notwithstanding public opinion, it behooves corporations to qualify as foreign corporations rather than domestic corporations because less of their profits would be subject to U.S. rates.

In addition to the higher corporate tax rates, the United States does not adopt a territorial system of tax.<sup>29</sup> In other words, a U.S. multinational corporation must pay taxes to the United States on profits generated abroad.<sup>30</sup> Generally speaking, however, a domestic U.S. corporation receives tax credits in the amount it paid in corporate taxes to foreign countries.<sup>31</sup> Therefore, when corporations operate internationally and have tax obligations to other countries, their tax obligations to the United States are reduced by that much. For example, if a corporation makes \$10 million in income in Ireland and pays a corporate tax to Ireland at a rate of 12.5%, then its obligations to the United States would be reduced by that much when those profits are brought into the United States and subject to U.S. corporate tax. The purpose of a corporate inversion is to keep such foreign profits outside of the United States,

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<sup>24</sup> *Id.*

<sup>25</sup> I.R.C. § 11(d) (2012).

<sup>26</sup> *Id.* § 11(b)(1)(D).

<sup>27</sup> *Id.* § 882 (West 2014).

<sup>28</sup> See *Corporate Tax Rates 2015*, *supra* note 3. Canada and Germany, among many others, have a tax rate of 15%. *Id.* Ireland, which is a very popular destination for corporate inversions, has a tax rate of 12.5%. See McKinnon & Paletta, *supra* note 1; *Corporate Tax Rates 2015*, *supra* note 3.

<sup>29</sup> Omri Y. Marian, *Meaningless Comparisons: Corporate Tax Reform Discourse in the United States*, 32 VA. TAX REV. 133, 163–67 (2012).

<sup>30</sup> *Id.* at 163.

<sup>31</sup> I.R.C. § 901 (2012).

effectively not paying the 35% tax on all income derived abroad.<sup>32</sup>

The United States, however, did not always have such a relatively high corporate tax rate compared to those of other countries.<sup>33</sup> In his comment discussing the various comparative arguments for corporate tax reform, Omri Marian summarized the changes countries have made to their corporate tax rates since the 1980s. He states:

In the early 1980s, the U.S. rate of fifty percent was only moderately higher than the OECD average (excluding the United States) of about forty-seven percent. The 1986 Tax Reform Act included a significant rate reduction, bringing the combined state and federal corporate tax rate in the United States to its approximate current level. This placed the U.S. statutory rate slightly below the then-average OECD rate. However, while U.S. statutory rates have remained pretty much constant since then, other countries have continued to cut their statutory rates. Participants in the discourse frequently cite recent examples that include Germany dramatically lowering its rates by ten percentage points as part of a 2008 reform; the UK lowering its statutory rate from 28% to 27% in 2011, with further gradual reductions planned over the next three years to 24%; Canada lowering its statutory rate from 22% in 2007 to 18% last year, with a planned gradual reduction to an eventual 15% starting in 2012; and China lowering its corporate tax rate from 33.3% to 25% in 2008. Other countries cited as examples for corporate tax rate-reducing reforms include, among others, Greece, Turkey, Poland, the Slovak Republic, Iceland, Ireland, Mexico, Macedonia, Vietnam, and Taiwan.<sup>34</sup>

These changes support the arguments made by proponents who demand U.S. corporate tax reform. While professionals in the field universally accept the need for reform, Kimberly Clausing has described three challenges the United States faces in addressing the corporate tax concerns.<sup>35</sup> First, due to the economic downturn that occurred around 2008 and the resulting budget deficits coupled with increased healthcare and other public costs, policymakers are sensitive to different reform proposals so as to generate sufficient revenue to cover such costs.<sup>36</sup> Additionally, policymakers must consider income inequality, as the top 5% of households have seen significantly greater increases in income, particularly with regards to capital gains.<sup>37</sup> Lastly, with evidence of globalization and an increase in foreign investments, the United States should consider, to some degree, the separation of its tax system from

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<sup>32</sup> Wells et al., *supra* note 5.

<sup>33</sup> See Marian, *supra* note 29, at 153–54.

<sup>34</sup> *Id.*

<sup>35</sup> See Clausing, *supra* note 9, at 420.

<sup>36</sup> See *id.* at 420–21.

<sup>37</sup> *Id.* at 421–22.

those of other countries.<sup>38</sup>

Arguments to reform the tax code and address the corporate inversion problem that plagues the United States are a fairly recent trend. Senator Baucus, a Democrat from Montana, while serving as the chairman of the Finance Committee, was among the first politicians to take steps against corporate inversions in 2002.<sup>39</sup> He, along with Republican Senator Charles Grassley, issued a warning of potential legislation against corporations should they continue to utilize the loopholes present in the tax code.<sup>40</sup> In 2004, actual legislation was enacted, formally codified in the Internal Revenue Code as section 7874.<sup>41</sup> Sophisticated tax professionals, however, managed to find a loophole in section 7874 to be able to continue the practice of avoiding taxes by moving a domestic corporation's headquarters abroad.<sup>42</sup> In 2013, with a potential inversion underway by Applied Materials Inc., a U.S. semiconductor corporation, Baucus urged Congress for further legislation.<sup>43</sup> His proposals, however, were denied due to lawmakers setting priorities and choosing to focus more on the recession rather than tax concerns that had not fully developed.<sup>44</sup> With the turn of the New Year came a surge of potential inversions, including big names such as Pfizer, Chiquita Brands, and Burger King.<sup>45</sup> Over the course of the previous two years, more than a dozen inversions had been completed, and it appeared that the number would continue to grow.<sup>46</sup> This captured President Obama's attention, along with those of many tax professionals and legislators.<sup>47</sup> Different proposals were made, primarily focused around completely restricting the practice of inversions or making the business environment in the United States more suitable for businesses.<sup>48</sup> While Democrat Senator Carl Levin and Democrat Representative Sander Levin, both from Michigan, argued that the Obama administration's budget proposal should be turned into highly restrictive legislation, Republicans and business lobbyists argued to the contrary.<sup>49</sup> In a floor speech on May 8, 2014,

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<sup>38</sup> *Id.* at 422–23.

