VIEWPOINTS

Will the Rush to Invert Spur Corporate Tax Reform? A Conversation

by H. David Rosenbloom and Rick D'Avino

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The views expressed here are personal views and don't necessarily reflect those of any firm or institution.

As the authors prepared for a recent panel at the Wall Street Tax Association on BEPS, inversions, and current tax litigation, they found themselves enmeshed in an e-mail debate exploring the four-way intersection of global tax policy, the state of the U.S. corporate tax system, inversions, and U.S. tax reform. What follows is an edited version of that debate.

Rick D'Avino: The revival of the decades-long desire to move the legal residence of parent companies out of the U.S. through inversions is not a new signal to enact legislation to stop inversions but rather fresh evidence that the U.S. tax rules applicable to U.S.-based MNCs are so out of step with the rules applicable to MNCs based in the rest of the world that CEOs and boards of directors are concerned enough about their competitive position that they are willing to alter the legal residence of their U.S. parent companies through acquisitive M&A transactions.

The very same features of the U.S. tax system that push CEOs and boards to engage in inversions — principally, the U.S. taxation of non-U.S. profits when dividends are paid to the U.S. parent or invested in U.S. assets — are the same ones that should push the U.S. Congress to reform the U.S. tax rules applicable to MNCs.

Indeed, if the recent spate of inversions results in a targeted crackdown on inversions rather than comprehensive reform of business income taxes, the primary result will be foreign acquisitions of the same U.S. companies that would otherwise have engaged in inversion transactions. Simply put, if the CEO and board of directors of a U.S. company are concerned enough about the competitive threat posed by the U.S. tax system to invert but the inversion is blocked by new U.S. tax rules, they will satisfy their fiduciary duties to their shareholders by shopping the U.S. company to a foreign acquirer.

As you well know, David, the U.S. tax results of an inversion are virtually identical to the tax results of a foreign acquisition. The only real difference is that, in an inversion, the company's physical headquarters and all of its jobs remain in the U.S., while the physical headquarters and the related jobs move overseas in a foreign acquisition. It is this apparent identity that we should explore further.

Thus, if you believe that inversions are a big problem that should be restricted apart from (or after) business tax reform, I'd be delighted to debate the point further. And I'm sure the debate will be fun and hopefully informative, since even my simple observation — that inversions, while reflecting poorly on the current U.S. corporate tax system, are still far better for the U.S. economy than foreign acquisitions of U.S. corporations — has provoked outrage.

H. David Rosenbloom: Reform? What reform? No one wants reform (not even me). The word reform is bandied around, but what is really meant is tax reduction. Look what happened to Mr. Camp [the U.S.

House Ways and Means Committee chair] when he took the concept of reform seriously. His colleagues ridiculed him.

D'Avino: Perhaps, but your observation that ''no one wants reform'' is incorrect. It turns out that, based on the most recent public opinion polling, almost everyone loves tax reform. The firm Public Opinion Strategies (POS) just released a scientific poll (available at http://pos.org/2014/11/new-national-pre-election-survey/) showing that almost all Americans agree that the tax code needs fixing and the parties should work together to get it done. POS found that:

- 95 percent of Americans think that Republicans and Democrats must work together to update the tax code;
- 93 percent think the tax code needs to be updated to help families and businesses; and
- Republicans and Democrats alike agree that simplifying the tax code would spur economic growth.

Amazingly, therefore, you're among a very small minority. But POS also reports that the public is almost evenly split on the question of whether corporate tax rates should be lowered, with 48 percent opposed and 45 percent in favor. Interestingly, the vast majority — 77 percent — opposed increased federal spending. Thus, the president and the Congress should get together to adopt a territorial system as part of revenue-neutral, business-only tax reform.

Rosenbloom: The Internal Revenue Code is ridiculous, of course, but it hardly got that way by accident. And I doubt that the statistics you cite refer to corporate taxation, which is terra incognita to most of the public. Simplifying the tax code has an even smaller constituency than tax reform (assuming the word ''reform'' means something other than mere tax reduction). I would agree with your favorable view of territoriality as a theoretical matter, but a territorial system is much more complex, especially for the United States, than it sounds (for example, what do you do with passive income?).

