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ESCAPING THE U.S. TAX SYSTEM: FROM CORPORATE INVERSIONS TO RE-DOMICILING

By

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Abstract

U.S. corporate income tax rates are among the highest in the world, and are projected to rise substantially in 2011. The U.S. also taxes the overseas profits of its Multinational Enterprises (MNEs). Worldwide taxation can increase a firm's tax obligations, and substantially complicates the process of calculating those liabilities. To avoid these costs and challenges, earlier this decade a number U.S.-based MNEs moved their corporate headquarters overseas through corporate inversions, which were reincorporation transactions which had negligible impact upon a company's operating activities. In response, the U.S. Congress enacted IRC §7874 in 2003, which was designed to curtail this activity. This law appears to have substantially reduced corporate inversions. However there are signs they may become more frequent. This paper analyzes the most recent developments in this field, and explains new approaches American MNEs might use to escape U.S. international tax laws.

Background

In the late 1990's and early 2000's, a number of large, U.S.-based Multinational Entities (MNEs) transferred their corporate home abroad through corporate inversions. In corporate inversions these U.S.-based firms reincorporated to nearby tax havens to reduce their tax obligations. In general these were paper transactions that moved the Multinational Enterprise's (MNE's) corporate home, but had little or no impact upon the firm's operations. As the U.S. Office of Tax Policy (2002) wrote: "Although an inversion transaction requires significant restructuring as a corporate law matter, the effect of such a transaction on the actual management and operation of the inverted company is generally limited" (p. 15).

While inverting firms said this action was necessary to compete effectively against foreign firms, corporate inversions created considerable controversy within the United States. U.S. legislators and tax officials were concerned with the foregone tax revenue, according to the Office of Tax Policy (p. 2). Corporate executives were criticized for moving their corporate home abroad (Godar, O'Connor and Taylor, 2005, p. 1). In response, in 2003 the U.S. Congress enacted IRC §7874, which appears to have substantially reduced inversion activity.

In explaining inversions, many U.S.-headquartered firms said American tax laws substantially increased their cost of doing business. The United States levies one of the highest corporate income tax rates in the world. In addition, while many countries have lowered their income tax rates in recent years, the United States has maintained high income taxes. Furthermore, U.S.-headquartered businesses are penalized by very complex international rules that tax the firm's worldwide income, and substantially complicate the process of determining tax obligations. These tax policies increase the MNE's cost of doing business. In contrast, most other countries impose lower income tax rates and do not tax overseas profits. U.S.-headquartered firms bear substantial tax costs, and there do not appear to be significant offsetting benefits. So companies might ask themselves: is there a way to escape the burden of high U.S. income tax rates and complex tax rules?

In the early part of this decade a number of U.S.-based MNEs accomplished this through corporate inversions. The U.S. Office of Tax Policy (2002) defined an inversion as "a transaction through which the corporate structure of a U.S.-based multinational group is altered so that a new foreign corporation, typically located in a low- or no-tax country, replaces the existing U.S. parent corporation as the parent of the corporate group" (p. 1). In most cases inversions were legal transactions in which a new corporate home was selected, but left the firm's business operations effectively untouched. In addition to reincorporating their headquarters abroad, the firms generally transferred ownership of their Controlled Foreign Corporations (CFCs) to the overseas headquarters or another overseas entity. The Office of Tax Policy wrote: "This basic reincorporation outside the United States often is accompanied by a series of other restructuring steps. Most commonly, the associated restructuring involves a shift outside the United States of the ownership of the group's existing foreign operations, accomplished through the transfer of the existing foreign operations to the new foreign parent corporation or a foreign subsidiary thereof" (p.4). By transferring their overseas operations to foreign entities, those inverted businesses lowered their worldwide tax rate and simplified the process of calculating tax obligations.

While corporate inversions generally improved the firm's financial performance, they reduced the U.S. treasury's tax collections. They also generated negative publicity. Corporate managers who supported inversions were often denounced as unpatriotic and immoral (Godar, O'Connor and Taylor, 2005, p. 1). In response, the U.S. Congress passed IRC §7874, which was designed to preserve U.S. tax revenue. IRC §7874 did not prohibit corporate inversions, but said the U.S. would continue to tax inverted corporations as domestic entities, as long as the firm's shareholders were essentially unchanged in the inversion's aftermath. The law has generally been considered successful at achieving its intended objective, as the pace of U.S. corporate inversions appears to have slowed since that law was passed (VanderWolk, 2010, pp. 1-2, and Leitner and Glicklich, 2009, p. 515).

Since IRC §7874 was enacted corporate inversions have attracted less attention. But it is possible this will change in the near future. The U.S. corporate income tax rate is one of the world's highest, and it is projected to increase substantially in 2011. The Obama Administration has also proposed a number of changes to international tax laws that are "significant revenue raisers targeting U.S. based multinationals" (Leitner and Glicklich, 2009, p. 515). In contrast, corporate income tax rates are declining in many other countries, and more countries are exempting worldwide income from domestic taxation. High tax rates and worldwide taxation policies may make the U.S. a less attractive headquarters location. Moving abroad might be an escape route more will consider, and there are still ways this can be accomplished, despite IRC §7874 and supporting Treasury Regulations.

As mentioned, the pace of corporate inversions appears to have slowed since IRC §7874 was passed. But some tax professionals believe they may become more frequent in the future. Leitner and Glicklich (2009) say privately held U.S. firms are continuing to invert. They write, "The tide has slowed, but the anti-inversion rules have not successfully eliminated all expatriation activity, especially in privately held U.S. companies" (p. 515). VanderWolk (2010) believes corporate inversions may become more popular in the near future, writing: "Section 7874 is widely believed to have had a severe chilling effect on inversions of publicly held corporations, but they may stage a comeback. In addition to potentially increased tax costs due to new international tax rules, factors such as reduced unrealized gain due to the economic downturn of 2008-2009 and rapid growth in foreign markets may lead to more inversions in the future" (p. 1-2). As an example, a U.S.-based firm, Ensco, recently moved its headquarters to the United Kingdom. These signs indicate that analyzing recent developments in corporate inversion activity is merited.

This paper contributes to knowledge of international tax issues by analyzing the most recent developments in corporate inversions. Current developments include high and rising U.S. income tax rates, new Treasury Regulations designed to limit tax-motivated corporate inversions, and the relocation of a publicly-held firm, Ensco, from the United States to the United Kingdom. This paper explains how and why American firms may re-domicile their headquarters abroad to escape U.S. tax laws. This paper also makes a distinction between corporate inversions and corporate re-domiciling, in which firms not only reincorporate, but shift the management and control of a MNE from one country to another. This paper suggests corporate re-domiciling may be one approach firms will use to escape U.S. tax laws.

Literature Review

Between 1999 and 2003 a number of U.S.-based multinationals moved their corporate headquarters abroad. The expatriating firms included seven members of the S&P 500 index: Cooper Industries, Ingersoll Rand, Nabors Industries, Noble Drilling, Stanley Tools, Transocean and Tyco (Desai and Hines, 2002, p. 416). These corporate inversions attracted considerable attention in business and general circulation media, and generated concerns about the possible loss of government tax revenue. In response, the U.S. Department of Treasury's Office of Tax Policy analyzed the motivations, methods, and implications of U.S. corporate inversions. Their report, Corporate Inversion Transactions: Tax Policy Implications was released in May, 2002.

The Office of Tax Policy report explained several legal approaches firms employed to effect corporate inversions. It identified the potential tax consequence of corporate inversions, and also analyzed the non-tax issues firms considered before making an inversion decision. The report also identified the tax advantages firms realized through moving their headquarters abroad, and offered a number of suggestions that would make inverting less attractive to U.S.-based MNEs.

In their September, 2002 article, Desai and Hines identified the causes of corporate inversions, and analyzed the consequences of these transactions, for firms and their investors. Their paper also explained both the process by which firms inverted, and advantages businesses realized as a result. In addition, Desai and Hines reached a number of significant conclusions. One was that favorable investor reaction to an inversion announcement could not be explained solely by a reduction in foreign tax obligations. They believed investors were also anticipating a reduction in taxes paid on U.S.-sourced income. Second, Desai and Hines concluded that inverting corporations were likely to have extensive international holdings. This suggested to Desai and

Hines that U.S. taxes on foreign-sourced income were key motivations for inverting. They also demonstrated that the stock market reacted more favorably to inversion announcements when the firms were highly leveraged. This indicated to Desai and Hines that the U.S. interest allocation rules, which shifted corporate interest expenses to non-U.S. subsidiaries, were also important factors motivating corporate inversions.

Seida and Wempe (2004) conducted a detailed study of twelve corporate inversions. They found the effective tax rate for inverted corporations decreased substantially after the inversion. While tax rates also decreased for firms that did not invert, inverted firms realized much steeper reductions in their worldwide tax rate. Seida and Wempe also concluded the decrease in the inverted firms' tax rate could not be explained solely by a decrease in taxes paid on foreign earnings. They showed that several of these companies reduced taxes by leveraging their U.S. subsidiary with intercompany debt, and shifting interest income from the United States to other countries imposing lower tax rates. Their work confirmed Desai and Hines's suggestion that through corporate inversions firms also found ways to shift taxable income out of the United States. In addition, Seida and Wempe concluded that laws meant to control the leverage of U.S. based firms were sometimes ineffective at controlling earnings stripping activities.

Kane and Rock (2007) looked at corporate inversions from a global perspective, evaluating international tax policies in a number of locations, including the United States, Canada, the EU and Israel. They explained that there are two general approaches to determine where a firm is headquartered. One method is to determine where the parent company is legally incorporated, or what they call its "place of incorporation." The second approach focuses on more substantive issues, such as where key business decisions are made, and where the firm's assets and employees are located. They called this the firm's "real seat." Kane and Rock argued that real seat rules should be used to determine a firm's tax home, as place of incorporation rules made it too easy to relocate a firm solely through legal transactions, often to a site in which the MNE has little or no business presence. They also argued that U.S. tax laws, which tax worldwide income at high levels and use place of incorporation rules to determine a firm's tax home, made the U.S. vulnerable to corporate inversions.

Rubinger (2007) evaluated IRC §7874 and the related Treasury Regulations supporting that law. Like Kane and Rock, Rubinger noted that the U.S. used place of incorporation rules to determine a firm's tax home. He said most other countries, including the U.K., use real seat rules. Rubinger explained how these different approaches could be used to facilitate a tax-motivated inversion. He noted that IRC §7874 does not apply when a U.S.-based firm inverts to a country in which the firm has a substantial business presence. Thus if a firm had significant business activities in the U.K., a U.S.-based MNE could reincorporate there and avoid being taxed as a U.S.-headquartered enterprise. However the U.K. uses real seat rules to determine a MNE's corporate home. Thus the firm could also move the firm's management and control activities to a third country with even lower tax rates. The third country would be the real seat of corporate management, so it should be subject to that country's tax policies under U.K. rules and tax treaties. For example, if a U.S.-based MNE legally inverted to the U.K. and simultaneously moved its management and control activities to Hungary, it could take advantage of the low taxes in the latter country. Rubinger demonstrated that in spite of the complexities of IRC §7874, there are still ways firms can escape U.S. tax rules.

