A Broader View of Corporate Inversions: The Interplay of Tax, Corporate and Economic Implications

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Introduction

The way to obtain a considerable tax saving promptly and also to reduce the future tax liability of a U.S. multinational corporation is by inversion. Corporate inversions – referred to in the tax literature as "outbound corporate inversions" – are transactions through which the corporate structure of a U.S. based multinational group is altered so that a new foreign corporation, typically located in country with a low or no corporate income tax, replaces the existing U.S. parent corporation as the parent of the group. This restructuring converts the U.S. multinational corporation in a foreign multinational and establishes the foundation for subsequent transactions and restructurings thatsignificantly reduce the U.S. tax exposure of the corporate group. Corporate inversions became a noticeable phenomenon between 1998 and 2002, when a number of major U.S. multinational corporations decided to 'expatriate'. This wave of corporate expatriations raised considerable concern within the government and among tax professionals. In the debate that emerged, corporate expatriations were examined, sometimes broadly and sometimes from a narrow technical perspective, as tax motivated transactions with essentially tax implications.

This study attempts to shed some light on a less visible side of corporate expatriation transactions, namely their corporate governance implications. The conversion of the U.S.-based parent corporation of a multinational into a foreign corporation not only alters the tax exposure of the corporate group but also changes the law that governs intra-corporate relations. The change is likely to affect corporate governance standards and bring about a lack of certainty and transparency in monitoring these standards. In the post-Enron era, marked by legislative and administrative attempts to increase transparency of corporate governance, these changes raise issues of some concern. Corporate expatriations were, at least temporarily, halted by the threat of imminent legislation in the middle of year 2002. However, the core issues concerning these transactions did not disappear, and discussion of them may aid in understanding whether, how, and in what degree their regulation should be considered. This study will examine the legal and economic framework in which these transactions took place, from a novel perspective that extends beyond tax law implications. At its foundation will be analysis of the tax issues, since corporate expatriations are essentially tax motivated transactions, but the analysis will then extend to crucial non-tax implications of inversions.

Parts I and II offer an introduction to the corporate inversion phenomenon, presenting the history and forms of outbound corporate inversions. The inversion by itself is often but a first step in a complex corporate restructuring that is designed to minimize the multinational's tax exposure. Therefore, the inversion transaction is described in conjunction with the complementary transactions designed to fully carry out its objectives.

Part III focuses on the tax effects of inversion transactions. The inversion is designed to minimize effective U.S. taxes on international (foreign) of the inverted multinational and also to reduce its tax liability on U.S. source income through the use of base erosion techniques. Comparative analysis of these two objectives -- performed on the basis of data offered by current economic studies -- is important since each has separate and distinct tax policy implications. The inversion debate was from its inception marked by the position of the Treasury Department which emphasized the foreign tax saving aspect of corporate expatriations and the necessity for corresponding comprehensive reform of the international tax system.[1] Concern for the domestic tax base erosion potential of inversions was expressed with emphasis on technical tax rules. The

[1] For the Treasury's position on inversion transactions See "Corporate Inversion Transactions: Tax Policy Implication" Preliminary Treasury Report, May 17, 2002 (hereinafter the "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 "Tax Notes Today, June 7, 2002; "Statement by Deputy Treasury Secretary Kenneth W. Dam on Corporate Inversions and on Dispute with E.U. over Extraterritorial Income and Foreign Sales Corporation Provisions", Tax Core, Oct. 9, 2002.

objectives followed by inverters, and the international tax principles and technical tax rules that affect them are discussed in this part.

Part IV examines the corporate governance changes that occur as result of the inversion. The pre-inversion multinational's intra-corporate relations are generally governed by Delaware law. After the inversion, the governing corporate law is the law of the offshore jurisdiction where the corporate group continues, usually Bermuda. This part explores the corporate governance implications of this change through a comparative analysis of the director's basic duties and shareholder's options to monitor their performance.

The conclusion part offers an overview of the economic and legal framework that facilitated corporate inversion, focusing on transactional costs, capital market access, corporate decision-making and conceptual and technical tax law factors that contributed to the phenomenon. Here also, the tax policy implications of corporate inversions that underlay the analysis in this article will be summed up.