And if we do attempt reform (presumably with some reduction), then as a trade-off I think we should get serious about taxation of inbound investment. If we really taxed income earned in the U.S. market, becoming a foreign company would not be nearly so attractive. After all, we have learned that pretty much every input to our tax system is mobile, but as far as I can see the U.S. market is not going anywhere.

D'Avino: I don't think that territoriality — or subpart F directed at passive income — is particularly complex, leastwise compared with all the other tax issues that MNCs routinely deal with. And subpart F certainly would be required to combat passive income — and maybe even tightened — in a territorial system.

I agree with your point about domestic income. The U.S. should tax its own market, which is immovable. But becoming (or being acquired by) a foreign company in a worldwide system would still be attractive to a U.S. company in order to compete most effectively with foreign competitors outside the U.S. market.

Given the range of unnecessary and unproductive corporate tax expenditures — and the (to me) false notion that the U.S. has a truly felt need for a lower tax rate on domestic income — a typical territorial system could be easily enacted on a revenue-neutral basis. The rub comes only if you push for too low a rate on domestic income.

Rosenbloom: Subpart F is pretty toothless for active income today. Any company too clueless to understand how to plan around it deserves what it gets. So where is the competitive disadvantage?

And what about transfer pricing? Do you think the business community would accept a territorial system for which I get to devise the TP rules?

D'Avino: Let me respond to both your observation and questions:

- Subpart F should be toothless for truly active income, but that's because of its purpose. I think it's pretty tight for passive income, as intended. But any tightening that covers passive income would be fine and needed.
- Maybe not you — too much power in one person — but certainly any reasonable arm's-length transfer pricing rules enacted by Congress or issued by the IRS would be acceptable to the business community as part of a new territorial system.
- So, if I were a member of Congress, I'd be pushing for ''real'' territoriality, based on the ''real'' territorial systems enacted by our true trading partners, aka the homes of the global competitors of domestic corporations and prime U.S. job creators. If foreign competitors of U.S. companies have materially different tax rules for income earned outside their home countries than the U.S. competitors, then the U.S.-based companies will gradually be acquired by the former. Thus, if the territorial systems adopted by Belgium, Italy, Germany, England, Japan, and China are generally the same as the one ultimately adopted by the U.S., then I think Congress's mission will be accomplished.

Rosenbloom: Sounds like a frantic race to the bottom to me. There are always going to be aspects of the tax systems of other countries that appear favorable by comparison to U.S. rules. And I said leave it to me, but I didn't really mean me — I meant someone who (a) understands the tax world and (b) is prepared to think creatively about what might work in the TP area. It would just be irresponsible to adopt a territorial system without thinking about the ways in which such a system can be misused.

If subpart F is toothless for active income and if you propose in the brave new world to continue to tax passive income (which, by the way, I am confident that not all of our trading partners do), then I really don't get it. What's the competitive disadvantage you are addressing?

D'Avino: I'll again respond separately to your observation and your question:

- I think the IRS/Treasury Department/Congress do indeed collectively well understand the tax world and think pretty creatively about it.
- The competitive disadvantage is the taxation of foreign ''active'' income outside the MNC's home country. In my view, if Alibaba's active income outside China is taxed differently than Amazon's active income outside the U.S., then Amazon will go the way of other U.S. companies that have been acquired by a foreign competitor, and U.S. jobs and the U.S.'s standard of living will suffer.

Rosenbloom: But if subpart F is toothless for active income, what's the terrible problem that the big bad Internal Revenue Code is causing for the afflicted multinationals?

D'Avino: The problem is the lockout effect. A globally competitive tax rate trumps efficient cash management for most MNCs. (But see eBay, which recently said it would bring as much as $9 billion that it had previously designated as permanently invested overseas back to the U.S.) The ''terrible problem'' caused by the Internal Revenue Code is illustrated by (1) the inefficiency of having idle cash abroad — where a U.S. parent company's foreign affiliate is forced to have deposits in a bank to defer the repatriation tax, while the U.S. parent is perhaps forced to borrow in the U.S. to fund cash needs here, (2) the inability to invest at home (or bring appreciated assets back to the U.S.) — forgone domestic investment — or (3) perhaps even worse, the temptation to use offshore cash in less than optimum ways. Thus, MNCs are not so much ''afflicted'' as less competitive and efficient than their non-U.S. competitors.