VanderWolk (2010) reviewed the legislative history of IRC §7874 and new, supporting Treasury Regulations which were released in June, 2009. VanderWolk analyzed both the new Temporary Regulations and the ones they replaced. He showed that the prior Treasury Regulations gave businesses better guidance than the new Treasury Regulations. The earlier regulations gave taxpayers detailed examples to demonstrate how the regulations should be interpreted, and provided taxpayers with a safe harbor to let them know when they had a substantial business presence in another country. In contrast, the new regulations deleted examples that provided taxpayers with such guidance, and removed the safe harbor. These actions will make it harder for taxpayers to know if they are complying with that law, and make §7874 more difficult to enforce. VanderWolk argued that the new regulations provide taxpayers with too little clarity.

U.S. Income Tax Rates

A number of factors contributed to the growth of U.S. corporate inversions during the late 1990's and early 2000's. Three primary causes were: 1) high U.S. corporate income tax rates; 2) the

U.S. policy of taxing a MNE's worldwide income; and 3) the ease with which a corporate inversion could be accomplished. These three factors will be explained in turn.
According to their public statements, many firms inverted to reduce their corporate income tax rate. In the prior wave of corporate inversions (1997-2003), U.S.-headquartered firms found they could substantially reduce their income tax obligations by reincorporating abroad. Campbell (2004) reviewed published reports from a number of firms to identify the tax savings. She reported: "Ingersoll-Rand Co., Cooper Industries, and Tyco International are among the most significant expatriating nomads, expecting to save $450 million dollars collectively in tax. Ingersoll-Rand Co. of New Jersey, one of Stanley Works' competitors, will save $40 to $60 million a year due to its reincorporation in Bermuda. As a result of its incorporation abroad, a spokesman for Cooper Industries, another of Stanley Works' competitors, said that it has saved about $13 million in taxes during the last fiscal quarter ending June 30. Tyco International Ltd. has estimated that it will save an estimated $400 million in U.S. taxes as a result of its conversion to a Bermuda Corporation" (pp. 113-114). The firms did not articulate any operational benefits generated by an inversion; these were exclusively tax-motivated actions. As Kane and Rock (2007) wrote: "In the United States the issue has been brought to the fore by the occurrence of several high profile corporate 'inversion' transactions. Such transactions, which typically involve reincorporating the parent company of a US multinational offshore, are unabashedly all about tax reduction" (p. 1).

U.S.-based firms also argued the country's high tax rates and policies put them at a competitive disadvantage with respect to their key competitors. Campbell (2004) wrote: "Stanley Works cited several reasons for its proposal to reincorporate outside the United States. The statement by Stanley Works noted that the tax treatment of foreign source income by the U.S. tax system does not enable U.S.-based multinational corporations to compete on a 'level playing field' in an increasingly globalized economy" (p. 108). By putting them at a competitive disadvantage with respect to its competitors, they might also find it difficult to price their products and services competitively, and grow sales and market share.

The corporate inversions prompted the Congress and tax officials to examine this activity. The Office of Tax Policy (2002) studied corporate inversions, and reported: "While the so-called corporate inversion transactions are not new, there has been a marked increase in the frequency, size and profile of the transactions" (p. 1). A primary concern was that more firms would invert, and this would decrease the U.S. tax base. The report stated: "Inappropriate shifting of income from the U.S. companies in the corporate group to the foreign parent or its foreign subsidiaries represents an erosion of the U.S. corporate tax base" (p. 2). Additional corporate inversions would not only reduce tax revenue, they could also undermine confidence that the U.S. tax system is just. The report stated: "Moreover, exploitation of inappropriate income-shifting opportunities erodes confidence in the fairness of the tax system" (p. 2).

High U.S. corporate tax rates were an important force motivating corporate inversions. A 2005 Congressional Budget Office (CBO) study analyzed U.S. corporate income tax rates through 2003, the year IRC §7874 was enacted. It showed that beginning in the early 1990's U.S. corporate income tax rates were among the highest in the world (p. 26). The difference grew larger by 2003, the last year studied. In 2003 U.S. income tax rates were substantially higher than in other OECD countries. The CBO (2005) said: "Among all OECD countries in 2003, the United States' top statutory corporate tax rate was the third highest; it was also higher than the top statutory rates in approximately 90 percent of those countries. The United States' top rate of 39.3% was 6.3 percentage points higher than the median for all OECD countries…" (p. 14).

The CBO report notes that corporate income tax rates declined substantially between the mid-1980's and 2003. It says: "After large reductions in statutory corporate tax rates by Ireland, the United Kingdom, and the United States in the mid-1980's, other OECD countries also cut their rates, perhaps out of concern that they would lose investments or part of their tax base—for example when corporations moved their operations to a lower-tax country" (p. xi). The report demonstrated the U.S. had maintained relatively consistent tax rates, while those in other countries continued to decline. The report showed the U.S. was not keeping pace with falling worldwide corporate income tax rates.

Furthermore, worldwide corporate income tax rates have fallen since that report was prepared. In 2003 Japan's highest corporate income tax rate was 40.9%, Germany's highest corporate income tax rate was 39.6%, Italy's was 38.3%, and Canada's was 35.6% (p. 22). According to

OECD information these countries have enacted lower rates since 2003. Thus since 2003 U.S. corporate income tax rates have become even less competitive. The following table shows income tax rates in effect for 2010.[1] U.S. tax rates in 2010 were the second highest in the world, exceeded only marginally by Japan's income tax rate.

Maximum Corporate Income Tax Rates—2010

Country (1)	Central government corporate income tax rate (2)	Adjusted central government corporate income tax rate (3)	Sub-central government corporate income tax rate (4)	Combined corporate income tax rate-2010 (5) the sum of columns 3 + 4
Australia	30.00	30.00		30.00
Austria	25.00	25.00		25.00
Belgium	33.99	33.99		33.99
Canada	18.00	18.00	11.50	29.50
Chile	17.00	17.00		17.00
Czech Republic	19.00	19.00		19.00
Denmark	25.00	25.00		25.00
Finland	26.00	26.00		26.00
France	34.43	34.43		34.43
Germany	15.83	15.83	14.35	30.18
Greece	24.00	24.00		24.00
Hungary	19.00	19.00		19.00
Iceland	15.00	15.00		15.00
Ireland	12.50	12.50		12.50
Italy	27.50	27.50		27.50
Japan	30.00	27.99	11.55	39.54
Korea	22.00	22.00	2.20	24.20
Luxembourg	21.84	21.84	6.75	28.59
Mexico	30.00	30.00		30.00
Netherlands	25.50	25.50		25.50
Norway	30.00	30.00		30.00
Poland	19.00	19.00		19.00
Portugal	25.00	25.00	1.50	26.50
Slovak Republic	19.00	19.00		19.00
Spain	30.00	30.00		30.00
Sweden	26.30	26.30		26.30
Switzerland	8.50	6.70	14.47	21.17
Turkey	20.00	20.00		20.00
United Kingdom	28.00	28.00		28.00
United States	35.00	32.70	6.51	39.21
Average				25.84

[1] The table below was retrieved from the OECD's web site on July 9, 2010. See http://www.oecd.org/ctp/taxdatabase. See Table II.1.

In the previous table, the second column identifies the highest marginal tax rate imposed by the national government. Some countries also levy income taxes to support local governments, or what the OECD calls sub-central governments, and may permit tax deductions or tax credits for these payments. The third column shows the federal income tax rate after deductions or credits for local government tax payments are calculated. The fourth column identifies the tax rate imposed by local governments. The fifth column is the key figure, as it compares the net corporate income tax rate in a country, after the net impact of local corporate taxes is included. It is the sum of columns three and four. It shows that in 2010 the combined income tax rate in the United States is 39.21 %, and is only exceeded by Japan's combined income tax rate of 39.54%. The U.S. rate is also 13.37 points above the OECD simple average of 25.84%.

Furthermore, the maximum U.S. corporate income tax rate is expected to increase substantially in 2011. As the Department of Treasury (2010) explains, the U.S. federal government's tax rate through 2000 was 39.6%. It was reduced to 35.0% between 2001 and 2010, but "the 35-percent tax rate sunsets after 2010" (p. 127). Thus the tax rate reverts to the 2000 level next year. As the Department of Treasury states: "beginning in 2011, the highest corporate income tax rate would be 39.6 percent" (p. 127). The report says it will apply to all income greater than $373,650, adjusted up for inflation experienced during 2010. When the Federal rate rises, the combined Federal and state corporate tax income rate will increase by 4.6% next year, from 39.21% to 43.81%. At that time the U.S. tax corporate tax rate will be the world's highest. It will be 4.27 points above Japan's 2010 rate, and approximately 18 points higher than the OECD average shown on the prior page, assuming those income tax rates do not change.

High U.S. corporate income tax rates may motivate future inversions. In the late 1990's and early 2000's U.S. firms inverted to tax havens. If IRC §7874 makes it difficult to invert to a tax haven, substantial benefits can still be realized by relocating to other countries, if this can be accomplished. For example, after next year's tax increase, Canada's rate will be 14.3 points lower than the U.S. rate. The United Kingdom's will be 15.8 points lower, and Ireland's will be 31.3 points lower. In addition, Canada and Ireland do not tax worldwide income, and the United Kingdom is moving towards a territorial tax system, to be described shortly.

Worldwide versus Territorial Tax Systems

As shown, U.S.'s income tax rates are significantly higher than those found in other countries. When a U.S.-based MNE earns profits in the United States, it is clear these income tax rates apply. However this raises a critical question: if a U.S. based MNE earns profits in another country, what country is entitled to tax those profits, and what tax rates should apply?

In general, countries take one of two approaches when taxing a MNE's earnings. Several countries tax all of a MNE's worldwide income, wherever it is earned. Most countries tax only the profits earned within their borders, even if the MNE earns profits abroad. These two approaches are generally called "worldwide taxation" and "territorial taxation." The U.S. enforces worldwide taxation policies.

Campbell (2004) writes: "The worldwide system is one where a domestic corporation must pay income tax to its home country on all income regardless of the source from which it was derived" (p. 99). Thus income earned in a foreign jurisdiction is subject to domestic taxation. Conceptually the U.S. taxes the worldwide income of its residents, however in practice there are limitations on this approach. Writing in 2002, Desai and Hines stated the United Kingdom, Italy, Japan, Norway and Greece also taxed worldwide income (p. 412).

Taxing a MNE's worldwide income is theoretically justified on the grounds there are worldwide benefits to citizenship or residence, even when a business operates abroad. Doernberg (2008) writes: "With respect to taxation, a country may claim that all income earned by a citizen or a company incorporated in that country is subject to taxation because of the legal connection to that country" (p. 7). Because of that legal link, governments provide services to businesses operating abroad, such as overseas consulates, income tax treaties, and defense of property rights. In return for such benefits, individuals and businesses are expected to pay taxes to support the parent country's government.

