CORPORATE INVERSIONS: THE INTERPLAY OF TAX, CORPORATE, AND ECONOMIC IMPLICATIONS

BY ORSOLYA KUN*

ABSTRACT

Within the last several years, public attention has focused on a number of high-profile "corporate inversions" or tax-motivated transactions, in which U.S.-based multinational corporations reincorporated in foreign jurisdictions. These tax-motivated expatriations raise a number of concerns justifying the added attention. Although corporate inversions do not substantively change business operations, these transactions alter the tax structure of the inverting multinational. The inverted corporation ceases to be subject to U.S. worldwide taxation, and may allocate income outside the reach of U.S. taxation. Participating corporations, however, do not lose the benefits of U.S. corporate status. Finally, the change in the jurisdiction of incorporation significantly affects corporate governance by changing the laws governing the fiduciary duties of corporate officers and directors.

This article examines the reasons behind corporate expatriations, the tax structure that makes them feasible and their legal and operational implications.

I. INTRODUCTION

Corporate inversions[1] provide considerable tax savings and reduce the future tax liabilities of U.S.-based multinational corporations. These transactions allow participating entities to alter their corporate structure, by which a new foreign corporation, located in a country with no or low corporate income tax, replaces the existing U.S.-based multinational corporation as the parent of the group. This restructuring converts the multinational corporation into a foreign multinational and establishes a foundation for future transactions and restructurings that significantly reduce the corporation's exposure to U.S. taxation.

---

*Tax attorney, Siegel & Kun. LL.M. International Taxation (New York University), Ph.D. (University of Cambridge). Special thanks are due to Professor Stanley Siegel of New York University Law School.

[1]The tax literature refers to these types of transactions as "corporate expatriations," "inversions," and "outbound corporate inversions." The terms are interchangeable.

Corporate inversions became a noticeable phenomenon between 1998 and 2002, when a number of large U.S.-based multinational corporations elected to expatriate.[2] This wave of corporate expatriations concerned Congress and tax professionals. The emerging debate examined corporate expatriations from a narrow, technical perspective limited to their tax motivations and implications.

Beyond examining the tax policy implications of corporate inversions, this article attempts to shed some light on a less visible side of inversion transactions, namely their effect on corporate governance. The conversion of a U.S.-based multinational into a foreign corporation not only alters the tax exposure of the corporate group, but also changes the laws that govern intra-corporate relations. The transaction affects corporate governance standards, while failing to clarify the methods for monitoring these standards. The changes, in a post-Enron era marked by legislative and administrative attempts to increase the transparency of corporate governance, deserve increased scrutiny. The threat of legislation temporarily halted corporate expatriations in 2002, but the core issues concerning these transactions did not disappear. This article demonstrates whether, how and to what degree new laws and regulations should be considered. This study also examines the legal and economic framework, in which these transactions took place. Tax issues, however, provide the foundation of this discussion, since corporate expatriations are essentially tax-motivated transactions.

Parts I and II offer an introduction to the corporate inversion phenomenon. The inversion is the first step in a complex, corporate restructuring designed to minimize a multinational's tax exposure. The inversion transaction, therefore, is described in conjunction with those complementary transactions necessary to fulfill its objectives.

---

[2]It has been estimated that companies expatriating to Bermuda have cost the United States approximately $1 billion in revenue. Inverting companies included, *inter alia*: Cooper Industries (CBE) (manufacturer of electric products, tools, hardware), Everest Reinsurance (RE) (underwriter of property/casualty reinsurance), Foster Wheeler (FWC) (manufacturer of steam generating units and related equipment for power and industrial plants), Helen of Troy (HELE) (sells licensed personal care products and accessories), Ingersoll-Rand (IR) (manufacturer of refrigeration equipment, construction and industrial equipment), Nabors Industries (NBR) (one of the world's largest drilling contractors), Noble Drilling (NE) (deepwater oil and gas drilling services), Transocean Offshore (RIG) (leading offshore drilling contractor), Triton Energy (OIL) (oil and gas exploration and production company), White Mountains (WTM) (reinsurance company), and Xoma (XOMA)(drug developer). Expatriations can occur not only by inversion, but through merger related transactions (Tyco International (TYC)) and by incorporating, *ab initio*, in the foreign jurisdiction. Examples for the latter type transaction include Accenture (the former consulting arm of Arthur Andersen) and Seagate Technology (a leading manufacturer of storage drives for computers).

Part III focuses on the tax effects of inversion transactions. This study analyzes the objectives of inverting companies as well as the international tax principles and technical tax rules affecting these transactions. The inversion minimizes the taxes incurred on the international (foreign) income of an inverted multinational corporation, while reducing its tax liability on U.S.-source income through the use of base erosion techniques. A comparative analysis of these two objectives is important because each objective has distinct tax implications. The inversion debate was marked from its inception by the position of the Treasury Department, which emphasized the foreign tax savings component of corporate expatriations and the necessity for reform of the international tax system.[3] The Treasury Department also examined the domestic tax base erosion potential of inversions.

Part IV examines how inversions change corporate governance. The pre-inversion multinational's intra-corporate relations are generally governed by Delaware law. The applicable law, following the inversion, is the law of the offshore jurisdiction, where the corporate group continues. This section explores the corporate governance implications through a comparative analysis of a director's fiduciary duties and shareholders' options to monitor their performance, respectively.

Part V offers an overview of the economic and legal framework that facilitates corporate inversions. The section focuses on the transactional costs, capital market access, corporate decision-making, and conceptual and technical tax law factors that contribute to the phenomenon. The final section also discusses the tax policy implications of corporate inversions.

II. THE HISTORY OF CORPORATE INVERSIONS

A tax-motivated restructuring of a U.S.-based multinational corporation causes the foreign corporation to replace the U.S. parent corporation, thereby converting the entity into a foreign-based multinational. These restructurings are a relatively recent practice. The 1983 McDermott

---

[3]For the Treasury's position on inversion transactions, see generally *Corporate Inversion Transactions: Tax Policy Implication, Preliminary Treasury Report* (May 17, 2002), *available at* http://www.treas.gov/press/releases/docs/inversion.pdf (last visited Sept. 20, 2004) (on file with the Delaware Journal of Corporate Law) [hereinafter *Treasury Inversion Report*]. *See also* Testimony of Pamela Olson, Acting Assistant Secretary (Tax Policy), U.S. Department of Treasury before the House Committee on Ways and Means on Corporate Inversion Transactions (June 6, 2002), *available at* http://www.treas.gov/press/releases/po3156.htm?IMAGE.X=12/&IMAGE.Y+7 (last visited Sept. 20, 2004) (on file with the Delaware Journal of Corporate Law). *See* Tax Analysts, *2002 TNT 110-2 Corporate Inversions Inspires Raucous Ways and Means Hearing*, TAX NOTES TODAY (June 7, 2002) (emphasizing that legislative action is needed to address the inversion phenomenon, which is "of concern" from a tax policy perspective).

transaction was the first major restructuring to attract significant attention from the IRS. Here, McDermott took advantage of a gap in the Subpart F regime of the Internal Revenue Code[4] to remove non-taxed passive income from the United States' taxing jurisdiction.[5] Congress promptly remedied the deficiency in the Subpart F rules by adopting a narrowly constrained measure that denied entities the specific benefit of the McDermott transaction.[6]

Expecting to enhance post-inversion stockholder value by achieving a lower post-inversion effective tax rate, Helen of Troy inverted into a Bermuda corporation in 1994.[7] The transaction was structured to protect shareholders from incurring tax liability. The IRS promptly adopted regulations to tax the gains realized by inverting shareholders.[8] This shareholder-level tax deterred further expatriation until 1998, when a new wave of outbound inversions began. This third wave resulted in the offshore reincorporation of several U.S.-based multinationals, but the risk of anti-inversion legislation halted the corporate exodus.[9] Although the history of inversions is reported in detail elsewhere and need not be repeated here,[10] some discussion of the progress of corporate expatriations is necessary to understand why anti-inversion measures have not been successful.

The purpose and form of the 1983 McDermott transaction substantially differs from recent inversions. Shareholders of McDermott exchanged their shares for stock of McDermott International, an existing

---

[4]Unless otherwise indicated all section references herein are to the Internal Revenue Code of 1986, as amended (I.R.C.).

[5]*See infra* text accompanying note 11.

[6]Although not named, the McDermott transaction is described in the legislative materials relating to the enactment of Section 1248(i). *See* STAFF OF JOINT COMM. ON TAX., 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 1037 (Comm. Print 1985). For a discussion of Section 1248(i), see *infra* text accompanying note 13.

[7]A complete description of the transaction is provided by David R. Tillinghast, *Recent Developments in International Mergers, Acquisitions and Restructurings*, 72 TAXES 1061 (1994). *See infra* text accompanying note 15.

[8]*See* I.R.C. Notice 94-46, 1994-1 C.B. 356, announcing modification of regulations under Section 367(a) of the Internal Revenue Code. For further discussion, see *infra* text accompanying note 19.

[9]Legislation remains forthcoming as of the date of publication. Separate tax reform bills, containing, *inter alia*, anti-inversion measures, were adopted by the House of Representatives and the Senate. *Cf.* H.R. 4520, 108th Cong. (2004), and S. 1637, 108th Cong. (2004). The two bills remain to be reconciled.

[10]For a detailed account of the history of corporate inversions, see Hal Hicks, *Overview of Inversion Transactions: Selected Historical, Contemporary and Transactional Perspectives*, 30 TAX NOTES INT'L 899 (June 2, 2003); *see also* Tillinghast, *supra* note 7.

Panamanian subsidiary with substantial earnings and profits. This transaction gave McDermott shareholders a commanding ninety percent ownership in the latter corporation. The corporation structured the transaction to allow exchanging shareholders to recognize a loss on the exchange.[11] The inversion also removed the earnings of McDermott International, which operated as a controlled foreign corporation (CFC) from the reach of U.S. taxation.[12] The accumulated earnings, in the absence of the inversion, would have been taxed to McDermott as a dividend, under Section 1248, upon the sale of the stock or liquidation of McDermott International.[13] Since McDermott literally made no disposition of stock to which Section 1248 could apply, the accumulated earnings were not taxed upon their removal from the reach of U.S. taxing jurisdiction. Congress, in response, adopted Section 1248(i) of the Code. This section applies when a domestic corporation owns stock in a CFC, and a shareholder exchanges stock of the domestic corporation for stock of the CFC.[14] Section 1248 treated the stock received as stock issued to the domestic corporation and transferred to its shareholders in the form of a redemption or liquidation. The domestic corporation recognized a gain on the constructive distribution, thereby incurring a tax cost that neutralized the benefits received from a McDermott-type transaction.

"The 1994 Helen of Troy transaction was the first of the modern wave of outbound inversions and . . . [came] to be regarded as the prototypical 'pure' inversion transaction."[15] Shareholders of Helen of Troy-U.S. exchanged their shares for stock in a newly-created Bermuda corporation, Helen of Troy-Bermuda, in accordance with Section 368(a)(1)(B). Under the rules then in effect, Section 367(a) did not require a recognition of shareholder gain on the exchange. Helen of Troy-Bermuda then contributed its stock in the American corporation to a Barbados corporation in order to obtain the benefit of a U.S. income tax treaty for

---

[11] *See* Tillinghast, *supra* note 7, at 1063 (describing the objectives and terms of the McDermott transaction).

[12] *See id.* (following the inversion, McDermott owned approximately ten percent, whereas former McDermott shareholders owned approximately ninety percent of the stock of McDermott International).

[13] I.R.C. Section 1248 requires that the gain on the sale or exchange of CFC stock by a U.S. shareholder (i.e., a U.S. person who owns ten percent or more of the total combined voting power of all classes of stock) be recognized as a dividend to the extent of the accumulated Subpart F earnings.

[14] The legislative history describes the McDermott-type transaction without naming it. *See* STAFF OF JOINT COMM. ON TAX., 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 1037 (Comm. Print 1985).

[15] *See* New York State Bar Assoc., Tax Section, *Outbound Inversion Transactions*, 96 TAX NOTES 127, 129 (July 1, 2002) [hereinafter NYSBA Report].

payments of interest and dividends originating from the American corporation.[16] At this point, however, Helen of Troy-U.S. and its shareholders had not removed themselves from the reach of the CFC rules.[17] The entity, through a number of intra-group sales, then transferred its assets to affiliated corporations, including newly-created Cayman Island and Hong Kong affiliates.[18] The income generated by the assets and operations transferred to foreign affiliates, as a result of the transaction, escaped U.S. taxation under the Subpart F rules. Similarly, the corporation could structure all future acquisitions through foreign (non-CFC) affiliates to avoid the application of the Subpart F rules.

The IRS chose not to attack the tax avoidance devices of the Helen of Troy transaction.[19] The agency, rather, adopted regulations to prevent inversions *ab initio*.[20] The newly-enacted regulations taxed gains realized from all transfers of stock or securities of a U.S. corporation to a foreign corporation if the transferors owned, in the aggregate, fifty percent or more in vote or value of the transferee foreign corporation following the exchange.[21] The IRS assumed that the "toll-charge" imposed on shareholders would deter future corporate inversions.

The capital gain tax imposed on shareholders lost its deterrent function as stock market prices fell and the market acceptance of inverted companies increased.[22] Potential inverters soon focused on the base erosion benefits of corporate inversions, resulting in an unprecedented wave of outbound inversions between 1998 and 2002.[23] Economic studies revealed

---

[16]Barbados-United States Income Tax Convention, effective from December 31, 1981, Electronic Citation 91 TNI 16-68. Article 4(1)(a)(ii) of the Convention provides that a corporation is resident in Barbados if it is controlled or managed in Barbados. Article 10 of the treaty limits the tax rate on dividends to five percent in the case of at least ten percent owned subsidiaries. Interest is taxed at a maximum 12.5% of the gross amount.

[17]Foreign corporations held by the pre-inversion U.S. parent maintain their CFC status.

[18]*See* Tillinghast, *supra* note 7, at 1065.

[19]*See* NYSBA Report, *supra* note 15, at 130.

[20]I.R.C. Notice 94-46, 1994-1 C.B. 356. The notice was examined in the New York State Bar Association Tax Section, *Report on Notice 94-46 Relating to Certain Outbound Stock Transfers*, 65 TAX NOTES 913 (Nov. 14, 1994). Temporary and proposed regulations implementing the notice were issued on December 26, 1995. *See* Certain Transfers of Domestic Stock or Securities by U.S. Persons to Foreign Corporations, 60 Fed. Reg. 66,739, 66,772 (Dec. 26, 1995). Final regulations, which modified the temporary regulations only slightly, were issued in 1997. *See* Treas. Reg. § 1.367(a)-3(c) (1997); T.D. 8702, 1997-8 I.R.B. 4.

[21]I.R.C. § 367(a) (2002).

[22]*See* NYSBA Report, *supra* note 15, at 131-32.

[23]For a list of corporate inversions, see Bryan C. Cloyd et al., *Firm Valuation Effects of Expatriations of U.S. Corporations to Tax Haven Countries*, 25 J. AM. TAX ASS'N 87 (Supp. 2003). The study examines data on nineteen inversions, sixteen of which were announced in the 1998-2002 period.

that inverting corporations shared a number of common characteristics.[24] Inverting firms were considerably larger than the median firm in their industries. The former had lower levels of leverage, but higher overall tax rates than the industry average. Certain inverting firms also belonged to the same industry category.[25] This pattern suggested that the tax savings of outbound corporate inversions offered strong incentives to corporations in the same industry group. Inversions essentially allowed participating entities to maintain a competitive advantage with other inverted U.S. corporations.

The abandonment of the proposed inversion of Stanley Works[26] brought the inversion debate to center stage in 2002. The resulting suggestion of anti-inversion measures[27] temporarily halted inversion transactions. Although the proposals have not yet materialized in a final regulatory measure,[28] the ultimate adoption of a law that deals with the inversion phenomenon seems likely.[29]

III. THE FORM OF THE TRANSACTION

Since the core element of the inversion transaction is the establishment of the parent corporation as a foreign corporation, participants must first substitute the foreign corporation for the existing U.S. parent corporation. This substitution may take the form of a share inversion, an asset inversion, or a combined inversion. The form of the inversion transaction affects the tax characteristics of the transaction as well as the

---

[24]*See id.*

[25]*Oil and Gas*: Triton Energy, Transocean Offshore, Nabors Industries, and Noble Drilling; *Insurance Carriers*: PXRE Corporation, Everest Reinsurance, White Mountains, and Leucadia National; *Tools and Appliances*: Foster Wheeler, Cooper Industries, Ingersoll-Rand, Stanley Works (inversion abandoned).

[26]Mihir A. Desai & James R. Hines, *Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions*, 55 NAT'L TAX J. 409, 422-23 (2002) (presenting a case study of the Stanley Works inversion).

[27]*See, e.g.*, Wellstone Bill, S. 2050, 107th Cong. (2002); Reversing the Expatriation of Profits Offshore Act, S. 2119, 107th Cong. (2002) (REPO); Reclaiming Expatriated Contracts and Profits Act, S. 3120, 107th Cong. (2002) (RECAP Bill); McInnis Bill, H.R. 3857, 107th Cong. (2002); Corporate Patriot Enforcement Bill, H.R. 3884, 107th Cong. (2002); Save America's Jobs Bill, H.R. 3922, 107th Cong. (2002); Uncle Sam Wants You Bill, H.R. 4756, 107th Cong. (2002); No Tax Breaks for Corporations Renouncing America Bill, H.R. 4993, 107th Cong. (2002); and American Competitiveness and Corporate Accountability Bill, H.R. 5095, 107th Cong. (2002).

[28]The IRS response was to require inverting companies to notify the Service about the inversion within thirty days. *See* T.D. 9022, Treas. Dec. Int. Rev. 9022 (2002).

[29]This article discusses S. 1637 and H.R. 4520, two bills presently under consideration. *See also* Samuel C. Thompson et al., *Economic Substance, Inversions and the Bush-Kerry International Tax Reform Debate*, TAX NOTES, June 14, 2004.

form of corporate and disclosure mechanics necessary for completion. The inversion transaction,[30] however, does not implement the purposes for which the restructuring was undertaken. The inversion, rather, establishes the framework for related transactions, such as asset and share transfers, recapitalizations, issuances of debt and the creation of new subsidiaries. These related transactions—often viewed as part of the inversion itself—are examined separately at the end of this section.

A. *Share Inversions Through Acquisition of the Stock of the Existing U.S. Parent*

Share inversions establish a new foreign corporation (Bermudaco), typically located in a jurisdiction with no or low corporate taxes like Bermuda, that becomes the parent of the existing U.S. corporation (USco).[31] The USco shareholders exchange all of their stock for shares of Bermudaco in a "B" reorganization.[32] USco, however, must be held by a small number of shareholders who unanimously support the transaction.[33] The alternative, widely used in other reorganization and acquisition transactions, is the three-party merger known as a "triangular" or "reverse triangular" merger. Most of the reported share inversions have taken the form of reverse triangular mergers, in which USco becomes a wholly-owned subsidiary of Bermudaco following the inversion.[34]

The corporate law requirements are generally straightforward. The merger requires a vote of USco shareholders.[35] The shares of USco become shares of Bermudaco and USco becomes a wholly-owned subsidiary of

---

[30]Asset inversions are excluded from this assertion.