Indeed, except for true loss companies, everyone pays the U.S. corporate tax on domestic income. You can rightly debate the proper scope of allocable deductions, the repatriation toll charge, and debt-equity rules for inbound companies, but the MNCs targeted by legislators like Senator Levin pay substantial U.S. corporate income taxes.

If you've found a way to lower the burden on domestic U.S. income below 30 to 35 percent, other than through statutory incentives passed by the Congress, you should let your clients know! I think you'll generally find that the 15 to 25 percent ETRs [effective tax rates] reported by MNCs are a blend of 30 to 35 percent on domestic income and 10 to 15 percent on offshore income. In my experience, there aren't ways to lower the former below 30 percent, unless the company invests unusually heavily in alternative energy, low-income housing, tax-exempt bonds, and the like.

Rosenbloom: OK. Understood. I am a bit skeptical that inefficiencies in managing excess cash lie at the heart of multibillion-dollar inversion transactions, but at least I see what you are saying. Insofar as your comments on domestic income are concerned, how is it that some multinationals with substantial U.S. operations end up with nil tax liability to the United States?

I definitely agree that the Internal Revenue Code is a threat to competitiveness, but I think its major anticompetitive effect lies in the temptation it offers companies to boost earnings through gimmicks rather than by improving their products.

D'Avino: I know you travel a ton; you must find that non-U.S. companies are doing the same types of planning as U.S. companies. Railing against for-profit enterprises seeking to lower all of their costs, including taxes, to the maximum extent legally possible, anywhere in the world, is like baying at the moon!

Rosenbloom: I fully understand that. Morality has no place in a tax compliance debate. (Whether it has a place when the debate moves to tax policy and what the law should say is another matter.) Companies can, should, and will take full advantage of what the law allows.

When you speak about a full tax on domestic income, isn't that just because you net out the interest and royalty deductions and take account of the supply chain arrangements that shift income abroad?

D'Avino: I don't think your ''just because'' is really right at all. I'll try to respond briefly:

- Many of the companies that have been called before the Senate Permanent Subcommittee on Investigations (PSI) and other legislative bodies are in a net positive cash position. While U.S. groups may deduct all of their domestic interest expense, even on debt economically supporting foreign equity — just like foreign companies in their own home countries — they also are fully taxable currently on the investment income earned on un-repatriated cash deposits. And a modern territorial system in the U.S. would presumably carry a toll charge on repatriated dividends, like the German system.
- Taking into account your observation about the need to ensure that transfer prices are truly arm's length, I don't understand why you think supply chain arrangements inappropriately deprive the U.S. government of tax on an MNC's domestic income. If a supply chain adds value through operations outside the U.S., there isn't domestic economic income from the supply chain for the U.S. to tax. My proposition is simple: If Germany allows its MNCs to locate a portion of their supply chain in a tax-advantaged country like China or Taiwan, the U.S. shouldn't be materially harder on U.S. competitors. Otherwise, the U.S. system will encourage capital to move and the German-based MNCs to use their capital to acquire those

U.S. competitors. I don't understand why such a reaction is either unexpected or in the U.S.'s best interests. For example, do you think the U.S. is better off as a result of a Brazilian acquisition of a U.S. company? If you do, I doubt the citizens of its home community would agree with you.

- On royalties, you're certainly right that the U.S. shouldn't permit all R&D expenses to reduce domestic taxable income, while allowing the resulting IP to migrate tax-free abroad. As the recent changes to cost sharing, even prior to the various pending reform proposals, illustrate, however, that result is not possible today and is destined for further tightening in the future.

Rosenbloom: You do realize that I actually *favor* some form of territorial system. I wrote to that effect years ago. In my view, the foreign tax credit system is an elaborate and costly contraption, which produces mechanical and sometimes ridiculous results and which is extremely hard to apply.

However, my territorial system would have a TP regime with teeth in it and would not give exemption to haven jurisdictions (defining them would be a challenge but I would err on the side of non-haven classification).

