

## Escaping the U.S. Tax System: From Corporate Inversions to Re-Domiciling

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**I**n the late 1990s and early 2000s, a number of large, U.S.-based multinational enterprises transferred their corporate homes 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 MNEs' corporate home but had little or no effect on the firm's operations. As the U.S. Treasury Department 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 businesses, corporate inversions created considerable controversy within the United States. U.S. legislators and tax officials were concerned about the forgone 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, 1). In response, in 2003 the U.S. Congress enacted IRC section 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. Further, the U.S. corporate income tax rates are the highest in the world. While many countries have lowered their income tax rates recently, the United States has maintained comparatively high income taxes. Also, U.S.-headquartered businesses are penalized by complex international rules that tax the firm's worldwide income and substantially

complicate the process of determining tax obligations. These tax policies increase a U.S.-based 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 must wonder whether there are significant offsetting benefits. So companies might ask: Is there a way to escape the burden of high U.S. income tax rates and complex tax rules?

In the late 1990s and early 2000s a number of U.S.-based MNEs accomplished this through corporate inversions. The 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 found but which 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 to the overseas headquarters or another overseas entity. The Office of Tax Policy stated:

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. They also simplified the process of calculating tax obligations by avoiding worldwide income taxation.

While corporate inversions generally reduced the firm's tax rate, 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, 1). In response, Congress passed IRC section 7874, which was designed to preserve U.S. tax revenue. Section 7874 did not prohibit corporate inversions, but said the U.S. would continue to tax inverted corporations as domestic entities, as long as 60 percent or more of the firm's stock was held by the same shareholders before and after the inversion. 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, 1-2; and Leitner and Glicklich 2009, 515).

Since section 7874 was enacted, corporate inversions have attracted less attention. But this might change in the near future. The U.S. corporate income tax rate is now one of the world's highest. Further, 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 section 7874 and supporting Treasury regulations.

Some tax professionals believe corporate inversions may become more frequent in the future. Leitner and Glicklich (2009) say privately held U.S. firms are continuing to invert. They stated, "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 section 7874 has been effective at limiting inversions of public companies, but this may change. He said:

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 [pp. 1-2].

As an example, a U.S.-based firm, Enesco, recently moved its headquarters to the United Kingdom. This, in addition to VanderWolk's comments, indicate that analyzing recent developments in corporate inversion activity is merited.

This article examines the most recent developments in corporate inversions. Current developments include comparatively high U.S. income tax rates, new Treasury regulations designed to limit tax-motivated corporate inversions, and the relocation of a publicly held firm, Enesco, from the United States to the United Kingdom. This article explains why and how U.S.-headquartered MNEs may re-domicile their headquarters abroad to escape U.S. tax laws. It also distinguishes between corporate inversions and corporate re-domiciling, in which firms not only reincorporate but also shift the management and control of an MNE from one country to another. This article suggests corporate re-domiciling may be one approach firms will use to escape U.S. taxation.

## Literature Review

Between 1999 and 2003, many U.S.-based multinationals moved their corporate headquarters abroad. The expatriating firms included six members of the S&P 500 index: Cooper Industries, Ingersoll Rand, Nabors Industries, Noble Drilling, Transocean, and Tyco (Desai and Hines 2002, 416). Stanley Works was also a member of the S&P 500 index and announced plans to invert. However, before the inversion was completed Stanley Works halted the transaction (Desai 2009, 1,285).<sup>1</sup> These corporate inversions attracted considerable attention in business and the media, and they generated concerns about the possible loss of government tax revenue. In response, the 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. The report identified the potential tax consequence of corporate inversions and also analyzed the nontax issues firms considered before making an inversion decision. The report identified the tax advantages firms realized through moving their headquarters abroad and offered several 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 article also explained both the process by which firms inverted and the advantages businesses realized as a result. They also 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

<sup>1</sup>In all cases I have used the name of the firm at the time of the proposed corporate inversion, as cited by Desai and Hines (2002, pp. 418-420). Several of the firms have changed their names since then.

tax obligations. They believed investors were also anticipating a reduction in taxes paid on U.S.-source income. Second, Desai and Hines concluded that inverting corporations were likely to have extensive international holdings. This suggested that avoiding U.S. taxes on foreign-source income was a key motivation 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 12 corporate inversions. They found the effective tax rate for inverted corporations decreased substantially after the inversion. While firms that did not invert also saw decreased rates, firms that did invert realized much steeper reductions in their worldwide tax rate than those that did not. Seida and Wempe also concluded that 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 with 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. Seida and Wempe concluded that laws meant to control the leverage of U.S.-based firms were sometimes ineffective at preventing earnings-stripping activities.

Kane and Rock (2007) looked at corporate inversions from a global perspective, evaluating international tax policies in numerous 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, known as the 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. This is the firm's "real seat." Kane and Rock argued that real seat rules should be used to determine a firm's tax home, because 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 section 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 section 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 U.S.-based MNE 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 an 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 despite the complexities of section 7874, there are still ways firms can escape U.S. tax rules.