[31]Further changes in corporate structure may include transfers among lower-tier corporations or changes of the incorporation jurisdiction of lower-tier corporations.

[32]*See* I.R.C. § 368(a)(1)(B) (2002) (qualifying for reorganization treatment at the *shareholder* level will be irrelevant because gain recognition will be required by I.R.C. Section 367(a) (2002)). Preservation of non-recognition at the *corporate* level is crucial and increases the importance of qualifying the transaction as a reorganization.

[33]*See id.* The "B" reorganization would require an exchange of eighty percent or more of the stock of USco "solely for" voting stock of Bermudaco. Achieving an exchange of this magnitude is very difficult because the transaction requires that shareholders tender their shares for exchange.

[34]Share inversions include TRITON ENERGY CORP., PROXY STATEMENT (Feb. 23, 1996); FRUIT OF THE LOOM, INC., PROXY STATEMENT (Oct. 15, 1998); EVEREST GROUP RE. LTD., REGISTRATION STATEMENT (Sept. 17, 1999); NABORS INDUS., REGISTRATION STATEMENT (Jan. 2, 2002); WEATHERFORD INT'L, NEWS RELEASE (Apr. 5, 2002).

[35]*See* DEL. CODE ANN. tit. 8, § 251(c) (2001).

Bermudaco.[36] USco stock, as a publicly-held corporation, is registered under the Securities Exchange Act of 1934, and the USco shareholders' vote falls under the proxy rules and associated disclosure requirements.[37]

The reverse triangular merger, if qualified as a reorganization,[38] results in a nonrecognition of gain or loss by both USco and its shareholders.[39] The nonrecognition rules, however, are substantially modified when the reorganization involves an outbound transfer of assets or stock. Shareholders must recognize all realized gains on outbound transfers of stock, but may not recognize any loss thereon.[40] If the shares of USco appreciate prior to the planned share inversion, then USco shareholders must pay significant taxes on their gains. Conversely, if the price of USco shares declines prior to the planned share inversion, then USco shareholders will lose the immediate benefit of recognizing any losses on the exchange.

An examination of the share ownership of inverting corporations raises questions about these initial conclusions. The inversion, in periods of stock market decline, will likely produce no gain for the exchanging shareholders. Appropriate tax planning, however, particularly the structuring of the transaction to disqualify reorganization treatment,[41] allows shareholders to recognize realized losses.

In periods of stock appreciation, a relatively small percentage of the stockholders of a publicly-traded corporation will be subjected to tax on the gain realized in the exchange. First, a significant portion of all publicly-traded stock is held by "zero bracket" institutional investors,[42] which do not pay taxes on current income or capital gains. Second, short-term traders, whose basis is often at or close to the market level, are likely to hold a significant portion of the stock. Third, when the former American

---

[36]*See id.* § 251(b)(5) (allowing the merger agreement to provide for the conversion of the shares of a constituent corporation into "cash, property, rights or securities of any other corporation or entity").

[37]*See* Securities Exchange Act of 1934, *as amended*, §§ 12 (registration requirement), 13 (periodical and other reports), 15 U.S.C. §§ 78m, 78n (2000); Securities Exchange Act of 1934, Regulation 13A: Reports of Issuers of Securities Registered Pursuant to Section 12.

[38]*See* I.R.C. § 368(a)(2)(E) (2002).

[39]*See* I.R.C. § 354(a)(1) (2002) (nonrecognition by exchanging shareholders); I.R.C. §§ 361(a), 362(a)-(b) (2002) (nonrecognition by corporations).

[40]Treas. Reg. § 1.367(a)-3(c) (1997) (adopting these regulations in response to the Helen of Troy transaction).

[41]*See* I.R.C. § 368(a)(2)(E) (2002). One way to assure non-reorganization status is to structure the transaction as a disqualified or "broken" reverse triangular merger under I.R.C. § 368(a)(2)(E). This effect may be achieved by issuing in excess of twenty percent "boot" in the transaction.

[42]*See infra* discussion at note 229.

parent has a relatively small group of founding shareholders, who own significant blocks of appreciated stock, the use of the "exchangeable share technique" may postpone the shareholder-level tax.[43] Finally, some long-term holdings are usually held by the heirs of the original purchasers, which cause the basis of the stock in their hands to be considerably higher than the original purchase price.[44] In sum, the threat of a "toll charge" is not likely to act as a significant deterrent to inversion transactions.

B. *Asset Inversions*

Share inversions superimpose a foreign corporation over the existing U.S. corporation, thereby partially changing the corporate structure. An asset inversion, however, is a complete corporate restructuring that replaces the former U.S. parent (USco) with the new foreign parent corporation (Bermudaco). An asset inversion typically is a two-step reincorporation. First, USco, generally a Delaware corporation, re-incorporates in a state that does not require a unanimous shareholder approval for a domestic-to-foreign reincorporation.[45] USco then reincorporates in a foreign jurisdiction. The U.S.-foreign reincorporation cannot use the Delaware continuation procedure and, therefore, loses the advantages of Delaware law.[46] If the jurisdiction has a statutorily recognized continuation procedure, the second step may be easier. Bermuda, the preferred target destination of inverting corporations, has a continuation statute.[47] USco, as a result,

---

[43]*See* Hicks, *supra* note 10, at 910-11. These transactions allowed American shareholders to exchange their stock in USco for units, each consisting of a share of Newco and one share of convertible preferred in USco. The recognition of the gain allocated to the newly-issued stock is postponed until the effective exchange into Newco stock. This technique was used by Fruit of the Loom and Triton Energy.

[44]*See* I.R.C. § 1014 (2002) (providing for a step-up in basis with respect to stock passing through decedent's estate).

[45]*See, e.g.*, ARIZ. REV. STAT. § 10-3226 (Supp. 2003) (discussing the transfer of domicile of corporation), § 10-1003 (2003) (requiring majority shareholder vote in order to amend the articles of incorporation); TEX. BUS. CORP. ACT ANN. arts. 5.17-5.20 (2003) (dealing with conversion), art. 5.03 (2003 & Supp. 2004) (requiring two-thirds shareholder vote to authorize a merger).

[46]*See* DEL. CODE ANN. tit. 8, § 390 (2001). Delaware law requires unanimous shareholder vote for the continuation of a Delaware corporation outside the state. When the continuation procedure is applicable, the continuing corporation may retain the application of Delaware law in the foreign jurisdiction.

[47]Section 132C of The Bermuda Companies Act 1981 states that a body incorporated outside Bermuda (hereafter in this Part referred to as a foreign corporation) may, subject to certain conditions, be continued in Bermuda as an exempted company. The conditions that need to be satisfied for continuation are administrative, including providing a memorandum of continuance, financial statements, and payment of a fee. *See* The Bermuda Companies Act 1981, § 132C (1989 rev.) (Berm.). For the analogous Cayman Islands continuation procedure, see Cayman Islands

automatically converts into Bermudaco and the outstanding stock in the U.S. company converts into stock of Bermudaco.[48]

Foreign corporations that USco held directly in a chain before the inversion were CFCs. These CFCs generated a U.S. tax liability for USco with respect to certain categories of passive or highly mobile types of income, like Subpart F income. When USco is converted into a non-CFC entity,[49] its foreign subsidiaries are also converted, thereby eliminating the exposure of the subsidiaries' income to Subpart F treatment. Controlled foreign corporations held through U.S. subsidiaries, however, retain their CFC status after the inversion. While this type of inversion may de-control more CFCs than a share inversion, the process imposes a significant tax cost.

Asset inversions carry a significant tax burden. For federal income tax purposes, the continuation should qualify as an F reorganization as long as the transaction meets the technical and doctrinal requirements thereof.[50] The reorganization must meet the continuity of interest and continuity of business enterprise tests, respectively, while serving a valid business purpose. Although the transaction would normally meet the continuity test, the inversion, given the prominence of U.S. tax planning, may not serve a valid business purpose. If the latter requirement is not met, then the government will tax the reincorporation at the corporate and shareholder levels.

If the reincorporation qualifies as an F reorganization, USco shareholders should be entitled to a non-recognition of gain or loss on the transaction.[51] Section 367(a), therefore, will not impose a shareholder-level tax.[52] The reincorporation, however, is fully taxable to USco at the corporate level because the reorganization involves a deemed transfer of its assets to the newly-incorporated foreign entity. USco, the former parent, is effectively treated as having sold its assets to Bermudaco. This outbound asset transfer is taxable,[53] and the high tax cost is likely to make asset

---

Company Law §§ 221-229 (2001 revision) (Cayman Is.).

[48]*See* XOMA CORP., PROXY STATEMENT (Nov. 30, 1998); WHITE MOUNTAINS INS. GROUP, REGISTRATION STATEMENT (Sept. 27, 1999).

[49]The new foreign parent corporation is publicly held, which allows the avoidance of CFC shareholder status for its shareholders. *See infra* text accompanying note 98.

[50]Alternatively the transaction may qualify as a C or nondivisive D reorganization.

[51]*See* I.R.C. § 354(a) (2002).

[52]In the absence of an "indirect stock transfer," an outbound F reorganization does not involve a Section 354 stock transfer that is subject to I.R.C. Section 367(a).

[53]I.R.C. § 367(a) provides that an outbound C, D, or F reorganization may not be rendered tax exempt by I.R.C. sections 367(a)(2) and 376(a)(3). The transfer, therefore, is fully taxable under I.R.C. § 367(a). Moreover, if USco owned CFCs, it will also have dividend income as a

inversions impractical in the absence of offsetting tax attributes. Where offsetting tax attributes are available (i.e., net operating losses or excess foreign tax credits), the Section 367(a) tax costs may be minimized.[54]

C. *Combined Inversions*

Combined inversions include elements of share and asset inversions alike to minimize tax costs and attain optimal tax efficiency.[55] The first step of the transaction is structured in a similar form to an asset inversion. The parent corporation, USco, reincorporates in an American jurisdiction that allows American-to-foreign reincorporation without unanimous shareholder consent. USco then reincorporates in a foreign jurisdiction. The second step of the transaction involves the transfer of certain assets of Bermudaco to a newly-formed American subsidiary (USnewsub) in exchange for the stock of USnewsub. The choice of the assets "re-transferred" to USnewsub depends on the nature of the assets originally held by USco, appreciation of the assets and the availability of tax attributes that may offset the gain inherent in appreciated assets. The parent corporation, Bermudaco, generally retains assets without a significant built-in gain, namely recently-purchased foreign subsidiaries and financial instruments, while transferring appreciated assets and American assets to USnewsub. These transactions are generally treated as outbound C reorganizations followed by a Section 368(a)(2)(C) drop.[56]

The overall transaction is viewed as containing two elements: (1) an outbound transfer by USco of its assets to Bermudaco, *except those assets deemed re-transferred to Usnewsub*; and (2) an indirect outbound transfer by the shareholders of USco of domestic stock—*the stock of USnewsub as*

---

result of the deemed sales of stock thereof, pursuant to I.R.C. § 1248.

[54]For the effective tax burden incurred by Xoma and White Mountain, see *infra* text accompanying notes 235-36.

[55]The NYSBA Report, *supra* note 15, at 133, refers to this type of inversion under the heading "F or C reorganizations followed by a drop-down to the U.S. holding corporation." *See Treasury Inversion Report, supra* note 3, ¶ 17.

[56]Related asset drop-downs may occur in certain reorganizations without affecting the characterization of the top tier reorganization. Combined transactions have traditionally been treated as an outbound C reorganization followed by an I.R.C. § 368(a)(2)(C) drop. Examples of this type of transaction can be found in TRANSOCEAN OFFSHORE, PROXY STATEMENT (Apr. 12, 1999); Foster Wheeler Corp., Registration Statement, Dec. 21, 2000. The transaction may also be characterized as an outbound D reorganization followed by an I.R.C. § 368(2)(C) type drop. Revenue Ruling 2002-85, 2002-52 I.R.B. 986, confirms that a subsequent drop-down will not disqualify a D reorganization. Alternatively, it is possible that the top tier reorganization may be treated as an outbound F reorganization followed by an "unrelated" contribution of property by Bermudaco to USnewsub. For the characterization of these transactions, see Hicks, *supra* note 10, at 913-15; NYSBA Report, *supra* note 15, at 133-34.

a partial successor of USco—to the extent of the assets retransferred by Bermudaco to USnewsub. This transaction generates tax at the shareholder and the USco levels. The assets retained by Bermudaco are considered transferred in an outbound asset transfer, in which USco recognized a gain.[57] The other part of the transaction—the deemed exchange of stock by American shareholders to the extent of assets deemed "re-transferred" to USnewsub—generates tax liability at the shareholder level.[58] The resulting corporate level tax may be minimized by limiting those assets transferred without substantial built-in gain and using offsetting tax attributes. The shareholder-level tax might be less significant to the extent that the shareholder base includes tax exempt investors and the share prices do not reflect built-in gains.[59] Because of the tax costs incurred at the shareholder and corporate levels and the complexity of the tax planning techniques, corporations rarely use combined inversions as a means of outbound corporate restructuring.

D. *Associated Transactions to Implement the Objectives of Outbound Corporate Restructuring*

The inversion generally does not fully implement the objectives of the outbound corporate restructuring. Inversions minimize tax liability on foreign source income and reduce tax liability on U.S.-source income. To minimize tax exposure on income earned abroad, corporations combine the inversion with related CFC and other restructuring. The second objective, the reduction of tax liability on U.S.-source income, is frequently accomplished by base erosion techniques.

1. Controlled Foreign Corporation Restructuring

The United States taxes[60] certain types of income earned abroad by foreign subsidiaries of a U.S.-based multinational that qualify as CFCs.[61] Inversions, therefore, eliminate or reduce this tax liability by transferring the ownership of the foreign subsidiaries to a foreign parent or sister

---

[57]*See* I.R.C. § 367(a)(5) (2002).

[58]Treas. Reg. § 1.367(a)-3(c) (2003).

[59]It has been suggested that the shareholder-level tax liability can be reduced if USnewsub assumes the liabilities of USco, which will drive down the value of USnewsub. *See* Hicks, *supra* note 10, at 915.

[60]The United States is able to tax these entities through the use of anti-deferral rules.

[61]For the operation of the anti-deferral rules, see *infra* text accompanying note 97.

corporation. This restructuring de-controls the foreign subsidiaries (e.g., CFCs).

A share inversion alone does not change the status of the existing CFCs. The transaction, rather, superimposes a new offshore parent over the pre-inversion parent, which, in the absence of additional restructuring, continues to hold all existing foreign subsidiaries. Newly-established foreign operations, of course, can be held directly by the new Bermuda parent corporation with no U.S. tax liability attaching. Asset inversions, by comparison, de-control all foreign subsidiaries held directly or through a chain of CFCs, by replacing the pre-inversion parent corporation with the new Bermuda parent. To the extent that American corporations remain in the chain of ownership, however, tax liability may still attach to the foreign subsidiaries held in the chain by these corporations.

The combination inversion contains elements of both asset and share inversions. This transaction may de-control certain foreign subsidiaries by leaving the corporation in the immediate holding of Bermudaco without re-contributing them to USnewsub. The basic inversion transaction, in short, often subjects many CFCs to the U.S. anti-deferral regime. Companies undertaking inversions, therefore, often engage in separate transactions to restructure their CFC ownership and foreign operations.

The creation of a cross-ownership structure, through the use of so-called "hook" or "tail-and-hook" stock, is the preferred technique for de-controlling CFCs in a stock-inversion transaction.[62] Here, USco transfers stock of the foreign CFCs to Bermudaco or a foreign affiliate thereof. Prior to or at the time of the inversion, USco may transfer the CFCs to Bermudaco by exchanging the stock of the CFCs for a second class of common stock in Bermudaco. The stock received does not carry voting privileges or similar rights as the common stock received by USco's shareholders in the stock inversion.[63] The resulting structure is open to possible criticism because it results in cross-ownership: USco becomes both a stockholder and a subsidiary of Bermudaco.[64]

Disclosures generally explain that a share inversion, when accompanied by a transfer of CFCs for tail-and-hook stock, does not

---

[62]*See, e.g.*, INGERSOLL RAND CO., PROXY STATEMENT (Nov. 2, 2001); COOPER INDUS., INC., REGISTRATION STATEMENT 14 (Mar. 8, 2002).

[63]*See Treasury Inversion Report*, *supra* note 3, ¶ 19.

[64]The cross-ownership structure carries a considerable risk for U.S. investors. A high ownership percentage of USco in Bermudaco increases the likelihood that Bermudaco qualifies as a CFC. The potential post-inversion Subpart F exposure on Bermudaco increased with respect to the inversion of Ingersoll-Rand. This inversion created a tail-and-hook structure, in which forty-five percent of Bermudaco was owned by USco and its U.S. subsidiaries. *See* INGERSOLL RAND CO., PROXY STATEMENT, *supra* note 62, at 13.

generate a substantial tax liability at the corporate level.[65] The public disclosure documents, in fact, are ambiguous about the characterization of these transactions. Provided that the statutory requirements are met, the transfer may take the form of a contribution of property under Section 351 of the Code.[66] The basis for this position appears to be that a single Section 351 transaction consists of two parts. The first part is the transfer of shares by shareholders of USco for stock of Bermudaco. The second part is the transfer by USco of its stock in the CFCs for stock of Bermudaco. The combined transferors control Bermudaco immediately after the transfers within Section 368(c) and arguably qualify as Section 351 transferors. If this characterization is respected, USco is deemed to have exchanged foreign stock for foreign stock in a Section 351 transaction without incurring tax liability. This specialized treatment applies only if the parties enter into a gain recognition agreement. Alternatively the proxy statements may assume, in the absence of a transaction that warrants non-recognition treatment, that the fair market value of the stock received in the exchange is not materially greater than the basis of the stock given up in the exchange.[67]

CFCs may also be de-controlled through transactions that follow the completion of the inversion. The stock of the foreign corporation may be distributed to the new foreign parent as a dividend. Alternatively the stock of CFCs may be sold to the new offshore parent or its affiliates. These arrangements seem to be the most frequently contemplated techniques for de-controlling CFCs post-inversion.[68] Shareholders have no vote with respect to these transactions, which occur at the level of the subsidiaries of the new offshore parent and are controlled by the latter. This status marks a considerable difference from the pre-inversion scenario, when a decision of USco to dispose of substantially all of its assets required shareholder approval.[69]

---

[65]*See* COOPER INDUS., INC., REGISTRATION STATEMENT, *supra* note 62, Preamble, Questions/Answers (discussing, among risk factors, the possibility of the IRS challenging the valuation of assets re-transferred through the new Bermuda parent to U.S. subsidiaries); INGERSOLL RAND CO., PROXY STATEMENT, *supra* note 62, at 13.

[66]I.R.C. § 351 allows tax free contribution of property to a controlled corporation. *See* NYSBA Report, *supra* note 15, at 133.

[67]*See, e.g.*, TRANSOCEAN OFFSHORE, PROXY STATEMENT, *supra* note 56, at 19; COOPER INDUS., INC., REGISTRATION STATEMENT, *supra* note 62, at 5 (asserting that the new Bermuda parent will not incur substantial tax liability as a result of the contribution of assets to the new U.S. subsidiaries because the stock received in the exchange will have equal fair market value).

