

You Can't Take It With You: Behavioral Finance and Corporate Expatriations

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In 2002, reports of corporate expatriations filled the headlines. These reports came as something of a surprise because the anti-inversion rules enacted in the early 1990s should have prevented almost all of these transactions. Various commentators have tried to explain this phenomenon. These explanations, however, are not consistent with the empirical evidence. This Article offers an explanation for the current inversion activity by arguing that corporate managers are exploiting fluctuations in stock prices to expatriate at reduced cost. Moreover, the Article proposes legislation to reduce expatriations consistent with this model.

INTRODUCTION

The sight of people fleeing a country sends a signal to the world that something is wrong in the jurisdiction. When corporations flee, the meaning is less clear. This is particularly true if the corporations can “flee” without significantly changing their operations. Some argue that corporate expatriation is a sign that the U.S. tax system needs to be changed. Others read expatriation activity as a manifestation of excessive corporate greed which must be restrained.

A corporation is, after all, a fiction. The unusual idea of a corporation “leaving” a jurisdiction derives from the fact that corporations are considered to be residents where they are incorporated¹ rather than where they actually operate. A corporate expatriation, sometimes called a corporate inversion or “flip” transaction, involves a reorganization in which the parent corporation of a group of related corporations moves from the taxing jurisdiction of the United States to that of a foreign jurisdiction.² By moving the parent corporation outside of the U.S. taxing jurisdiction, many of the U.S. tax rules no longer apply to the group as a whole.³ What may in substance be little more than a “paper” transaction can significantly reduce the worldwide taxation of the entire group.⁴

¹ 26 U.S.C. § 7701 (2000). All section references are to the Internal Revenue Code of 1986 [hereinafter I.R.C. or the Code], as amended, unless otherwise indicated.

² Bermuda seems to be the jurisdiction of choice. Tyco International, Ingersoll-Rand, and Helen of Troy (which, on December 30, 1993, made the first inversion announcement that alerted the I.R.S. to tax-driven expatriations, leading to the enactment of the 1994 anti-inversion provisions of the Internal Revenue Code) all reorganized to Bermuda. MIHIR A. DESAI & JAMES R. HINES, JR., EXPECTATIONS AND EXPATRIATIONS: TRACING THE CAUSES AND CONSEQUENCES OF CORPORATE INVERSIONS tbl.1 (Nat'l Bureau of Econ. Research, Working Paper No. 9059, 2002).

³ See discussion *infra* Part II.A.3.

⁴ See discussion *infra* Part II.A.2.

Corporate expatriations, which historically have occurred primarily in the insurance and oil and gas industries, are now occurring among a wider distribution of American industries.⁵ These expatriations became the focus of congressional debate in the summer of 2002, as industry leaders such as Stanley Tools — America's largest tool manufacturer — made inversion announcements.⁶ Notwithstanding the public antipathy for corporate inversions following the attacks of September 11,⁷ there is every reason

⁵ U.S. TREASURY, OFFICE OF TAX POLICY, CORPORATE INVERSION TRANSACTIONS: TAX POLICY IMPLICATIONS, Doc. 2002-12288, reprinted in 2002 TNT 98-49 (May 21, 2002) [hereinafter TREASURY REPORT] (“[T]here has been a marked increase recently in the frequency, size, and profile of the [inversion] transactions.”). American corporations that have expatriated include: Helen of Troy (Dr. Scholl’s) to Bermuda, Tyco International (ADT Security Systems) to Bermuda, Santa Fe International to the Cayman Islands, Fruit of the Loom to the Cayman Islands, Playstar (Internet gaming) to Antigua, Cooper Industries to Bermuda, Ingersoll-Rand (tool and die manufacturer) to Bermuda, and Stanley Works (America’s largest tool manufacturer), which announced its intention to expatriate to Bermuda but reconsidered in the face of overwhelmingly negative publicity. *Id.*, at 7, 96 (“Both the recent inversion activity and the increase in foreign acquisitions of U.S. multinationals are evidence that the competitive disadvantage caused by our international tax rules is a serious issue with significant consequences for U.S. businesses and the U.S. economy.”); *id.*, at 4 (“U.S.-based companies and their shareholders are making the decision to reincorporate outside the U.S. largely because of the tax savings available.”); *id.*, at 19-21 (citing protection of foreign operations from application of subpart F as justification for the costs associated with expatriation). Expatriation also provides the opportunity to exploit differences in the treatment of equity investments and debt to reduce both U.S. and local-country tax. Reuven Avi-Yonah, *For Haven’s Sake: Reflections on Inversion Transactions*, 95 TAX NOTES 1793, 1794 (2002) (explaining use of debt in place of equity capital to reduce U.S. income through use of deductible interest payments).

⁶ Seven of the Standard and Poor’s 500 have either expatriated or made the public inversion announcements and public filings required under state corporate law and federal securities laws. These are Cooper Industries, Ingersoll-Rand, Nabors, Stanley Works, Transocean, and Tyco International. DESAI & HINES, *supra* note 2, at tbl.1. Inversion announcements in the last eighteen months represent more than \$25 billion in market capitalization as of the announcement date. In a March 1999 Senate Finance Committee hearing Robert Perlman, a former vice-president for tax at Intel, testified that “if Intel were to be founded today, I would strongly advise that the parent company be incorporated outside the United States.” *Unofficial Transcript of Finance Hearing*, 1999 TNT 50-54 (Mar. 16, 1999). Technically, a reorganization comes within the meaning of an “inversion” transaction when a U.S. corporation becomes a subsidiary of a newly-established tax haven parent corporation. Several significant expatriations — the Daimler-Chrysler, BP-Amoco, and AirTouch-Vodafone mergers, for example — have been structured as acquisitions of smaller, preexisting entities so as to preclude the application of the Code’s anti-inversion provisions. Finally, the expatriation of two prominent U.S. multinationals — Accenture and Seagate Technologies — have avoided inversion characterization by strategically structuring their initial capitalization outside the United States. See DESAI & HINES, *supra* note 2, at tbl.1; see also *Treasury Subcommittee Hearing: Testimony of Reuven S. Avi-Yonah Before the Senate Appropriations Subcommittee on Treasury and General Government Operations*, 107th Cong. ¶ 26 (2002) (distinguishing non-inversion transactions such as Accenture and Seagate, which newly incorporated overseas).

⁷ One need only examine the titles of bills offered in Congress to stem the tide of

to believe that inversion activity is continuing and that non-public corporations are engaging in inversion activity as well.⁸

The increase in inversion activity represents an anomaly. As explained more fully in Parts II and III, if traditional finance theory is correct, the U.S. tax rules operate to impose a cost to expatriate from the United States that should equal or exceed any potential tax benefits from inversion. Therefore, a decision to expatriate should very rarely be a rational business decision.⁹ In the last three years, however, there have been an increasing number of corporate inversions, seemingly undeterred by the imposed or impending tax liability.¹⁰ The academic literature has not yet adequately explained this anomaly in corporate decision making. Some commentators have argued that there are other potential tax savings that explain the anomaly of corporate inversions.¹¹ As this Article shows, however, these explanations are not consistent with the law or recent empirical studies.

corporate inversion activity to conclude that expatriations by U.S. corporations are considered "anti-American." The anti-inversion bills offered in the spring and summer of 2002 included the Corporate Patriot Enforcement Act of 2002, the No Tax Breaks for Corporations Renouncing America Act of 2002, and the Save America's Jobs Act of 2002. See *infra* note 214.

⁸ The Treasury Department has recently promulgated regulations requiring all corporations that relocate outside the United States to notify the I.R.S. within thirty days. See T.D. 9022, Treas. Dec. Int. Rev. 9022 (2002), described in *IRS Issues Temporary Regs on Information Reporting of Taxable Stock Transactions*, 97 TAX NOTES 895 (Nov. 18, 2002). This indicates that the Treasury believes not only that corporate inversion activity is still continuing, but also that inversion activity represents a continuing threat to the collection of federal revenues.

⁹ For taxable entities, the price of escaping the U.S. tax net is recognition of the appreciation inherent in the assets of the parent corporation, as well as the appreciation in the shares of the parent corporation itself. The second way in which this Article adds to the literature is that it proposes a solution to the problem that avoids a moratorium on inversions that would appear quite drastic and desperate, and might actually be unfair. This tax liability, imposed on the shareholders of the U.S. corporation rather than the corporation itself, has historically limited the number of corporate expatriations from the United States to one or two per year. DESAI & HINES, *supra* note 2, at tbl.1 (detailing data on inversion activity among public corporations from 1982 to 2002). In theory, the application of the anti-inversion provisions of the U.S. international tax rules, together with the public notice and filing requirements of state corporate law and federal securities law, should operate to discount any potential tax savings from inversion into the share price of the announcing corporation. RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 354-56 (5th ed. 1996) (stating that under efficient market hypothesis, market prices are "informationally efficient," responding to new information almost instantaneously).

¹⁰ Avi-Yonah, *supra* note 5, at 1793-94.

¹¹ *Id.* at 1795; DESAI & HINES, *supra* note 2, at 4. Presumably, though, any potential tax savings would increase the price of the shares at the time of the expatriation and hence would increase the cost of expatriation because the cost is based on the value of the shares post announcement, which would mean that these savings are not only taxed by the United States but taxed on a current rather than a future basis.

Moreover, neoclassical economics would argue that any potential savings post-inversion are factored into the stock price post announcement¹² and are, as such, subject to immediate taxation.

This Article adds to the literature in two ways. First, the Article offers a new explanation for corporate inversion activity based upon behavioral finance models. Behavioral finance is an approach to the analysis of financial markets that emerged in the 1980s in response to empirical research which pointed out anomalies in market behavior.¹³ This research has documented systematic deviations from classical theories of efficient markets, specifically the efficient market hypothesis, which was widely accepted in the 1970s.¹⁴ The Article argues that corporate managers are exploiting actual or perceived imperfections in the market to reduce the cost of expatriation to the level that they deem it profitable for their companies to “leave” the United States based on tax considerations alone.

Second the Article proposes a technical solution to the problem that avoids drastic measures such as the congressionally-proposed moratorium on expatriations¹⁵ — which could have significant negative long-term investment consequences¹⁶ — but nevertheless prevents

¹² Federal securities laws and state corporate law require public notice and shareholder approval for any corporate reorganization. ROBERT CLARK, *CORPORATE LAW* 414-16 (1986). Moreover, federal securities laws require a detailed filing of the plan of reorganization prior to the shareholder vote. *Id.*

¹³ Werner DeBondt & Richard Thaler, *Does the Stock Market Overreact?*, 40 J. FIN. 793, 793-94 n.21 (1985) (describing early research on overreaction in markets conducted by Kahneman and Tversky and tying their theories to market behavior); see, e.g., ANDREI SHLEIFER, *INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE* (2000) (analyzing markets using this theory). For Kahneman and Tversky’s work on deviations from the standard decision making theory, see Daniel Kahneman & Amos Tversky, *On the Psychology of Prediction*, 80 PSYCHOL. REV. 237, 237-51 (1973) [hereinafter Kahneman & Tversky, *On the Psychology of Prediction*] (stating that individuals systematically violate maxims of probability theory such as Bayes rule, which holds probabilities follow standard algebraic laws, i.e., if person does not follow Bayes rules they are behaving as if probabilities of all events either exceed or are less than 1); Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263, 291 (1979) [hereinafter Kahneman & Tversky, *Prospect Theory*] (finding that individuals do not always act rationally with respect to gambles and, more specifically, display aversion to loss more strongly than preference for gain).

¹⁴ SHLEIFER, *supra* note 13, at 10.

¹⁵ See discussion *infra* Part IV.A.

¹⁶ In addition to potential negative long-term consequences, discussed *infra* at Part IV.A, moratoria could, in some circumstances, be unfair. Legitimate reasons for expatriation include if the shareholders change so as to avoid the imposition of withholding taxes, and if the tax rules of the United States are likely or about to change. Moreover, should the United States materially change its tax structure, it seems reasonable to allow corporations to pay their taxes and leave.

corporate managers from abusing the tax system.¹⁷ Specifically, the Article proposes a modification to the current anti-inversion rules that would ensure that corporate managers could not take advantage of temporary market fluctuations to avoid paying their fair share of taxes, by valuing the expatriating corporation over a period of time rather than solely based on market price on the actual day of inversion. Moreover, this Article argues that the inclusion of options in market value renders a more accurate value of the inverting corporation and would serve to deter expatriation activity.

Part I of the Article provides a discussion of the U.S. international tax rules and the reasons why corporations might wish to expatriate. Part II addresses the issues surrounding corporate expatriation including the tax rules that apply to these transactions. This Part includes a discussion of how corporate inversions can be used to circumvent the U.S. international tax rules. Part II also explains that the U.S. international tax rules are based on traditional finance theory containing outdated assumptions that render them inadequate to explain the phenomena of corporate inversions. Part III proposes a model of the expatriation decision based on the behavioral finance literature and shows how this model can explain the anomaly of corporate inversions. Under this model, corporate managers take advantage of temporary downturns in the price of the stock of the corporation to reduce the price of expatriating. Part IV proposes a solution to the problem of corporate inversions based on this behavioral finance model. The Article concludes that the tax price for expatriation should include a mechanism that takes into account changes in market price to derive an accurate value of an expatriating corporation at the time of inversion.

I. THE ONTOLOGY OF CORPORATE EXPATRIATION

In order to understand the anomaly of corporate inversions, one needs to understand the mechanics of the transaction and the rules promulgated to neutralize the tax benefits of expatriation. Any income that arises from cross-border transactions is potentially subject to tax in two or more jurisdictions: the residence country¹⁸ and the source country.¹⁹ Generally,

¹⁷ See discussion *infra* Part III.

¹⁸ The residence country is the country where the taxpayer resides, and the source country is the country where the taxpayers' activities generate the relevant income. See Terrence R. Chorvat, *Taxing International Corporate Income Efficiently*, 53 TAX L. REV. 225, 228-30 (2000).

¹⁹ Double taxation is highly inefficient. If foreign investment is subject to two layers of

the residence country is responsible for alleviating any double taxation that may occur.²⁰ There are two primary methods of dealing with double taxation.²¹ The first is the "worldwide" or "credit" method, in which the residence country taxes foreign source income but provides a credit for taxes paid to foreign jurisdictions. The alternative is the "territorial" or "exemption" method, under which the residence country cedes all taxing jurisdiction to the source country.

A. *Worldwide and Territorial Systems of Taxation*

Under a worldwide or credit system, such as that of the United States, a country taxes all the income of its residents, irrespective of the source.²² In order to alleviate potential double taxation, the residence country generally permits its taxpayers a credit for income taxes paid on income earned in other jurisdictions.²³ Under this system, the income earned by a multinational enterprise²⁴ will be taxed, at a minimum, at the rates set by the residence country.²⁵

Almost all countries that use a worldwide system to impose a limitation on the foreign tax credit.²⁶ The foreign tax credit limit is generally equal to

tax, while domestic investment is subject to only one, the tax system will significantly discourage investment in foreign countries. See RICHARD CAVES, *MULTINATIONAL ENTERPRISE AND ECONOMIC ANALYSIS* 189, 190 (2d ed. 1996).

²⁰ PETER HARRIS, *CORPORATE-SHAREHOLDER INCOME TAXATION AND ALLOCATING TAXING RIGHTS BETWEEN COUNTRIES* 320 (1996).

²¹ Alternatively, a country could allow corporations to deduct foreign taxes from taxable income. A deduction does not eliminate double taxation, but rather simply reduces its effect. Both countries still tax the income. The total tax paid is higher than the tax rate in either country. Fortunately, this deduction is rarely the only method available to deal with double taxation. HARRIS, *supra* note 20, at 320.

²² HUGH J. AULT, *COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS* 381 (1997).

²³ *Id.*

²⁴ A multinational enterprise is defined here as an enterprise that controls and manages business activities in at least two countries. See CAVES, *supra* note 19, at 1.

²⁵ See AULT, *supra* note 22, at 381. To illustrate the application of the foreign tax credit, assume that A, a U.S. multinational, earned \$100 in Hong Kong and \$100 in the United States. Hong Kong will tax the \$100 of income earned within its borders at a rate of 17%. The United States will tax A's worldwide income of \$200 at a rate of 35%. However, because of the foreign tax credit, A will only have to pay an additional U.S. tax of \$53, rather than \$70. Because the total amount of tax A will pay is \$70, \$50 dollars to the U.S. and \$17 to Hong Kong, the Hong Kong income and the U.S. source income are both subject to a total tax rate of 35%, which is the rate A would have paid if all the income had been earned in the United States.

²⁶ For example, limitations are imposed on the foreign tax credits allowed in the United Kingdom, Australia, and Norway. See AULT, *supra* note 22, at 388-91; see also Joel Slemrod, *The Taxation of Foreign Direct Investment: Operational and Policy Perspectives* 11, 34-

the amount of residence country tax on foreign source income.²⁷ From the point of view of the taxpayer, the foreign tax credit limit operates such that the tax rate applicable to foreign source income is the higher of the residence country rate or the source country rate.²⁸ From the standpoint of the residence country, the credit limit ensures that no other country's treasury will be subsidized with credits from the residence country.

Under an exemption or territorial system, such as is employed in Canada, Germany,²⁹ the Netherlands, and France,³⁰ foreign source income is generally not subject to tax in the residence country.³¹ The residence country taxes active business income only if it is earned within its borders.³²

35, in BORDERLINE CASE: INTERNATIONAL TAX POLICY, CORPORATE RESEARCH AND DEVELOPMENT AND INVESTMENT (James M. Poterba ed., 1997) (providing examples of limitations on foreign tax credits).

²⁷ I.R.C. § 904 (2000). For the United Kingdom rules, see AULT, *supra* note 22, at 385-91.

²⁸ To illustrate the application of the foreign tax credit limitation, assume that A also operates in Italy, where the tax rate is 56%. If A earns \$100 in Italy, this income will be subject to \$56 of Italian tax. The Italian source income will also be subject to tax in the United States at a 35% rate, but A will receive a tax credit for the taxes paid to Italy. Before taking into account the foreign tax credit limitation, A is eligible for a foreign tax credit of \$56, even though the U.S. tax on the income is only \$35 dollars. Therefore, A will owe no further U.S. tax. Because the Italian rate of tax is greater than the U.S. rate of tax, A will not pay any tax on this income in the United States. However, the credit is limited to \$35 in the United States (the amount of U.S. tax on the Italian income), even though the total tax paid on the income is the higher Italian rate of 56%. Generally, if a multinational taxpayer has foreign tax credits that it cannot use on a particular item of income, the taxpayer is permitted to use these credits to reduce U.S. tax on other items of foreign source income. However, the foreign tax credit is subject to many more restrictions and is beyond the scope of this Article (and very likely the tolerance of the gentle reader).

