THE BROOKINGS INSTITUTION

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CORPORATE INVERSIONS AND TAX POLICY
FEATURING KEYNOTE REMARKS BY SENATOR ORRIN HATCH

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Introductory Remarks:

WILLIAM GALE
Co-Director
Urban-Brookings Tax Policy Center

JOHN SAMUELS
Chairman
International Tax Policy Forum

THE INVERSION EXPERIENCE IN THE UNITED STATES AND THE UNITED KINGDOM:

Moderator:

ERIC TODER
Co-Director
Urban-Brookings Tax Policy Center

Panelists:

MIKE WILLIAMS
Director, Business and International Tax
U.K. Treasury

ANDREW BIRD
Assistant Professor of Accounting, Tepper School of Business
Carnegie Mellon University

INCENTIVES TO INVERT AND THE MARKET FOR FOREIGN TAKEOVERS:

Moderator:

JAMES R. HINES, JR.
L. Hart Wright Collegiate Professor of Law
Michigan Law

Panelists:

MIHIR A. DESAI
Mizuho Financial Group Professor of Law, Harvard Business School
Professor of Law, Harvard Law School

ANDREW BIRD
Assistant Professor of Accounting, Tepper School of Business
Carnegie Mellon University

POLICY RESPONSES TO CORPORATE INVERSIONS:

Moderator:

MICHAEL J. GRAETZ
Columbia Alumni Professor of Tax Law
Columbia Law School

Panelists:

EDWARD KLEINBARD
Ivadelle and Theodore Johnson Professor of Law and Business
University of Southern California Gould School of Law

MICHAEL DEVEREUX
Director, Oxford University Centre for Business Taxation
Professor of Business Taxation, Said Business School
Professorial Fellow, Oriel College

STEPHEN E. SHAY
Professor of Practice
Harvard Law School

JAMES R. HINES, JR.
L. Hart Wright Collegiate Professor of Law
Michigan Law

Luncheon Address:

THE HONORABLE ORRIN HATCH (R-UT)
Incoming Chairman, Committee on Finance
United States Senate

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P R O C E E D I N G S

MR. GALE: Welcome to the Brookings Institution. My name is Bill Gale; I'm a co-director of the Tax Policy Center. This is a joint event with TPC and the International Tax Policy Forum, ITPF. John Samuels will tell you about ITPF in just a second. I do want to mention that Tax Policy Center is a joint venture of the Urban Institute and the Brookings Institution. We emphasize the development of research analysis communications that are non partisan, timely, and accessible. We have a website, taxpolicycenter.org; we have blog, taxvox, that we invite you take a look at.

The focus of our event this morning is on corporate inversions, what are they, what causes them, are they good or bad, what can or should we do about them, is the issue just corporate inversions or is the issue the corporate tax system, is the issue the corporate tax system or is the issue the whole tax system. So we expect wide ranging conversation on these issues from a really superb set of panels of experts.

I have a few housekeeping comments to make at the beginning and then I'll sit down. First I want to encourage you to ask questions of the panelists. The good news is the panelists are extremely knowledgeable about these topics; the bad news is that means it's quite possible that they end up in the weeds and if you want to bring the discussion back to a broader level I encourage you to do so in your questions. You will not be the only person in the room who will be dazzled by their expertise, but perhaps still confused. Second I want to thank the panelists in advance for their contributions. People have come in from all over the country and we greatly appreciate that. Third, probably the only truly important thing I say right now for most of you is that I would want to remind you that anything that is said at the podium, on the stage and in question and answers, anything that's public is on the record, okay. It's being recorded and it's on the record. If you're having a private conversation with a journalist that is not necessarily on the record and of course as always you should clarify with the journalist beforehand whether it is. But anything that is said from here or the stage or in Q & A is both public and on the record.

All right. Lastly I just want to point out we run a lot of events, Tax Policy Center, Brookings, et cetera, and typically the events go very well, everybody is happy at the end, and there's a tendency to think that that means it's easy to set up events. That is anything but the case. Events are always complicated to set up; they're particularly complicated to set up when you have several different organizations with different cultures or approaches or typical ways of doing things. There are a large number of people who make important contributions to bringing this conference to the point it's at. I want to thank specifically Sarah Holmes here at the Brookings Institution; my right hand person who performed her usual magic in making this conference work. And Allison Street at ITPF who did a great job taking a lead on so many parts of this. So if you will just take a break and join me in thanking them in advance I would appreciate it. (Applause)

Okay. So my job is done and it is with great pleasure that I turn over the mic to John Samuels of ITPF.

MR. SAMUELS: So thank you, Bill, and good morning, everyone. I'd like to add my welcome to Bill Gale. And thank you all for coming. As Bill said I'm John Samuels and I am the Chairman of the International Tax Policy Forum which is an independent group of more than 40 major U.S. multinationals, and we're very pleased to be co-sponsoring this conference with Brookings today. Now I think we have a terrific program and I'd like to thank Bill and Brookings for helping to make it possible.

Now I know everyone in this room is familiar with Brookings and the important role that Brookings place in fostering dialogue on important issues of public policy like the ones we're going to talk about today. But I hope by now you are also familiar with the International Policy Forum, or the ITPF because in addition to supporting an active research program, for the last 21 years we've been sponsoring conferences like this one. But for those of you who are not familiar with the ITPF I'm going to spend a minute on telling you what the ITPF is, which I always do, and the way I'd like to start, which I always do, is by telling you what the ITPF isn't. The ITPF is not a lobbying group with an agenda for particular legislation change; we have not and do not lobby for specific and even general changes in law or policy. Indeed I doubt -- in fact I'm pretty sure we could never reach a consensus among our members on a particular set of legislative proposals. Instead what the ITPF is is a truly unique inter§ between business, the academic community, and government policy makers. We organized the ITPF in 1992, more than 22 years ago with the principal mission of sponsoring independent academic research in the international tax area. Our goal was to develop over time a body of objective economic research on how tax policy affects cross border capital flows and investments, that hopefully would help policy makers make more informed decisions about the design of the U.S. international tax system.

Now today under the guidance of Jim Hines who is ITPF's Director of Tax Policy Research we're sponsoring a wide variety of research projects undertaken by leading academic economists in the area of international tax that are of interest to them. Our research program is overseen by our distinguished and independent board of directors or board of academic advisors who in addition to Jim Hines of Michigan includes Alan Auerbach of Berkeley, Mihir Desai of Harvard, Michael Graetz of Columbia, Matt Slaughter of Dartmouth, and Michael Devereux of Oxford University. Now we are very fortunate to have this incredibly talented group of leading academic thinkers to help guide our research program. Now I want to be clear as I always am on a very important point, it is the stated policy and practice of the ITPF not to attempt to control of influence the subject matter or conclusions of this research in any way. Indeed I hope, as most of you in this room appreciate, good academics simply would not allow that to happen.

Now we've sponsored or co-sponsored many conferences on important issues of tax policy over the years, ranging from the effects of FDI on the domestic economy to locating the source of taxable income in the global economy. And these conferences have spawned more than 30 academic papers on the economic effects of international tax policy, papers that we hope have advanced the state of our knowledge and contributed to a more rational and informed policy debate.

Now today we're going to be talking about another important area of tax policy, one that is certainly ripe for consideration, so-called corporate inversions, cross border acquisitions that result in changing the tax home of the acquired company. And obviously I think as most of you appreciate there has been some very large and high profile acquisitions of very prominent U.S. companies recently. Now of course there's nothing new about U.S. companies being acquired by foreign companies in cross border mergers. Indeed for the last two decades U.S. companies were the targets in 57 percent of cross border mergers based on dollar volume and were the acquirers in only 43 percent of cross border mergers of these deals. But while there's nothing new about foreign acquisitions of U.S. companies, there's clearly been a dramatic increase in the number, size, and profile of these transactions in the last several years. So what can explain this recent wave of high profile acquisitions, or so-called corporate inversions? What's going on?

Well, it's been suggested there are at least three fundamental and probably related underlying reasons for this recent increase in foreign acquisitions of U.S. companies. First virtually every other major developed country in the world has dramatically reformed its tax system to make it more business friendly including by reducing or eliminating the tax on international business income. For example in 1995 only 27 percent of the non U.S. global Fortune 500 companies were headquartered in countries with territorial tax systems. Today, however, 93 percent of these global Fortune 500 companies are headquartered in countries with territorial tax systems. And all of these countries have a lower corporate rate than the United States. So today in any cross border merger involving a U.S. company it's almost certain that the U.S. company's foreign merger partner will be based in a country whose tax system makes it far more attractive for the transaction to be structured so that the foreign company acquires the U.S. company and not vice versa. And unlike in the past these new business friendly tax regimes are in developed countries like the UK, that have stable governments, the rule of law, an educated workforce, major research centers and universities, and world class infrastructure. Now these countries have a lot more to offer than the sandy beaches, warm climates, and waving palm trees of the islands in the Caribbean.

Now the second development driving the increased foreign takeover of U.S. companies is the dramatic increase in the proportion of the income that U.S. companies earn outside the United States. In 1982 U.S. multinationals earned only about 23 percent of their income from outside the United States. In 2012 54 percent of the income of U.S. multinationals was earned outside the United States. So today more than 50 percent of the income of U.S. multinationals is from outside the United States. And this a trend that is certainly likely to continue given that 95 percent of the world's population and 75 percent of the world's purchasing power lies outside the United States. So simply put the stakes of having a U.S. tax home have been increased, they've been raised. Today with most of their income and almost all of their growth outside the United States, U.S. companies have a lot more to gain by relocating their headquarters to a foreign country with a more hospitable tax regime. And conversely they have a lot more to lose by remaining in the United States and having their growing global income swept into the worldwide U.S. tax net and taxed at a 35 percent rate. And since neither the growing importance to U.S. companies of their foreign earnings, nor the proliferation of favorable tax regimes is going to go away anytime soon I think we can expect foreign acquisitions of U.S. companies to continue and perhaps accelerate at least until the U.S. reforms our international tax system to bring it in line with the rest of the world.

Which brings me to tax reform which perversely may be a third factor driving the recent wave of so-called inversions, and that's for several reasons. First and simply put, some companies may have lost hope that tax reform will happen anytime soon and they're tired of losing market share and being outbid for foreign acquisitions by their foreign competitors who are subject to more favorable tax regimes. So instead of sitting around and waiting any longer for tax reform some of these companies may have decided to take matters into their own hands and adopt a sort of self help tax reform by merging with a foreign company based in a country like the UK that has already reformed and modernized its corporate tax system. And yet another group of companies may have inverted to avoid the risk that while they were waiting for tax reform to happen they would be taken over by a larger foreign company who would use that tax savings from the deal that would be unlocked in the deal to finance the acquisition and help justify it. So to avoid being a sitting duck for a foreign acquisition these U.S. companies may have inverted as kind of a poison pill since by merging with a smaller foreign company the managers of the U.S. company would remain in control of the combined enterprise after the merger and allow them to keep their jobs. And ironically and perhaps most importantly tax reform may have contributed to the recent wave of so-called inversions because some companies have gotten a glimpse of what U.S. tax reform might look like, and in particular how it would affect their international operations, and they did not like what they saw because under most of the tax reform proposals that have been advanced to date the U.S. international tax system would still not be aligned with the rest of the world. So these companies may have inverted because they concluded that even after tax reform it would still be more attractive to be headquartered in a foreign country. And this is a very important point because it shows that unless U.S. tax reform aligns our international system with the tax systems of the rest of the world we can expect inversion to continue even after tax reform.

Now some argue that instead of trying to align the U.S. tax system, international system with the tax systems of the rest of the world the better way to stop inversions would be to enact tougher anti inversion provisions as part of tax reform. However, many believe that just as the efforts in the past to stop inversions have failed, stop gap measures to prevent inversions will prove to both be ineffective and counterproductive. And that is because of a simple basic and undeniable economic truth. In today's open global economy one way or another income producing assets will ultimately end up being owned by companies in whose hands they produce the highest after tax rate of return. And inversions of course as we all know are only one way, albeit a highly visible one, in which the foreign operations of U.S. companies end up being owned by foreign companies in whose hands they produce a higher after tax rate of return. So even if all inversions were somehow stopped in tax reform, like water seeking its own level the migration of the foreign operations of U.S. companies to foreign companies in whose hands they would produce a higher after tax rate of return would continue, but they would just morph into a different form. For example, stop gap measures would not prevent and might even encourage foreign takeovers of U.S. companies. And of course U.S. companies could sell their foreign operations in direct cash sales to foreign buyers in whose hands they would produce higher after tax rates of returns. For example, like Merck's, $14 billion sale of its consumer products division to BAYER, a German company, and BAYER outbid substantially U.S. companies who were competing for that division. And more companies would start up outside the United States. None of the anti inversion provisions will slow down foreign start ups. And more capital would flow out of the United States at the portfolio level when U.S. shareholders sold their stock in U.S. companies to buy stock in foreign companies whose earnings in global markets would be higher than U.S. companies because they would earn higher after tax rates of return.

So simply put many believe that in today's open global economy attempts to use our tax system to lull capital in the United States when other countries are reducing the tax burden on international income are doomed to fail. Any efforts to lull Capital into the United States they believe are no more likely to be successful than King Canute's efforts to hold back the tide or the Berlin Wall to restrain the spread of democracy. So perhaps these people argue it's time for the U.S. to stop trying to stop companies from leaving the United States and instead start thinking about what we can do to make it more attractive for them to stay in the United States. And by doing so also make the United States more attractive for foreign investment and for start-ups of new businesses.

Now all of this reminds me of an apt analogy I heard from my good friend and colleague Peter Merrill and I'll repeat it to you; Peter told me when you're love interest leaves you for another at first you're inclined to blame it on the deserter's character defects rather than on your competitor's attractiveness, but when it happens 20 times in a row perhaps it's time to look in the mirror and address your own deficiencies.

Well, we are very fortunate to have a blue ribbon cast of leading academics, economists, practitioners, and government officials here today to help us look into the mirror and address what we should do about corporate inversions, a question that demands and deserves full rigorous and open discussion and debate, exactly the kind of public discourse that the International Tax Policy Forum was formed to foster. Now it will be surprising of all of the participants in today's conference find themselves in complete agreement. I'm sure several of today's presentations will engender some lively and hopefully enlightening discussion. And in this spirit in encourage our large and well informed audience to join in the discussion today. Just remember where's there's heat there is light.

Finally I would like to express my appreciation to Bill Gale of Brookings and Jim Hines, the ITPF's Director of research, and Peter Merrill and Allison Street of ITPF who've helped to make this conference possible, as well as Sarah Holmes from Brookings.

We have as our luncheon speaker today Senator Orrin Hatch as you know. I think that ought to be very enlightening and interesting. Bill Gale reminded me so I will tell you now, after Senator Hatch's remarks I'd appreciate it if you would all wait in the room because he will leave; he has to leave and he's got a security detail. So after he speaks please stay seated.

So I now want to turn the program over to Eric Toder who is going to moderate our first panel on the inversion experience in the United States and the United Kingdom. In that regard Bill said many -- thanked our speakers for coming from all over the country. At least one of our speakers has come from the motherland, farther from outside the country, so I would like to thank him, Mike Williams. So thank you all for coming and thanks for participating in this conference. (Applause)

MR. TODER: Okay. So my job is to introduce the first panel. I guess as you could judge from John's remarks there's probably few issues in tax policy that have generated as much emotion as the inversions issue in the past year, but aside from emotion I think it's important in tax policy system analysis to know the facts or at least to start out with the facts. And we have two speakers this morning who are uniquely qualified to give us that, what is an inversion, what has been the history of inversions, and what's been happening both in the United States and the United Kingdom.

So I'm pleased to introduce Paul Oosterhuis who is a Senior International Tax partner at Skadden, Arps, and Mike Williams who has come from across the pond. He's the Director of Business and International Tax at the UK Treasure. So let's begin. Paul, I guess you're going to start?

MR. OOSTERHUIS: Thank you, Eric. My mission is to give a little background on the history of inversion transactions in the United States and really I would say give you a sense of whether the sky is falling or whether this has just been a phenomenon that is very much of interest but is maybe not cataclysmic in the history of U.S. transactional tax policy.

As John talked about inversions or transactions where a larger U.S. company ends up either on its own, which we call a self inversion, or in combination with a non U.S. company, which we would call a migration combination or a combination inversion, however you want to describe it, ends up with a foreign parent company after the transaction. John gave some of the reasons for why these transactions occur and I'm not sure I need to elaborate much on that. I put them into four categories. One is with respect to future growth of acquisitive company, I think Actavis and Valeant, one is putting leverage in U.S. operations. I think 163J and its limitations or generosity. Restructuring of legacy foreign operations of the U.S. group, much easier in combination transactions than in self inversions obviously. And the final is access to historic offshore cash.

Transactions that are called inversions go back to the '80s with the McDermott transaction that achieved some infamy back then. It's funny, these slides have boxes for every kind of step in the evolutionary process. I was talking to Michael Graetz before we started and he said that he was totally confused by the boxes, and I was musing on the difference between tax practitioners who can't really read a slide presentation without the boxes and the academic community. It's kind of like tax practitioners need boxes, economists need formulas, and we all have our predilections. So these are the boxes on the McDermott transaction. I really don't have time to dwell on it. Suffice it to say that it was a transaction that essentially flipped the CFCs on top of the U.S. company, so not only did you succeed in having a foreign parent, you succeeded at least to some extent in DCFCing your foreign affiliates and that was something that both Congress and the Service had real objections to. The law changed in important ways to make that transaction a very difficult one to do for the last 20 plus years.