<sup>39</sup> Wells et al., *supra* note 5.

<sup>40</sup> *Id.*

<sup>41</sup> *See id.*; *see also infra* Section III.A.

<sup>42</sup> Wells et al., *supra* note 5.

<sup>43</sup> *Id.*

<sup>44</sup> *Id.* Smaller companies, not yet household names, were pursuing inversions at the time in small numbers, but there had not yet been concern for larger corporations. *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

Republican Senator Orrin Hatch from Utah argued that legislation must “make the United States a more desirable location to headquarter one’s business.”<sup>50</sup> The U.S. Chamber of Commerce also expressed concern.<sup>51</sup> Bruce Josten, a lobbyist for the chambers stated: “We’ve got companies from one end of the coast to the other who are very concerned about the need to fundamentally make our tax code more competitive.”<sup>52</sup> He described inversions as a negative consequence of a failing tax code that is not in tune with its foreign counterparts.<sup>53</sup> With a wave of new potential inversions, the Treasury Department became concerned.<sup>54</sup> Tax revenue was in jeopardy. In an urgent demand to Congress, Treasury Secretary Jacob Lew stated: “Congress should enact legislation immediately . . . to shut down this abuse of our tax system . . . What we need as a nation is a new sense of economic patriotism, where we all rise and fall together.”<sup>55</sup> It was under these frantic circumstances, with a wave of potential international mergers, that the Internal Revenue Service, under the Treasury Department, provided the new proposed regulations that would make inversions more difficult.<sup>56</sup>

### III. THE LAW BEFORE THE IRS NOTICE

#### A. *Inversion Transactions*

Pursuant to the Internal Revenue Code section 7874, an inversion transaction is an acquisition in which a foreign acquiring corporation is treated as a surrogate foreign corporation.<sup>57</sup> In essence, it is when a foreign corporation consumes a domestic corporation.<sup>58</sup> A foreign acquiring corporation is treated as a surrogate foreign corporation when it (1) acquires substantially all of the property of the domestic corporation, (2) at least 60% of the stock of a foreign acquiring corporation is held by former shareholders of the domestic corporation, and (3) after the transaction, the expanded affiliated

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<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> *See id.*

<sup>55</sup> *Id.*

<sup>56</sup> *See id.*

<sup>57</sup> I.R.C. § 7874 (2012). This section of the code governs corporate inversions and addresses corporations’ attempts to invert into foreign corporations in order to save on tax. *Id.* Instead of merely treating a domestic corporation purchased by a foreign corporation as a foreign corporation, section 7874 prescribes rules in order to prevent corporations from scheming their way out of their U.S. tax obligations. *See id.*

<sup>58</sup> *See id.*

group (EAG) does not have much business in the country of the foreign acquiring corporation relative to its business everywhere else.<sup>59</sup> An EAG is defined as a network of corporations of which 50% of its stock value and voting power is owned directly by a parent corporation or indirectly by another corporation, of which the parent corporation owns at least 50% of its stock value and voting power.<sup>60</sup> In other words, the EAG is a chain of corporations that are controlled by the parent.<sup>61</sup> Upon an inversion transaction's completion, the domestic corporation becomes known as an expatriated corporation,<sup>62</sup> likely because of the negative stigma associated with the tax avoidance purposes of inversions.

As previously mentioned, domestic corporations become involved in inversion transactions in order to be categorized as foreign corporations, so as to not pay the 35% United States corporate tax rate. The idea is that if a foreign corporation buys a domestic corporation, the domestic corporation would become a foreign corporation and would not subject its entire income to U.S. taxes. The United States, aware of a corporation's interest in minimizing

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<sup>59</sup> 26 U.S.C. § 7874(a)(2)(B) (2014). Generally speaking, a foreign acquiring corporation is often considered a surrogate foreign corporation when the purpose of the inversion is to only avoid taxes. The assumption is that the domestic corporation is totally consumed by the foreign corporation. Additionally, in order to maintain control while avoiding taxes, the former shareholders of the domestic corporations will retain as much stock in the foreign corporation as possible. Therefore, the 60% stock ownership will readily be met. Note that the primary ownership percentage that will be of issue is an 80% stock ownership calculation to treat foreign corporations as domestic corporations. See *infra* note 63 and accompanying text. Lastly, in reference to the third element, assuming the domestic corporation's sales and operations continue as before, much of the activity will continue to be conducted internationally, and would not necessarily be focused in the country of the foreign acquiring corporation. The primary debate for inversions, and the point of consideration of Notice 2014-52, is section 7874(b), which governs when a foreign corporation will be treated as a domestic corporation for tax purposes. See *infra* Section IV.A.

<sup>60</sup> 26 U.S.C. § 7874(c)(1) (2014).

<sup>61</sup> See *id.*

<sup>62</sup> *Id.* § 7874. The negative stigma of corporate inversions is frequently perpetuated by the popular media. In one Huffington Post piece, author Richard Trumka claims:

The real problem is that many of these so-called "U.S." corporations want to keep dictating our economic policies and dominating our politics, yet they have less and less loyalty to the people who actually live and work in America. They want to keep benefiting from all the things our government does for them . . . but they want the rest of us to front their share of the bill.

Trumka, *supra* note 8.

Furthermore, Robert Stack, deputy assistant secretary of the U.S. Treasury states: "Congress should pass legislation immediately with an effective date of May 2014 to prevent companies from effectively renouncing their citizenship." Kevin Drawbaugh, *Top Lawmaker Wants Corporate Tax Loophole 'Plugged Now'*, REUTERS (July 22, 2014, 5:33 PM), <http://www.reuters.com/article/2014/07/22/us-congress-tax-inversions-idUSKBN0FR1RA20140722>.

costs, included a provision that a foreign corporation is treated as a domestic corporation if it is a surrogate foreign corporation of which at least 80% of its stock is owned by former shareholders of the domestic corporation.<sup>63</sup> The difference between the tax code and the new Department of Treasury Notice is how share ownership is calculated.