²⁹ Although Canada and Germany have a worldwide system by statute, they effectively have an exemption system created by the various treaties into which they have entered. AULT, *supra* note 22, at 314-16.

³⁰ For descriptions of the Dutch and French exemption systems, see AULT, *supra* note 22, at 315.

³¹ See AULT, *supra* note 22, at 381.

³² *Id.* To illustrate the application of a territorial system, assume that B is a Dutch multinational and has a subsidiary in Hong Kong. B earns \$100 in the Netherlands, and the subsidiary earns \$100 in Hong Kong. The Netherlands has an exemption system and a 35% corporate rate on income earned in the Netherlands. See AULT, *supra* note 22, at 384-85, 87. B will pay \$17 in tax to Hong Kong, and will only pay tax in the Netherlands on its Dutch source income. B will not pay any tax in the Netherlands on the income from its Hong Kong operations. Therefore, B will have to pay less in total worldwide tax than A [\$52 (\$17 + \$35) for B versus \$70 (35% on \$200) for A]. If B had an Italian subsidiary, its income would also be subject to a tax rate of 56%. Under a worldwide system, the higher of the source country rate or the residence country rate applies. Therefore, if the tax rate in the source country is higher than in the residence country, under either a worldwide system or a territorial system, the higher source country rate applies. Thus if A and B both have operations in the same high-tax jurisdiction, A and B will be taxed alike on this income.

Most countries that employ an exemption system also tax the passive foreign source income of their residents, because passive income is viewed as having no natural geographical tie.³³ For example, someone who owns shares of a U.S. publicly-traded corporation will obtain the same pre-tax benefits whether he resides in the United States, Bermuda, or Australia. As a result, a multinational group of corporations will have an incentive to shift its passive income to the lowest-taxed jurisdiction in which it operates, in this example in Bermuda. Because this shifting of investment activity likely has no economic basis,³⁴ it is viewed as an abuse of the system and, as such, many exemption systems subject foreign source passive income to tax in the residence country.³⁵

All things being equal, a multinational enterprise would generally prefer to be considered a resident in a territorial system rather than in a credit system. Under a territorial system, if a member of the corporate group earns active business profits in a low-tax country, the only tax to which the income will be subject is the low source country rate. On the other hand, if the group is subject to a worldwide system, income eventually repatriated to the parent corporation³⁶ will be subject to another layer of tax. Therefore, a corporation operating under a territorial system will generally have a lower tax cost associated with operations even in countries with low local tax rates.

B. The U.S. International Tax Provisions

The United States has adopted a form of a worldwide system which allows corporations to defer the inclusion of foreign source income until the income is repatriated to the United States. This section explores the major features of this system.

³³ For this purpose, passive income includes such items as dividends, interest, and royalties not received from affiliates. The Netherlands, France, and Canada tax these types of income. See AULT, *supra* note 22, at 403-06.

³⁴ Whether, for example, the income is earned by a U.S. or a Bermudan subsidiary, the activities that generated the income do not change, nor are the natural persons enriched by the income any different. Therefore, the shifting of such income between subsidiaries would be viewed as not having economic substance.

³⁵ See AULT, *supra* note 22, at 411-13; see also NFTC, THE NFTC FOREIGN INCOME PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY, PART ONE: A RECONSIDERATION OF SUBPART F 57, 156, ¶¶ 129, 148, 156-57, 180, 356 (1999) (explaining that passive income is generally taxed in residence country and comparing provisions related to passive income in Canada, Germany, the Netherlands, and United States).

³⁶ In order for it to be distributed to the shareholders or for reallocation back to other members of the group, income must first be repatriated to the parent. CAVES, *supra* note 19, at 189-93.

1. Fundamentals of the U.S. Credit System

The United States has, since 1909, asserted its jurisdiction to tax the worldwide income of domestic corporations, regardless of the source of their income or where they are engaged in a trade or business.³⁷ Income earned by foreign branches³⁸ of U.S. corporations is taxed when the income is earned abroad. Dividends, interest, rents, royalties, and similar kinds of income received by U.S. persons are also subject to U.S. income tax.³⁹

Consistent with a worldwide system, the U.S. tax system allows a limited credit against the U.S. tax, available for certain income taxes paid to foreign countries, thereby mitigating the double taxation of U.S. taxpayers on foreign source income.⁴⁰ The credit, however, is available only up to the amount of U.S. tax attributable to the foreign income.⁴¹ If the foreign tax is less than the amount of the U.S. tax, the United States will collect any incremental income tax on the foreign income where the U.S. tax rate exceeds that of the foreign country. On the other hand, if the foreign tax exceeds the amount of the U.S. tax, no portion of the excess credit is available to reduce U.S. tax on income earned in the United States. For a U.S. multinational corporation, this general limitation operates as a "ceiling" on the amount of credit available for each dollar of foreign tax paid.

³⁷ BORIS BITTKER & JAMES EUSTICE, *THE FEDERAL TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 1.01. (7th ed. 2001).

³⁸ A foreign branch is a direct operation of a U.S. corporation in a foreign country. A foreign subsidiary is a foreign corporation which is owned by a U.S. corporation. If a multinational chooses to operate in the local jurisdiction in the form of a foreign subsidiary, it must form a foreign corporation to conduct its business. If it chooses a branch, it conducts the business in the foreign jurisdiction directly, without the use of an intervening entity. See Slemrod, *supra* note 26, at 12-13.

³⁹ I.R.C. § 61 (2000).

⁴⁰ *Id.* § 901.

⁴¹ Congress limits the credit to that portion of the corporation's total U.S. tax liability that equals the ratio of net foreign source income over worldwide income. Because the numerator of the general limitation is described in terms of *net* foreign source income, the limitation is sensitive to formulaic (i.e., non-economic) allocations of expense against foreign source income or, alternatively, inclusion of income as U.S. source which would, in economic terms, be appropriately considered foreign source. Congress has incorporated in the international provisions several formulaic allocations of income or expense which serve to disallow credits for foreign taxes paid by U.S. corporations in their foreign operating jurisdictions. Unfortunately for U.S. multinationals, to the extent that these formulaic allocations operate to disallow otherwise creditable foreign taxes, the U.S. corporation is subject to double taxation. Examples may be found in the interest expense allocation rules, discussed *infra* Part II.C.2.b.i, and in the rules for allocating income from insurance-related services. Treas. Reg. § 1.861-14T(h); I.R.C. § 904(a).

The mechanics of the U.S. foreign tax credit limitation are somewhat complex. Many of these rules are designed to prevent taxpayers from using passive income — the paradigmatic low-taxed “mobile” income — to artificially increase the limit and thereby circumvent the purpose of the limit.⁴² The operation of the general limitation allows taxpayers to combine the foreign source income from all non-U.S. jurisdictions where the U.S. corporation operates. This allows U.S. corporations to average the local tax rates of all non-U.S. jurisdictions over combined foreign source income.⁴³ To preclude the U.S. taxpayer from averaging the rates of high-tax jurisdictions with low-tax jurisdictions to increase the available limitation (sometimes called “blending” or “cross-crediting”), Congress has imposed separate limitations on certain types of foreign source income.⁴⁴ Theoretically, these separate limitations or “baskets” were applied to certain categories of income that were viewed by Congress as more likely to distort the foreign tax credit because they were “mobile” and could be diverted to tax-favored jurisdictions to further the process of cross-crediting.

2. Deferral and Non-Deferral of U.S. Taxation of Foreign Source Income

The U.S. tax rules technically apply only to U.S. corporations.⁴⁵ As discussed earlier, a corporation is considered to be resident in its country of incorporation.⁴⁶ The corporation is a legal entity separate and apart from its shareholders.⁴⁷ Under recognized international principles, the United States does not have the right to tax foreign corporations on their worldwide income.⁴⁸ What are the limits then on the right of the United States to tax income earned by its resident corporations when the income is

⁴² See U.S. TREASURY, OFFICE OF TAX POLICY, *THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY* ix-xi (Dec. 2000).

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ The U.S. rules also apply to foreign corporations that do business or own real property in the United States. See I.R.C. §§ 882, 897 (2000). However, I will ignore these operations for purposes of this Article because they do not significantly add to the analysis.

⁴⁶ *Id.* 7701(a).

⁴⁷ This separate entity concept is basic to the concept of a corporation and the limited liability of its shareholders. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 426-28 (6th ed. 2003). Moreover, separate entity is generally accepted internationally as the appropriate standard for the taxation of operations conducted in one country by the resident of another. Diana Wollman, *Recent U.S. Earning Stripping Proposals: Why Were the Doctors Called and Is the Medicine Worse than the Disease?*, 30 *TAX NOTES INT'L* 483, 500 (2003).

⁴⁸ HARRIS, *supra* note 20, at 40-48.

earned through a foreign corporation?

a. Basic Rule of Deferral

The United States can tax U.S. resident corporations on their worldwide income. Respect for the entity concept, however, means that income that U.S. corporations earn through foreign subsidiaries is not subject to tax in the United States until the income is repatriated back to the U.S. parent corporation. This principle allows for significant deferral of the U.S. tax earned by U.S. subsidiaries.⁴⁹

b. Anti-Deferral Rules

Notwithstanding the separate entity concept, the international provisions of the U.S. tax rules have, since the early 1960s, contained aggressive anti-deferral provisions. The U.S. anti-deferral provisions are found in subpart F of subchapter N of the Internal Revenue Code (the "Code"),⁵⁰ colloquially referred to as "the subpart F rules." Under the subpart F rules, a U.S. shareholder⁵¹ of a domestic corporation that comes within the meaning of a controlled foreign corporation⁵² or "CFC" is currently taxed on certain earnings prior to the actual distribution of those earnings as dividends.⁵³ These rules prevent deferral of tax by causing certain types of income earned by controlled foreign corporations⁵⁴ to be included in the taxable income of the U.S. parent in the year it is earned, even though the income has not yet been repatriated to the U.S. parent. In effect, the Code treats U.S. shareholders as though they had received a current dividend to the extent of the corporation's subpart F income. Foreign earned income

⁴⁹ Terrence R. Chorvat, *Ending the Taxation of Foreign Business Income*, 42 ARIZ. L. REV. 835, 841-43 (2000).

⁵⁰ See I.R.C. §§ 951-963 (2000).

⁵¹ A U.S. shareholder is any U.S. person who owns or is considered to own 10% or more of all classes of stock entitled to vote of the foreign corporation. *Id.* § 951(b).

⁵² *Id.* § 957(a). A CFC is any foreign corporation 50% owned (by vote or value) by U.S. shareholders. Because a "U.S. shareholder" is defined as a U.S. person holding 10% or more of the vote or value of a foreign corporation, if a foreign corporation is 100% owned by unrelated U.S. persons but no single U.S. person owns 10% of the stock of the corporation, it is not a CFC.

⁵³ *Id.* § 951(a). Specifically, a U.S. shareholder of a CFC is required to take into account its pro rata share of the CFC's subpart F income as a constructive dividend limited, however, by the actual amount of earnings from profits that the CFC has generated during the taxable year.

⁵⁴ See *id.* § 957(a). A controlled foreign corporation is a foreign corporation of which more than 50% of its shares are owned by U.S. shareholders. A U.S. shareholder is defined as a U.S. person who owns 10% or more of the voting stock of the foreign corporation. See *id.* § 951(b).

captured as “subpart F income” is usually otherwise mobile categories of income that Congress views as likely retained outside of the United States solely for tax avoidance purposes.⁵⁵

In addition to passive income, subpart F income can also include income referred to as “foreign base company income,” comprised of various types of *active* foreign source business income. Foreign base company income includes income from: (i) the purchase of personal property from a related corporation followed by a sale of that property to anyone, (ii) the sale of personal property to anyone on behalf of a related corporation, (iii) the purchase of personal property from anyone followed by its sale to a related corporation, and (iv) the purchase of personal property from anyone on behalf of a related corporation.⁵⁶ Foreign base company income can also include (v) income from services performed by a CFC for or on behalf of a related company that are performed outside of the CFC’s home country,⁵⁷ (vi) shipping income of any kind,⁵⁸ or (vii) income from the insurance of any U.S. risk.⁵⁹ Consequently, non-passive income derived from the active conduct of a trade or business in any taxing jurisdiction other than the United States can trigger the immediate recognition of income for U.S. tax purposes, even if it is reinvested in local operations and taxed locally under territorial tax principles.

3. Ramifications of the U.S. System

The existing subpart F rules are considered much stricter than the rules found in similar regimes in other countries.⁶⁰ In particular, subpart F counterparts in other countries only apply to passive income.⁶¹ Because the U.S. subpart F rules include various types of active business income such as

⁵⁵ Subpart F income includes income derived from the insurance of U.S. risks, the CFC’s foreign base company income, international boycott-related income plus the sum of the amounts of any illegal bribes, kickbacks, or other illegal payments. *See id.* § 952.

⁵⁶ *Id.* § 954(b).

⁵⁷ *Id.* § 954(c).

⁵⁸ Foreign base company shipping income includes income derived from, or in connection with, the use or leasing of any aircraft or vessel in foreign commerce or income that arises from the performance of services related to such property or from its sale or exchange, except to the extent that section 954(b)(2) excludes an amount equal to reinvested shipping income. *Id.* § 954(f).

⁵⁹ *Id.* § 953. Section 953(a)(1)(B) is designed to cover attempted avoidance through reciprocal arrangements by which the CFC insures foreign risk under an agreement with an unrelated foreign corporation which takes on the U.S. risk.

⁶⁰ NFTC, TERRITORIAL TAX STUDY 12 (2002).

⁶¹ *Id.*

foreign base company sales and services income,⁶² the U.S. rules increase the tax burden on these categories of business income compared to the taxing regimes of other countries.⁶³

In addition, all income earned by U.S. corporations that is deferred will eventually be subject to U.S. tax. Under a territorial system, this extra layer of tax would not exist. This additional layer will affect decisions of when and whether to repatriate, and often results in complicated investment

⁶² See TREASURY REPORT, *supra* note 5, at 10.

⁶³ In fact, the U.S. Treasury Office of Tax Policy has stated that “[t]he U.S. international tax rules can operate to impose a burden on U.S. based companies with foreign operations that is disproportionate to the tax burden imposed by our trading partners on the foreign operations of their companies.” *Id.* at 7, 96. The Treasury Report went on to state for the consideration of “fundamental reform of the U.S. international tax rules, including the merits of the exemption-based tax systems of some of our major trading partners.” *Id.* at 98.

The provisions of the U.S. tax code that come in for the most criticism are the U.S. subpart F rules. The controlled foreign corporation rules in subpart F of the Code arose out of the Kennedy administration’s desire to reduce the ability of U.S. corporations to (i) defer the domestic taxation of U.S. source income by operating in foreign jurisdictions and (ii) invest passive income in tax-favored or tax haven jurisdictions, rather than repatriating the income to the United States. CHARLES KINGSON, INTERNATIONAL TAXATION 451-54 (2000). At the time the rules were adopted, the relative volume of international trade was much lower and the size and reach of multinational corporations was much less than today. In addition, the market dominance of U.S. multinational corporations as compared to those of other nations was unquestioned. Many commentators argue that today that is no longer the case, and the ability of U.S. multinationals to compete with foreign multinationals subject to the lower tax costs of non-U.S. taxing authorities is a real issue. Studies of the international tax regimes of different countries find that the U.S. international tax rules are the most stringent in the world. NFTC, *supra* note 35. In addition, studies of the cost of capital faced by multinationals in different nations consistently find that the cost of capital to U.S. corporations is either the highest or the second highest of those surveyed. Joosung Jun, *The Impact of International Tax Rules on the Cost of Capital*, in THE EFFECTS OF TAXATION ON MULTINATIONAL CORPORATIONS 95-120 (Martin Feldstein et al. eds., 1996). By avoiding the application of the subpart F rules to foreign operations, U.S. multinationals can reduce their worldwide effective tax rate by achieving deferral of taxation on at least some foreign-generated profits. Further, U.S. multinationals may be able to retain any tax savings that accrue from foreign operations, which otherwise would eventually be subject to a residual U.S. tax on the repatriation of earnings.

Other commentators disagree. They argue that multinational competitiveness should not be the primary goal of a tax system and, even if it is, our system does not actually put these corporations at a very big disadvantage. See generally Robert Peroni et al., *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999) (arguing for this position). Furthermore, commentators make the argument that, although the case has not yet been made that increased tax rates increase the cost of production, tax competition encourages the movement of production facilities and other forms of investment towards low-tax jurisdictions. See Avi-Yonah, *supra* note 5, at 1794; see also Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1575-76 (2000) (arguing that developing countries utilize low tax rates on income to attract investment in form of foreign capital as well as direct investment, that is to say, production facilities).

arrangements to utilize earnings while avoiding the tax on repatriation.⁶⁴ Further, this residual tax increases the cost of raising additional equity capital for U.S. corporations as compared to those operating in countries with territorial systems.⁶⁵ In addition, as described in section II.B.2 *infra*, the limitation on the foreign tax credit often operates to create an even higher rate of tax, by precluding a full dollar-for-dollar credit for foreign taxes paid.⁶⁶

C. Corporate Inversions: Self-Help Territorialism

Because of the disparity between U.S. and non-U.S. treatment of foreign source income, there can be significant pressure to change the place of incorporation. The determination of whether the multinational group is subject to worldwide or territorial taxation is not where the operations of the corporations are conducted, but rather where the parent is incorporated. If the parent of a corporate group is incorporated in a non-U.S. country with more lenient tax rules, the total tax paid by the group will be less than it would be than if the group were headquartered in the United States.

II. THE ANOMALY OF CORPORATE INVERSIONS

The U.S. tax rules have for some time been modified to create a financial disincentive for expatriation. In fact, this section will demonstrate that the tax cost associated with an inversion transaction has been structured in such a fashion that it will almost always exceed any benefit from escaping the U.S. tax net.

⁶⁴ See generally ROSEANNE ALTSCHULER & HARRY GRUBERT, REPATRIATION TAXES, REPATRIATION STRATEGIES AND MULTINATIONAL FINANCIAL POLICY (Nat'l Bureau of Econ. Research, Working Paper No. 8144, 2001) (providing example that dividend payments from one subsidiary to another will be taxed as repatriation of income but equity investment in other non-U.S. subsidiaries will not come within meaning of subpart F income, complicating holding company structure and any subsequent transactions involving these entities).