Moving to the '90s with what's called the Helen of Troy transaction. The Helen of Troy was a small Texas company. One of the themes you will see is that if you look state-wise there are a disproportionate number of Texas companies that are engaged in inversions. I'm not sure what to make of it, but it is definitely a trend and economists could do a regression analysis and prove that I think. Helen of Troy did a self inversion back in the early '90s and that was kind of the poster child for the change in the 367A regulations that was adopted in notice form in 1994 and later reduced to regulations. There's a lot of details around it but the basic takeaway from a policy point of view is that if U.S. shareholders of U.S. public company end up owning more than 50 percent of the stock by voter value of the foreign company after the inversion transaction then it's taxable to the U.S. shareholders. And it's an interesting application of 367A because I think as one of the drafters of 367A back in the '70s we were focused not on transactions where a foreign parent is put on top of a U.S. parent, we were focused more on transfers of assets and shares by U.S. companies down to U.S. subsidiaries, but nobody has challenged the validity of that regulation and it's a theme that reappears more than once here about the Treasury using its authority in an expansive way in this area.

One thing going back to the transaction to note is that all that happened was a foreign parent was put on top of the U.S. parent in an exchange transaction, obviously approved by the shareholders in the public context. The foreign subs are still under the U.S. company, so there's no change in the CFC status, the inability to access offshore cash or any of the other features that John was talking about by doing this transaction in and of itself. And it's important to keep that in mind, a self inversion transaction has some limits on the tax advantages that result from it. After the 367A regs were adopted, as we got into the later '90s and particularly once the stock market went down so that the shareholder gain was less of an issue, you saw a number of transactions. You look at the list of companies here and besides the predominance of Texas you can see industry bias here that I think is instructive. One is insurance/reinsurance companies and the insurance world is one where subpart F has always reached into the active business of insurance companies, particularly insurance companies with respect to U.S. risk. So whether it's life insurance or property and casualty insurance, subpart F is applied broadly to a foreign subsidiary of a U.S. multinational insurance company and like has happened in other industries where subpart F interferes in your real business in a major way, it tends to increase the incentives for you to not operate in subsidiary form. I think the other thing about the insurance industry is that your assets tend not to be worth more than book value and so selling them from for example a CFC to a non CFC is not a painful transaction because there's unlikely to be gain. So not surprising that the insurance industry restructured itself to some extent back in these days through self inversions.

The second is the oil drilling and services business, whether it's Triton, Transocean, GlobalSantaFe, Noble, in that business. And similarly subpart F applies broadly in some services business and the oil services business is one of the main ones where subpart F can apply to tax your real non U.S. business operations, for example if you're operating in the North Sea as a U.S. company with CFCs. And so that was a particular incentive in my mind for those companies to engage in these transactions. And most of them happened after the late '90s when oil prices went down and therefore the value of drilling rigs went down, the value of oil services companies went down, and so the gains that were triggered by moving assets out from under the U.S. after a self inversion seemed to be more manageable for many companies.

So this set of transactions gave rise to Congressional interest. That really came about in 2002 and Senator Baucus and Senator Grassley made a proposal that ultimately became §7874 and it was enacted in 2004, ended up having an effective date of the spring of 2003 and it's why you saw a lot of transactions happen in 2002, but a definite decline in transactions after that as everybody saw that the legislation was coming. I think most of us understand the basics of §7874 really has three requirements. One is that a foreign company acquires substantially all the assets or stock of a domestic corporation or a domestic partnership. Second that the former shareholders of the U.S. company own more than 80 percent. There's another set of rules for owning more than 60 percent of the foreign company after the transaction. And, third, that the group after the transaction does not have substantial business activities in the country where the foreign parent is incorporated; an important exception that we'll talk about shortly. As I say the provision was enacted in 2004. Seemed to be an anti abuse provision that had limited application because nobody would do these deals now with self inversions unless you had substantial business activities. At least that's what people thought. By today I will tell you that for international practitioners who deal with cross border M&A, we probably spent half of our time dealing with this section because there is an amazing number of circumstances where it can apply. We're talking to the Service right now about a situation where a foreign insurance company wants to acquire a U.S. insurance company. The foreign insurance company is probably four times as big as the U.S. insurance company, but we think we fail under §7874 given the way the provisions work.

And that's something the Service is aware of and I think is sympathetic to, but it just shows you the breadth of what's happened under this provision over the last 11 years.

So the application of the rule to the typical self inversion is pretty obvious. It means that the foreign parent will not be taxed as the foreign parent, it will be taxed as a U.S. company. It's an extraordinary reach of tax policy. I don't know of any other country that has a rule that comes close to it. I think many will say, and Mike Williams will talk about this in the UK context, that it was an alternative to say a managed and controlled test for that company which we don't have and which our Treasury Department has historically not been in favor of establishing as a base for taxing foreign companies as if they were U.S. companies. And so it made it easier in the U.S. for you to do an inversion than maybe in some other countries where not only would you have to put a non U.S. company on top, but you would have to meet the requirements for that company to be managed elsewhere, and so it's probably one reason why we ended up with a provision like §7874.

After the 2004 Act there was a bit of a pause -- and these lists by the way are not comprehensive; I should have said that with the earlier ones. They are ones that either I remember or some that my partners have remembered and are not by any means comprehensive, but certainly illustrative and hopefully didn't miss very many. There were a few combination migration transactions. The most visible ones were the Biolvail-Valeant transaction 2010 and the Eaton-Cooper transaction in 2012. And there were some self inversions that met the substantial business activities test. Tim Hortons is one that I think many people know about. Tim Hortons clearly had most of its business in Canada but had a U.S. parent on it and it migrated. You had a couple of oil services companies, Ensco and Rowan, that moved to the UK because of their North Sea operations once the UK rules became more user friendly for parent companies.

The interesting thing from my perspective is what didn't happen back then and I'd like to talk about that by illustrating a transaction I was involved in that was in 2006. A U.S. company that had been maybe one of the top 10 repat companies under HIA, the repat that was put into the 2004 Act, it was doing a deal with a foreign company that was about 30 percent of its market cap, so it could have done a combination inversion in that deal, and in fact we sat down with the CFO and the CEO of the company to suggest that because they had thought about it as just a stray acquisition transaction. We went back and for on it, but they decided to do it as an acquisition transaction. And the main reason they did that was that it was a better pipeline for repatriating future cash because if you paid 30 percent of your market cap for a foreign company you could have 30 percent of your market cap as leverage in your CFC structure if you bought that foreign company through a CFC which they did. And so it gave them what we would call a repat val equal to 30 percent of their market cap. In other words U.S. parent borrows money, foreign subs buy stock of U.S. parent for a note, foreign parent lends cash down. So if you're a $10 billion company you've got $3 billion of debt in your CFC structure and you can repatriate $3 billion future. That company decided that from a repat perspective it was better to do it as a U.S. company. One feature of that transaction was that the foreign company did not have significant U.S. operations and so it had not had significant leverage in the U.S. If you're buying a foreign multinational that has substantial U.S. operations they're going to have substantial leverage in the U.S., it's malpractice not to and obviously you can't continue that when the U.S. company buys the foreign company. And so there's a negative synergy that happens by reason of that situation.

Anyway, continuing on, it only gets more satisfying (audio skips) was the main element of self inversions, really the only element of self inversions after the 2004 Act and the Treasury reacted to that with regulations, particularly, most importantly the 2012 regulations that established a 25 percent test for the various types of activities.

That happened a few months after the Aon self inversion transaction to the UK. Aon is an insurance broker out of Chicago, a major U.S. multinational that had substantial business activities in the UK, obviously UK being a global insurance hub, and under the 2009 and 2006 regs met the test. I seriously doubt it would have met them under the 2012 regs, but they got the transaction closed before the regs were published. Under those regs there's been one transaction that clearly met the test, that's Liberty Global-Virgin Media. That was a combination transaction but they were both U.S. companies, so it was like two self inversions in one. Both of them are cable companies. Virgin Media was almost entirely a UK cable company and so, on a combined basis they could meet the substantial activities test and do their inversion. According to the public disclosure the Burger King-Tim Hortons transaction that most of you have probably heard about would also meet the 25 percent test, but obviously because it's a real combination transaction of a foreign company and a U.S. company it didn't necessarily have to meet that test in order to qualify. But the 2012 regs have largely shut down self inversions meeting that test, and in particular the requirement that you get 25 percent of your gross income from transactions with third parties in your country of incorporation. That's a very, very difficult test. I mean how many multinationalists do you know that get 25 percent of their gross income from third party transactions in any country in the world, maybe even including the United States, but certainly any non U.S. country. So it's a very difficult test to meet. Again a very aggressive use of regulatory authority to try to limit taxpayers' flexibility under the statute.

Once M&A -- there wasn't much M&A, as firms like mine saw painfully in the 2009, 10, and '11 and in '12. It started picking up late in '12 and became much more robust in '13 and '14, and it's not surprising that a certain percentage of those transactions were inversion transactions for reasons that John talked about and for reasons like not if the foreign company has substantial U.S. operations not wanting to reverse the tax planning that they have with respect to their U.S. operations in terms of leverage for example. You will notice if you're trying to look at the various transactions and discern patterns there's a clear pattern towards the healthcare industry. Obviously healthcare is one where IP is the most important asset. IP is pretty mobile and so there's a lot of flexibility in that industry to take advantage of a foreign parent organization. A lot of the companies are smaller and so in my view based on the transactions we were involved in among these it was definitely more about future planning than about existing planning. The model of Actavis and Valeant was not lost on other companies and CEOs and Boards who want to see their companies thrive, and that drove a fair number of these transactions. I think the other thing to comment on that's kind of interesting is the number of spinoffs that have occurred from various companies. Tyco is now -- what, Cathy, five different companies isn't it, maybe six with Mallinckrodt? Tyco originally split into three and then the original Tyco and Covidien have also split. And they're all of course foreign parent companies, so you see these companies begetting more foreign companies. Over time Ingersoll-Rand has spun off Allegion, their security business as well.

I think the final thing to talk about is the deals that weren't done and you can infer as much as I can from the reasons why they weren't done. Some of these clearly were affected by the Treasury regulatory activities in September of 2014, some of them clearly weren't. And I mean the Chiquita deal situation where Fyffes was outbid, the Auxilium deal was a situation where somebody else came in and bid more for Auxilium. So you put yourself in play when you do one of these transactions. These are real transactions, they have real economic impacts. Companies don't do them lightly, they don't do them solely for tax reasons obviously, and a lot can happen once you put the transaction into the public domain. This is slide that just shows how these transactions work obviously. The foreign parent tends to both acquire the foreign target and the U.S. target you tend to have a transaction with a new foreign parent that is then owned by the shareholders of both companies with the foreign company shareholders owning more than 20 percent of the stock.

So let's just spend a moment on the Treasury guidance, and I think others are going to talk about more that came out in September as a response to the set of transactions that we just saw. There's really three important things that the Treasury guidance did to stay away from the technical side and just deal with it from a high level. One is modifying the 7874 rules to make it harder in some cases to count the stock that's issued to the foreign company shareholders. That's done two ways. One, if the foreign company has a lot of cash you reduce the number of shares that's treated as going to its shareholders. The second is to treat shares that have been bought back or distributions that have been made by the U.S. company over the prior three years as amounts that have to be added back to the shares that the U.S. company takes. The latter one is a very broad provision, very complicated provision. The notice only states it in a couple of sentences. There are real issues as to whether people have reasonable notice about how the provision works from the notice because you can have situations for example where say the U.S. company has a spinoff two years ago and then is acquired for cash, and if you add back the shares that were effectively redeemed in the spinoff it doesn't have any shareholders outstanding in the transaction, but you still have to count the shares arguably from the spinoff. And so you could have an inversion if the spinoff was big enough even though there's no shareholder continuity at all. Again that's a situation Treasury is aware of and is thinking about whether something shouldn't be done about that, but again it shows you the reach of how this provision has come to sprawl over all of cross border M&A. The second is to treat any use of existing foreign cash and earnings for the benefit of the foreign parent through loans or other types of transactions as a 956 event --an extraordinary reach of authority. There's nothing in 956 that says buying share of a foreign company or lending money to a foreign person has anything to do with 956, but they decided that if it's a foreign parent then it should have something to do with 956 and pick it up. The final thing is some limitations on your ability to restructure your legacy CFC operations in combination with a foreign company and to try to DCFC if you will some of your CFCs. All these things limit the -- assuming they are valid limit the benefits of inversions to very large companies. They really don't limit the benefit inversions if you go back to the slides to some of the smaller companies here. And so my sense is that by the end of the winter, once we get into the spring you'll start to see more deals hitting the radar screen, but they won't be the AbbVie Shire type transactions, they'll be more of the kind of Endo Health Solutions type transaction of smaller companies that want to become like Valeant and like Actavis.

That's it. (Applause)

MR. WILLIAMS: Good morning everyone. I think inevitably we will find that the UK experience and the U.S. experience is really rather different. I suspect we will also conclude that in the sense the UK experience is more similar to that of the rest of the world and the U.S. experience is therefore sort of doubly different if you like. I think in very broad summary before I get onto the slides, you can leave the UK, and we have less defenses against companies leaving the UK, but equally we focus rather more on whether you've left or not because perhaps a consequence of people being more free to leave is a need to actually see whether they really have or not.

If I then go on to the structure of the presentation, again I think it's significant that I will need to focus on residence not so much on incorporation. The UK cap system is founded on the proposition that on the individual side you tax residence not citizens. And equally I think you can argue both in the U.S. and in the UK on the corporate tax side because then the next extrapolation of that basic proposition, if you're taxing individuals who are resident in the UK and you also want to tax corporations, I think it's not then surprising that you decide you want to tax corporations that's a resident in the UK -- residents of a corporation is more equivalent though than to individual residents in the same way that incorporation of a company is more similar to citizenship for an individual. So I'll talk about company residence; I'll then go on to CFC rules and then onto migrations from and into the UK. We would tend to call them migrations rather than inversions and I think that goes back to the point I made at the start, that we're talking about businesses being able to leave, corporations being able to leave, but equally have you they left or not.

The UK test for residents was as Paul said traditionally based solely on the place of central management and control. And I think this is probably a crucial initial divergence blind as to where the company was incorporated. It didn't at all matter where the company was incorporated; you could perfectly well have a U.S. incorporated company that was centrally managed and controlled in the UK, and absent the tax treaty then that company will be UK resident. It was expanded to cover incorporation in the UK from 1988. Maybe I should pause at that point and note that there isn't such a thing as incorporation in the UK anyway, just as I understand that there is incorporation in the U.S. There isn't a UK company register; we have three company registers for England, Wales, Scotland, and North Ireland, but the reality is that it covers the three different sorts and indeed the corporate law is not substantially different across the three.

Then inevitably tax treaties are needed to cope with conflicts and interactions between the way our rules for taxing companies and whether resident interacts with other countries. And generally in our tax treaties, and this will be our quite strong preference, a tie is broken by looking at the place of effective management and I'll come on to what we mean by effective management. I think again that's not just the case with the UK, it would I think be pretty similar if you looked at say France or Germany, and equally they are probably closer to effective management as their domestic test where you have a company that's not incorporated in France or Germany that is in fact based there. Worth perhaps noting along the way through, but Ireland would have inherited our traditional way of deciding where a company was resident because it was invented at a time when Ireland was part of the UK. Ireland stuck with the UK's traditional approach, but is to become realigned with the UK from this January by actually including in its residence test incorporation in Ireland. Like us they have also gone for five year grandfathering, but on the other hand they have waited a quite significantly longer time than us to actually extend their test for residence to include incorporation.

Let me go on to central management and crop control. It's a case law test that emerged from the need to know whether people were resident or not. Even in the 19th century people needed to know that, and not surprisingly therefore it was tested in case law. The leading decision is a case called De Beers. It dates perhaps not surprisingly again from the 19th century. They key point is the focus on central management of control. Subsequent case law established means the highest level of control of the business, not some lower level. Highest level will generally be exercised by the company's board of directors and with the caveat that that's provided that the directors generally control the company. It is difficult to envisage where you will get control below the level of the directors I think. And that will be probably quite uncommon. On the other hand you could I think more readily envisage control by a shadow director, say a very dominant shareholder that was in truth exercising control through stooge directors who in reality lack substance. So you can see in that circumstance if you have a shadow director of that sort what will be important is where the shadow director was based rather than where the stooge directors happen to have their board meetings. A weakness in it is that it obviously worked better in a time when it was much harder to travel about. It worked better in a time where things like teleconferencing worked, in reality not possible. If you look back to the 19th century, basically if you wanted to have a board meeting in particular place, if you weren't there you'd have to get on a ship to get there. So it was a clearer and easier test. And you can see why over time it became rather less satisfactory as a sole test, and I don't think it would be realistic to contemplate having that as a sole test now.

If we then go on to effective management, this is the tie breaker in most of the UK's tax treaties. I mean if you can think of a pretty straightforward example, you have a corporation that is incorporated in France say, but has its central management and control in the UK, you could presumably envisage a case where you have the directors and the main shareholders being French, they happen to want to work in the UK, but equally they're more familiar with French company law, something like that. They would rather be governed by that. You need then some way of breaking the tie between the UK that will be wanting to tax based on central management and control in the UK, and France that will be wanting to tax based on the incorporation of the company in France. And then there is a quite clear and explicit test in the UK-France tax treaty which makes clear that where a person other than an individual is residence in both states, then its deemed to be resident in the state in which its place of effective management is situated. Inevitably there are similar rules for individuals, but different rules that, you know, again both UK and France taxing individuals on the basis of residence, there's a need to cope with situations where say someone has a house in both countries. Then the interpretation of that is left to the OCD model tax convention primarily. I think a key point is that you can only have one place of effective management even though you can have any number of places where there is some management. And it's where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made. So again the in substance protects against subterfuge or shams, but if in substance those decisions are made in place X, then place X is where the company is effectively managed. I think in some very brief shorthand, I mean you can reasonably translate that as the company's headquarters where most if not all of the senior executives are based. Inevitably the executives will travel around, but most corporations even now have what you might call a headquarters, and I think you can see that in the UK context with two of the UK banks, Lloyds Banking Group and RBS NatWest. Both are headed by Scottish companies, both hold most of their board meetings in Scotland, and I think you can reasonably suppose that had Scotland separated from the UK following their referendum in September, in that circumstance it's reasonably clear that central management and control would have been in Scotland. Equally it's clear that the head offices of RBS NatWest and Lloyds Banking Group are based in London; that's where their senior executives sort of habitually work from and where most of their meetings would take place. So you can see how you can get a distinction between central management and control and effective management in circumstances where there's no contrivance, there's no sham, where all the directors and all the other people involved genuinely have the capacity to do the work they're appointed to do and indeed do it.