[68]*See, e.g.*, FRUIT OF THE LOOM, REGISTRATION STATEMENT (Feb. 10, 1998), at 34; TRANSOCEAN OFFSHORE, PROXY STATEMENT, *supra* note 56, at 18.

[69]*See, e.g.*, DEL. CODE ANN. tit. 8, § 271(a) (2001) (requiring majority shareholder vote).

2. Transactions to Optimize U.S. Base Erosion

Transactions that create inter-company indebtedness frequently accompany inversions. These transactions generate future interest expenses that reduce the taxable income of the U.S. members of the post-inversion multinational. Several techniques are available to inject tax efficient leverage into the inverted corporation.[70] First, USco may exchange an existing, high basis inter-company loan with Bermudaco for a second class of common stock of Bermudaco. This type of transaction will likely involve stock with characteristics similar to tail-and-hook stock. Second, USco may distribute a note to Bermudaco as a dividend. In either case, the payment of post-transaction interest on the indebtedness generates an interest deduction for the American corporation or corporations and reduces U.S. taxable income.

IV. THE TAX EFFECTS OF CORPORATE INVERSIONS

A. *Introduction*

The Treasury Department has described outbound corporate inversions as technically-complicated, transparent transactions.[71] This form of inversion substantively changes the management or operations of the multinational corporation. While the inverted corporation resides, for corporate law purposes, in a jurisdiction with low or no corporate taxes, the entity usually establishes residence for tax treaty purposes in a jurisdiction accessible to the U.S. treaty network. The locations of its economic operations worldwide, however, remain the same.[72] Furthermore, the effective control of its operations continues to reside in the United States.[73] SEC filings support this conclusion, often explicitly stating that the transaction does not materially alter the operation and management of the inverted corporation.[74]

---

[70]For a discussion of transactions creating inter-company indebtedness as part of the outbound corporate restructuring, see Hicks, *supra* note 10, at 916-19.

[71]*See Treasury Inversion Report*, *supra* note 3, ¶ 5.

[72]*See, e.g.*, COOPER INDUS., INC., REGISTRATION STATEMENT, *supra* note 62, at 14; INGERSOLL RAND CO., PROXY STATEMENT, *supra* note 62, at 16.

[73]The composition of the board remains the same. *See, e.g.*, COOPER INDUS., INC., REGISTRATION STATEMENT, *supra* note 62, at 18; INGERSOLL RAND CO., PROXY STATEMENT, *supra* note 62, at 19.

[74]The inversion does not alter the day-to-day operations of the inverting corporation. *See, e.g.*, COOPER INDUS., INC., REGISTRATION STATEMENT, *supra* note 62, at 3; INGERSOLL RAND CO., PROXY STATEMENT, *supra* note 62, at 2.

The inversion does not affect the inverting corporation's access to U.S. capital markets because foreign corporations, in compliance with the U.S. accounting and disclosure rules, have access to the NYSE. Thus, the inverted corporation maintains its NYSE listing under the ticker symbol used prior to the inversion.[75] The corporations' eligibility for inclusion in the Standard & Poor's 500 index also continues by virtue of its trading on the NYSE,[76] thereby securing its eligibility for investment by index investors.[77]

Outbound corporate inversions are carried out for the purpose and with the expectation of obtaining immediate and future tax savings.[78] The inverted corporation's tax liability on its foreign source income decreases because the post-inversion foreign multinational is subject to U.S. tax only for its U.S. operations. This effect will be referred to as *post-inversion tax saving on foreign source income*. The inverted corporation's tax liability on U.S.-source income may also be minimized through certain base erosion techniques unavailable to U.S. multinationals. This effect will be referred to as *post-inversion saving on U.S.-source income*. Because the inverted corporation is taxed only on its U.S.-source income, the inversion may reduce U.S. taxable income through earning stripping and inter-company transactions, which create U.S. expense items without corresponding U.S. income items.[79]

---

[75]The ability to use the same ticker symbol is often a condition of the underlying merger agreement.

[76]Continued listing in the Standard & Poor's 500 (S&P 500) was initially subject to ambiguity. A subsequent statement by the S&P 500 clarified the issue in favor of inverters. The Standard & Poor's Index Committee, Press Release, July 9, 2002, *available at* http://www.standardpoors.com and http://www.spglobal.com.

[77]The inverted corporations, as Bermuda corporations, would otherwise have no access to a system of indices and would be excluded from an index investor's portfolio. Bermuda has no index system as part of the global system of indices. Studies that evaluate the effect of S&P 500 listing on the value of corporate stock indicate that the inclusion in the index increases the price on average by 8.5% from the time when the inclusion is announced to the time when it becomes effective. Roger J. Bos, *Event Study: Quantifying the Effect of Being Added to an S&P Index* (2002), *available at* http://www.spglobal.com/EventStudy.pdf.

[78]For example, Ingersoll Rand reported an expected annual saving on U.S. taxes of $40 million. *See* INGERSOLL RAND CO., PROXY STATEMENT, *supra* note 62. Cooper Industries expected a reduction of its effective tax rate by twelve to seventeen percent, amounting to an expected annual saving of $54 million. *See* COOPER INDUS., INC., REGISTRATION STATEMENT, *supra* note 62. Stanley Works reported an expected reduction of its effective tax rate by seven to nine percent, amounting to expected tax savings of $30 million. *See* THE STANLEY WORKS, LTD., REGISTRATION STATEMENT (Apr. 2, 2002).

[79]Prior to the inversion, inter-company transactions would not reduce the U.S. tax base because both the income and expense sides of these transactions would be reflected in the financial results—and ultimately in the taxable income—of the U.S. parent of the group.

The techniques for post-inversion tax saving on *foreign source income* and those for post-inversion saving on *U.S.-source income* have different policy implications. Post-inversion tax savings on foreign income removes non-U.S.-source income from the ambit of U.S. worldwide taxation, thereby creating "self-help territoriality."[80] Arguably, these techniques are a response to the "competitive disadvantage" that U.S. multinationals face as a result of the global reach of U.S. taxation.[81] One suggested approach to this issue is a reevaluation of the principles of international taxation. By contrast, post-inversion tax savings on *U.S.-source income* diminish the multinational's U.S.-source taxable income through the use of base erosion techniques. One solution to this problem is to eliminate the base erosion benefits for inverted corporations by strengthening the technical tax rules.[82] It is difficult to ascertain the relative importance of each, though, because outbound corporate inversions are clearly motivated by both objectives.

Post-inversion tax savings on foreign source income, nevertheless, provides a measurable future benefit. Inverting corporations disclose the estimates of this benefit and rely on this reward when seeking shareholder approval. In contrast, the post-inversion tax savings on *U.S.-source income*, which represents the immediate benefit of the transaction, are neither quantified nor relied upon in the disclosure documents. Two reasons explain this omission. First, the calculation of savings inherent in future inter-company transactions is a complex task. Second, the expected tax savings are realized through the erosion of the U.S. tax base by employing tax avoidance techniques. Disclosure of such information, therefore, may not be the best strategy for corporations wishing to protect their potential post-inversion tax savings.

Inversion transactions initially focused on the avoidance of U.S. tax on foreign income.[83] "[N]otwithstanding the longer-term competitive

---

[80]*See Treasury Inversion Report*, *supra* note 3, ¶ 97.

[81]For an overview of the competitiveness issue, see Joint Committee of Taxation Report, *The U.S. International Tax Rules: Background and Selected Issues Relating to the Competitiveness of U.S. Businesses Abroad*, JCX-68-03 (July 14, 2003), *available at* http://www.house.gov/jct/x-68-03.pdf (last visited Oct. 26, 2004) [hereinafter JCT Report on U.S. Competitiveness]. The competitiveness argument is addressed in the conclusion of this article, *infra* text accompanying note 294.

[82]*See generally* Harry Grubert et al., *Explaining the Low Taxable Income of Foreign Controlled Companies in the United States*, TAX NOTES INT'L (June 24, 1992) (concluding that I.R.S. statistics provide indirect evidence that many foreign-based multinationals reduce U.S. taxable income by manipulating transfer prices).

[83]*See Econometric Study May Lend Support to Charges of Transfer Pricing Abuse*, TAX NOTES TODAY (Nov. 14, 1991) (presenting a study completed by Grubert, Goodspeed and Swenson comparing the taxable income of foreign firms as a percentage of assets and the taxable

benefits related to the tax treatment of future foreign operations or foreign acquisitions, the decision to enter into the inversion may be dependent in many cases on the immediate expected reduction in U.S. tax on income from U.S. operations."[84] Arguably, inversions would continue to be carried out in the absence of potential savings on foreign source income.[85] In short, the post-inversion reduction of tax on U.S.-source income seems to be more important than corporate disclosures suggest.

Post-inversion reduction of tax on foreign source income is a future benefit. The tax savings with respect to income on *existing* foreign operations held by the U.S. parent becomes available when those foreign operations are removed from the reach of the U.S. holding company. The removal of foreign operations often occurs, as previously described, as a second step concomitantly with or subsequent to the stock inversion, which may result in tax costs at the corporate level. Tax savings with respect to income on *future* foreign operations are likely to be realized without additional tax costs, as new foreign subsidiaries are held from their inception by a non-U.S. brother or sister corporation. By contrast, tax savings on the U.S.-source income of the inverted corporation are immediate. The share inversion transaction creates a corporate structure in which inter-company transactions may reduce the U.S. tax base.

Share price changes associated with the inversion announcements may shed light on the motivation of inverting corporations. One economic study[86] analyzed the share price fluctuations associated with the Stanley Works' inversion announcement and subsequent withdrawal.[87] The study showed an approximately $200 million increase in market value following the inversion announcement, whereas Stanley Works estimated that post-inversion tax savings on foreign source income would likely be

---

income of domestic firms based on data gathered from the IRS Statistics of Income; the conclusions of the report were largely interpreted to support transfer pricing abuse by foreign corporations, a view not shared by the authors).

[84] *Treasury Inversion Report*, *supra* note 3, ¶ 66.

[85] *See* Reuven S. Avi-Yonah, *For Haven's Sake: Reflections on Inversion Transactions*, 95 TAX NOTES 1793, 1794-95 (2002).

[86] *See* Mihir A. Desai & James R. Hines, *Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions*, 55 NAT'L TAX J. 409 (2002).

[87] *See id.* at 423. Stanley Works announced its intention to expatriate on February 8, 2002. On the date of the announcement, the market value of Stanley's equity increased by $199 million. Proposed legislation to limit expatriations was announced on April 11, 2002. On May 10, 2002, a shareholder vote on expatriation passed with a narrow majority, but was challenged by the Connecticut Attorney General. On that date, the market value of Stanley declined by $252 million.

approximately $53-$83 million.[88] The market reaction likely factored in the expectation that the inverted corporation would realize a substantial post-inversion tax saving on its U.S.-source income in addition to the expected savings on its foreign source income.

B. *Post-Inversion Tax Savings on Foreign Source Income*

1. The Tax Objectives

An outbound corporate inversion changes the US. multinational company into a foreign-based multinational, thereby creating a framework for removing foreign assets, business activities and taxable income from the United States' reach. Similarly, the inversion creates a corporate structure in which newly-acquired foreign assets and newly-started foreign operations are placed outside the reach of U.S. taxing jurisdiction. In principle, this is the basic consequence of an outbound corporate inversion on the inverting corporation's foreign source income.[89] The foreign tax exposure of a U.S. multinational, however, is a considerably more complex issue. The United States assertion of taxing jurisdiction over the world-wide income of its domestic companies is coupled with important tax policy objectives. First, excessive tax burdens should not discourage American corporations from optimizing their global economic performance through active foreign investment. Second, American corporations should not be encouraged to locate their active investments in low tax foreign jurisdictions for tax saving objectives alone.

Different policies apply to income realized from passive investment and highly mobile active investment lacking a substantive connection with local economic activity. The incentive to reinvest passive income in low tax jurisdictions is great and, apart from tax savings, distinct from optimizing the global economic performance of the company. The protection of the U.S. tax base is, therefore, relegated to an anti-deferral

---

[88] *See id.* at 425-27. In its February 8 inversion announcement, Stanley Works disclosed that it expected a reduction of its effective tax rate from the thirty-five percent pre-inversion to twenty-two to twenty-three percent.

[89] *See id.* at 427-430. An analysis of the size and structure of inverting corporations reveals that post-inversion tax savings on foreign source income are an important factor of the decision to invert. The probability that a firm will invert increases with firm size and with the share of firm assets located abroad. Heavily leveraged firms are the most likely to expatriate, as are those operating in low-tax foreign countries. Because the U.S. system of worldwide taxation is particularly costly for firms with sizable interest expenses as well as firms facing low foreign tax rates, this behavior is consistent with the view that allocation rules play an important role in the decision to give up U.S. identity.

regime that taxes certain types of passive income realized abroad by U.S. persons.[90]

Implementation of these different policies results in different tax treatment for active business income and passive income subject to the various deferral regimes. Consequently, the pre-inversion foreign income of a U.S.-based multinational corporation effectively subject to U.S. taxation includes income from active business activities subject to residual U.S. tax only upon repatriation and Subpart F income currently subject to inclusion and residual U.S. tax.

2. General Principles: The U.S. Worldwide Tax System and the Operation of Subpart F

An analysis of the principles underlying U.S. taxing jurisdiction is necessary to understand a company's motivation to invert. In the course of the inversion debate, tax scholars and practitioners have frequently questioned these principles and the technical rules adopted to implement them. The policies supporting worldwide taxation of U.S. multinationals have been criticized as unduly discriminating against these corporations.[91] Alternatively, while the policies may be sound, the technical rules that implement them are claimed to undermine their objectives and place U.S. multinationals at a competitive disadvantage.[92]

The United States has a worldwide tax system that taxes domestic corporations on income generated in the United States and abroad.[93] Income earned from non-U.S. operations of foreign corporate subsidiaries of a domestic parent corporation is generally subject to U.S. tax only when distributed as a dividend to the domestic corporation. The U.S. income tax

---

[90]The anti-deferral rules target, in principle, passive income. The reach of these rules, however, is broad. *See infra* note 105.

[91]This view was endorsed by the Treasury Report, which labeled inversions "self-help territoriality" and recommended a substantial reform of the U.S. international tax rules. *Treasury Inversion Report*, *supra* note 3, ¶ 98; William G. Gale, Corporate Inversions: An Economic Perspective Testimony Submitted to the United States Senate Comm. on Appropriations, Subcomm. on Treas. and Gen. Gov't (Oct. 16, 2002), *in* TAX NOTES TODAY (Oct. 17, 2002), *at* LEXIS 2002 TNT 201-26 (last visited Oct. 26, 2004).

[92]The interest allocation rules are the technical tax rules that place the highest pressure on U.S. multinationals. *See infra* text accompanying note 121.

[93]About one half of the OECD countries use a worldwide tax system. Michael J. Graetz & Paul W. Oostehuis, *Structuring an Exemption System for Foreign Income of U.S. Corporations*, 54 NAT'L TAX J. 771 (2001).

on such income is, as a result, deferred until repatriation.[94] The possibility of deferring taxes on income earned abroad until repatriation confers a valuable benefit on U.S. multinationals operating in low-tax foreign jurisdictions.[95] Deferral, however, is not without limitations. Anti-deferral rules may impose a current tax liability on the domestic parent corporation with respect to certain categories of passive or highly-mobile income earned by its foreign subsidiaries. This liability may arise regardless of whether the income has been distributed as a dividend to the domestic parent corporation.[96] A foreign tax credit generally is available to offset—in whole or in part—the U.S. tax payable on foreign-source income, whether such income is earned directly by the domestic corporation, repatriated as an actual dividend, or included under one of the anti-deferral regimes.[97]

Subpart F,[98] applicable to CFCs and their shareholders, is the most relevant anti-deferral regime to U.S. multinationals.[99] A CFC is generally defined as any foreign corporation in which U.S. persons own—directly, indirectly, or constructively—more than fifty percent of the corporation's stock, measured by vote or value,[100] considering for this purpose only those

---

[94]As an example of the benefits offered through deferral, consider the case of an American corporation, P, with a foreign subsidiary, S, that earns $1,000 in a country with a twenty-five percent income tax rate. S will pay taxes of $250 to the foreign country ($1,000 x 25%). Assume that S remits $400 in dividends to P and retains the remaining $350 ($1,000 - $250 taxes and $400 dividends) to reinvest in its own, foreign, operations. P must pay U.S. taxes on the $350 of dividends it receives and is eligible to claim a foreign tax credit for the foreign income taxes paid by S on the $350. P, however, does not pay U.S. taxes on any part of the $350 earned abroad and retained by S. If S, however, were to distribute a dividend of $350 to P the following year, P would then be required to pay U.S. tax—again subject to foreign tax credit—on that amount.

[95]The repatriation of earnings of U.S. multinationals from low tax jurisdictions is very low in the early years of operations in the country. *See* John Buckley & Al Davis, *The ETI /Corporate Inversion Debate: Will Myths Prevail?* 27 TAX NOTES INT'L 443, 446-47 (July 22, 2002).

[96]I.R.C. §§ 951-964 (2002).

[97]*Id.* §§ 901-902, 960.

[98]*Id.* §§ 951-964.

[99]The anti-deferral regime is often criticized for its imperfections. *See* U.S. Treasury Department, *The Deferral of Income Earned Through U.S. Controlled Corporations: A Policy Study* (2000) (making no special proposals for reform but noting that Subpart F needs to be revised to deal with the modern form of commerce and with the gaps in its current coverage). *See also* Robert J. Peroni, *Deferral of U.S. Tax on International Income: End It, Don't Mend It—Why Should We Be Stuck in the Middle with Subpart F?*, 79 TEX. L. REV. 1609, 1618 (2001) (arguing that the balance between capital-export neutrality and capital-import neutrality manifested in Subpart F "has resulted in an incoherent set of provisions that fail to substantially cut back on deferral . . . [and] add[s] tremendous complexity to the Internal Revenue Code").

[100]I.R.C. § 957 (2002).

U.S. persons that own at least ten percent of the stock.[101] Under the Subpart F rules, the United States generally taxes the U.S. ten-percent shareholders of a CFC on their pro rata shares of certain income from the CFC (Subpart F income) without regard to whether the income is distributed to them.[102]

Subpart F income generally includes passive income and other income readily transferable from one taxing jurisdiction to another.[103] To the extent that Subpart F includes active income,[104] it has the effect of taxing non-repatriated *active* foreign income realized by American corporations abroad.[105] This result contradicts the legislative intent of deferring taxation on active income until its repatriation.[106] In the absence of an inversion, the U.S. parent corporation is treated as having received current distributions of the Subpart F income of its CFCs. In addition, the parent corporation must include, for U.S. tax purposes, its pro rata shares of the CFCs' earnings invested in U.S. property.[107]

3. Operation of the Foreign Tax Credit

The United States provides a credit against U.S. income taxes for foreign income taxes paid or accrued.[108] In the case of foreign income taxes paid or accrued by a foreign subsidiary, a U.S. parent corporation is generally entitled to a "deemed paid" credit for such taxes when the U.S. parent corporation receives an actual or deemed distribution of the underlying earnings from the foreign subsidiary.[109] The foreign tax credit mitigates the double taxation of foreign-source income without offsetting

---

[101]Defining CFC measured by vote only. *See id.* § 951(b). Stock ownership is determinant upon the constructive ownership rules of I.R.C. § 958.