U.S. expenses benefiting exempt foreign income would be nondeductible. That would include interest and a decent chunk of R&D. (A toll charge on repatriated profits is a very poor substitute unless it is imposed at a meaningful rate, and I take it your entire point is for that *not* to happen.)

Royalties remitted to the U.S. would be taxable. Passive income would be taxable (but there would be exemption for income on working capital of a real trade or business).

Would this be acceptable to the multinational community? I wonder.

D'Avino: All interesting proposals. Indeed, your article (''From the Bottom Up: Taxing the Income of Foreign Controlled Corporations,'' *Brooklyn Law Journal*, Vol. XXVI:4 (2001), 1525) should be required reading.

A few more observations:

- As long as the mouth is an arm's-length one and generally consistent with OECD and international standards, I'm sure that the MNC community would accept more or sharper transfer pricing teeth. But they shouldn't be twisted just because the counterparty is subject to low taxes. The issue with low-tax jurisdictions should be dealt with directly.
- As you point out, defining a tax haven is the difficult problem, though most public MNCs — as a result of PSI focus or otherwise — now strive to avoid beach havens. If you define Ireland, Luxembourg, China, or the Netherlands as a haven, however, I'm sure you'd get MNC pushback as well as pushback from their own ministries of finance.
- The key point here, from an MNC perspective, would be how any nondeductible expenses affect a U.S. company's competitive position. As the rush of foreign acquisitions and inversions attest, if such rules are tougher on U.S. MNCs than foreign MNCs, the global capital markets will take action.
- If royalties received by a U.S. MNC are taxed at 35 percent and royalties received by an English or Irish MNC are taxed in a patent box at 10 percent or even less, where should technology and pharmaceutical companies — and their highly paid ''white coat'' employees — be located? Why is it in the U.S.'s best interest to push them offshore?

Rosenbloom: There's that downward race again.

Returning to your observation about cost sharing, the Internal Revenue Service is consistently outgunned by taxpayers and is always closing the barn door after the horses are long gone. It makes no sense to me to cite much-delayed, and usually defective, attempts to put a thumb in the dike as success stories.

And returning to another earlier point, I doubt that non-U.S. companies are doing the same things as U.S. companies. In many countries (for example, Japan, possibly Germany, probably others), taxpayers exhibit a loyalty toward the nation and deeply respect, perhaps even fear, their tax authorities. That's a big difference from our situation. And some countries have GAARs or other general statutes. If we made a technical correction to change the word ''chapter'' to ''title'' in section 9722, I would feel a lot better.

D'Avino: Based on extensive research and personal experience, I think your doubt is misplaced. A few reactions:

- German and Japanese public companies, along with their Italian, Dutch, Swedish, Norwegian, Indian, French, and English counterparts, do plenty of tax planning, as ETR studies regularly confirm. And, in the private-equity world, where U.S. corporate taxes are often inapplicable, you would have no trouble finding the same squadron of tax experts at law and accounting firms outside the U.S. as you'd find right here in the good old U.S. Tax planning luminaries — lawyers and accountants — around the world do plenty of work for non-U.S. MNCs. Finally, as a practical observation, a key element of board of director reviews worldwide is how the company's ETR lines up against its global competitors.
- While I certainly agree that public MNCs in Japan, Germany, and other countries scrupulously comply with the law, including GAARs, so do their U.S. counterparts. Having observed closely some of the world's largest MNCs for over 20 years, I can assure you that U.S. public companies

respect the tax authorities and are loyal to the U.S. But, because the U.S. has a strong rule of law and ample guidance and precedent, I don't think that fear is a reasonable emotion to seek.

- I don't know the chapter and title reference you cite, but notwithstanding whatever glitch that creates, I am quite certain that the tax teams at the largest public U.S. MNCs simply seek to pay the minimum tax that the law requires. With annual audits, uncertain tax position disclosures, dozens of IRS agents physically present in their offices, board audit committee oversight, whistleblower statutes, and the like, I don't think you have any reason to feel bad with the current version of the section you mention. I think the war you're fighting was already won by the IRS and the Congress by the end of the last decade.

Rosenbloom: Sorry to say, I do not consider your experience at GE to be representative of the multinational community, either in the care GE devotes to tax matters, the lack of enthusiasm it shows for ''products,'' or the positive attitude it adopts toward the Internal Revenue Service. I understand your views and respect your experience. But I have seen a wider, if not deeper, world.