What I think is quite important and worth noting, and this is you can't -- if you've got a test of this sort keep your headquarters in Turin or in Paris or in Frankfurt, and then be effectively UK residents simply by having board meetings in the UK. That's generally not going to work. If your senior executives in reality want to keep working in Turin because that's where they want to live, where their families want them to stay, and their headquarters stay in Turin, then it's going to be unlikely under the UK residence test as modified by treaties that you're going to get to be a UK resident on that basis. Generally in those circumstances the other country would assert residence and under the tiebreaker they will get residence. And I think that is a key difference and I think hopefully illustrates the point I made at the start about have you left. It's the same in reverse. It would be quite difficult if you wanted to keep your headquarters in London or in

Edinburgh to assert that just because you put on top of your existing UK incorporated company a foreign incorporated one and you have board meetings of that foreign incorporated company outside the UK that that was enough. In many circumstances it wouldn't be.

In terms of whether we have similar rules as Paul described to prevent migrations and inversions -- I haven't got a slide on that because broadly we don't have such rules. In many circumstances EU law would prevent us having such rules. We can't prevent a genuine transfer of the headquarters of a UK incorporated group to another member state of the EU. That would contravene the freedoms of the single market. Equally, and of course all these things tend to be reciprocal, other member states can't prevent the transfer of residence from another member state to the UK. And if we go back to my example of a company headquartered in Turin, if it stays headquartered in Turin it will be resident in Italy. On the other hand EU law prevents any step being taken to stop headquarters being moved to the UK and if it is moved to the UK then it will be resident in the UK. And the same in reverse. So in a sense we lack any of the sort of protection from the U.S. on conversion rules, but equally the other member states lack those protections as well.

If we then come on to our CFC rules we revamped our CFC rules at broadly the same time as we moved to a much more territorial system of tacks. And that slide gives a very broad summary of the old rules and the new rules. I think two key points about the old rules, they contained a quite strong presumption that activity should be in the UK if could be if you like. So therefore there was a tendency for there to be a pull into the UK. If you moved activity from country X to country Y there might be a question why hadn't you moved it into the UK, or even sometimes why wasn't it in the UK in the first place. So that impact on foreign transactions was particularly crucial, particularly difficult I think for many businesses to handle. And I think another key difference is that the current rules are more proportionate. Under the old rules you could in some circumstances have quite a lot of income that would otherwise have been caught by CFC rules, and income that you would logically want to capture with CFC rules. You could avoid that being caught by a technique called swamping where you make sure that income was in an entity that also had a lot of good income that would not normally trigger the CFC rules. The rules worked on an all entity or nothing in the entity basis in those circumstances, therefore there wasn't a CFC charge. Equally the rules worked rather harshly in other circumstances where you had a lot of bad income and a bit of good income. In those circumstances the old rules taxes a lot. The current rules would focus just on the bad income.

I go on now to migrations from and into the UK. There were a large number of businesses that did leave the UK, a large number in the UK context, maybe small in a U.S. context. I note some of them there. What the broad picture is I think that a fair number of businesses left the UK; a very significant number of those have returned for lowering our corporate tax reforms. Tax administration HMCR did have a project tracking this. When that was closed in 2011 it tracked two sets of migrations. The groups that are dealt with by its large business office would generally be quoted groups, and therefore generally larger and lower 15 migrations of those and 24 other groups, groups that would generally not be quoted, generally smaller. And that 24 would exclude migrations that I think you could reasonably conclude were not done for corporation tax reasons. And I think it's fair to conclude that the flow of migrations, the flow of groups outside the UK was a significant spur for corporation tax reform. And it's maybe also significant though that corporate tax reform is (inaudible) bipartisan support. If we go through the various elements you often find that the previous labor government took some steps, and the current coalition government is taking further steps in that direction. For example we currently have a 21 percent corporation tax rate which will go down to 20 percent from the first of April. The previous labor government reduced corporation tax rate from 30 percent to 28 percent. This government has reduced it 21 percent. It was the previous government that introduced the foreign dividend exemption, and this government if you like completed that piece of work by also introducing an exemption for foreign (inaudible). And it's probably worth noting on the way through as well we have no withholding tax on dividends paid by UK resident companies.

In a sort of similar them R&D tax credits were introduced by the previous government and have been improved by this one. The patent box was announced by the previous government, was introduced by this one. The patent box gives a 10 percent rate on profits within the box. And perhaps most crucially, because I think it's fair to say that some of the business who left didn't come back until we had reformed our CFC rules which I think tells you that it was that that they were most concerned about, the previous government launched the consultation on reform of the CFC rules, it was then taken forward and actually adopted by this government. So as John said earlier on there is a fair amount of stability in this new regime and I think probably that stability is one of the attractions to businesses who have left and then come back. It seems to me it would be slightly odd if you were to take a step as major as leaving a country to come back until you were sure if there were features of that country's tax regime that forced you to migrate out of the country, it seems to me you'd want to be sure that those features were not likely to return before you came back.

As to businesses that have returned, a fair number of them have. The ones listed there, including WPP, the large advertising agency. Also some insurance businesses that had left and returned. And also again as Paul mentioned other groups have come to the UK such as Aon and again, you know, Aon is an example of a case where the headquarters have moved to the UK. And I think back to the point about whether there is headquarters in the UK, it seems clear that there are very good reasons why we will be in competition for genuine headquarters of businesses. Why would we not want to compete for those just like other countries do, just like the U.S. does. You get the top executives based in the territory. In a sense the requirement generally in our treaties for effective management is quite a strong tie to the territory. And they will tend to want to have around them advisors, key workers, other people centrally involved in the business. So there are good reasons why you would want a company to move residence into the UK. I think in other circumstances where we have a company that may be incorporated in the UK, but its effective management is outside the UK maybe because that is advantageous under some other country's tax rules, well I think it's hard to say that it's UK that's encouraging that. Equally I think it's hard to say that we have any incentive to do that. We have no incentive to encourage what are clearly not brass plate operations because there will be some substance. There will be board meetings in the UK, but plainly in economic terms there's no great value from having a few people flying to the UK, have a board meeting every quarter, and then fly out again. We're not in the business of encouraging or indeed discouraging that, but equally it's not really something that is down to the UK tax rules I would suggest. You know we do have a fairly coherent set of rules on which companies we regard as ours and which we don't regard as ours. And as I said early on I think those rules are pretty consistent certainly with our neighboring countries, but equally I think if you look also with most other countries. You know, it's not surprising in that context that we have been able to draw from the OCD model tax convention in the definition of effective management; it's there because many countries use it.

Let me stop there and leave time for discussion. Thank you. (Applause)

MR. TODER: We have time for just a couple of questions. I'd ask you to please frame these as questions and not speeches and keep them short so we can hear from the people we want to hear from. So please raise your hand. I' hope there will be some questions. Yes?

SPEAKER: I thought there was an exit -- I thought there was a toll charge on exit where groups -- you know, unrealized gains would be deemed to be realized for tax purposes?

MR. TODER: And I'll take one more and then we'll (inaudible). Mike, what -- we'll --

MR. WILLIAMS: In very broad terms, I mean there is an exit tax. I think most people would tell you that it's significant. In relation say to the U.S. anti inversion rules it's really quite small. In many circumstances it won't be triggered. If it is triggered in many circumstances there will be say existing capital losses to cover any capital gains charge. And again I think you can see why that is. It reflects the impact of EU law that exists to free up the single market and allow moves of operations within the EU. The extent it's there I think you should see it's a pretty residual and -- not ineffective, but it's not intended to serve a big purpose. And I think you can see from the number of migrations that took place in reality it doesn't.

SPEAKER: Hi. I'm interested in your perspective in the political dynamic around enacting a business friendly tax reform. You know, at the same time in the UK there's been a lot of sort of anger against multinationals and stripping the UK tax base. I find it really interesting that you've got what is a business friendly tax reform that was passed on a bipartisan basis. Can you comment on just what was that sort of political discourse and were there questions about whether this reform is really good for the middle class or for workers, for the economy, and how were those addressed?

MR. WILLIAMS: I mean the circumstance is different in the sense that most of the measures wouldn't be passed with bipartisan support, it's more the one government that used its own votes to pass measures is followed by a different government that used the votes of its supporters to sort of continue along a similar path, in a sense to go further. I think there is public support, there has been public support for this. Maybe it's easier for that public support to exist where you've got a much smaller country where it's easier to see that, you know, if a UK based multinational is to grow it's going to have to have very large operations outside the UK, otherwise antitrust considerations will constrain its growth. Equally if you look at the shareholder registers of very large UK based public companies, then quite often you will get more than 50 percent foreign shareholders. You know, in that circumstance it's harder I think to justify say a CFC charge on money coming out of the foreign based operations through a UK company, and then out to foreign shareholders. If the foreign shareholders have invested directly in the foreign operations or had gone through some other vehicle that wasn't based in the UK, nobody would contemplate the UK (audio skips). I think you're right though to ask the question about public support in the face of concern for aggressive tax (inaudible). UK Prime Minister, UK Chancellor of the Exchequer George Osborne had been very clear that the UK is welcoming of foreign investment, the UK is welcoming of foreign businesses moving operations to the UK. Equally when they come to the UK they must pay their fair share, you know, that's having public support for a 20 percent rate. That 20 percent rate has come down from 28 percent at the time for example when the VAT rate has gone up 20 percent. (Audio skips) individuals are paying more VAT, corporations are paying less.

MR. TODER: Yeah.

SPEAKER: So this is a question for Paul. Paul, I know you've been in board rooms when boards have been -- of U.S. companies deliberating whether or not to invert. What is it that are the drivers? (Laughter) Is it to get -- no specific company.

MR. OOSTERHUIS: Am I an accessory to a crime? Is that what you're saying? (Laughter)

SPEAKER: No. Do they want to get their hands on their foreign cash or what is it that motivates them to invert?

MR. OOSTERHUIS: You really can't generalize because it depends on a bunch of things. But as I said when I gave the example of the 2006 transaction, if they were just used to tapping in -- if they were just interested in tapping into offshore cash the best structure would be for the U.S. multinational to buy the foreign multinational and use the leverage that you would put in place internally as a repat val. Just to use the example of Pfizer AstraZeneca, I mean if Pfizer is going to pay $110 billion or AstraZeneca they would have a pipeline for repat as far as the eyes could see. But there's no way you can do that transaction for reasons that had to do with bringing an AstraZeneca into the U.S. tax net.

SPEAKER: What is the tax -- what is (audio skips)?

MR. OOSTERHUIS: It's all kinds of reasons, some of them that you listed, some of them that I think had to do with global politics. You know, the UK reaction on that transaction was very interesting. And so it's really a variety of reasons, but I think it's one place where I disagreed with Ed Kleinbard's piece that is in your materials. I don't think repat was the primary driver at all.

SPEAKER: Mike, a major concern in this country that's been expressed is about companies that hold their earnings offshore and I'm wondering if you could describe for us the UK rules before the change of territorial? And it's been my understanding that the foreign affiliates of UK companies could lend their funds back and that that was an important driver in your change. Can you comment on that or describe that?

MR. WILLIAMS: It's more I think about previous foreign dividend rules, the CFC rule. Additionally before the dividend exemption if you paid a dividend from a foreign affiliate into the UK you would have faced a UK tax charge. You would have got credit for the underlying tax on the profits from which those dividends were paid. People got around that by upstream loans. (Audio skips) don't have a constructive dividend rule. We didn't have one so you could do an upstream loan and there were many instances of those upstream loans. What you were then probably inhibited from doing though, and that would depend on the (inaudible) property, it would be quite hard then actually to pay any dividend to the end shareholder (audio skips) constrained by company law from being able to pay a dividend. And you're on the proposition that you should be paying dividends to your shareholders after profit, it's not after loan (audio skips) foreign affiliates. That change to dividend exemptions make it a lot easier to get money from foreign operations into the UK than out. Then often the shareholders will -- foreign shareholders probably not based in the territory where (audio skips) foreign shareholder.

MR. TODER: Jim?

SPEAKER: This may be a quick question, and it's to Mike. If the UK had not been constrained by EU rules then would its reaction to the inverting U.S. companies that went elsewhere, would it have been the route that you took which was to have a more attractive environment to try to get inverted companies to come back and not to have your own companies invert, or would it have been to put on more restrictions on inversions if that had been legally possible? Do you know?

MR. WILLIAMS: I think it's near impossible to say in the sense that we are -- within the EU we are bound by EU laws, so in a sense there isn't that counter factual that we'd ever need to consider. On the other hand it seems to me this is probably an example by the EU's fundamental freedoms --illustrate globalization rather than impose constraint. We are in a much more global word; you know, the example of foreign shareholders in UK based groups is ample, but you can argue I think that it forced us to confront some of the underlying economics more quickly than we might otherwise have had to. Even in that circumstance where (audio skips) that outside the EU we could have exit rules (audio skips), but then still be nothing to stop UK businesses being taken over by foreign businesses. Quite hard to see why you would want a rule that equally (audio skips) think about this when they're doing start ups, but in that circumstance some people who though that they got a fantastic (audio skips) gone down that road (audio skips) that that would be better.

SPEAKER: So I guess I have a question for Paul. The UK has this effective management standard for residents while the U.S. doesn't have that rule, so there's not much consequence to changing residence in terms of just incorporating somewhere else. But in order to do that you have to do all of these other kinds of things like get a merger partner and everything else. So I was wondering if he thinks the distortions are worse under one system rather than another. In one system you have to do one set of actions, another system would force you to effectively move your management if you wanted to go overseas.

MR. OOSTERHUIS: Well, yeah. There's no question that there would probably be more deals that were done with a U.S. parent than with a foreign parent if we technically had had a managed and controlled test or an effective management test, really not a formalistic test but a real substantive test like, for example in our Dutch protocol, the Dutch treaty. But doing it -- and that's if we had done it say back in the 1960s, 1962 Act or something like that so that everybody had grown up with it. The problem is we didn't go down that road and if we were to change to go down that kind of road now you're faced with a real dilemma because we do have a pretty large set of companies who are managed from the U.S. but are foreign. And some of them are companies that did an inversion, many of them are companies that didn't do an inversion, that's just the way they became organized. And all those companies are going to have to face with what do they do now. And I can tell you it's very hard for the senior executives of the company to say to the shareholders you're EPS is going to go down by 20 percent because I want to send my kids to (audio skips) and not move to Ireland or Switzerland or London. And so I think the answer would be in many cases that the management ends up having to move or you would change managers. I always look at the example of Transocean. Transocean back in 1999 did its original inversion to the Cayman but then in 2008 it moved from the Cayman to Switzerland. And at that time CEO decided that they wanted to be not just a paper Swiss company but a real Swiss company, and so they told the top 16 executives they needed to move to Geneva; 15 of them did, 1 left. And over the time period since 2008 you've seen a fair change in the senior executive levels of that company and it has become much more European as some of the Americans have come back. But they've been replaced by Europeans. And so the face of the company has changed as a result of that decision to move real management abroad. And I think that's the kind of that you would see (audio skips) to go down that road.

MR. TODER: I think we're out of time. So I want to thank the panelists for a very stimulating presentation. (Applause)

MR. HINES: Our next panel is about incentives to invert and the market for foreign takeovers. Corporate inversions are takeovers, and, of course, there's a market for that. In order to understand that we turn to a young expert on international takeovers, and that's Andrew Bird who's an assistance professor at the Tepper School of Business at Carnegie Melon University.

The commenter in this session will be Mihir Desai who's a professor of law at Harvard Law School and Mizuho Financial Group professor of finance at Harvard Business School. But we start with Andrew Bird, Andrew.

MR. BIRD: Good morning. So I was gratified to hear John's opening remarks this morning, and then Jim's done the same thing. So my first slide is really to draw the analogy between inversions and foreign takeovers more generally, and I think that's kind of been done already. I'll go over the argument again just to be clear.

So, of course, the incentives to convert, generally speaking, are to try to reduce taxes on both foreign and domestic income, so that come be a stock of past earnings as well as on a go forward basis. So there we heard about different structures for inversions. They basically involve getting a new foreign parent.

Now, of course, the other place you can get a new foreign parent is if you're just acquired by a foreign company. This has been happening for a long time, but the tax incentives -- as a very close parallel, the tax incentives for a foreign acquire to take over a U.S. company as there are for that U.S. company to find some other way to get a foreign parent.

There are actually a number of advantages from a research perspective of looking at these foreign acquisitions. The main one is just that there are many more of them. So I think inversions are very interesting, but there aren't that many. So if you look at foreign acquisitions more generally, so this is on the order of hundreds of billions of dollars a year of domestic assets are taken over by foreign companies.

Obviously, there's a lot of volatility, but there's a lot of such behavior. Because of that, to the extent that we're worried with tax inversions about things like tax revenues and economic efficiency, it may actually be the case that we should be more worried about these tax incentives underlying foreign acquisitions just because it happens so much more.