VanderWolk (2010) reviewed the legislative history of section 7874 and new supporting Treasury regulations that were released in June 2009. VanderWolk analyzed both the new and prior temporary regulations. He showed that the prior Treasury regulations gave businesses better guidance than the new Treasury regulations. The earlier regulations provided taxpayers with detailed examples to demonstrate how the regulations should be interpreted and offered taxpayers a safe harbor to determine 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 section 7874 more difficult to enforce. VanderWolk argued that the new regulations provide taxpayers with too little clarity.

### Inversions and Section 7874

As noted, section 7874 appears to have significantly reduced corporate inversions. This is shown in the history of inversion activity of S&P 500 members before and after the passage of section 7874, which became effective on March 4, 2003. Desai and Hines (2002) identified six members of the S&P 500 index that inverted between 1997 and 2002. Those firms are shown in Table 1.

For this article, the author looked at firms that were in the S&P 500 index as of March 4, 2003, to determine how many moved their headquarters out of the United States between that date and December 27, 2010. Standard and Poor's provided a list of the 500 members of that index as of March 4, 2003. The current corporate home for each firm was researched by reviewing each firm's most recent SEC filings. Over

Table 1. Corporate Inversions

| Firm              | NYSE Ticker Symbol | Year of Inversion | Original Corporate Home | New Corporate Home |
|-------------------|--------------------|-------------------|-------------------------|--------------------|
| Tyco              | TYC                | 1997              | United States           | Bermuda            |
| Transocean        | RIG                | 1999              | United States           | Cayman Islands     |
| Cooper Industries | CBE                | 2001              | United States           | Bermuda            |
| Ingersoll Rand    | IR                 | 2001              | United States           | Bermuda            |
| Nabor Industries  | NBR                | 2002              | United States           | Bermuda            |
| Noble Drilling    | NE                 | 2002              | United States           | Cayman Islands     |

Table 2. HQ Relocations of Inverted Corporations

| Firm              | New Firm Name (if applicable) | Year of Relocation | NYSE Ticker Symbol | Prior Corporate Headquarters | New Corporate Headquarters |
|-------------------|-------------------------------|--------------------|--------------------|------------------------------|----------------------------|
| Transocean        | No change                     | 2008               | RIG                | Cayman Islands               | Ireland <sup>a</sup>       |
| Cooper Industries | No change                     | 2009               | CBE                | Bermuda                      | Ireland <sup>b</sup>       |
| Ingersoll Rand    | No change                     | 2009               | IR                 | Bermuda                      | Ireland <sup>c</sup>       |
| Noble Drilling    | Noble Corp. <sup>d</sup>      | 2009               | NE                 | Cayman Islands               | Switzerland <sup>e</sup>   |
| Tyco              | Tyco Electronics              | 2009               | TEL                | Bermuda                      | Switzerland <sup>f</sup>   |
| Tyco              | Tyco International            | 2008               | TYC                | Bermuda                      | Switzerland <sup>g</sup>   |
| Tyco              | Covidien                      | 2010               | COV                | Bermuda                      | Ireland <sup>h</sup>       |

<sup>a</sup>See Transocean 10-K, filed February 24, 2010, p. 5.

<sup>b</sup>See Cooper Industries 10-K, filed February 19, 2010, p. 2.

<sup>c</sup>See Ingersoll Rand 10-K, filed February 26, 2010, p. 5.

<sup>d</sup>Noble Corp. is the successor to Noble Drilling. See Noble Corp. 10-K, filed February 29, 2008, p. 1.

<sup>e</sup>See Noble Corp. 10-K, filed February 26, 2010, p. 2.

<sup>f</sup>See Tyco Electronics 10-K, filed November 10, 2010, p. 58.

<sup>g</sup>See Tyco International 10-K, filed November 12, 2010, p. 6.

<sup>h</sup>See Covidien 10-K, filed November 22, 2010, p. 1.

that time period, approximately 145 firms were removed from the index for various reasons, including acquisition, privatization, financial problems, or financial irregularities. Since March 4, 2003, no member of the S&P 500 index that was headquartered in the United States has moved its headquarters abroad. This information supports the comments of VanderWolk (2010, 1-2) and Leitner and Glicklich (2009, 515) that section 7874 has prevented new corporate inversions of U.S.-based firms, particularly publicly held enterprises.<sup>2</sup>

For this article, the author also looked at the current corporate home for the six S&P 500 members that inverted before March 4, 2003, when section 7874 took effect. Five moved their corporate headquarters again.

<sup>2</sup>In 2007 Halliburton, a member of the S&P 500, announced it was opening a headquarters location in Dubai. However, according to its most recent Form 10-K, filed February 17, 2010, its primary headquarters is still in Houston, and the Dubai site is identified as a second headquarters. According to the Form 10-K, it is still taxed as a U.S.-headquartered firm.

One of the six firms, Tyco, split into three firms in 2008, each of which has found a new headquarters location. Only one of the original six firms, Nabor Industries, has not relocated again. Table 2 shows the former and new headquarters of those businesses.

