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For Haven's Sake: Reflections on Inversion Transactions

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FOR HAVEN’S SAKE:
REFLECTIONS ON INVERSION TRANSACTIONS

By Reuven S. Avi-Yonah

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Introduction: A Brief History of Inversions

“Inversion” transactions are defined in the recent Treasury Report 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.”1

The first well-known inversion from the U.S. was McDermott International’s relocation to Panama in 1983, which prompted the enactment of section 1248(i).2 The next inversion, more than 10 years later, was Helen of Troy (1994), which prompted the IRS to issue Notice 94-46, making inversions taxable to public shareholders.3 Nevertheless, inversions continued, with one transaction in each of 1996, 1997, and 1998.4 But as the Treasury Report notes, “there has been a marked increase recently in the frequency, size, and profile of the transactions.”5 There were no less than six inversions in 1999,6 followed by at least two more

2All section references are to the Internal Revenue Code of 1986, as amended.
31994-1 C.B. 356 now reflected in the regulations under section 367.
4Triton Energy, Tyco, Playstar. For a description of all these transactions, see the NYSBA Report.
5Treasury Report, at 2.
6Fruit of the Loom, Gold Reserve, White Mountains Insurance, PXRE, Amerist Insurance, Xoma.
Why Inversions Now?

The significant increase in the frequency of inversion transactions in the last three years raises the question of what accounts for this trend. As the Treasury Report notes, inversion transactions are primarily tax driven: “U.S.-based companies and their shareholders are making the decision to reincorporate outside the U.S. largely because of the tax savings available.” Moreover, these transactions involve little or no operational change in the company’s business.

The tax advantages from inversion transactions are twofold. First, since the new parent of the group is not a “U.S. shareholder,” the group can establish new foreign operations without being subject to subpart F. In some cases, the potential tax saving is significant enough so that even foreign operations currently held by the U.S. parent are transferred to the new foreign parent, even though these transfers are generally taxable at the corporate level.

Second, and no less significantly, the existence of a new foreign parent may enable the U.S. group to reduce taxes on U.S.-source income by paying the parent deductible interest and/or royalties through a treaty jurisdiction such as Barbados or Luxembourg, and by manipulating transfer pricing. In addition, U.S. risks formerly insured in the U.S. may be reinsured overseas, with deductible premiums and no U.S.-source income to the reinsurer. Existing provisions such as sections 163(j) (the earnings stripping rule) and 482 appear to be inadequate to prevent this erosion of U.S. corporate tax on U.S.-source income.

The combination of these postinversion tax advantages can lead to significant reductions in effective overall tax rates for the group. For example, Coopers Industries and Stanley Works have stated that they expect their inversions to reduce their annual effective tax rate by 12-17 percent (Coopers) and 7-9 percent (Stanley). These reductions can translate into significant dollar amounts — Tyco International, for example, has been reported to save $400 million in 2001 by reason of its inversion, and Ingersoll Rand has stated that it expects to increase net earnings after its inversion by $40 million per year. Thus, the U.S. fisc’s loss of revenues from inversions is likely to be significant, which explains why even the current Treasury is concerned.

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If inversions are so tax effective, why did they not take off before 1999? The principal reason appears to be not tax-related, but rather involves the increased market acceptance of the transaction. Until Tyco inverted successfully in 1997, investment bankers generally assumed that a U.S. company would pay an unacceptable price in its share value if it reincorporated in Bermuda. This was the case even though U.S. securities law protections continue to apply to any stock traded on a U.S. exchange, and the companies are not delisted from, for example, the S&P 500. The presumed drop in share value related to corporate governance concerns and to reputational issues. But after Tyco, it became clear that share prices do not drop as a result of reincorporation — on the contrary, recently inverting companies have seen their share prices rise in reaction to the expected tax savings. Thus, despite the recent troubles of Tyco and Global Crossing, there seems to be no market downside to inversions.

In addition, as the Treasury Report notes, after the market declines in 2000-2001, when most taxable shareholders do not have big unrealized gains in their shares and many corporations have net operating losses,
neither a shareholder-level tax nor even a corporate-level tax is likely to deter inversion transactions. The present value of the expected recurrent tax savings overwhelms a one-time toll charge.