So what I'm going to take about today is going to be how the characteristics of U.S. target firms affect the competition between foreign and domestic acquirers. So when a U.S. company is taken over I there's at least an implicit competition to be the successful acquirer. There's at least an implicit competition between domestic and foreign acquirers to do that.

So the key different I don't think is controversial, especially now, between foreign acquirers and domestic acquirers in this markets is that foreign acquirers face lower effective tax rates. I think that's been changing over time, but I think that's probably been true on average for quite a long time now. So I'm going to talk about three different characteristics of these target firms that I think's going to do two things.

So one is it's going to tell us something about behavior, so it's going to tell us something about what kind of U.S. companies are good targets for foreign takeovers, and so, in turn, would be good targets for inversions as well. I'm picking these characteristics in a particular way so that they're going to also tell us something, I think, about how we can make domestic policy choices, and how domestic policy choices are going to affect foreign acquisitions and inversions.

So I think some of these are obviously going to affect inversions and foreign acquisitions, and some of them are less clear. I hope they'll be clear after I've explained them. So I'm going to talk about locked out earnings. I'm going to talk about profitability, and I'm going to talk about tax shields. So we'll get into, sort of, the policy relevance of each one of those as we go.

So to be clear, the sample across all of these three results come from two different papers. It's going to be acquisitions of publicly traded U.S. firms, kind of over the last 20 years. All right. So start with the one that I think is the most straightforward is, obviously, an international tax policy choice that the U.S. has made. It's going to be the worldwide system. So a well-known consequence of choosing a worldwide system in combination with deferral is that you're going to get locked out earnings. So you're going to have earnings of U.S. multinationals that can't be repatriated without facing, potentially, quite a large tax.

We're going to measure the locked out earnings using an accounting designation called PRE which is permanently reinvested earnings. So let me explain just briefly what that is. So in principle for accounting purposes, so under GAP, what you should have to do as a U.S. multinational with foreign earnings abroad that face, potentially, quite a low tax rate there is that you should have to book a deferred tax expense associated with the fact that yes, you're paying a low tax rate right now, but there is this, potentially, large tax expense that you'd have to pay going forward if you ever wanted to bring those earnings back to the U.S.

So that's, in principle, how things should work for accounting purposes. For various reasons they don't, so there's kind of a special exception to this rule that says if the company certifies that these earnings are permanently reinvested, so they're not going to come back to the U.S. for the foreseeable future then the company doesn't have to take this deferred tax expense which has a very big impact on its GAP book reported numbers.

So the nice thing about that is that making this designation, potentially, is somewhat costly that you're committing, at least to your auditor, that you're not going to be bringing those earnings back, but you get a big benefit in terms of your reported numbers. That benefit is larger, the greater is the potential repatriation tax burden. So when we see firms making this designation those are going to be firms that foresee a nontrivial tax cost of repatriating earnings.

So I'm not going to get into, sort of, the details of the transactions. That's not my expertise. I think antidotally, at least, there seem to be lots of ways that inversions and foreign takeovers could unlock these earnings, so could access theses unrepatriated foreign earnings without triggering, at least, such a large tax burden.

So I'm going to look at in the data does that appear to be true? So it seems like there are ways to structure acquisitions and then reorganize the structure of the business to access these earnings. If that's true then what we should see is that U.S. target firms with more PRE, so more locked out earnings, should be more likely to be acquired by foreign companies. In fact, that's what we find.

So if we take a target firm with some PRE, so it's sort of recognized that it has some locked out earnings, and we compare it to another similar U.S. target firm that doesn't have any locked out earnings what we see is that the locked out earnings target is 4.4 percentage points more likely to be acquired by a foreign company rather than a domestic company. So I don't know whether that number looks large. It is large. So in this sample about 16 or percent of these acquisitions are by foreign companies, so this 4 percentage points is quite a lot.

I think one of the interesting things is that this is true even after controlling for the foreign activities of the target. So you might imagine, of course, foreign acquirers might like U.S. targets with lots of foreign activities just because of a kind of like homogeneity kind of assumption that these foreign companies are already active in foreign countries. There might be more synergies for them to acquire more foreign activities.

But this effect of locked out earnings comes above that, above and beyond that. So it is true that foreign companies like to acquire U.S. multinationals with lots of foreign activity. But even beyond that, the stock of locked out earnings seems to be a big driver of foreign acquisitions.

So there's two, kind of, related points that I think drive home the fact that taxes are really what's going on here and it's not some other weird story is that this foreign preference for PRE is concentrated in acquires from companies with territorial systems, as you'd expect. So it's easier for such an acquire to restructure and get access to these earnings at a low tax cost.

Even further than that, if we just restrict ourselves to the two large countries that change from worldwide to territorial systems, the UK and Japan, we actually see that they increase their preference for U.S. targets with locked out earnings after reforming their international tax system. So it seems to me to be pretty strong evidence that, in fact, this acquisition behavior is really being driven by this issue of locked out earnings.

So the empirical evidence here I think is relatively clear, and I think it makes sense intuitively as well that the lock out of earnings caused by the worldwide tax system used by the U.S. encourages foreign acquisitions of U.S. companies. I think that, just as it's true for acquisitions of U.S. companies, I think it's also true for inversions.

So next I'll turn to the profitability of the U.S. target. So it may not be immediately clear why that's an interesting thing to look at. So one thing that we definitely like to know is the effect of the statutory rate in the U.S. on this kind of behavior on foreign acquisitions. So unfortunately, it's difficult to do that directly because -- so I said the statutory rate doesn't change much. I mean, it didn't change at all during my sample. It's been a long time since it's changed.

So what I think is a useful thing to do is to try to investigate these tax differences. So by tax differences I mean it's not just the U.S. statutory rate that matters it's also how it differs from the effective tax rates or the statutory rates in other countries. So we can look at that indirectly by looking at the effect of the profitability of target firms on the identity of the acquirer.

So the reason that works, or at least the reason that it works in theory, is that foreign bidders are more likely to acquire more profitable target firms. I think the intuition is relatively straightforward. So a dollar of profit yields more after-tax cash flow the lower is your tax rate. So, of course, all acquirers like profitability, right? So for an equal price they would all prefer the more profitable firm. But dollar for dollar foreign acquirer should be willing to pay more for that dollar of profit because they get to keep more of it after tax.

So before I tell you the result let me just, sort of, preview. So if it's the case that we have this kind of sorting where foreign acquirers are particularly interested in high profitability targets then I think that's pretty strong evidence that tax differences across acquirers are important in this market.

So one, kind of, straightforward way of looking at this is just across industry. So what we've got in this picture along the vertical access is by industry the fraction of target firms in that industry that were acquired by foreign acquirer. So this varies from, you know, maybe 5% to 25% in the sample. Along the horizontal access we have the median profitability of the firms in these industries. So if you're wondering the size of the dot is reflective of the number of transactions there were in that industry.

So what we can see, especially because I've drawn this line here, is that there is a positive relationship. So it is the case that industries with higher median profitability experience relatively more foreign takeovers. So that's consistent with the theory that I've outlines.

Now, of course, I'm not going to talk too much about alternative theories, but you can imagine they're other explanations for this picture. It may just be the case that there are lots of foreign acquisitions in mining, and mining happens to be a relatively profitably sector.

So what you can do is, in fact, so let me go back to this for a second. What we can do, in fact, is look within each of these industries. So we have this behavior across industries which is consistent with the theory, what we can do is look within those industries. So they're relatively a lot of foreign acquisitions in manufacturing. We can look within manufacturing and see whether the more profitable manufacturing targets are more likely to be acquired by foreign acquirers. In fact, that's the case.

So just to be a little bit concrete about it, so one standard deviation higher target profitability, so this is something like 10 percentage points of return on assets, increases the probability the acquirer will be foreign by 2.8 percentage points. So again, you should think about this as relative to the 16% average in the sample.

So again, this preference could be due to non-tax acquirer differences. So, I mean, one story would be that foreign acquirers kind of like the prestige of acquiring a really successful U.S. company. But for a couple of reasons I think that this is really a tax story.

So the first thing is that if you, sort of, replicate this exercise for minority transactions, so you're not acquiring control you're just acquiring a stake in these firms. If you do this exercise there you don't see any of this profitability sorting. So, in fact, if anything, you see that foreign minority purchasers are looking for less profitable targets.

So what I think is a key difference between the majority transactions and the minority transactions is that if you only have minority control then you can't really shift income successfully. You really need to have control of the target to be able to exercise these effective tax rate benefits. So the fact that we don't see that when foreign acquirers can't exercise at least quite as large tax benefits suggests that this profitability sorting is really coming from taxes and not something else.

Second piece of evidence here that I think is pretty strong is that if you split the acquirers, so among this subset of foreign acquirers that like profitability, if you split those into the ones that are resident in tax havens versus not it's the tax haven acquirers that really like profitability. Those are the companies that have the biggest tax advantages, and those are the ones that are most willing to bid for high profitability U.S. targets.

So the third result that I want to talk about, so this may not be clear right away why this is necessarily relevant to this issue, and that's tax shields or tax deductions, tax preferences. They go by many names. So the intuition here is similar, so foreign bidders are less likely to acquire targets with more tax deductions.

That's because a given tax deduction of tax preference saves you less tax if you've already got some other way of lowering your effective tax rate. So in the extreme the way to think about it is if your effective tax rate is zero you don't need tax shields or tax preferences. You've already managed to get all the way down to zero. So what that means is that we should see foreign bidders as being relatively disadvantaged at acquiring targets with lots of available tax deductions.

So to test this proposition what we'd like is to have a nice natural -- in economics we call a natural experiment. So we'd like to see a case where tax deductions change in a way that's not obviously connected with anything to do with foreign takeovers. So I think bonus depreciation, so I'm using, sort of, the start of bonus depreciation in 2001 as a natural experiment here, and I think it's nice because at least I've never heard anybody say that the channel of foreign takeovers was something that was being discussed when bonus depreciation was instituted.

So the empirical strategy here is going to be that we're going to compare across industries what happens after bonus depreciation. So as an example if you take an industry like manufacturing that got a relatively big increase in allowances associated with bonus depreciation. That's by design of their reform. You compare manufacturing to real estate which, again, by the nature of bonus depreciation was almost not affected at all. Then what we'd expect to see is a decline in foreign takeovers in manufacturing relative to real estate post-bonus depreciation. So that's the test that I'm going to do.

It turns out that it works. So, in fact, this theoretical idea that it's, in fact, domestic bidders that are more likely to win when a target has a lot of tax deductions that's actually what we see in the data. So let me show you a picture of that as well. So here I've kind of skipped the result and I'm going to a counterfactual story here, so hopefully you can see the differences in the colors on the bars there.

So the dark bar is what we actually saw. So that's the dark bar there says that, you know, we had something like 20 percent foreign takeovers in manufacturing. The light colored bar is showing us -- supposed that bonus depreciation hadn't happened, so we hadn't relatively disadvantaged foreign acquires around this time. That's the level of foreign acquisitions that we would have seen in those industries. It always would have been higher. That's because bonus depreciation is a one-way deal, so maybe you didn't get much in the way of extra deductions, but everybody got something.

But it had a pretty considerable effect, so on average my results show that the reform explains about a five percentage point fall in foreign acquisitions following the reform, which I think is large in comparison to the numbers that I've told you so far. I think it's also large because of the three things that I talked about I think that this one is the least obvious. The least obviously related to foreign acquisition. I don't think it's really discussed -- so when bonus depreciation's discussed I don't think that this is really the kind of thing that's being talked about, but it appears to be quite important.

So I have not much time left, so I'm going to mostly restrict myself to kind of giving you a summary of the consequences of the behavior that I've talked about today. I'll mostly leave the policy to me here and the next panel. But to summarize, so the worldwide system of international taxation, a high statutory rate, or just big ETR differences, and a wide tax base encourage foreign takeovers. Whereas a territorial system or small ETR differences which you might get by either changing the statutory rate or further regulating income shifting to making it more difficult, and a narrow tax base, so a tax base with a lot of tax preferences, for example, encourage domestic takeovers.

So I think the main policy message is that if you have an idea of which way you think this, sort of, balance between foreign and domestic takeovers should go which, I mean, one can have lots of points of view on that. If you have a point of view on that I think that what these results are showing you is how you can use domestic policy to achieve that goal.

So I won't say too much about my thought, for now anyways, on my thoughts about these other issues, but let me just highlight the ownership efficiency issue. I think what's important here, at least from a policy perspective in the MNA market, is it involves combinations of assets that businesses have. What we would like is the assets that get combined are ones that exploit synergies, reduce production costs, increase revenues, things like that. So these are pre-tax concepts. We'd like to have assets combine to maximize pre-tax returns.

In fact, as we already heard that's the concern of businesses to maximize post-tax returns. So the greater these kind of tax incentives and disincentives and distortions the farther we're going to get away from this ideal of maximizing pre-tax returns.

Then, of course, there are all these different effects. What matters, really, is whether we're too high or too low on net. So I talked about some things that are favoring foreign acquisition, some things that are discouraging them, and so the right direction to go depends on how we're doing so far.

So with that I guess I'll turn it over to Mihir for his comments.

MR. DESAI: Thank you so much for the invitation to be here. It's a real pleasure. I really enjoy this paper. Andrew's one of a new generation of folks who's really providing lots of new empirical evidence, and there's a wave of new papers on this topic, so it's a delight to be discussing it.

Let me just tell you what I was hoping to do. I'm going to first just begin with a review of what Andrew went through. I think it's pretty straightforward. Then try to just address why you might care, and then talk about some of the issues and problems. In order to maintain my street credibility I do have to, at least, prompt some questions about results and investigate some alternative explanations for that, and then wrap up.

So as Andrew laid out, there are several results here and there's some nice robustness tests that I want to just highlight. So the big headlines are foreign acquirers are more likely to purchase profitable U.S. targets. Interestingly, it's more true for majority of transactions, and Andrew points out that's where you'd expect to see it, and it's more true for acquires from havens, so called havens, than from non-havens. Again, where you'd expect it, which is, again, a nice empirical robustness test.

The second piece of it is that increases in depreciation allowances decrease the likelihood of foreign acquisition. This, again, I think as Andrew suggested is not immediately intuitive, but I think the way to think about it is well, if they're scooping out their domestic base with depreciation then there's not as much domestic base to scoop out for the foreign acquirer. I think that's a simple way to think about it. Then more locked out earnings are associated with the greater likelihood of foreign acquisitions, clearly relevant in the inversion setting.

But what's really nice here is that varies depending on the regime of the home country. Sorry, of the acquire country -- the country of the acquirer. This is the really nice thing, this is where economists get really excited, when you see a regime switch as in the UK and Japan, and then you see the effect even more so. So a very nice set of results.

So just briefly before I put forward some quibbles, you know, why should you care? I think the first thing just to say here is, you know, when I began in this business it was common to think that taxes were something that you addressed after the investment decision or merger decision you wanted to undertake. The tax experts would then come in and arrange things in order that they were optimized.

This has just been a secular trend, and this inversion wave, and these results would suggest that that's just no longer true. That taxes aren't the afterthought. That they are, in fact, a leading though in the design of these transactions. So that gives rise to a variety of concerns. One of which is highlighted by Andrew which is are we having productivity distortions because of who owns what. That's certainly a concern I'm sympathetic too. I just wanted to raise a few others just so we understand why you might care again about this.

One is that there's aggregate productivity problems. But in this literature there's been concerns that it's not really clear why we care about how the world is doing. We should care about how America is doing. So even in national welfare terms you might care about this. I just want to lay out a couple of reasons why so the rest of the results are interesting to you.

The first is highlighted by Mike, I think, and Paul, and their earlier discussion, although it came up at the end. Which is we just might care about where headquarter jobs are. That just might be a first-order thing that we care about. You know, Mike suggested it was because other advisors around them, there's a whole network of people around them.

Paul suggested it's because the next generation of headquartered people are not likely to be Americans. They're likely to be non-Americans. So that's one other reason why in addition to some aggregate productivity, which might feel unfemoral to you, you might care about those particular jobs in a way you might not have thought of otherwise.

The second thing just to highlight here is these are good firms. These are high quality, high productivity, high profitability firms. So it's not as if the selection mechanism is working in America's favor, in some general sense, it's working against them. What do we know about high profitability firms? Well, we know high profitability firms share rents with workers. We know that shows up in wags. We know that high profitability firms and firms that do we in particular abroad now I think it's well-established that they do well domestically. So these are not the firms you want to be taken over. They're, in some sense, exactly the ones you don't want to have to be taken over.

Then the final thing to say about that is we know, and I think we need a lot more research, but we already know something about the fragility of jobs as a function of the distance to headquarters. The fact that we know roughly is that as you increase the distance from headquarters the fragility of jobs, by that I mean the likelihood of a layoff, increases. So for that reason you might care about this as well.

Then the final thing to say is from a revenue perspective the long, persistent fact, I think it's still true, is that foreign multinationals in the U.S. have remarkably low profit rates. That might be for a variety of reasons. One potential reason for that is they're particular good at scooping out the base. So if we're seeing that more than that would seem problematic from a revenue perspective. So for all those reasons I think these results are things that go beyond some notion of aggregate productivity problems of which, of course, I'm very sympathetic.

So just a couple of thoughts about the results themselves. The first is, you know, the profitability results, I think, are really interesting and, perhaps, the strongest of all of them that, you know, I would like to see more. Which is, of course, what I want to do. So, you know, the first is, as Paul highlighted, there's really different mechanisms in place with respect to foreign profits and domestic profits.

So in the domestic profit setting we care because we think they're scooping out earnings via interest stripping or other allocations. Then with the foreign profits it's more about the repatriation taxes and such. So I would imagine that, Andrew, you have the data to actually separately identify those, so I would like to see that because we really have very different policy responses to those two kids of profit bases being stripped out. So that would be the first thing.