Thus, it appears Ireland and Switzerland are becoming favored sites for companies that inverted before the passage of section 7874. The motivations for these subsequent moves may merit further study. Nonetheless, it appears section 7874 was effective at preventing new U.S. corporate inversions, particularly for large, publicly held businesses. Six members of the S&P 500 index moved their headquarters out of the United States between 1997 and 2002. However, no members of the S&P 500 index moved their headquarters out of the United States after March 4, 2003, the date when section 7874 became effective.

### U.S. Income Tax Rates

Many factors contributed to the growth of U.S. corporate inversions during the late 1990s and early 2000s. Three primary causes were:

- high U.S. corporate income tax rates;
- the U.S. policy of taxing an MNE's worldwide income; and
- 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 a prior wave of corporate inversions (1997-2002), U.S.-headquartered firms found they could substantially reduce their income tax obligations by reincorporating abroad. Campbell (2004) reviewed published reports from several 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 [million] 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 U.S. multinational offshore, are unabashedly all about tax reduction [p. 1].

U.S.-based firms also argued that the country's high tax rates and policies put them at a competitive disadvantage compared with their 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].

Stanley Works argued this could make it difficult to price its products and services competitively and grow sales and market share. However, Stanley Works ultimately decided to halt its inversion after unfavorable publicity, a close shareholder vote, and a threatened investigation into possible irregularities in that vote (Desai 2009, 1285).

The corporate inversions prompted Congress and tax officials to examine this activity. The Office of Tax Policy (2002) studied corporate inversions and reported that "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 U.S. tax revenue. The report said: "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).

A 2005 Congressional Budget Office study analyzed U.S. corporate income tax rates through 2003, the year section 7874 was enacted. It showed that beginning in the early 1990s, 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 percent 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-1980s and 2003. It said:

After large reductions in statutory corporate tax rates by Ireland, the United Kingdom, and the United States in the mid-1980s, 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 that 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.

Further, worldwide corporate income tax rates have fallen since that report was prepared. In 2003 Germany's highest corporate income tax rate was 39.6 percent, Italy's was 38.3 percent, and Canada's was 35.6 percent (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. Table 3 shows income tax

Table 3. Corporate Income Tax Rates — 2010

| 1) Country      | 2) Central Government Corporate Income Tax Rate | 3) Adjusted Central Government Corporate Income Tax Rate | 4) Subcentral Government Corporate Income Tax Rate | 5) Combined Corporate Income Tax Rate — 2010 (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   |
| <b>Average</b>  |   |  |  | <b>25.84</b>  |

rates in effect for 2010.<sup>3</sup> U.S. tax rates in 2010 were the second highest in the world, exceeded only marginally by Japan's rate.

In Table 3 the second column identifies the highest marginal tax rate imposed by the national government. Countries with progressive or graduated tax systems frequently impose lower income taxes on firms or individuals with lower earnings; Table 3 identifies the maximum tax rate countries levy, which is generally

levied on firms with high earnings. Some countries also levy income taxes to support local governments, or what the OECD calls subcentral 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 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 was 39.21 percent and was exceeded only by Japan's combined

<sup>3</sup>The table was retrieved from the OECD's website on July 9, 2010. See <http://www.oecd.org/ctp/taxdatabase>. See Table II.1.

income tax rate of 39.54 percent. The U.S. rate was also 13.37 points above the OECD simple average of 25.84 percent. Also, while the U.S. corporate income tax rates will remain flat during 2011 and 2012, the U.S. federal income tax rate is scheduled to increase by another 4.6 points in 2013, the rate in effect during 2001.<sup>4</sup>

High U.S. corporate income tax rates may motivate future inversions. In the late 1990s and early 2000s, U.S. firms inverted to tax havens. If section 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. Also, the United States taxes worldwide income, while most countries in the world tax only the income earned within their borders.

### Worldwide vs. Territorial Tax Systems

As shown, U.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 U.S. 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 an MNE's earnings. Several countries tax all of an 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. uses worldwide taxation.

Campbell (2004) wrote, "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. In 2002 Desai and Hines pointed out that Greece, Italy, Japan, Norway, and the United Kingdom also taxed worldwide income (p. 412).

Taxing an 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 (2004) wrote, "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 U.S. Supreme Court in *Cook v. Tait*.<sup>5</sup> In that decision, Justice Joseph 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) described the Court's 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 2004, 7).

In the United States, the central taxing issue has shifted from U.S. citizenship to residency. Isenbergh (2005) wrote: "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, 2).

Determining an individual's tax residence can sometimes be complicated, as the IRC defines residency several ways, depending on the issue at stake. But for businesses it is clearer. Desai and Hines (2002) stated:

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.<sup>6</sup> 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 below.

An alternative to worldwide taxation is levying taxes based only on income earned within a nation's borders or within its territory. In a territorial system a country taxes only domestically earned income and exempts income earned in other jurisdictions. Doernberg (2004) wrote, "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

<sup>5</sup>*Cook v. Tait*, 265 U.S. 47 (1924).

<sup>6</sup>See section 7701(a)(4) for corporate place of incorporation rules.