[102]I.R.C. § 951(a) (2002).

[103]*Id.* § 952(a). *See* JCT Report on U.S. Competitiveness, *supra* note 81.

[104]The *Treasury Inversion Report*, *supra* note 3, ¶ 5, singled out shipping income in support of the criticisms leveled against the anti-deferral regime in the context of outbound corporate inversions.

[105]I.R.C. § 954(d) (2002) (foreign base company sales income); *id.* § 954(e) (foreign base company service income). The anti-deferral rules apply to sales and service income realized through a foreign subsidiary lacking sufficient ties to its country of organization—likely a low tax jurisdiction—and arguably used simply to keep the income out of the United States. While these corporate structures may reduce or delay the ultimate U.S. tax exposure of the parent on repatriated foreign earnings, operational reasons may justify them in an increasingly global marketplace.

[106]*See* JCT Report on U.S. Competitiveness, *supra* note 81.

[107]I.R.C. § 956 (2002).

[108]*Id.* § 901.

[109]*Id.* §§ 902, 960.

the tax on U.S.-source income.[110] This tax credit has two main constraints: (1) the credit is limited to the amount of the U.S. income tax liability on the taxpayer's foreign source income; and (2) the taxpayer's foreign source income is determinant upon the principles of U.S. tax law.[111]

Because the foreign tax credit is intended to alleviate international double taxation, the foreign tax credit is limited to the amount of the U.S. tax liability on foreign-source income.[112] When the taxpayer's foreign tax payments exceed the U.S. tax liabilities applicable to their foreign income, the taxpayer is deemed to have "excess foreign tax credits."[113] Correspondingly, taxpayers whose foreign tax payments are smaller than their foreign tax credit limits have "deficit foreign tax credits." Taxpayers may use excess foreign tax credits in one year to reduce their U.S. tax obligations on foreign source income in either of the two previous years or in any of the following five years.[114]

The foreign tax credit limitation is applied separately to different types of foreign-source income. These separate applications reduce the extent to which excess foreign taxes paid in a high-tax foreign jurisdiction can be "cross-credited" against the residual U.S. tax on low-taxed foreign-source income. If a taxpayer pays foreign tax at an effective rate higher than the U.S. effective rate on certain active income earned in a high-tax jurisdiction and pays little or no foreign tax on certain passive income earned in a low-tax jurisdiction, the earning of the untaxed or low-taxed passive income could increase the taxpayer's ability to claim a credit for the otherwise non-creditable excess foreign taxes paid to the high-tax jurisdiction. This expansion can be obtained by increasing the foreign tax credit limitation without increasing the amount of foreign taxes paid. This type of cross-crediting is limited by rules that require the computation of the foreign tax credit limitation on a category-by-category basis. The passive income and the active income are placed into separate limitation

---

[110]*Id.* §§ 901, 904.

[111]The limitation on the foreign tax credit are intended to protect the ability of the United States to collect taxes on U.S.-source income. *See* Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 26 BROOKLYN J. INT'L L. 1357, 1367 (2001).

[112]For example, a U.S. corporation with $1,000 of foreign income that faces a U.S. tax rate of thirty-five percent has a foreign tax credit limit of $350 (thirty-five percent of $1,000). If the corporation pays foreign income taxes of less than $350, it will be entitled to claim foreign tax credits for the entire amount of its foreign taxes paid. If the corporation pays, however, for example, $400 of foreign taxes, it will be permitted to claim no more than $350 of foreign tax credit.

[113]The excess foreign tax credits represent a portion of the taxpayer's foreign tax payments that exceed the U.S. tax liabilities generated by their foreign incomes.

[114]I.R.C. § 904(c) (2002).

categories called "baskets," and the low taxed passive income is not allowed to increase the foreign tax credit limitation applicable to the credits arising from the high-taxed active income.[115]

4. Further Limitation on the Foreign Tax Credit Allocation of Expenses

The foreign tax credit is limited to the amount of the U.S. tax liability on the taxpayer's foreign source income. The foreign source income, calculated for foreign tax credit purposes, must reflect certain expenses incurred in the United States. Firms with certain types of tax-deductible expenses, particularly interest charges, expenditures on research and development, and general administrative costs are required to allocate these expenses between domestic and foreign sources. The reason for requiring the allocation is that certain firm functions, such as raising investment capital, generating innovations, and managing firm operations contribute proportionately to the multinational's worldwide income. The allocation rules are intended to limit the deductibility of such expenses against domestic income only to the amounts proportionately connected with producing income taxable by the United States. U.S. tax rules attempt to implement this principle by assigning a fraction of general expense items to domestic source and the remainder being assigned to foreign source. This fraction is based on complex and ever-changing formulas.

Interest expenses are generally the largest of these allocable expenditures. The interest expense allocation rules, therefore, are considered to be the most relevant factor distorting the availability of the foreign tax credit.[116] Under present law, interest expenses that a U.S. multinational corporate group incurs in the United States is allocated to U.S. and foreign sources based on the amount of gross assets located in the United States relative to those located abroad.[117] The allocation, however, does not account for any interest expenses that foreign corporations within the group may incur abroad.[118] Thus, a U.S. multinational, which possesses a significant portion of its assets overseas, must allocate a significant portion of its U.S. interest expense against foreign-source income. The allocation reduces the foreign tax credit limitation, thereby reducing the credit. This

---

[115] *Id.* § 904(d)(2).

[116] *See* Kenneth Frooth & James R. Hines, *Interest Allocation Rules, Financing Patterns, and the Operations of U.S. Multinationals* in THE EFFECTS OF TAXATION ON MULTI-NATIONAL CORPORATIONS 277-307 (Univ. Chicago Press 1995).

[117] Measured either by basis or fair market value.

[118] I.R.C. § 864(e) (2002); Temp. Treas. Reg. § 1.864-11T (2003).

allocation is required even if the foreign corporation undertakes its own debt financing abroad or the interest expense incurred by the United States parent is not deductible in computing the taxable income of the foreign subsidiary for purposes of determining its actual tax liability under applicable foreign law.

Expenses allocated to foreign source income reduce the magnitude of foreign income for the purpose of calculating the foreign tax credit limit. This increases tax costs for some firms with excess foreign tax credits, but does not increase costs for firms with deficit foreign tax credits. Because interest expenses are typically a firm's largest allocable expense, firms with heavily-taxed foreign income and considerable U.S. interest expenses are likely to incur significant costs associated with the inability to receive the full benefits of interest expense deductions.[119]

The availability of the foreign tax credit may be reduced further by the taxpayer's foreign losses. If a taxpayer generates an overall foreign loss (OFL) for the year, the taxpayer cannot claim foreign tax credits for that year because it will have no foreign-source income and a foreign tax credit limitation of zero. If the taxpayer generates foreign-source income in later years, some portion of such income will be "recaptured" or re-characterized as U.S.-source income, thereby reducing the foreign tax credit limitation in later years.[120] The rationale for OFL recapture is that the foreign-source losses offset U.S.-source income in the year generated, which reduces the U.S. tax collected on U.S.-source income.

C. *Post-Inversion Savings on U.S.-source Income*

1. The Tax Objectives

Outbound corporate inversions are typically accompanied by earning stripping and income shifting through inter-company transactions that reduce the inverted corporation's U.S.-source income.[121] Earning stripping is achieved when USco and/or U.S. subsidiaries of Bermudaco make deductible interest payments to Bermudaco. Income shifting is accomplished through inter-company payments that may take the form of management fees, licensing fees, or royalties. The inversion transaction also permits the companies to reduce their U.S. taxable income by moving assets and functions to an offshore parent or sister corporation. Finally, the inversion

---

[119] *See* Desai & Hines, *supra* note 26, at 414.

[120] I.R.C. § 904(f) (2002). These rules also operate on a category-by-category basis.

[121] *See Treasury Inversion Report*, *supra* note 3, ¶¶ 63-66; NYSBA Report, *supra* note 15, at 135.

creates a structure in which the foreign affiliates will acquire the economic benefit of certain intangible assets developed and acquired by the pre-inversion U.S. multinational, such as goodwill or corporate opportunity.[122]

Interest payments appear to be the most significant method of reducing post-inversion U.S.-source income.[123] Share inversion transactions are frequently accompanied by the creation of a new leverage structure or the extension of the existing leverage structure, thereby taking optimal advantage of income stripping potential.[124] Experience with inter-company advances in the domestic setting suggests that intra-group debts may be informally documented and flexibly administered. Debt service, including principal and interest payments, may not be enforced when group economic or business circumstances render the payments burdensome or inconvenient. Under critical examination, the character of some of these debts as true debt, as well as the reality of the interest payments thereon, may be questionable.[125]

From a worldwide tax standpoint, the newly-injected leverage is designed to be tax efficient. This efficiency is accomplished by deducting interest payments, while avoiding or minimizing the withholding tax in the country of the payor and income tax in the country of the payee.[126] Stripping income out of the United States through related party debt will be effective if the receipt of the interest payment generates less tax than the earnings otherwise would have been subject to. Interest payments made by a U.S. corporation to its foreign affiliates, absent special treaty provisions, are generally subject to a thirty percent withholding tax. Interest payments are also generally included in the taxable income of the foreign recipient. Minimization or avoidance of foreign taxation may be achieved by arranging for the outbound payments to be made to a recipient located in

---

[122]*See* NYSBA Report, *supra* note 15, at 135. Income shifting may also occur when the U.S. corporation incurs expenses, such as general or administrative expenses, for the benefit of its non-U.S. affiliates and fails to charge the foreign corporation for services and assets it provides, or where profitable opportunities are shifted outside the U.S. or profit is shifted by transfer pricing or other inter-company arrangements. *See, e.g.*, David. R. Hardy, *Assignment of Corporate Opportunities—The Migration of Intangibles*, 100 TAX NOTES 527 (July 28, 2003).

[123]Singled out by the *Treasury Inversion Report*, *supra* note 3, ¶¶ 69-79.

[124]For a presentation of the techniques used to inject additional leverage in the corporate structure, see Hicks, *supra* note 10, at 916-18.

[125]*See* Robert E. Culbertson & Jaime E. King, *U.S. Rules on Earnings Stripping: Background, Structure and Treaty Interaction*, 29 TAX NOTES INT'L 1161 (Mar. 24, 2003); Lee Sheppard, *News Analysis: Preventing Corporate Inversions*, Pt. 3, 95 TAX NOTES 1864 (June 24, 2002).

[126]The absence of Subpart F income with respect to interest income may be viewed as a fourth planning criterion. In the pre-inversion structure, any interest received by the foreign subsidiaries would have qualified as Subpart F income. *See* Hicks, *supra* note 10, at 916.

a tax haven jurisdiction. The net tax benefit will be the difference between the foreign tax imposed on the interest income and the U.S. tax saved by obtaining the deduction for interest expense. The jurisdiction of choice is usually Bermuda, which has no corporate tax. Minimization or avoidance of U.S. withholding tax may be achieved if the payee, Bermudaco, takes advantage of special U.S. tax treaty provisions by becoming a "resident" in a country like Barbados. This structure is facilitated by the different definitions of residence. While the recipient corporation claims residence for income tax purposes in one country, Bermuda, it invokes a different residence for tax treaty purposes, Barbados.[127]

2. Earning Stripping Through Foreign Related Party Debt

The potential to use foreign related party debt to reduce liability on U.S.-source income and erode the U.S. tax base is not unique to inversion transactions.[128] Foreign-based multinationals, whether founded as foreign corporations or created through inversions, can use inter-company loans to reduce U.S.-source taxable income. The effects of this technique prompted the enactment of I.R.C. Section 163(j) in 1989. This provision addressed these concerns by denying U.S. tax deductions for certain interest expenses paid by a corporation to a foreign related party. Section 163(j) applies when the corporation's debt-equity ratio exceeds 1.5 to 1 and its net interest expenses exceed fifty percent of its adjusted taxable income. The ratio is computed by adding back net interest expense, depreciation, amortization, depletion, and any net operating loss deductions. If the corporation exceeds these thresholds, then no deduction is allowed for interest in excess of the fifty percent limit paid to a related party that is not subject to U.S. tax.[129]

The earning stripping rules of Section 163(j) permit a substantial amount of base erosion because the section denies deduction of interest expense only for corporations having a debt-equity ratio that exceeds 1.5 to 1. This threshold effectively operates as a safe harbor for corporations

---

[127]*See Treasury Inversion Report*, *supra* note 3, ¶ 38.

[128]The base erosion techniques available to inverting companies—earning stripping through related party debt and income shifting through inter-company transactions—"are equally available to U.S. enterprises beneficially owned by U.S. owned foreign holding companies *and* to foreign owned multinationals." *See* NYSBA Report, *supra* note 15, at 138. *See Treasury Inversion Report*, *supra* note 3, ¶ 63. The trend of foreign multinationals to reduce U.S.-source taxable income by way of various base erosion techniques has been an issue of concern.

[129]I.R.C. § 163(j)(2) (2002). Special rules apply in the case of interest paid to an unrelated party on debt guaranteed by a related party—*id.* § 163(j)(6)(D)—and in the case of interest that is subject to a reduced rate of U.S. tax pursuant to an income tax treaty—*id.* § 163(j)(5)(B).

with lower debt-equity ratios than 1.5 to 1.[130] The safe harbor allows companies from less leveraged industries to implement inter-company financing solely for tax reasons without the threat of losing the interest deduction. These rules allow inverted corporations to increase their leverage, and empirical evidence demonstrates that inverting firms have lower leverage prior to inversion and increase in leverage afterwards.[131]

3. Income Shifting Through Other Inter-Company Transactions

A share inversion transaction is often accompanied or immediately followed by a transfer of assets or subsidiaries previously held in the direct ownership chain of the pre-inversion U.S. parent to the new foreign parent or subsidiary. This transfer may take the form of a dividend or sale after the inversion is consummated.[132] In addition to the transfer of stock of foreign subsidiaries or assets, the inversion is likely to be accompanied by non-traceable transfers of business opportunities, which carry future income potential removed from the reach of U.S. taxation. These cross border transfers of subsidiaries and assets give rise to important valuation problems.

These ongoing transactions similarly give rise to important income allocation issues. Inversions place considerable pressure on the application of transfer pricing and income allocation rules designed to implement arm's-length standards in inter-company transactions. To the extent that the arm's-length standard is not applied or enforced, income shifting will further erode the U.S. tax base.[133]

One significant source of such payments, singled out by the Treasury report on corporate inversions, is associated with the outbound transfer of intangible assets. These transfers raise significant valuation issues.[134] While transactions between related entities are generally evaluated under an arm's-length standard, pursuant to the transfer pricing rules of Section 482, the application of the standard is difficult in the case of intangible assets. First, it is difficult to determine whether a transfer of a non-legally protected intangible, such as know-how or business opportunity, has

---

[130] *See Treasury Inversion Report*, *supra* note 3, ¶ 72. Recent legislative proposals targeted a review of the § 163(j) earning stripping rules. For a summary and analysis of these proposals, see Diana L. Wollman, *Recent U.S. Earning Stripping Proposals: Why Were the Doctors Called and is the Medicine Worse than the Disease?* 30 TAX NOTES INT'L 483 (May 5, 2003).

[131] *See* Cloyd et al., *supra* note 23.

[132] *See supra* text accompanying notes 61, 97.

[133] I.R.C. § 482 (2002)

[134] *See Treasury Inversion Report*, *supra* note 3, ¶¶ 80-83; Hardy, *supra* note 122, at 102.

occurred. Second, the transaction that removes the asset from the reach of U.S. taxing jurisdiction may be structured in different ways,[135] which might require application of a variety of transfer pricing treatments. The determination of the appropriate transfer price is further complicated when less than all of the rights to the intangible asset are transferred in the transaction.

An inter-company transaction may fully comply with the arm's-length principles of Section 482, but still cause untaxed migration of value out of the taxing jurisdiction. The inversion creates the opportunity to shift functions to the offshore affiliate and impose an arm's-length deductible charge for them thereafter, which may include a profit element not subject to U.S. tax.[136] To address the issue of untaxed transfer of value through inter-company transactions, it has been proposed that post-inversion inter-company transactions be mandatorily subject to Section 482 scrutiny for a determined period.[137]

D. *Conclusion*

Inversions allow corporations to opt out of the tax status of a U.S. multinational for the tax status of a foreign corporation. Companies' foreign active and passive income, as a result, escapes U.S. taxation. Supporters of inversions argue that the tax liability imposed on the worldwide income of pre-inversion U.S.-based multinationals is too extensive. The tax liability, however, is limited to an incremental amount that reflects the excess amount of U.S. tax over the amount imposed by the foreign jurisdiction. A complicated tax credit system is designed to mitigate the effects of double taxation. It is conceivable that U.S.-based multinationals, nevertheless, bear excessive tax burdens on their foreign income, and some technical tax rules work against the principles on which the foreign tax system rests, thereby imposing additional burdens on U.S. corporations. The claimed burden of extensive taxation of foreign income, however, is not the only motivation for inverting companies. The change in status from a U.S.-based multinational to a foreign corporation allows inverters to use income allocation and earnings stripping techniques available only to foreign corporations.

---

[135]For example, fractional, territorial, or home-limited licenses.

[136]*See* NYSBA Report, *supra* note 15, at 135.

[137]*Id.*

V. THE CORPORATE GOVERNANCE EFFECTS OF CORPORATE INVERSIONS

A. *Introduction*

Initiating companies view inversions solely as tax-based transactions without significant changes to corporate governance. The proxy statements issued by the inverting corporations are the principal sources of information on the details of inversion transactions, including their underlying motivations.[138] While these statements generally describe the corporate governance changes brought about by the inversion, they also focus on the detail of the law, but fail to highlight the substantive and practical differences between the two legal systems.

The inversion proxy statements generally assume that post-inversion shareholder rights and protections differ, but Bermuda law nevertheless provides for satisfactory shareholder protection.[139] The proxy statements provide an item-by-item comparison of the texts of the relevant corporate laws,[140] comparing the law of the inverting corporation's state of incorporation—usually Delaware[141]—with the law of the new resident jurisdiction, usually Bermuda.[142] While these disclosures appear to be

---

[138]Proxy statements seek shareholder approval, in compliance with the proxy rules of the Securities Exchange Act of 1934, *as amended*, § 12, 15 U.S.C. § 780 (2000); Securities Exchange Act Regulation 14A: Solicitation of Proxies. Most proxy statements and other filings are available on line through the SEC's EDGAR (Electronic Data Gathering, Analysis and Retrieval) system of filing and retrieval, *available at* http://www.sec.gov/edgar/searchedgar/webusers.htm (last visited Sept. 26, 2004).

[139]*See, e.g.*, WEATHERFORD INT'L, NEWS RELEASE, *supra* note 34, at 28; NABORS INDUS., REGISTRATION STATEMENT, *supra* note 34, at 27. The proxies generally state that the principal attributes of the existing common stock of the inverting corporation and stock of the new foreign parent corporation will be substantially similar. There are certain differences between the rights shareholders have under Delaware law and Bermuda law, which relies heavily on the law of England.