The Competitiveness Excuse

The Treasury Report highlights another purported reason for inversions — the supposed competitiveness concerns of U.S. multinationals. According to the Treasury, “[t]he U.S. international tax rules can operate to impose a burden on U.S. based companies with foreign operations that is disproportionate to the tax burden imposed by our trading partners on the foreign operations of their companies. . . . Both the recent inversion activity and the increase in foreign acquisitions of U.S. multinationals are evidence that the competitive disadvantage caused by our international tax rules is a serious issue with significant consequences for U.S. businesses and the U.S. economy.”

Thus, the Treasury recruits inversions as an argument in its quest for a territorial tax regime for the U.S., labeling them “self help territoriality,” and calling for a consideration of “fundamental reform of the U.S. international tax rules, including the merits of the exemption-based tax systems of some of our major trading partners.”

There are well-known counterarguments to this line of thinking, including: Is there a direct relationship between the competitiveness of U.S. multinationals and the competitiveness of the U.S. economy? What is a “U.S. multinational,” anyway (inversions seem to raise some questions on this point)? Is there any evidence for the supposed competitive disadvantage, or for the alleged harshness of our rules compared to those of our trading partners? If a subsidy to U.S. multinationals is needed, why limit it to foreign-source income, since a subsidy directed at their domestic operations would be just as effective? And finally, what about the competitive disadvantage to U.S. companies with purely U.S. operations, if a subsidy is given only to U.S. multinationals by exempting their foreign-source income?

But it is not my intention here to rehash these old arguments. Instead, I would like to emphasize that in the inversion context the competitiveness issue is the reddest of red herrings — a completely irrelevant line of argument. To demonstrate this, try the following thought experiment: Suppose nothing was done to deter inversions, but the U.S. adopted an exemption for foreign-source active income (for example, by exempting dividends from this income from U.S. tax, as some have suggested). Would inversions stop?

The answer is no, for three reasons. First, as the Treasury Report notes, a major reason for inversions is to reduce U.S. tax on U.S.-source income, which would not be affected by the adoption of territoriality. Second, inversions enable U.S. multinationals to avoid all of subpart F, including the taxation of passive income. None of the current proposals for territoriality go that far, since this would be an open invitation to U.S. multinationals to move their investment earnings overseas.

In the inversion context the competitiveness issue is the reddest of red herrings — a completely irrelevant line of argument.

But the major reason why inversions are unrelated to competitiveness is the following: As even the Treasury Report acknowledges in a footnote, all of our major trading partners have regimes in place that tax passive income of their multinationals. Some of these regimes, in fact, are tougher than subpart F — the French, for example, require only 10 percent ownership of a foreign corporation to apply CFC rules to it, and many countries include some low-tax active foreign income in their regime. Permitting inversions gives investing U.S. multinationals a significant competitive advantage over foreign multinationals and noninvesting U.S. multinationals that have to pay tax currently on their foreign-source passive income, at the expense of the U.S. fisc.

Thus, the whole competitiveness issue is misleading. It is not the reason for inversions, and inversions would continue even if the U.S. adopted territoriality. The competitiveness debate will doubtless go on (as it has for the last 40 years), but it should not affect what we do about inversions.


23Treasury Report, at fn. 50.

Currently Proposed Responses to Inversions

There are currently six bills pending in Congress to deter inversions — four in the House and two in the Senate.29

All of these bills share two common features. They define an inversion as a transaction in which (a) a foreign corporation acquires the stock or substantially all the assets of a domestic corporation or partnership and (b) more than 50 percent (or 80 percent) of the foreign corporation’s stock (by vote or value) is held by former shareholders of the domestic corporation (or partners in a domestic partnership). In addition, some of the bills add a requirement that the foreign corporation (and its group) not have “substantial business activities” in its country of incorporation. If these definitional prongs are met, the inverted corporation is treated as a domestic corporation. (Some of the bills also have lesser penalties if some but not all of the prongs are met.)

The most problematic feature of the proposed bills is their focus on the composition of share ownership in the new foreign parent.