⁶⁵ Chorvat, *supra* note 49, at 841-44. Because subpart F increases the tax on capital, the returns to capital are decreased which, in turn, increases the cost of raising equity capital. In other words, a greater return must be offered to attract the same level of capital.

⁶⁶ If taxes are paid to a source country and are not fully credited, then the rate can exceed both United States and foreign country tax rates. See HARRIS, *supra* note 20, at 281-86.

A. The Mechanics of Inversions

Corporate inversions or “flip” transactions are reorganizations⁶⁷ resulting in the parent of a multinational group moving from the taxing jurisdiction of the U.S. to a foreign jurisdiction. Corporate inversions typically involve two steps to reorganize the structure of the group. The first step is a stock-for-stock swap⁶⁸ by the shareholders of the U.S. parent corporation whereby the stock of the parent is exchanged for the stock of a non-U.S. subsidiary, newly incorporated in a tax-favored jurisdiction. This taxable exchange⁶⁹ results in the non-U.S. company replacing the former U.S. parent corporation as the parent of the multinational group. Although the first step replaces the U.S. corporation with a non-U.S. entity as parent of the group, the operating structure of the group remains vulnerable to the application of the subpart F rules unless the U.S. corporation is actually removed from the group.⁷⁰ Hence, step two removes the U.S. corporation from the group via a taxable liquidation⁷¹ of the U.S. corporation into the new foreign parent of the group.

⁶⁷ Typically, these transactions are structured as reorganizations. See TREASURY REPORT, *supra* note 5, at 3.

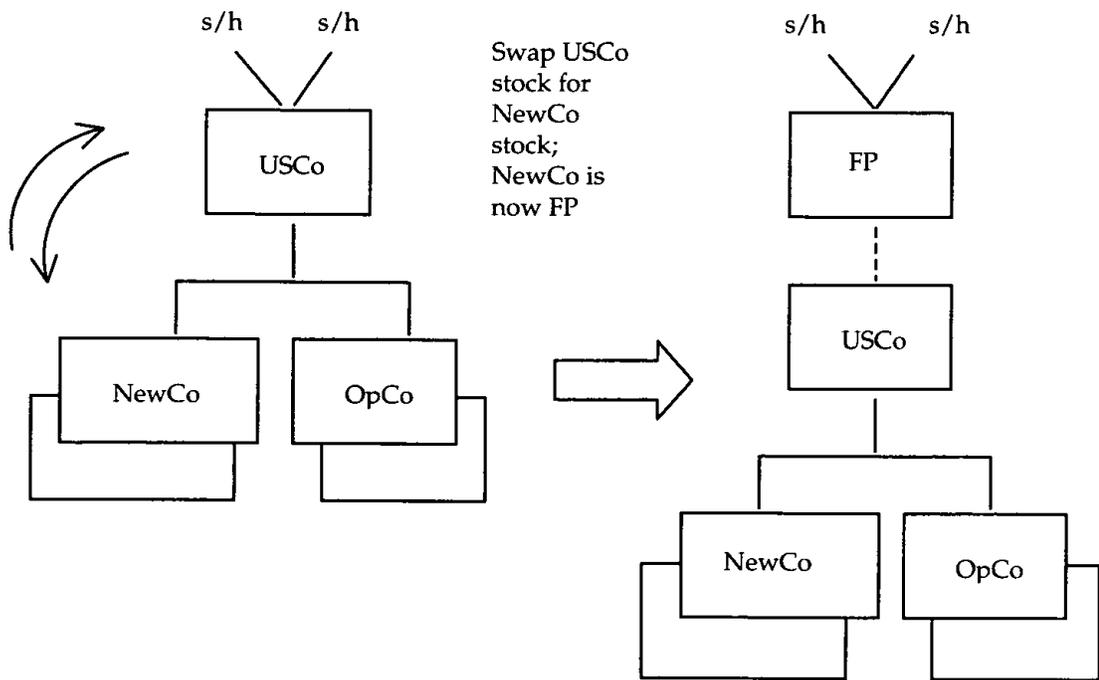
⁶⁸ Although steps one and two would be nontaxable transactions if they occurred in a domestic setting, they are taxable if they occur as cross-border transactions because of the potential loss of taxing jurisdiction over assets or entities. CHARLES H GUSTAFSON ET AL., TAXATION OF INTERNATIONAL TRANSACTIONS 744-45 (2d ed. 2001).

⁶⁹ Step one of the inversion transaction involves the exchange of U.S. corporation (“USCo”) shares for the shares of a newly-formed foreign corporation (“ForCo”) by the shareholders of USCo. Under the anti-inversion provisions of the Code, section 367(a) causes recognition of shareholder-level gain (i.e., taxation to the shareholders of USCo of the gain inherent in the USCo stock) in what would otherwise be a section 368(a)(1)(B) nonrecognition transaction, technically by denying “corporate” status to USCo. The resulting taxation of the inherent gain in the USCo shares is valued by the I.R.S. utilizing the market capitalization method by relying on the published value of USCo stock. I.R.C. §§ 367(a), 368 (a)(1)(B) (2000).

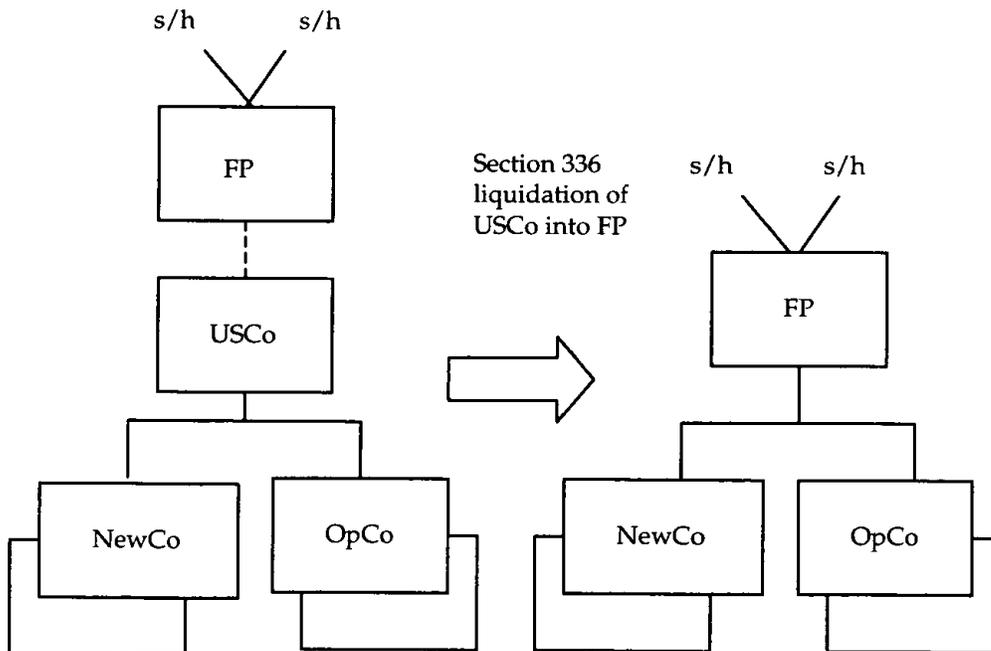
⁷⁰ More specifically, the CFCs owned by the former U.S. parent are vulnerable to the application of subpart F.

⁷¹ The section 336 liquidation of the stock of USCo into ForCo triggers corporate-level taxation of the gain inherent in USCo’s assets and, under section 331, the former shareholders of USCo (now the shareholders of ForCo) must recognize the difference between the value of USCo’s assets and their adjusted bases in the USCo stock. Again, the assets are valued utilizing the market capitalization method, grossed up for the section 336 tax. I.R.C. §§ 331, 336.

Flip Transaction Step One: Putting the Foreign Parent in Place



Flip Transaction Step Two: Protecting Existing Operations from Subpart F



As discussed above, U.S. multinational corporations engage in this strategic behavior to reduce worldwide taxation.⁷² Corporate managers often argue that a reduction in the worldwide effective tax rate of the group is necessary in order to maintain competitiveness. Because the empirical evidence gathered by the U.S. Treasury (the "Treasury") does appear to indicate that the U.S. rules with respect to foreign source income place U.S. multinationals at a competitive disadvantage, perhaps such a response is understandable. Basic notions of equity, however, require that an expatriating corporation pay over an appropriate amount of tax on the increase in value which has accrued within the U.S. taxing jurisdiction.

B. Corporate Expatriation: Crime and Punishment

Taxation of expatriating U.S. multinationals is a matter of fairness.⁷³ In economic terms, U.S. multinationals earned income while subject to the U.S. tax system, availing themselves of U.S. laws and the benefits of the U.S. legal system, such as protection of intellectual property rights and limited liability. Moreover, domestic multinationals benefited from the current U.S. tax system, specifically the deferred recognition of income under the principle timing doctrine of the Code — the realization doctrine. Under the realization doctrine, the mere appreciation of an asset, regardless of whether the asset is tangible or intangible, is not taxed until "realized" in a taxable event.⁷⁴ Academic literature generally agrees that the realization doctrine results in slowing the inclusion of income, so that income is often not taxed until well after it is accrued.⁷⁵ By contrast, the economic definition of income includes any net increases in the value of assets the taxpayer holds.⁷⁶

⁷² Expatriation also provides the opportunity to exploit differences in the treatment of equity investments and debt to reduce both U.S. and local-country tax. See ROBERT LIPSEY, HOME AND HOST COUNTRY EFFECTS OF FDI 2 (Nat'l Bureau of Econ. Research, Working Paper No. 9293, 2002).

⁷³ That is to say, the application of the U.S. tax rules at the date of expatriation is a matter of equity. My point is distinguishable, however, from suggestions by academics such as Reuven Avi-Yonah of the University of Michigan, who has proposed that the effect of corporate inversions be denied to U.S. multinationals and that the section 11 entity-level U.S. corporate tax be applied to corporations that are "managed and controlled" in the United States, notwithstanding their country of incorporation. See Avi-Yonah, *supra* note 5, at 1796.

⁷⁴ David Schizer, *Realization as Subsidy*, 73 N.Y.U. L. REV. 1549, 1551 (1998).

⁷⁵ Alan J. Auerbach, *Retrospective Capital Gains Taxation*, 81 AM. ECON. REV. 167 (1991).

⁷⁶ See Joseph Bankman, *A Market Value Based Corporate Income Tax*, 68 TAX NOTES 1347 (1995) (explaining economic definition of income). See generally Michael Knoll, *An Accretion Corporate Income Tax*, 49 STAN. L. REV. 1 (1996) (providing background on economic definition of income).

1. The Crime: Why "Flips" Are Taxed

The realization doctrine exists largely to address valuation problems and liquidity concerns.⁷⁷ These concerns, however, do not apply as strongly to corporations undergoing corporate inversions.⁷⁸ The deferral afforded by the realization doctrine is justified where appreciation will ultimately be subject to U.S. taxation on the later sale or exchange of the corporation's assets. Immediate taxation, however, is required when an expatriating corporation is leaving a jurisdiction where it earned income on which it has not yet paid tax.⁷⁹

Moreover, very likely the expatriating corporation has been able to deduct the costs of increasing the value of its business.⁸⁰ If the corporation expatriates, it becomes possible that the income attributable to any increase in the value of the assets of the corporation might never be taxed again. There is little reason why this income should not be taxed at the time of the expatriation.⁸¹

Under the prevailing "corporation as a nexus of contracts" theory,⁸² it is to some degree arbitrary where a multinational corporation is considered to be resident. The initial choice of country in which to incorporate may have

⁷⁷ Schizer, *supra* note 74, at 1594-95.

⁷⁸ Corporate and securities laws require corporations undergoing reorganizations to value the actual assets owned as well as all equity held by members of the group. See WILLIAM CARNEY, *MERGERS AND ACQUISITIONS* 406 (2000). Measuring changes in value is difficult for most assets without a transfer event to fix value. Without such a transfer event, appreciation does not provide liquidity with which to pay the tax.

⁷⁹ By contrast, if a U.S. firm inverts because it has a high basis relative to asset value (i.e., it will not incur a large tax penalty for inversion), there is no reason we should not allow the corporation to expatriate at a low cost. Because the corporation has paid all of the tax on the income it has earned while resident in the United States, there are no fairness concerns. Caesar has been paid, as it were. Any wealth generated by the corporation in the future for which the corporation does not pay U.S. tax will be generated by the corporation as a non-U.S. resident. Note also that, if the prospects for future profits are high, the stock price will also be high and thus the value of goodwill or going concern will be high. Therefore, this situation should only arise for a business whose prospects are normal to subnormal.

⁸⁰ For example, expenses such as deduct advertising, salaries, and other items that increase goodwill and going concern value are deductible under I.R.C. § 162.

⁸¹ For an argument supporting the application of accrual taxation to corporations, see Knoll, *supra* note 76, at 37. See also Bankman, *supra* note 76, at 1347-53 (proposing replacement of corporate income tax with market value tax, under which tax liability would be based on annual change in equity value of corporation, which would solve "perhaps the most intractable aspect of outbound investment... the determination of transfer prices between a domestic parent and foreign subsidiaries.").

⁸² For a discussion of the "corporation as nexus of contracts" theory, see ROBERT W. HAMILTON, *CASES AND MATERIALS ON CORPORATIONS - INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS* 10-14 (1988).

little connection with where a corporation eventually does business or where its shareholders reside.⁸³ However, if a corporation can “earn” income — or, more properly, accrue gain — while under the tax regime of one country, but is not forced to recognize that income because taxation of the income is allowed to be deferred, it is unfair to allow the corporation to leave the taxing jurisdiction of its “home country” without realizing and recognizing this income.

2. The Punishment: The I.R.C. Anti-Inversion Provisions

Transfers of assets by persons (both individuals and corporations) to a corporation that is controlled by the transferors in exchange for shares of the receiving corporation are generally non-taxable.⁸⁴ Such transfers are not viewed as an appropriate time for taxation because, in a real sense, the taxpayers have not parted with the assets.⁸⁵ They still own the corporation which in turn owns the assets.

On the other hand, the transfer of assets from a U.S. entity to a foreign corporation controlled by the U.S. entity carries with it significant potential for abuse of the tax system. Because the foreign corporation is not subject to U.S. tax rules, the U.S. entity could earn income through the foreign corporation without paying U.S. tax on the income. For example, assume that a U.S. taxpayer owns an asset which he wishes to sell. If the U.S. person were allowed to transfer the asset to a foreign corporation in a tax-free transaction, and the foreign corporation were to sell the asset, neither the transferor nor the foreign corporation would pay U.S. tax on the sale.⁸⁶ The U.S. person would not pay tax on this gain until the income was repatriated or the shares in the foreign corporation were sold. This deferral would significantly reduce the tax burden on the sale.⁸⁷

a. Section 367(a)

In response to this problem, section 367(a) of the Internal Revenue Code prevents the application of provisions that would otherwise defer gains on transfers to related foreign corporations. If shares of stock of a domestic corporation are transferred to a foreign corporation, any inherent gain will

⁸³ I.R.C. § 7701(a) (2000).

⁸⁴ *Id.* § 351.

⁸⁵ BITTKER & EUSTICE, *supra* note 37, ¶ 3.01.

⁸⁶ The foreign corporation is not subject to U.S. tax and the sale proceeds might not be subpart F income.

⁸⁷ A deferred tax has a significantly lower present value. See MYRON SCHOLES ET AL., TAXES AND BUSINESS STRATEGY 22-25 (2000).

be recognized unless the taxpayer complies with very specific regulations.⁸⁸ To facilitate transfers that occur for legitimate business reasons, Treasury Regulations permit a number of transfers to remain tax free, as long as some fairly stringent conditions are met. In particular, the taxpayer must often enter into a gain recognition agreement, under which the shareholder agrees to recognize any gain deferred in the original transfer on a later disposition of the assets acquired in the transaction.⁸⁹ In order to understand the purpose and structure of the section 367(a) "toll charge," it is helpful to consider the transaction that prompted the legislation.⁹⁰

b. Helen of Troy and Its Aftermath

In 1994, a U.S. publicly-traded corporation, Helen of Troy, caught the attention of both the financial community and the Treasury when it announced that it was going to become a Bahamas corporation.⁹¹ The Internal Revenue Service (the "I.R.S.") and the Treasury were concerned, not only because the transaction had the potential to create a structure specifically to avoid subpart F⁹² but because, by relocating to a tax haven, there was a chance that the corporation would pay *no* tax on some of the

⁸⁸ BITTKER & EUSTICE, *supra* note 37, ¶ 15.80.

⁸⁹ Treas. Reg. § 1.367-3(a)(3)(iii) (2003).

⁹⁰ Hal Hicks, *Section 367: Overview, Background, and Selected Issues and Problems*, 32 TAX. MGM'T INT'L J. 179, 187 (2003).

⁹¹ According to Philip Tretiak, former I.R.S. Office of Chief Counsel (International), and author of the section 367(a) regulations, the Helen of Troy expatriation first came to the attention of the I.R.S. and the Treasury as the subject of an article in the Wall Street Journal. Because inversion transactions, like any corporate reorganization, require a filing with the SEC regarding the details of the transaction, Tretiak and his colleagues immediately obtained a copy of the prospectus regarding the inversion transaction. Tretiak has since joked that it was very helpful that, on the first or second page of what might otherwise have been a long and cumbersome document to review, Helen of Troy stated that there was no reason for the transaction other than tax avoidance. Benjamin G. Wells & Philip L. Tretiak, Address at the American Bar Association Corporate Tax Committee Meeting (May 1, 1999) (recording no. ABA-9123, available from Section of Taxation, American Bar Association, at 662-8670 (2002)) [hereinafter Wells & Tretiak, Address]; see also Benjamin G. Wells & Philip Tretiak, *The Impact of Section 367 on Outbound Transactions*, 549 PLI/Tax 733, 744-45, 750 (2002) [hereinafter Wells & Tretiak, *Outbound Transactions*] (publication based on Wells-Tretiak speech, available from Practising Law Institute, Order No. J0-005N).