[140]*See e.g.*, WHITE MOUNTAINS INS. GROUP, REGISTRATION STATEMENT (Sept. 23, 1999); NABORS INDUS., REGISTRATION STATEMENT, *supra* note 34, at 27-37; WEATHERFORD INT'L, NEWS RELEASE, *supra* note 34, at 28-38.

[141]The following inverting corporations had their pre-inversion residence in Delaware: Everest Reinsurance, Fruit of the Loom, Nabors Industries, Noble Drilling, PXRE Corporation, Transocean Offshore, Triton Energy, Weatherford International, White Mountain, and Xoma.

[142]The preferred target jurisdiction for inverting corporations is Bermuda. The following entities reincorporated in Bermuda: Applied Power, Cooper Industries, Everest Reinsurance, Foster Wheeler, Helen of Troy, Ingersoll Rand, Leucadia National, Nabors Industries, PXRE Corporation, Stanley Works (abandoned inversion), Triton Energy, Weatherford Inc., and Xoma. The merger related expatriations of Trenwick and Tyco, similarly targeted Bermuda. The other popular target jurisdiction for inverting corporations is the Cayman Islands (Fruit of the Loom, Noble Drilling, Transocean Offshore, and Triton Energy).

technically complete, few American shareholders possess a sufficient understanding of the Bermuda legal system. Shareholders, as a result, are unlikely to evaluate how the relevant corporate law actually operates in Bermuda compared to relevant U.S. state corporate law.[143]

None of the inversion proposals suggest that the change of corporate domicile yields substantial corporate, economic, market, or financial advantages apart from tax savings. As this article will demonstrate below, it would be very difficult to identify any such advantages. The question, instead, is what corporate governance *disadvantages* result from the inversion. Until recently, there has been a glaring silence on the effect of inversions on corporate governance.[144]

Differences between standards of corporate governance, particularly those that shareholders may not initially have been aware of, have recently drawn the attention of major institutional investors, including public pension funds.[145] In 2001, a number of public pension funds initiated a movement that required inverted corporations to reconsider their decisions to expatriate. The resulting disclosures revealed differences in corporate governance that had not previously been fully examined in the initial tax-centered inversion debate.[146] A number of inverted corporations have since submitted re-domestication proposals to their shareholders. While the

---

[143]The one reported shareholder challenge to this form of disclosure under the federal securities laws proved unsuccessful. *See* Rosenberg v. Nabors Indus., No. H-02-1942, 2002 U.S. Dist. LEXIS 14255 (S.D. Tex. June 14, 2002). Civil action brought by a dissatisfied shareholder of Nabors Industries seeking a temporary restraining order to prevent the corporation from closing its shareholder vote on the inversion. The plaintiff claimed that the proxy statement/prospectus violated Sections 13 and 14 of the Securities Exchange Act of 1934. The court refused to grant the order and found that disclosure by Nabors Industries—containing a general statement to the effect that Delaware and Bermuda law provide substantially similar shareholder rights followed by a detailed comparison of the differences—did not violate the federal securities laws.

[144]Inversion transactions have been dealt with exclusively in the tax literature, which generally ignored any implications of the transactions on corporate governance. *See Treasury Inversion Report*, *supra* note 3, ¶ 49 (stating that the rights of the shareholder with respect to governance may change in some respects due to the inversion).

[145]The re-incorporation movement started through the effort of various California public pension funds, for example, CALPERS (California Public Employees' Retirement System), CalSTRS (California State Teachers Retirement System), and joined by ISS (Institutional Shareholder Services). Re-incorporation advocates submitted re-domestication proposals to Tyco, McDermott International, Ingersoll Rand Co., Ltd., Nabors Industries, and Cooper Industries Ltd., *available at* http://www.calpers.ca.gov (last visited Sept. 23, 2004) .

[146]Pension funds identified the loss of corporate accountability as an issue of concern in the case of corporate expatriations. *See* CALPERS, *Press Release: Reincorporation Efforts Gain Momentum with ISS Recommendation Supporting Tyco Return to the U.S.* (Feb. 25, 2003), *at* http://www.calpers.ca.gov/index.jsp?bc=/about/press/archived/pr-2003/feb/reincorporation.xml (last visited Sept. 24, 2004).

votes in these cases were negative, support for re-domestication efforts appears to be on the increase.[147]

B. *Comparison of Corporate Laws*

Bermuda has been the preferred destination of expatriating companies. In the latest wave of inversions, all but three companies were re-incorporated in Bermuda.[148] The issues of corporate governance center on whether and how the shift to Bermuda law will affect the rights of shareholders and standards, which directors and officers will be held in law and in practice. Comparison of Bermuda and Delaware law poses some difficulties. The comparison must extend beyond the words of the relevant statutes to include the following factors of central importance: (1) the breadth, clarity and coherence of the body of decisional law interpreting and applying the statute; (2) the quality, experience, accessibility, and efficiency of the courts; (3) the depth and breadth of practical experience with the corporate law and commentary thereon; and (4) the character of the legal system, including its practices and traditions.[149]

1. Delaware Corporate Law

Most of the inverting corporations were initially incorporated in Delaware.[150] This practice is not surprising because Delaware corporate law is characterized by a modern corporate statute, a specialized corporate judiciary, an extensive body of precedent, and a multitude of practice and scholarly commentaries. Further, the Delaware Revision Commission subjects the Delaware General Corporation Law (DGCL) to frequent

---

[147]Two corporations have initiated the review of the reasons for expatriations, McDermott and Tyco International. Ingersoll Rand shareholders voted in their March 6, 2003 shareholder meeting against repatriation, with forty-five percent of shareholders supporting the initiative.

[148]Of the inversions effected between 1998 and 2002, three—Fruit of the Loom, Transocean Offshore, and Noble Drilling—chose the Cayman Islands as the incorporation jurisdiction of the new parent corporation. Thirteen inverting corporations targeted Bermuda for their expatriation.

[149]These factors, among others, are elaborated in two leading studies by Roberta Romano. The first study examines reincorporation decisions and the second reevaluates the long-standing view concerning the basis for the initial choice of incorporation jurisdiction. *See* Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985). More recently, the subject has been revisited empirically in connection with incorporation decisions upon initial public offerings. *See* Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U.L. REV. 1559 (2002).

[150]*See supra* note 141.

revision and amendment.[151] In order to respond to current corporate developments and maintain updated legislation, the Delaware Revision Commission and state legislature play a prominent role in proposing and adopting changes to the state's body of corporate law. Over the past half century, Delaware's legal reforms have often served as a model for statutory revision in other states.

Unlike most common law jurisdictions, Delaware maintains separate courts for law and equity. This distinction has particular relevance for corporate law, where the Delaware Court of Chancery has emerged as the leading specialized corporate law court in the United States.[152] Delaware, as a result, has become the dominant jurisdiction of incorporation for major American corporations, and a significant portion of American corporate law, legal precedent, and practical guidance bears the imprint of Delaware.[153]

2. Bermuda Corporate Law

While Delaware attracts corporations with its corporate law structure, Bermuda attracts corporate entities with its lack of corporate income tax. Bermuda law accommodates the influx of these corporations by granting the entities exempted status and automatic continuation.[154] As of 2002, 12,000 exempted companies, most of which had no assets, personnel, operations, or substantial economic ties with Bermuda, were incorporated in Bermuda. Under general conflict-of-law principles, however, issues of corporate governance would normally be decided on the basis of Bermuda corporate law.[155] This principle applies when the plaintiff files a lawsuit challenging corporate governance acts outside

---

[151]On the political process of adoption and amendment of the Delaware General Corproate Law, see Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885 (1990).

[152]*See id.* at 918 (arguing that the specialized judiciary makes Delaware incorporation more attractive); Bernard S. Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 NW. U.L. REV. 542, 589-90 (1990) (arguing that Delaware's prominence is due to its judiciary).

[153]Commentaries, interpretations, and practical guidance on the meaning and operation of the Delaware corporation law are abundant. *See* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 14-16 (2002); Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CINN. L. REV. 1061 (2001).

[154]An "exempted company," though subject to the Companies Act, does not carry on business or own property within Bermuda, with limited exceptions. *See* The Bermuda Companies Act 1981, §§ 127-132C (1989 rev.) (Berm.); for the continuation procedure, see *id.* § 132C.

[155]The principle, that the law of the state of incorporation governs the intra-company relationships, is known in American law as the internal affairs doctrine. *See* RESTATEMENT (SECOND) OF THE CONFLICT OF LAWS § 302 (1971).

Bermuda. When a Delaware corporation inverts and substitutes a Bermuda corporation as the top tier, the entity replaces the previously applicable law and practice of Delaware for the corporate law and practice of Bermuda with respect to directors and officers.

Publicly available materials reveal a very sparse record of corporate litigation and precedent in Bermuda. Similarly, few published commentaries on Bermuda law exist. Bermuda corporate law purports to be based on English law,[156] yet there is only a limited body of case law that interprets the meaning and application of the major aspects of Bermuda corporate law within the English law context.[157] A comprehensive view of the meaning and operation of Bermuda corporate law cannot be obtained.[158] These sparse resources call into question whether Bermuda law can offer effective guidelines to corporate executives on a daily basis.[159]

C. *Comparative Analysis of Directors' Duties and Liabilities*

The duties of directors and officers under Delaware law are based principally on case law, not statute. Delaware courts have consistently held that corporate directors and officers owe fiduciary duties of care and loyalty to the corporation.[160] The duty of care, embodied in the "business judgment rule," has been extensively interpreted by the courts.[161] The duty of loyalty, sweepingly described in the case law,[162] has been ameliorated by statutory procedures permitting effectuation of interested transactions.

Bermuda law includes a broad statutory statement of these fiduciary obligations. English company law, which Bermuda practice is expected to follow, similarly recognizes the existence of a fiduciary relationship

---

[156]There are significant differences between the two legal systems. The most relevant difference for directors' duties is the reach of exculpatory clauses. *See infra* text accompanying notes 201-07.

[157]*See generally* Stena Finance BV v. Sea Containers Ltd., Civ. Judgment No. 178 of 1989 (Berm. Sup. Ct.) (appearing to be the only publicly-available reported case interpreting, by reliance on English law, the extent of permissible derivative suits in Bermuda).

[158]Case summaries are published in the *Royal Gazette*. Some Supreme Court decisions are reported in the West Indian Reports and a few court of appeals cases are reported in the British Guyana Supreme Court Reports of Decisions. Decisions are available through only one on-line subscription (http://www.bdalawreports.net), which contains selected case reports beginning in the 1980s.

[159]The analysis of Bermuda corporate law relies primarily on a discussion of the statutory language.

[160]*See* Cede & Co. v. Technicolor Inc., 634 A.2d 345, 361 (Del. 1993) (describing both the duty of care and the duty of loyalty for corporate directors).

[161]*Id.* at 367.

[162]*See id.* at 360; Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939) (defining the duty of loyalty).

between directors and corporations.[163] The absence of substantial Bermuda precedent or English interpretive application, however, along with the differences between Delaware and Bermuda corporate law, raise questions about the similarity of fiduciary duties under the two legal systems. Advocates of re-domestication consequently question whether Bermuda directors and officers can be held to the same fiduciary duties as their American counterparts.[164]

1. The Duty of Care

The first fiduciary obligation of directors and officers is the duty of care, which under Delaware law is subsumed under the business judgment rule. Under the business judgment rule, a Delaware court will not enjoin a board decision or impose personal liability upon members of the board for a business decision as long as the directors acted in good faith, without self-interest, and on the basis of reasonable consideration of the reasonably available material information.[165] This deferential position remains even if the decision was unwise, foolish, or negligently undertaken.[166] The rule presumes that directors "acted on an informed basis [e.g., with due care], in good faith and in the honest belief that the action was taken in the best interest of the company," in the absence of fraud, bad faith, or self-dealing.[167] Normally, the business judgment rule will result in substantial deference to directors' actions, including negligent conduct. The Delaware Supreme Court has held, however, that gross negligence receives no protection.[168]

---

[163]For a summary description of director's duties under English law, see DOING BUSINESS IN THE U.K. § 18.03 (gen. ed. Barbara Ford, Matthew Bender 2004).

[164]*See supra* note 146 (expressing concern by CALPERS over corporate accountability).

[165]*See Cede & Co.*, 634 A.2d at 367; Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). Directors who pay no attention to corporate affairs will not be protected by the business judgment rule. *See id.* Among the most widely-cited cases of director liability following flagrant inattention is a New Jersey decision. Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981).

[166]*See, e.g.*, Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049 (Del. Ch. 1996) (stating that whether a decision is foolish or unwise has no legal significance).

[167]Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. 1989) (quoting Aronson v. Lewis, 473 A.2d 805,812 (Del. 1984)).

[168]Smith v. Van Gorkum, 488 A.2d 858 (Del. 1985) (holding liable the directors for breaching their duty of care in connection with approval of a "white knight" merger). *Van Gorkum* was heavily commented on immediately after it was decided. *See, e.g.*, Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkum, 41 BUS. LAW. 1 (1985); Herbert S. Wander & Alain G. LeCoque, *Boardroom Jitters: Corporate Control Transactions and Today's Business Judgment Rule*, 42 BUS. LAW. 29 (1986). The legislative response of Delaware to the risks of *Van Gorkum* was DEL. CODE ANN. tit. 8, § 102(b)(7) (2001), discussed *infra* text accompanying note 201.

Bermuda law similarly subjects the conduct of directors and officers to a standard of care.[169] The Bermuda standard imposes a two-fold requirement under the heading of "duty of care of officers,"[170] but it contains two separate requirements. First, officers must "act honestly and in good faith with a view to the best interests of the company."[171] Second, officers must "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances."[172]

Unlike Delaware's standard of care, with its elaborate judicially-constructed business judgment rule, Bermuda's statutory standard appears to have been largely unexplored by the courts. In testing directorial conduct under the second prong of the test, the court, based on English precedent,[173] will likely consider the specific skills and knowledge available to the director through his or her education and experience.[174] There appears to be no litigated case on the availability and possible reach of a rule similar to the business judgment rule.[175] On its face, with this limited judicial gloss, the applicable standard appears higher than its Delaware counterpart.. This difference may suggest that a corporate inversion from Delaware to Bermuda elevates the standard of care applicable to officers and directors. The open question, nevertheless, as to how Bermuda's courts will apply this standard, remains unanswered. The exculpatory provisions permitted by Bermuda law, which may be adopted by inverting corporations, can also render the Bermuda standard academic. Finally, the

---

[169]The Bermuda Companies Act 1981, § 2 (1989 rev.) (Berm.) defines the term "officer" to include director.

[170]*Id.* § 97.

[171]*Id.* § 97(1)(a).

[172]*Id.* § 97(1)(b).

[173]The duty of care of officers is tested under a two prong test: (1) an objective standard tests whether the director exercised the care and skill of a reasonably prudent person, and (2) a subjective standard assesses whether the director satisfied the duty properly based on his personal knowledge, skill, and experience. *See In re* D'Jan of London Ltd., Copp v. D'Jan [1994] 1 BCLC 561, 563; Equitable Life Assurance Soc'y v. Bowley, [2004] 1 BCLC 180, 189.

[174]*See* Focus Ins. Co. v. Hardy, Civ. App. No. 15 of 1992 (Ct. App. Berm. 1992) (citing *In re* City Equitable Fire Ins. Co. Ltd., [1925] 1 Ch. 407)).

> In determining whether a director has been guilty of negligence, "the court will take into account the character of the business, the number of directors, the provisions of the articles, the normal course of the management and practice of directors, the extent of their knowledge and experience and any special circumstances which apply."

Id. at 5-6 (citing *In re* City Equitable Fire Ins. Co. Ltd., [1925] 1 Ch. 407).

[175]English law affords some protection to negligent executive decisions, provided that they are sufficiently reasonable to justify the excusal of the director. Excusal may apply in proceedings for negligence, default, breach of duty, or breach of trust against an officer or an auditor. *See* Companies Act 1985, § 727; Equitable Life Assurance Soc'y v. Bowley, [2004] 1 BCLC 180.

effective unavailability of shareholder derivative actions to enforce the fiduciary standard of care leaves shareholders of the Bermuda corporation without effective remedies to protect their rights.[176]

2. The Duty of Loyalty

The second fiduciary obligation of directors and officers is the duty of loyalty, which prohibits a director or officer from obtaining or retaining a personal benefit from a corporate transaction. As implemented in both common law and statutory rules, the duty of loyalty in Delaware constrains corporate transactions, in which one or more members of the board are "interested."[177]

As a general rule, a director is "interested" in a corporate decision when certain factors affect his independent exercise of judgment in a manner inconsistent with uncompromised loyalty to the corporation's interest.[178] Decisions in Delaware and other states have interpreted "interest" to include the following circumstances: (1) a director has a personal financial stake in the decision contrary to the corporate interests; (2) a director contracts or transacts business directly or indirectly with the corporation on whose board he or she serves; (3) a director holds a direct or indirect material interest in the entity contracting or transacting business with the corporation; (4) a director receives a fee or other benefit for an otherwise arm's-length corporate transaction;[179] (5) a director who serves on two corporate boards has conflicting duties of loyalty with respect to a transaction between the two corporations;[180] or (6) board action is affected by structural bias.[181]

---

[176]*See infra* text accompanying note 212.

[177]*See* Cede & Co. v. Technicolor Inc., 634 A.2d 345, 361 (Del. 1993) (stating the common law definition of the duty of loyalty). *See also* DEL. CODE ANN. tit. 28, § 144 (2001) (defining the statutory requirement of the duty of loyalty).

[178]*Cede & Co.*, 634 A.2d at 361.

[179]The Delaware Supreme Court, however, held that the director's interest in the challenged transaction must be sufficiently material to amount to a breach of the duty of loyalty and "infect" the board's decision. *See id.*; Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156 (Del. 1995).

[180]*See* Krasner v. Moffett, 826 A.2d 277 (Del. 2003) (affirming the court of chancery's decision to infer interest of directors who served on the board of both parties to the transaction).

[181]The argument of structural bias explains that directors with no direct, or even indirect, financial stake in a corporate decision may so identify with other directors, who have a financial interest, that the independence of their judgment will be impaired. This argument has been given little weight by the Delaware Supreme Court. *See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 815 (Del. 1984) (stating that argument of structural bias "does not support any claim under Delaware law that these directors lack independence").

Early common law found interested director transactions to be void *ab initio*. Case law later softened this rule, rendering the transaction voidable at the option of the corporation. The interested director, however, could neither vote upon nor qualify as an attending director for quorum purposes with respect to approval of the transaction.[182] Delaware legislators abrogated these rules, substituting a structure of disclosure and approval that allows transactions involving interested directors or officers to be binding upon all the parties thereto.[183]

The Delaware procedure, now adopted with some variations in most other states, provides three methods for approval of an interested director's transaction. The transaction does not become void or voidable solely because the director or officer is present at the meeting during which the transaction is authorized. The interested director must disclose the material facts as to his relationship or interest to the board, and the board in good faith must authorize the transaction by a majority vote of the disinterested directors.[184] The transaction is similarly protected if the material facts are disclosed to or known by the shareholders entitled to vote thereon, and the transaction is specifically approved in good faith by the shareholders.[185] When neither of these procedures is followed, the transaction, nevertheless, may stand if it "is fair as to the corporation as of the time it is authorized."[186] This determination can only be made by the court following a hearing.