While the Department of Treasury anticipated foreign corporate action to reduce ownership by the domestic corporation to below 80%, the measures it adopted to prevent such schemes were not sufficient. The primary measure was to exclude disqualified stocks, issued in relation to the acquisition, in calculating the ownership fraction.<sup>64</sup> Disqualified stock is stock of the foreign corporation acquired for non-qualified property, such as cash or its equivalent, marketable securities, certain obligations, and property intended to avoid section 7874 of the Internal Revenue Code.<sup>65</sup> The main concern for this measure is that, in connection with the foreign acquisition of the domestic corporation, the foreign corporation would issue more stock to dilute the domestic corporation's shares just below 80% to avoid being treated as a domestic corporation.

### *B. Hopscotch Loans*

After the inversion transaction, in which the domestic corporation is acquired by the foreign corporation such that the domestic corporation owns just less than 80% of the foreign corporation, the new corporation would attempt to utilize the profits without repatriating income into the United States to avoid the 35% tax rate. Should those profits be distributed within the United States as dividends, they would be subject to the United States corporate tax.<sup>66</sup> Corporations, however, utilize other loopholes, known as "hopscotch loans" and like strategies, to deliver profits to other foreign subsidiaries disguised as loans, or other property, rather than dividends, in order to officially avoid the

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<sup>63</sup> 26 U.S.C. § 7874(b) (2014). The portion of Notice 2014-52 that tackles corporate inversions focuses on this 80% calculation. *See infra* Section IV.A. As will be discussed in specific detail, the Internal Revenue Service takes a new approach to calculating the domestic corporation's share of the foreign corporation's stock. As could be inferred from a glance at the Internal Revenue Code, a corporation that schemes to avoid taxes would benefit most if its shareholders make up just less than 80% of the foreign corporation's stock. This would maximize the domestic corporation's control of the foreign corporation while not being classified as a domestic corporation.

<sup>64</sup> 26 U.S.C. § 7874(c)(2)(B) (2014).

<sup>65</sup> *Id.*; 26 C.F.R. § 1.7874-4(T)(c)(1) (2014).

<sup>66</sup> *See supra* note 25 and accompanying text.

35% corporate tax.<sup>67</sup> Section 956 of the Internal Revenue Code addresses these dividends disguised as loans.<sup>68</sup> Generally speaking, the loans or investments would be given to the domestic corporation from a foreign corporation that the domestic corporation controls. Section 957(a) of the Internal Revenue Code deems foreign corporations, of which U.S. shareholders own 50% or more of the value of stock or the combined voting power of all classes of stock, a controlled foreign corporation (CFC).<sup>69</sup> The code states that a U.S. shareholder means, “with respect to any foreign corporation, a United States person . . . who owns . . . or is considered as owning . . . 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such a foreign corporation.”<sup>70</sup> Corporations are considered persons in the code.<sup>71</sup> Given the circumstances of corporate inversions, this ownership requirement is generally met, and the U.S. domestic corporation that inverts abroad would be considered a U.S. shareholder of that corporation.

According to the IRS Notice 2014-52, “[i]n the absence of section 956, a U.S. shareholder of a CFC could access the CFCs funds . . . in a variety of ways other than by the payment of an actual taxable dividend . . . .”<sup>72</sup> While short-term investments or loans made by CFCs would not fall under the purview of section 956, when long term transactions are made, such as a foreign purchase of tangible property in the U.S., stock of the domestic corporation, obligations to the U.S. shareholder, or various rights of use (i.e. patents), some of the value given to the United States entity are taxable because they are essentially dividends. Specifically, the lesser of

(1) the excess (if any) of – (A) [the U.S.] shareholder’s pro rata share of the average of the amounts of United States property held (directly or indirectly) by the controlled foreign corporation . . . over (B) the amount of earnings and profits described in section 959(c)(1)(A) . . . or (2) such shareholder’s pro rata share of the applicable earnings of such a controlled foreign corporation.<sup>73</sup>

Congressional intent was that such property should be “taxed . . . on the

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<sup>67</sup> See *supra* note 42 and accompanying text.

<sup>68</sup> 26 U.S.C. § 956(a) (2012).

<sup>69</sup> *Id.* § 957(a).

<sup>70</sup> *Id.* § 951(b).

<sup>71</sup> *Id.* § 7701(a)(1).

<sup>72</sup> *Rules Regarding Inversions and Related Transactions, Notice 2014-52*, INTERNAL REVENUE BULL. (Dep’t of the Treasury, Internal Revenue Serv., Washington, D.C.), Oct. 14, 2014, at 712–23, <https://www.irs.gov/pub/irs-irbs/irb14-42.pdf>.

<sup>73</sup> 26 U.S.C. § 956(a) (2012).

grounds that this is substantially the equivalent of a dividend.<sup>74</sup> These provisions, however, leave open the opportunity of a CFC to transfer loans to or exchange cash for stock in a foreign acquiring corporation, which is not a U.S. shareholder, and therefore would not fall under section 956. In other words, while gains from long term CFC transfers to U.S. shareholders fall under 956, transfers to other parties, not U.S. shareholders, do not fall under section 956.<sup>75</sup> The Internal Revenue Service Notice 2014-52 addresses this loophole.

To summarize the common practice of corporate tax avoidance before the recent regulations, it is best to think of the transactions in two steps, consisting of three entities. The first step is the corporate inversion, during which there is a transaction between two corporations, one domestic and one foreign. The foreign acquiring corporation (FAC) acquires the domestic corporation (DC), such that just less than 80% of the FAC's stock remains in the hands of the DC's shareholders. This formally makes the DC a foreign corporation, and sets the stage for various other strategies to use funds without paying taxes. These strategies require the presence of another foreign corporation (FC), of which the DC owns more than 50%, and would be considered a CFC. Since the FAC is not considered a domestic entity, FC could loan money to the FAC or transfer cash for stocks in FAC, skipping over the DC altogether. The result is that those profits are transferred around the world and used to continue operations but are not repatriated into the United States to be taxed.