⁹² In what has since been called a "Helen of Troy transaction," shares of the U.S. parent corporation are exchanged for shares of a Bermuda holding company, and the U.S. parent becomes a wholly-owned subsidiary of the Bermuda corporation. At the time, the I.R.S. anticipated that the reorganization would be followed by a taxable spin-off to separate some of the controlled foreign operations from the U.S. tax net. Wells & Tretiak, *Outbound Transactions*, *supra* note 91. Although the spin-off itself might be taxable under section 311, the future operations of the subsidiaries, that would no longer be 10% owned by U.S. shareholders but rather by a Bermuda corporation, could escape U.S. tax and possibly any tax anywhere in the world. *Id.*

activities of the group.⁹³ In addition, and perhaps most importantly, the transaction was structured so that neither the shareholders nor the corporation would have to recognize the gain inherent in the assets transferred outside the U.S. tax net. In fact, neither Helen of Troy nor its shareholders paid any tax price for the expatriation.⁹⁴

Thinking that this type of transaction could significantly harm federal revenues, especially if major domestic corporations such as General Motors or Chrysler ever considered going offshore,⁹⁵ the Treasury adopted the position that these inversion transactions should be treated as taxable sales, not only to the inverting corporation, but to the shareholders themselves. The I.R.S. issued Notice 94-46, which stated that regulations would be issued to the effect that, if U.S. transferring shareholders as a group received back at least 50% of the value of the new foreign parent corporation, such a transaction would be considered a taxable sale of stock in the U.S. corporation.⁹⁶ The Treasury followed up with temporary regulations in 1995, adding the requirement that the foreign acquiring corporation had to have been engaged in a "substantial" *active* business prior to the inversion. With this requirement, the Treasury was obviously attempting to preclude the purchase of a domestic corporation by a "shell" corporation located in a tax haven.⁹⁷ In 1996, final regulations were issued which included these provisions. The final regulations refined the notion of a "substantial" acquiring business by adding the requirement that, for the transaction to be deemed a tax-free reorganization, the foreign acquirer had to be at least equal in value to the U.S. target corporation at the closing date.⁹⁸

⁹³ *Id.* They were concerned with earnings stripping, as discussed in the TREASURY REPORT, *supra* note 5, at 15.

⁹⁴ Wells & Tretiak, *Outbound Transactions*, *supra* note 91.

⁹⁵ Notwithstanding the expressed preferences of the U.S. taxing authority, the Daimler-Chrysler merger occurred in 1997. Even though the overall parent corporation of the group is a foreign corporation, because Chrysler owned a significant number of subsidiaries before the merger, these subsidiaries remain subject to subpart F. Ken Brewer, *Treason? Or Survival of the Fittest? Dealing with Corporate Expatriation*, 95 TAX NOTES 603 (2002).

⁹⁶ Wells & Tretiak, *Outbound Transactions*, *supra* note 91.

⁹⁷ Treas. Reg. § 1.367(a)-3T (2003).

⁹⁸ *Id.* This requirement served to preclude what is sometimes called "minnows swallowing whales," where what is in truth the acquired corporation purchases the acquiring corporation, because the acquired corporation has desirable property that would have been extinguished had the property holder not survived the transaction. BITTKER & EUSTICE, *supra* note 37, ¶ 14.02. If the target purchases what would otherwise have been the acquiring corporation, the net operating losses of the target can be used to offset operating income of the acquirer. If the corporate entity survives, so do the net operating losses. Absent sections 367 and 382, these "minnows swallow whales" transactions would

c. The Price of Expatriation

The effect of these regulations is to place a high tax cost on expatriation. Under the final regulations, the price of escaping the U.S. tax jurisdiction is taxation of the built-in gain in the assets of the former U.S. parent corporation,⁹⁹ plus the appreciation in the shares of the former U.S. parent corporation itself. It is important to understand exactly how the tax cost arises. In step one of an inversion transaction,¹⁰⁰ the shareholders of the original U.S. parent of the multinational group exchange stock in the parent for stock of a foreign corporation, usually newly formed in a tax haven jurisdiction. This exchange results in the former direct shareholders of the U.S. parent becoming direct shareholders of a foreign corporation that, in turn, becomes the new foreign parent of the group. Section 367(a) will apply to cause recognition of shareholder-level gain in what would otherwise be a section 368(a)(1)(B) nonrecognition transaction¹⁰¹ in a purely domestic context, technically by denying "corporate" status to the former U.S. parent.

Step one alone, however, will not achieve the desired result. In order to completely avoid the application of subpart F to both current and future foreign operations, the former U.S. parent corporation must be removed from the group.¹⁰² Thus, in step two of the transaction, the

occur in order to preserve key tax attributes in the corporate solution of the smaller company. *Id.* For example, the use of net operating losses in a target corporation post-acquisition is severely limited by section 382. *Id.* ¶ 14.02. However, the policy behind the substantiality requirement in the section 367 regulations has nothing to do with fish. Treas. Reg. § 1.367(a)-3, which is called colloquially the "50%" requirement, is intended to preclude the "stuffing" of a group into a tax haven. *Id.* ¶ 15.81.

⁹⁹ The built-in gain in the assets of the former U.S. parent corporation is calculated in the form of a deemed section 338 asset sale as the (i) value of the stock plus (ii) the liabilities of the corporation (debt, trade, creditors, judgments).

¹⁰⁰ See discussion *infra* Part II.B.3.

¹⁰¹ Absent section 367(a), this exchange of U.S. parent stock for foreign corporation stock would come within the meaning of a section 368(a)(1)(B) nonrecognition transaction. Such a stock-for-stock exchange is typically not considered a taxable event because, although the two parties are exchanging shares, they each have a continuing interest in the same assets they held prior to the exchange. This notion of continuity of interest is the rationale for many of the nonrecognition provisions in the Code. See *Cortland Specialty Co. v. Comm'r*, 60 F.2d 937 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1932).

¹⁰² New capital investments by the foreign parent directly into new or existing foreign operations will be shielded from the application of subpart F. I.R.C. § 951 (2000). Income which accrues to existing capital investment, by contrast, will be subject to subpart F unless the subsidiaries are transferred from the former U.S. parent to the new foreign parent. These subsidiaries could be removed from the U.S. chain via taxable section 311 / section 355 spin-offs. Owned directly by FP, the earnings of these foreign subsidiaries would not be subject to U.S. tax. Alternatively, corporations can do a "freeze," whereby the former

former U.S. parent is liquidated into the new foreign parent. Absent the anti-inversion regulations, step two would be a tax-free liquidation under section 336.¹⁰³ However, under section 367(a), the liquidation of the former U.S. parent causes immediate taxation of any gain inherent in the foreign subsidiaries of the former U.S. parent. Remember, inversions occur in order to shelter the foreign operations of U.S. multinationals from the application of subpart F, which would cause current inclusion of foreign income and, potentially, double taxation. In addition to the recognition of gain by the liquidating U.S. corporation, the new foreign parent must also recognize the difference between the fair market value of assets it receives in the liquidation and its adjusted basis¹⁰⁴ in its stock of the former U.S. parent.¹⁰⁵ Because the new foreign parent's basis in the U.S. corporation is established in step one, the value of the U.S. corporation shares and the foreign parent's basis in those shares will usually be equal.¹⁰⁶

d. Does the Punishment Fit the Crime?

In summary, for a U.S. corporation to leave the U.S. tax system by way of a corporate inversion, the corporation *and its shareholders* have to recognize all the gain which has been deferred by the U.S. tax system at the time of the inversion. Although, as described in Part II.A.4.a, there is ample justification for the taxation of built-in gains accrued in the domestic corporation while operating in the United States,¹⁰⁷ note that the

U.S. parent exchanges its voting stock in its foreign subsidiaries for preferred shares that are limited as to value and dividends, followed by the foreign subsidiaries issuing new common shares to the new foreign parent. Going forward, the foreign subsidiaries would still be controlled foreign corporations for purposes of subpart F, but the amount of subpart F income that would be included currently in U.S. income would be that amount attributable to the preferred shares, which will decline in value over time. Importantly, however, neither of these alternatives removes existing operations from the application of subpart F.

¹⁰³ Normally, the liquidation of a subsidiary into an 80% or greater parent corporation is a tax-free transaction, on the theory that economic control has not been altered. I.R.C. §§ 332, 336.

¹⁰⁴ *Id.* § 1012.

¹⁰⁵ USCo's assets will be valued using the market capitalization method, discussed *supra* note 71, grossed-up for the section 336 tax. The built-in gain in the assets of USCo is calculated in the form of a deemed section 338 asset sale as the value of the stock *plus* the liabilities of the corporation (debt, trade, creditors, judgments).

¹⁰⁶ When gain is recognized in the first transaction, the basis in the shares is increased to the fair market value. I.R.C. §§ 1011-1012.

¹⁰⁷ Note, however, that the corporation will have to recognize gain earned on the assets that are used exclusively in the United States, even though there is no possible improvement in the taxation of these assets from expatriation.

shareholders are also taxed on their built-in gains. One can argue in favor of this layer of tax on shareholders because it is not clear that their gains will ever be taxed, by reason of the step-up in basis at death¹⁰⁸ or the application of other non-recognition transactions. Moreover, should the corporation expatriate, there is a concern that the corporation might fail to report to the I.R.S. the amount of dividends paid to U.S. residents. It is possible that this is the last time the I.R.S. will be able to assess tax on these U.S. shareholders.

Of course, the identity of the shareholders can greatly affect the importance of this second tax on the shareholders. Some companies have expatriated and allowed their shareholders to be taxed, knowing that they would not care because they were largely either tax-exempt entities or managed on a pre-tax basis.¹⁰⁹ For example, Triton Energy inverted in 1996, giving its U.S. shareholders an option to keep a share in the U.S. subsidiary rather than being taxed on the inversion transaction.¹¹⁰ Triton, however, announced that it would only offer this "share retention" option if enough shareholders felt strongly about the taxability of the transaction.¹¹¹ As it happened, more than 85% of the shares went voluntarily in a taxable exchange, and the share retention option was dropped.¹¹² Because the Triton Energy share base was largely composed of tax-exempt entities, the shareholders were not overly concerned with the tax consequences of the transaction. By contrast, if the stock in an inverting company is closely held by individual shareholders, to whom the inversion will trigger large amounts of gain, the shareholders would probably not approve of an inversion.¹¹³ However, there does not appear to be a statistically significant relationship between tax-exempt ownership and most expatriations.¹¹⁴

One other factor for consideration regarding both the accuracy of the taxation of built-in gain and the efficacy of the tax to deter expatriation activity, is the measurement of that gain. One might ask whether the market capitalization of an expatriating corporation accurately captures value. Equity is comprised of more than just stock; options are a form of

¹⁰⁸ I.R.C. § 1014.

¹⁰⁹ BRYAN CLOYD, ET AL., FIRM VALUATION EFFECTS OF THE EXPATRIATION OF U.S. CORPORATIONS TO TAX HAVEN COUNTRIES, 22-23 (Ctr. for Int'l Bus. Educ., Working Paper No. 01-102, 2002) (on file with U.C. Davis Law Review).

¹¹⁰ *Id.* at 20-26.

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ DESAI & HINES, *supra* note 2, at 23.

equity.¹¹⁵ A more accurate measure of value might be achieved by including the value of non-traded securities such as stock options issued to corporate management.¹¹⁶ A portion of the built-in gain in an expatriating corporation is reflected in changes in value of options held by corporate managers.¹¹⁷ Corporate managers, as option-holders, should be responsible for that portion of the tax cost of expatriation associated with the change in value of the corporation captured in their employee stock options. Moreover, given that accuracy and concerns for fairness support the taxation of options held by corporate managers, such taxation might force corporate managers to make decisions which are more likely to improve shareholder value, since they themselves would share in the tax cost of expatriation. In summary, if the value represented by options is excluded, the tax rules are effectively operating to encourage inversions. Conversely, taxing the value of options would operate to improve the incentives of those managers making the inversion decision.

C. The Anomaly

The toll charge imposed by section 367(a) should be sufficient to prevent these expatriations from occurring in all but the rarest of circumstances. Given the immediate recognition of gain that would otherwise be deferred, and the fact that the price of the expatriation is almost certainly going to exceed the tax savings from the expatriation of the operating companies,¹¹⁸ why do corporations expatriate? This section explores the explanations of the phenomena so far discussed in the academic literature. This section shows that the purported explanations for inversions are not consistent with the empirical data, which was sometimes gathered by the proponents of the explanations themselves.¹¹⁹ Other commentators offer no

¹¹⁵ KENNETH M. MORRIS & ALAN M. SIEGEL, *THE WALL STREET GUIDE TO UNDERSTANDING MONEY AND INVESTING* 124 (1993); Knoll, *supra* note 76, at 8.

¹¹⁶ Knoll, *supra* note 76, at 21-22.

¹¹⁷ *Id.* at 21 (explaining that corporate managers commonly receive compensation in form of options on employer's stock); see MYRON S. SHOLES & MARK A. WOLFSON, *TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH* 200 (2000).

¹¹⁸ CLOYD ET AL., *supra* note 109, at 22-23; Wells & Tretiak, *Outbound Transactions*, *supra* note 91.

¹¹⁹ The data from the Desai-Hines study precludes the accuracy of their explanation that savings from avoidance of the U.S. interest expense allocation rules, as explained *infra* Part II.C.2.b.i. To summarize, Desai and Hines argue that U.S. multinationals expatriate in order to avoid the application of the interest expense allocation rules. DESAI & HINES, *supra* note 2, at 7-8. However, these rules operate as a limitation on the foreign tax credit, which would not matter to an excess limitation taxpayer. Since Desai and Hines find that most

explanation for the rise in inversion activity but predict that inversions will subside.¹²⁰

1. The Efficient Market Hypothesis and Current Tax Rules

Under the standard neoclassical model of behavior, all economic actors act to maximize their utility in a rational manner.¹²¹ Therefore, individuals will attempt to maximize their profit on their investments. Most models assume that individuals care about two things in connection with their investments: the expected return and the variance or risk of that return.¹²² Based on these assumptions, economists have created models of how individuals interact collectively to create a market.

a. The Efficient Market Hypothesis

The most prominent of the neoclassical models of market behavior is the efficient market hypothesis.¹²³ The basic idea behind the efficient market hypothesis is that individuals trading collectively create a market which is able to aggregate information, such that the prices derived by the market for traded assets are more efficient than any one market participant could derive.¹²⁴ An efficient market is therefore one where stock prices always incorporate information about fundamental values and, conversely, where prices change only because of such information.¹²⁵ Moreover, the efficient market hypothesis holds that real-world financial markets, such as the U.S. securities markets, actually are efficient.¹²⁶ The rationale for the efficient market hypothesis is threefold: (i) investors are rational, (ii) to the extent that investors are not rational, their trades will cancel each other out, and (iii) to the extent that

inversions are effectuated by excess limitation taxpayers, their explanation is inconsistent with their empirical findings. *Id.* at 3, tbl.4.

¹²⁰ CLOYD ET AL., *supra* note 109, at 22-23.

¹²¹ See DAVID FRIEDMAN, PRICE THEORY 2-5 (1996).

¹²² BREALEY & MYERS, *supra* note 9, at 160-62.

¹²³ See generally Eugene Fama, *Market Efficiency, Long-Term Returns, and Behavioral Finance*, 49 J. FIN. ECON. 283 (1998).

¹²⁴ See generally Dhananjay Gode & Shyam Sunder, *What Makes Markets Allocationally Efficient*, 112 Q.J. ECON. 603, 604, 622-25 (1997) (demonstrating that market rules can aggregate individual preferences to bring efficiency close to 100%, even when human traders are replaced with Zero Intelligence traders).

¹²⁵ SHLEIFER, *supra* note 13, at 2-5. See generally Robert J. Shiller, *From Efficient Markets Theory to Behavioral Finance*, No. 1385 Cowles Foundation Discussion Papers, Yale University (Oct. 14, 2002).

¹²⁶ See generally BURTON MALKIEL, A RANDOM WALK DOWN WALL STREET (1973).

investors are irrational in similar ways that create asymmetries between price and fundamental value, rational arbitrageurs in the market will take offsetting positions to arbitrage the price to its correct level.¹²⁷

Mispricing phenomena, where prices do *not* reflect fundamental value, are referred to as stock market anomalies.¹²⁸ Notwithstanding the predictions of the efficient market hypothesis, these anomalies have been shown to exist in the short to mid-term and, in some cases, for years.¹²⁹

¹²⁷ SHLEIFER, *supra* note 13, at 2.

¹²⁸ According to the efficient market hypothesis, market participants are rational and the price of securities should equal their fundamental value. Nicholas Barberis & Richard Thaler, *A Survey of Behavioral Finance*, in HANDBOOK OF THE ECONOMICS OF FINANCE 3 (published as Nat'l Bureau of Econ. Research, Working Paper No. 9222, 2002). Fundamental value means "true" value, equivalent to the present value of all future cash flows that a market participant expects to earn on an investment asset. BREALEY & MYERS, *supra* note 9, at 15-17.

¹²⁹ ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 191-200 (2000) (explaining how long it takes investors to learn how to incorporate information into market price); Werner De Bondt & Richard Thaler, *Does the Stock Market Overreact?*, in ADVANCES IN BEHAVIORAL FINANCE 249 (Richard Thaler ed., 1992) (showing that pricing anomalies regularly exist for at least 36 months). Consider two examples of asymmetries between price and fundamental value that have continued for years ("persistent mispricing"). The most famous example of persistent mispricing is that of the "twin shares" phenomenon. K.A. Froot & E. Dabora, *How Are Stock Prices Affected By the Location of Trade*, 53 J. FIN. ECON. 189, 213-14 (1999); L. Rosenthal & C. Young, *The Seemingly Anomalous Price Behavior of Royal Dutch Shell and Unilever NV/PLC*, 26 J. FIN. ECON. 123, 141 (1990) (documenting consistent mispricing of Royal Dutch and Shell on both London and New York exchanges). Royal Dutch Petroleum and Shell Transport are independently incorporated in the Netherlands and England, respectively. SHLEIFER, *supra* note 13, at 29. The current structure emerged from a 1907 alliance between Royal Dutch and Shell Transport in which the two companies agreed to merge their interests on a 60:40 basis while remaining separate and distinct entities. *Id.* at 29-30; Richard Thaler, *The End of Behavioral Finance*, 55 FIN. ANALYSTS' J. 12, 12-13 (Nov.-Dec., 1999). Although Royal Dutch and Shell trade on a total of nine exchanges in the United States and Europe, Royal Dutch trades primarily in the United States and in the Netherlands, while Shell trades primarily in London. Thaler, *supra* at 13. According to any rational model of behavior, the shares of Royal Dutch and Shell, making adjustments for foreign currency exchange, should trade in a 60:40 ratio. *Id.* They do not; in fact, the actual price ratio has deviated from parity by more than 35% for at least fifteen years, with Royal Dutch exhibiting relative underpricing by 35% to relative overpricing by 10%. SHLEIFER, *supra* note 13, at 30. Moreover, simple explanations, such as taxes and transaction costs, cannot explain the disparity. *Id.* at 30-31.