In contrast, the foundation of the duty of loyalty in Bermuda law is statutory. Officers must act honestly and in good faith with a view towards the best interests of the company.[187] The Bermuda Companies Act 1981 lists certain types of conduct that per se violate the officers' obligations to act in good faith. Those actions include: (1) failure to disclose on request compensation, benefits or a loan received from the company; and (2) omission to disclose an interest in any material contract, proposed contract, or any material interest in any person that is a party to such a contract or proposed contract.[188] Materiality of contracts or proposed contracts is

---

[182]*See* Blish v. Thompson Automatic Arms Corp., 64 A.2d 581, 602 (Del. 1948).

[183]DEL. CODE ANN. tit. 8, § 144 (2001).

[184]*Id.* § 144(a)(1).

[185]*Id.* § 144(a)(2). The statute is silent on whether shareholders who are interested in the transaction may vote thereon. The Delaware Supreme Court has held, however, that avoidance of a substantive hearing on fairness requires an affirmative vote of disinterested shareholders. *See* Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976).

[186]DEL. CODE ANN. tit. 8, § 144(a)(3) (2001).

[187]The Bermuda Companies Act 1981, § 97(1) (1989 rev.) (Berm.).

[188]*Id.* § 97(4).

statutorily defined,[189] as is—by exclusion—materiality relating to ownership interests.[190] A general notice to the directors of a company disclosing the existence of the material interest is a sufficient declaration of interest to satisfy the statute.[191]

Apart from requiring disclosure to the board, however, the statute is silent. The law does not require that the board approve or disapprove the interested transaction. Likewise, there is no indication of whether the interested director or directors may be present during the deliberations or how the vote is to be counted. Finally, there is no procedure for a shareholder vote or a standard to evaluate the validity of the transaction if the necessary disclosures or approvals are not undertaken.

There are further unanswered questions. Conduct violating the director's duty of loyalty under Delaware law might fall outside of the ambit of Bermuda's statutory disclosure requirement. It remains to be seen, however, whether such conduct might violate the general standard that the director must act honestly and in good faith with a view toward the best interests of the corporation.[192] Such conduct might include, for example, transactions that do not involve a material interest, as statutorily defined, such as receipt of a special benefit incidental to an otherwise arm's-length corporate transaction with a third party or conflicting loyalties between two transacting corporations on the board of which the interested director serves.[193] The treatment of these acts, given the unavailability of Bermuda precedent, is uncertain and troublesome because the circumstances occasionally require corporate executives to make decisions that probe their duty of loyalty. The absence of procedures for the approval of interested directors' transactions may raise doubts about the validity of certain corporate transactions that may involve a potential fiduciary conflict.

An interesting contrast presents itself with respect to loans to corporate officers because the Bermuda standard[194] appears more restrictive

---

[189]*Id.* § 97(5)(b) (referring to "the materiality of that contract or proposed contract in relation to the business of the company to which disclosure must be made").

[190]*Id.* § 97(5)(c) (stating that ownership or indirect control "of not more than 10% of the capital of a person shall not be deemed material").

[191]The Bermuda Companies Act 1981, § 97(5)(a) (1989 rev.) (Berm.).

[192]The specific disclosure requirements of § 97(4) are preceded by the phrase "[w]ithout in any way limiting the generality of subsection (1)," which sets forth the general fiduciary duties of officers. *Id.* § 97(4).

[193]These examples assume that the interested director does not directly or indirectly own ten percent of the shares of the other contracting corporation. *See* The Bermuda Companies Act 1981 § 97(5)(c) (1989 rev.) (Berm.).

[194]*See id.* § 96.

than Delaware. Delaware law permits corporations to grant a loan or guarantee an obligation of an officer or director "whenever, in the judgment of the directors, such loan, guaranty, or assistance may reasonably be expected to benefit the corporation."[195] The corporation may grant these loans without satisfying any special approval procedure. In contrast, Bermuda law prohibits loans to corporate officers without the consent of ninety percent of the shareholders holding voting rights.[196] An exception exists,[197] yet Bermuda law severely limits the recourse of officers to access corporate funds by way of loans.[198] Proxy statements relating to inversion transactions emphasize this more restrictive attitude of Bermuda law with respect to loans.[199] The enactment of the Sarbanes-Oxley Act of 2002, however, introduced a significant change in American corporate law concerning corporate loans. The Sarbanes-Oxley Act amended § 13 of the Securities Exchange Act of 1934 to prohibit the grant of loans to directors and officers of issuers registered under § 12 thereof.[200] This federal prohibition effectively preempts the field, prohibiting such loans for both domestic and foreign registered corporations and reversing any preexisting differences in applicable corporate law.

3. Exculpatory Provisions in the Articles or Bylaws

An area of sharp contrast between Delaware and Bermuda is the extent to which corporate law permits articles or bylaws that relieve directors and officers of liability for a violation of their duties. Delaware law permits the adoption of a provision in the certificate of incorporation that eliminates or limits a director's personal liability to the corporation or shareholders for a breach of fiduciary duty. Such provision, however, may not eliminate or limit the liability of a director for any breach of the duty

---

[195]DEL. CODE ANN. tit.8, § 143 (2001).

[196]The Bermuda Companies Act 1981, § 96 (1989 rev.) (Berm.).

[197]The company may provide the executive with funds to meet expenditures incurred for the purpose of the company or for the purpose of performing his duties as an officer of the company, subject to the approval of the company's general meeting. *See id.* §§ 96(1)(a), (2)(a).

[198]Note that there may be questions with respect to this issue (for example, what transactions are covered by the term "loan") that are not addressed by the statutory rules.

[199]Proxy statements frequently follow the practice of contrasting the Delaware standard of duty of loyalty with the Bermuda standard for corporate loans. Yet the duty of loyalty encompasses a much broader area than merely loans to executives. Proxy statements do not provide any guidance on the general treatment of interested director transactions under Bermuda law. *See* XOMA CORP, PROXY STATEMENT, *supra* note 48, at 28-29; WHITE MOUNTAINS INS. GROUP, REGISTRATION STATEMENT, *supra* note 140, at 34-35.

[200]*See* Securities Exchange Act of 1934, *as amended*, § 13(k), 15 U.S.C. § 78m(k) (Supp. 2003).

of loyalty with respect to acts or omissions not committed in good faith, behavior involving intentional misconduct, a knowing violation of the law, or any transaction in which the director derives an improper personal benefit.[201] The Delaware Court of Chancery recently narrowed the protections of permitted exculpatory provisions holding that a director's conscious and intentional disregard of directorial responsibilities constitutes either lack of good faith or intentional misconduct.[202]

Bermuda corporate law, on its face and in its application, significantly differs from Delaware law. Bermuda allows corporations, through the bylaws or any contractual arrangement, to relieve officers from personal liability for negligence, default, breach of duty, or breach of trust.[203] Only provisions limiting the liability of officers for conduct involving fraud or dishonesty are void under the statutory terms.[204] Corporate bylaws, therefore, may indemnify directors for their willful default, willful neglect or ordinary breaches of duty.[205] Claims against directors of Bermuda companies having such bylaws must plead detailed particulars of the alleged willful neglect or default to secure relief.[206] It will, therefore, be difficult to obtain full recovery against directors of such Bermuda companies in Bermuda courts.[207]

A comparative assessment of the pre- and post-inversion corporate governance standards raises questions about whether Bermuda rules can effectively guide officers and directors in their relationship with the

---

[201]DEL. CODE ANN. tit. 8, § 102(b)(7) (2001). Limitation of director's liabilities under DEL. CODE ANN. § 174 with respect to unlawful payment of dividends or unlawful stock purchase or redemption is also disallowed.

[202]*In re* Walt Disney Co. Deriv. Litig., 825 A.2d 275 (Del. Ch. 2003) (distinguishing Malpiede v. Townson, 780 A.2d 1075, 1094 (Del. 2001), as holding that as a matter of law, DEL. CODE ANN. § 102(b)(7) bars a claim only if there is only a due care claim). *See also* McCall v. Scott, 239 F.3d 808 (6th Cir.), *amended by* 250 F.3d 997, 1000 (6th Cir. 2001) (applying Delaware law, the court noted that reckless or intentional misconduct could constitute breach of the duty of good faith). *Cf. In re* Caremark Int'l, Inc. Deriv. Litig., 698 A.2d 959, 971 (Del. Ch. 1996) (holding that when a director makes a good faith attempt to assure himself that the corporate information and reporting system is adequate, he will be deemed to have upheld his duty of attention and care).

[203]The Bermuda Companies Act 1981, § 98(1) (1989 rev.) (Berm.). This section permits similar limitation of the liability for auditors.

[204]*Id.* § 98(2).

[205]Such contractual limitation of liability is unknown in English law, which prohibits any provision intended to relieve directors of liability for any negligence, default, breach of duty, or breach of trust. *See* U.K. Companies Act 1989, § 310.

[206]*See* Focus Ins. Co. v. Hardy, Civ. App. No. 15 of 1992 (Ct. App. Berm. 1992) (citing Intercontinental Natural Res. Ltd. v. Dill (Bermuda Civil Appeal No. 14 of 1981)).

[207]*See* John Milligan-Whyte, *Preventing Bermuda Companies from Relocating to the U.S.*, BERMUDA SUN, Apr. 25, 2003, *available at* http://www.bermudasun.bm/archives/2003-04-25/03business16/ (last visited Sept. 25, 2004).

corporation and its shareholders. Bermuda law contains detailed statutory guidance on some matters, but it is unlikely, in the absence or unavailability of interpretative case law, to offer a basis for the officers' daily decisions. Perhaps this defect may be remedied by consulting the corporation's Bermuda counsel, a solution readily available to the corporate executives, but less to shareholders who wish to scrutinize executive conduct. In addition to these shortcomings, judicial enforcement mechanisms available to shareholders are incomplete.[208]

Against this background, proxy materials and prospectuses, although technically accurate, may ultimately mislead shareholders unfamiliar with Bermuda law. The proxy materials may convey the misleading impression that a more stringent duty of loyalty standard applies to executives under Bermuda law.[209] Loans to corporate executives, in fact, are transactions that receive special treatment under both legal systems, independent of the general duty of loyalty. A similarly misleading impression may be conveyed that the post-inversion corporation will exempt directors from liability to the fullest extent permissible, which implies that the same standards will continue to apply to executive conduct and its susceptibility to liability.[210] After the inversion, however, corporate executives may conceivably breach the duty of loyalty, perform acts or omissions not in good faith, or engage in a transaction to derive an improper personal benefit, yet escape liability through the bylaws in Bermuda. By contrast with Delaware law, the bylaws may apparently exonerate directors and officers from liability as long as they do not act fraudulently or dishonestly.

4. Shareholders' Action for Enforcement

The corollary of the substantive duties of corporate executives is the enforcement of shareholder rights, which, with respect to American corporations, is principally accomplished through derivative action.[211] The shareholders of the inverted corporations may be able to pursue two avenues for the enforcement of their rights. They may file suit in Bermuda in support of their rights or initiate proceedings in the United States and

---

[208]The statute itself contains administrative enforcement mechanisms. *See* The Bermuda Companies Act 1981, § 97(6) (1989 rev.) (Berm.) (imposing a $1,000 fine on officers who fail to make the required disclosure for interested director transactions).

[209]*See, e.g.*, XOMA CORP., PROXY STATEMENT, *supra* note 48, at 28-29.

[210]*See, e.g.*, WHITE MOUNTAINS INS. GROUP, REGISTRATION STATEMENT, *supra* note 140, at 34-35.

[211]This discussion is limited to the enforcement of causes of action that customarily arise under state law. The shareholders of inverted corporations retain their right to sue under federal causes of action. *See infra* text accompanying note 222.

apply, if necessary, for the recognition and enforcement of the judgment in Bermuda thereafter. A choice between these tactics is important, particularly when the plaintiffs seek a monetary judgment. When seeking monetary damages, a dissatisfied shareholder may prefer to start proceedings in the jurisdiction where the assets, out of which a potential money judgment will be collected, are located.

Dissatisfied shareholders may experience difficulties initiating a derivative action in a Bermuda court. Bermuda law does not provide shareholders with a statutory right to file derivative actions, but Bermuda law is expected to follow English precedent. English law follows the rule established in *Foss v. Harbottle*,[212] which holds, with limited exceptions, that only the company can initiate an action. Common-law exceptions, however, permit a derivative action, when (1) the complained of act is *ultra vires* or illegal; (2) the complained of act constitutes fraud against the minority, in which the majority exploits its position to prevent company action against wrongdoers; (3) shareholder approval for the act was below the percentage required by the law for a valid approval; or (4) the complained of act violates the company's memorandum or articles of association. These narrowly defined exceptions do not include alleged violations of the directors' duties of care and loyalty.

In the general absence of case law confirming the Bermuda courts' use of English precedent in derivative actions, inversion prospectuses and proxy statements discuss the possibility of initiating a derivative suit in conditional language. The materials do not clarify what procedure, if any, an aggrieved shareholder should follow to obtain enforcement of her rights, or the pre-litigation support of the corporation for the enforcement of her rights.[213] The bylaws of inverting corporations could provide alternative devices, such as arbitration, to facilitate the enforcement of shareholder rights. Inverting corporations could also establish a structure that allows shareholders to alert the corporation and possibly obtain its support before resorting to litigation, such as a litigation or oversight committee of the board of directors. Inverting corporations however, do not follow any such practice and limit disclosure to the summary description of the English practice to initiate a derivative action.

---

[212] 2 Hare 461 (1843), *discussed in* Stena Finance BV v. Sea Containers Ltd., Civ. Juris. No. 178 of 1989, at 25-28 (Berm. Sup. Ct. 19898).

[213] *See, e.g.*, XOMA CORP., PROXY STATEMENT, *supra* note 48, at 29 (citing and describing the rules of Foss v. Harbottle, 2 Hare 461 (1843); WHITE MOUNTAINS INS. GROUP, REGISTRATION STATEMENT, *supra* note 140, at 36 (listing the same rules without case citation); NABORS INDUS., REGISTRATION STATEMENT, *supra* note 34, at 36 (listing the same rules without case citation).

The probability that dissatisfied shareholders of inverted corporations would attempt to enforce their rights through the Bermuda court system is low. Shareholders who elect to enforce their rights usually pursue recourse in the United States' court system, unless service of process cannot be effected in the United States.[214] Litigation involving corporate governance issues, however, would require the court to apply Bermuda law. Certain corporate governance issues, such as loans to executives, may also involve the application of the provisions of the Sarbanes-Oxley Act of 2002. If the litigation raises issues relating to the violation of the federal securities laws, the court would apply U.S. law. Direct corporate actions against the executives of corporations involved in the recent corporate scandals have been initiated in the United States.[215] These proceedings are unlikely to involve any problem of enforcement because they are based on federal causes of action and directed against the individual executives whose assets are probably located in the United States. A judgment of an American court against a Bermuda corporation itself or a corporate officer without a substantial American presence and American assets, however, may raise enforcement problems in Bermuda.

The United States and Bermuda do not have a treaty governing the mutual recognition and enforcement of judgments. Inverting corporations frequently emphasize this absence. Where no treaty exists, Bermuda courts, however, would enforce money judgments granted by a court in the United States, following the common-law rules on the enforcement of foreign judgments. Common-law recognizes foreign *in personam* judgments where (1) the issuing court properly assumed jurisdiction and (2) the judgment is not (a) obtained by fraud, (b) contrary to public policy or (c) converse to natural justice.[216]

---

[214]Several prospectuses, in the section headed "Risk Factors," warned shareholders of inverting corporations of the serious difficulties in starting proceedings in U.S. courts. It was stated that service of process on or enforcement against the corporation, a foreign entity with possibly no assets in the United States, would be difficult. *See* WHITE MOUNTAINS INS. GROUP, REGISTRATION STATEMENT, *supra* note 140, at 10; NABORS INDUS., REGISTRATION STATEMENT, *supra* note 34, at 13. Similarly, it may not be easy to bring an action or enforce judgment against the officers and directors who may be residents of jurisdictions outside the United States. *See* WHITE MOUNTAINS INS. GROUP, REGISTRATION STATEMENT, *supra* note 140. Query whether inverting companies and their executives would not have sufficient presence to warrant service of process. Clearly, any uncertainty in this respect could be resolved by submitting to U.S. jurisdiction.

[215]A summary of actions awaiting trial in U.S. courts appears in On the Docket, *Where the Fallen Stand Now*, WALL. ST. J., Sept. 25, 2003, at C1.

[216]DICEY AND MORRIS ON THE CONFLICT OF LAWS 421 (11th ed., Sweet & Maxwell, 1991).

The extent to which these rules may deny the enforcement of an American judgment is uncertain. First, the recognition of a U.S. court decision involving the application of the federal securities laws may encounter obstacles. Certain remedies, available under the federal securities laws in the United States, may not be enforced in Bermuda courts because these remedies are contrary to public policy.[217] Second, the existence of two forums, where disputes may potentially be litigated, may threaten the recognition or enforcement of the judgment in the alternative forum. For example, Bermuda courts may grant anti-suit injunctions in support of their jurisdiction.[218] An anti-suit injunction, however, may be granted against proceedings initiated in the United States in violation of a clause requiring Bermuda arbitration. If the litigation proceeds further and results in a final judgment thereafter, this judgment will not be recognized or enforced in Bermuda because the judgment violates natural justice.[219]

D. *Conclusion*

Proxy statements and prospectuses associated with inversions assert that shareholders will continue to have fundamental rights in and enforcement alternatives against the new parent corporation. Bermuda law includes prohibitions, limitations, and protections that constrain the conduct of corporate officers and directors. In addition, there is a basis for shareholder enforcement of these duties. Our detailed comparison, nevertheless, clearly reveals one distinguishing element of post-inversion corporate governance and shareholders' right enforcement: *uncertainty*. While executives of Bermuda corporations have duties of care and loyalty, the metes and bounds of those duties, unlike those in Delaware, lack clarity. Furthermore, while shareholders of inverting corporations arguably continue to have the right to seek judicial enforcement of the duties of directors and officers, this enforcement is also affected by the ambiguity of Bermuda law. Finally, corporate transparency is impaired by the complexities involved in accommodating different systems of law. Directors and officers must face the difficulty of adjusting their conduct to comply with

---

[217] *See* WHITE MOUNTAINS INS. GROUP, REGISTRATION STATEMENT, *supra* note 140, at 10.

[218] An anti-suit injunction will direct the defendant to refrain from proceeding with an alternative suit in another jurisdiction. The injunction is directed against a litigant who commenced the U.S. proceedings. It has no binding effect on the U.S. court itself.

[219] This is not a hypothetical scenario. In an analogous case, the Supreme Court of Bermuda has held that a U.S. judgment granted in violation of a Bermuda anti-suit order is not enforceable in Bermuda. *See* Nassau Ins. Co. v. Andra Ins. Co., Civ. Juris. No. 484 of 1995 (Berm. Sup. Ct. 1995).

the rules of two different systems. Shareholders, in turn, must contend with the complexity of assessing and attempting to enforce their rights under the potentially conflicting rules of the state law of corporations in the United States and Bermuda company law.

