Beyond Territoriality and Deferral: The Promise of "Managed and Controlled"

Reuven S. Avi-Yonah
University of Michigan Law School, aviyonah@umich.edu

Available at: https://repository.law.umich.edu/articles/815

Follow this and additional works at: https://repository.law.umich.edu/articles

Part of the Taxation-Federal Commons, Taxation-Transnational Commons, and the Tax Law Commons

Recommended Citation
Beyond Territoriality and Deferral: The Promise of ‘Managed and Controlled’

by Reuven S. Avi-Yonah

Reuven S. Avi-Yonah is the Irwin I. Cohn Professor of Law and director of the International Tax LLM program at the University of Michigan. The author would like to thank Mike Durst and Jeff Kadet for their helpful comments.

In the new version of his Stop Tax Haven Abuse Act, Sen. Carl Levin, D-Mich., once again proposed to modify the definition of residence for domestic corporations (IRC section 7701). Section 103 of the act seeks to:

stop companies run from the United States claiming foreign status by treating foreign corporations that are publicly traded or have gross assets of $50 million or more and whose management and control occur primarily in the United States as U.S. domestic corporations for income tax purposes.1 [Emphasis in original.]

This is not a new suggestion. In response to the inversions of the early 2000s, the Joint Committee on Taxation made a similar proposal.2 Moreover, the “managed and controlled” test is well established in the jurisprudence of our trading partners (for example, the U.K.) and is similar to determining the “place of effective management,” which is included in all tax treaties based on the OECD model (for example, in article 8).

The original point of the managed and controlled proposal was to combat inversions, that is, artificial migrations of U.S. companies to offshore locations such as Bermuda. In a classic inversion, the shareholders of a publicly traded U.S. company would exchange their shares for shares in a new Bermudan company, which would then become the parent of the group. The advantage of this maneuver was:

• to enable the group to add new subsidiaries that would not be controlled foreign corporations and whose income is therefore outside the scope of subpart F; and
• to enable the U.S. parent to borrow from its Bermudan parent and deduct the interest up to the IRC section 163(j) limit without triggering subpart F (since the Bermudan company is not a CFC).

It is not clear that the managed and controlled test is necessary to combat inversions, for two reasons. First, IRC section 7874 was enacted in 2004 and puts significant roadblocks in front of inversions, although it has loopholes that can be exploited. Second, and more importantly, recent empirical research suggests that inversions are difficult for most U.S. companies for both tax and nontax reasons (for example, shareholder reluctance to switch Bermuda for Delaware law for corporate governance purposes).3


3 Eric Allen and Susan Morse, “Firm Incorporation Outside the U.S.: No Exodus Yet” (2011). This paper was presented at the 2011 National Tax Association Meeting in Washington and will be presented at the American Tax Policy Conference on International Taxation and Competitiveness in Washington on October 17, 2011.
Does “managed and controlled” still have a role to play in U.S. tax policy if it is not needed to stop inversions? In my opinion the answer is a resounding yes. As Willard Taylor has shown, shell corporations are ubiquitous in U.S. outbound international tax planning. 4 Adopting “managed and controlled” would be a significant deterrent to this type of planning, because it would require all foreign corporations to actually be run from abroad to avoid being redefined as U.S. corporations.

A recent U.K. case illustrates some of the antiabuse potential of “managed and controlled.” 5 In that case, a Dutch company was owned by a U.K. non-domiciled individual, who also served some time as director (but not at the time of the relevant transaction). The U.K. CFC rules were inapplicable because the individual was not a U.K. resident for tax purposes. The board met overseas and had full legal control of the company. Nevertheless, the U.K. court (including Commissioner John Avery Jones, a very tax-sophisticated judge) found that because the U.K. shareholder exercised de facto control of the company, it was managed and controlled from the U.K. and therefore was resident in the U.K. for tax purposes.

Imagine the consequences of adopting such a de facto control test in the U.S. It would further deter inversions and would make it difficult for U.S.-based hedge funds and nonprofits to use blockers to avoid effectively connected income and unrelated business taxable income without actually operating the blockers offshore. 6 These are significant improvements over the current system.

But the biggest impact will be on subpart F. The debate between opponents and proponents of deferral and territoriality seems unlikely to produce real reform any time soon. But if we adopted the managed and controlled test, it would become much more difficult for U.S. multinationals to avoid subpart F merely by creating shell companies overseas and using one of the myriad loopholes in the existing rules.

To name some recent examples, Microsoft and Google would have to really run their Irish, Dutch, and Bermudan CFCs from those countries to avoid having them re-characterized as U.S. corporations. Caterpillar would not be able to avoid the base company rule by putting a shell operation in Switzerland while running the actual buying and selling of spare parts from Peoria, Illinois. Using IRC section 954(c)(6) to shift profits from high-to low-tax countries overseas (which in turn encourages shifting from the U.S. to high-tax countries) would become much more difficult because the tax haven subsidiaries would really have to be run from the tax havens.

No loophole closer is ever perfect. 7 There will, of course, be situations in which the tax benefit is so great that companies will pay executives the extra compensation needed to persuade them to live in Bermuda. But in many other cases the hassle will be too much. I worked on a transaction once in which the entire carefully planned tax structure was jeopardized by the unwillingness of the designated CEO of an offshore joint venture to live outside the United States. Moving people is harder than creating corporate shells.

Recent news reports as well as the careful JCT study of transfer pricing from last summer have shown the extent of tax avoidance by U.S. multinationals. 8 The best solution would be to abolish deferral in conjunction with lowering the corporate tax rate. A second-best solution would be to condition deferral on the foreign tax rate being about as high as the U.S. rate. 9 But in the absence of such significant reform, Congress would be well advised to at least adopt the managed and controlled test for U.S. corporate residency. Such a test would make corporate tax avoidance by U.S. multinationals significantly more expensive for the actual individuals who make the decisions to engage in such behavior. As indicated by the outcry against the personal responsibility provisions of the Sarbanes-Oxley Act of 2002, putting the onus personally on the decision-makers is the best deterrent.

---
6See Taylor, supra note 4.