This approach was first tested in the United States Supreme Court case, Cook v. Tait.[2] In that decision, Justice McKenna wrote that worldwide taxation: "is based on the presumption that government by its very nature benefits the citizen and his property wherever found. " Isenbergh (2005) describes the Court opinion this way: "Thus, along with whatever protections and benefits it confers, U.S. citizenship brings worldwide income taxation with it as its price, a quid pro quo expressly invoked in Cook v. Tait as justifying worldwide taxation of U.S. citizens" (p. 19). However the United States is one of a small number of countries that claims worldwide taxing authority based on citizenship or residence (Doernberg, 2008, p. 7).

Within the United States the central taxing issue has shifted from U.S. citizenship to residency. Isenbergh (2005) writes: "Individual residents of the United States, regardless of nationality, are exposed to U.S. tax on their worldwide incomes…Residence is therefore the first and most important touchstone of U.S. taxation for foreign nationals" (p. 20). Thus the worldwide tax system is frequently identified as a "residence-based" international tax system (Avi-Yonah, 2008, p. 2).

Determining an individual's tax residence can sometimes be a complicated topic, as the IRS Code defines residency several ways, depending upon the issue at stake. But for businesses it is clearer. As Desai and Hines (2002) write: "From a legal standpoint, the definition of American tax residence is reasonably straightforward: a corporation is 'American' for tax purposes if it is incorporated in the United States. Firms choose their sites of incorporation, and, under current U.S. law, a company need not produce or sell anything in the country that serves as its tax home" (p. 410). Thus the central issue is where the parent firm is incorporated or chartered.[3] Whether the firm actually produces goods or services in that location is not pertinent in most cases, but this topic will be discussed in more detail shortly.

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[2] Cook. V. Tait, 265 U.S. 47 (1924)
[3] See IRC 7701(a)(4) for corporate place of incorporation rules

An alternative to worldwide taxation is levying taxes based only on income earned within a nation's borders, or within its territory. This is frequently called a "territorial" tax system (Doernberg, 2008, p. 7). In a territorial system a country taxes only domestically earned income, and it exempts income earned in other jurisdictions. Doernberg (2008) writes "A territorial connection justifies the exercise of taxing jurisdiction because a taxpayer can be expected to share the costs of running a country which makes possible the production of income, its maintenance and investments, and its use through consumption" (pp. 7-8). In other words, when an individual or business earns income within a country's borders, they should also pay for the government services that support commerce, such as necessary infrastructure and legal protection. Territorial policies are also called "source" tax systems, as the income is taxed only where it is earned, or sourced (Doernberg, 2008, p. 8). In general the income earned in other jurisdictions is exempt from domestic taxation. For this reason some call territorial tax policies "exemption" tax systems (Campbell, 2004, p. 98). The majority of the world's nations tax income earned with their territory, and exempt the income earned in other locations, even if the parent firm is headquartered in that country (Desai and Hines, 2002, p. 412).

Conflicting worldwide and territorial tax policies create the potential to tax the same income twice. Suppose a business is headquartered in the United States and it opens a subsidiary in a second country. Both countries may claim the right to tax the MNE's earnings in that second country. The U.S. taxes worldwide income, while the second country may tax all income earned within its borders. Double taxation would make it very difficult for firms to compete abroad, so most countries feel it is necessary to prevent this. In general countries with worldwide taxation policies have enacted two key limitations on these rules, to mitigate their impact and allow their firms to be more competitive. The first is to defer taxation of overseas profits until funds are transferred to the corporate home. The second is to allow a tax credit for taxes paid overseas.

In general, the U.S. and other countries defer taxation of overseas earnings until profits are repatriated to the home country. As a U.S. Office of Tax Policy (2000) paper stated, "Thus by organizing a foreign corporation a taxpayer can, absent certain rules, defer U.S. taxation on foreign income until it is repatriated, for example, as a dividend" (p. ix). Due to the time value of money, tax deferral can be an important benefit, particularly if the company defers domestic taxation for a long period of time.

The second limitation permits businesses to reduce their domestic tax obligations when taxes are paid in another country. While the laws in the United States and other countries are quite complex, the general idea is that taxes paid to a foreign jurisdiction can be credited against the taxes due within the United States. As the Office of Tax Policy (2000) writes: "most jurisdictions with worldwide systems, including the United States, allow a credit against domestic tax for foreign taxes imposed on income subject to domestic tax. Under a worldwide system with a foreign tax credit, an item of foreign income generally is not taxed domestically to the extent it is taxed abroad" (pp. x-xi).

In spite of deferral and foreign tax credits, worldwide tax policies can still increase the tax burden on a U.S.-headquartered business if the company moves funds to the United States. In those cases, a U.S.-based MNE has to pay taxes twice. First, the overseas CFC has to pay taxes to the local government based on its earnings. As U.S. income tax rates are among the highest in the world, the parent firm frequently has to pay additional taxes to the U.S. government when it receives dividends from its CFCs. The U.S. parent can take a foreign tax credit for taxes paid abroad, which reduces the tax impact. But since U.S. tax rates exceed those found in most countries, additional taxes are still due the U.S. Treasury. Desai and Hines (2002) wrote: "One consequence of the U.S. tax system is that a corporation considered to be American for tax purposes will typically face greater tax obligations on its foreign income than would the same company if it were considered to be, say, German for tax purposes" (p. 410).

And in addition to higher income taxes, worldwide tax policies add considerable complexity and cost to the process of determining tax obligations. Even the Office of Tax Policy (2002) acknowledges this complexity, commenting on certain U.S. international tax policies: "no country has rules for the immediate taxation of foreign-source income that are comparable to the U.S. rules in terms of breadth and complexity" (p. 28). Understanding the subtleties of foreign tax credit rules is generally considered challenging. Complying with the complexity of the U.S. tax system can be expensive, as firms must either hire or develop expensive expertise to prepare worldwide tax returns. These policies can also complicate cash management. U.S.-based MNEs may want to use cash earned and invested overseas, but as intercompany dividends can trigger tax liabilities, they may be reluctant to access those funds.

As described, deferral and foreign tax credit rules can narrow several of the differences between worldwide and territorial taxation policies. In addition, some countries enforcing territorial policies have enacted rules that tax passive income earned abroad. Avi-Yonah (2008) notes that the United States strengthened its worldwide tax system when it enacted Subpart F in 1962, which restricted deferral on passive income earned abroad. He says the U.S. gradually expanded the law's scope and strength through 1993 (p. 2). He argues the U.S. tax policies on passive income encouraged many countries with territorial-based tax policies to develop similar rules, and they began to tax interest income earned abroad. He writes: "As a result, the traditional dividing line between global and territorial jurisdictions became blurred, so that it could be said that most countries tax foreign passive income of their residents, but they do not tax currently foreign source active income (which was entitled to deferral or exemption)" (p. 2). Nonetheless, while worldwide and territorial tax systems may tax interest income similarly, there are major differences in how they tax active business income, so the distinction is still valid.

As the U.S. imposes high income tax rates and taxes worldwide income, U.S.-headquartered firms face large tax obligations. Desai and Hines (2002) described how the U.S. compares with other countries, stating that in such comparisons: "The United States tends to fare poorly in such calculations, since American companies owe taxes to the United States on their foreign incomes, while companies based in numerous other countries, including Germany, the Netherlands, Canada and France, not to mention most tax havens, owe little or no tax to their home governments on any foreign income" (p. 410). Moreover, since Desai and Hines wrote that a number of countries have lowered income tax rates, while the U.S.'s have remained steady, and are projected to increase soon. In addition, more countries are moving from worldwide to territorial-based tax systems. Thus the U.S. may be less competitive today than it was when IRC §7874 was enacted.

More countries are also moving towards territorial tax systems. As mentioned earlier, in 2002 Desai and Hines identified six countries that enforced worldwide tax systems. However according to VanderWolk (2010) two of those countries, the United Kingdom and Japan, are taking steps towards territorial policies. These actions can make their country's tax policies more competitive internationally. VanderWolk writes "Japan and the United Kingdom, for example, have recently adopted legislation making their tax rules for foreign-source dividends more like those of continental European countries, which generally provide an exemption for foreign-source dividends paid out of foreign-taxed earnings" (pp. 15-16). According to HMRC (2010), "An essential part of adapting a more territorial approach to the new rules will be moving from the current default presumption that all activities that could have been undertaken in the UK would have been carried on here, had it not been for the tax advantages of the overseas location" (p. 4). According to Neubig and Angus (2009) "Japan's recent adoption of a territorial tax system as part of a broader reform reduces the tax burden on the foreign-source income of Japanese multinational corporations by exempting dividends from non-Japanese subsidiaries from Japanese tax" (p. 252). This is not to say that both countries have immediately adopted territorial tax systems; any such transition takes time. But both are taking steps in that direction.

Determining the MNE's "Home"

In many cases it is clear where a MNE is headquartered. Businesses frequently begin operations in one country, file legal documents to incorporate there, and the owners and managers reside in that same nation. Successful firms often expand internationally, and to do this they generally form local subsidiaries to comply with legal requirements, such as determining their local tax obligations. However it is often clear the parent firm is headquartered in the first country, and the subsidiaries are CFCs managed by the parent firm. It is generally thought that Coca-Cola is an American firm, Novo Nordisk is Danish, Toyota is Japanese and Fiat is Italian, though they all have overseas subsidiaries. In each case the parent company needs to comply with international tax laws applicable in its "home" country.

However as the world has become more globalized, and large corporations operate in many countries, in some cases it may be more difficult to determine the MNE's home. Perhaps two similarly sized companies from different countries decide to merge, as German-based Daimler and U.S.-based Chrysler did in the 1990s. The company may need to determine which one is the parent company, and which tax laws should govern the MNE. Or perhaps a company's senior executives determine they need to be closer to their operations and key customers, as the oil services firm Halliburton did when its senior executives moved from the United States to Dubai. And in other cases a firm may incorporate a parent company in a new jurisdiction, as many U.S.-based firms did when they inverted to Caribbean tax havens. In such cases it may not be entirely clear what international tax policies should govern the MNE. There must be some way to determine which country's international tax laws should apply.

Due to the tax implications, determining a parent company's tax home is a critical issue. Desai and Hines (2002) write: "Tax authorities are keenly interested in the nationality of their companies for the simple reason that, if a multinational corporation is Japanese for tax purposes, then its foreign profits are subject to taxation in Japan, while if the same corporation were American, then the United States would receive any taxes due on foreign profits" (p. 410). As mentioned, Japan has made changes to its laws since 2002, but the general point is still valid. Moreover, because the U.S. taxes worldwide income, a U.S.-based firm may owe taxes based on profits earned in Germany, for example. But because Germany exempts foreign income, a firm headquartered in Germany does not owe that government taxes for profits earned in the United States.[4]

Countries generally use one of two approaches to determine a firm's headquarters. In some countries the key issue is where the parent firm is legally incorporated. In other words, the location where the parent company's incorporation papers are filed is the corporate home.[5] In contrast, other countries seek to ascertain the focal point of the MNE's operations, such as where key business decisions are made, or where the largest segment of the firm's assets and employees are located. Under this approach, for example, if the parent company's senior management works in a particular country, and the majority of its employees and its assets are there, that

[4] Desai and Hines (2002) identify the United States, the United Kingdom, Italy, Norway, Japan and Greece as countries that tax the worldwide income of residents, and that other countries generally exempt overseas income (p. 412).