You know, I think industry controls -- you know, Paul highlighted this, we see big industry effects. We saw oil. We saw insurance. We're seeing pharma. So we need industry effects, and I think that should be the baseline.

I think the majority/minority test, frankly, is just a little bit difficult to swallow. So the identifying assumption there is that the motivations for the minority investment, this is a less than 50 percent investment, are the same as firm majority investment. I think that's a little tough. It's tough because in an unrestricted market where people can either take minority or majority positions they have very, very distinct motivations. You know, one is typically about learning which is the joint venture of the minority. The other is about control. So I'm not sure I like that.

I like the haven one. That test is much more convincing to me, and I'd like to see lots more. So I'd love to see, you know, a test that was, I think, originated by Jim and his paper on state taxes in (inaudible) which is do they come from the territorial regimes or do they come from the worldwide regimes. I'd love to see differences in tax rates. So it's not just that the foreign people want to buy things, but it's the foreigners from lower tax countries. So you could think about that in a more continuous way than the binary notion of havens.

There is a persistent puzzle in all these results, and I may just be misunderstanding the results, but there's this persistent result which is losses go the other way. So losses are highly significant in all these regressions and they go the wrong way. So, as I understood them, and maybe I'm wrong, because there's not a lot of -- I didn't quite understand this which is it's the high profitability firms and the high loss firms who are being acquired. And so I just -- I don't understand that, and it would be useful to think a little bit more about that.

Then, finally, I would just say I'd love to see this move away from, you know, are you acquired by a foreigner to notions of value. I think combined aggregate returns is the way to go for here, right? So if all this stuff is true you should see very high combined aggregate returns on the acquisition because you're taking a lot of value away from the U.S. tax payers. So I'd like to see that, and it should show up in combined aggregate returns. That would be a nice place to see it.

Then, finally, I would just say, you know, this has come up briefly, but there's a lot governance issues in these transactions which might be nice to address. So first, the broader cross border MNA literature has a lot governance things to say. They could be incorporated in these regressions.

If you think about the inversion setting the governance issues are first order. In the original wave of expatriations they were first order. If you thought about Paul's discussion of why 7874 was originated, because the previous one where shareholders suffered, but managers didn't, didn't really work. If you think about Valiant and the concerns about their transaction in this last year it has a similar ring to it. So the governance attributes of these transactions, I think, are first order, and I'd like to see them addressed.

The depreciation results are really interesting for the reasons Andrew suggested. I confess, I had a little harder time with them, and I had a harder time with them because, you know, I think about merger decisions. It's hard to imagine the short-run change on bonus depreciation is going to trigger a very large MNA response. So bonus depreciation comes in and there's some notion which is this is a short-run thing, and so why would I then make a long-run merger decision that was predicated on that. So I thought that was a little bit complicated.

You know, in general, I'd love to think more, and this is true in the profitability results as well as here, about interest allocation rules, and understand how the variation and the ability to use interest allocation could be used to further identify this. That's a little bit in the weeds. But there are some other things you do in the other paper that I would love to see here.

Then the final thing is on the locked out earnings results. Just a few comments here. This is really interesting, and I think if you think about these transactions that happened last year, you know, clearly part of it was using off-shore cash to finance transaction, directly finance transactions. So I think that's really interesting.

You know, just briefly they're too measurers here. One is PRE, which is permanently reinvested earnings, as described by Andrew. The other one he talked less about, but it's interesting as well, which is repatriation cost which is seeing if you've had low average foreign tax rates in the past, roughly speaking. That's a measure that originated in paper by Fritz and Cherdonton and others.

So the question is what are we talking about with these measures. So here's one of the ultimate ironies, I think, here which is PRE, which is the firm designation of money that I'm keeping abroad permanently is being used to signify cash that I'm not using. So that's a perversion in a sense. We're assuming that exactly what the managers say is the opposite, right? It's cash that's not being used is what we think it is, so that's a little bit weird. That's okay.

But it's not clear that it's cash abroad, and it's not clear that it's really about the tax or if it's about the accounting frictions. So that's also a little bit unclear. We know that the accounting frictions are important.

You know, one alternative way to interpret these results is that they're really about -- and maybe this is just another way of saying what Andrew said, but I think it's important. They're really about firms that have low average foreign tax rates. So the other way to understand that results, which is those firms are likely to have higher PRE. Those firms are likely to have the higher 'repatriation costs.' So then it's not about locked out earnings per say, it's about firms that have low average foreign tax rates, and they may have them for lots of reasons, and the, being attractive for that reason. So, maybe, perhaps there's just a slightly different way to think about the results, but I think they're important.

Again, you know, loses are puzzling. It would be neat to get more of the kind of variation we saw in some of these other papers. You know, clearly AJCA would seem to be a time in a legislative change that would seem to provide an opportunity to say, well wait, when you get the repatriation tax holiday what happens to the merger activity. If there's all these locked out earnings and I get a reprieve then how does the merger activity change. So that would be really interesting.

So again, a really nice set of papers and results. I think part of a wave of really new levels of understanding about what the tax system is doing. You know, briefly, you know, what is the big takeaway from all this? You know, I think first, this is one piece of a puzzle, and we know lots more as well.

I just want to briefly talk about that which is we know not just on the inbound MNA side which is what Andrew's talking about, and which I think is very important for the reasons I said. We also know that off-shore cash is shaping outbound activity. So as one example of this, Michelle Handlin and others have papers looking at announcement returns on outbound MNA activity by multinational firms who have large amounts of cash abroad.

It's a mouthful which is way of saying when Microsoft has a bunch of cash abroad and they buy Skype what do investors think. The answer is, they don't think very highly of it which would suggest that those are sub-optimal investment decisions, and those announcement returns are telling us that.

So what's the broader lessons, and I'll finish with this. You know, I think from a policy perspective, I’m not going to spend a lot of time. We have a distinguished panel coming up. But I think the clear point is you can't think about inversions in isolation. There's a market for corporate control. This is a piece of the market for corporate control, and you just can't think about them in isolation.

If you do the consequence can be very difficult. So in particular -- by the way, you know, the evidence for that is the tax link is there, but the more general point is these are all transactions on a continuum. We should understand them as such. The reason that that's important is if you address these problems in piecemeal ways you are likely to cause other problems that are maybe even more severe elsewhere.

So when the disease is systemic and if you diagnose it as non-systemic, and you treat one piece of it you delay and you see further consequences that are even worse. So the reason to think about this, without saying what the right systemic answer is, is just to make clear that it's systemic, and so when we have approaches that are piecemeal, including regulatory that are specifically designed. Most obvious being, changing thresholds from 80 percent to 60 percent they can only, not that they can only, but they will have consequences that we should understand which is they will tilt the playing field towards larger foreign acquires who then will have an advantage bidding on U.S. assets.

That may be okay, but it's not clear why we'd want policy response to be one that favors Siemens' ability to buy or Merck Agassiz's ability to buy U.S. assets rather than other ones. Thank you.

MR. HINES: I got the first microphone, so I get to go first. We're not going to have some questions and answers, but I want to start with a question to Mihir. My question is when you were talking about the distinction between foreign ownership of a business activity in the United States and domestic ownership, and point out, you know, some of the benefits that come from domestic ownership, domestic headquarters, and so forth were you suggesting that we should have severe rules on foreign acquisitions of American companies? Like, you know, have laws that put up -- how would we know when we've got the right treatment? You know, which is an issue that Andrew raised as well in his presentation.

MR. DESAI: Well, I certainly wouldn't favor, you know, barring foreign ownership. I don't think that's the right answer, and I, frankly, don't have a perspective on the optimal rate, and I wouldn't pretend to.

But I think the reason to think about it is simply to say that we seem to have a distorted market, and the tax rules are creating that distortion. So at a first approximation I think it's safe to say that removing that distortion would be an advantageous thing. I think so it's less about putting up rules than it is about, you know, at least removing the ones that are disadvantageous.

The second thing to say is I think it changes our attitude from a policy perspective in the electorate, hopefully, which is that we don't understand -- we understand that having an American firm that's headquarters in America and succeeding abroad is broadly a positive thing.

I think that's the mindset change that is required, and so we should understand that, you know, it may well be very good to have an American firm be located here and succeeding abroad. We should not be indifferent between that, and having a subsidiary of a non-U.S. firm here. Again, this is where I think research should go. I think it's speculative now, but I think it's really important and interesting.

MR. HINES: We do have time for some questions. Sir?

QUESTIONER: Thank you. How would this change if we cut the U.S. rate from 35 percent to 25 percent? Because it almost seems like you're setting yourself up for just a renewed cycle. When the UK's going to have a 20 percent corporate rate, and Ireland has a 12.5 corporate rate, and in cases of IP there's patent boxes. A UK patent box is going to be 10 percent, and when Ireland gets there patent box is going to be 6.75 percent.

So, again, don't want to make a speech, just ask a question. Does this, sort of, reduce the desirability of the type of corporate tax reform that everyone's talking about where we cut the rate from 35 percent to, say, 25 percent?

MR. HINES: I think that question was for you, Andrew?

MR. BIRD: Sure. So I think to some extent that's the nature of tax competition. We may, sort of, you know, from a broader perspective that may not be desirable that that's the behavior that we're seeing across countries, but that doesn't mean necessarily that unilaterally there's anything to be done about it.

I think, of course, there are opportunities for cooperation. I think the OECD is doing a lot of different things to maybe try to mitigate what you're talking about. But I don't think by itself I don't think it -- I think the fact that, you know, competitors for investment to the United States are doing these kind of things. I think there needs to be some kind of a response.

MR. HINES: Bill Gayle?

MR. GAYLE: Hi, thanks. I was intrigued by the results of the paper and by the comments. I just want to think through this to see if I'm thinking through it right. You said that higher profitability raises the likelihood of foreign purchase, and bonus depreciation reduces the likelihood of foreign purpose.

So suppose we have a revenue neutral change that reduces the tax rate but restricts depreciation rules to pay for the lower tax rate. It seems like on a first order that means that the overall profitability would not be affected, and bonus depreciation would go away. So it seems to me like the net impact of that would be to increase foreign purchases of American companies. I'm wondering if that's right? Do you have a sense of how big that would be for revenue neutral tax reform, etcetera?

MR. BIRD: So an exact number is maybe a little bit beyond the scope of my investigation, but I think your intuition is right. So I think if you do, kind of, a back of the envelope calculation about combing these two effects I think that what -- I mean, at least what the results that I'm finding suggests is that is what you'd get.

MR. HINES: Eric Totter?

MR. TOTTER: Yes. I'd like to just follow-up on one comment that Mihir made. The story I'd often heard about this acquisition of a lot of money by U.S. firms overseas is since they don't have anything to do with the money it costs them a lot to bring it back that encourages then outbound merges with a purchase foreign firms.

So I wonder if you had looked at anything to do with outbound merges, and if we're looking at something that's a gross effect, and more merges in both directions? Or a net effect of foreign takeovers when we're looking at the U.S. tax rules?

MR. DESAI: So I think there's pretty strong evidence for both of those channels. I think the nature of this kind of empirical work is it's difficult at least -- looking at individual mergers it's difficult to answer how big is the new channel. What we can say is that there's a certain amount of FDI in this form that's going in and out, and that it's affected by these types of incentives. It's hard to say whether on net it's an increase or a decrease. It's a change in the character of the FDI that we see.

MR. HINES: John Samuels?

MR. SAMUELS: So I think there's a nice parallel between the paper that Mihir cited that Michelle Handlin recently published that shows that firms with foreign cash tend to invest it in ways that the market doesn't like, the Microsoft Skype example. You might ask, why do they do that?

If I link that with Andrew's paper, if I'm a firm sitting around with a lot of cash, and that makes me a more likely target for a foreign takeover what am I going to do? I'm going to invest that cash. I don't think that's true in the Microsoft case, but it may well be true in others, so there may be an agency cost issue here.

MR. DESAI: I mean, the way I would say it, it's definitely an agency cost issue, but also a reinforcing cycle. I think the way to think about it is what's triggering the suboptimal use of the off-shore cash is the pressure that's in part felt because of the foreign acquirers. So that's a reinforcing cycle of sorts.

MR. SAMUELS: (off mic).

MR. DESAI: No particular reason like it, for sure, yeah.

MR. HINES: Loads of other acquisition studies have found that firms with cash, you know, are more apt to be acquired. Michael Devereux, and I'm afraid this is our last question.

MR. DEVEREUX: I was just going to pick on that point from John because as I understood what Andrew's paper said if the firm is acquired it's more likely to be acquired by a foreign firm rather than a U.S. firm. It wasn't the results that it's more likely to be acquired per say. Is that right?

MR. BIRD: Exactly right. It may be true ended also -- well, it raises the possibility that there's additional bidders in raising, you know, potential reservations which is, at least, implicit.

MR. HINES: If there's anything that we've learned from this session is that there's competition for everything. Part of what there's competition for is our time. If we went on we would eat into the break and I know we don't want that. So we have time for a 15 minute break. We will reconvene at 11:15.

(Recess)

MR. GRAETZ: We're going to get started. Our panel is entitled Policy Responses to Corporate Inversions (sic). I think it means that we are to enlighten the audience as to how to solve all of the problems that have been discussed earlier today, and for those who know the players you will expect unanimity among the panel.

I will say Paul began the day by pointing out that I don't understand boxes, and I should correct him. I don't understand formulas either, but words, actually you can probably get some benefit from, and that's what we're going to engage in up here.

I'm tempted to introduce the group by describing the red corner and blue corner, but I won't do that. I'll just introduce them from my left in the order they're going to speak. Most of these people are well known to you and I won't say much about them.

Michael Devereux runs the Center for Business Taxation and teaches economics at the Saïd Business School at Oxford, so you should not believe what his resume says in the book. It's at least 10 years out of date I think.

Stephen Shay teaches at Harvard Law School. He was Deputy Assistant Secretary International at the Treasury Department, and practiced law in Boston for many years.

Jim Hines is a University of Michigan economics and law professor trained in economics and teaching law which tells you a lot about law schools these days, but Jim is the Director of the ITPF Research Institute, and I think along with Mihir Desai wrote the first analysis of corporate inversions, at least the first one that I remember reading.

And Ed Kleinbard is now a professor at the University of Southern California. He was a practitioner in New York for many years and Chief of Staff of the Joint Committee on Taxation, so we have an experienced and knowledgeable group and I am the referee. Michael, you're up.

MR. DEVEREUX: Okay, thank you. Thanks for inviting me. I've got five minutes, I believe, so what I thought I'd do is address some broad questions. My fellow panelists know far more about the U.S. tax code than I do, so I'm going to leave them to trade section numbers with each other and deal with the big questions, I think.

I just want to make a few kind of very broad points to start off with. First of all, when we talk about policy and policy recommendations, we often get disagreements between people, and often the disagreements stem from acknowledged and implicit assumptions about what we take as given in the tax system. When we're thinking about inversion rules, for example, are we taking as given the rest of the U.S. tax system or not? How broad are we talking about it, and I think quite a lot of disagreement stems from actually people starting from different points, so I hope we can be clear with each other exactly and with the audience exactly where we're starting from here to try and make explicit what we take as given and what we don't.

Second point, taxes cause lots of problems and governments address those problems in a number of ways, but quite often they address them in ways that don't address the -- they don't address the underlying problem itself but they deal with the symptoms, and I think there are many examples of that.

There are many examples in international tax, for example, so I think if we just think about international tax broadly, then what does the international tax do? We go back to 1920's compromises, and Michael's referred to it.

So, active business income is taxed in the source country. Passive income dividends, royalty, and interest are taxed in the residence country. Now, that might seem like a good idea in the 1920's but it causes enumerable problems because we have to figure out what "residence" means. We have to figure out what "source" means. We have to figure out what "royalties," what "interest" and "dividends," and there are many of the problems of trying to allocate profits between different jurisdictions come down to those kinds of problems.

Now, we've already talked, for example, about how we measure residence this morning. Now is it in the place of incorporation? Is it the place of effective management, management and control, and those kind of issues?

So, actually, as an aside -- an aside in five minutes, so I'll be quick -- but the OECD BEPS Project, for example, is taking the existing system as given. Kind of started off by saying we're going to have a fundamental review, but actually what it's doing is taking those principles as given and trying to fix some of the problems that it observes there. It's trying to fix it ways which actually may well be introducing more problems down the road, so one of the things the OECD BEPS Project seems to be doing is to say we ought to be looking for economic substance.

Now, that may or may not be a good idea, but it's not actually part of what the original system is trying to do, so it would be much better in my view to actually go back to fundamental principles first and say, "Well, what is it that we're trying to tax," and then figure out how the tax system should address that.

Okay, can we take inversions? Why is it that U.S. companies want to invert? Well, we've heard about that this morning. One is that foreign companies find it easier to strip income out of the U.K. than U.S. companies because of USCFC rules, and the second is that the worldwide tax system in the U.S. doesn't allow multinationals to bring income home without a tax charge, so they leave it outside the U.S. So, those are two real problems. How to re-address them if we think those are the problems?

The first question is "Well, are happy that foreign companies or foreign owners of U.S. subsidiaries can easily strip income out of the U.S. through use of debt? And if we are, then there's no problem. If we are worried about that, then we should do something about that. We should have rules which address that particular problem. What the anti-inversion rules say, "Well, we observe foreign owners of U.S. companies stripping income out of the U.S. so we'd better stop U.S. companies becoming foreign because otherwise they'll be allowed to do it as well." That seems like a kind of somewhat indirect route to trying to fix this particular problem.

The second problem, it's what I think Ed called the ersatz territorial system. It's not worldwide system at all because the U.S. actually doesn't raise very much tax revenue from taxing worldwide income, but the main effect is to keep all this money offshore. So, do we think that's a problem? I think we probably do. That's bad for U.S. multinationals, but it's bad for the U.S. as well because that money's not coming back and being reinvested in the U.S., so that seems to me that this is broad question about the U.S. tax system. How should we try and address those kinds of questions?