While the change in applicable corporate law may affect standards of corporate governance, federal securities laws continue to apply and regulate some aspects of corporate conduct and shareholders' remedies. While these laws focus primarily on issues of corporate disclosure, recent amendments, most notably the Sarbanes-Oxley Act of 2002, incorporate some components of corporate governance.[220] These amendments would apply to inverted corporations.[221] Nevertheless, it is a fundamental principle of the federal securities laws that they are not directed to the regulation of state-regulated areas of corporate governance or to their remediation.[222] The duties of directors and officers and their enforcement, therefore, are not addressed by federal law.

VI. THE LEGAL AND ECONOMIC FRAMEWORK THAT FACILITATES CORPORATE INVERSIONS

Outbound corporate inversions would not be favored as a tax-saving tool in the absence of a legal and economic framework that facilitates these transactions. It is unlikely that inversions would have been possible without the interaction of multiple factors: (1) modest transactional tax costs; (2) continued access to capital markets, market acceptance, and eligibility for government contracts following the inversion; (3) corporate motivations and the absence of shareholder awareness, including inadequate emphasis on corporate governance changes; (4) non-enforcement of potential anti-inversion measures; and (5) deficiencies in the conceptual framework of the tax law for the taxation of multinationals. Tax commentators have addressed the effects of some of these factors,

---

[220] *See, e.g.*, Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301 (establishing standards for public company audit committees); § 302 (requiring CEO and CFO certification of annual and quarterly reports); § 304 (requiring that CEO and CFO reimburse incentive and equity compensation if accounting restatement is required); § 402 (amending Securities Exchange Act of 1934, *as amended*, § 13, 15 U.S.C. § 78m(k) (prohibiting of loans to directors and officers of registered companies)).

[221] With limited exceptions (for example, the requirement for audit committee in § 301, which is limited to listed companies), the provisions of the Sarbanes-Oxley Act of 2002 apply to all issuers registered under the Securities Exchange Act of 1934 §12A.

[222] *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977).

although without emphasis on their interaction.[223] The impact of these factors on the creation of a pro-inversion tax and economic environment are detailed below, along with a consideration of the major features of currently pending legislative proposals that address some of these issues.[224]

A. *Transactional Tax Costs*

The recent increase in inversion activity suggests that the current transactional tax costs are too low to deter this type of corporate restructuring. As demonstrated earlier, inversions are generally structured as stock-for-stock exchanges accompanied or followed by transfers of stock and/or operating assets to foreign affiliates. These transfers remove assets from the ambit of the CFC rules. Section 367(a) imposes a "toll-charge" on the stock-for-stock exchange by taxing the exchanging shareholder on the capital gain realized.[225] The "toll charge" initially deterred this practice, and few outbound corporate restructurings occurred from the adoption of the regulation until the most recent wave of inversions.[226] The resulting shareholder-level tax, however, has become less significant today. Most importantly, stock prices have fallen considerably in the past years.[227] This development is significant in the light of the trend in shareholder turnover, which indicates that shareholders are holding stock for shorter periods of time, thereby reducing the level of built in capital gains.[228] There has also been a significant increase in shareholdings by entities not subject to, or less sensitive to, U.S. capital gains tax, including pension funds and institutional investors.[229] While

---

[223]The NYSBA Report, *supra* note 15, offers the most comprehensive analysis of the factors facilitating outbound inversions. The Report does not examine, however, corporate governance implications.

[224]Pending as of this writing is the Jumpstart Our Business Strength Act (JOBS Act), S. 1637 and H.R. 4520, 108th Cong., 2d Sess. (awaiting reconciliation). The JOBS Act addresses, *inter alia,* several issues related to corporate inversions and is discussed *infra* Part VI.C.-E.

[225]I.R.C. § 367(a) may, however, deter certain legitimate transactions while it overlooks certain abusive transactions. *See* Samuel J. Thompson, Section 367: A "Wimp" for Inversions and a "Bully" For Real Cross-Border Acquisitions, 26 TAX NOTES INT'L 587 (May 6, 2002).

[226]An exception was Triton Energy in which the inversion was announced on Feb. 8, 1996 and completed on Mar. 25, 1996. *See also* NYSBA Report, *supra* note 15, at 131.

[227]*See Treasury Inversion Report, supra* note 3, ¶ 51 (noting that the three most widely quoted indices of U.S. corporate share prices, the Dow Jones Industrial Average, the Standard & Poor 500 Index, and the Nasdaq Composite have dropped approximately twenty percent, thirty percent, and seventy percent, respectively, from their all time highs reached in 2000).

[228]NYSBA Report, *supra* note 15, at 132.

[229]Both dividends and capital gains on stock investments of qualified pension funds and of non-profit institutional investors are immune from current taxation. Also, mutual fund managers generally appear to be less sensitive to tax considerations, though their investors are

there is no comprehensive listing of the percentage of tax exempt holders of stock of inverted corporations, the available data suggests that the percentage of institutional investors of inverting entities is high.[230]

These developments undermined the deterrent effect of the Section 367(a) capital gains tax on the shareholder-level stock exchange. Some tax planning techniques have further minimized the shareholder-level tax.[231] Subsequent transactions designed to remove the foreign subsidiaries from the CFC net, though taxable, are individual transactions that allow the transferring corporation to time and structure the transaction in order to minimize its tax cost.[232]

As previously stated, asset inversions are fully taxable at the corporate level because the Code treats inverting corporation as having sold all its assets to the resulting entity. In a manner similar to tax planning for transactions that accompany share inversions, however, inverters may use strategic planning to time and structure the transaction to obtain the most tax efficient result. Xoma Corporation carried out this type of inversion virtually tax-free,[233] while White Mountains Insurance Group incurred a minimal tax cost through the reorganization.[234] Tax minimizing techniques are available when the inverting American corporation has tax attributes, such as net operating losses and excess foreign tax credits, that can offset a significant portion of the resulting U.S. tax. As presently structured, the tax law allows the use of such corporate attributes to reduce the amount of U.S. taxes owed by inverting corporations.

---

subject to tax on their allocable shares of income and capital gains.

[230]*E.g.*, PRXE Corporation—89%; Ingersoll Rand—91%; Everest Reinsurance—82%; Cooper Industries—76%; Fruit of the Loom—57%; Noble Drilling—88%; Nabors Industries—87%; Weatherford Int'l—90%. Institutional ownership, as defined in the study providing this data, refers to percentages held by banks, investment firms, insurance firms, college endowments and 13F money managers. Some of these investors are tax exempt, and others are subject to taxation. *See* Cloyd et al., *supra* note 23.

[231]For example, the exchangeable share technique, discussed *supra* note 43.

[232]For example, Fruit of the Loom and Transocean Offshore contemplated sale of assets to foreign subsidiaries. This technique is available, when the asset has no substantial built in gain. *See supra* text accompanying note 67. On the techniques to structure these transactions in a tax-efficient manner, see Hicks, *supra* note 10. Another technique to remove CFC's from the U.S. taxing jurisdiction in a tax efficient manner may be a combined inversion. *See Treasury Inversion Report*, *supra* note 3, ¶ 19.

[233]The inversion took place when the corporation had substantial net operating losses prior to the approval of a new drug developed by the corporation. *See* XOMA CORP., PROXY STATEMENT, *supra* note 48.

[234]The corporate level tax was estimated to be between $5 and $20 million. *See* WHITE MOUNTAINS INS. GROUP, REGISTRATION STATEMENT, *supra* note 140.

Transactional tax costs, as presently structured and applied, have been ineffective in deterring expatriating corporations.[235] The potential function of transactional tax costs, however, may be more extensive. A central question posed by inversion transactions is whether valuable assets have been removed from the taxing jurisdiction of the U.S. without appropriate taxation thereof. Although no commentator has quantified the removed benefits, the answer appears to be affirmative.[236] From the outset, the now foreign-based multinational is "in the position of benefiting from the accumulated goodwill and going concern value of the U.S. company."[237] In addition, the foreign subsidiaries of the group benefit from corporate opportunities attached to the pre-inversion multinational by virtue of economic characteristics developed as a U.S. corporation.[238] The Treasury Report listed, as an income shifting device, the opportunity that "the existing foreign subsidiaries of the U.S. group are allowed to 'wither away' with the new business and growth opportunities directed to the foreign subsidiaries of the new foreign parent."[239] Post-inversion inter-company dealings, if not adequately monitored for compliance, may achieve a similar result.

It has been suggested that inverting companies should be disallowed the use of offsetting tax attributes, which would impose an inescapable tax cost on the removal of tangible and intangible property from the U.S. taxing jurisdiction. This measure could address asset inversions as well as the associated transactions supplementing stock inversions, all of which have the effect of removing property from the U.S. taxing jurisdiction. The JOBS Act took this approach with respect to inversions that followed December 31, 1996 and preceded March 20, 2002.[240] The Act provides that the tax on inversion gains associated with these transactions cannot be offset by tax attributes.

B. *Continued Access to Capital Markets*

Inverted corporations enjoy continued access to American capital markets. Their stock continues to be listed on the New York Stock

---

[235]*See* NYSBA Report, *supra* note 15, at 131.

[236]The NYSBA Report points out that goodwill and going concern value are conveyed tax free to the new Bermuda corporation, by virtue of the share inversion. *See id.* at 138-39.

[237]*See id.* at 139 (noting specifically the benefit of using the corporate name).

[238]For an overview of this topic, see Hardy, *supra* note 122.

[239]*Treasury Inversion Report*, *supra* note 3, ¶ 80.

[240]S. 1637 and H.R. 4520, Sec. 441 adding I.R.C. § 7874(b)-(c). The proposed Act also would also require that inversions completed after March 20, 2002, with some exceptions, be disregarded, resulting in the inverting company continuing to be treated as a U.S. corporation.

Exchange (NYSE) and the Standard & Poor's 500 (S&P 500), thereby securing access to investors. Offshore companies have experienced increased market acceptance in the past decade and "appear not to be regarded by capital markets with suspicion, as they once were."[241] Further, investment bankers are increasingly supportive of transactions involving stock of offshore corporations.[242]

There is a strong basis for arguing that the inverted corporations' access to the U.S. capital markets is a product of their previous U.S. corporate status. Many inverting corporations started their operations as small businesses decades earlier[243] and grew with the American economy. This factor alone, however, should not warrant continued subjection to U.S. taxation, irrespective of subsequent changes in their structures and operations. Arguably, those corporations received an opportunity unavailable to foreign corporations in foreign and American capital markets. This asset was the original opportunity to raise and grow capital in the American market, the value of which they retain today in their existing capital structure. If such an asset exists, there may be justification for taxation of its transfer through inversion.

The inversion debate also highlights the fact that start-up companies can avoid the application of burdensome U.S. international tax by incorporating in a foreign jurisdiction. These corporations often benefit from the American capital market structure, *but not in the same way as inverting corporations*. It is not likely, for example, that a start-up Bermuda corporation will raise any significant portion of its capital in the jurisdiction of its incorporation.[244] Capital would likely be raised through an IPO in the United States, facilitated by the investment banking community's increased acceptance of foreign incorporated companies. Still, a newly-formed company incorporated in Bermuda, at its outset, may not have the same investor acceptance as a Delaware corporation. The standards applied to a foreign entity in obtaining a NYSE listing are higher

---

[241]NYSBA Report, *supra* note 15 at 132.

[242]*See* John R. Zavoli, *High Tech Firms Going Public: Benefits of Listing as a Foreign Issuer in U.S. Capital Markets*, 10 J. INT'L TAX'N 7 (1999).

[243]For example, Stanley Works claims a corporate history of 160 years. *See* STANLEY WORKS, COMPANY HISTORY, *available at* http://www.stanleyworks.com/a_history.asp (last visited Sept. 25, 2004). Ingersoll Rand claims a corporate history dating back to 1871. *See* INGERSOLL RAND, HISTORY, *available at* http://www.irco.com/aboutir/history.html (last visited Sept. 25, 2004).

[244]The sources of investment capital in Bermuda are limited. Only two of the companies that expatriated to Bermuda were listed on the BSE, namely Tyco and Global Crossing. Both are listed on the NYSE.

than those applicable to U.S. corporations,[245] including inverting companies. Thus, the preferred market status secured by inverters through their original U.S. incorporation is available to foreign start-ups only by incurring higher "costs."[246]

Inversions do not affect the eligibility of the inverted corporation to obtain federal or state government contracts.[247] Arguably, companies outside the taxing jurisdiction of the United States, both inverted companies and foreign start-ups alike that exclude themselves from the tax costs of corporate "citizens," should be restricted in their eligibility to compete for contracts with the government. The continued eligibility of inverted multinationals for governmental contracts has been widely criticized, but not yet addressed.

C. *The Decision to Invert and the Implications for Shareholders*

Corporate inversions substantially affect corporate governance by introducing a component of uncertainty and ambiguity in the corporate governance model. Bermuda law, which is frequently the governing corporate law following the inversion, does not provide guidance with the level of clarity and comprehensiveness of Delaware law. The new governing law may provide inadequate guidance for shareholders to monitor directors' compliance with their duties and may lack satisfactory means of enforcement. This uncertainty is relevant in today's economic climate, where corporate scandals have drawn governmental and public attention to the accountability of corporate executives.

Corporate inversions require the approval of shareholders, who may wish to relinquish a degree of transparency and certainty in the

---

[245]Section 103.01 of the Listed Company Manual, NYSE Listing Rules (2004), *available at* http://www.nyse.com/listed/p1020656067970.html?displayPage=lcm/lcm_section.html?snumber=1&ssnumber=103.01 (last visited Sept. 25, 2004).

[246]The higher costs of market access refer to the fact that a foreign corporation must meet higher financial standards—measured by earnings, operating cash flow and global market capitalization—to be listed on the NYSE.

[247]A General Accounting Office report, released on Oct. 2, 2002, showed that four of the top 100 federal contactors that are publicly traded corporations are incorporated in a tax haven country. In 2001, the federal government awarded $2.7 billion in federal contracts (roughly 2.6% of all contracts) tothe following four companies: McDermott International, Inc. ($1.885 Billion); Foster Wheeler, Ltd. ($286.3 million); Accenture Ltd. ($279 million); and Tyco International Ltd. ($206.4 million). James R. White, *GAO Discovers $2.7 Billion in Federal Contracts to Corporate Expatriates*, TAX NOTES TODAY (Oct. 3, 2002), *at* LEXIS 2002 TNT 192-18 (last visited Oct. 26, 2004).

accountability of corporate executives in return for tax benefits.[248] Absent overriding public policy considerations, the shareholder decision should not be subject to question, provided that it reflects an informed choice. The earlier discussion of the limited information available to shareholders,[249] however, raises serious questions about the informed nature of these inversion votes. This shortcoming will be addressed in the proposed JOBS Act, which would impose additional proxy disclosure requirements for corporate inversions.[250] The inverting corporation, pursuant to the proposal, must disclose details pertaining to the transaction in a document separate from its proxy statement details. This heightened disclosure requirement is consistent with the concerns expressed in this article about the ineffectiveness of disclosure with respect to these transactions.

Effort to raise public awareness concerning the corporate governance changes inherent in the transaction were notably absent from the inversion debate, except for a movement initiated by several California pension funds seeking the re-domestication of a number of inverting corporations. Shareholder awareness of the post-inversion corporate governance changes could affect the expatriation decisions.[251] For example, the Stanley Works inversion plan, amidst negative publicity, attracted a narrowly positive shareholder vote. Confronted with a challenge from the Connecticut Attorney General the company abandoned the plan thereafter.[252] Ingersoll Rand shareholders displayed a high, although insufficient, level of support in favor of re-domestication.[253] These developments suggest the importance of increased shareholder awareness of corporate governance changes brought about by inversion.

Management typically proposes an inversion only if the expatriation will maximize shareholder value. Recent scholarship suggests that the

---

[248]Shareholder approval percentages of inversions are very high, generally in the eighty-five to ninety-five percent range. *See* C. Bryan Cloyd et al., *Market Nonreaction to Inversions*, 98 TAX NOTES 259 (Jan. 13, 2003).

[249]In the most recent wave of corporate inversions, the corporate proxy statements appeared to be the exclusive source of information on changes in corporate governance.

[250]JOBS Act § 441(e) (adding § 14(i) of the Securities Exchange Act of 1934).

[251]At least two inverting corporations, Tyco and McDermott International, announced an expatriation review process in response to the CALPERS initiative. *See Robin Londner, Tyco to Consider Reincorporation, Auditors Removed*, S. FLA. BUS. J., Mar. 10, 2003); AFL-CIO Press Release, *McDermott and Institutional Investors Agree on Expatriate Review Process*, AFSCME NEWS, Apr. 1, 2003.

[252]For a description of the inversion and the share price fluctuations associated with it, see Desai & Hines, *supra* note 26.

[253]The Ingersoll Rand vote on re-domestication was supported by forty-five percent of the shareholders. This figure sharply contrasts with the original eighty-nine percent vote in favor of inversion.

change of jurisdiction of incorporation may be based on different considerations from those that apply to the initial choice of the place of incorporation. American corporations prefer to reincorporate in Delaware for initial public offering because the choice of Delaware law adds measurable share value.[254] Subsequent change of the jurisdiction of incorporation by inversion appears to place less emphasis on shareholder value maximization than the pre-IPO choice of incorporation. Arguably, the loss of the protective framework and advantages of Delaware law through the subsequent change of the jurisdiction of incorporation may negatively impact shareholder value.[255] The desire to maximize shareholder value, therefore, may not be the only motivation for inversion.

Management may have different incentives for a decision to expatriate than the shareholders. The structure of the company's compensation plans or the inversion itself may result in management capturing a considerable portion of the future tax savings.[256] Furthermore, to the extent that share prices react positively to the inversion, managers may exercise their stock options, thereby diluting share values for existing shareholders.[257] The proposed JOBS Act targets this shortcoming by imposing an excise tax on stock compensation of insiders in certain inverted corporations.[258]

---

[254]*See* Robert Daines, *Does Delaware Law Improve Firm Value?* 62 J. FIN. ECON. 525, 532 (2001) (finding, based on empirical study, measurably higher value for Delaware corporations than for those incorporated in other states); Daines, *supra* note 149, at 1603-04 ("Delaware attracted the most firms and appears to have offered valuable legal rules and to be relatively unlikely to entrench incumbent managers. Delaware IPO firms were also more widely held, consistent with theories that Delaware improves governance and reduces agency costs in public firms.").

[255]There is no empirical evidence to suggest that share prices systematically increase in response to announcements of corporate inversions. *See* Cloyd et al., *supra* note 23. This study suggests among other possibilities that much of the tax saving may be captured by top management rather than the shareholders, and this as well as the loss of shareholder rights to take legal actions in the offshore jurisdiction may have negative valuation implication for the shares of inverting firms. But there is no consensus about share price reactions to inversions. *See* Desai & Hines, *supra* note 26, at 435 (finding mixed stock price reactions to inversion plan announcements, but concluding (based on their empirical data) that share prices are "consistent with careful tax planning on the part of inverting firms" and managers maximizing shareholder wealth rather than share prices).

[256]For example, the compensation plans for Nabors Industries were so structured that top management would capture eight percent of the tax savings resulting from the inversion. NABORS INDUS., REGISTRATION STATEMENT, *supra* note 34.

[257]*See* Cloyd et al., *supra* note 23.

[258]JOBS Act § 443 (adding I.R.C. § 5000A).