<sup>4</sup>See P.L. 111-312, signed into law on Dec. 17, 2010.

investments, and its use through consumption” (pp. 7-8). In other words, when individuals or businesses earn 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 2004, 8). The income earned in other jurisdictions is generally exempt from domestic taxation. For this reason, some call territorial tax policies “exemption” tax systems (Campbell 2004, 98). Most of the world’s nations tax income earned within their territory and exempt the income earned in other locations, even if the parent firm is headquartered in that country (Desai and Hines 2002, 412).

Conflicting worldwide and territorial tax policies create the potential for double taxation. Suppose a business headquartered in the United States 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 difficult for firms to compete abroad, so most countries enact policies to avoid this. Most 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.

The U.S. and other countries typically defer taxation of overseas earnings until profits are repatriated to the home country. As an 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). Because of the time value of money, tax deferral can be an important benefit, particularly if the company defers domestic taxation for a sustained time period.

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 complex, they basically allow taxes paid to a foreign jurisdiction to 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].

Despite deferral and foreign tax credits, worldwide tax policies can still increase the tax burden on a U.S.-headquartered business if the company repatriates 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. Because U.S. income tax rates are 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 an FTC 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 to 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) acknowledged this complexity, commenting on some 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 FTC rules is challenging. Complying with the complex 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 because intercompany dividends can trigger additional tax liabilities, they may be reluctant to access those funds.

As described, deferral and FTC rules can narrow several of the differences between worldwide and territorial taxation policies. 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 that the U.S. gradually expanded the law’s scope and strength through 1993 (p. 2). He argues that 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 wrote, “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.

Because 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 2002, many countries have lowered their income tax rates, while the U.S. has kept its rates flat. Also, more countries are moving from worldwide to territorial tax systems. Thus, the U.S. may be less competitive today than it was when section 7874 was enacted.

As noted above, 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 toward territorial policies (VanderWolk, pp. 15-16). These actions can make their country's tax policies more competitive internationally. According to HM Revenue & Customs (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 an MNE is headquartered. Businesses frequently begin operations in one country and 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, often 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 Co. is a U.S. firm, Novo Nordisk is Danish, Toyota is Japanese, and Fiat is Italian, although they all have overseas subsidiaries. In each case, the parent company must comply with international tax laws applicable in its home country.

However, large corporations operate in many countries, and in some cases it may be more difficult to determine the MNE's home. Perhaps two similarly sized

companies from different countries may 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 finds the focus of its work shifting from one country to another, necessitating the transfer of senior executives from one country to another. 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 clear which international tax policies should govern the MNE. There must be some way to determine which country's international tax laws should apply.

Because of the tax implications, determining a parent company's tax home is critical. Desai and Hines (2002) state:

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 noted, Japan has made changes to its laws since 2002, but the general point is still valid. Moreover, because the United States 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.<sup>7</sup>

Countries generally use one of two methods 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.<sup>8</sup> In contrast, other countries seek to determine the location 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 second approach, for example, if the parent company's senior management works in a particular country, and most of its employees and assets are located there, that 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 methods is not always clear.

<sup>7</sup>Desai and Hines (2002) identified Greece, Italy, Japan, Norway, the United Kingdom, and the United States as countries that tax the worldwide income of residents, and noted that other countries generally exempt overseas income (p. 412).

<sup>8</sup>See section 7701(a)(4), which prescribes place of incorporation rules to define corporate residency in the United States.

Nonetheless, this is a useful distinction, as most countries use one of these two means to determine the MNE's corporate home.

Kane and Rock (2007) described the difference this way:

Basically, in locating a corporation, a legal system can adopt either the "place of incorporation" (POI) rules or 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 section 7874 was enacted, and in some circumstances the U.S. uses real seat rules to reach a conclusion. But Campbell's description accurately describes U.S. laws before section 7874 became effective, and is still generally true.

As noted, 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 on real seat rules, though some countries may consider other issues. Kane and Rock (2007) stated: "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 said, "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."<sup>9</sup> HMRC recently won an important case in which it argued that a Dutch-incorporated firm was actually managed in the U.K., so it should be taxed there.<sup>10</sup>

However, real seat rules are also imperfect, as creative firms may be able to work around them. 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 are working in separate locations and meet over the phone or through videoconferencing equipment. In practice, in many companies such decisions are sometimes made in various locations, so it may be difficult to identify one site where these actions take place. And the site may change from year to year. There may not always be a clear, unambiguous answer to where the real seat of company management is. Taxpayers may also disagree with regulators, resulting in costly litigation. In contrast, a place of incorporation rule generally provides a straightforward answer.

Determining a corporation's home for tax and other purposes is likely to become increasingly difficult. Desai (2009) said: "The archetypal multinational firm with a particular national identity is becoming obsolete as firms continue to maximize the opportunities created by global markets. National identities can mutate with remarkable ease and firms are unbundling critical headquarters functions and reallocating them worldwide" (pp. 1271-1272). In the future it may not be possible to ascertain where a corporation's home is.

### International Tax Policies and Jurisdictions

As noted, 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 rules or real seat rules to determine who it taxes? And does it tax a firm's worldwide income, or only the income earned within its territory?