#### IV. IRS NOTICE 2014-52: NEW RULES REGARDING INVERSIONS AND RELATED TRANSACTIONS

The IRS Notice 2014-52 (“Notice” or “Notice 2014-52”) attacks the corporate scheme from two fronts. For one, it makes corporate inversions more costly than before, making it difficult to qualify as a foreign corporation. Secondly, even if a corporation qualifies as a foreign corporation, the tax avoidance scheme is fruitless without being able to transfer profits without paying U.S. income tax.

##### *A. Regulations on Corporate Inversions*

The first part of the Notice addresses corporate inversions. As described above, the IRS treats foreign surrogate corporations as domestic corporations

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<sup>74</sup> S. REP. NO. 87-1881, at 99 (1962).

<sup>75</sup> *Id.*

when a domestic corporation owns 80% or more of its stock.<sup>76</sup> Notice 2014-52 prescribes a different method of calculating a domestic corporation's ownership fraction by not including some property owned by the expanded affiliated group from the denominator, effectively inflating the domestic corporation's ownership. The Notice proposes a two-step process in reducing the denominator value in the fraction of ownership. The first step is to determine whether the denominator could be reduced. The second step specifies how much the denominator would be reduced by.

The first part states that "if more than 50 percent of the gross value of all 'foreign group property' constitutes 'foreign group nonqualified property,' a portion of the stock of the foreign acquiring corporation will be excluded from the denominator of the ownership fraction."<sup>77</sup> This test would be applied after the acquisition and related transactions.<sup>78</sup> Foreign group property is "any property . . . held by the EAG after the acquisition . . . [is] completed."<sup>79</sup> Property held directly or indirectly by the domestic entity at the time of the acquisition that was acquired in the acquisition is not considered foreign group property.<sup>80</sup> In other words, property in the hands of the domestic entity is not included.<sup>81</sup> Foreign group nonqualified property is foreign group property that includes:

(i) cash or cash equivalents, (ii) marketable securities, . . . (iii) an obligation owed by . . . [a] member of the expanded affiliated group that includes the foreign acquiring corporation; [a] former shareholder, . . . or former partner . . . of the domestic entity; or [a] person that, before or after the acquisition, either owns stock of, or a partnership interest in [the EAG or former partner or shareholder of the domestic entity], [and] . . . (iv) [a]ny other property acquired in a transaction . . . related to the acquisition with a principal purpose of avoiding the purposes of section 7874 . . . .<sup>82</sup>

Foreign group nonqualified property that is transferred in exchange for foreign group property that would be qualified is nevertheless treated as nonqualified.<sup>83</sup> Once it is determined that more than half of the foreign group property is foreign group nonqualified property, the Notice prescribes how

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<sup>76</sup> See *supra* Section III.A.

<sup>77</sup> See *Rules Regarding Inversions and Related Transactions, Notice 2014-52, supra* note 72, at 712.

<sup>78</sup> *Id.*

<sup>79</sup> *Id.*

<sup>80</sup> *Id.*

<sup>81</sup> See *id.*

<sup>82</sup> 26 C.F.R. § 1.7874-4T(i)(7).

<sup>83</sup> See *Rules Regarding Inversions and Related Transactions, Notice 2014-52, supra* note 72, at 712.

much of the EAG property will not be included in the denominator of the total ownership fraction.<sup>84</sup>

The second part of the Notice to reduce the denominator is to determine exactly how much property to not include in the denominator.<sup>85</sup> The regulation states after it is determined that more than half of the foreign group property is considered foreign group nonqualified property, the amount that will be excluded from the denominator of the fraction of ownership is the product of (1) the value of stock of the foreign acquiring corporation, not including the value of stock already excluded from the denominator because they are disqualified stock, as expressed in regulation 1.7874-4T(b), and the value of stock held by former shareholders of the domestic entity by reason of their ownership of the domestic stock and (2) the foreign group nonqualified property fraction.<sup>86</sup> The foreign group nonqualified property fraction is the fraction determined in the first step of the Notice mentioned above, but the numerator and denominator are both reduced by the value giving rise to unqualified stock, defined in regulation section 1.7874-4T(c).<sup>87</sup>

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<sup>84</sup> *Id.*

<sup>85</sup> *Id.*

<sup>86</sup> *Id.*

<sup>87</sup> *Id.* The IRS presented a few hypotheticals to help gauge the exact process of calculating the exclusion of certain assets from the denominator. *Id.* The Notice presented a situation in which a foreign corporation, FA, has 20 shares of outstanding stock held by individual A. *Id.* FA acquires all of the stock of a domestic corporation, DT, in exchange for 76 newly issued shares of FA stock. *Id.* FA has become a foreign surrogate corporation as it acquired DT. *Id.* In a transaction related to this acquisition, FA issues four shares of stock to individual A in exchange for \$50x cash. *Id.* As of this point, DT owns 76 shares of FT stock and individual A owns 24 shares of FT stock. *Id.* After these transfers, FT owns \$50x cash (from individual A) and the DT stock (from DT). *Id.* In addition to this, FT owns two other forms of assets: \$150x of asset A (which is foreign group nonqualified property) and \$100x of asset B (which is not foreign group nonqualified property). *Id.*

The facts in the previous paragraph present sufficient information to calculate the ownership fraction and to determine whether FA will be treated as a domestic corporation pursuant to section 7874. *Id.* The first step is to determine whether there would be a reduction of the denominator because at least half of the foreign group property is foreign group nonqualified property. *Id.* Aside from the DT stock, which is not included in the calculation, FT has a total of \$300x in assets (\$100x of asset B, \$150x of asset A, and \$50x cash from individual A). *Id.* The \$200x, in asset A and cash from individual A, are nonqualified property. *Id.* Therefore, two-thirds (more than 50%) of the foreign group property is made up of foreign group nonqualified property, which means there will be some exclusion of assets of the ownership fraction denominator. *Id.*