Another example of persistent mispricing is the phenomenon of abnormal returns that accompany the inclusion of a stock in the S&P 500. Index inclusion should not trigger an increase in price because it does not represent any change in fundamental value. Barberis & Thaler, *supra* note 128, at 10. The S&P selects stocks for inclusion that merely represent a cross section of the U.S. economy, not to convey information about a particular company. *Id.* Nonetheless, stock prices typically jump 3.5% on inclusion, and the increase is usually permanent. Jeffrey Wurgler & Ekaterina V. Zhuravskaya, *Does Arbitrage Flatten Demand Curves for Stocks?*, 75 J. BUS. 583, 585 (2002) (studying 236 stocks that were added to S&P 500 between 1976 and 1996 that were not subject of any contemporaneously-reported news and finding average share price increases of 3%). The price of Yahoo actually jumped

In response to these real-world pricing problems, the efficient market hypothesis has been restated in various weaker formulations.

There are three major forms of the efficient market hypothesis: the strong, semi-strong, and weak forms.¹³⁰ The strong form of the efficient market hypothesis holds that prices incorporate all information, both public and non-public. Few commentators believe in the strong form of the efficient market hypothesis.¹³¹

According to the semi-strong form of the efficient market hypothesis, asset prices incorporate all *available* information at any given time.¹³² However, prices may not reflect information available exclusively to non-market participants such as insiders.

Finally, the weak form of the efficient market hypothesis holds that although not all information is incorporated into prices, it is not possible to derive profits from the inefficient prices that exist.¹³³ This weak form holds that because of risks, information asymmetries, and the like, full and complete arbitrage is impossible. Therefore, the prices in the market may be inaccurate. The inaccuracies, however, are not large enough for someone to consistently make a profit merely by betting against the market.¹³⁴

According to the strong and semi-strong versions of the efficient market hypothesis, at any given time, the stock price of a corporation reflects all available information about the corporation.¹³⁵ Even under the weak form,

24% the day that it was added to the S&P 500. Barberis & Thaler, *supra* note 128, at 10. Like the twin-share phenomenon, this evidence challenges the efficient market hypothesis, which holds that prices react to information and not to non-information. SHLEIFER, *supra* note 13, at 22-23.

For an examination of how bubbles and crashes can persist even with the presence of rational market arbitrageurs, see Dilip Abreu & Markus Brunnermeier, *Bubbles and Crashes*, 71 *ECONOMETRICA* 173, 174-78, 204-205 (2003) (concluding that "large and long-lasting bubbles can persist even though all rational arbitrageurs know that the price is too high and they jointly have the ability to correct the mispricing"). According to Abreu and Brunnermeier, these bubbles and crashes can persist because of the inability of arbitrageurs to coordinate their activity and their desire to time the market. *Id.* at 205 (attributing length of bubble to differences of opinion regarding timing of mispricing).

¹³⁰ BREALEY & MYERS, *supra* note 9, at 357-58.

¹³¹ Fama, *supra* note 123, at 130 (stating that market efficiency is "a faulty description of price information").

¹³² *Id.*

¹³³ *Id.* at 288.

¹³⁴ BREALEY & MYERS, *supra* note 9, at 358.

¹³⁵ *Id.* at 357. A paradigm of corporate finance for more than forty years, the efficient market hypothesis ("EMH") holds that, at any given time, the stock price of a corporation reflects all relevant information about the corporation. The semi-strong form of the hypothesis assumes that price only incorporates public information. The strong form of the EMH, which no longer has much support in the literature, would assume that all

the price is close enough to the correct price that it is not possible to make a profit by betting against such prices. The ability of capital markets to adjust price to reflect even publicly-available information is dependent on effective arbitrage.¹³⁶ Notice that the efficient market hypothesis does not assume that all investors are rational and knowledgeable. Even if a substantial portion of market traders are irrational,¹³⁷ arbitrageurs should not be subject to the psychological biases described in modern financial theory as noise trading.¹³⁸ When market price diverges from economic value, arbitrageurs should take the opposite trading position from that of "unsophisticated demand" to bring price back to fundamental value.¹³⁹ When arbitrage activity does not drive market price back to fundamental value, an asymmetry between price and value can persist for at least the short and possibly the mid-term.

A possible fourth version of the efficient market hypothesis, which we might call a "semi-permeable" form of the hypothesis, would hold that, although in general it is not possible to generate infra-marginal returns by betting against the market, particular agents may be able to "beat" the market in a particular circumstance due to their market position and the general incompleteness of markets. This ability may arise not only because of information asymmetries, but also because of a market position that allows the agent to arbitrage an inefficiency that other agents are not in a position to accomplish. These opportunities might arise because of the incompleteness of markets.¹⁴⁰ This Article argues, for example, that the market may still exhibit this form of efficiency, and still allow corporate managers to take advantage of their market position to exploit the pricing inefficiencies that result in the corporation's shares being under priced relative to fundamental value for the short to mid-term. In effect, one can

information - public and nonpublic - is reflected in stock price.

¹³⁶ SHLEIFER, *supra* note 13, at 13.

¹³⁷ Barberis & Thaler, *supra* note 128, at 10 (arguing that market participants do not always act rationally to arbitrage market price to correct level due to limits to arbitrage and investor psychology); Lynn A. Stout, *Corporate Finance: How Efficient Markets Undervalue Stocks: CAPM and ECMH Under Conditions of Uncertainty and Disagreement*, 19 CARDOZO L. REV. 475, 478 (1997).

¹³⁸ See generally Fischer Black, *Noise*, 41 J. FIN. 529, 529-34 (1986); J. Bradford De Long et al., *Noise Trader Risk in Financial Markets*, 98 J. POL. ECON. 703, 703 (1990) (distinguishing noise traders from "rational arbitrageurs"); J. Bradford De Long et al., *The Size and Incidence of the Losses from Noise Trading*, 44 J. FIN. 681, 694-95 (1989); Andrei Shleifer & Lawrence Summers, *The Noise Trader Approach to Finance*, 4 J. ECON. PERSP. 19, 20 (1990) (defining arbitrage as "trading by fully rational investors not subject to such sentiment").

¹³⁹ SHLEIFER, *supra* note 13, at 13.

¹⁴⁰ As discussed earlier, one of the limits to arbitrage is the incompleteness of markets for risk and return. Barberis & Thaler, *supra* note 128, at 10.

view the actions of corporate managers as attempts to arbitrage the inefficiencies in the price of the shares of the companies that they manage.

b. Application of the Efficient Market Hypothesis to the Section 367
"Toll Charge"

The tax rules implicitly assume the validity of some form of the efficient market hypothesis. The valuation of shares of publicly-traded corporations for tax purposes is based on the market price per share of those corporations, multiplied by the number of shares outstanding (the "market capitalization").¹⁴¹ In order for this calculation to yield a fair amount of tax, the price of the shares must be "correct."

If the market price per share of a publicly-traded corporation accurately reflects all available information, basing the "toll charge" on the market capitalization for the corporation less the corporation's basis in the transferred assets should accurately reflect the amount of the unrealized gain. Therefore, if the efficient market hypothesis is correct, the section 367(a) "toll charge" should be adequate to police corporate inversions.

Commentators have argued that, as would be the case with respect to any strategic business decision, the primary concern of corporate managers regarding an expatriation decision is the maximization of shareholder wealth.¹⁴² This view is consistent with the model of corporate behavior which was widely accepted prior to the economic analysis of law which began at the University of Chicago in the late 1930s.¹⁴³ Since that time, however, the law and economics literature has addressed the agency problems inherent in the divergent interests of corporate managers and shareholders.¹⁴⁴ Specifically, although

¹⁴¹ Eran Kahana, *Intellectual Property in an Information Economy: Protecting Intellectual Capital in Start-Ups*, 28 WM. MITCHELL L. REV. 1187, 1195-96 (2002).

¹⁴² DESAI & HINES, *supra* note 2, at 22 (concluding from empirical analysis of stock price reactions to inversion announcements that corporate managers, acting to maximize shareholder wealth rather than share price, consider tax liability to shareholders in making decision whether or not to expatriate). See generally Avi-Yonah, *supra* note 5, at 1795.

¹⁴³ Under the traditional view of corporate governance, because shareholders own the corporation, directors have a fiduciary duty to maximize shareholder wealth. Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409, 1410-12 (1993). Under this "shareholder primacy" theory, shareholders own the corporation and corporate managers are merely stewards of the shareholders' interests. STEPHEN BAINBRIDGE, *THE BOARD OF DIRECTORS AS NEXUS OF CONTRACTS: A CRITIQUE OF GULATI, KLEIN & ZOLT'S 'CONNECTED CONTRACTS' MODEL* (UCLA Working Paper No. 02-05, 2002).

¹⁴⁴ The law and economics literature is generally viewed as having begun with Ronald Coase's seminal work, *The Nature of the Firm*, 4 ECONOMICA 386 (1937). See generally

shareholders own the firm, they have virtually no power to control either its day-to-day operations or its long-term policies.¹⁴⁵ Instead, the firm is controlled by corporate managers,¹⁴⁶ whose equity stake is often small. This separation of ownership and control means that the decisions of corporate managers may be influenced primarily by the firm's compensation structure for management, which may be tied to share price, net profits, or other indicators of performance. Management's decisions with respect to the strategic behavior of the firm may or may not encourage transactions which increase shareholder value. Managers may engage in inversion transactions to reduce the effective tax rate of the firm which would, in turn, increase profits and the return to shareholders. Alternatively, managers may be prompted to expatriate the corporation in order to increase profitability — and their own compensation — at the expense of the shareholders who must bear the tax cost of the transaction.¹⁴⁷ Empirical evidence does show that highly-

STEPHEN BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* (2002); RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* (4th ed. 1992). The dominant model for corporations in current legal scholarship views the firm as a nexus of contracts and rejects the idea of ownership as irrelevant. BAINBRIDGE, *supra* at 26-38.

¹⁴⁵ BAINBRIDGE, *supra* note 144, at 37.

¹⁴⁶ The term "corporate managers" is used in this Article to denote both the firm's board of directors and subordinate managers.

¹⁴⁷ In truth, U.S. shareholders typically bear the tax cost of an inversion alone. N.Y. ST. BAR ASS'N, *Report on Outbound Inversion Transactions*, TAX SEC. Rep. 1014 (May 24, 2002). U.S. international tax planners are able to structure an inversion transaction to avoid the section 367(a) tax penalty to the corporation on liquidation of the U.S. parent via the relatively straightforward use of U.S. tax attributes or, alternatively, by employing planning techniques such as "freezes."

The least costly method for avoiding the application of the penalty to the corporation is where there is not much gain inherent in the assets of the corporation, or where the former U.S. parent has a net operating loss that can offset the tax cost of the transaction. Alternatively, the former U.S. parent can use foreign tax credits to offset the tax cost where the gain inherent in its foreign subsidiaries can be reclassified as a dividend under section 1248, to the extent of the section 1248 amount attributable to each foreign subsidiary. This dividend amount can be offset by section 902 credits. If the foreign subsidiaries have a lot of earnings and profits, have paid a lot of foreign tax, and the former U.S. parent does not have an overall foreign loss and can otherwise credit, the U.S. gain on the transfer of the foreign subsidiary shares might be fully offset by foreign tax credits.

If the application of tax attributes alone is insufficient to offset the inherent gain in the U.S. group, the U.S. corporation may engage in a transaction commonly referred to as a "freeze," whereby the former U.S. parent exchanges its voting stock in its foreign subsidiaries for preferred shares that are limited in value and/or dividends, followed by the foreign subsidiaries' issuing new common shares to the new foreign parent. Going forward, the foreign subsidiaries remain CFCs, but the only amount of subpart F income that is includable is that amount attributable to the preferred shares, which will decline in relative value over time.

leveraged firms are more likely to invert.¹⁴⁸ One might argue that this is an important clue to the inversion phenomenon, on the theory that highly-leveraged firms present less attractive takeover targets and managers are therefore comparatively free to engage in transactions that can compromise shareholder value.¹⁴⁹ In other words, corporate managers of firms that are highly-leveraged may be in a position to extract more of the surplus generated by the corporation's operations. It is not obvious, however, that the corporation's lower susceptibility to takeovers means that there is less supervision of the managers. If the debt-equity ratio is high, creditors may actually start to exercise more oversight of the operations of the corporation. Creditors may also be less likely to agree to measures such as expatriation unless they think it would improve the performance of the firm.

The advantages of inverting are (i) the avoidance of the subpart F rules, which subjects some foreign income to immediate taxation at a rate equal to the U.S. rate less the applicable tax rate of the country where the income was earned and, for income not subject to subpart F, and (ii) the ability to avoid the residual U.S. tax upon the repatriation of earnings that eventually must be paid. However, there is an anomaly, an incongruity, in the expatriation decision if the section 367(a) "toll charge"

There is another alternative for reducing the tax burden to the corporation in step two of the inversion transaction, although it yields a messy ownership structure. U.S. shareholders contribute the shares of the former U.S. parent to the new foreign parent in exchange for "Class A" voting stock, in a section 351 nonrecognition transaction. Next, the former U.S. parent contributes the stock of its foreign subsidiaries to the new foreign parent for "Class B" nonvoting stock, which should also qualify for section 351 nonrecognition. Both steps of the section 351 transaction avoid the application of section 367(a) if a gain recognition agreement is filed, although the second step — the contribution of the foreign subsidiaries to the new foreign parent — is subject to the application of section 367(b), which creates a section 1248 toll charge (which, as noted above, might be sheltered by foreign tax credits). Interview with Mark Hoose, Senior Tax Counsel, Occidental Petroleum Corp. (Feb. 19, 2003) (citing N.Y. ST. BAR ASS'N, *supra*); see also Hicks, *supra* note 90, at 187-88 (describing alternative means by which U.S. tax liability of former U.S. parent may be reduced).

Finally, there is a way, for certain taxpayers with a particularly suitable asset mix, by which the transaction can be structured so as to reduce the U.S. tax liability for the transaction at both the corporate and the shareholder level. See Hicks, *supra* note 90, at 188-89. This involves the additional step of forming a new domestic subsidiary which will receive some of the assets from the former U.S. parent on its liquidation. *Id.* at 189. A prudent allocation of assets between the new foreign parent and the new domestic subsidiary should minimize the U.S. tax liability for step two at both the corporate and shareholder levels. *Id.*

¹⁴⁸ DESAI & HINES, *supra* note 2, at 22.

¹⁴⁹ The author would like to offer particular thanks to Jeff Rachlinski for this point. Interview with Jeff Rachlinski, Professor of Law, Cornell Law School (Apr. 24, 2003).

accurately captures the market value of the corporation. The cost of repatriating — that is to say, current recognition for tax purposes of all the built-in gain in the corporation's assets, including going concern value and goodwill, both at the corporate and the shareholder level — will almost never be less than the potential tax savings associated with flipping.¹⁵⁰ The tax penalty for inversion is based on the value of the expatriating company's stock, with value based on the market capitalization¹⁵¹ of the corporation at the actual date of the inversion. Because value is calculated at the date of inversion, which is necessarily *after* the inversion announcement, the value should reflect any potential savings that the corporation will accrue from fleeing the U.S. taxing jurisdiction. Therefore, the tax penalty for inversion should preclude the transaction itself. It would not generally be rational to expatriate if the price to be paid was current taxation on inherent gain as well as future gain discounted into present value.¹⁵² Thus, the value of expatriation

¹⁵⁰ Another possible rational explanation for inversion would be that the group is facing a negative effective tax rate for its foreign operations. The negative effective tax rate could occur, for example, where a foreign government is subsidizing capital investments for development purposes. See ELIZABETH CHORVAT, EFFICIENCY AND JUSTICE: A NORMATIVE APPROACH TO TAX COMPETITION (University of Virginia Working Paper, 2003) (on file with author). Although this situation would only rarely occur, and would certainly never occur with respect to the entire group, it is conceivable that Bermuda, for example, might subsidize foreign direct investment to generate employment for its citizens which would, taken into account with the zero local corporate tax rate, create a negative effective tax rate for that entity. Moreover, when corporate managers estimate the cost of the inversion, they must account for the fact that some of the net present value of those earnings included in asset price will be subject to tax in the foreign jurisdiction. When eventually this income is realized, the taxes paid will reduce U.S. tax, due to the operation of the foreign tax credit. I.R.C. § 901(a) (2000). However, if the net present value is recognized today (because of the operation of section 367(a)), there will be no reduction and no foreign tax credit, because the earnings have not been realized and no foreign taxes have been paid.

¹⁵¹ Market capitalization, the I.R.S. method of choice for valuing public corporations, is the share price of the U.S. corporation, multiplied by the number of shares outstanding. BREALEY & MYERS, *supra* note 9, at 67-71. The "market cap" of a corporation should, under the efficient market hypothesis, equal the present value of all future earnings of the corporation, and should reflect all publicly available information. *Id.* at 62-67. In the case of an inverting corporation, the stock price should also reflect the present value of all future tax savings from inversion, because state and federal laws require complete public disclosure of the inversion plan. BAINBRIDGE, *supra* note 144, at 655-58.

¹⁵² Moreover, on a technical note, the tax cost should clearly exceed the tax savings from inversion because the tax, as applied to the market value of the inverting corporation, does not reflect a *credit* for the foreign taxes paid on future earnings, because the foreign tax credit is only available on foreign taxes already paid. BORIS I. BITTKER & LAWRENCE LOKKEN, FUNDAMENTALS OF INTERNATIONAL TAXATION ¶¶ 72.14.3 (2002).

At most, the discounted present value of future earnings could reflect a *deduction* for foreign taxes paid on future earnings, which, if the U.S. tax rate is anything other than 0%

equaling or exceeding the cost of escaping the U.S. tax net, assuming that stock price accurately reflects the fundamental economic value, is highly unlikely. The tax associated with the recognition of all of the built-in gain inherent in an operating corporation — as opposed to a corporation holding passive investments — will almost certainly exceed the value of tax savings associated with the actual or deemed repatriation of income. This inequity is in large part due to the fact that while the tax rules which apply to U.S. corporations may create a competitive disadvantage, the effect on the value of the corporation as a whole should be rather small.¹⁵³ In addition, the expatriation tax is assessed on a gross basis, i.e., gains are not permitted to offset losses.¹⁵⁴ Because of these and other aspects of the tax on expatriations, it will be an extremely rare case in which the tax benefits of expatriating will exceed the costs for a corporation which has been operating for a significant period of time and amassed significant built-in gain.¹⁵⁵ When one considers the additional shareholder-level tax, a situation in which a publicly-traded corporation

or 100%, is less valuable than a credit. MARVIN CHIRELSTEIN, *FEDERAL INCOME TAXATION 2* (2002) (explaining that credits are worth more than deductions).