Anti-inversion rules -- are they addressing those problems? They don't seem to be addressing those problems. What they're doing is designed to kind of prop up the existing system with all these problems inherent in it, and it's a tax on old capital. If you're already a U.S. company and you've already got foreign activities, then U.S. anti-inversion rules are trying to stop you from going somewhere else. If you're starting up a new company, I guess if you get well advised, then you wouldn't set up as U.S. company in the first place. You would just kind of set up as a foreign company, and then have a subsidiary in the U.S. doing that. So, this is also trying, in effect, to be a tax on old capital rather than new capital.

MR. GRAETZ: Thank you. You kept to your five minutes. Steve, you're next.

MR. DEVEREUX: That is what I was told to do.

MR. SHAY: Well, I'm --

MR. GRAETZ: That proves you're from the U.K. (laughter)

SPEAKER: And now we have an American.

MR. GRAETZ: Now we have Steve's five minutes. (laughter)

MR. SHAY: No tax code sections if I can get away with it. I think I'm going to follow Mike's advice actually. I'm going to end up making three points about corporate inversions and tax policy, but before doing that I'm going to start with what you might think of as my assumptions or level seven.

First, the United States along with most of the rest of the world will continue to have a separate corporate income tax as an integral part of its overall income tax system. One theme you're going to hear me come to is just how holistic an income tax has to be to work.

Second, the United States will continue to rely on the corporate tax for a small but material portion or fraction of its income tax revenue.

Three, a critical role of the corporate tax is to maintain the integrity of the overall income tax, both business and individual by preventing avoidance of individual income tax through the use of corporate entities. While the economists continue to debate the insurgence of the corporate tax, no one questions that a material portion is born by shareholders.

And while there's debate about the exact extent, the data are reasonable clear that American companies, unlike what we're hearing about from Mike in the U.K., are very largely owned by Americans; U.S. residents, taxpayers. For this reason the taxation of international income of U.S. multinationals is integrally related to the individual income tax.

Next point, level (inaudible), I spent decades advising clients how to minimize taxes, and that experience taught me that a tax system that purports to put income into neat separate categories is easily exploited, something actually Ed can speak to even more fully I think. Wherever there is a boundary it will be tested. Anyone who advises clients knows that the line between personal and business is porous. The just-released *National Taxpayer Advocate Report* I think again lists trader-business expense as one of the most litigated issues. The line between compensation and return to capital is abused by carried interest.

I could go on, but my point is it's fool hardy to put weight on the distinction between corporate tax and business taxation generally, and equally mistaken to treat business taxation as fundamentally distinct from income taxation.

The same principle that a tax system is holistic in nature motivates my view that treating foreign income as somehow distinct from domestic income is a fundamental mistake. That should not be exacerbated in any tax reform.

I'm going to make my three points now. First, I would be remiss not to start out by showing where I agree with John Samuels. The pressure for inversions is not going to go away as a result of shifting to a territorial or dividend-exemption system (inaudible) any version that has been proposed by the United States to date or that I think plausibly could be adopted. The experience of the United Kingdom I think has shown that robust, controlled, foreign-company rules trigger corporate expatriations, and the reason I say that is because part of that time they were able to use their foreign earnings with the upstream loans that Michael referred to, so their driver wasn't what seems to be the driver here which is so-called trapped offshore earnings. Their driver in terms of expatriations had much more to do with CFC rules, and all of the proposals in the U.S. are increasing the strength of one form of CFC rule or another. So, that's my point of agreement.

My second and I think possibly most important point is that the taxation of multinational business income raises important issues of economic justice. That word has not been used today, but that concept I think was put squarely on the table by the President's State of the Union speech, and I don't think there has been a reset in the thinking.

The framework for business tax reform was put out in early 2013. It seems clear to me that after that speech a lot of things have changed, and I haven't seen it filter back into the rest of the Administration's proposals. Economic justice requires that the owners of capital pay their share of the overall tax that allocates the burden on an ability-to-pay basis. As I -- and I had some -- my two co-authors Cliff Fleming and Bob Peroni observed in a 2001 *Florida Tax Review* article, it is unfair to the rest of us to give an unjustified special tax break for foreign corporate income. One of the issues we're here on: Is it unjustified? That's a reform issue. Or is it justified, and that's the source of the research that needs to be done that John was referring to. XXX 00:13:34 A lot of false starts here-- not sure what to cut outXXX But that is most troubling that -- it seems to me economic is most troubling -- justice is most clearly on the table when we take income that was earned under the privilege of deferral, not getting -- that income was earned under the privilege of deferral, and if we allow that income to be taxed at a lower rate or to be exempted. That seems to me to raise fundamental economic justice issues if you're going to have to increase tax somewhere else.

So, where does all that point me? Where does that take me, and this is my third set of points. As we learned from the earlier panel, inversions seek to exploit the line determining when a corporation is a U.S. corporation or when it's a foreign corporation. It's an attempt to gain the advantage of being a foreign corporation, and there are three tax objectives: reduce U.S. tax through a U.S. tax base or use of earning-stripping interest royalties and other deductible payments, to avoid U.S. tax on past foreign earnings, and to avoid U.S. tax on future foreign earnings. So, I would favor an approach that addresses all three problems.

Andrew's presentation, it seems to me, showed that foreign acquirers are advantaged, and at least the data as I understand it suggests that those advantages are there for foreign-owned U.S. affiliates. That should be reduced by enhancing earning stripping, and in my view is already sufficiently an issue and problem that I do think the Treasury should move forward on the second step that was foreshadowed in its September Notice and adopt some more stringent earning-stripping rules until fundamental reform is revisited.

Second, we should prevent avoidance of U.S. tax on foreign earnings that accrue under rules that clearly provide it for deferral, and my view is with respect to those earnings the time to pick up the U.S. tax that's been deferred should be when there's decontrol. Now, we can discuss whether there should be a lower rate. There are arguments for and against that, and I would say I start out with some trouble on that side, but I everything should be up for discussion and that's included.

Third, I would adopt reforms in two areas that have not really been discussed seriously, although one of them has been talked about this morning. First, we should change the definition of when a corporation is a U.S. corporation to take account of U.S. shareholder composition, and that is something my co-authors and I discuss in an article in the *Michigan Journal of International Law* that's just been posted. It's really a side discussion in that article which is labeled "Formulary Apportionment," but we need to start thinking about that because we've learned that place of effective management doesn't work, and yet we have a strong intuition from our current anti-inversion rules that we care about where the shareholders are as we should if a corporation is owned largely by U.S. residents.

The second major area we need to revisit that has not been talked about is the taxation of U.S. portfolio shareholders in foreign corporations to take into account the fact there is often a reduced corporate-level tax on those holdings that is not the case when they hold U.S. equities, so we need to fundamentally revisit the portfolio taxation of U.S. shareholders of foreign equities in relation to U.S. equities.

If a corporation is going to invert and simply become foreign parent instead of U.S. parent, why should a U.S. shareholder get advantages with respect to holding a new foreign parent when the U.S. corporate tax isn't being paid on a large swath of its earnings, whereas in a U.S. parent it will be taxed under whatever system we decide to adopt? Stopping here. That's a Shay five.

MR. GRAETZ: I -- that's -- I noticed. And I saw John Samuels nodding in agreement with you at, I think, every single word you uttered. At least he was nodding. (Laughter) Jim Hines is next.

MR. HINES: I'm going to have to disagree with John Samuels then. I urge us to think about inversions from a worldwide perspective. Most of the advanced world has territorial tax systems. The United States does not. Interestingly, many American policy makers agree in one form or another that we need to move our system to make it more similar to the rest of the world. Obviously there are many different ways of trying to do that. People talk about tough territorial over other territorial and that kind of thing, but I think there's general agreement that your tax system winds up in trouble when it differs so much from the tax systems that countries like Canada, Japan, U.K., Germany, and so forth.

If we think that movement in the direction of a territorial system is good, then we could pose the question why are so many people concerned about corporate inversions? What happens in a corporate inversion is in essence one company at a time they take themselves out of the worldwide tax system and into a territorial system, and if that's what we want for the whole -- suppose that's what you want for the whole economy, then why are you upset when it happens one company at a time?

Indeed, the companies that inverted not only put themselves into territorial tax systems but paid for the privilege because when you invert you have to recognize the capital gains of the shareholders, whereas some of the proposed reforms to give the U.S. a territorial system wouldn't impose that large a tax on the transaction. Again, the proposals, of course, differ in their details.

There is a reason to be concerned about one at a time tax reform of that type, and it is that it's less efficient than sort of having a broad playing field for the whole economy of firms, and it sort of makes more sense if your companies are going to invert one at a time, you may as well just adopt a territorial system in the first place, and of course there are many proposals to do that.

As the session with Andrew Bird and Mihir Desai noted, too, one of the things you worry about it that because of the current difficult -- the costs imposed on firms that invert, obviously it's only a portion of companies that do that, a rather small portion, and so it creates incentives for foreign takeovers for those who don't invert. And if you have excessive incentive for foreign takeovers relative to domestic ownership of these companies, that could cause problems because then you have inefficient ownership of business assets and you've got other issues associated with having foreign owners relative to domestic owners.

So, how should we think about inversions generally? Here's the reality. It's still only a portion of the corporate sector and a relatively small portion. The issue with corporate inversions is what is it telling you about our tax system? And it is also partly what is happening to the resources of these inverted companies. What do inversions do? They take assets that would have been owned by a U.S. entity and make them owned by a foreign entity; in this case by changing, obviously, the residence of the ownership entity.

If that's our notion of what an inversion is, inversions are happening every day, and some days every hour. When are they happening? They're happening in the world around us, probably next week there will be a company that is acquired in Singapore, and the acquirer might be a German firm or it might be an American firm. Singapore is a low-tax country. Germany has a territorial tax system. It's generally more beneficial from a tax standpoint for a German owner to own a Singapore company than it is for an American owner to own a Singapore company because with the low Singapore tax rate there's a residual U.S. tax due ultimately on the Singapore income, now whereas for the German owner there is not a residual tax due.

And so, in the bidding for that Singapore company, the German firm has a slight tax incentive to bid a bit more than an American firm does, and over time there are going to be more German acquirers of those Singapore firms than there will be American acquirers, and those Singapore assets will not be owned by an American company. They'll be owned by somebody else. We don't call that an inversion, but that's our use of language. What has happened there is that the U.S. tax system by taxing foreign income the way that we do has caused an asset that would otherwise, in this example, have been owned and controlled by the United States to be owned and controlled by a firm from a different country. That's what happens in an inversion, but that's what happens every day in the business world because of the U.S. tax system.

So, if we're concerned about inversions, we should be concerned about what happens every day which is that we've got this erosion of ownership of assets by American companies due to the actions of the U.S. tax system compared to the actions of the tax systems of all the other OECD countries that look very different than the United States.

In addition, it goes on. Companies from countries other than the United States, those who have territorial tax systems generally speaking have less fettered operations, domestic and foreign. With American firms, as we know famously, it's hard to transfer resources back and forth because you can trigger taxes. It impedes other -- the U.S. tax system, the CFC rules, impede other aspects of American-firm operations that would not bear on firms from countries that have other rules.

So what should we want at the end of all this? Look, it's complicated. People get emotional about these issues, and we're all concerned about tax revenue and for good reason because the country needs tax revenue, but the country needs tax revenue and it needs economic prosperity, and actually these two go hand in glove together. The more prosperity you have, the easier it is to raise tax revenue. Duh. So, what should we do? What we should want is the most efficient business setup possible.

If you have the most efficient and productive businesses, then you will have higher worker productivity and higher wages, and you'll have greater tax capacity. It's not really very complicated. So, our discussion really should be about what is the most efficient configuration specifically when it comes to inversions, then is it more efficient to put on rules like 7874 -- there, I said the section number -- and the regulations of which we recently got notice, and other rules to try to prevent corporate inversions? Is that the efficient thing?

Or is the efficient thing to use it to learn from the corporate inversion experience that we don't have a very efficient tax system relative to the rest of the world, that we are distorting the asset ownership of American companies and encouraging foreign takeovers and encouraging foreign expansion to the expense of U.S. firms, and use that as impetus to try to get a smarter tax system and a more efficient tax system. Obviously, I'm in favor of having a tax reform that would create a more efficient system and thereby enhance U.S. productivity.

Steve Shay, just before me, raised the issue of economic justice, and of course that always has to be part of our tax discussions. How should we think about economic justice in this context? I urge you again to take a worldwide perspective on that.

Is it just to have an American tax system that looks so different than the tax systems of other countries that are otherwise similar to the United States like Canada, like Britain, like Japan, like Germany, in order to have the system appear to be consistent with our taxation of individuals? If we want to help American individuals, the way to help American individuals is to have an economy that makes them productive. There are a lot of ways to do that, but you cannot be productive unless you work for firms that themselves are productive, and our tax system is impeding the productivity of American firms and thereby hurting American workers. You'll help American workers if you make them more productive, and the way to make them more productive is to remove some of the tax impediments to efficient business operations.

MR. GRAETZ: Thank you, Jim. I was waiting for him to take a breath --

MR. HINES: No, no.

MR. GRAETZ: -- in order to thank him, but it took a little time. Ed?

MR. KLEINBARD: Thank you. So, I had a little bike crash and a small concussion, and as a result I was warned by my internist that a concussion can have emotional ripple effects for several weeks, and it was true and I found myself to be uncharacteristically nice (laughter) for some time. But the effect was slowly dissipating and having listened to my friend Jim, I can now say I'm completely cured. (Laughter)

Look, let's begin with clearing the air on this fundamental misimpression. We don't have a worldwide tax system in the United States. We have, in fact, an ersatz territorial tax system. U.S. firms operate in practice in a territorial system without any of the safeguards that would be imposed by a well-ordered territorial system. There is a cost to that ersatz territorial system which is lockout and that is a stupid kind of place to be. No one can disagree with that. What we want to end up with from an international point of view is either a territorial system that works or worldwide tax consolidation because both of those solve lockout. There's no lockout effect in either case, once you go to either extreme. And it's important to therefore keep in mind that we have a solution other than territorial which needs to be fairly considered.

There is, at the same time, a fundamental problem that we have in the United States and that the rest of the developed world has which is the problem of stateless income. U.S. firms have been the world leaders in tax avoidance technology, but they've taught others well, and the result is extraordinarily low effective tax rates on foreign income of U.S. firms operating outside the United States and non-U.S. firms operating outside of their home jurisdictions.

In the case of the United States, just to be clear, we have about $2 trillion of offshore permanently reinvested earnings, about a trillion of that in cash. Just to correct what Mike Devereux said, it's in the U.S. economy because that cash is invested in U.S. dollar assets, but it's not in the right place, and I agree that those are economic inefficiencies.

So, what do we do about stateless income? We can see the example just the other day at Amazon with a structure that is laughable on its face as a matter of economic reality as a result of which Amazon pays essentially no income tax anywhere with respect to its European operations. The BEPS Project is responsive to that.

This is not a problem with the United States is in it alone. Every developed country faces it. I agree with Mike Devereux that the BEPS Project is likely to fail because it begins from the wrong premise which is to respect the separate economic reality of each juridical entity, every little subsidiary as a risk-taker with its own capital structure and so on. The fundamental premises are ones that really ought to be revisited.

If we have this problem of U.S. firms reporting single-digit effective tax rates, we don't have a competitiveness problem. They enjoy those single-digit effective tax rates on foreign income in respect of their cash tax liabilities and in respect to their GAP liabilities, but we do have fundamental distortions that come from essentially an unpoliced territorial tax system today, and on top of that the bizarre distortions of lockout.

So, for example, in Jim's discussion of the Singapore case, right now U.S. firms buy other foreign firms at a discount relative to their other opportunities because of the lockout effect, so if anything we're incentivizing U.S. firms to buy the Singapore company, not the other way around.

Inversions in 2014 are, of course, a canary in the coal mine. They are a sign that the system is fundamentally broken, but they don't by themselves tell us what the new system ought to be. The wave of 2014 inversions I think -- here I confess of having spoken to dozens of institutional investors, to have closely followed the filings of a number of firms, in fact are driven by three things. The first is do repatriation gain that the September regulations put a stop to get effective repatriation largely tax free? Second, does earning stripping -- earning stripping is a polite term for eroding the U.S. domestic tax base in ways that are fundamentally unfair to the positions faced by wholly domestic firms that are direct competitors. I'm all for efficient tax systems. Jim and I agree on that, but I think the place where you start is at home, and right now the question is do we have consistently-applied tax rates to different firms conducting business in the United States?

So, the three reasons for inversion? The repatriation. The second is the earning stripping. And the third was financial-accounting anxiety. On information and belief, financial accountants are getting a little bit fed up with the representations being made to them. Firms with tens or even $100 billion in offshore earnings but not to worry, one of these days they'll come up with a plan to really do something with all that cash, and the financial accountants themselves are putting some pressure on firms.

Is all of this problematic? Of course it is. Jim and I would agree that there are distortions all over the place, and we'd agree that we could do better at that, but the answer is not to endorse inversions as simply heroic first movers to a new territorial regime, but to have temporary legislation so that everybody is in the same soup rather than encouraging a pell-mell rush to the exits from which revenues inevitably would suffer.

Finally, you need to take a step back and say what is the corporate income tax? It's a tax on capital income. And how are we doing in general at taxing capital income? And the answer is we're doing a piss-poor job. (Laughter) We have --

MR. GRAETZ: Is that a technical term?