I. The History of Corporate Inversions.

Tax motivated corporate restructurings of U.S.-based multinational corporations, in which the U.S. parent corporation is replaced by a foreign corporation, thereby converting the entity into a foreign-based multinational, are a relatively recent practice. The first such major restructuring, which attracted significant attention by the IRS, was the 1983 McDermott transaction, discussed below, which took advantage of a gap in the Subpart F regime of the Internal Revenue Code to remove non-taxed passive income from U.S. taxing jurisdiction. The deficiency in the Subpart F rules identified by McDermott was promptly remedied by the adoption of a narrowly constrained section of the Code which denied the specific benefit that was the object of that transaction.

Then in 1994 another corporation found moving offshore tax effective. Helen of Troy inverted into a Bermuda corporation, based on the expectation of creating enhanced post-inversion stockholder value by achieving a the lower post-inversion effective tax rate.[2] The inversion transaction was so structured that it was not taxable to the inverting corporation's shareholders. Again, the IRS responded promptly, this time by adopting regulations making the gain on the exchange of shares in the inversion taxable, and thereby imposing a shareholder level "toll-charge" on corporate inversions. This shareholder level tax seemed to be an effective deterrent until 1998-1999 when the new wave of outbound inversions began. This third wave resulted in the offshore re-incorporation of 17 U.S. multinationals by the middle of the year 2002, and it was ultimately halted by the risk of imminent anti- inversion legislation; that legislation – the content of which is not readily predictable – remains forthcoming as this article is written).

The history of inversions is reported in detail elsewhere[3] and need not be repeated here. Nevertheless, some of the transactions that have been undertaken require discussion to allow an understanding of the effectiveness or ineffectiveness of the measures taken and those under consideration to address the tax and other issues raised by the inversion phenomenon.

The purpose and form of the McDermott transaction were very different from inversions as known today. Shareholders of McDermott exchanged their shares for stock of McDermott International, an existing Panamanian subsidiary with substantial earnings and profits, and ended up owning 90% of the latter corporation. The transaction apparently was deliberately structured to be taxable to allow exchanging shareholders to recognize loss on the exchange.[4] The inversion had the further benefit of removing from U.S. taxing jurisdiction the earnings that had been accumulated in McDermott International while it was a controlled foreign corporation (CFC).[5] Absent the inversion,

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[2] See text at note10, infra.

[3] For a complete account of the history of corporate inversions see D.R. Tillinghast, *Recent Developments In International Mergers Acquisitions and Restructurings* 72 Taxes 1061 (1994); H. Hicks, *Overview Of Inversion Transactions: Selected Historical, Contemporary and Transactional Perspectives*, 30 Tax Notes Int'l 899 (June 2, 2003).

[4] The details and objectives of the McDermott transaction are extensively described in Tillinghast, op. cit. supra note 3 at 1063.

[5] Following the inversion McDermott owned only about 10%, whereas former McDermott shareholders owned approximately 90%, of the stock of McDermott International.

the accumulated earnings would have been taxed to McDermott as a dividend under § 1248 upon the sale of the stock or the liquidation of McDermott International.[6] Since, in form, McDermott made no disposition of stock to which § 1248 could apply, those accumulated earnings had by this transaction been effectively removed from U.S. taxing jurisdiction.[8] In response to the transaction Congress adopted §1248(i) of the Code, which applies when a domestic corporation owns CFC stock and a shareholder exchanges stock of the domestic corporation for stock of the controlled foreign corporation.[9] The stock received in the exchange is treated as being issued to the domestic corporation and then transferred to its shareholders in a distribution in redemption or liquidation. The domestic corporation thus recognizes gain on the constructive distribution, resulting in a tax cost that neutralizes the benefits from a McDermott type transaction.

"The 1994 Helen of Troy transaction was the first of the modern wave of outbound inversions and has come to be regarded as the prototypical pure inversion transaction."[10] The transaction involved the tax-free exchange by Helen of Troy - U.S. shareholders of their shares for the shares of a newly established Bermuda corporation,

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[6] Unless otherwise indicated, all section references herein are to the Internal Revenue Code of 1986, as amended (the "Code").