[5] See IRC 7701(a)(4) which prescribes Place of Incorporation rules to define corporate residency in the U.S.

country may be the parent firm's home. Again, as we investigate this topic in more detail, we will see that some countries use a combination of approaches to settle this issue, so the distinction between these approaches is not clear in every case. Nonetheless, this is a useful distinction, as most countries use one of these two approaches to determine the MNE's corporate home.

Kane and Rock (2007) describe the difference this way: "Basically, in locating a corporation, a legal system can adopt either the 'place of incorporation' (POI) rules of some version of the 'real seat' (RS) rule. Under the POI rule, the corporation's location is determined by where it was incorporated, a purely formal criterion. Under the RS rule, a corporation's location depends upon some combination of factual elements, such as the location of the administrative headquarters or the location of the firm's center of gravity, as determined by the location of the employees and assets. The place of incorporation can bear on this determination but is not determinative" (p. 7). In short, real seat jurisdictions emphasize business substance, while place of incorporation countries focus on the legal form.

Not everyone believes place of incorporation rules are effective. Campbell (2004) writes: "In the U.S. corporate tax arena, no other bases for taxing corporations is considered, including nationality of owners, principal place of business, or where the primary management occurs. This opens up the U.S. system to the possibility of abuse by corporations that may take advantage of such an enormous loophole. Because a corporation is not more than a piece of paper that is granted separate legal status, this simple basis for taxing corporations has been criticized for having such large tax consequences depending solely upon which sovereign issued the document rather than any other criteria" (p. 102). As we will see later, U.S. laws have become a little more sophisticated since IRC §7874 was enacted, and in certain circumstances the U.S. uses "real seat" rules to reach a conclusion. But Campbell's description accurately describes U.S. laws before IRC §7874 became effective, and is still generally true.

As mentioned, real seat jurisdictions determine the firm's headquarters by emphasizing business substance and physical location. The issues may be where senior managers and employees work, where business decisions are made, and where the firm's assets reside. The criteria can differ from country to country. Most EU members rely upon "real seat" (RS) rules, though some countries may consider other issues. Kane and Rock (2007) write: "With respect to corporate tax, on the whole, EU member states apply an RS location rule. Again, however, there is blurring around the edges as we discuss in more detail" (p. 54). U.K. tax policies focus on where business decisions are made. Referring to U.K. rules, HMRC states: "it has long been recognised that the residence of a company is determined according to where its central management and control is to be found."[6] HMRC recently won a key case in which it argued a Dutch-incorporated firm was actually managed in the U.K., so it should be taxed there.[7]

Again, creative firms can work around such rules, so real seat rules are also imperfect. In view of the tax benefits available, a company might move its management from one location to another solely to lower taxes. However this requires more effort than merely filing legal papers, as place of incorporation rules require. Real seat rules can also be criticized for being subjective. It may not always be easy to identify where key management and business decisions are made, particularly when managers meet over the phone or through videoconferencing equipment. In practice, in many companies such decisions are probably made in a variety of locations, so it may be difficult to identify one site where these actions take place. And the site may change from year to year. So there may not always be a clear, unambiguous answer to the question: where is the real seat of company management? Taxpayers may also disagree with regulators, resulting in costly litigation. In contrast, a place of incorporation rule generally provides a clear, straightforward answer.

International Tax Policies and Jurisdictions

As discussed, two important international tax issues are what businesses a country taxes, and what income it taxes. In other words, does a country use place of incorporation (POI) rules or real seat (RS) rules to determine who it taxes? And does it tax a firm's worldwide income, or only the income earned within its territory?

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[6] See INTM120150—Company Residence. Retrieved July 16, 2010 from http://www.hmrc.gov.uk
[7] See *Laerstate BV v HMRC* (2009) UKFTT 209 (TC).

Kane and Rock (2007) created a matrix to display the four tax alternatives. They write: “The conjunction of two possible locational rules (POI or RS) and two possible substantive regimes of taxation (worldwide or territorial) yields four possible combination of rules for any given jurisdiction” (p. 16). This can be a useful framework to display a country’s tax policies. It can also help us understand the choices a MNE faces if it considers moving from one jurisdiction to another. We can use this matrix as a starting point to demonstrate a country’s tax policies, but as we examine tax laws more closely, we will see that some countries use a combination of approaches.

Substantive Corporate Tax Law and Location
International Tax Policies [8]

		Worldwide	Territorial
Tax Locational Rule	Place of Incorporation (POI)	1 Worldwide/POI	2 Territorial/POI
	Real Seat (RS)	3 Worldwide/ RS	4 Territorial/RS

As mentioned, the U.S. taxes the worldwide income of its businesses. In general the United State**s** uses place of incorporation rules to determine where a MNE is headquartered.[9] Thus Kane and Rock (2007) placed the United States in the matrix’s first box (p. 18), as this reflects the general approach the U.S. uses to tax its MNEs. However, as we will see later, §7874 has introduced “real seat” rules in the United States in certain circumstances.

Kane and Rock argue the U.S. Worldwide/POI tax policies made it particularly vulnerable to corporate inversions. They write: “For example, during the recent wave of corporate migrations out of the United States, it was observed that the problem had been aggravated by the fact that

[8] Kane and Rock (2007) developed the matrix and located the United States in the first box (p. 18).
[9] See IRC 7701(a)(4)

the United States applies worldwide taxation and applies a POI locational rule. This combination appears lethal because it makes tax migration easier (as compared to an RS rule) and it makes tax migration more beneficial (as compared to a territorial system)" (p. 25). In short, Kane and Rock felt the U.S. enforced unattractive policies that taxed worldwide income, which were exacerbated by high income tax rates. In addition, the POI rules made it relatively easy to avoid its rates and policies. If it is easy to escape complex and costly tax policies, why wouldn't a firm find a new corporate home? A number of U.S. companies decided to do so in the late 1990's and early 2000's.

If a company wishes to escape Worldwide/POI tax policies, what policies will attract a firm? All other factors being equal, the second box (Territorial/POI) and the fourth box (Territorial/RS) are attractive. In both cases the MNE can escape costly and complex worldwide tax policies. Of course if those countries offer lower income tax rates, these locations become even more desirable. Unless it offers lower income tax rates, box three (Worldwide/ RS) is less attractive due to its worldwide taxation policies.

How does a firm choose between box two (Territorial/POI) and box four (Territorial/RS) jurisdictions? It is easier, faster and cheaper to move to another POI jurisdiction than it is to move to a Real Seat jurisdiction. Reincorporation papers are filed in a new jurisdiction, the firm's attorneys take a series of legal steps to declare a new corporate home, but the firm's business operations are not affected. This can be accomplished quickly. Moving to another POI jurisdiction does not require moving senior management, employees or assets, which Real Seat jurisdictions may require. Moving people and a corporate headquarters to a Real Seat location can be disruptive, costly and time-consuming. A new headquarters has to be found and outfitted, and key employees may have to move. The firm might lose valuable employees in the transition. But moving to another POI jurisdiction requires no such changes. So moving to a box two jurisdiction (Territorial/POI) has significant advantages over moving to a box four country (Territorial/RS).

This is what U.S.-based MNEs did between 1997 and 2003. All of the inverting firms identified by Desai and Hines (2004) reincorporated in the Cayman Islands or Bermuda (pp. 418-420).

Both countries determine tax residence through place of incorporation rules. According to the Office of Tax Policy's study (2002) of corporate inversions: "While the jurisdiction of incorporation is changed in an inversion transaction, there need not be any change in the location of the corporation's headquarters or its other business operations" (p. 15).

In addition, the Cayman Island and Bermuda do not tax overseas income. When describing those inversions the Office of Tax Policy (2002) wrote: "To the extent the ownership of foreign subsidiaries has been shifted out of the former U.S. group to the new foreign parent or a foreign subsidiary thereof, an inversion transaction eliminates the U.S. corporate-level taxation of these foreign operations. Accordingly, the significance of the foreign tax credit limitation (and the related rules concerning the allocation of expenses, including interest) to the inverted corporate group is reduced or eliminated, as foreign-source earnings of the corporate group will not be subject to U.S. tax" (p. 14). In summary, two popular destinations for corporate inversions between 1997 and 2003 were the Cayman Islands and Bermuda, countries that both offered territorial tax policies and place of incorporation rules.

Tax Consequences of Inversion Transactions

While the legal mechanics of a corporate inversion can differ from firm to firm, in general inversions are structured as either stock sales, asset sales, or a mixture of the two. They are generally taxable events. As Desai and Hines (2002) wrote: "U.S. law generally recognizes foreign inversions to be recognition events for capital gains purposes, meaning that taxpayers will incur capital gains tax liabilities for any previously unrecognized gains" (p. 416). The structure of the transaction determines how the gain is calculated and what party is taxed. But in any case, corporations considering an inversion need to weigh the immediate tax cost generated by the inversion against the longer term benefits of lower tax obligations and territorial taxation.

In all cases an inversion requires the incorporation of an entity in the new corporate home. In the first category, stock sales, the new foreign parent then acquires the shares of the U.S. firm, which was formerly the corporate parent. As Desai and Hines (2002) wrote: "In a taxable stock transfer, the new foreign parent company effectively exchanges its own shares for shares of the

American company" (p. 416). At the conclusion of the transaction, the shareholders own shares in the new foreign parent, rather than the U.S. firm. According to the Office of Tax Policy: "The amount of taxable gain recognized is equal to the excess, if any, of the fair market value of the stock over the shareholder's adjusted tax basis therein…" (p. 8). The shareholders of the corporation are taxed on any gain recognized as a consequence of the stock sale (p. 8).

In the second type of inversion, the new corporate parent acquires the assets of the U.S. entity. They are transferred between the U.S. entity and the new corporate parent at the fair market value of those assets. Again, this is a taxable event. As Desai and Hines write: "In an asset inversion, all of the assets of the U.S. entity are transferred to the foreign entity (which has no material assets) in exchange for stock in the foreign entity, and a taxable gain is realized on the excess of the fair market value over the U.S. entity's cost basis in those assets" (p. 417). However in this case the tax obligation is paid by the firm itself, rather than the shareholders (Office of Tax Policy, 2002, p. 8). At the transaction's conclusion, the shareholders own shares in the foreign entity.

To summarize, it is the shareholders who are taxed when the transaction is structured as an exchange of stock. Their taxable gain is the difference between the stock's fair market value and its adjusted basis. However the firm itself is taxed on asset sales. Its gain is the difference between the fair market value of the assets and their basis. Firms evaluate the financial impact of these alternatives when they decide how to structure an inversion.