Kane and Rock (2007) created a matrix to display the four tax alternatives. They wrote: "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 an MNE faces if it considers moving from one jurisdiction to another. We

<sup>9</sup>See INTM120150 — Company Residence, available at <http://www.hmrc.gov.uk>.

<sup>10</sup>See *Laerstate BV v. HMRC* (2009), UKFTT 209 (TC).

Table 4. Matrix of International Tax Policies

| Tax<br>Location<br>Rule |                              | Worldwide           | Territorial          |
|-------------------------|------------------------------|---------------------|----------------------|
|                         | Place of Incorporation (POI) | 1<br>Worldwide/POI  | 2<br>Territorial/POI |
| Real Seat (RS)          | 3<br>Worldwide/RS            | 4<br>Territorial/RS |                      |

Source: Kane and Rock (2007).

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

In general the United States uses place of incorporation rules to determine where an MNE is headquartered.<sup>11</sup> Thus, in Table 4, Kane and Rock (2007) placed the United States in Box 1 of the matrix (p. 18), as this reflects the general approach the U.S. uses to tax its MNEs. However, as we will see later, section 7874 has introduced real seat rules in the United States in some circumstances.

Kane and Rock argue that the U.S. worldwide/place of incorporation 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 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 believe the U.S. enforced unattractive policies that taxed worldwide income — policies made worse by high income tax rates. Also, the place of incorporation rules made it relatively easy to avoid the U.S. 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 did just that in the late 1990s and early 2000s.

For a company that wishes to escape worldwide/place of incorporation tax policies, what policies will attract it? All other factors being equal, Box 2 (territorial/place of incorporation) and Box 4 (territorial/real seat) 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 a country offers lower income tax rates, Box 3 (worldwide/real seat) is less attractive because of worldwide taxation policies.

How does a firm choose between Box 2 and Box 4 jurisdictions? It is easier, faster, and cheaper to move to another place of incorporation 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 place of incorporation 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 place of incorporation jurisdiction requires no such changes. So moving to a Box 2 jurisdiction has significant advantages over moving to a Box 4 country.

This is what U.S.-based MNEs did between 1997 and 2002. All the inverting firms identified by Desai and Hines (2002) 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).

Also, the Cayman Islands and Bermuda do not tax overseas income. The Office of Tax Policy (2002) describes those inversions:

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,

<sup>11</sup>See section 7701(a)(4).

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 2002 were the Cayman Islands and Bermuda, countries that offered both 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, inversions are often structured as stock sales, asset sales, or a mixture of the two. They are generally taxable events. Desai and Hines (2002) said: “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. Corporations considering an inversion should 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. Desai and Hines (2002) said that “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. According to Desai and Hines:

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, 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 “dropdown” 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].

Because 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, 9).

In addition to the transactions involving the former U.S. parent, foreign subsidiaries are usually transferred from the former U.S. parent to the new foreign parent, or to one of its overseas subsidiaries (Office of Tax Policy 2002, 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. The Office of Tax Policy also states that 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 that 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 should be evaluated against the benefits of a corporate inversion, which include territorial taxation, lower income tax rates, and the opportunity to shift earnings from the U.S. entity through intercompany loans.

## Nontax Considerations

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

As noted, most corporate inversions had very little impact on the daily 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 on business operations has not discouraged corporate inversions.

Corporate inversions appear to have had little effect on firms’ access to capital markets, as many MNEs are listed on several stock exchanges. If anything, they may improve in some circumstances. 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 that it may increase its access to international investors (Ensco proxy statement/prospectus 2009, 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 on their personal reputation, and businesses may fear a decrease in the value of the firm’s brand.

However, since section 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.<sup>12</sup> 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 conduct a significant portion of their business with the U.S. government should consider whether an inversion would reduce this revenue source.

<sup>12</sup>See Omnibus Appropriations Act of 2009 (P.L. 111-8), section 743 of Division D.

## Section 7874

Section 7874 was passed as part of the American Jobs Creation Act of 2004.<sup>13</sup> 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.”<sup>14</sup> It is generally believed the law has been successful at achieving its objective. Leitner and Glicklich (2009) said that since section 7874 was enacted, “the tide has slowed” (p. 515). VanderWolk (2010) took a stronger position, saying the law “is widely believed to have had a severe chilling effect on inversions of publicly held corporations” (p. 1). As shown, between 1997 and 2002 six members of the S&P 500 index moved their corporate home out of the United States, but since section 7874 was passed, no members of that index have done so.

Section 7874 does not prevent firms from inverting, and it may not be possible to enforce such a law. However, the law either:

- eliminates the tax benefits associated with inverting; or
- increases the tax cost of a corporate inversion.

In the first case, section 7874 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 some 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.”<sup>15</sup> This section was prepared to cover the various legal techniques used to complete a corporate inversion. As noted, in some cases inversions were structured as stock purchases, in other cases as asset purchases. Some were a combination of the two. Section 7874 covers all these events.

The second test compares the firm’s ownership before and after an inversion. If 80 percent or 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 that the

<sup>13</sup>P.L. 108-357 (Oct. 22, 2004).