D. *Imperfect Enforcement of Measures Designed to Halt Inversion Type Transactions*

Corporate expatriations must have a "business purpose" in order to be respected as reorganizations for tax purposes. The business purpose requirement is elaborated in the judicially developed and statutorily confirmed business purpose doctrine.[259] Section 269 of the Internal Revenue Code also invokes business purposes to deny benefits and deductions of certain asset transfers unless the business reasons thereof outweigh their tax motivations. There are numerous reasons to question whether outbound corporate inversions satisfy these requirements.[260]

The inversion dramatically changes the tax liability of the inverted multinational without substantially altering its operation. The location of the corporate headquarters and economic operations, along with the corporation's business practices, remain unchanged. The inversion proxy statements emphasize that the inversion does not alter the operational structure of the inverted corporation. The inverted company maintains its attractiveness to investors because it maintains its access to the American capital markets, and its operations remain subject to the federal securities laws. While business operations continue unaffected, the entire tax structure of the inverted multinational changes. The inverted corporation achieves foreign status by filing for continuance in a tax haven jurisdiction. In order to be eligible for benefits under a bilateral income tax treaty, the inverted corporation also claims residence for treaty purposes in a third country through minimal contract with the jurisdiction.[261] Consequently, post-inversion payments between the USco and Bermudaco will be taxed under the regime of the bilateral United States-Barbados tax treaty.[262]

The dramatic difference between pre- and post-inversion tax treatment, in the absence of a corresponding operational or structural change, raises important tax policy concerns. On a general level, it is open to question whether these transactions should have been disregarded as shams. On a technical level, the question is why the regulatory tax

---

[259]Treas. Reg. § 1.368-2(g) (2000).

[260]NYSBA Report, *supra* note 15, at 135 (questioning whether inversions are shams because they "achieve a dramatic reduction in a U.S. company's U.S. tax liability without, in substance, affecting its ownership, headquarters, operations, or business practices").

[261]Under Barbados law, it will be sufficient for the expatriated corporation to conduct directors' meetings in Barbados to be able to claim residency. *See* Barbados-United States Income Tax Convention, *supra* note 16.

[262]U.S. bilateral income tax treaties exempt large public companies from the limitation on benefits article. *See* Sheppard, *supra* note 125.

measures designed to halt abusive tax transactions were not invoked to halt corporate inversions.

1. The Business Purpose Doctrine

The business purpose doctrine denies tax-free reorganization treatment to any transaction entered into solely for the purpose of achieving a particular tax result and not "for reasons germane to the continuance of the business of a corporation a party to the reorganization."[263] The transaction should not only meet the technical terms of the statute, but the reorganization must partake of those characteristics "which underlie the purpose of Congress in postponing tax liability."[264] While the mere presence of tax planning will not cause a reorganization to fail the business purpose requirement, the taxpayer bears the burden of proving a business purpose unrelated to the tax benefit.[265] The asserted business purpose need not be the principal motivation for the transaction or exceed the tax avoidance purpose in importance. The business purpose, nevertheless, must be real and substantial.[266]

The disclosure documents accompanying inversions have generally been vague in their description of the purposes for restructuring.[267] Inverting corporations often invoke a number of reasons in support of their decision to expatriate. Inverting corporations typically state that the inversion improves the inverting firm's global tax position by creating a new corporate structure that lowers the worldwide tax liability and effective tax rate. This purpose, however, is clearly tax-related. Inverters also argue that the tax savings will increase the capital that may be committed to international expansion. The increase in capital will (1) make the corporation more attractive to investors; (2) enhance its ability to compete with non-American firms; (3) enhance its ability to pursue business

---

[263]Treas. Reg. § 1.368-2(g) (2000).

[264]*See* Wortham Mach. Co. v. United States, 521 F.2d 160, 163 (10th Cir. 1975) (citing Bazley v. C.I.R., 331 U.S. 737, 741 (1947)).

[265]Gregory v. Helvering, 293 U.S. 465 (1935).

[266]*See, e.g.*, *Wortham Mach. Co.*, 521 F.2d at 163.

[267]Certain statements made in support of the proposed inversions are often unsubstantiated. For example, one inverting company asserted that an offshore holding company structure would be beneficial for a future sale of assets, but there was no indication of any contemplated asset sale. *See* TRITON ENERGY CORP., PROXY STATEMENT, *supra* note 34, at 10. Another inverter claimed that the post-inversion structure would offer a better framework for future strategic alliances when the corporation, in fact, had no plans for strategic alliances or acquisitions. *See* XOMA CORP., PROXY STATEMENT, *supra* note 48, at 11.

combinations with non-American entities; and (4) increase its visibility within the investment banking community.[268]

Due to the reduced tax liability generated by the change in tax status and eligibility for new tax reduction techniques, the inverted corporation will have a higher net economic value. This reasoning, however, views the economic benefits related to tax minimization as the ultimate business purpose of the transaction, thereby making a tax-reduction purpose a business purpose. This reasoning renders the business purpose doctrine ineffectual because any transaction that carries a tax saving enhances the value of the company or shareholder wealth.

A more useful test to discern the benefits of an outbound inversion would focus on the location of expansion potentials for the inverting corporation. The potential for economic growth outside the United States may necessitate a structure that is efficient from the inception of new foreign operations. Foreign expansion may require additional financing, which is more easily raised in a tax efficient corporate structure. As a result, the removal of active income generated by *future* foreign operations from the ambit of the United States' taxing jurisdiction could be considered more appropriate. The inversion would, nevertheless, remove business opportunities developed prior to the inversion from the reach of U.S. taxation.[269] Moreover, there seems to be no indication that inverting corporations show a higher growth in foreign income than the industry median.

These factors raise questions as to whether outbound inversion transactions comply with the business purpose doctrine.[270] But since these reorganizations do not enjoy entirely tax-free status, challenging the transaction for lack of business purpose may not always be effective. For example, if reorganization status were denied in a stock inversion, there would be little practical consequence because shareholders are taxed pursuant to Section 367(a). In the case of asset inversions and combined inversions, however, the denial of tax-free treatment for lack of a business purpose would carry additional tax liability. Asset inversions, fully taxable on the corporate level, are carried out without shareholder level tax. Combined inversions treat the transfer of assets to the newly-created American subsidiary in a drop down that is part of the reorganization as

---

[268] *See, e.g.*, FRUIT OF THE LOOM, INC., PROXY STATEMENT, *supra* note 34, at 11; TRITON ENERGY CORP., PROXY STATEMENT, *supra* note 34, at 10; XOMA CORP., PROXY STATEMENT, *supra* note 48, at 11.

[269] For the implications of the migration of business opportunities, see Hardy, *supra* note 122, at 531-32.

[270] *See* NYSBA Report, *supra* note 15, at 139.

non-taxable. The transfer of appreciated assets, therefore, would be rendered taxable if reorganization treatment would be denied based on absence of a valid business purpose.[271]

2. Section 269 of the Internal Revenue Code

An outbound corporate inversion that meets the standard of the business purpose doctrine may nevertheless be subject to review under Section 269 of the Internal Revenue Code.[272] Section 269(a) grants the IRS authority to disallow deductions, credits, or allowances, when a corporation directly or indirectly acquires the property of another corporation for the principal purpose of evading or avoiding federal income taxes.[273] Evasion or avoidance of federal income tax is the principal purpose of the transaction, if the transaction "exceeds in importance any other purpose."[274] The determination of the taxpayer's principal purpose is a question of fact, and the tax avoidance motive is examined against the aggregate of all legitimate business reasons. This complex, factual inquiry has caused Section 269 to be viewed as a weak countermeasure that fails to deter corporations from inverting.[275]

The rules on disallowance of tax benefits on primarily tax-motivated acquisitions of property appear to be well suited to deal with outbound corporate inversions. In fact, the legislative history of Section 269 confirms[276] that its objective was "to prevent the distortion through tax avoidance of the deduction, credit, or allowance provisions of the code."[277] An outbound corporate inversion, however, is a transaction directed toward more than the use of deductions, credits, and allowances. The transaction

---

[271] *See id.*

[272] Some commentators have accepted in principle that corporate inversions may, if contested, not withstand scrutiny under § 269 of the Internal Revenue Code. This seems to be the approach taken by the NYSBA Tax Section. *See also* Hicks, *supra* note 10 (stating that an inversion transaction may be subject to challenge under § 269, but without making any assessment as to the success of such challenge); Wollman, *supra* note 130 (voicing doubts on whether an inversion withstands scrutiny under I.R.C. § 269).

[273] I.R.C. § 269(a) (2002). The basis of the acquired property in the hands of the acquiring corporation must be "determined by reference to the basis in the hands of the transferor corporation." *Id.* This would normally be the case. For example, in outbound share inversions, in which no gain or loss is recognized at the corporate level, the asset basis of corporate assets carries over.

[274] Treas. Reg. § 1.269-3(a).

[275] NYSBA Report, *supra* note 15, at 139.

[276] The predecessor to § 269 originated in the Revenue Act of 1943. Following the enactment of the excess profits tax law in 1940, a market in loss companies developed, which § 269 was designed to deter. H.R. REP. NO. 871, 78th Cong., 1st Sess 49 (1943).

[277] S. REP. NO. 627, 78th Cong., 1st Sess. 58 (1943).

also alters the entire corporate structure. The penalty of Section 269, denial of deductions, allowances, and benefits obtained through the "principally" tax-motivated transaction, does not encompass the tax structuring involved in the inversion, in which the tax "benefit" is a switch from U.S.-based multinational status to foreign-based multinational status. It was suggested that the Section 269 "loophole" might be closed by continued treatment of the inverted corporation as a U.S. multinational.[278] Although this measure would deny "abusive" transactions the tax benefit, it would fall outside the terms of Section 269 without legislative amendment. The proposed JOBS Act does not address inversions merely by this technical measure.[279]

E. *The Tax Law's Flawed Conceptual Framework for the Taxation of Multinationals*

The inverted corporation claims a tax status that is entirely different from the one applicable prior to the inversion by virtue of a change of its tax residence. How does this change of residence occur when the operational structure of the corporation remains the same? The answer to this question is found in the conceptual framework of the U.S. tax system, which allows a corporation to claim a jurisdiction of residence by virtue of incorporation without regard for the location of its economic activities. Section 7701(a)(4) of the Internal Revenue Code states that a domestic corporation is a corporation created or organized under the laws of the United States.[280] This approach contrasts with the position taken by other common law jurisdictions, which adopt, as the criterion for residence, the location of the management and control of the multinational enterprise. In these jurisdictions, the residence of a corporation is determined in this manner by the location of the operational decisions.[281] Corporate

---

[278]This might take the form of denying recognition of the transfers of assets, thereby—within the general concept of § 269—denying the deductions, credits or allowances associated with their transfer. *See* NYSBA Report, *supra* note 15, at 139. The proposed JOBS Act would take a similar approach, though not in the context of § 269. *See infra* text accompanying note 283.

[279]*See* JOBS Act § 435 (amending I.R.C. § 269). The amendment extends the scope of § 269 to include acquisitions of property from controlled corporations; the amendment leaves unaffected the "principal purpose" requirement and the sanction of disallowance of "deduction, credit, or other allowance." *See also infra* text accompanying note 283.

[280]I.R.C. § 7701(a)(5) (2002) states that the term foreign, when applied to a corporation or partnership, means a corporation or partnership which is not domestic.

[281]Common law jurisdictions follow the U.K model. *See* Avi-Yonah, *supra* note 85, at 1793, 1797. The U.K. "management and control" test has recently supplemented the test with a place of incorporation test. *See* Rules of Procedure, SP1/90 Company residence, *available at* http://www.inlandrevenue.gov.uk/manuals/intmanual/INTM120140.htm (last visited Oct. 26,

inversions would be less attractive if they would imply some substantial restructuring of the corporation, not a mere change in filing jurisdiction. Under this approach, an inversion, in which operational decisions remained in the United States, would not change the tax residence of the inverting multinational. A multinational seeking recognition of its change of residence would, in effect, be required to shift the locus of its decision making, most likely the seat and residence of its board and top management, to the jurisdiction of inversion. This approach has been suggested as a long term solution to inversions that would remedy a conceptual inadequacy of the U.S. tax system.[282] The immediate solution is to treat corporations that invert after March 20, 2002 as continuing with their American corporate status.[283] If the JOBS Act is ultimately reconciled and enacted into law, then these corporations would continue to be treated as U.S. corporations deprived of the benefits targeted by the inversion.

VII. POLICY ISSUES RAISED BY OUTBOUND CORPORATE INVERSIONS

Outbound corporate inversions are viewed by some as appropriate actions to minimize the negative impact of U.S. tax laws that put American multinationals at a competitive disadvantage with foreign-based multinationals.[284] Other commentators view inversions as unpatriotic acts. On the spectrum of opinions marked by these extremes, there is a consensus that outbound corporate inversions negatively impact tax policy.

On a technical level, inversion transactions are designed to achieve objectives that are "outside the system Congress established for taxation of U.S. corporations."[285] The inverting corporation changes its status for tax law purposes without undergoing any substantial organizational and functional change. Tax status alterations of this magnitude that are not substantiated by business changes may undermine public confidence in the consistency and equity of the tax system. This potential lack of public confidence represents a serious risk to the U.S. tax system, which is based on voluntary compliance. Moreover, the inversion phenomenon highlights

---

2004).

[282]*See* NYSBA Report, *supra* note 15; Avi-Yonah, *supra* note 85; Lee Sheppard, *Preventing Corporate Inversions*, TAX NOTES (Apr. 1, 2002).

[283]JOBS Act § 441(a) (adding I.R.C. § 7874(a)).

[284]The position taken by a number of commentators might be summed up by the statement made by Senator Charles E. Grassley. At the announcement of remedial legislation dealing with inversion transactions, he questioned the morality of the transaction, not its legality. Press Briefing Memo on REPO Bill, Apr. 11, 2002, *reprinted in* DAILY TAX REP., Apr. 12, 2002, at L-11.

[285]NYSBA Report, *supra* note 15, at 134.

the deficiencies of the basic principles and conceptual framework of the tax system, gaps in the technical rules and imperfections in the enforcement mechanisms.

Tax commentators, who view inversions as a product of the deficiencies of the basic conceptual framework of the tax law, invariably emphasize that the types of tax reductions targeted through inversions may legitimately be achieved through other means. "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."[286] An acquisition of the American corporation by a foreign corporation may achieve the same result.[287] This reasoning views corporate expatriations as a response to the "disproportionate" tax burdens imposed on American multinationals. According to this approach,

> *The 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.*[288]

These conclusions are not supported by unequivocal statistical data.[289] Nevertheless, the Treasury Report seems to accept "the competitiveness excuse"[290]and use it to advocate for change in the U.S. foreign tax regime.

The competitive disadvantage excuse is based on the assumption that

---

[286]*Treasury Inversion Report*, *supra* note 3, ¶ 54. This technique was recently used by Accenture, Ltd. Prospectus/Registration Statement, July 19, 2001; Seagate Technology, Inc., Prospectus/Registration Statement, Apr. 20, 2002.

[287]*Treasury Inversion Report*, *supra* note 3.

[288]*Id.* ¶ 7 (emphasis added).

[289]A battle of statistics has developed around the question whether the "competitive disadvantage" faced by U.S. companies has caused or contributed to the proliferation of foreign takeovers of these companies. *See* COMM. ON WAYS AND MEANS, 107TH CONG., H.R. 5095, THE "AMERICAN COMPETITIVENESS AND ACCOUNTABILITY ACT OF 2002" (COMPETITIVENESS—INVERSIONS—TAX SHELTERS) SUMMARY OF LEGISLATION, *available at* http://www.waysandmeans.house.gov/legacy/fullcomm/107cong/hr5095/hr5095summary.htm (last visited Sept. 26, 2004) (on file with the Delaware Journal of Corporate Law); Organization of International Investment, *The Foreign Takeover Myth: Facts about Global M&A Activity and U.S. Companies Global Business Ranking*, WORLDWIDE TAX DAILY, July 26, 2002.

[290]*See* Avi Yonah, *supra* note 85 (referring to the "competitiveness excuse").

the United States asserts a more extensive taxing jurisdiction over the income of domestic companies than other countries. This argument is frequently used in conjunction with theories advancing the benefits of the territorial taxation.[291] The United States, however, is not unique in asserting jurisdiction over the worldwide income of multinationals headquartered within its jurisdiction and taxing their passive income through anti-deferral regimes.

Even if the argument of competitive disadvantage could withstand scrutiny on the basis of a comparison of effective tax rates, it is subject to other conceptual questions. The effective tax rate is only one of many factors relevant to corporate well-being and performance. A start-up business makes locational decisions determined by a variety of economic factors, while the decision to incorporate is often influenced by other criteria. For example, the preferred incorporation jurisdiction for a corporation that contemplates an IPO is usually one that offers legal certainty and transparency enhancing the value of the corporation. At incorporation, the entity elects a system of legal rules and administrative and judicial enforcement mechanisms. The corporation also elects the financial market structure of the jurisdiction in which it raises its capital. Relying solely on a comparison of tax regimes, therefore, may not be conclusive in evaluating the competitive position of U.S. corporations. Other economic benefits may be conferred upon a corporation because of its status as a U.S. corporation. These benefits may bestow a "competitive" advantage on a U.S.-based multinational, which would counterbalance "disadvantageous" tax treatment.[292] In response to the frequently expressed concern that U.S. tax rules operate as a disincentive to corporate location in the United States, one may ask whether these inverted corporations would have achieved the same economic success by starting their business initially in Bermuda. Upon their inversion, does the United States fully tax the value they accumulated as corporations? Approaching the argument from a different angle, it may be questioned whether attempts to "level the playing field" for American corporations through a reform of the international tax rules should also consider that tax treatment may not be the only incentive/disincentive for the location of multinationals. This appears to be specifically true in an era when major corporations become

---

[291]Inversions were labeled in this context as "self-help territoriality." *See Treasury Inversion Report*, *supra* note 3, ¶ 28. Some authors seem to disapprove entirely of the use of "territoriality rhetoric" in this context. Others argue that proposals to consider territorial taxation are appropriate with respect to active income.

[292]This question is in some respects analogous to asking whether there "[i]s a direct relationship between the competitiveness of U.S. multinationals and the competitiveness of the U.S. economy." Avi-Yonah, *supra* note 85, at 1795.

increasingly global and less connected with one base jurisdiction, thereby making it more difficult to answer the question "who is us."[293] These questions seem to be justified in conjunction with the principle of "benefit based taxation."[294]

VIII. CONCLUSION

Outbound corporate inversions could be facing the prospect of extinction. Heightened public attention, along with the threat of imminent legislation, halted the latest wave of expatriations. Although direct anti-inversion legislation has not yet been enacted, pending legislation addresses some inversion related issues. The larger policy questions that the corporate expatriation process has brought to light, however, will not disappear easily. In the world of multinational enterprises, the questions of taxing jurisdiction, economic benefit, and corporate governance remain fundamental.

---

[293]Robert Reich, *Who Is Us?* HARV. BUS. REV. 53 (Jan. 1990).

[294]The principle of "benefit based taxation" posits that the taxing jurisdiction asserted and exercised over a subject are based on the benefits bestowed on the subject by the taxing jurisdiction. Most recently, the principle was articulated by the Joint Committee of Taxation with respect to taxing jurisdiction over U.S. citizens.