MR. KLEINBARD: It is. It's 7875. We have negative effective marginal tax rates in the United States of America today on debt financed corporate investments in grease eat machinery. That means we all in this room are paying firms to make those investments. That's insane. Negative effective marginal tax rates is probably not the right rate. We have super-low effective tax rates on foreign earnings of large, successful U.S. multinationals whether it's Amazon, whether it's Google, whether it's Microsoft. There are a dozen other examples. The pharma industry; dozens of other examples, and again that's crazy because if we want the territorial system, great, but what a territorial system implies is that taxes are actually being collected in the countries where business is really being done. There's a strict connection, a geographic nexus between the income and the business activities. That is the entire intellectual predicate to territorial systems, and the only problem is it's impossible, in fact, to do. That's why we talk about a territorial system with teeth, having a minimum tax, for example, as part of the territorial system. What that really is is a territorial system with a residence system bolted on at the bottom to assure some minimum level. So, what I want is a territorial system where the minimum tax happens to be the same as the U.S. domestic rate which is another way of saying genuine worldwide tax consolidation.

Finally we have in the United States way to high an effective marginal tax rate on equity-financed domestic investment. All of this points to lower corporate rates, and it points, I believe, as a practical matter to worldwide tax consolidation in respect to foreign earnings, not because it's the best idea in theory but because we face a Hobson's choice between two disagreeable alternatives, and as between the two -- effect putting a floor on foreign tax-avoidance strategies will give courage to our European brethren to stop their race to the bottom. It will collect some tax, and it will provide a happier domestic environment.

To get to there the critical piece that's going to supply the revenue that we all are going to have to suck it up and start to think about is that we're going to face domestic thin-cap rules. We cannot go on any longer with zero tax on corporate income that is debt financed or negative when you take accelerated depreciation into account and significantly high rates in respect to equity finance.

MR. GRAETZ: Thank you, Ed. Michael, I want to congratulate you again on the five-minute (laughter) rule.

MR. DEVEREUX: Goes slowly (inaudible).

MR. GRAETZ: Let me just make a couple of observations. I want to see if I can find a little agreement, and it seems to me that there -- I mean you've raised every issue, I think, of international taxation which makes it seem to me that we all agree that inversions are a symptom and not the underlying problem; that is that they are a symptom of other structural difficulties, that there are differences about how they might be resolved, but that they can only be resolved in some sense through fundamental changes in the U.S. tax system, and that I see everybody nodding their head about, and so I think I'm just going to take that as agreement.

There are two other points that at least I want to raise. One is that I sit here and I've been sitting here all day looking at how the U.S. has evolved and its treatment of inversions, and I remember Jim's early paper about people moving paper to Bermuda and getting these tax benefits, and my thought was we were better off when all they were moving was paper to Bermuda than we are today when they're moving people to Switzerland who don't like the Swiss Alps and are moving back, and then the Swiss people take over the company, and the more you tie economic substance to the tax rules the more risk there is of moving real activities, and it seems to me that we need to think about that rather carefully as we build these rules.

Two other points. One is that residence and source are both hard concepts to live with in the modern world even though in the '20 and even in the '60s for the U.S. when it had all the money there was because of the war they were reasonable, but now they've become less reasonable, and the one piece that we cannot tax, at least as I understand things, is the foreign income of foreign companies. And so, this it seems to me is a constraint on some of the notions that are floating around here. That is if you are going to take the position that you can't tax the foreign income of foreign companies and you're not going to bar foreign ownership of U.S. operations, and all you can tax then is the U.S. income of foreign-owned businesses, you've got a bit of a conundrum. And it does seem to me that you then have to ask yourself two questions. One is -- and this I'd like to get everybody's response to; these are genuine questions and see if there's agreement.

One is does it matter to the U.S.? I care about U.S. welfare. I know Jim cares about worldwide welfare, but I'm just a nativist, and I care about U.S. welfare and the well-being of the U.S. people, and if you want to give money to others we'll do that. I don't mean that literally, but that's my starting point in thinking about U.S. tax policy since it's the starting point of thinking about U.S. policy generally.

And so the question is does it matter to U.S. citizens in residence whether domestic operations are U.S. owned or foreign-owned; that is does having a U.S.-owned headquarters make a difference, or does it make it more likely that we will have a headquarters if it's U.S. owned? That's question number one, and question number two is does U.S. ownership of foreign operations make a difference? That was the example that Jim gave where the German and U.S. companies were buying the Singaporean company. Do we care about that? And if so, why?

So, I would really just like to see first whether we agree on those two principles. If we disagree, then I'd want to hear more about it because I think they're fundamental questions in how one thinks about the basic problems that each of you in your own way has raised. If you could for a moment put yourself in the mindset of an American and ask yourself would U.S. -- take these questions the way I put them. I gather the U.K. has made a decision that U.S. headquarters matter to the U.K., and that U.K. operations may matter to the U.K., but you can -- we just go down the panel and see how people react to this because I think the answers to these questions are important in trying to sort out what it is you can do here.

MR. DEVEREUX: Me first?

MR. GRAETZ: You're first.

MR. DEVEREUX: Okay, how long do I have?

MR. DEVEREUX: A minute and a half.

SPEAKER: Do it the American way; as long as he wants.

MR. GRAETZ: You have a minute and a half (laughter).

MR. DEVEREUX: So, does it matter to the U.S. whether domestic operations are domestically owned or foreign owned? So, Mihir here kind of addressed this a bit this morning. So, he'd want -- I guess there are two aspect to that and one is you want it to be owned by the people that are going to run it the most efficiently because that's going to be good for the state of the business; the employees, the customers. Prices are going to be lower. Wages are going to be higher if it's run in an efficient way. If the most efficient people to run it are British people, then that would be good for America.

There may be another aspect there that if they're -- that actually means some profits are going back to Britain rather than staying in the U.S., so that would be a counter-argument, I think, so maybe it's -- to some extent it would be better for Americans to run less productive firms in the U.S. because it needs -- the money stays here and doesn't get (inaudible).

MR. GRAETZ: Well, and the management and control as Mike pointed out earlier this morning would be in Britain and not in the U.S., and there at least some literature that suggests that having management and control domestically headquartered domestically has some benefits, right?

MR. DEVEREUX: Yes, but it --

MR. GRAETZ: Magnitudes, magnitudes.

MR. DEVEREUX: Other things being given, yes. Does U.S. ownership of foreign activities make a difference? Well, yes again. I mean if the U.S. is kind of losing opportunities because of the tax system, you know, if the U.S. want to go in and invest in Singapore and they're not able to do that because German firms are buying out all the Singaporean companies, then there's a lost opportunity in the U.S., yes.

MR. GRAETZ: So, does everybody agree with Michael on these issues or does anybody want to say anymore?

SPEAKER: I agree.

SPEAKER: No.

SPEAKER: No, no, I think the question --

MR. GRAETZ: No, you don't agree or --

MR. SHAY: The part I agree with is people who should -- the best effect is have people run an operation who will run it most efficiently.

I think the core problem with the question, Michael, is it starts when you ask U.S. owned verses foreign owned, you're starting with, I think implicitly, you meant U.S. corporation-owned versus foreign-corporation owned. You weren't disregarding the corporation, and I think what we have to start recognizing is among the other things that have changed since '30's, '60's, whatever, between -- the corporate form is losing its viability. We ignore it. We check the box.

Inversions have demonstrated it doesn't matter whether the box has a label U.S. or foreign. Both the early naked inversions or self-inversions -- I mean inversions that we see more recently, nothing changes in inversion. I've worked on an inversion. It's been completed. It's in the public domain, and the biggest question was where is the box going to be? Is it going to be Netherlands, the U.K., or Ireland? That was one set of questions, and the investment bankers come up with their enormous array of pros and cons, governance and otherwise, and then the second biggest question was do we have to fly there (laughter). That's, no -- and Paul can tell me whether I'm wrong. His experience is a much broader experience, but basically management wants to know how often they're going to have to leave their headquarters.

MR. GRAETZ: So, the fundamental -- I just want to understand what I think to be the fundamental point you're making which is that in the current world we ought to be looking to the owners of the capital and taxing the shareholders, and whether they're income is coming from a foreign corporation or from a domestic corporation, and that in some sense we're starting from the wrong place.

And the Treasury Department in 1992, when it proposed a dividend-exclusion system which was then enacted in 2003, got it exactly backwards, and that is my view today, although I was an active participant in the 1992 Treasury Department study. I like to say if it was right then, it's wrong now, but the truth is probably it was always wrong, and that what we ought to be thinking about is how we're going to collect tax on the owners because they're much less mobile and so forth, and there are a number of proposals out there for doing that ranging from various forms of integration and so forth. That point which I think goes to your justice point and to your economic efficiency point is fundamental and so far has not gotten into the tax reform discussion.

MR. SHAY: Except for the Senate; I see Chris Hanna in the back.

MR. GRAETZ: Well, the Senate report. That's correct. The Senate Staff Report has talked about it a good bit, so it may get into the domain. They may be putting it in the domain.

MR. SHAY: And also I think you don't have to go to integration. That's why you have less pressure on existing forms and approaches if you think about corporate residence taking into account shareholder composition, so just to tie it back to what I was raising before.

MR. GRAETZ: So, my superiors have indicated that we should open this up to the audience for questions which I'm happy to do. Yes, over in the corner.

MR. DESAI: I get the benefit of being close to you.

MR. GRAETZ: The tall fellow near the microphone.

MR. DESAI: So, two questions, first for Ed. I guess I'd like to square your depiction of the wonderful tax status of U.S. multinational firms with inversions. How do you square with that Pfizer approaches AstraZeneca and they say I want to be a U.K. firm? They never say we should be a U.S. firm. So, I just want to understand that.

And then, Steve, I guess I appreciate the appeal to justice. It's moving in many ways. What I don't understand is in what world does international tax policy become the preferred instrument for income redistribution? I just don't get it. So, I'm all for justice. I think you meant justice not in the way that Ed meant it which is across firms, but you meant it, I think, in the context of income inequality. So then I have to get convinced that international tax policy is the preferred instrument for affecting income redistribution. I like income redistribution. I think it's interesting, but in what --

MR. SHAY: I'll answer it. Do you want Ed to go first?

MR. GRAETZ: Ed, Ed --

MR. KLEINBARD: It would be easier of the two questions -- because I don't have any interest in justice (laughter). Like Jim, I only care about efficiency. I just get there in a more practical vein, so --

MR. GRAETZ: Your concussion is wearing off. (Laughter)

MR. KLEINBARD: So, the short of it is that inversions -- I don't want to speak to Pfizer specifically. They have a ton of currently reinvested earnings, but the answer is it was access to the stash. I'm not talking Pfizer specifically, but access to the offshore cash and the creation of a brand new ability to opt in through self-help to lower domestic U.S. effective tax rates by virtue of loading up what will then be the U.S. subsidiary with interest expense that has no significance from the point of view of public investors, but that just reduces the U.S. tax bill. So, those are the principle drivers.

MR. GRAETZ: Can I just ask a quick question of the panel? Is there anybody up here who doesn't think that we need to tighten our rules about earning stripping with -- certainly with interest, and in some sense you mentioned royalties, but at least in some sense with intellectual property, I would describe it more broadly.

SPEAKER: Right.

MR. GRAETZ: Seems to me that -- you think we should not?

SPEAKER: Should not.

MR. GRAETZ: Well now, that's an interesting response. (Laughter)

SPEAKER: He's written a paper.

MR. GRAETZ: I answered.

SPEAKER: He has a good paper about that. It's just --

MR. GRAETZ: Well, I know. I know his paper.

SPEAKER: Wrong. (Laughter)

MR. GRAETZ: I know that paper. That paper's a friend of mine. It's not a good paper.

MR. SHAY: Are you finished with the first one? So, Michael, should I take Mihir's question?

MR. GRAETZ: Yes, you take Mihir's question. Sorry.

MR. SHAY: The connection --

MR. GRAETZ: I knew this was get unruly. It was just a question of when.

MR. SHAY: The connection with economic justice -- the first question Mihir asked is is it your preferred instrument? And my response to that is motivated by how difficult it is to address inequality, and again, the motivation to me shouldn't be to address inequality in the sense of you're taking something from somebody and giving it to somebody else. It is what is the socially -- the best socially productive and fairest system that will help our country be best off.

And so, David came and had this nice piece in *Tax Law Review* that pointed out that if we took all of the income tax imposed on the top 20 percent of the U.S. top quintile of income owners, we still would not move the genie coefficient very much, so you could say, “Oh, well then, why use tax at all? It’s hopeless.”

The fact is this is such a difficult issue that you can’t ignore and avoid any single piece. It’s not a question -- I know the Congress might say choose the best instrument, optimal outcomes, and we know what we’re doing. My observation from having been in government in practice is we really don’t know what we’re doing in large measure. That when government tries to make these fine distinctions between foreign income and U.S. income we get it wrong just more often than we get it right. The broader the base, the better off we are. Foreign income, there’s really no real excuse to privilege foreign income unless we can justify it with the headquarters argument or with some other reasonably-developed, data-based, evidence-based support for it, and I have so far not been overwhelmed with the support partly because like Ed I haven’t seen the evidence that we’re so disadvantaged among our corporate world that we need to give that group a break and then tax everybody else more in order to fund I think our very beneficial spending which is beneficial because it finances Medicare. It finances all kinds of good social spending, and -- as well as defense, and as Jim points out we need to revenue. So, I’m very low on giving --

MR. GRAETZ: Michael wants to also say a word.

MR. DEVEREUX: Can I just come in -- picking on me -- his question because I think it goes to the heart of what Steve’s saying about the nature of the tax which is -- this is -- I think that Steve’s saying it’s a proxy for personal income tax. We want to have a fair system of income tax for U.S. residents. The question is does that work. Does corporation tax actually fulfill that goal? And it seems to me it doesn’t at the moment. It may if we change the system perhaps, but one thing that you mentioned yourself is foreign investment. If U.S. individuals want to buy British companies, then they're not taxed under corporation tax, and if U.K. decides not to have a corporation tax, then they won't be taxed at all. So, U.S. income tax -- I'm not an expert on U.S. income tax, but certainly in the U.K. and I believe in the U.S. there's all kinds of forms of investment income which are not taxed.

MR. GRAETZ: We've got time for one more question, and Mr. Burman would like to get in and since he owns the Tax Policy Center (laughter), we ought to let him in.

MR. BURMAN: I'm just thinking about all my untaxed capital gains. So, suppose we were convinced that we wanted to have a well-designed territorial system. Concern is that whenever you have a source of income that's exempt, it's really hard to police that boundary and what we kind of imply; that well, we have these boundary problems now, but we could just make them going away by ignoring the foreign income. I'd like you to just comment on that.

SPEAKER: I think that's to Jim, right?

MR. HINES: I'll start. Is there an issue about policing the boundary of foreign versus domestic? Of course there is. There is now, too, but Len's point, and it's right, is that that would become even more important if you had a territorial system. That's absolutely right. You're not the first to voice concern about that problem, and there's a lot of concern in the United States about if we had a territorial system then American firms would take profits that were really earned in the United States and somehow attribute them to a foreign jurisdiction, and that even though we're concerned about that currently, it would be more of a concern under a territorial system.

The United States is not unique but close to unique in having the system that we have. The other OECD countries, they've already encountered this problem. Canada has had a territorial system roughly since 1975. Canada still collects loads of corporate tax revenue, and the U.K. is collecting corporate tax revenue, and Japan and

Germany and France and a lot of other countries have encountered the exact same set of issues.

Now, does it work perfectly in Canada? Of course not. No tax system if perfectly enforced for the same reason that no laws are 100 percent complied with. On the other hand, is it a workable system? Absolutely, if it weren't workable Canada sometime in the last 40 years would have changed their system, and so I think that yes, we should be concerned about compliance. Yes, if we have a reform we need to think hard about how it's going to work in practice. Do we have enough resources for the IRS and so on? Of course we have to think about all of that, but the hysteria that -- Len was not voicing, but others have about this -- I think is misplaced given the international experience that we've got.

SPEAKER: Can I speak for the voice of hysteria? (Laughter)

MR. HINES: You always do. (Laughter)

MR. GRAETZ: By all means.

MR. KLEINBARD: I think that Len's point goes to the insolubility of territorial tax systems. That's why Dave Camp's proposal contained anti-abuse rules. That's why any territorial system that will come out will have anti-abuse rules. We see today in the OECD BEPS Project and the urgency with which the entire OECD is approaching this issue that all countries have become fed up with what they see as a generation of unconscionable amounts of stateless income by multinational firms headquartered in every developed country.

The question is not does Canada collect corporate income tax. The question is does Canada collect the corporate income tax that Canada thinks it should collect on the non-Canadian income of Canadian firms, and that's the relevant question if we're responding to Len who said can we design a well-designed territorial system. I would love to have a well-designed territorial system. It would be the simplest thing to do, but I believe that we are confronted by a Hobson's choice. There's nothing -- and that as a practical matter a low-tax corporate tax system of the United States with worldwide tax consolidation so that our rate is squarely in the middle of the other herd of gazelles is a system that removes stateless income, gaming, and enables U.S. domestic industry to enjoy a more appropriate burden on its capital income.

MR. GRAETZ: We're being told firmly --

MR. KLEINBARD: And so, in conclusion. (Laughter)

MR. GRAETZ: -- that it is time for us leave. I'm glad that Senator Hatch was not here for this discussion because I think if he wanted to walk away with clear guidance on international tax policy, he would have been disappointed, but for the young people in the room who want to continue having this discussion over the next generation you can leave with great optimism (laughter) from this panel. Thank you. (Applause)

MODERATOR: All right, so all right. Thank you to the panelists and all the earlier speakers. I have two pieces of good news, one piece of bad news. The good news is Senator Hatch is on his way. The other good news is that we have lunch in the hallway you can walk through and get. The piece of bad news is that when Senator Hatch gets here we want to start. We don't want to make him wait, so we may well cut off the line at some point and ask you to come back, listen to Senator Hatch, and get your lunch afterwards. So, that should give you tremendous incentive to go get your lunch.