<sup>14</sup>S. Rep. No. 108-192, 108th Cong., 1st Sess., at 142 (Nov. 7, 2003).

<sup>15</sup>Section 7874(a)(2)(B)(i).

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, section 7874 treats a firm as a “surrogate foreign entity” when 60 to 80 percent of its shares are owned by the same shareholders before and after the inversion.<sup>16</sup> Leitner and Glicklich (2009) explained this impact:

Under section 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 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 no 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. Thus, the exit tax for relocating abroad may increase, but the parent company will be taxed under the international tax laws applicable in its new corporate home.

Finally, if less than 60 percent of the shareholders are the same before and after the inversion, section 7874 does not apply. In those 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) said 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 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 U.S. tax purposes” (p. 4). Still, one wonders whether this was the most effective way to determine whether a transaction had nontax purposes. And it is not entirely clear why the lines were drawn at 60 percent and 80 percent continuity of ownership. If 50 to 60 percent of shares remain in the same hands, section 7874 does not apply, but more than half the shares are still owned by the same parties.

<sup>16</sup>Section 7874(a)(2)(B).

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, section 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 section 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.”<sup>17</sup> If the firm does have a substantial business presence there, the inversion is respected.

However, section 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 section 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 has 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 must demonstrate that it has a substantial business presence in another location. This appears inconsistent.

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 initial public offering (IPO), since substantial ownership changes would allow the firm to escape section 7874.

VanderWolk (2010) summarized section 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 U.S. tax

<sup>17</sup>Section 7874(a)(2)(B)(iii).

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].

VanderWolk also criticized the law, stating:

Section 7874 is the most extreme of the U.S. international tax rules aimed at preserving residence-based taxation of foreign-source earnings of U.S. 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 section 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. 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 2009 with new temporary regulations, which do not provide a safe harbor, nor do they provide examples to explain how the IRS interprets section 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:

- the historical conduct of continuous business activities in that country before the inversion;
- the presence of operational activities in that country, including property ownership, performance of services, and sales by EAG members;
- the presence of substantial managerial activities by EAG employees in that country;
- a substantial degree of ownership by investors residing in that country; and
- strategic factors, including “business activities in the foreign country that are material to the achievement of the EAG's overall business objectives.”<sup>18</sup>

<sup>18</sup>Reg. section 1.7874-2T(d)(1)(ii).

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.”<sup>19</sup> The facts and circumstances in each case need to be evaluated separately.

As noted, 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,”<sup>20</sup> 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,”<sup>21</sup> 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,”<sup>22</sup> the third measure is attained. If the firm met or exceeded all three measures, it had a substantial business presence in that location and section 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 know whether 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 section 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

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

<sup>20</sup>Prior temp. reg. section 1.7874-2T(d)(2)(ii).

<sup>21</sup>Prior temp. reg. section 1.7874-2T(d)(2)(iii).

<sup>22</sup>Prior temp. reg. section 1.7874-2T(d)(2)(iv).

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 an MNE had 89 percent of its employees, assets, and sales in the United States, and 11 percent 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:

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].

Further, the new regulations are 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 released soon. The new regulations were released last year, replacing more specific regulations that had been in effect from 2006 through 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) said this puts taxpayers in a difficult position, since they cannot be assured they comply with the substantial business presence test. He wrote, "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 in 2010 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 as they seek to escape high income tax rates and worldwide income tax policies, 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. During the fiscal year ending December 31, 2009, its revenue was approximately \$1.9 billion and its net income was \$779 million.<sup>23</sup> It employs about 3,700 people, and in December 2010, its market capitalization was \$6 billion to \$7 billion.

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. Ensco has been headquartered in London since March 2010.

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 on a firm's operating activities, a re-domiciliation includes moving corporate offices and personnel 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. Further, 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. Key differences between prior corporate inversions and a re-domiciliation are shown in Table 5.

As noted above, section 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

<sup>23</sup>See Form 10-K for Ensco, Feb. 25, 2010, available at <http://www.edgar.com>.

**Table 5. 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 or 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 |

country in which, or under the law of which, the entity is created or organized.”<sup>24</sup> Enesco argued that it has a substantial business presence in the U.K. and is therefore not subject to section 7874.

Enesco emphasized that it was moving management and control of the firm from the United States to the U.K. According to its proxy statement/prospectus:

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.<sup>25</sup>

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 noted above, 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.”<sup>26</sup> 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.”<sup>27</sup>

Because it intends to be taxed under U.K. international laws, Enesco believes its tax rate will decrease. Tax treaties are also an important consideration. The proxy statement/prospectus said that re-domiciling its headquarters to London would allow the company “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.”<sup>28</sup> While Enesco was not relocating exclusively for tax reasons, there were still tax advantages to moving to the U.K. Enesco 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.

Enesco was careful to distinguish its actions from prior corporate inversions, which generated adverse publicity. Referring to prior transactions, the company 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). Enesco was moving to a country in which it had a substantial, historical business presence, and where it could manage its operations more effectively. Also, while the U.K.’s 28 percent tax rate is substantially lower than the U.S. rate, it is not considered a tax haven.