[7] The IRS unsuccessfully sought redress arguing that McDermott shareholders received a taxable distribution from McDermott pursuant to Section 304(a). See Bhada v. Comm'r, 89 T.C. 959 (1987), aff'd 892 F 2d 39 (6th Cir. 1989)

[8] The IRS unsuccessfully sought redress arguing that McDermott shareholders received a taxable distribution from McDermott pursuant to Section 304(a). See Bhada v. Comm'r, 89 T.C. 959 (1987), aff'd 892 F. 2d 39 (6th Cir. 1989).

[9] The legislative history describes the McDermott transaction, but without specific reference as the type of targeted transaction. See Staff of the Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Reform Act of 1984*, 962 (1985).

[10] Report of New York State Bar Association, Tax Section, on Outbound Inversion Transactions, Tax Notes, July 1, 2002, 129 (hereinafter "The NYSBA Report").

Helen of Troy – Bermuda, in accordance with Code § 368(a)(1)(B). Under the rules then in effect § 367(a) did not apply to require recognition of gain on the exchange by the shareholders. Subsequent to the inversion Helen of Troy - Bermuda contributed its stock in the U.S. corporation to a Barbados corporation to obtain the benefit of the U.S.-Barbados income tax treaty for payments of interest or dividends originating from the U.S. corporation. At this point, however, Helen of Troy -U.S. and its shareholders had not yet removed themselves from the reach of the CFC rules. Subsequently, therefore, through a number of intra-group sales, the assets (operating assets/stock) of the U.S. corporation were transferred to affiliated corporations, including newly created Cayman Island and Hong Kong affiliates.[11] The income generated by these assets and operations ceased to be subject to the current inclusion rules of Subpart F. Similarly all future acquisitions could be structured through foreign (non CFC) affiliates to avoid the application of the Subpart F rules.

The IRS did not choose to attack the particular tax avoidance devices of the Helen of Troy transaction, [12] but instead it adopted regulations designed to prevent inversions *ab initio*.[13] Gains on all transfers by U.S. persons of stock or securities of a domestic corporation to a foreign corporation were made fully taxable under § 367(a) if the U.S. transferors owned in the aggregate 50% or more in vote or value of the transferee foreign corporation immediately after the exchange. Imposition of this "toll-charge" on the shareholders of the inverting corporation was based on the assumption that requiring the recognition of the built in gain on the stock would act as a deterrent against future inversions.

The shareholder level capital tax lost its deterrent function as stock market prices fell (resulting in potential losses, rather than gains, on inversion exchanges) and as the

[11] Tillinghast, op. cit. supra note 3 at 1065.

[12] NYSBA Report at 130.

[13] Notice 94-46, 1994-1 C.B. 356. The notice was examined in the NYSBA Tax Section, *Report on Notice 94-46 Relating To Certain Outbound Stock Transfers*, Tax Notes (Nov. 14, 1994) at 913. Temporary and proposed regulations implementing the notice were issued on December 26, 1995 (60 FR 66739 and 66771). Final regulations, which modified the temporary regulations only slightly, were issued in 1997; Treas. Reg. § 1.367(a)-3(c), T.D. 872, 1997-8 IRB 4.

market acceptance of inverted companies increased. Potential inverters begun to focus on the base erosion benefits of corporate inversions. The result was an unprecedented wave of outbound inversions between 1998 and 2002. Economic studies reveal that the inverting companies had a number of common characteristics. Inverting firms were considerably larger than the median firm in their industries, and had lower levels of leverage and higher overall effective tax rates than their industry average. Certain inverting firms belonged to the same industry category.[14] This pattern seems to suggest that tax savings resulting from outbound corporate expatriations offer strong incentives to expatriate for corporations with certain characteristics from the same industry group. In other words, inversion appears in part an issue of maintaining competitiveness with other inverted American corporations. These factors make clear that if the underlying reasons for inversion are not addressed, outbound inversion is might develop into a mass movement.

The mid-year 2002 abandonment of the proposed inversion of Stanley Works[15] brought the inversion debate to the center of public attention. Anti-inversion measures were suggested, some with retroactive effect.[16] These proposals alone were sufficient to halt inversion transactions at this point. The various legislative proposals have not yet materialized in a final regulatory measure, although the adoption of a law that deals with

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

[15]For a case study on The Stanley Works inversion, see M.A. Desai & J.R. Hines, *Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions*, 55 National Tax Journal 409 (2002).