The third type of transaction is a mixture of a stock sale and an asset sale. These are frequently called "drop down" transactions. As the Office of Tax Policy (2002) stated: "The third category of transaction that has been used to implement the reincorporation step involves elements of both stock and asset transfers. In this type of transaction, the U.S. parent transfers its assets to a new foreign corporation, and then a portion of those assets is contributed immediately to a U.S. subsidiary of the new foreign parent," which is the origin of the "drop down" terminology. "To the extent that assets are contributed to a U.S. corporation, and therefore effectively remain in U.S. corporation solution, the result generally is the same as in a Stock Transaction…To the extent the foreign directly holds some of the assets of the former U.S. parent, the result generally is the same as in an Asset Transaction…" (p. 5). Since the transaction is both a stock sale and an asset sale, the gain is taxed both ways. Shareholders pay that portion of the gain related to the stock sale, determined by the difference between the shares' value and their basis. The firm pays that portion of the gain triggered by the asset sales, and the gain is the difference between the fair market value of the assets and their cost basis (Office of Tax Policy, 2002, p. 9).

In addition to the transactions involving the former U.S. parent, in general foreign subsidiaries are transferred from the former U.S. parent to the new foreign parent, or one of its overseas subsidiaries (Office of Tax Policy, 2002, p. 6). Thus the U.S. parent is no longer responsible for paying taxes on the worldwide income of its overseas subsidiaries. This is one of the key benefits of these transactions. In addition, the Office of Tax Policy says many inversions have been accompanied by intercompany loans extended to the U.S. entity, which can shift a portion of the U.S. entity's earnings to a low tax jurisdiction (p. 6).

To summarize, corporate inversions generally trigger a taxable gain which cannot be deferred. As Desai and Hines (2002) said: "The costs of inversions include not only the administrative costs of undertaking inversion transactions, but also the capital gains tax liabilities they entail" (p. 431). These costs need to be evaluated against the benefits of a corporate inversion, which include territorial taxation, lower income tax rates, and the opportunity to strip earnings from the U.S. entity.

Non-tax Considerations

Prior to an inversion, firms also need to determine if there are any non-tax issues which they should consider. In general, inverting firms have not identified many issues which prevent them from structuring an inversion. However since that time the U.S. government has begun to use its purchasing power to discourage corporate inversions, so this should be considered in the future.

As mentioned, most corporate inversions had very little impact upon the day-to-day operations of a firm. As the Office of Tax Policy report stated: "the effect of such a transaction on the actual management and operation of the inverted firm is generally limited. While the jurisdiction of incorporation is changed in an inversion transaction, there need not be any change in the location of the corporation's headquarters or its other business operations" (p. 15). Thus the potential impact upon business operations has not discouraged corporate inversions.

Corporate inversions have had little impact upon firms' access to capital markets. If anything, they may improve in certain circumstances. The Office of Tax Policy report stated that after an inversion those firms were able to continue to use the same ticker symbol on U.S. stock exchanges (p. 15). Inverted firms that were members of the S&P 500 index were able to remain in that index (p. 16). A firm that recently moved its corporate headquarters from the United States to the United Kingdom, Ensco, believes its relocation will improve its visibility in worldwide markets, and may increase its access to international investors (Ensco proxy statement/prospectus, 2009, p. 44).

Negative publicity may be one of the strongest arguments against corporate inversions. According to Godar, O'Connor, and Taylor (2005): "Politicians in the U.S. are labeling inversion, this movement of business incorporation locations to offshore tax haven, 'unpatriotic' and 'immoral'" (p. 1). Business executives may be concerned about the impact upon their personal reputation, and businesses may fear impact upon the value of the firm's brand.

However, since IRC §7874 was passed, firms considering an inversion will also need to consider an additional risk. Inverting firms may lose U.S. government contracts. Effective July 1, 2009 the Federal Government will not award contracts to inverted U.S. corporations.[10] The U.S. government is using its purchasing power to discourage inversions. The law can be waived when it is in the national interest to do business with a particular firm. Nonetheless firms that do a significant portion of their business with the U.S. government will want to consider whether an inversion would reduce this revenue.

[10] See Omnibus Appropriations Act of 2009 (Public Law 111-8), Section 743 of Division D

IRC §7874

IRC §7874 was passed as part of the American Jobs Creation Act of 2004.[11] Its primary objective was preserving U.S. tax revenue. The Senate Finance Committee's Report explained the law as follows: "The Committee believes that inversion transactions resulting in a minimal presence in a foreign country of incorporation are a means of avoiding U.S. tax and should be curtailed."[12] It is generally believed the law has been at successful at achieving its objective. Leitner and Glicklich (2009) said that since §7874 was enacted "the tide has slowed" (p. 515). VanderWolk (2010) takes a stronger position, saying the law "is widely believed to have had a severe chilling effect on inversions of publicly held corporations" (p. 1).

IRC §7874 does not prevent firms from inverting, and it may not be possible to enforce such a law. However the law either: 1) eliminates the tax benefits associated with inverting; or 2) increases the tax cost of a corporate inversion. In the first case it ignores the inversion for tax purposes, and says the firm will continue to be taxed as a domestic entity. In the second case it recognizes the inversion, but may increase the tax bill that is triggered by the transaction. It does this by denying certain tax deductions that can reduce the taxable gain set in motion by the inversion.

The law has three tests, all of which must be met for the law to apply. The first applies when all, or substantially all, of a firm is acquired. The test is met when "the entity completes after March 4, 2003, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation or substantially all of the properties constituting a trade or business of a domestic partnership."[13] This section was prepared to cover the various legal techniques used to complete a corporate inversion. As mentioned, in some cases inversions were structured as stock purchases, in other cases as asset purchases, and some were a combination of the two. §7874 covers all of these events.

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[11] P.L. 108-357 (October 22, 2004).
[12] S. Rep. No. 108-192, 108th Cong., 1st Sess., at 142 (Nov. 7, 2003)
[13] IRC §7874(a)(2)(B)(i)

The second test compares the firm's ownership before and after an inversion. If 80% of more of a firm's shares were owned by the same shareholders before and after the inversion, the firm's tax status does not change. Section 7874(a)(3) says in this case the inverted firm "is treated as a domestic entity." In other words, the inversion will not be respected for tax purposes. Worldwide taxation and U.S. tax rates still apply. For other corporate law purposes the firm is now a foreign corporation, but for tax purposes it is still treated as a domestic entity.

However §7874 treats a firm as "surrogate foreign entity" when 60-80% of the firm's shares are owned by the same shareholders before and after the inversion.[14] Leitner and Glicklich (2009) explained this impact, stating "Under §7874(a), the taxable income of an expatriated entity during the 10-year period beginning on the date of the acquisition 'shall in no event be less than' the inversion gain of the expatriated entity. In other words, any inversion gain cannot be offset by other deductions including accumulated net operating losses. In addition, the inversion gain cannot be offset by any credits to which an expatriated entity might otherwise be entitled" (pp. 515-516). In short, the taxable gain triggered by the inversion cannot be reduced by net operating losses and tax credits. VanderWolk (2010) says: "the phrase 'surrogate foreign corporation' has not meaning outside of section 7874" (p. 9). Thus the only impact of this section is to deny tax credits and deductions that could reduce the firm's tax obligation generated by the inversion. In the future the parent company is taxed under the international tax laws applicable in its new corporate home.

Finally, if less than 60% of the shareholders are the same before and after the inversion, §7874 does not apply. In such situations the inverted firm is a foreign entity.

Determining an inverting firm's tax status based on the number of shares that change hands seems like a curious approach. Why should a firm's tax status be determined by the number of shares that transfer ownership? VanderWolk (2010) says Congress intended to permit corporate restructurings not motivated primarily by tax objectives (pp. 4-7). If there was little or no change in the ownership of a firm, this indicated the transaction was structured only to avoid the U.S. tax

[14] §7874(a)(2)(B)

system. But if there was a substantial change in the ownership of a firm, this suggested that that "transactions would have sufficient non-tax effect to justify being respected for US tax purposes" (p. 4). Still, one wonders whether this was the most effective way to determine if a transaction had non-tax purposes. And it is not entirely clear why the lines were drawn at 60% and 80% continuity of ownership. If 50-60% of shares remain in the same hands §7874 does not apply, but over half the shares are still owned by the same parties.

The third test is whether the inverted firm has a substantial business presence in its new corporate home. If the firm does not have such a presence in that location, §7874 applies. The purpose is to prevent inversions to countries in which the MNE conducts minimal business, such as Caribbean tax havens. This test compares the volume of work performed in the new corporate home to that done by the entire worldwide enterprise, or what §7874 calls "the expanded affiliate group (EAG)." Section 7874 applies if "after the acquisition the expanded affiliate group which includes the entity does not have substantial business activities in the foreign country in which, or under the laws of which, the entity is created or organized, when compared to the total business activities of the expanded affiliate group."[15] If the firm does have a substantial business presence there, the inversion is respected.

However §7874 does not explain what constitutes a "substantial business presence." The subsequent Treasury Regulations provide more detail. The substantial business presence test also introduces real seat rules into U.S. tax laws. But they only apply as part of §7874. Place of incorporation rules are still the standard used to determine whether firms are taxed as U.S. entities; no substantial business presence is necessary. But to escape U.S. tax rules a firm needs to demonstrate it has a substantial business presence in that new corporate home. Thus a firm that incorporates in the United States will be taxed as a U.S. entity, even if no business is conducted here. If the same firm wants to flee the U.S. tax system, it has to demonstrate it has a substantial business presence in another location. This appears inconsistent.

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[15] 7874(a)(2)(B)(iii)

One other section is noteworthy. Section 7874(c)(2)(B) disregards “stock of such foreign corporation which is sold in a public offering.” This section was drafted to prevent firms from simultaneously inverting and going public. In most public offerings the ownership of a firm changes substantially, as privately held shares are sold to the public. Without this section many U.S.-based firms might expatriate as part of an IPO, since substantial ownership changes would allow the firm to escape §7874.

VanderWolk (2010) summarized §7874 this way: “The new law effectively negated the tax benefits of inversions into tax haven parent corporations where the ownership of the group was not significantly affected by the restructuring. If, on the other hand, there was a significant change in ownership, and if the change was not due to a public offering of shares in the foreign corporation, the new law sought only to impose US tax on gains accrued up to the date of expatriation, without offset by foreign tax credits or net operating loss carryovers. If the group had substantial business activities in the foreign corporation’s country of incorporation, the new law would not apply” (p. 1). It should also be noted VanderWolk is critical of the law, stating: “Section 7874 is the most extreme of the US international tax rules aimed at preserving residence-based taxation of foreign-source earnings of US multinationals. The deemed domestication of a foreign corporation not managed or controlled in the United States, under the 80-percent ownership change test of section 7874, is a radical assertion of tax jurisdiction in context of international tax norms” (p. 16). One can also question the logic underlying §7874, particularly the 80-percent and 60-percent tests. In many ways real seat rules seem more logical; the country that taxes the MNE parent does so because that is where business decisions are made, where senior executives work, or where a large portion of the firm’s assets and employees reside.

Treasury Regulations explain how the IRS interprets the substantial business presence test. Two sets of Temporary Regulations were drafted on this topic, and they provide different guidance. The first regulations were in effect until June, 2009, and they included detailed examples to explain how the IRS interprets the law. They also included a safe harbor. The safe harbor included tests to determine whether the substantial business presence test is met. However they were replaced in June of 2009 with new Temporary Regulations, which do not provide a safe harbor nor do they provide examples to explain how the IRS interprets §7874.