Enesco’s prospectus/proxy statement explained the tax advantages of re-domiciling to England:

We believe that the merger should improve our ability to maintain a competitive worldwide effective tax rate because the U.K. corporate tax rate

<sup>24</sup>Section 7874(a)(2)(B)(iii).

<sup>25</sup>See Enesco’s letter to its stockholders, written by Chairman of the Board Daniel W. Rabun, dated Nov. 20, 2009, which included its merger prospectus, available at [http://www.enscos.com/Theme/Enesco/files/docs\\_financial/Enesco%20Special\\_Proxy\\_Statement.pdf](http://www.enscos.com/Theme/Enesco/files/docs_financial/Enesco%20Special_Proxy_Statement.pdf).

<sup>26</sup>See INTM120150 — Company Residence.

<sup>27</sup>Section 7874(a)(2)(C).

<sup>28</sup>*Id.*

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].

Enesco is attracted to the U.K.'s lower tax rate and the steps the U.K. has taken toward a territorial tax system. In Table 4, the United Kingdom moves from Box 3 to Box 4. And Enesco moves from being taxed under Box 1 policies to under Box 4, using the substantial business presence test in section 7874 to achieve that objective.

To escape section 7874, Enesco's proxy statement/prospectus specifically evaluated each of the five factors identified in the Treasury regulations' substantial business presence test, and explained how the regs support Enesco's contention that it has a substantial business presence in the U.K. One factor concerns the firm's historical presence in that country:

However, Enesco UK is a company formed under English law, and Enesco 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 Enesco UK should not be treated as a U.S. corporation for U.S. federal income tax purposes under section 7874 [p. 23].

The statement also notes that the company began drilling activities in the U.K.'s North Sea in 1993, and had a local headquarters in Aberdeen, Scotland, since 1994.

The firm maintained that it had substantial managerial activities in the United Kingdom, another factor identified in U.S. Treasury regulations. Its proxy statement/prospectus said: "After relocating to Aberdeen, Scotland in 1994, the U.K. headquarters have served an increasingly important managerial role within the Enesco 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 managers all live and work in Scotland. Enesco added that it expects further growth in the U.K.: "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). Enesco also said the firm's senior managers will move to the U.K., effectively shift-

ing 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 an 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."<sup>29</sup> The firm acknowledged that few of its current investors are U.K. residents, but said it hopes to change this. The proxy statement/prospectus stated:

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 Enesco'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."<sup>30</sup> Enesco said it is re-domiciling for strategic reasons. While the company began in the United States, it is growing more rapidly in international markets and wants to be perceived as a global provider of deep-water drilling services. To substantiate this, Enesco explained 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: "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, the Mediterranean, Africa, and other sites. It added, "Consistent with these global trends, we expect that we will derive approximately 86 percent of our 2009 gross revenues from our operations in the Foreign Drilling Markets" (p. 42). Enesco said its goal is to expand internationally, and the U.K. location is a better site to achieve that objective (p. 43). In short, it believed the U.K. was 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

<sup>29</sup>Reg. section 1.7874-2T(d)(ii)(D).

<sup>30</sup>Reg. section 1.7874-2T(d)(ii)(E).

in that country, the “performance of services by individuals in the foreign country which is owned by members of the EAG,”<sup>31</sup> and sales made in that country by members of the EAG. As discussed, under the safe harbor, if 10 percent of the worldwide enterprise’s assets, employees, and sales are located in the new corporate home, the “EAG will be considered to have substantial business activities”<sup>32</sup> in that location.

EnSCO said that under the former Treasury regulations, it met each of the safe harbor elements. EnSCO’s proxy statement/prospectus stated:

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 argued it would have had a safe harbor under the prior regulations. EnSCO believed it had a solid case. The firm’s management determined that case was strong enough and proposed the re-domiciliation to EnSCO’s shareholders, even though the regulations removed the safe harbor. The shareholders supported the move, and the firm is now headquartered in London.

However, EnSCO cannot be entirely sure its move will not be challenged by the IRS. Thus, it acknowledged 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). Should that happen, it said, “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 before 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 U.S. tax laws. While other countries seek to attract MNEs through tax-friendly policies, the U.S. tries to keep them from fleeing, at least for tax purposes. What alternatives might U.S. businesses con-

sider? Following are options firms and investors might evaluate, depending on 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 1: 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 on 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 depicted in Table 4, the firm could start operation in the second box. 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 would still be subject to high taxes on U.S.-source earnings, but it could avoid the cost and complexity of worldwide taxation. As noted, 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 that 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 place of incorporation rules make it easy to incorporate abroad.

Testifying before Congress in 1999, Intel’s vice president of tax, Robert Perlman, advised:

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.<sup>33</sup>

Since that time, the disparity between U.S. tax policies and those in other countries has grown. Today, the U.S. tax rate is one of the world’s highest, and fewer countries are enforcing policies that tax worldwide income.

Well-funded, high-tech 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:

<sup>31</sup>Reg. section 1.7874-2T(d)(ii)(B)(2).