All of these definitional prongs raise troubling issues. First, the focus on the transfer of stock or substantially all the assets misses the point, which is that a new parent corporation has taken over the group. Thus, you could have an inversion even if significant assets remain in the U.S. and are not transferred to the new foreign parent (for example, by a split-off in which they end up in a separate U.S. group owned by the same shareholders). It would be better to define an inversion directly as any transaction in which a foreign corporation becomes the parent of an affiliated group formerly headed by a U.S. corporation.30

Second, the focus on “substantial business activities” in the foreign jurisdiction is likely to lead to endless arguments about what is substantial enough (a captive insurance company?). It would be better to omit this prong altogether, or at least define it much more explicitly.

But the most problematic feature of the proposed bills is their focus on the composition of share ownership in the new foreign parent. First, this is likely to be difficult for the IRS to administer. Publicly traded shares change hands all the time, so it would be impossible for the IRS to track ownership continually. But even if the test is restricted to ownership “immediately after” the transfer, it would still be difficult to establish beneficial ownership of shares held through nominees. Second, the test is manipulable. Presumably, the IRS could litigate transactions in which stock is temporarily parked in the hands of new shareholders. But it may not be a huge price to pay to avoid the threshold by persuading a sufficient number of old shareholders to permanently sell their shares to new shareholders as part of the inversion. The IRS would find it hard to litigate this scenario.31

The last point raises the fundamental problem with a share ownership test: It is not related to what makes a multinational U.S.-based, and management does not care very much about the composition of public shareholders. Large U.S. multinationals and large foreign multinationals currently trade on 20 or more exchanges all over the world. Their share ownership is widely dispersed and it is doubtful whether some “U.S.” multinationals have many more U.S. shareholders than some “foreign” multinationals. In short, the share ownership test is manipulable at little business cost precisely because it has little to do with what makes a publicly traded multinational U.S.-based.32

Redefining Corporate Residence

If share ownership does not define a U.S. multinational, what does? This question is at the heart of the inversion issue. It stems from a long-lasting debate about whether multinationals have a national identity. In the 1950s the distinction between a U.S. and a foreign multinational was clear. A U.S. multinational raised most of its capital (both debt and equity) in the U.S., was managed from the U.S., and had most of its operations and biggest market in the U.S. Although there were some operations and sales overseas, the bulk of the income came from the U.S. — and vice versa for a foreign multinational. In that context it was indeed plausible to state that “what is good for GM is good for America.”

Today, the distinction is far more cloudy. As Robert Reich has pointed out, no distinction can be made between U.S. and foreign multinationals on the basis of where their capital is raised (both trade shares and borrow at home and overseas), where their operations are (all over the world), and where their customers are


30This definition would include takeovers by existing foreign multinationals, but they could be excluded by the other prongs.

31In the PwCC transaction, for example, this prong is not met because U.S. persons own less than 50 percent of the stock of the new Bermuda parent before the transaction, and considerably less after the stock offering that is part of the transaction. PwCC prospectus (May 2, 2002).

32For securities law purposes, a foreign private issuer is defined to exclude issuers more than 50 percent of whose stock is held by U.S. residents and the majority of their executive officers or assets are in the U.S. or their business is administered principally in the U.S. See Securities Act of 1933. Rule 405. Thus, mere U.S. shareholdership is not enough.
(the most profitable markets for U.S. multinationals are frequently overseas). \(^{33}\)

Reich would thus argue that there is no meaningful distinction any more between U.S. and foreign multinationals. In the tax area, this would suggest abandoning residence-based taxation in favor of a purely source-based (that is, territorial) regime. \(^{34}\)

If properly defined and interpreted, the managed and controlled test offers the most promising current definition of corporate residency — the one most congruent with business realities and therefore least open to abuse.

However, most Americans still believe that there is a meaningful distinction between, say, GM and Toyota, even though there is little significant difference in their capital structure, operations, or markets. The difference, as Laura d’Andrea Tyson pointed out in response to Reich, is that GM is run from Detroit, Toyota from Tokyo. \(^{35}\) There even is a difference between GM and DaimlerChrysler, because the latter (as Chrysler management belatedly found out) is run from Stuttgart.

This would suggest that the immediate answer to inversions is to change the way corporate residence is defined for tax purposes. Instead of defining a U.S. corporation as one incorporated in the U.S. and a foreign corporation as one incorporated overseas, we should adopt the definition used by many of our trading partners — from where the corporation is “managed and controlled.” \(^{36}\)

The “managed and controlled” test has a long history, some of which is not very distinguished. In particular, many former U.K. colonies have interpreted it in a mechanical way to focus on where the Board of Directors meets, which makes the test not less manipulable than the U.S. test. Boards do not mind meeting twice a year in Bermuda. Even the U.K., from which “managed and controlled” originated, has recently supplemented it with a place of incorporation test.