Both prior and current Temporary Regulations identify five factors to be considered when determining whether businesses have a substantial business presence in their new corporate home. Those factors are: 1) the historical conduct of continuous business activities in that country prior to the inversion; 2) the presence of operational activities in that country, including property ownership, performance of services, and sales by EAG members; 3) the presence of substantial managerial activities by EAG employees in that country; 4) a substantial degree of ownership by investors residing in that country; and 5) strategic factors "the existence of business activities in the foreign country that are material to the achievement of the EAG's overall business objectives."[16] However it is unclear how important each factor is. Both sets of regulations state: "The presence of absence of any factor, or of a particular number of factors, is not determinative. Moreover, the weight given to any factor (whether or not set forth below) depends on a particular case."[17] The facts and circumstances in each case need to be evaluated separately.

As mentioned, the prior regulations provided taxpayers with a safe harbor. They stated taxpayers met the substantial business presence when all three measures were met. The prior regulations said if "after the acquisition, the group employees based in the foreign country account for at least 10 percent (by headcount and compensation) of total group employees,"[18] that measure is met. If "the total value of group assets located in the foreign country is at least 10 percent of the total value of all group assets"[19] the second measure is reached. And when "the group sales made in the foreign country accounted for at least 10 percent of total group sales"[20] the third measure is attained. If the firm met or exceeded all three measures it had a substantial business presence in that location, and IRC §7874 did not apply. But the Treasury Department replaced those regulations and eliminated the safe harbor in 2009, making it very difficult for taxpayers to

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[16] Regs. §1.7874-2T(d)(ii)
[17] Ibid
[18] Prior Temporary Regs. §1.7874-2T(d)(iii)(2)(ii)
[19] Prior Temporary Regs. §1.7874-2T(d)(iii)(2)(iii)
[20] Prior Temporary Regs. §1.7874-2T(d)(iii)(2)(iiii)

know if the IRS will challenge a firm's contention it has a substantial business presence in a new corporate home. Since the substantial business presence test has not yet been litigated, businesses cannot look to court decisions, either.

Leitner and Glicklich (2009) wrote: "This safe harbor was removed from the new temporary regulations. According to the Preamble, the IRS and Treasury Department were concerned that the safe harbor might apply to certain transactions that are inconsistent with the purposes of §7874. For similar reasons, the examples in the former temporary regulations that illustrated the general application of the facts-and-circumstances test were also eliminated. Whether the IRS believes that the thresholds in the safe harbor and the facts of the examples were simply too generous—or whether the IRS prefers to retain a level of subjectivity and uncertainty to deter taxpayers from relying on the substantiality exception—is not entirely clear. However, a clue may exist where the Preamble notes that, in addition to the elimination of the safe harbor and examples, the question is whether the substantial business activities condition is satisfied will continue to be an area with respect to which the IRS will ordinarily not rule. The implication is that the IRS is intentionally making it more difficult for taxpayers to rely on the substantiality exception" (p. 521). Thus the IRS will not give taxpayers advance guidance on the topic; businesses have to invert first, and then learn if the IRS will challenge the firm's position.

In some ways one can understand why the IRS dropped the safe harbor. It had flaws. Suppose a MNE had 89% of it employees, assets and sales in the United States, and 11% in Canada. Under the safe harbor it would have a substantial business presence in Canada, and thus could choose to be taxed there. But in that situation it seems that the corporation's "real seat" would be the United States, if those rules applied.

VanderWolk (2010) had further criticisms. He wrote: "For a group that conducts significant business activities in many different countries, the business-activities test would be impossible to satisfy if 'substantial' were interpreted to mean "at least 50 percent," or even "at least 20 percent." It is likely that many global businesses are spread over a large number of countries, such that no single country accounts for more than a single-digit percentage of the global business. Did Congress intend to create a condition that could not be met, in practice, in some cases? There is no evidence in the legislative history that this result was intended?" (pp. 11-12).

Furthermore, the new regulations are too vague. VanderWolk (2010) wrote: "The inability to know the tax consequences of a major transaction is a real problem, which only the IRS and Treasury (or Congress) can solve. The sooner the IRS and Treasury can produce new guidance regarding the level of business activity in the foreign country or incorporation that will be considered 'substantial' when compared to the total business activities of the group, the better for all concerned" (pp. 17-18). However it seems unlikely such guidance will be forthcoming soon. The new regulations were released last year and they replaced more specific regulations that had been in effect from 2006-2009. The lack of clarity in the new regulations appears to be a conscious strategy that reflects the Obama Administration's intention to limit inversion activity.

VanderWolk (2010) says this puts taxpayers in a difficult position, since they cannot be assured they comply with the substantial business presence test. He writes, "In contrast to the bright line test of 80 percent ownership in section §7874(b), the business-activities test in section §7874(a)(2)(B)(iii) draws a very fuzzy line, the crossing of which has enormous consequences…Unfortunately, the adjective 'substantial' is ambiguous" (p. 11).

The Ensco Re-domiciliation

Despite the added confusion created by the new Treasury Regulations, earlier this year the oil drilling firm Ensco moved its corporate headquarters from the United States to the United Kingdom. The Ensco action illustrates issues other U.S.-based firms might encounter in the future as they seek to escape high income tax rates and worldwide income tax policies. The issues raised by this headquarters relocation may be faced by other firms in the future, so Ensco's actions serve as a useful case study.

Ensco is a drilling services firm that began operations in Texas in 1975. It specializes in deep water drilling, an activity that has become more visible as oil exploration has shifted from coastal to deep ocean waters. Ensco provides drilling services to oil companies around the world. It currently has market capitalization of approximately $6 billion and nearly 3,700 employees. During 2009 its revenue was approximately $1.9 billion, and its net income was $779 million.[21]

In November, 2009 the firm announced its intention to "re-domicile" its corporate headquarters from the United States to England. On December 22, 2009 its shareholders met in Texas to approve this action. As of March, 2010 Ensco is headquartered in London, England.
Ensco consistently says it has re-domiciled, and does not use the words "corporate inversion" to describe its actions. Re-domiciliation can be distinguished from a corporate inversion in several important ways. While a corporate inversion is generally a tax strategy that has little impact upon a firm's operating activities, a re-domiciliation includes moving corporate offices and personnel move to a new site, where the worldwide enterprise can be managed more effectively. For example, Ensco announced it was moving key activities and officers to the United Kingdom to improve access to customers and business operations. While a corporate inversion may be done only for tax purposes, a re-domiciliation should improve both operating performance and a firm's tax rate. Furthermore, in corporate inversions firms generally reincorporate to a tax haven, while in a re-domiciliation a firm moves its corporate home to a country in which it has a substantial business presence, or where the MNE is managed. This is not necessarily a tax haven. The following table summarizes key differences between prior corporate inversions and a re-domiciliation:

Corporate Inversions and Re-domiciliation

	Corporate Inversion	Re-domiciliation
Stated purpose	Reduce income tax rate	Improved management and control of MNE, and reduce income tax rate
Relevant rules to determine MNE corporate home	Place of incorporation rules determine MNE home	Real seat rules determine MNE home
Impact on operations	Negligible—no significant impact upon how firm is managed	Firm relocates headquarters operations to improve business management
New corporate home	Tax haven jurisdictions such as Bermuda and Cayman Islands	Country in which firm has significant business activities; not necessarily a tax haven

[21] See 10-K for Ensco date February 25, 2010 at http://www.edgar.com

As previously mentioned, IRC §7874 applies when three tests are met. The third is the substantial business presence test. Expatriating firms must be taxed as domestic entities when the first two tests are realized, and "the expanded affiliate group which includes the entity does not have substantial business activities in the foreign country in which, or under the law of which, the entity is created or organized…"[22] Ensco argues it has a substantial business presence in the U.K. and thus it is not subject to §7874.

Ensco emphasized that it was moving management and control of the firm from the United States to the U.K. Its proxy statement/prospectus says: "Our Board of Directors expects that the reorganization and relocation of our principal executive offices, including most of our senior executive officers and other key decision makers, to the U.K., would, among other anticipated benefits: enhance management efficiencies resulting from the U.K. time zone overlap with geographies where we operate, improve access to key customers located in the U.K. or Western Europe or who routinely travel to the U.K., enhance our access to European institutional investors, improve the general customer and investor perception we are an international driller…"[23] In short, senior executives to London will manage the firm more effectively when they reside in the United Kingdom, since they will be closer to key customers, investors and operations. As mentioned previously, U.K. tax laws state "that the residence of a company is determined according to where its central management and control is to be found."[24] This is similar to one of the substantial business presence factors in U.S. Treasury Regulations. The third factor in those regulations states the IRS will evaluate: "The performance in the foreign country of substantial managerial activities by the EAG members' officers and employees who are based in the foreign country."[25]

Because it intends to be taxed under U.K. international laws, Ensco believes its tax rate will decrease. The proxy statement/prospectus says that re-domiciling its headquarters to London

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[22] IRC§7874(a)(2)(B)(iii)
[23] See Ensco's letter to its stockholders, written by Chairman Daniel W. Rabun, dated November 20, 2009, included its merger prospectus. Downloaded July 19, 2010 from http://www.enscous.com/Theme/Ensco/files/docs_financial/Ensco%20Special_Proxy_Statement.pdf
[24] See INTM120150—Company Residence
[25] IRC§7874(a)(2)(C)

will "allow us to take advantage of the U.K.'s developed and favorable tax regime and extensive treaty network, and allow us to potentially achieve a global effective tax rate comparable to that of some of our global competitors…"[26] While Ensco was not relocating exclusively for tax reasons, there were still tax advantages to moving to the U.K. Ensco also contended that U.S. worldwide tax policies and rates made it more difficult for them to compete effectively, a claim made in the prior era of corporate inversions.

Ensco was careful to distinguish its actions from prior corporate inversions, which generated adverse publicity. Referring to prior transactions they wrote: "In most cases, those corporations expatriated to tax haven jurisdictions in which the applicable U.S. multinational corporation had no (or minimal) historic business activities" (p. 40). Ensco was moving to a country in which it had a substantial, historic business presence, and where it could manage its operations more effectively. Furthermore, while the U.K.'s 28% tax rate is substantially lower than the U.S. rate, it is not considered a tax haven.

Ensco's prospectus/proxy statement explains the tax advantages of re-domiciling to England. It says: "We believe that the merger should improve our ability to maintain a competitive worldwide effective tax rate because the U.K. corporate tax rate is lower than the U.S. corporate tax rate and because the U.K. has implemented a dividend exemption system that generally does not tax subject non-U.K. earnings to U.K. tax when such earnings are repatriated to the U.K. in the form of dividends from non-U.K. subsidiaries. In addition, the U.K. Government is consulting on reform of the U.K. controlled foreign company rules (under which, in some circumstances, low-taxed profits of foreign subsidiaries of the U.K. companies may be taxed in the U.K.) with a view to moving towards a more territorial system of taxing foreign profits of U.K. companies" (p. 23). Ensco is attracted to the U.K.'s lower tax rate and the steps it has taken towards a territorial tax system. In the Kane and Rock model on page 22, the United Kingdom is moving from box three (Worldwide/RS) to box four (Territorial/RS). And Ensco is moving from being taxed under box one policies (Worldwide/POI) to box four (Territorial/RS), using the substantial business presence test in IRC §7874 to achieve that objective.