The next step is to determine how much of the assets will be excluded from the denominator of the ownership fraction. *Id.* The exact amount to exclude from the denominator is the product of the outstanding value of stock in FA (minus some exceptions) and the foreign group nonqualified property fraction. *Id.* FT has 100 outstanding shares. *Id.* The 76 shares owned by DT by reason of and the four shares transferred to individual A for cash (which are disqualified shares) are not included in the outstanding value of stock. *Id.* Therefore, the outstanding value of stock for the purposes of the calculation is 20 shares. *Id.* The next step is to determine the foreign group nonqualified property fraction. *See id.* This is determined as the fraction of foreign group

In addition to proposing specific calculations to reduce the denominator of the ownership fraction of the foreign acquiring corporation, the second part of the Notice includes provisions for calculating the numerator. Section 2.02 of Notice 2014-52 described proposals affecting the numerator of the ownership fraction, by disregarding certain transfers made by the domestic entity to reduce its ownership to below 80%.<sup>88</sup> This provision would attribute greater ownership to the domestic corporation and effectively increase the ownership percentage.

### *B. Post-Inversion Regulations for Hopscotch Loans*

Section 3 of Notice 2014-52 proposes regulations affecting the post-inversion transactions undergone by international corporations.<sup>89</sup> The Notice addresses the tax avoidance strategies that section 956 in its previous form did not prevent. For one, hopscotch loans, property transferred from a CFC to the foreign acquiring corporation, will be treated as U.S. property going to a U.S. shareholder, although the foreign acquiring corporation is not a U.S. shareholder.<sup>90</sup> Similar treatment will be applied to transaction in which shares of the foreign acquiring corporation are transferred to the CFC in exchange for cash. In other words, when the foreign acquiring corporation receives cash as a loan or for shares from a CFC, the proposed regulations would treat that cash as U.S. property, as it would have had the cash fallen under section 956.<sup>91</sup>

## V. THE EFFECTS OF NOTICE 2014-52

While Notice 2014-52, if adopted, would not be applied retroactively,

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nonqualified property over the foreign group property, but both the numerator and denominator are reduced by the value giving rise to unqualified stock. *Id.* In this case, \$200x is foreign group nonqualified property and \$300x is the total foreign group property. *Id.* The value giving rise to unqualified stock, which would be taken from both the numerator and denominator, is the \$50x cash that was received for the 4 shares of stock to individual A. *Id.* Therefore, the foreign group nonqualified property fraction would be \$150x/\$250x. *Id.* The product of outstanding shares (20 shares) and the foreign group nonqualified property fraction (\$150x/250x) is 12 shares. *Id.* Therefore, the denominator of the ownership fraction is reduced by 12 shares. *Id.* The result is that instead of DT owning 76 of the 96 shares (4 shares reduced as disqualified stock) of FT stock (which is 79.2%), DT would be considered to own 76 of the 84 shares of FT stock (which is 90.5%). *Id.* Therefore, FT would be treated as a domestic corporation. *See id.* Had this regulation not been in place, FT would not be considered a domestic corporation and the corporate inversion scheme would have worked more easily. *See id.*

<sup>88</sup> *See id.*

<sup>89</sup> *See id.*

<sup>90</sup> *Id.*

<sup>91</sup> *Id.*

many pending acquisition deals were put into question. The U.S. corporations that were preparing to invert included Burger King Worldwide Inc., Pfizer Inc., Medtronic Inc., Chiquita Brands International Inc., and other pharmaceutical and tech companies.<sup>92</sup> While the regulations were anticipated, many experts did not anticipate such far-reaching provisions.<sup>93</sup>

With new potential regulations essentially prohibiting hopscotch loans or de-structuring strategies, many of the U.S. corporations with pending deals had to reconsider their plans. AbbVie Inc., a U.S. pharmaceutical company, cancelled its \$54 billion merger with Irish pharmaceutical company Shire Plc., and instead paid Shire a \$1.635 billion cancellation fee.<sup>94</sup> Shire shares were down 25% after the announcement.<sup>95</sup> Salix Pharmaceuticals Ltd. planned a \$2.7 billion merger with Italian company Cosmos Technologies Ltd., but, after the regulations, was pressured to cancel the deal with a \$25 million cancellation fee.<sup>96</sup> The deal would have allowed Salix to reduce its then effective tax rate of over 30% to a low 20%.<sup>97</sup> As a result of the regulations and the cancellation of many of these mergers, United States corporations were subject to multi-million dollar cancellation fees while the foreign corporations experienced significant drops in share value.<sup>98</sup>

Despite the cancellation of many pending deals, one merger slipped through the cracks: the merger between the Florida based Burger King and Canadian coffee chain Tim Hortons.<sup>99</sup> The two fast food chains managed to close their deal in August.<sup>100</sup> Media outlets featured this deal.<sup>101</sup> While both companies claim that they had legitimate business reasons for merging<sup>102</sup> and

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<sup>92</sup> Ben Hirschler, *AstraZeneca, Shire Dive As U.S. Tax Move Punctures Deal Hopes*, BUS. INSIDER (Sept. 23, 2014, 7:43 AM), <http://www.businessinsider.com/r-astrazeneca-shire-dive-as-us-tax-move-punctures-deal-hopes-2014-9>.

<sup>93</sup> *Id.*

<sup>94</sup> Brian Solomon, *Inversion Implosion: AbbVie-Shire Merger Officially Dead*, FORBES (Oct. 20, 2014, 6:43 PM), <http://www.forbes.com/sites/briansolomon/2014/10/20/inversion-implosion-abbvie-shire-merger-officially-dead/>.

<sup>95</sup> *Id.*

<sup>96</sup> Cummins, *supra* note 12.