¹⁵³ The gain from eliminating subpart F should be rather small. As Desai and Hines discussed, the increase in the value of the expatriating corporations following the expatriation announcement is significantly larger than merely the ability to avoid subpart F and other repatriation taxes. They reach this conclusion by examining in depth the case of the inversion of Stanley Works, Inc. Given that the total average increase in the price of the shares of expatriating corporations was only 1.7%, a very small amount of difference in gross gains should wipe out the tax advantage. This value is low in part from the fact that it is relatively easy to avoid subpart F and other repatriation taxes by continuing to invest earnings abroad. See generally Chorvat, *supra* note 49, at 843-44. Because of these methods, the net expected value of these repatriations or deemed repatriation taxes is much less than it otherwise would be. *Id.*

¹⁵⁴ Because under section 367(a) gains but not losses are recognized, the expatriation tax is essentially a tax on gross amount of gain, rather than on the net amount of gain. Furthermore, under *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945), the gain on the transfer of a business must be separately calculated, asset by asset. Therefore, losses on some assets will not be able to offset gains on other assets. Even if the corporation has no net gain on its assets, if it has low basis assets, such as goodwill or going concern value, the corporation will have to recognize gain on the expatriation. If a corporation has just been formed, it might not yet have substantial basis assets in which case it might make sense to initially incorporate abroad.

Because there are two layers of tax, if the amount of gross gain at the shareholder and corporate levels combined exceeds 5%, then it would not generally make sense to invert. Recall again that this calculation is on a gross basis not net basis. All of these factors together show that it will be an extremely rare case where it would be rational for an established corporation to expatriate, assuming all of the valuations of the assets and the shares are correct. These valuation issues are explored more fully in CLOYD ET AL., *supra* note 109, at 22-23.

¹⁵⁵ CLOYD ET AL., *supra* note 109, at 22-23 (coming to same conclusions).

would find it advantageous to invert is difficult to conceive.

If valuation theories based on the efficient market hypothesis are correct, the number of expected corporate inversions per year should be close to zero.¹⁵⁶ However, there has been a significant increase in both public and nonpublic corporations choosing to invert since 1999.¹⁵⁷ This is the anomaly of corporate inversions.

2. Empirical Evidence and the Purported Explanations for Increased Inversion Activity

This section examines the empirical evidence concerning corporate inversions. There have been two studies to date: the first by Mihir Desai of Harvard University, together with James Hines of the University of Michigan, and the second by Bryan Cloyd at the University of Illinois at Urbana-Champaign, together with Lillian Mills at the University of Arizona and Connie Weaver at the University of Texas. These two studies come to very different conclusions, using what is essentially the same data.

a. The Desai-Hines Study

The only significant empirical study on the causes of inversions has been conducted by Mihir Desai and James Hines. In their study, Desai and Hines undertook an empirical analysis of the economic factors related to expatriations that take the form of corporate inversions and the stock price reactions to inversion announcements.¹⁵⁸ Desai and Hines found correlations between corporate inversions and enterprises that are engaged in: (i) foreign operations, (ii) low tax rates in the operating jurisdictions of expatriating multinationals, and (iii) highly-leveraged firms.¹⁵⁹ Desai and Hines also reported that corporate managers acted to maximize shareholder value, inverting when the price of the stock was low, and that corporations whose stock price had dropped recently were more likely to invert than those whose stock price had appreciated.¹⁶⁰ Finally, Desai and Hines concluded that there is a significant increase in share value following an inversion announcement, and that the increase in share price was greater than that which would be warranted by the

¹⁵⁶ Those which have no gain yet because they just started are among the companies that might be likely to expatriate.

¹⁵⁷ See DESAI & HINES, *supra* note 2, at 2.

¹⁵⁸ *Id.* The study included a statistical analysis of the factors leading to expatriation and an event study analysis of reactions to expatriations. *Id.*

¹⁵⁹ *Id.* at 3.

¹⁶⁰ *Id.* at 3-4.

potential tax savings from subpart F and the elimination of the residual U.S. tax on repatriated earnings.¹⁶¹

This last finding is interesting, in that it points to a possible secondary anomaly associated with corporate inversions: the share price increase in response to inversion announcements exceeds the present value of the tax savings from avoiding the application of subpart F. If this statement is true, there must be another reason for the additional inference of value by investors.¹⁶² Further, share appreciation beyond the expected benefit of tax savings means that corporate managers who actually follow through with inversions proceed under the assumption that the expected benefits exceed the net costs of the inversion, discounting (i.e., adjusting upward) for the price increase following the inversion announcement, because the tax cost will necessarily be based on the price following the inversion announcement. Corporate managers would not undertake expatriation if the costs of inversion merely equaled the expected benefit.¹⁶³ Therefore, the possibility of a price increase following the inversion announcement adds an additional element of risk to the decision making of corporate managers.¹⁶⁴

¹⁶¹ Note that Desai and Hines also cite avoidance of the U.S. interest expense allocation rules as a rationale for corporate inversions. *Id.*, at 10-11, 24. See *infra* Part VI.A for a description of this theory, the international tax rules that clarify why this cannot be the rationale for corporate inversions, and a discussion of the Desai-Hines data that supports the conclusion that avoidance of the interest expense allocation rules cannot be a factor in corporate expatriations. DESAI & HINES, *supra* note 2, at 2-4, 20. Specifically, the Desai-Hines study consisted of an event study of stock market reactions to 19 separate inversion announcements between 1993 and 2002, and concluded that stock prices appreciate on average 1.7% over a five-day window centered on inversion announcements. *Id.* at 3, 20, 24. Although 19 is a fairly low number of observations to try to obtain statistical significance, it represents the total number of publicly traded corporations that have completed inversions since 1993. *Id.* at 20, 24. Therefore, while the results are not conclusive, they are all that is available, and are not inconsistent with the model proposed in this Article.

¹⁶² Because the section 367(a) tax is based on market capitalization, it would not be prudent for corporate managers to enter into a transaction that costs more than the benefits which would accrue as a result of the transaction.

¹⁶³ See DESAI & HINES, *supra* note 2, at 24-25. This is especially true since the September 11 attacks on the United States that imposed additional non-tax or political costs to corporate expatriations. See CLOYD ET AL., *supra* note 109, at 22-23. There are likely to be significant transaction costs from such an inversion and so, because the two costs are merely equal, the transactions will probably not take place.

¹⁶⁴ Apart from the Desai-Hines empirical findings with regard to stock price appreciation following inversion announcements, corporate valuation theory would suggest that corporate managers must incorporate the reactions of shareholders to (i) signal that there are tax savings to be obtained by expatriating and (ii) that there may be shareholder-level gain triggered by the transaction. The response will differ according to the tax attributes of the shareholder. Tax exempt shareholders will be motivated to buy flip

b. Purported Additional Explanations

Because the avoidance of the subpart F rules cannot provide a sufficient motive to incur the large costs of expatriation, some commentators have argued that there are other tax savings that explain the anomaly of corporate inversions.¹⁶⁵ This subsection examines these additional purported tax savings and shows that they do not have significant explanatory power.

(1) Avoidance of the U.S. Interest Allocation Rules

The U.S. international tax rules treat interest expense as a fungible expense of the multinational group and allocate it between foreign source income and U.S. source income.¹⁶⁶ This treatment is important because the greater the amount of foreign source income, the larger the foreign tax credit limitation. The greater the amount of interest expense allocated against foreign source income, the lower the foreign source income. Hence, to the extent the interest expense rules over-allocate interest to foreign source income, they artificially reduce the foreign tax credit limit. The problem with the interest expense allocation rules is that they allocate the interest expense of U.S. members of the group to both foreign and domestic income, based on the distribution of assets which produce each type of income, but do not allocate interest expense incurred by foreign subsidiaries back to U.S. assets.¹⁶⁷ As a consequence, only foreign source income is reduced. Thus, the foreign tax credit limit is reduced below its correct value. The inappropriately high allocation of interest expense to foreign source income results in the disallowance of earned credits for foreign taxes paid by U.S. multinationals — effectively subjecting U.S. companies to double taxation.¹⁶⁸

shares and taxable shareholders will be motivated to sell. A recent federal reserve study indicated that approximately 40% of the shares of U.S. corporations were held by tax exempt or non-U.S. shareholders. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES 1991-1999, 82 (2000). Consequently, the net effect on value will be uncertain because 40% of flip shareholders have a greater perception of value for their shares but 60% may lower their estimation of value for the same shares. Much may depend on the shareholder perception of the signal from corporate managers, and whether the shareholders trust the decision making ability of the managers.

¹⁶⁵ Others argue that the decision is simply a mistake. See discussion *infra* Part II.B.2.b.iii.

¹⁶⁶ Treas. Reg. § 1.163-8 (2003).

¹⁶⁷ *Id.*

¹⁶⁸ See I.R.C. § 904(a) (2000).

Commentators like Desai and Hines argue that the operation of the interest expense allocation rules is another justification for inversions and, therefore, another potential source of tax savings for inverting U.S. corporations.¹⁶⁹ The problem with this theory is that it is not in accord with the historical data or the empirical evidence collected by Desai and Hines. The interest expense allocation rules are only a problem for “excess credit” taxpayers — those who, on average, pay a higher tax rate than the U.S. rate. If the foreign credit does not affect taxes paid because the amount of tax paid is significantly lower than the U.S. tax on the income, these rules have no effect on tax paid. Data regarding corporate inversions in general, and the Desai-Hines study in particular, indicate that companies that invert are in fact almost always “excess limitation” taxpayers, that is, taxpayers paying an average rate far below the U.S. rate.¹⁷⁰ It would be difficult to argue successfully that the interest expense allocation rules are one of the justifications for corporate inversions, when those companies that do invert are among the least likely to be affected by the interest expense allocation rules.

(2) Earnings Stripping

Another explanation for corporate inversions is that they allow former U.S. corporations to reduce their tax on U.S. source income. This view has been proposed by Desai and Hines,¹⁷¹ as well as by Reuven Avi-Yonah.¹⁷² The theory is that U.S. multinationals which reincorporate in foreign jurisdictions use interest deductions to “strip” earnings out of the United States, generating interest deductions against U.S. income and repatriating earnings to a foreign parent which might be taxed at a lower rate in to the foreign parent than they would in the United States. Although this is an interesting theory, there are rules in the tax code designed to prevent this behavior and, moreover, there is empirical data that would indicate that earnings stripping does not provide a reasonable justification for expatriation.

The key to this argument is that debt is a tax-favored source of capital. This tax advantage results from the fact that interest is a deductible expense, while dividends paid to shareholders are not.¹⁷³ If a U.S. operating subsidiary pays interest to its parent corporation on corporate debt, rather

¹⁶⁹ DESAI & HINES, *supra* note 2, at 2-4, 19, 24.

¹⁷⁰ *Id.* at 3, 19 (attributing expatriation behavior to tax avoidance motive).

¹⁷¹ *Id.* at 24-27.

¹⁷² Avi-Yonah, *supra* note 5, at 1796-97.

¹⁷³ I.R.C. § 163 (2000).

than dividends on equity, the earnings that make up the interest payments are deductible from the U.S. income of the subsidiary. Moreover, these earnings are taxed only in the country of the parent corporation, rather than in both. If the foreign parent is incorporated in a low-tax jurisdiction, the total worldwide tax has been reduced. Hence, some commentators claim that earnings stripping provides an incentive to invert in order to reduce U.S. tax on U.S. source income.¹⁷⁴

One of the key problems with this explanation is that there are rules designed to prevent this reduction in U.S. tax. Section 163(j) limits earnings stripping by disallowing deductions for interest paid to a related party (e.g., subsidiary and parent) for loans or guarantees, where the payor of the interest is moderately to highly-leveraged.¹⁷⁵ Entities that engage in earnings stripping behavior would almost certainly fall within the provisions of section 163(j), because the amount of debt capital has been increased to take advantage of the interest deduction. The Desai-Hines data confirms that highly-leveraged firms are more likely to expatriate, demonstrating that these are the very corporations that would be precluded from earnings stripping behavior under the section 163(j) earnings stripping rules.¹⁷⁶ Section 163(j) clearly reduces the ability of these companies to engage in earnings stripping. Moreover, the strategy of

¹⁷⁴ DESAI & HINES, *supra* note 2, at 24; Avi-Yonah, *supra* note 5, at 1796.

¹⁷⁵ I.R.C. § 163(j)(2). The provision applies to corporations that have a debt/equity ratio of greater than 1.5-to-1 and interest expense that exceeds 50% of "adjusted taxable income." Wollman, *supra* note 47, at 492. ATI is rather like earnings before interest, taxes, and depreciation. Note that the section 163(j) limitation is stated in the conjunctive as both (i) a debt-equity ratio that exceeds 1.5-to-1 and (ii) net interest expense that exceeds 50% of "adjusted taxable income" or ATI. I.R.C. § 163(j)(2)(A). In practical terms, then, whether section 163(j) applies to preclude earnings stripping will depend on the debt-equity ratio that the taxpayer would have had in the absence of "earnings-stripping." *Id.* If the debt-equity ratio of the taxpayer would have been moderate to high, these limitations should effectively foreclose any significant use of earnings stripping. The debt-equity ratio of a particular taxpayer is a function of the risk associated with the taxpayer's business, which might include activities in more than one industry. Commonly, the higher the risk, the lower will be the debt-equity ratio. See P.V. Viswanath & Mike Frierman, *Asset Fungibility and Equilibrium Capital Structures*, 47 J. ECON. & BUS. 319, 321 (explaining that equity-holders have incentive to increase variance of cash flows generated by assets of firm, that is to say, risk). This is because the return to increased risk generally accrues to equity holders. See BUSINESS ORGANIZATION AND FINANCE 45-46 (William A. Klein & John C. Coffee, Jr. eds., 8th ed. 2002). Because debt increases the risk of bankruptcy, creditors will not lend as readily to companies with high debt-equity ratios. See *id.* at 348. If the debt-equity ratio in the taxpayer's industry is low, this generally indicates a high degree of risk, such as is the case in the high tech industry. See *id.* at 353. Within high-risk industries, therefore, there is more room for an earnings stripping play. More notably, however, in industries with less risk such as mature U.S. industries, corporations are able to take on more debt, and section 163(j) would apply to preclude any benefit from earnings stripping.

¹⁷⁶ DESAI & HINES, *supra* note 2, at 2-4.

earnings stripping would not reduce worldwide tax unless a treaty applied to reduce the applicable 30% withholding tax on interest payments,¹⁷⁷ the non-U.S. lender is eligible for benefits under the treaty, and the non-U.S. lender is not subject to tax on its interest income at a rate comparable to the U.S. rate.¹⁷⁸

Perhaps a more significant problem with the argument that inversions are motivated by opportunities for earnings stripping is that the empirical evidence indicates that foreign-owned U.S. corporations do not actually engage in earnings stripping. The Blouin study found no empirical evidence to suggest that, when U.S. companies are acquired by non-U.S. companies, they engage in earnings stripping more frequently than do U.S. corporations.¹⁷⁹ They found that foreign-owned corporations were not more likely to have high levels of debt than U.S. corporations, and the two groups of corporations were likely to pay the same effective tax rates.¹⁸⁰ The U.S. tax rules appear to prevent earnings stripping out of the United States from occurring. Therefore, the empirical evidence indicates that inversions occur among U.S. multinationals not to reduce U.S. tax by earnings stripping from U.S. operations, but rather to reduce tax on non-U.S. operations.

(3) Mistake By Management

While economists Bryan Cloyd, Lillian Mills, and Connie Weaver agree that costs associated with corporate inversions likely outweigh the benefits, they offer no explanation for continuing inversion activity and simply predict that inversions will subside given the current anti-inversion rules and the antipathy toward corporate expatriation following September 11.¹⁸¹ Specifically, Cloyd, Mills, and Weaver state that inversion behavior is anomalous and does not, on net, increase shareholder value.¹⁸²

¹⁷⁷ I.R.C. § 881(a)(1); Wollman, *supra* note 47, at 519.

¹⁷⁸ Wollman, *supra* note 47, at 519.

¹⁷⁹ JENNIFER L. BLOUIN ET AL., DOES ACQUISITION BY NON-U.S. SHAREHOLDERS CAUSE U.S. FIRMS TO PAY LESS TAX? (Kenan Flagler School of Business, Working Paper, 2002) (on file with author).

¹⁸⁰ *Id.*

¹⁸¹ CLOYD ET AL., *supra* note 109, at 22-24.

¹⁸² Cloyd, Mills, and Weaver. attempt to demonstrate that the empirical data do not support the conclusions that Desai and Hines reach, particularly the increase in stock price value. *Id.* at 22. They show that, although there was a 1.7% increase in price on average, the median price increase was lower. Cloyd, Mills, and Weaver do this by disaggregating the average price increase into three parts: (i) the effect on the average price increase, (ii) the effect on those whose price did not significantly change, and (iii) those companies whose price actually declined. They proceed in this manner even though, as Desai and

Notwithstanding the anomaly in corporate behavior indicated by transactions in which cost exceeds benefit, their analysis is implicitly based on efficient market theory, assuming that market price represents a correct value per share. Employing a rational markets approach, Cloyd, Mills, and Weaver conclude that there is no explanation for corporate inversion activity and that it is a mistake that will disappear over time. It is not surprising that Cloyd, Mills, and Weaver are unable to formulate an explanation for inversion activity, given their assumption of rational markets. As this Article will discuss in Part III, it is only by relaxing the assumptions of neoclassical economics and considering a behavioral finance solution that we can explain inversion behavior.

III. A BEHAVIORAL FINANCE EXPLANATION FOR CORPORATE EXPATRIATIONS

Although standard neoclassical economics may not be able to explain corporate inversion, the emerging line of research in behavioral finance may be able to provide the basis of an explanation. This subpart will first survey this literature and then show how it can aid in the formation of an explanation of the inversion phenomenon.

A. Behavioral Finance

Not all who study markets believe in the efficient market hypothesis. Since the 1980s, behavioral finance research has relied on cognitive psychology decision theory to study market anomalies.¹⁸³ The literature

Hines pointed out, the sample size is extremely small already. Cloyd, Mills, and Weaver found that of the nineteen firms they investigated, two had large increases in value and two had no significant increase. They broke it down even further to only ten firms and, not surprisingly, found no statistically significant results. One might expect this result because, as sample size decreases, the likelihood of finding statistically significant results likewise decreases.