And yet, if properly defined and interpreted, the managed and controlled test offers the most promising current definition of corporate residency — the one most congruent with business realities and therefore least open to abuse. \(^{37}\) That is because even in this age of teleconferencing, there is a distinct business advantage in locating the principal officers of a corporation in one location where they can meet and run the corporation on a daily basis. Thus, if one defines “managed and controlled” as the place where the principal officers of a corporation (the CEO and those reporting to her) manage the corporation’s business on a daily basis, one gets close to what actually distinguishes GM from Toyota.

The major advantage of this test is that it is difficult to avoid without significant business cost. The principal officers will not relocate to Bermuda for tax reasons, because the personal and business costs of actually living in a tax haven are too high. And it is still very hard to run a corporation at long distance. \(^{38}\)

Several objections can be raised against this proposal. \(^{39}\) First, the test represents a significant departure from a long-held U.S. tradition. \(^{40}\) But it is congruent with the test used by many of our trading partners and in tax treaties, and therefore will readily win international acceptance — an important consideration when changing international tax rules unilaterally. Second, the proposed change will affect more than inversion transactions. For example, it would catch corporations newly incorporated overseas, such as Accenture, PwCC, and Seagate. But that is actually an advantage, since it is hard to distinguish as a policy matter between these transactions and “pure” inversions. Accenture, PwCC, and Seagate, like Tyco and Stanley Works, continue to be managed from the U.S. Third, the test will not catch foreign takeovers of U.S. multinationals (like Daimler/Chrysler or BP/Amoco). But these transactions are motivated by business reasons and should not be deterred. \(^{41}\)

Finally, the proposed test does not draw a bright line like the current, more formal one, and therefore involves some added measure of uncertainty. But it is clear enough, and far more congruent with business realities (and thus less manipulable) than place of incorporation. U.S. taxpayers have been living with less well-defined terms, such as “effectively connected” and


\(^{35}\) Laura d’Andrea Tyson, “They Are Not Us,” The American Prospect (Winter 1991).

\(^{36}\) A corporation incorporated in the U.S. should be presumed to be managed and controlled from the United States.

\(^{37}\) Note that there have been few inversions from Europe, not because of territoriality (Europe has a tax passive income too), but because the managed and controlled test makes it harder to invert.

\(^{38}\) In addition, changes in the location of management and control should be a taxable event at the corporate level. That would deter tax-motivated expatriations under the new test.

\(^{39}\) See NYSBA Report, which considers these issues but concludes that “this alternative merits serious consideration and study” (at 27).

\(^{40}\) For example, it may make many CFCs incorporated in tax havens into domestic corporations. That is an advantage, since it indicates they do not have a real business presence overseas and thus should not enjoy deferment.

\(^{41}\) It was not primarily tax considerations that led to Daimler/Chrysler being a German corporation, it was the German government’s determination to protect Daimler and co-determination.
"U.S. trade or business." They can learn to live with "managed and controlled" as well.

A Modified Source-Based Regime

In the longer term, however, Reich may be right and residence-based corporate taxation may be doomed. With advances in technology, it may one day be possible to efficiently run a multinational enterprise from multiple locations via an intranet, without the need to meet face to face. In that case, the headquarters-based definition of corporate residency offered above would become obsolete. This is not likely to happen, however, in the next couple of decades, even if a "managed and controlled" test is adopted (and there is therefore a tax incentive to disperse top management).

If residence-based corporate taxation becomes impossible, the only way to continue to tax multinationals is on the basis of source. In principle, this would not be a terrible outcome.

If residence-based corporate taxation becomes impossible (much to the chagrin of economists, who tend to prefer it), the only way to continue to tax multinationals is on the basis of source. In principle, this would not be a terrible outcome, because the current international tax regime assigns the primary right to tax active business income to the source jurisdiction, for good reasons.

However, a pure source-based regime is problematic, for two reasons. First, it fosters tax competition among source jurisdictions, not just for passive but also for active income, leading to erosion of the corporate tax base. Second, the current source rules (and their cousin transfer pricing) are notoriously manipulable and if left unchanged in a purely source-based world, would lead to massive shifting of income to low-tax jurisdictions.