D'Avino: I certainly don't want to debate whose worldviews are wider or deeper since we've both spent such a long time running in similar circles. But from a tax policy perspective, I think 80 percent of the government revenue and potential government revenue from the corporate tax is concentrated in roughly 20 percent of public companies. Based on a ton of contact with such companies, I think those companies have much higher standards than you're giving them credit for. Indeed, those companies are populated by tax executives, including former IRS and Treasury officials, with sound moral compasses.

Rosenbloom: I don't think I am talking about morality here. And as I reflect on what you are saying the basic problem I have is placing the United States in a ''follower'' position. When did that become a norm? (Though I suppose we deserve it, given the quality of our tax ''leadership'' in recent years.)

I am personally *very* skeptical of making U.S. tax policy by trying to match the rules of other jurisdictions — especially rules taken out of the local context and collected in a montage of greatest hits in the developed world. For years (at Treasury) I was on the receiving end of ''see what the Japanese do,'' ''see what the French do,'' and so forth. The proponents were terrific at identifying aspects of those countries' rules that were more favorable than similar U.S. rules, but they invariably disregarded the less favorable bits.

We should be developing our own policies, not chasing after other countries. One of the (several) things that is happening in BEPS is that provisions we developed years ago on our own (not to mention subpart F) are finding acceptance in the international tax community at large. Of course we can learn from the ideas and experience of other countries, but systematically comparing our rules to theirs in the name of competitiveness is foolish. We cannot match them individually, much less collectively, and I don't believe we should even try.

For the record, I am also skeptical about hyperventilation on the entire subject of tax and competitiveness. I seriously doubt that U.S. taxation is holding U.S. companies back. If it was, how did they amass those huge pots of untaxed foreign earnings reported on financial statements under Accounting Principles Board Statement No. 23 (APB 23)?

D'Avino: The U.S. tax system is the very reason the earnings are still being amassed offshore rather than being deployed more strategically in the U.S. In any event, you raise an important point on leader versus follower, which deserves a full debate. I think the U.S., in the current highly linked global economy, should be both a leader and a follower. In the good old days when you and I were at the Treasury Department, U.S. MNCs dominated the global economy and all the league tables. Thus, it was easier for us to occupy only the leader position.

With a more level global economic playing field and much more mobile capital, I don't think the U.S. can now afford to be a singularly exceptional leader. It should certainly continue taking a leadership position as I think it has with BEPS, FATCA, model treaties, and other examples. At the same time, if the U.S. ignores global developments like territorial systems, patent boxes, and avoidance of nondeductible expenses, it risks having foreign-based companies acquire their competitors in the U.S. and, in my view, having the U.S. suffer as a result.

I do agree that tax isn't holding all U.S. companies back. That's why approximately $2 trillion has been amassed offshore with no U.S. residual tax provided on financial statements under APB 23. No U.S. policy interest is furthered by forcing those companies to keep that capital abroad. That's why Japan and England switched sides in the last few years from global to territorial tax systems.

In the same vein, now that some of our principal competitors for global capital and jobs — including the U.K. — have adopted low-tax patent boxes for royalty income when the IP is owned by a resident of the country *and* the related ''white coat'' jobs are also in that country, it seems to me incumbent on the U.S. Congress to react positively to ensure that the U.S. remains the best place to locate IP and those high-paying jobs. Indeed, just as enactment of a modern territorial system would encourage U.S. companies to return capital to the U.S. by eliminating the lockout effect, the U.S. Congress also should encourage U.S.-based companies to repatriate IP — and the related jobs — that were (or will be) transferred abroad, as part of the enactment of tax reform with a U.S. version of an IP patent box regime. Whether it is adopting a territorial system or a patent box regime, I think the hallmark of a good leader is to know when to be a follower — at least when the result will be more jobs in the U.S.

Rosenbloom: You place an awful lot of weight on the ''lockout.'' I would have thought the link between inefficiencies in managing earnings and competitiveness is pretty tenuous. You seem to suggest that U.S. companies will move abroad because they cannot find sufficient outlets for their foreign earnings. That may be the case (in which event the current inversion craze is attributable in large part to the economic downturn in the EU). But it then strikes me as odd that the solution is to become a foreign company. And as for inversions morphing into acquisitions of U.S. companies, I don't believe management would view the potential tax savings as a compelling reason for surrendering its jobs.