<sup>32</sup>Prior reg. section 1.7874-2T(d)(iii)(2).

<sup>33</sup>R. Perlman, International Tax Issues Relating to Globalization: Hearing before the S. Comm. on Finance, 106th Congress 1 (2009).

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 [pp. 18-19].

When this statement was written, inversions were easier to accomplish, so the motivation to incorporate overseas from the start is even stronger today. At some point it is 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 on the success of new business ventures.

### Option 2: International Merger

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 on U.S.-headquartered firms, 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). The report said this could negatively affect the U.S. economy in the long-run: “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 is not 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 U.S. 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, Avi-Yonah questioned this and said he 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. 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 U.S. by the trend in inversion transactions, in which U.S. MNEs reincorporated

in Bermuda in part to avoid Subpart F. The trend was stopped by legislation in 2004, but the competitiveness issue continues [p. 6].

But the EnSCO re-domiciliation indicates there are ways for some firms to work around section 7874.

Depending on the location of the acquiring firm, the merged company could be in any of the four boxes in Table 4. However, since most countries apply territorial tax policies, the new firm is likely to be in Box 2 or Box 4. 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. Also, even if the acquiring firm is in either Box 1 or Box 3, it may make sense to designate that firm as the parent, due to the high U.S. income tax rate.

### Option 3: Attract New Investors

As noted above, 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 percent 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 to 40 percent of the shares change hands, the cost of expatriation can increase, as the firm cannot use net operating losses and tax credits to reduce the exit tax. And if more than 40 percent of the shares change hands, section 7874 does not apply. But in any case, if more than 20 percent 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 an opportune time to invert. Both new and existing shareholders benefit from a lower tax rate, as long as the firm is profitable. As VanderWolk (2010) wrote:

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 [Foreign Corporation] stock, and the U.S. 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 U.S. international tax rules [p. 17].

And if more than 40 percent of shares change hands, the firm can use NOLs and tax credits to reduce the exit tax.

But in either case, the firm is escaping section 7874 under its second test, and it is not concerned with the substantial business presence test. That issue is irrelevant. Thus, the firm can invert as opposed to re-domicile. It can select a tax haven to be its new corporate home. It can move from Box 1 to Box 2. It does not have to move its corporate headquarters or senior executives to the new site. Its daily operations can remain untouched. Of course, if it wanted to move its headquarters to a jurisdiction in Box 4, it could. 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 4: Re-Domicile Abroad

Re-domiciliation may be attractive for firms that have a substantial business presence in another country, particularly if that country has low income tax rates and enforces 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 be preferable locations.

Many MNEs might evaluate whether they have a substantial business presence in another G-7 country if they have extensive operations and a long history of conducting business there. 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 Enesco did.

In the Kane and Rock model depicted in Table 4, Enesco moved from Box 1 to Box 4, with the caveat that the U.K. is transitioning toward territorial taxation. To escape section 7874, Enesco claimed it had a substantial business presence in the United Kingdom. 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. continues 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 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 [p. 522].

While Canada is not considered a tax haven, its 29.5 percent corporate income tax rate for 2010<sup>34</sup> is

still far below the United States' 39.2 percent rate. Rates in Germany, the U.K., and Italy are scheduled to be approximately 10 percentage points below the U.S. rate next year.

#### Option 5: Invert and Re-Domicile

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

Rubinger proposed that a firm could escape U.S. taxation under section 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, because they have low tax rates, territorial tax policies, and favorable tax treaties with the U.K.

Rubinger (2007) stated:

Section 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 section 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 section 7874 in certain circumstances [p. 45, emphasis in original].

Since Rubinger wrote his article, the U.K. has taken steps toward territorial taxation, but its income tax rates are still higher than, for example, Hungary's.

Rubinger (2007) wrote: "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

<sup>34</sup>According to the Canada Revenue Agency, the Canadian corporate income tax rate decreased by 1.5 percentage points in

(Footnote continued in next column.)

2011 and will decrease by another 1.5 percentage points in 2012. Available at <http://www.cra-arc.gc.ca/tx/bsnss/tcps/crptns/rts-eng.html>.

and royalties, and low taxes on dividends. “In this scenario, section 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, an 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 that 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. These are important considerations. Also, Rubinger’s example relies partly on favorable tax treaties. But tax treaties are not permanent; they can be renegotiated. It would be 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 section 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).

Section 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.

Section 7874 also includes several escape clauses U.S. firms might be wise to consider. If a firm is attracting new investors, it might use that opportunity to invert to a tax haven. If it believes it has a substantial business presence in another country, it 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 maintaining high corporate tax rates and 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, it should offer incentives to make it their corporate home. It is understandable that Congress has directed government agencies not to do business with inverted businesses. However, this doesn’t address the real problem, and it only provides financial incentives to firms with substantial government contracts. 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 have 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 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). Because of 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 section 7874. Determining a firm's tax status based on how many shares change hands does not seem like the most logical 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 argued. Taxpayers, investors, and even regulators deserve more certainty than the current rules provide.

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