<sup>97</sup> *Id.*

<sup>98</sup> *Id.*

<sup>99</sup> Clare O'Connor, *Burger King and Tim Hortons Make it Official, Merge to Form Third Largest Fast Food Company*, FORBES (Aug. 26, 2014, 7:58 AM), <http://www.forbes.com/sites/clareoconnor/2014/08/26/burger-king-and-tim-hortons-make-it-official-merge-to-form-third-largest-fast-food-company/>.

<sup>100</sup> *Id.*

<sup>101</sup> *Id.*

<sup>102</sup> Michelle Ye Hee Lee, *Explainer: Elizabeth Warren vs. Weiss and the Use of Corporate Inversions*, WASH. POST (Dec. 12, 2014), <http://www.washingtonpost.com/blogs/fact-checker/wp/2014/12/12/explainer-elizabeth-warrens-war-on-wall-street/>. There were many other benefits in

that tax savings were not a primary motivation, the amount of taxes the new foreign corporation would avoid is staggering. Due to Burger King's move to Canada, Americans for Tax Fairness projects the corporation will avoid at least \$400 million, not to mention potentially over \$800 million in capital gains taxes for its shareholders.<sup>103</sup>

The Burger King and Tim Hortons merger is a prime example of how the current regulatory code and the new proposed regulations polarize corporations from the general public. It is largely undisputed that Burger King will likely avoid paying taxes because the new conglomerate will be headquartered in Canada. This is hardly newsworthy, as any corporation that has its headquarters outside of the United States or Japan will lower its tax rate. Certainly, it is unfair to negatively judge a United States corporation solely on the basis that it merges with a foreign corporation. There are often legitimate business reasons beyond taxes that motivate these transactions, as was the case with Burger King.<sup>104</sup> Yet merely because such a corporation will save on taxes as a result of the transaction, it will face strict public backlash. It is as if a corporation's interest to expand internationally and compete with its counterparts is completely outweighed by a consequential avoidance of taxes. Even if Burger King or similar corporations do not intend to avoid taxes by moving their headquarters abroad, because the United States corporate tax rate is higher than those of nearly every other country and because moving would potentially save such corporations hundreds of millions of dollars, it is easy to claim that the corporation intended to avoid taxes. Consequently, media outlets attack these corporations, the public becomes skeptical, and business is hindered.

The Treasury Department must consider not only the interest of the United States, and its tax revenue, but also the interests of the corporations themselves. There would be no tax revenue to collect from corporations

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seeking the merger, including an increase in Burger King's breakfast sales and an international expansion of Tim Hortons. *Id.* This deal would also make the new merged company the third largest fast food chain, trailing behind McDonalds and KFC. O'Connor, *supra* note 99. Since there are apparent business reasons beyond saving taxes that motivated the merger between Burger King and Tim Hortons, it is debatable whether the IRS regulations had these sorts of transactions in mind. The IRS and the Treasury Department are not against mergers between multi-national corporations per se, but rather, the regulations were intended to prevent transactions that were attempting to avoid section 7874 of the Internal Revenue Code. 26 U.S.C. § 7874. The specific provision gives the Treasury Department powers "as are necessary to carry out this section, including regulations providing for such adjustments to the application of this section as are necessary to prevent the avoidance of the purposes of this section." *Id.* § 7874(g).

<sup>103</sup> Gregory Wallace, *Burger King's Controversial Tax Savings*, CNN MONEY (Dec. 11, 2014, 2:08 PM), <http://money.cnn.com/2014/12/11/news/burger-king-tax-savings/>.

<sup>104</sup> See generally O'Connor, *supra* note 99.

without United States corporate profits. While the Notice was effective in preventing inversions, which likely prevented a decrease in tax revenue, if regulations weigh too heavy against corporations, there may be future unwanted consequences.<sup>105</sup> It is imperative to consider United States corporate reactions to the regulations because should the regulations push too hard, corporations may find it beneficial to move their entire operations abroad. As foreign countries develop more purchasing power and as big business increasingly crosses borders, there would be little incentive for U.S. corporations to keep their operations within the United States. Additionally, such strict laws hurt the prospect of foreign corporations moving their operations to the United States, bringing with them jobs and increased tax revenue.

Prior to the Notice, arguments for reducing the tax rate, structured around competitiveness of United States corporations in the international market, were not supported because U.S. corporations managed to reduce their tax rate by conducting inversions. United States corporations were effectively able to reduce their own tax rate by not repatriating their foreign earned profits. As a result, technically, they were not taxed at a higher rate compared to their foreign counterparts.<sup>106</sup> As long as conducting corporate inversions was possible, domestic corporations could manage to keep their effective tax rate lower than the statutory tax rate codified in section 11 of the Code. This would allow them to compete with foreign corporations. New regulations, however, which would effectively freeze foreign profits until they are subject to United States taxes, would open the door to arguments that the current regulations make United States corporations less competitive than foreign corporations. Notice 2014-52 creates the need for urgent corporate tax reform.<sup>107</sup>

Regulations would also have implications on social issues and how individuals view corporations. By law, the board of directors for a corporation is supposed to make business decisions for the purpose of maximizing share value and profits. While there are many particular variables to consider in making a business judgment, peoples' perception of the corporation is imperative. If a corporation, which sells its product directly or indirectly to consumers, has a bad image, its value is at risk. Collectively, as people become more skeptical of big business and choose to purchase from small businesses in lower tax brackets, big business profits would decline and United States tax revenues may follow.

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<sup>105</sup> See generally Ye Hee Lee, *supra* note 102.

<sup>106</sup> *Id.*

<sup>107</sup> See *supra* note 59 and accompanying text.

Notice 2014-52 paints corporations as villains, scheming their way out of tax liability. The popular press, and even the President of the United States, condemn corporations for merging with foreign corporations and maximizing profits—decisions that the law prescribes them to make.<sup>108</sup> The current law treats corporations as entities that must be stopped, rather than pursuing mutually beneficial ends.