Insofar as the prevailing practices among companies are concerned, *someone* was doing those LILO transactions.

And may I suggest that we not get started on BEPS and FATCA in this discussion. FATCA seems to me to be a pretty goofy piece of legislation designed to (a) irritate the entire world; (b) waste precious tax administration resources in the United States; and (c) collect very little revenue by comparison with its many costs. As for BEPS, though a number of things the United States has long done are being adopted, we are hardly leading there. In fact, we will be fortunate if we can manage to come out of what looks like years of debate without a large-scale surrender of the U.S. tax base.

D'Avino: Of course people did LILO transactions. In my view, however, I think LILOs represent a success of the U.S. tax system: Big Law took a position. Their clients listened. The IRS reacted. The courts ruled. The Congress legislated. And all the tax was collected, with interest and penalties.

Rosenbloom: My point, of course, is that LILOs, like a lot of other products, were craptacular from the get-go. As were the ''loss generators'' a la *Black & Decker* (*Black & Decker Corp. v. United States*, 436 F.3d 431 (4th Cir. 2006)) and *Coltec* (*Coltec Industries Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006)). And a whole lot of other strategies that lead me to believe the corporate community, as a whole, was *not* like GE. Do you realize how much of that stuff went down? It all goes to prove, in my view, that we cannot adopt a territorial system unless and until we understand how such a system can be gamed and take the necessary steps to prevent it.

D'Avino: I do know (almost) exactly how much went down but I think laying the blame solely at the door of the ''corporate community'' is largely misplaced. Almost no corporation — and certainly none of the regulated banks — would have even entertained such transactions if (very) big law firms had not given them clean tax opinions. Those law firms — and thus their clients — didn't think they were craptacular!

And remember, that was a long time ago. While our system will never be perfect, the advent of FIN 48, Schedule UTP, and a host of other changes leave the current system far fairer than it once was, for both the U.S. and its resident MNCs.

Rosenbloom: It wasn't so very long ago. The cases are still playing out. And I think UTP is a paper tiger. There's essentially no penalty for what goes on the form, or not. FIN 48 is so mangled in its wording that the interpretation is in the eye of the beholder. As for opinions of the ''big law firms,'' well, perhaps you have not been reading the newspapers.

Some might say the Treasury has a tendency to equate the best interests of multinationals with the best interests of the United States. The arm's-length standard has been revealed as something of a joke, and yet there is no movement whatever (at least in the United States) to find something more workable.

D'Avino: You packed several criticisms in there. I'll try to unpack them a bit:

- Schedule UTP, in my experience, is not at all a ''paper tiger.'' While there are doubtless improvements that can and should be considered, the form does give the IRS a comprehensive roadmap to the tax issues and transactions that, in the view of the taxpayer and its independent audit firm, are uncertain. FIN 48, which led the way there, certainly requires interpretation, but the taxpayer's judgment is subject to real-time evaluation by an independent audit firm. So it's not just about the IRS form but the accounting requirements themselves have sharp teeth.
- I don't think the Treasury Department necessarily equates the best interests of MNCs with the country's best interests. Rather, I think senior officials there appreciate that the U.S. jobs that successful U.S. MNCs create or support are in the country's best interests and raise our standard of living. To be sure, if the White House or the secretary of the Treasury disagrees with positions taken by the Office of Tax Policy or the IRS, they know where to find them. I'm sure we agree that, in a democracy, such a value judgment should be made in the first instance by an elected POTUS and a cabinet officer confirmed by the Senate. And the people always get the final say at the ballot box!
- If the arm's-length standard is a joke, why does (almost) the whole world adopt it? What do you know that they don't?

Rosenbloom: *Tout va pour le mieux dans le meilleur des mondes possible.*

D'Avino: You're the second person to spring *Candide* on me today. I was called ''Panglossian'' a few hours ago. I take them both as compliments.

Rosenbloom: It seems to me I should have sprung it earlier in this discussion. ◆