The first problem can be addressed by limiting tax competition, as the OECD is currently trying to do. However, the ability to do this would itself be compromised by a demise of residence-based taxation. Currently, OECD members are the residence jurisdictions for 85 percent of the world’s multinationals. Therefore, a major focus of the OECD effort has been to expand CFC regimes in its member countries, thus eliminating the incentives of source countries to engage in tax competition. But if residence jurisdiction succumbs, then the OECD can only restrict competition by its members and (perhaps) by pressuring the weaker tax havens. It can do little about tax competition by nonmembers that are not tax havens, but have preferential regimes to attract foreign investors.

If the OECD cannot be relied on to limit tax competition, what can be done? One possibility is to use the WTO, since some preferential regimes (involving export of goods) are export subsidies under WTO rules. But the WTO subsidies code does not currently cover services, and therefore does not address the tax haven problem and financial services (the current focus of the OECD effort). In addition, as the FSC litigation shows, combating export subsidies via the WTO is a long and cumbersome process.

A potential solution to both issues (tax competition and sourcing) involves a general shift to formula apportionment in a way that restricts the ability of multinationals to shift income to jurisdictions in which they have no substantial economic activity (measured, for example, by payroll, tangible assets, or arm’s length sales). But even that would leave “production tax havens” (preferential regimes for real activities) in place, unless some kind of throwback rule that reassigned low-tax income to other jurisdictions was agreed on. In any case, the adoption of such an agreed on formula seems at present unlikely, although the recent EU proposals in this direction are a promising start.

The most plausible long-term solution to the problems of source-based taxation involves a coordinated effort by the large market jurisdictions (most of whom are OECD members) to tax multinationals on sales into their markets. The key consideration is that market jurisdictions do not typically engage in tax competition to attract imports. Thus, one could impose a withholding tax on sales to consumers in a given market (such as the EU tax on e-commerce sales to consumers). Such a tax can be modeled on a destination-based VAT, but designed to replicate the corporate income tax base. Moreover, a credit or refund can be given for taxes imposed by other source jurisdictions, thus providing an incentive to them to refrain from tax competition.

Commentary / Special Report


Note, however, that the U.S. Treasury’s E-Commerce White Paper (1996) predicted the demise of source-based taxation because of e-commerce, and recommended re-evaluation of corporate residency.

43For these reasons see Avi-Yonah, Structure, supra note 34.

Conclusion

The current international tax regime is based on two principles: The single tax principle and the benefits principle. The single-tax principle states that cross-border transactions should be subject to a single level of tax — no more but also no less. The benefits principle sets the tax rate by allocating passive income primarily to the residence jurisdiction and active income primarily to the source jurisdiction.

The inversion issue illustrates the potential tension between the two principles: If active income is taxed purely on a source basis (under the benefits principle), there will be zero taxation if income can be sourced to no-tax jurisdictions (a violation of the single-tax principle). Residence-based taxation of corporations was designed by T.S. Adams (the inventor of the foreign tax credit) to prevent zero taxation by having the residence country pick up the tax when there is no source-based taxation. That was the reason Adams rejected territoriality.

If residence-based corporate taxation becomes impossible because technological developments have reduced corporate residence to meaninglessness, some other solution needs to be found to preserve the corporate tax base. A source-based tax on sales into market jurisdictions is the most plausible solution. But I am not convinced that as of 2002, corporate residence has lost its meaning as a business concept, if it is redefined as where the corporation is actually run from. That, and not a narrow fix focused on the identity of shareholders, is the immediate solution to the inversions problem.

48 See Avi-Yonah, Electronic Commerce, supra note 47.

49 Interestingly, the Treasury Report acknowledges this when it states that the purpose of tax treaties is to "reduce or eliminate double taxation of income, not eliminate all taxation of income.” Treasury Report, at 78. This seems incongruent with the Treasury’s support of a territorial tax regime that exempts foreign-source income regardless of whether it was taxed overseas. Note that the adoption of a territorial regime for the U.S. without changing the source rules (e.g., the title passage rule) would leave us vulnerable to WTO action, since it would be an export subsidy.


51 Of course, this assumes that the corporate tax should be preserved, an issue I hope to address elsewhere.