## VI. POSSIBLE ALTERNATIVES

Over the past few years, alternative approaches to corporate tax reform have been proposed to address the high statutory tax rate and other distinctions between the United States system and those of other countries. An alternative approach that would repatriate profits, prevent corporate inversions, increase corporate cooperation, and address the public skepticism of United States corporations would be to simply reduce the corporate tax rate.<sup>109</sup> Creating an environment conducive to business, particularly in a time of worldwide development and technological innovation would help propel the United States ahead of competing countries.<sup>110</sup> Merely reducing the rate, however, may not be sufficient.

### A. Reduce the Corporate Tax Rate and Increase the Tax Base

One possible alternative tax reform would be to reduce the tax rate and increase the tax base to offset the possible loss of revenue.<sup>111</sup> To first address the tax consequences of reducing the corporate rate, it may be possible to increase corporate tax revenue by lowering the corporate tax rate. Canada is the prime example. Since 2000, Canada has reduced its corporate tax rate from 43% to 25%.<sup>112</sup> Despite the lower rate, Canada's corporate tax revenue has steadily increased over the years.<sup>113</sup> Compared to the total corporate tax revenue as a percentage of GDP of the United States, Canada has experienced greater overall revenue.<sup>114</sup>

Media outlets generally portrayed Tim Hortons, prior to its recent dealing

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<sup>108</sup> Ye Hee Lee, *supra* note 102.

<sup>109</sup> William McBride, *Canada's Lower Corporate Tax Rate Raises More Tax Revenue*, TAX FOUND. (Aug. 27, 2014), <http://taxfoundation.org/blog/canadas-lower-corporate-tax-rate-raises-more-tax-revenue>.

<sup>110</sup> *Id.*

<sup>111</sup> *Id.*

<sup>112</sup> *Id.*

<sup>113</sup> *Id.*

<sup>114</sup> *Id.*

with Burger King, as a demonstration of a corporation's tendency to move into lower tax-rate jurisdictions. Tim Hortons, originally a Canadian company, was acquired by Wendy's International Inc. in 1995.<sup>115</sup> As Canada began to reduce its corporate tax rate in 2009, Tim Hortons made the move back to Canada.<sup>116</sup> At this time, while Canada was experimenting with a plan to slowly cut its corporate tax rate, its practical effects were not certain.<sup>117</sup> By the end of 2010, however, Canada experienced a surge of attention from businesses worldwide.<sup>118</sup> Despite running a sizeable deficit in 2010 of 55.6 billion Canadian dollars, Canada nonetheless planned to make further cuts in the corporate tax rate to 15% by 2012, down from the 42.6% corporate tax rate of 2000.<sup>119</sup>

It is undeniable that Canada experienced an increase in business as a result of this tax cut.<sup>120</sup> KPMG, among the largest service companies in the world, moved its internal marketing, technology, and service departments to Canada in 2008, making Toronto KPMG's biggest support center.<sup>121</sup> Spectra Energy Corp. expressed interest in investing billions of dollars toward infrastructure projects for natural gas facilities in British Columbia.<sup>122</sup> Among these changes included an influx of financial groups and banks that anticipated increased business as a result of the changes in Canada.<sup>123</sup> Canada demonstrated that the development of business in the country could dramatically outweigh the lost tax revenue caused by the reduced corporate tax rate. Therefore, reducing the corporate tax rate could be an overall beneficial resolution to the current corporate tax problem that the United States is facing.

As occurred in Canada, while the Federal Government would receive lower revenue per dollar of profit, the overall increase in taxable profits within the United States may outweigh the loss due to the increase of businesses headquartered in the United States. For one, corporations would be less likely to invert, even when it is a possibility without regulations. Some corporations would repatriate their profits into the United States and pay the requisite tax, even if those corporations would retain more money abroad should they not repatriate. Corporations, after an inversion, still have some difficulty bringing

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<sup>115</sup> Virginia Galt, *Time Hortons Makes Move Back to Canada*, GLOBE & MAIL (June 29, 2009, 7:11 PM), <http://www.theglobeandmail.com/globe-investor/tim-hortons-makes-move-back-to-canada/article1199653/>.

<sup>116</sup> *Id.*

<sup>117</sup> *Id.*

<sup>118</sup> Phred Dvorak, *Canada Slashes Business Levies*, WALL ST. J., <http://www.wsj.com/articles/SB10001424052970203525404576050080874854882> (last updated Dec. 30, 2010).

<sup>119</sup> *Id.*

<sup>120</sup> *See id.*

<sup>121</sup> *Id.*

<sup>122</sup> *Id.*

<sup>123</sup> *See id.*

profits within the border, where they would be able to reinvest the money in their headquarters. If the corporate tax rate was lowered, the small cost a corporation would pay in taxes to repatriate its profits into the United States, in some instances, would outweigh the benefits of keeping the money abroad and not paying any additional taxes.

Additionally, corporations would be hesitant in conducting inversions when the tax rate is lower because scheming out of lower tax liabilities opens the door to more public backlash. While some of the public may understand that it would be advantageous for a domestic corporation to be acquired by a foreign corporation in order to forego the 35% rate, such schemes under a lower tax rate would be justifiably wrong. The greater the public backlash against a corporation, the greater the risk of losing profits. From a business development perspective, the public backlash alone may, in some instances, deter corporations from inverting despite the existence of immediate financial incentives. As such corporations disenchant the public, the loss of profits would outweigh the short financial gains.

Aside from lower tax rates keeping United States corporations within the United States, lower rates could also attract businesses from abroad. This would not only increase overall revenue, but would also create more jobs and increase production within the United States. Lastly, by reducing the corporate tax rate, corporations would become more reluctant to devise plans to avoid taxes, public backlash of corporations would decline, and societal skepticism would be relieved.