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[26] Ibid

To escape §7874, Ensco's proxy statement/prospectus specifically evaluates each of the five factors identified in the Treasury Regulations' substantial business presence test, and explains how they support Ensco's contention it has a substantial business presence in the U.K. One factor concerns the firm's historical presence in that country. Its proxy statement says: "However, Ensco UK is a company formed under English law, and Ensco Delaware has, continuous and substantial business activities in the U.K. as a result of its longstanding North Sea drilling activities and management and control over the Europe and Africa Business Unit, headquartered in Aberdeen, Scotland. We therefore believe Ensco UK should not be treated as a U.S. corporation for U.S. federal income tax purposes under Section 7874" (p. 23). It also notes that it began drilling activities in the United Kingdom's North Sea in 1993, and had a local headquarters in Aberdeen, Scotland since 1994.

The firm argues it has substantial managerial activities in the United Kingdom, another factor identified in U.S. Treasury Regulations. Their proxy statement/prospectus says: "After relocating to Aberdeen, Scotland in 1994, the U.K. headquarters have served an increasingly important managerial role within the Ensco Delaware expanded affiliate group. The Aberdeen facility is the headquarters for the Europe and Africa Business Unit, which is one of four business units…" (p. 43). The General Manager of that division and seven of his/her managers all live and work in Scotland. Furthermore, Ensco expects further growth in the U.K., stating: "For the strategic business reasons discussed above, management in the U.K. has grown. More importantly, for the same reasons, the Company expects the long-term historic growth of management in the U.K. to continue" (p. 43). Ensco also says the firm's senior managers will move to the U.K., effectively shifting the worldwide enterprise's management to the U.K. Thus it will comply with the U.K.'s international tax laws, which emphasize management and control when determining a MNE's corporate home.

Another factor to be considered is whether there is "A substantial degree of ownership of the EAG by investors resident in the foreign country."[27] The firm acknowledges that few of its current investors are U.K. residents, but they hope to change this. Their proxy

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[27] Regs. §1.7874-2T(d)(ii)(D)

statement/prospectus states: "The enhanced relationships with potential U.K. and European investors are likely to result in an expanded U.K. and European Union shareholder base. However it is unlikely that U.K. residents will comprise a substantial portion of Ensco's shareholder base in the near term" (p. 44).

Current and prior Treasury Regulations also evaluate whether the firm has strategic reasons for moving abroad. The Treasury Regulation says one factor to be evaluated is: "The existence of business activities in the foreign country that are material to the achievement of the EAG's overall business objectives."[28] Ensco says it is re-domiciling for strategic reasons. While they began in the United States, they are growing more rapidly in international markets, and they want to be perceived as a global provider of deep water drilling services. To substantiate this, Ensco explains how it began a U.S. firm, with an initial focus on drilling activities in the United States and the Gulf of Mexico. However, since that time it has grown more rapidly in international markets. They write: "Specifically, 94 percent of the proven worldwide oil reserves and 95 percent of proven worldwide gas reserves are located in the Foreign Drilling Markets. By contrast, only 6 percent of the proven worldwide reserves and only 5 percent of the proven worldwide gas reserves are located in the U.S." (p. 42). The U.K. headquarters gives senior management easier access to operations in the North Sea, Mediterranean, Africa and other sites. They write: "Consistent with these global trends, we expect that we will derive approximately 86 percent of our 2009 gross revenues from our operations is the Foreign Drilling Markets" (p. 42). Ensco says its goal is to expand internationally, and the U.K. location is a better site to achieve that objective (p. 43). In short, they believe the U.K. is a better strategic location than the United States for a worldwide drilling services firm.

The regulation's fifth factor is whether the firm has substantial operational activities in its new corporate home. Specific items to be evaluated include property in that country, the "performance of services by individuals in the foreign country which is owned by members of the EAG,"[29] and sales made in that country by members of the EAG. As discussed, under the safe harbor, if 10% of the worldwide enterprise's assets, employees and sales are located in the

[28] Regs. §1.7874-2T(d)(ii)(E)
[29] Regs. §1.7874-2T(d)(ii)(B)(2)

new corporate home, the "EAG will be considered to have substantial business activities"[30] in that location.

Ensco says that under the former Treasury Regulations it met each of the safe harbor elements. Ensco's proxy statement/prospectus states: "The ratios of the ENSCO Delaware expanded affiliate group's assets, employees and revenues in the U.K. compared to its worldwide assets, employees, and revenues exceeded the former 10 percent 'safe harbor' contained in the 2006 Regulations for each calendar year from 2005 through 2008 and are projected to exceed the former 'safe harbor' in 2009. The 2009 Regulations contain no 'safe harbor' or example to illustrate the application of the relevant factors to determine whether substantial business activities exist. There is no judicial or administrative guidance on the meaning of 'substantial business activities' for purposes of Section 7874" (p. 41). Thus Ensco argues it would have had a safe harbor under the prior regulations. Ensco appears to believe it has a solid case. The firm's management determined it was strong enough that they proposed the re-domiciliation to its shareholders, though the regulations removed the safe harbor. The shareholders supported the move, and the firm is now headquartered in London.

However Ensco could not be entirely sure its move will not be challenged by the IRS. Thus it acknowledges in its proxy statement/prospectus: "Notwithstanding the foregoing, it is possible that the IRS may assert and ultimately establish that Ensco UK should be treated as a U.S. corporation for U.S. federal income tax purposes, under Section 7874 of the Code" (p. 46). If this happened "we would become involved in a tax controversy with the IRS regarding possible additional U.S. tax liability" (p. 23). The firm had no way to resolve this issue prior to re-domiciling, and still took that action.

Options Available to U.S. Firms

Given the high cost and complexity of U.S. international tax policies, some firms may want to consider alternatives to American tax laws. While other countries seek to attract MNEs through

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[30] Prior Regs. §1.7874-2T(d)(iii)(2)

tax-friendly policies, the U.S. is trying to keep them from fleeing, at least for tax purposes. What alternatives might American businesses consider? Following are options firms and investors might evaluate, depending upon their circumstances. In the examples below, I have tried to emphasize the most likely scenarios, rather than identify every option a firm could consider, however improbable.

Option one: Incorporate abroad from the outset

If a firm has not yet incorporated it may want to consider doing so in a tax-friendly jurisdiction at inception. The U.S. still relies primarily upon place of incorporation rules to determine what businesses it should tax. There is nothing that prevents a firm from incorporating abroad during its start-up phase. Thus in the Kane and Rock model the firm could start operation in the second box (Territorial/POI). The firm could still be managed and directed within the United States, but its worldwide tax policies would not apply.

The parent company could then form a U.S. subsidiary to conduct business here. The firm is still subject to high taxes on U.S.-sourced earnings, but it can avoid the cost and complexity of worldwide taxation. As mentioned, it may also be possible to extend loans from the overseas parent to the U.S. subsidiary, and strip a portion of its earnings from the United States to a low-tax jurisdiction.

The Office of Tax Policy (2002) recognized new businesses may not choose to incorporate in the U.S. stating: “As we formulate a response, however, we must not lose sight of the fact that an inversion is not the only route to accomplishing this type of reduction in taxes. A U.S.-based start-up venture may incorporate overseas at the outset” (p. 2). The U.S. tax system is costly and burdensome, and its place of incorporation rules make it easy to incorporate abroad.

Testifying before Congress in 1999, Intel’s Vice President of Tax, Robert Perlman, said this is what he would advise. Perlman said: “if I had known at Intel’s founding (over thirty years ago) what I know today about international tax rules, I would have advised the parent company be established outside the U.S. This reflects the reality that our Tax Code competitively disadvantages multinationals simply because the parent is a U.S. corporation."[31]

Since that time the disparity between U.S. tax policies and those in other countries has grown. Today the U.S. tax rate is the world's second highest, and it is projected to rise substantially next year. Few countries enforce worldwide tax policies. Japan and the United Kingdom are migrating towards territorial international tax systems; soon the United States will be the only G-7 country that taxes worldwide income.

Well-funded, high technology start-ups are often backed by sophisticated investors with international experience, and the advantages of incorporating abroad from inception are known. As the Office of Tax Policy noted: "A start-up venture that contemplates both U.S. and foreign operations must choose a location for its corporate parent. While the natural choice for a U.S.-based venture may be a U.S. parent corporation, that often will not be the most tax efficient choice. By forming initially through a foreign parent corporation, the venture can enjoy the same tax savings as would be available through a subsequent inversion transaction" (p. 18-19). When this was written inversions were easier to accomplish than today, so the motivation to incorporate overseas from the start today is even stronger. At some point it seems possible that incorporating in the U.S. will not be the "natural choice," as tax attorneys and CPAs advise clients to incorporate abroad from day one. Such actions may not attract the same attention as corporate inversions by well-established, household names. However in the long run it can be more damaging, as the U.S. economy and its tax base rely upon the success of new business ventures.

Option two: if you are merging with an overseas company, select that location as your corporate home

As international trade and investment grow, cross-border mergers may become more frequent. If tax policies continue to levy high tax rates and complex tax rules upon U.S.-headquartered firms,

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[31] Perlman, R. (1999). International Tax Issues Relating to Globalization: Hearing before the S. Comm. On Finance, 106th Congress 1.

when firms merge or are acquired they may want to identify the overseas location as the corporate headquarters. The Office of Tax Policy also acknowledged this was a threat, stating: “An existing U.S. group may be the subject of a takeover bid, either friendly or hostile, from a foreign-based company” (p. 2). Their report said this could have a negative impact upon the U.S. economy in the long-run, stating: “Moreover, these transactions can have significant adverse effect on the U.S. economy in the long term, as decisions affecting the future location of new investment, operations and facilities, and employment opportunities are made by what is a foreign-based company rather than a U.S.-based company” (p.2).

This may not be just a theoretical concern. There is evidence this has happened. According to Avi-Yonah (2008): “When Daimler bought Chrysler in 1998 to form Daimler Chrysler AG, Juergen Schrempf, the CEO of Daimler/Chrysler, testified before the US Senate Finance Committee that Subpart F was a major reason that the combined company was German and not American” (p. 6). While Schrempf said this was a significant factor, it should be noted that Avi-Yonah questioned this, and thought the German government and unions may have had a larger influence. Nonetheless, Schrempf’s comments indicate that taxes can play a role in such decisions. And Avi-Yonah also commented: “However, Schrempf addressed a broader phenomenon, which is that lawmakers are reasonably concerned about the impact of CFC rules on the decision where to incorporate MNEs. This can be shown for the US by the trend in inversion transactions, in which US MNEs reincorporated in Bermuda in part to avoid Subpart F. The trend was stopped by legislation in 2004, but competitiveness issue continues” (p. 6). But the Ensco re-domiciliation indicates there are ways for some firms to work around IRC 7874.