¹⁸³ Actually, beginning in the early 1970s, prominent cognitive psychologists Amos Tversky and Daniel Kahneman challenged the idea of rational market participants as not corresponding to actual human behavior. See Kahneman & Tversky, *On the Psychology of Prediction*, *supra* note 13, at 237; Kahneman & Tversky, *Prospect Theory*, *supra* note 13, at 263; see also LEONID KOGAN ET AL., THE PRICE IMPACT AND SURVIVAL OF IRRATIONAL TRADERS (MIT Sloan School of Management, Working Paper 4293-03, 2003) (arguing that irrational traders can affect market price of assets even if they continue to lose money so it is not evident that market will always reflect prices that would result from efficient market).

One should note that behavioral finance theories do not necessarily imply the irrationality of individuals to the extent put forth in the behavioral economics literature, only that markets may systematically undervalue the price of an individual stock, or even the market as a whole, for the short to mid-term. See Peter Knez et al., *Individual Rationality, Market Rationality and Value Estimation*, 75 AM. ECON. REV. 397 (1985); see also Dhananjay

has developed along the lines of two simple principles. The first is that investors exhibit systematic biases that are identified as individual investor heuristics, that is, mental short cuts that are used in place of purely unbounded¹⁸⁴ rational thinking.¹⁸⁵ These biases can result in incorrect values, in the short to mid-term, for both individual stocks and the market as a whole. The second principle in behavioral finance is that there are limits to arbitrage. In other words, even in markets with both rational and irrational traders, irrational traders can have a sustained impact on prices.¹⁸⁶ Even if rational investors correctly perceive and analyze the available information, limits to arbitrage exist such that rational traders are not able to arbitrage the difference between the

Gode & Shyman Sunder, *Allocative Efficiency of Markets with Zero-Intelligence Traders: Markets as a Partial Substitute for Individual Rationality*, 101 J. POL. ECON. 119 (1993). Compare a very interesting experiment dealing with the ability of institutions to get around cognitive biases in probability, found in Tilman Slembeck and Jen-Robert Tyran's *Do Institutions Promote Rationality? An Experimental Investigation of the Three-Door Anomaly*, University of St. Gallen Discussion Paper No. 2002-21 (Sept. 2002). This experiment showed how institutions were better able to make probability assessments than were individuals. The theory that markets can be irrational even when its participants are rational is accepted by even strong critics of behavioral economics. See Gregory Mitchell, *Taking Behavioralism Too Seriously? The Unwarranted Pessimism of the New Behavioral Analysts of Law*, 43 WM. & MARY L. REV. 1907 (Apr. 2002).

In some cases, group deliberations and collective decision making moderate bias, in some cases they have no apparent net effect, and in some cases they amplify bias. . . . [T]he question of whether group judgments and decisions tend to be more or less biased than individual judgments and decisions is enormously complex and defies a simple answer. Accordingly, legal decision theorists should refrain from simple conclusions about the similarity of group and individual decision making processes and outcomes.

Id. at 2004-05 (explaining that, although individuals behave more rationally than would be suggested by behavioral economics literature, there are particular problems that result in market's irrational behavior, even though each individual actor may behave rationally). In fact, none of the literature cited argues that the market is always rational.

¹⁸⁴ The literature on bounded rationality, also called structural uncertainty, relaxes the traditional assumptions of individual rationality. Bounded rationality, for example, would study behavior in which individuals do not act in accordance with Bayes' law, that is, they do not believe that potential outcomes are algebraic or additive. Thus, someone *not* acting in accordance with Bayes law would not understand that, if each of two alternate outcomes of an event were 90% likely to be favorable, that there was more than a 90% chance that the outcome would be favorable.

¹⁸⁵ For example, investors focus more on the risk associated with losses than the potential benefits associated with gains. This risk preference associated with losses is known as the "Prospect Theory." See generally Kahneman & Tversky, *Prospect Theory*, *supra* note 13. Prospect theory exposed the greater sensitivity to losses than to gains exhibited by individuals choosing between gambles, a feature known as "loss aversion." Barberis & Thaler, *supra* note 128, at 15-17.

¹⁸⁶ Barberis & Thaler, *supra* note 128, at 2. Rational traders are referred to in financial literature as "arbitrageurs," while irrational traders are known as "noise traders." *Id.* at 4.

theoretically “correct” value and the current market price.¹⁸⁷

Defenders of the efficient market hypothesis generally acknowledge that there are many irrational traders in the market. They argue, however, that rational investors will be able to arbitrage between the “irrational” prices set by these irrational traders and theoretically “correct” prices.¹⁸⁸ For this correction to occur quickly, and for it to occur at the optimal level, arbitrage must be costless and riskless.¹⁸⁹ Research in behavioral finance has shown that, not only is real-world arbitrage often costly and accompanied by non-diversifiable risk, but arbitrage is the most constrained when prices are farthest from the fundamentals.¹⁹⁰

1. Investor Heuristics

Research by cognitive psychologists has pointed up systematic biases, known as heuristics, which prevent investors from either perfectly perceiving or perfectly processing all available information.¹⁹¹ These biases can be reflected in underreaction or overreaction to news such as earnings announcements which, in turn, can lead to mispricing. For example, psychological research has demonstrated that people are overconfident in their judgments.¹⁹² This overconfidence leads to excessive trading without sufficient information and, as a result, lower returns.¹⁹³ On the other hand, conservatism — the tendency for people to cling to old beliefs in the face of new evidence — has been linked to underreaction to news such as earnings announcements.¹⁹⁴

¹⁸⁷ *Id.* at 2.

¹⁸⁸ Eugene Fama, *Efficient Capital Markets, A Review of the Theory and Empirical Work*, 25 J. FIN. 383 (1970).

¹⁸⁹ Barberis & Thaler, *supra* note 128, at 2.

¹⁹⁰ *See id.*, at 4, 7, 9.

¹⁹¹ SHLEIFER, *supra* note 13, at 112-30 (describing heuristics as examination of failures of individual judgment under uncertainty).

¹⁹² *See* M. Alpert & H. Raiffa, *A Progress Report on the Training of Probability Assessors, in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES* 294 (Daniel Kahneman, Paul Slovic & Amos Tversky eds. 1982) (demonstrating that 98% confidence intervals assigned to estimates of quantity are correct 60% of time); *see also* B. Fischhoff, Paul Slovic & S. Lichtenstein, *Knowing With Certainty: The Appropriateness of Extreme Confidence*, 3 J. EXP'L PSYCHOL.: HUM. PERCEPTION & PERF. 552 (1977) (finding that events which people think are certain to occur actually happen only 80% of time while events they believe are impossible happen approximately 20% of time).

¹⁹³ B. Barber & T. Odean, *Online Investors: Do The Slow Die First?*, 15 REV. FIN. STUD. 455, 458-60, 477-78 (2002) (showing that investors that switch from telephone-based trading to online trading demonstrate increased confidence but performed subpar); Barberis & Thaler, *supra* note 128, at 12, 47-50.

¹⁹⁴ V. Bernard, *Stock Price Reactions to Earnings Announcements, in ADVANCES IN*

Overreactions to information derive from a different heuristic known as representativeness.¹⁹⁵ Representativeness is the tendency of people to evaluate probabilities in light of broad patterns with which the person is familiar, thus projecting patterns onto random sequences.¹⁹⁶

A well known phenomenon in investor behavior is the reluctance of people to sell "losers," that is, stocks trading at a loss.¹⁹⁷ This

BEHAVIORAL FINANCE (R. Thaler ed., 1992) (describing underreaction of U.S. stock prices to earnings announcements); N. Jegadeesh & S. Titman, *Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency*, 48 J. FIN. 65, 90 (1993) (finding evidence of underreaction and slow incorporation of new information into stock prices).

¹⁹⁵ Overreaction occurs when an investor becomes overly optimistic after a series of positive news announcements, pushing the stock price to unjustifiably high levels. SHLEIFER, *supra* note 13, at 89, 120-29.

¹⁹⁶ A pedagogical example of the representativeness heuristic comes from the research of Daniel Kahneman and Amos Tversky. Daniel Kahneman & Amos Tversky, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCI. 1124, 1124 (1974). They show that this tendency to evaluate information in light of perceived patterns can lead to the incorrect assignment of probabilities. *Id.* For example, Kahneman and Tversky presented the following description to a group of individuals of a fictional character, Linda.

Linda is 31 years old, single, outspoken, and very bright. She majored in philosophy. As a student, she was deeply concerned with issues of discrimination and social justice, and also participated in anti-nuclear demonstrations.

The individuals were then asked to assign probabilities to the following statements.

Linda is a bank teller, or

Linda is a bank teller and is active in the feminist movement.

The individuals assigned greater probability to the second statement, an impossible result that can be explained by the fact that the description of Linda *sounds* like the description of a feminist. *Id.* Kahneman and Tversky's subjects assigned greater probability to the statement that was most representative, rather than most likely. *Id.*

Representativeness is also related to the concept of sample size neglect, which explains the "hot hand" phenomenon, a common misconception in sports. Barberis & Thaler, *supra* note 128, at 12-15. Sports fans that demonstrate the "hot hand" phenomenon become convinced that a basketball player who sinks three shots in a row will score again, even though three shots are too small of a sample size from which to make the inference. T. Gilovich et al., *The Hot Hand in Basketball: On the Misperception of Random Sequences*, 17 COGNITIVE PSYCHOL. 295 (1985).

In fact, the methods that individuals use to process and answer probability questions are a complicated subject. For a more detailed discussion of the topic, see Daniel Kahneman & Amos Tversky, *Extensional Versus Intuitive Reasoning: The Conjunction Fallacy in Probability Judgments*, 90 PSYCHOL. REV. 293 (1983).

¹⁹⁷ H. Shefrin & M. Statman, *The Disposition To Sell Winners Too Early and Ride Losers Too Long*, 40 J. FIN. 777 (1985). The tendency to hold losers in light of the tax benefits extended to losses leads to curious results. Terrence Odean has shown that, in the month of December (presumably in the context of tax planning), investors prefer to sell losers, but the tendency to hold losers prevails over the rest of the year. Terrence Odean, *Are Investors*

phenomenon has been linked to both confirmation bias and prospect theory.¹⁹⁸ Investors do not seek out information that challenges previously held beliefs, even misinterpreting new evidence that may challenge those beliefs.¹⁹⁹ Moreover, in the face of uncertainty, individuals exhibit a greater sensitivity to losses than to gains, a feature of prospect theory known as "loss aversion."²⁰⁰ Taken together, the real-world failures of investor judgment under uncertainty contribute to delayed market reactions to new information, precluding efficiency.

2. Limits to Arbitrage

In real-world markets, the uncertainty associated with future events means that all prices are subject to risk and, when arbitrageurs trade for outside investors,²⁰¹ there are transactional costs associated with borrowed capital and risks that limit arbitrage when it is most needed.²⁰² There are primarily two types of risk facing rational traders who actually perceive instances of mispricing and have the opportunity to take positions to offset the market and make a profit, in essence, to arbitrage. The first is the fundamental risk associated with the value of a security, that is, that news about the company will drive the stock price up or down.²⁰³ The second relates to investor heuristics, and is called "noise

Reluctant To Realize Their Losses?, 53 J. FIN. 1775 (1998).

¹⁹⁸ C. Lord et al., *Biased Assimilation and Attitude Polarization: The Effects of Prior Theories on Subsequently Considered Evidence*, 37 J. PERSONALITY & SOC. PSYCHOL. 2098 (1979) (demonstrating that people do not look for evidence that contradicts existing beliefs and, even when presented with such evidence, are skeptical and misconstrue evidence as supportive of prior beliefs). For a discussion of prospect theory, see Kahneman & Tversky, *Prospect Theory*, *supra* note 13 and accompanying text.

¹⁹⁹ See Kahneman & Tversky, *Prospect Theory*, *supra* note 13 and accompanying text.

²⁰⁰ *Id.*

²⁰¹ In the simplest models, arbitrageurs use their own wealth to trade. SHLEIFER, *supra* note 13, at 28-52, 89. However, in real-world financial markets, arbitrage is conducted by highly specialized investors who trade with the capital of others — professional arbitrageurs such as mutual and pension fund managers. *Id.* at 89.

²⁰² Because professional arbitrageurs are judges based on past performance and must borrow to invest, often using their investments as security, arbitrage can be the most constrained when prices are the farthest from fundamentals. SHLEIFER, *supra* note 13, at 89-101. As prices fall, the value of the investments offered as security by a leveraged arbitrageur fall. *Id.* at 89. Because professional arbitrage is performance based, outside investors may refuse to provide more capital or withdraw funds already extended. *Id.* As prices move farther from fundamental values, arbitrageurs have the least stabilizing effect, sometimes bailing out of the market entirely. *Id.* at 89-101.

²⁰³ *Id.* at 14-15 (explaining differences between fundamental risk, idiosyncratic risk, and noise trader risk).

trader risk."²⁰⁴ Noise trader risk describes the chance that the mispricing will continue or worsen because of investor sentiment.²⁰⁵ When mispricing continues, or even widens, professional arbitrageurs such as mutual and pension fund managers run the risk that they will lose access to capital, lose the capital that they have already invested or, worse yet, lose their jobs.²⁰⁶ These professionals are evaluated on the basis of performance, and must demonstrate positive returns or liquidate their positions, triggering potentially greater losses.²⁰⁷

In addition to real-world risks associated with attempts to correct mispricing, there are real-world costs that are not considered in the textbook model of an efficient market. These costs include transaction costs such as commissions, as well as the impact of the bid-ask spread for which the arbitrageur is responsible.²⁰⁸ For professional fund managers, there are also the costs associated with borrowing, and the potential for large losses if poor performance causes creditors to withdraw capital.²⁰⁹

The costs and risks of arbitrage are the highest when prices move farthest from fundamentals.²¹⁰ In fact, contrary to the term "arbitrage," which implies a quick and easy profit, attempts to correct mispricing by professional fund managers occur less frequently in stock markets than in bond markets or foreign exchange markets, where it is easier to ascertain value and locate close substitutes, which are essential to limit the risk of taking positions against the rest of the market.²¹¹

²⁰⁴ *Id.* at 6.

²⁰⁵ Barberis & Thaler, *supra* note 128, at 5-6; SHLEIFER, *supra* note 13, at 89-90.

²⁰⁶ SHLEIFER, *supra* note 13, at 89-106.

²⁰⁷ Andrei Shleifer & Robert W. Vishny, *The Limits of Arbitrage*, 52 J. FIN. 35, 36 (1997) (calling phenomenon of professional arbitrage "separation of brains and capital").

²⁰⁸ SHLEIFER, *supra* note 13, at 90-91.

²⁰⁹ *Id.*

²¹⁰ *Id.* at 100 (demonstrating with agency model of limited arbitrage that increased risks accompany extreme mispricing which, in turn, limits arbitrage to point that, in face of panics, professional fund managers will bail out of market entirely). For related research on fire sales, see generally Andrei Shleifer & Robert W. Vishny, *Liquidation Values and Debt Capacity: A Market Equilibrium Approach*, 47 J. FIN. 1343 (1992) (showing that, when assets are liquidated involuntarily at time when potential buyers have limited funds and capital is not readily available, prices fall farther from fundamental value and "noise trader" shock is constant).

²¹¹ SHLEIFER, *supra* note 13, at 100-02. Bond markets and foreign exchange markets have the advantage of offering closer substitutes for cash flows, which are essential to arbitrage. Richard Roll, *R²*, 43 J. FIN. 541 (1988). By contrast, perfect substitutes are almost never found in the stock market. Wurgler & Zhuravskaya, *supra* note 129, at 101. To demonstrate the use of a hedge, suppose that a stock is overpriced as compared to its "true" or fundamental value. See Barberis & Thaler, *supra* note 128 (discussing meaning of fundamental value); see also ACCOUNTING FOR STOCK-BASED COMPENSATION, Statement of

3. Implications for the Expatriation Decision

As a result of the costs and risks of real-world arbitrage, temporary price asymmetries can be perceived by market movers and yet remain in place for at least the short to mid-term.²¹² Therefore, systematic biases in the market can occur which can be exploited by market participants not subject to the same constraints as most arbitrageurs. Corporate managers may act as these arbitrageurs.

If corporate managers are better at perceiving the market situation than the average investor, they might be able to exploit these irrationalities, actually arbitraging the difference between market value and perceived fundamental value. One of the ways corporate managers might exploit a stock price that is perceived by them as undervalued is to accept the tax liability associated with the gain inherent in their corporation and exit the U.S. taxing jurisdiction, expatriating out from under the U.S. tax net at a reduced cost.

B. Alternative Rational Markets Explanations

There is another possible explanation for such expatriations which does not require a rejection of the semi-strong or weak form of the efficient market hypothesis. If there are informational asymmetries and, in particular, if the managers of the corporation know that profits are likely to rise dramatically in the future, and this information has not yet reached the market, managers will have an incentive to expatriate before the information reaches the market and the price of the stock increases. In this case, all actors are behaving rationally based on the information that they have, yet the price of the stock does not reflect "true" economic value, given all of the information that exists in the world. Notice that, in this case, one could argue that because the events which cause the eventual increase in value occurred while the corporation was resident in the United States, even though the information was only later

Financial Accounting Standards No. 123 (Financial Accounting Standards Bd. 1995). Theoretically, in the absence of additional cost or risk, rational investors would then seize upon the opportunity for a quick profit by selling (or "shorting") the overpriced security and buying a similar (or substitute) security to "hedge" the trade. Thus, the investor has sold the overpriced security and bought the cheaper, substitute security, and should earn a profit. Clearly, then, successful arbitrage depends upon the availability of good substitutes. Moreover, in the real world, as costs and risks increase as mispricing deepens, arbitrage is more and more limited.

²¹² Barberis & Thaler, *supra* note 128, at 2. For a further discussion of how risk encountered by individual agents will result in a distorted market, see generally Terrence R. Chorvat, *Ambiguity and Income Taxation*, 32 CARDOZO L. REV. 635 (2002).

revealed, this increase in value should be taxed in the United States.

Another possible explanation for corporate expatriation not dependent upon behavioral finance would be that, while market price is accurate, corporate managers overestimate the value of their companies.²¹³ Initially, if this is the case, it is not obvious that a retrospective valuation of the corporation and its assets is necessary if the market has derived the correct value. However, if the corporate managers are inefficiently deciding to expatriate, this Article's proposal for imposing what is in effect an increased tax on these transactions will cause the efficiency of corporate decision making to increase, because it should deter what would otherwise be inefficient actions by corporate managers.

It is also theoretically possible that corporate managers might manipulate the price downwards for the long-term gain of the corporation (by inversion). The literature, however, does not have many examples of firms intentionally misleading the public by understating profits, so this theory seems unlikely.