As a precautionary measure, however, the reforms could also widen the tax base in order to offset any loss of revenue should the United States not experience an influx of businesses and increased profits as a result of a lower corporate tax rate. This was one alternative that Senators Ron Wyden and Dan Coats proposed as legislation.<sup>124</sup> In his blog, supported by Republican Senator Dan Coats, Senator Wyden claimed, “[t]ax reform can create a simpler, more business-friendly tax code that increases tax revenue without raising tax rates. It can lower corporate tax rates to make American businesses more competitive, which will help businesses to create jobs that pay middle class wages.”<sup>125</sup> This bipartisan effort modeled the proposed legislation after the Tax Reform Act of 1986, when tax rates were reduced and the tax base widened to maintain tax revenue.<sup>126</sup> Kimberly Clausing presented in her article

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<sup>124</sup> Ron Wyden, *Bipartisan, Comprehensive Tax Reform Will Restore America's Competitive Edge*, RON WYDEN, SENATOR FOR OR. (May 31, 2012), <http://www.wyden.senate.gov/news/blog/post/bipartisan-comprehensive-tax-reform-will-restore-americas-competitive-edge>.

<sup>125</sup> *Id.*

<sup>126</sup> *Id.*

various other proposals from senators, the Obama Administration, and professionals in the field that in some way, shape, or form reduce the statutory corporate tax rate to below 30%.<sup>127</sup> The primary concern is the trillions of dollars in deferred profits abroad<sup>128</sup> that have not yet been taxed by the United States.<sup>129</sup> As a general point, however, changes to the corporate tax rate and to the tax base are a widely accepted necessity.

### *B. Changes to the Non-Territorial System*

Another alternative, which Great Britain and Japan recently adopted, and a method which is utilized by the majority of developed countries, would be a territorial tax system. Under a strictly territorial system, the United States would not tax profits made outside of its borders.<sup>130</sup> While adopting such a system would greatly favor corporations and would completely solve the problems of repatriation, it would be unduly detrimental to United States tax revenues.<sup>131</sup> Under this system, the United States would collect less revenue than it already does because not only would it not tax foreign profits from inverted corporations, but foreign profits of domestic corporations would also not be subject to tax.<sup>132</sup> However, there are variations of the territorial system that would subject some foreign income to United States taxes.<sup>133</sup> For example, in Japan, if foreign profits arise in a country with a corporate tax rate below 20%, Japan administers a tax that is higher than the rate it applies to profits made domestically.<sup>134</sup> Other countries adopt a system that compares its rate to those of the country in which foreign profits arise.<sup>135</sup> If that foreign country's rate is significantly lower than the domestic country's rate, then an alternative rate is applied.<sup>136</sup> Under either Japan's system or that of other

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<sup>127</sup> Clausing, *supra* note 9, at 440–41.

<sup>128</sup> Kevin Drawbaugh and Patrick Temple-West, *Untaxed U.S. Corporate Profits Held Overseas Top \$2.1 Trillion: Study*, REUTERS (Apr. 8, 2014, 8:35 PM), <http://www.reuters.com/article/2014/04/09/us-usa-tax-offshore-idUSBREA3729V20140409>. Studies have found that there are over \$2.1 trillion in U.S. corporate profits overseas that have not been taxed by the United States. There have been various other proposals in an effort to merely bring these profits into the United States. *Id.* Known as “tax holiday” proposals, in which the government cuts corporations a break and allows them to repatriate profits at a lower tax rate. *Id.* These proposals are independent of the long-term tax reforms proposed. *Id.*

<sup>129</sup> *See Rules Regarding Inversions and Related Transactions, Notice 2014-52, supra* note 72.

<sup>130</sup> Clausing, *supra* note 9, at 439.

<sup>131</sup> *Id.*

<sup>132</sup> *Id.*

<sup>133</sup> *Id.*

<sup>134</sup> *Id.*

<sup>135</sup> *Id.*

<sup>136</sup> *Id.*

countries, repatriation is not necessary to apply the tax.<sup>137</sup> Therefore, transactions such as inversions or hopscotch loans would not help corporations avoid their tax obligations.<sup>138</sup> Should the United States adopt a territorial system, and apply taxes immediately on foreign profits in countries with tax rates below a certain threshold at a fairly higher rate, such an alternative would be favorable to corporations, without creating an incentive to keep profits abroad, or intentionally do business in low tax countries in order to merely avoid taxes. Alternatively, United States tax revenue would not be greatly affected when corporations do business in low tax rate countries.

## VII. CONCLUSION

As a result of the economic downturn in 2008, increased public costs in healthcare, and the growing budget deficit, the United States recognizes its tax revenue is not sufficient to cover its costs. Simultaneously, as the United States maintains such a high corporate tax rate in order to cover these costs, multinational corporations utilize loopholes, preventing trillions of dollars in profits from being taxed by the United States. As is expected given these circumstances, both public officials and everyday citizens condemn these corporations for being unpatriotic and legally avoiding their tax obligations. It is this predicament that makes tax reform a priority for corporations, professionals in the field, Congress, and the President of the United States. It is widely accepted that the United States corporate tax system is broken. It is unnecessarily complex, difficult to enforce, out of tune with its foreign counterparts, and an undue burden to corporations and their practices. The Notice released in September 2014 does not help. The proposed regulations further complicate the already complicated code and put United States corporations at a disadvantage by effectively shutting every door they may use to compete against foreign corporations from nearly every other developed country.

A better alternative to these regulations would not be to focus on the minor provisions in the code that allow corporations to invert and lend hopscotch loans, but rather to attack the problem at its root. A root made up of a combination of the exorbitantly high corporate tax rate unchanged since the 1980s, the non-territorial system that creates a disincentive for corporations to repatriate their profits, and the tax base, which could be widened in order to maintain the requisite revenue. Once these core issues are remedied, the need for further regulations will become known. Closing the current loopholes is

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<sup>137</sup> *Id.*

<sup>138</sup> *Id.*

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merely a wasted effort that may be completely unnecessary should fixing the core issues solve the problem on their own. The government cannot demand patriotism; it is the individual's choice to be patriotic. If the current state of affairs puts corporations at a disadvantage, we cannot blame them for being unpatriotic when they find legal means to save money. The problem may just be from within.