(Recess)

MODERATOR: If I could ask you to please take your seats and not rattle your plastic knives and forks. Our luncheon speaker is here, and it's my pleasure to introduce Senator Orrin Hatch, who is the senior senator from Utah and the chairman of the Finance Committee. Senator Hatch is in his seventh term in the Senate, and he is now the most senior Republican in the Senate, which makes him the president *pro tem* of the Senate, which puts him third in line for the presidency of the United States. It also means he signs all legislation that is passed by the Senate, which hopefully this year will include a major tax reform bill.

Now, Senator Hatch understands the importance of education and hard work. He was the first member of his family to attend college. He then went on to law school, and while he was in law school he worked as a construction worker, a janitor, and a dormitory attendant. But he's not just a hard worker. He knows how to play, too. He's an accomplished poet, song writer, and musician. He plays the violin, organ, and piano. And he's actually also had a brief career in the movie industry where he had a cameo role in a film that won four Oscars. I don't think he won one of the Oscars, but maybe he'll --

SENATOR HATCH: I should have.

MODERATOR: He should have. That's right. Left that out. (Laughter)

But, importantly, he's here today as a longstanding champion of and steadfast supporter of pro-growth tax reform, something he's made clear he intends to try to accomplish in his new job as chairman of the Finance Committee by reaching across the aisle and working with Democrats to produce a broad, bipartisan tax reform bill that will help grow our economy, jobs, and ways.

I left Senator Hatch's most important accomplishment until last, which is that he has 6 children, 23 grandchildren, and 14 great-grandchildren. So, he has a very good reason, or maybe 43 reasons to care about the future of our country, and I think the future of our country could not be in better hands than in the hands of Senator Hatch. So, please join me in welcoming him and thanking him for coming.

SENATOR HATCH: Thank you. I'm very honored to be with all of you here today -- it's 15 great-grandchildren, last one not that my wife would be slighted here. (Laughter)

I'm grateful to be with you. This is a very important institution as far as I'm concerned. I read everything I get my hands on -- well, almost everything. There are some things that I won't waste time on, but --(Laughter).

I appreciate that kind introduction. It means a lot to me.

I'd like to begin with just a short story. A member of Congress is walking along the beach and he finds an old lamp. He picks it up, rubs it, and of course a genii appears. The genii says, "I am the most powerful genii in the world who has ever lived. I can do great and wonderful things, and I can grant you your dearest wish -- but only one." Well, this member of Congress was well-attuned to international affairs, so he pulls out a map of the Middle East and said, "My dearest wish is that you solve the Israeli-Palestinian conflict." The genii strokes his beard, look worried, and says, "Oh, dear." Staring at the map, he says, "That's a tough one. You should probably make another wish." The Congressman is disappointed but he understands. He says, "All right, how about this? I want you to rewrite the American Tax Code so that everyone can understand it." There's a long silence, and finally the genii says, "Let's have another look at that map." (Laughter)

I think you understand this more than anybody. And I know that's just a bit of humor, but doesn't it feel true sometimes.

I'm very happy to be here today to talk about a problem with inversions and what I believe may be the solution. Let me start with the basics. I don't think it would surprise anyone here to learn that I do not believe that the best solution to the inversion problem is government regulation. And the solution is not building a wall around U.S. companies to keep them from moving offshore. The best solution to this problem is, in my view, tax reform. Tax reform, if it's done right, will help grow our economy, create jobs in the United States, and discourage businesses from leaving our shores and invite business to set up and locate here.

Though there are disagreements on the details, there is bipartisan support for tax reform in Congress. Indeed, members of both parties have expressed their support for a tax overhaul, and I believe that there is real momentum to get something done on tax reform this year. I don't want to overstate this, however. If we remain committed, I think we can get tax reform done. And, believe me, I'm committed.

Now, if the Keystone Pipeline is any illustration of what we're going to go through the rest of the year, we won't get it done.

As the new chairman of the Senate Finance Committee, I've made reforming our nation's broken tax code my highest legislative priority. I'll have more to say about the specifics of our tax reform efforts in a few minutes, but first I want to lay some groundwork. I want to make the case for tax reform and why tax reform is the only real lasting solution to the inversion problem.

When we talk about inversions, particularly in recent decades, history seems to repeat itself over and over. There's a cycle when it comes to inversions, and it usually happens in four steps. Step 1, a few high-profile inversions take place and people become concerned about the possibility of a trend. No. 2, the government takes steps to shut these inversions down. Step 3, inversions are temporarily halted, but the underlying economic conditions remain the same. Step 4, companies find ways around whatever solution the government puts in place, and another wave of inversions takes place. And we need to learn from this history.

Let me give you a few examples. In 1994, a U.S. corporation called Helen of Troy, a company that sold health care and beauty products inverted. Maybe Helen of Troy was the corporation that eventually launched a thousand inversions. (Laughter)

The U.S. Treasury reacted to the Helen of Troy transaction by issuing regulations, making it clear that once a U.S. corporation inverts, it triggers a shareholder-level capital gains tax. Given an increase in stock prices in the mid to late 1990s, attributable largely to the dot-com boom, many shareholders had a low basis in their shares, but yet these shares had a high value. So, at that time, the idea of an inversion tripping a significant capital gains tax on this built-in gain was a serious deterrent against the company inverting in the first place. I wish we could say that about all companies.

But then in the early 2000s, the dot-com bubble burst. At that point, shareholders didn't have nearly the built-in gains that had been so typical just a couple of years earlier. When shareholders depressed, U.S. corporations realized that it was once again a good time to invert. So, in the early 2000s there was another wave of inversions.

This time, Congress acted to stem the tide, enacting bipartisan legislation to establish Section 7874 of the U.S. Tax Code, which imposed another significant hurdle for inversions. Under Section 7874, a U.S. corporation cannot engage in what is called a "naked" inversion where they invert single-handedly without being considered a U.S. corporation for tax purposes. And with the enactment of this provision, inversions slowed down once again. Obviously, that decline was not permanent. If it had been, none of you would be attending this conference to talk about inversions.

There were a number of factors that led to the most recent wave of inversions, which reached a peak last year. One of these factors was likely the collapse in stock prices in 2008 and 2009. With this collapse in share prices, there was a decline in the built-in gains inherent in an inversion transaction and therefore a decline in the tax penalties associated with them. Now, this may have reinvigorated interest in inversions while stock prices were depressed.

Although, stock prices largely recovered over the next two years, U.S. multinationals had increasing amounts of offshore earnings, resulting in significant amounts of trapped cash. This also reinvigorated interest in inversions. So, highly intelligent international tax planners, like the people in this room right now, gave yet more thoughts about ways around Section 7874.

I don't know exactly how it happened, but this is how I picture it. There was a conversation sometime around 2010 where some clever tax lawyers relaxing in the South of France over bottles of Bordeaux -- I think some of you understand this (laughter) -- conceived of a new wave of inversions. Now, as a good Mormon boy, I don't drink. That's probably why I missed out on the all the filthy liquor that comes with being an international tax planner.

I can see that didn't go over very well. (Laughter) It's tough to be a tax planner and always being criticized and picked on, I know.

Anyway, in this Bordeaux-infused brainstorming session, these lawyers conceived of a way to pair U.S. corporations with smaller but yet still sizable foreign corporations in order to get around Section 7874 rules. Prodded on by these very clever lawyers, global investment banks took on the role of matchmaker, setting up U.S. corporations with foreign corporations, and the rest, as they say, is history.

The last factor in this wave of inversions that I will mention today, and the one most relevant to my job, was likely the realization that U.S. international tax reform was not going to happen soon enough. Sure, there were members of Congress committed to the job, even some who were putting their own tax reform proposals and frameworks. But there was not any presidential leadership or engagement, nor is there today. And as a result, the failures of our tax system seemed more and more permanent, and the pressure to invert became even greater and greater.

It appears that all of these pressures reached the tipping point with the wave of 2014 inversions. This, of course, led to the September 2014 Treasury Notice. The Notice certainly stymied inversions, but if history has taught us anything we can count on seeing more. The pace of inversions could in fact pick up again, and if we are unable to fix our code once and for all, it almost certainly will.

For those who believe in a worldwide tax system, you probably saw the September 2014 Treasury Notice as a good thing. That Notice certainly made it harder to escape the worldwide tax net. For my part, I don't believe in a worldwide tax system. I believe we need to go a different direction when comes to taxing international income and move from our worldwide-leaning international tax system toward more territoriality.

If we're serious about preventing inversions and about keeping American companies from picking up and moving their legal headquarters elsewhere, we need to get to the root of the problem. Anything else that we do, any tinkering along the regulatory edges will only address the symptoms and, in the end, it will be like using a Band-Aid to treat a broken arm.

Despite what some, including the President and high-ranking officials in the administration, have claimed, companies were not leaving the U.S. because of a lack of "economic patriotism." For the record, I'm no fan of inversions, but I'm even less of a fan of the rhetoric and the tax that surrounded this issue in the last year. If you ask me, it is the national leaders that use their position to demonize our own companies that are lacking in "economic patriotism," not the companies who are simply trying to do right by their shareholders and firms trying to compete, produce, and hire workers to tap into markets and customers in growing economies.

But I digress. I see these inversions as symptomatic of a dysfunctional tax code that is taxing at too high a rate and is attempting to tax worldwide income. What we need is a tax system that will encourage investment and growth within the United States. For that, we need tax reform.

If you've been around Washington over the past few years, chances are you've already heard me talk about tax reform. I've been making the case for tax reform on the Senate floor, in the Finance Committee, and in public appearances and written materials and in private conversations. And I'm going to continue to do so.

I want to pose a question to the audience. Raise your hand if you've heard about the tax reform book that I released in December. How many of you have heard about it? Oh, quite a few. Quite a few in this minority who have heard about it. Now raise your hand if you read the whole thing. My goodness gracious. This is a tax group? You should read it. It looks like some of you have more homework to do, and you should read it. It's very interesting. Even I thought it interesting. (Laughter) And that's a big confession by a member of Congress.

In that book and elsewhere, I've laid out seven principles that I believe should guide our tax reform efforts. I won't go into detail on each principle today. Instead, I'll just list them and encourage you all, once again, to read the book. Don't wait to see the movie.

I don't think there'll be a movie from that, but you never know. We're so screwballed up there, it could come out a very comical movie.

The seven principles are (1) economic growth; (2) fairness; (3) simplicity; (4) permanence; (5) American competitiveness; (6) promoting savings and investment; and (7) revenue neutrality.

Not all of these principles directly relate to the problem of inversions, but some of them do. The one that relates the most is American competitiveness. Put simply, we need to make America a better place to do business and put our job creators on an equal footing with their foreign competitors. To do that, we need to lower our our corporate tax rates and transition toward a territorial system. Our President wants to lower the corporate tax rates under certain circumstances, and I believe that Jack Lew does as well, the Secretary of Treasury.

That is what is being done in the rest of the industrialized world. That, more than anything else, is what makes some of these foreign countries, particularly countries like Ireland and U.K., more attractive destinations for American companies seeking to invert. There's a lot of agreement on bringing down the corporate rate. Both Republicans and Democrats endorse that general idea as the basis for reforming our business tax system.

Unfortunately, there continues to be widespread disagreement on getting rid of our current worldwide tax system. Most of my Republican colleagues want a territorial tax system. Some of the mighty Democrats are sympathetic to it, especially if they really want to stem the pressure to invert. But as of yet, we have not gotten significant buy-in from a large number of Democrats on this idea. I hope that will change, and I'm going to try to get it to change. I think it will. After all, it only makes sense. Like I said, the rest of the world is already moving in that direction, and if we want to keep up or compete, we're going to have to follow suit.

What we mean by a territorial tax system, it's not taxing foreign source business income but at the same time making sure we do tax U.S. source income, accurately measured. Under such a system, we would continue to tax domestic source income of U.S. multinationals, but the earnings they make offshore would not be subject to U.S. tax. Of course, I don't believe a territorial system would be a magic elixir. There will likely still be pressure to invert even if we make that change. But this much needed transition is the first and a very important step we can take to stem the future of inversion ways. And once we have agreement on the overall idea of the territorial system, we can talk about other ideas that will further prevent erosion of our tax base.

But in all discussions, we must -- and I can't stress this enough -- we must always be looking at our international taxing system with an eye toward improving our competitiveness. We cannot be competitive with our current treatment of taxation of foreign source business income and our current tax rates as well. Our corporate tax rate, as you all know, is the highest in the industrialized world, and proposals for reform have envisioned rates that are not even at or below the average of OECD countries. Maybe we won't have the lowest rates in the world; we should at least be able to not have the highest.

As most of you know, the Senate Finance Committee is already fully engaged in a very real tax reform effort. We've created five working groups -- Senator Wyden and I have -- that will look at all areas of our tax system with an eye toward producing recommendations for a comprehensive tax reform bill. I proposed to introduce such a bill and mark it up in committee later this year.

As I said earlier this week, this is not an exercise. This isn't just for show. I'm not in this just to introduce a proposal or two and move on. My only goal, when it comes to tax reform, is to make new law. And with the help of all my great colleagues on the Finance Committee, Ranking Member Wyden in particular, that's just what we're going to do. I hope we can learn from our history of inversions. I hope we can go after the root causes of this problem rather than merely treating the symptoms. Once again, the solution to this program is tax reform.

I want to once again thank Brookings for having me here today. I want to thank all of you for taking time to listen. God bless you all.

MODERATOR: So, the Senator is on a very tight time schedule, but he's agreed to answer one question which I have the privilege of asking him, which is: I'd like to follow up on these working groups that you mentioned. What are you expecting them to produce? Do you have a timeline? When are you expecting them to deliver something? And is there a way that the business and broader tax policy group can help this process?

SENATOR HATCH: Well, thank you. That's a good question, and I anticipated that, so let me answer it this way. The plan is for these groups to study all of these issues in their various areas and come up with a list of policy proposals. We have five working groups: (1) Individual Income Tax; (2) Business Income Tax; (3) Savings and Investment; (4) International; and (5) Community Development and Infrastructure. Did you know that we're engaged in that as we speak. And Senator Wyden and I do not want to be two prescriptive on the form of their recommendations. We just need them to be useful in the development of an eventual tax reform bill.

Our desire is to see very detailed discussion of the tensions in the policy choices and detailed proposals, and it would be best if they can produce legislative text. I don't fully expect them to do that, but if they do, if they really take it as seriously as I would like them to, they may do that. JCT -- the Joint Committee on Taxation -- will also play a key role in the development of the products of the groups.

And as for the timeline, my hope -- and I think Senator Wyden's as well -- is to have all of their products back to us later in this spring as long as we appreciate the business community's insight and feedback on what their preferences are and what they believe should go into the various proposals. Of course, there will be some tradeoffs. We won't be able to use or follow every recommendation, but I find that input from the business community is always very, very helpful, and I hope you'll all participate with us in this.

Now, you'll notice that that's tilted heavily towards business tax reform, and there's a reason for that, because the President seems to -- he seems to want to do business tax reform solely. I would like him to go farther than that, but if that's all we can do, we certainly will get a lot of ideas from these working groups that hopefully will help us to come up with some business tax reform that will help our economy, help our country, and help us to go forward in a very progressive way -- and I don't mean progressive taxation way but in a progressive way -- and I do mean that to a degree to get this done and done well for our country.

Let me just say that it's an interesting committee. We have some very, very good people on that committee. In fact, I think everyone on that Committee is a superior senator, and I'm very grateful -- very, very grateful to be able to chair the Committee. And I've enjoyed it when Senator Barkus chaired it and when Senator Wyden chaired it. We get along, I think, pretty darned well, and I hope that that will continue now that I'm chairman. I'll surely do everything in my power to see that it continues. And we're not going to ignore great ideas of Democrats or liberal Republicans or whoever.

I think it's a big undertaking. It's a big undertaking just to do -- if we did full reform -- I was here; took three years to do that, and we were lucky to get that done. And in the intervening years we have clobbered the code for almost every un-sanely thing we can possibly put in it, and I'd like to see that change. I'd like to see us come up with a way that we could simplify this code to the degree that everybody can understand it in their economic strata.

So, hopefully these working groups will get some help from Brookings and from all of you. We hope you'll weigh in. We don't think that members of Congress are the only people with ideas. We get most of our ideas from outside Congress, and we certainly pay attention to all of you. It makes no difference to me whether you're a liberal, conservative, or moderate. It makes no difference to me. I just like good ideas, so wherever they come. And we'll do our best to do that.

All right, just maybe one little story of this fella who died and went up to the Pearly Gates, and he said, "Where do I go from here?" Peter said, "Well" -- he said, "You have your choice." He said, "You can either go to Heaven or down below. Of course we know which one you're going to choose." And said, "Don't be so sure." He said, “How about telling me the differences between the two.” And Peter said, “Well, Heaven -- that’s a land of smooth-flowing rivers and streams and green forests and green pastureland and good companionship and everything,” and he said, “Hell -- all that is, is one old hot vast dry desert.” The guy said, “Well, that sounds pretty good to me” and (inaudible). So, on the way down to the Gates of Hell, Peter explained the differences again. The guy relentlessly wanted to go to Hell. So, finally they get down to the gates of Hell and Peter says, “Look, fella, the joke has gone far enough.” He said, “Heaven’s a land of smooth-flowing rivers and streams and green forests and green pastureland and companionship and everything. All this place is, is one old hot vast dry desert.” The fella said, “Well, I like the heat.” Peter said, “Okay, buster, you had your” --. He opens the gate and he looks in there and there’s a smooth, babbling brook with streams and green forest and green pastureland and good companionship, and Peter said, “Oh, those damned Mormons, they’ve been irrigating again.” (Laughter)

Hang in there.

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