Depending upon the location of the acquiring firm, the merged company could be in any of the four boxes in the Kane and Rock table. However since most countries apply territorial tax policies, the new firm is likely to be in the second or fourth box (Territorial/POI or Territorial/RS). In this event it may be an opportune time to transfer CFCs to the new corporate parent, and escape worldwide taxation policies of those entities. In addition, even if the acquiring firm is in either the first box (WW/POI) or the third box (WW/RS) it may make sense to designate that firm as the parent, due to the high U.S. income tax rate.

Option three: find new investors as part of a corporate inversion

As mentioned earlier, the U.S. laws governing corporate inversions are curious, in that a firm's tax status can change when the firm attracts new investors. If less than 20% of the firm's shares change hands as part of a corporate inversion, the firm continues to be taxed as a domestic entity. If 20-40% of the shares change hands, the cost of expatriation can increase, as the firm cannot use NOLs and tax credits to reduce the exit tax. And if more than 40% of the shares change hands, IRC 7874 does not apply. But in any case, if more than 20% of a firm's shares change hands, the firm is no longer taxed as a domestic entity.

There may be occasions when a firm seeks new investors and additional capital. This may be the perfect time to invert. Both new and existing shareholders benefit from a lower tax rate, as long as the firm is profitable. As VanderWolk (2010) writes: "For some group owners, the effective transfer of more than 20 percent of their equity interest in the group to new investors via a private placement of FC stock, and the US tax cost of the related inversion, would be acceptable trade-offs for the future benefits to be derived from positioning the group outside the increasingly onerous US international tax rules" (p. 17). And if more than 40% of shares change hands, the firm can use NOL's and tax credits to reduce the exit tax.

But in either case, the firm is escaping IRC 7874 under the second test, and it is not concerned with the substantial business presence test. That issue is irrelevant. Thus the firm can invert. It can select a tax haven to be its new corporate home. It can move from the first box (Worldwide/POI) to the second box (Territorial/POI). It does not have to move its corporate headquarters or senior executives to the new site. Its day-to-day operations can remain untouched. Of course if it wanted to move its headquarters to a jurisdiction in the fourth box (Territorial/Real Seat) it would have the option of doing so. But this would add expense, time and disruption associated with moving corporate offices and senior managers to a new country. They would also need to be concerned with ensuring they complied with the Real Seat rules in the new jurisdiction.

Option four: re-domicile to a country in which you believe you have a substantial business presence

Re-domiciliation may be an attractive option for firms that have a substantial business presence in another country, particularly if that country has low income tax rates and applies territorial tax policies. And since the U.S. has very high income tax rates, and is one of the few countries to tax worldwide income, there may many preferable locations.

For many MNEs, they might evaluate whether they have a substantial business presence in another G-7 country, as they may have extensive operations and a long history of conducting business there. Today the U.S. income tax rate is higher than that in every G-7 country, with the exception of Japan. And it is projected to increase above Japan's in 2011. Furthermore, the United States is the only G-7 country maintaining worldwide taxation policies. So there may be tax advantages to selecting one of these sites as the new corporate home, as Ensco did.

In the Kane and Rock model, Ensco moved from the first box (WW/POI) to the fourth box (Territorial/RS), with the caveat that the U.K. is transitioning towards territorial taxation. Ensco claimed it had a substantial business presence in the United Kingdom to escape IRC 7874. In moving its corporate home to the U.K., it shifted management and control of the firm there to comply with U.K. rules.

Leitner and Glicklich (2009) explained why firms may want to pursue this approach: "The U.S. continue to tax corporations on their worldwide income and the looming budgetary deficits make it unlikely that the U.S. will shift to a territorial system in the foreseeable future. On the contrary, the Obama's Administration's 2010 budget included several significant revenue-raisers targeting U.S.-based multinationals. These include the elimination of the use of check-the-box disregarded entities to reduce foreign taxation through debt financing arrangements and restrictions on the deductibility of interest attributable to debt that is allocable to foreign operations. While the natural destination for expatriating U.S. corporations would seem to be traditional 'tax haven' or similar low-tax jurisdictions, other countries (such as Canada) that offer more favorable treatment of multinational corporations (in the form of lower corporate tax rates and the substantially complete exemption of foreign business income from Canadian tax) may also be attractive relocation alternatives for some companies" (Leitner and Glicklich, 2009, p. 522). While Canada is not considered a tax haven, its 29.5% corporate income tax rate is still far below the U.S. rate, which is scheduled to be nearly 45% in 2011. Rates in Germany, the U.K, and Italy are scheduled to be approximately 15 points below the U.S. rate next year.

Option five: invert to a country in which you have a substantial business presence, and then re-domicile to a country with an even lower tax rate

Another option was proposed by Rubinger in his 2007 article. It is admittedly the most elaborate maneuver, and it is unlikely many firms would want to attempt it for several reasons to be explained. Nonetheless, it may be a possibility for some firms, and it does illustrate the options that may exist.

Rubinger proposed that a firm could escape U.S. taxation under IRC 7874 by demonstrating it had a substantial business presence in another jurisdiction, such as the United Kingdom. The firm could invert to that country. But rather than shift the management and control of the firm to the United Kingdom, it would shift that activity to another country with even more favorable tax policies. He cited Hungary and Switzerland as two attractive locations, as they have low tax rates, territorial tax policies, and favorable tax treaties with the U.K.

Rubinger (2007) says: "§7874 will apply only if, among other requirements, the expanded affiliated group does not have substantial business activities in the jurisdiction in which the new foreign parent is *created or organized.* Therefore, if a U.S.-based multinational has substantial business activities in a high-tax foreign jurisdiction, such as the U.K., it will no longer be possible to invert by using a holding company created in a low-tax jurisdiction, such as Bermuda or Barbados, where there is little, if any presence. Nevertheless, because §7874 is focused on the expanded affiliate group having substantial business activities in the jurisdiction where the foreign parent is created or organized, rather than where such entity is resident for foreign tax purposes, there may still be planning opportunities to avoid the reach of §7874 in certain circumstances" (p. 45). Since Rubinger wrote his article the U.K. has taken steps towards territorial taxation, but its income tax rates are still higher than, for example, Hungary's. Rubinger (2007) writes: "The management and control of the U.K. holding company is then moved to Hungary, causing the holding company to be treated as a resident of Hungary under the U.K.-Hungary income tax treaty" (p. 46). According to Rubinger that tax treaty offers some benefits to firms managed and controlled in Hungary, such as no withholding on interest and royalties, and low taxes on dividends. "In this scenario, §7874 would not appear to apply because the expanded affiliate group has substantial business activities in the jurisdiction where the foreign holding company is created or organized (i.e., the U.K.), even though such company is a resident of Hungary…" (p. 46).

While Rubinger focused on the U.K., this is not the only location where this is possible. Conceptually a MNE might invert to any country in which it has a substantial business presence, and simultaneously re-domicile to a country with low tax rates, territorial tax policies, and favorable tax treaties.

From a legal perspective, it appears Rubinger's proposal is feasible. However there are several practical issues which may make it unattractive to many U.S.-based companies. While taxes are important, relocating a company from the United States to Hungary (or another low tax jurisdiction) may not make sense for many operational reasons. Access to customers, capital markets and operations may suffer, and these are very important considerations. In addition, Rubinger's example relies in part on favorable tax treaties. But tax treaties are not permanent; they can be renegotiated. It would be very damaging and costly if a firm moved its headquarters overseas, and then saw many of the tax benefits disappear if countries renegotiated a tax treaty. Rubinger's proposal may make sense if a firm expected to achieve operational improvements through relocation, but for other firms it may be too risky to consider.

Conclusion

While IRC 7874 has generally been considered successful at limiting corporate inversions, the forces that motivated that activity have, if anything, grown stronger. Those drivers include high

U.S. corporate income tax rates, and complex, worldwide taxation policies. As Leitner and Glicklich (2009) wrote, “The fundamental incentives that drove companies to flee the United States are still there for those that can avoid being subject to the anti-inversion rules” (p. 515).

§7874 has made it more difficult to escape U.S. tax policies, but it has not made it impossible. Most start-up firms would be wise to incorporate abroad, unless they plan to do considerable business with the U.S. government. When a domestic firm merges with a foreign enterprise, they might choose the latter to be the corporate parent, at least for tax purposes. U.S. worldwide tax policies increase tax and administrative costs, and there are no signs this will change soon.

IRC §7874 also includes several escape clauses U.S. firms might be wise to consider. If they are attracting new investors, they might use that opportunity to invert to a tax haven. If they believe they have a “substantial business presence” in another country, they might consider re-domiciling to that location. Tax rates and policies are more attractive in almost all other jurisdictions.

These opportunities may not exist for all firms, but they do represent a threat to the U.S. tax base. While many countries are lowering tax rates and most enforce territorial international tax policies, the U.S. is raising corporate taxes and maintaining worldwide taxation. In the short-run these policies may be effective, but in the future they may not be. As the Office of Tax Policy (2002) report stated: “Measures designed simply to halt inversion activity may address these transactions in the short-run, but there is a serious risk that measures targeted too narrowly would have the unintended effect of encouraging a shift to other forms of transactions to the detriment of the U.S. economy in the long run” (p. 2).

If the U.S. wants to attract businesses and investment there needs to be an incentive to make it their corporate home. It is understandable that Congress has directed government agencies not to do business with inverted businesses. However this is not addressing the real problem, and it only motivates government contractors. There needs to be some advantage to being headquartered in the United States. Lower tax rates and more straightforward tax policies would be a more effective approach, as these would encourage all businesses to make the U.S. their corporate home.

In the end, the United States needs to become a more attractive location for business investment, and its tax policies need to be competitive. As Leitner and Glicklich (2009) said: “Ultimately, if the U.S. wishes to remain a preferred location for multinationals, it will need to move to a more competitive international tax regime” (p. 522). In 2002 the U.S. Office of Tax Policy said: “A comprehensive review of the U.S. tax system, particularly the international tax rules, is both appropriate and timely. Our overarching goal must be to maintain the position of the United States as the most desirable location in the world for place of incorporation, location of headquarters, and transaction of business” (p. 30). Due to high income tax rates and worldwide tax policies, it seems the United States today is far short of that goal.

The U.S. should also consider changing its place of incorporation rules. As Kane and Rock noted, these rules are easy to manipulate, and made it simple for businesses to invert. Today they make it easy for a start-up firm to select a corporate home where it may have little or no business presence. Real seat rules focus on business substance and are more difficult to manipulate. If it does consider real seat policies, the U.S. should consider rules in other countries and anticipate technological changes. While the U.K rules focus on where management and control of a firm exists, one can imagine a world in which senior managers work in different countries and use advanced technologies to communicate and make key decisions. In some cases it may be difficult to identify one country from which a firm is managed.

Finally, the U.S. should also consider rewriting IRC 7874. Determining a firm’s tax status based on how many shares change hands does not seem like the most effective approach. There should be better ways to determine whether a restructuring has objectives other than minimizing taxes. And the “substantial business presence” test within that law needs more clarity, as VanderWolk argues. Taxpayers, investors and even regulators deserve more certainty than the current rules provide.

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