IV. REDUCING EXPATRIATIONS

This Part explores how we can formulate a response to corporate inversions, if the activity can be explained by a behavioral finance model. This Part first discusses how Congress and academics have proposed that we respond, and then discusses how the behavioral finance based model offers better alternatives than those which have been proposed to date.

A. Congressional Response to Corporate Inversions

In the absence of adequate explanations for the increase in inversion activity, and concern that somehow inversions must be impacting revenue collections, several bills have been proposed to prevent corporate expatriation activity. These bills would extend U.S. taxing authority beyond that which is justified under traditional notions of international tax policy.²¹⁴ The most prominent proposal in the Senate,

²¹³ For examples of overestimation by business operators, see generally Colin Camerer & Dan Lovallo, *Overconfidence and Excess Entry: An Experimental Approach*, 89 AM. ECON. REV. 306 (1999).

²¹⁴ See, e.g., Reversing the Expatriation of Profits Offshore Act, S. 2119, 107th Cong. (2002); American Competitiveness and Corporate Accountability Act, H.R. 5095, 107th Cong. (2002); Corporate Patriot Enforcement Act of 2002, H.R. 3884, 107th Cong. (2002); To Amend the Internal Revenue Code of 1986 to Treat Nominally Foreign Corporations Created Through Inversion Transactions as Domestic Corporations, S. 2050 and H.R. 3857,

the bill proposed by Senators Max Baucus and Charles Grassley, would have banned corporate inversions altogether.²¹⁵ In the House of Representatives, a bill proposed by Representative William Thomas would have placed a three-year moratorium on corporate inversions and expanded the application of the earnings stripping rules.²¹⁶ Several academic proposals have included provisions to deem foreign corporations with majority U.S. shareholders to be U.S. corporations and tax them accordingly.²¹⁷

There are significant problems with all of these proposals. First, a moratorium on inversions creates significant pressures to incorporate the group parent abroad.²¹⁸ As soon as inversions are prohibited, the pressure to incorporate abroad will increase, even for corporations that plan to operate primarily in the United States. If this planning strategy should become relatively common, there would be significant tax advantages for foreign corporations to acquire existing U.S. operations in order to shield these operations from the application of the U.S. international tax rules. Therefore, a simple moratorium is at best a short-term solution, which could significantly distort U.S. investment incentives. One can also make a fairness argument against a moratorium. The original incorporation decision was based on certain assumptions about how the U.S. tax laws operate. If the United States alters or is likely to alter these laws significantly, it seems fair to allow corporations to relocate their place of residence, as long as they pay any deferred taxes. In addition, in some very rare instances, it may actually be profitable from a non-tax perspective to expatriate the corporate group.²¹⁹

107th Cong. (2002); To Amend the Internal Revenue Code of 1986 to Prevent Corporations from Exploiting Treaties to Evade Taxation of United States Income, H.R. 4993, 107th Cong. (2002); Save America's Jobs Act of 2002, H.R. 3922, 107th Cong. (2002); Uncle Sam Wants You Act of 2002, H.R. 4756, 107th Cong. (2002).

²¹⁵ See generally S. 2119, *supra* note 214.

²¹⁶ See generally H.R. 5095, *supra* note 214.

²¹⁷ See generally Samuel Thompson, *A Critical Perspective on the Thomas Bill*, 96 TAX NOTES 581 (2002).

²¹⁸ See C. BRYAN CLOYD ET AL., WHAT DO TRENDS IN LOCATION DECISIONS FOR INITIAL PUBLIC OFFERINGS IMPLY FOR CORPORATE INVERSIONS? (University of Arizona Working Paper, 2002) (on file with author) (suggesting that costs already imposed on flip transactions have caused many businesses to initially incorporate abroad). The 2001 incorporations of Seagate Technology and Accenture *ab initio* are representative of the pressures to do so. Seagate is a leading manufacturer of storage drives, and Accenture is the world's largest management and technology consulting firm and the former consulting arm of Arthur Andersen. Although not technically corporate inversions, these foreign incorporations essentially represent U.S. corporate expatriations.

²¹⁹ For example, non-tax regulation or local-country rules may better support the

Because some academics have understood the problems with such a moratorium, they have proposed treating all corporations that are majority owned by U.S. persons as U.S. corporations.²²⁰ However, this solution has its own problems. Many legitimately foreign corporations are majority owned by U.S. persons. For example, Seagrams Corporation, the Canadian distillery, is majority owned by U.S. persons.²²¹ Canadian and Mexican corporations are often majority owned by U.S. persons, as are many legitimate Bermudan and Caribbean corporations.

Second, there are significant issues of fairness as well as international law that are raised by such proposals. What could justify the United States' imposition of an entity-level tax on a non-U.S. corporation over which it would otherwise have no jurisdiction? This proposal would significantly interfere with the national sovereignty of the other relevant jurisdictions.²²²

Third, the most likely effect of such a proposal would be merely to increase the transaction costs of escaping the U.S. tax net. Those parties, which seek to incorporate abroad, will find a willing foreign party by which to be acquired and will share the transaction costs and tax benefits appropriately.²²³ Although this might reduce the amount of inversion activity, those corporations that seek to expatriate will develop strategies to expatriate without technically inverting.

The proposals to declare what are actually non-U.S. corporations as U.S. corporations would likewise do violence to the concept of the corporation as separate and distinct from its owners.²²⁴ Although the initial effect of such a rule may appear ambiguous, there may be negative longer term effects. As the United States' economy becomes a relatively

operations of the group. Further, where the ownership of a non-public corporation is transferred to non-U.S. persons, expatriation seems reasonable and should not necessarily be deterred.

²²⁰ Thompson, *supra* note 217, at 581-82; see also *Testimony of Reuven S. Avi-Yonah*, *supra* note 6, ¶¶ 17-26 (proposing "managed and controlled" test for U.S. residency which would have similar effect).

²²¹ See generally Lorange Bravenc, *Connecting the Dots in International Taxation*, 97 TAX NOTES 562 (2002).

²²² For a discussion of issues related to interference with national sovereignty, see CHORVAT, *supra* note 150.

²²³ One potential avenue of accomplishing this is for the corporation to be acquired by a foreign bank, where the foreign bank then issues "tracking stock" which precisely tracks the results of the acquired (formerly U.S.) corporation.

²²⁴ This principle goes back for centuries in Anglo-American Law. See POSNER, *supra* note 47, at 426-28; see also HAMILTON, *supra* note 82, at 166.

smaller portion of the global economy,²²⁵ many former U.S. corporations may become majority owned by non-U.S. persons. We would probably not want to consider General Motors a non-U.S. corporation merely because the majority shares were held by non-U.S. persons.

In addition, all such proposals would effectively create an even greater incentive for U.S. persons to invest in foreign corporations. They would serve to reduce equity capital flowing to U.S. corporations from foreign investors, because the elimination of the option to invert and hence reduce the effective U.S. tax, would decrease the value of the U.S. corporation. Furthermore, these proposals would create an even greater incentive for U.S. corporations to escape the U.S. tax net via acquisitions by foreign corporations.²²⁶ The evidence suggests that it would be U.S. citizens (workers in particular) who would bear the burden of this tax rather than capital providers because, ultimately, the citizens of a country bear the burden of a tax on capital rather than the owners of capital.²²⁷

B. A Proposal: A Retrospective Value Standard

Due to actual or perceived market failures, it might be possible for corporate managers to exploit an asymmetry between market value and economic value to leave the U.S. taxing jurisdiction without paying the appropriate amount of taxes. Absent insider information, however, the only administratively feasible way to measure the assets of a corporation is to look at market value.

1. Capturing Economic Value

Prior to the 1986 Tax Reform Act, a similar opportunity existed with respect to transfers of intangible property by U.S. corporations to their foreign subsidiaries. This situation prompted Congress to impose the "commensurate with income" standard,²²⁸ under which the reported value of an intangible transferred from a U.S. to a foreign corporation must be commensurate with the value of the income later generated by that

²²⁵ See VITTO TANZI, *INTERNATIONAL TAXATION IN AN INTEGRATING WORLD* xiv (1996).

²²⁶ Such foreign acquisitions included the British Petroleum-Amoco "merger" and the Daimler-Chrysler "merger."

²²⁷ JOSEPH STIGLITZ, *THE ECONOMICS OF THE PUBLIC SECTOR* 315 (2000).

²²⁸ U.S. pharmaceutical companies transferred ownership of intangible rights to their self-developed intangibles, i.e., drug patents, to Puerto Rican subsidiaries in anticipation of U.S. F.D.A. approval in order to minimize the value transferred abroad, and therefore the section 367(a) toll charge on domestic-to-foreign property transfers.

intangible.²²⁹

The “commensurate with income standard” is the only retroactive valuation rule in the Code.²³⁰ When intangible property (i.e., intellectual property) is transferred for a period of more than one year, the price paid for the intangible must be commensurate with the income attributable to the intangible.²³¹ That is, the value of the intangible is tested not only on the day of transfer, but also two years following the transfer. If, upon examination, the original value of the intangible is within 80% to 120% of the redetermined value, the original valuation stands.²³² If, on the other hand, the redetermined value gives rise to an additional assessment, the taxpayer is liable for the redetermination, interest, and penalties which accrue if substantial understatement or substantial overstatement. Conversely, if the redetermined value suggests that the taxpayer might be entitled to a refund, the standard procedural rules will apply to allow for or disallow such a refund.²³³

2. Applying Commensurate With Income to Inversions

Although the current anti-inversion rules impose a tax or “toll charge” on corporate inversions, this tax is calculated according to the value of the corporation at the date of the inversion. There is no retroactive standard of valuation to capture the actual economic value of the corporation when the market price might be inconsistent with fundamental economic value. Unlike that which is applicable to transfers of intangible property, there is no general commensurate with income

²²⁹ Treas. Reg. § 1.482-4(f)(2)(i) (2003).

²³⁰ The commensurate with income standard does not apply to corporate inversions because they are not transfers of intangibles, but rather the transfer of ownership of the corporation itself, usually via a stock-for-stock swap.

²³¹ Treas. Reg. § 1.482-4(f)(2)(i). On audit, transfer prices are subject to adjustment by the IRS notwithstanding an arm’s length determination in an earlier year, or whether the statute of limitations on assessment remains open for the first year of the transfer. *Id.* The commensurate with income standard of section 482 - often referred to as the “super-royalty provision” - was imported into the transfer pricing rules by the Tax Reform Act of 1986, and was accompanied by parallel amendments in sections 367(d)(2) and 936(h)(5)(c)(i)(I) relating to transfers of intangibles by a U.S. person to a foreign corporation (in a section 351 incorporation transfer or a section 361 reorganization) or amounts paid by a section 936 U.S. possession corporation for the right to use a manufacturing intangible. BITTKER & LOKKEN, *supra* note 152, ¶¶ 68.6.5, 67.2.4; ROBERT COLE, PRACTICAL GUIDE TO U.S. TRANSFER PRICING § 13.01[B][2] (2d ed. 2001).

²³² Treas. Reg. § 1.482-4(f)(2)(ii)(C)(4).

²³³ Generally a taxpayer has two years from the filing of a return to file for a refund. Because of this time period, there is only a very limited ability to seek a redetermination in favor of the taxpayer.

standard in the U.S. tax law. This Article proposes to modify the Internal Revenue Code to apply the commensurate with income standard to corporate inversions. That is, the market capitalization of the corporation would be determined, not only on the day of transfer, but also two years following the transfer. If, on the basis of the value two years after the inversion, the original value falls within a specified safe harbor, the taxpayer's valuation would stand and no additional taxes would be assessed. However, if the value fell above or below the original value such that an additional assessment is indicated, the redetermined value should be discounted back to the date of the inversion (to reflect time value of money and other returns), and this redetermined value could be substituted for the value of the corporation on the date of the inversion, in a manner similar to the application of the commensurate with income standard.²³⁴ The addition of the commensurate with income standard to the U.S. anti-inversion provisions would preclude market timing by corporate managers in periods of economic downturn if short to mid-term market failure occurs.

3. Implementation

One relatively simple way to accomplish the extension of the commensurate with income standard to corporate inversion transactions would be to treat goodwill and going-concern value of the group as separately transferred to the new foreign parent for purposes of sections 367(d) and 482 in corporate inversion.²³⁵ Most of the value of a corporation is to be found in its goodwill and going-concern value, rather than in the tangible assets of the corporation.²³⁶ Currently, section 367(d) does not reach goodwill and going-concern value because these transactions are generally only a transfer of stock and securities.²³⁷ Arguably, this might be accomplished via Treasury regulations rather than congressional legislation, if such a suggestion is considered an

²³⁴ Invested capital always requires some compensation for the time value of money. BREALEY & MYERS, *supra* note 9, at 12-13, 14. The 80%-120% safe harbor is contained in the commensurate with income regulations, discussed *supra* note 231. Treas. Reg. § 1.482-4(f)(2)(i). For more background, see generally I.R.C. §§ 482, 367(d) (2000) and the regulations promulgated thereunder.

²³⁵ Note that, if I.R.C. § 367(a) applies to a transaction, either I.R.C. § 367(d) or § 482 will apply, *ipso facto*.

²³⁶ See MICHAEL J. MARD, VALUATION FOR FINANCIAL REPORTING: INTANGIBLE ASSETS, GOODWILL, IMPAIRMENT COSTS, SFAC 141, 142 (2002).

²³⁷ Treas. Reg. § 1.482-4(b).

interpretation of existing rules rather than creating a new rule.²³⁸

One of the significant differences between the application of commensurate with income to inversions as proposed by this Article and the current application of commensurate with income to intangibles transfers is that corporations should be permitted to prove that, if the value of the corporation has significantly increased after the inversion, the increase resulted from actions taken after the inversion transaction. The burden of proving an unrelated, post-inversion increase in value should rest with the corporation. The default assumption is that the value of the corporation at the time of the inversion was simply a discounted value of what it would be two years (or some other period) later. This assumption is more lenient than the current commensurate with income rules dealing with the transfer of intellectual property, because these rules do not allow for corporations to dispute that the increase in value that occurred later should not be used to derive the earlier value of the asset.

If the market value of the corporation has fallen two years after the inversion, this reduced value should probably not be allowed to be used by the taxpayer to readjust the tax owed. In general, under the *Danielson* doctrine, the form of the transaction should be construed against the taxpayer.²³⁹ So here too, the taxpayer will be held to that valuation which it asserts.²⁴⁰

One additional problem for deriving a value for the firm as a whole, and consequently the assets owned by the firm, is the existence of options and, in particular, options to purchase newly-issued shares of stock from the parent corporation.²⁴¹ These constitute equity interests in the corporation.²⁴² Their existence decreases the value of the other equity interests in the corporation because, to the extent that they capture some

²³⁸ See generally I.R.C. § 7805 (granting Treasury authority to issue provisions interpreting Internal Revenue Code).

²³⁹ See generally *Danielson v. Comm'r*, 378 F.2d 771 (3d Cir. 1967). Taxpayers are held to the form which they choose. Robert H. Scarborough, *How Derivatives Use Affects Double Taxation of Corporate Income*, 55 TAX L. REV. 465, 491 (2002).

²⁴⁰ A more precise standard could be based on the corporation's beta with the market. See Robert Ackerman & Elizabeth A. Chorvat, *Modern Financial Theory and Transfer Pricing*, 10 GEO. MASON L. REV. 637 (2002); see also Elizabeth A. Chorvat, *Forcing Multinationals to Play Fair: Proposal for a Rigorous Transfer Pricing Theory*, 54 ALABAMA L. REV. 1254 (2003).

²⁴¹ Options which would not involve the issuance of new shares by the corporation would not directly reduce the value of the equity interests of the corporation, and as such do not need to be included in the calculation of the value of the corporation. Because these interests merely allocate the risk of the already existing shares, the total value of the equity of the corporation is not changed by these securities. Knoll, *supra* note 76, at 4-5.

²⁴² *Id.*

of the potential profits of the corporation, they reduce the potential profits of the organization. Therefore, in calculating the value of the assets of the firm, one needs to add to the equity value the value of the outstanding warrants.²⁴³

This proposal will eliminate the ability of corporate managers to reduce the tax cost of expatriating via a corporate inversion by opportunistically choosing the time of the transaction. Corporate managers will have to bear the risk that stock price will not increase in the two years following the inversion. "Market timing" would then entail significant risk and corporations would be discouraged from inverting merely to take advantage of temporary asymmetries between market price and economic value.

CONCLUSION

U.S. multinational corporations have significant incentives to try to escape the U.S. international tax rules which are almost universally considered to be the most stringent in the world. Since 1994, the current anti-inversion rules have been deemed sufficient to preclude inversion transactions that are not accompanied by an appropriate level of U.S. tax having been paid. These rules, however, only operate in this fashion if the stock price truly reflects the underlying economic value of the company and, since the beginning of the current economic downturn in 1999, corporate inversions have occurred with increasing frequency and among an ever-widening distribution of American industries. Furthermore, there is every reason to believe that non-public corporations are engaging in inversion activity as well.

As discussed in this Article, there are significant reasons for believing that the stock prices of corporations that choose to "flip" do not reflect the economic value of these corporations. Therefore, the appropriate response to the corporate inversion "problem" is to adopt more appropriate pricing policies. The simplest and most reasonable way to value the stock and assets of these corporations would be to use retrospective valuation as is currently applied to the transfer of intellectual property through the application of the "commensurate with income standard." One relatively simple way to accomplish the

²⁴³ The calculation of value including options is not simple addition of the value of options to the equity. *See id.* at 4-5. One will also have to adjust the value of the firm in the later period for the value of the options exercised and outstanding at the time. If the proportion of equity held as options is different at the time of the later valuation, this could alter the results of the retrospective valuation.

extension of the commensurate with income standard to corporate inversion transactions would be to include goodwill and going concern value in the definition of intangibles for purposes of sections 367(d) and 482. Currently, the section 367(d) definition of an "intangible" does not include goodwill and going-concern value. That the commensurate with income standard would be effective to preclude the transfer of most corporate assets outside of the U.S. tax net without an appropriate measure of taxing built-in gain is demonstrated by the fact that the retrospective valuation rules of section 367(d) currently operate to prevent expatriation by firms with large built-in gain in patents, self-created processes, and other intellectual property. This explains, for example, why major pharmaceutical companies have not seriously considered expatriating.

The proposed solution both prevents corporations from abusing the U.S. tax system, while still allowing individual corporations the freedom to arrange their business affairs to remain competitive in the international marketplace. Of course, longer term solutions to the competitiveness concerns of U.S. multinationals would include considerations of the repeal of subpart F, reform of the formulary methods of apportioning income and deductions, and even the merits of a territorial system of taxation. These future concerns, however, are beyond the scope of the issues addressed in this Article.