[16] The legislative proposals intended to address some, many, or almost all aspects relating to inversions and similar transactions. These have included the REPO Bill (S. 2119), the RECAP Bill (S. 3120), the Wellstone Bill (S. 2050), the Corporate Patriot Enforcement Bill (H.R. 3884), the McInnis Bill (H.R. 3857), the Save America's Jobs Bill (H.R. 3922), the Uncle Sam Wants You Bill (H.R. 4756), the No Tax Breaks for Corporations Renouncing America Bill (H.R. 4993), and the American Competitiveness and Corporate Accountability Bill (H.R. 5095). These bills address as a group a wide range of issues, including preventing inversions, leveling the playing field, preventing the avoidance of U.S. tax on foreign income, and preventing the reduction of U.S. tax on domestic income.

the inversion phenomenon – whether directly or through its ancillary aspects – seems to be likely.[17]

II. The Form of the Transaction.

Since the core element of the inversion transaction is establishment of the parent corporation as a foreign corporation, the first step must be substitution of a foreign corporation for the existing U.S. parent corporation. This substitution may take a variety of forms.

The form of the inversion transaction may affect not only the immediate tax characteristics of the transaction, but also the corporate and disclosure mechanics that must be carried out in order for the transaction to be effected. It should be emphasized at the outset – as will be demonstrated later in the article – that the inversion transaction itself normally does not carry out the purposes for which inversion is undertaken. Rather, it only establishes the framework under which other and related transactions (such as asset and share transfers, recapitalizations, issuances of debt, creations of new subsidiaries, etc.) may be carried out. These related transactions, normally viewed as part of the inversion transaction itself, are examined separately at the end of this section of the article.

Nevertheless, the form of the initial transaction is crucial for a number of reasons. First, it sets the terms on which the *initial transaction* will be taxed, and thereby determines whether – and to what extent – the inverting company or its shareholders will need to pay up-front tax costs. Second, it may affect the nature of the corporate disclosure and corporate formalities necessary to undertake the transaction. Finally – and crucially for purposes of this article – it creates a new top-level corporate structure, which alters significantly not only the tax structure of the enterprise, but its corporate and regulatory structure as well.

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[17] The most current legislative proposal is contained in the FY 2004 Budget, released by the Administration on February 3, 2003 and it addresses the change of earnings stripping rules. The proposed Energy Tax Policy Act (H.R. 1531) contains a temporary moratorium on inversion transactions by treating inverting corporations as U.S. entities.

The principal forms of inversion are the so-called "share inversion", normally effected by means of a three-party ("triangular") merger, and the so-called "asset inversion", normally carried out by transfer of assets to a newly-created corporation. Alternatively, the transaction may combine aspects of share and asset inversion to achieve the desired top-level corporate structure. These three forms are described in detail below.

A. *"Share Inversions" through acquisition of the stock of the existing U.S. parent.*

The object of this form is to establish a new foreign corporation ("Newco") that becomes the parent of the existing U.S. corporation ("USco").[18] In its simplest form, this transaction might be achieved by having the USco shareholders exchange all of their stock for shares of Bermudaco – a classic "B" reorganization[19] – but unless USco is held by a small number of shareholders all of whom agree with the transaction,[20] this apparently simple procedure is unfeasible. The alternative, widely used in other reorganization and acquisition transactions in the United States, is the three-party merger, known generally as a "triangular" or "reverse triangular" merger, depending upon which corporation survives the transaction. Most of the reported share inversions, have taken

[18] Further changes in corporate structure, possibly including transfers among lower-tier corporations or change of the incorporation jurisdiction of lower-tier corporations, are likely to be essential to the plan of inversion. See text at note 55, infra.

[19] IRC § 368(a)(1)(B). As will be noted below, qualification for reorganization treatment at the *shareholder* level will be irrelevant, since gain recognition will be required by § 367(a). However, preservation of non-recognition at the *corporate* level is crucial, and therefore qualification as a reorganization is also crucial. The transaction might alternatively qualify for non-recognition treatment under § 351.

[20] The "B" reorganization would require that 80% or more of the stock of USco be exchanged "solely for" voting stock of Bermudaco. Achieving such an exchange with respect to the stock of a publicly-held corporation is normally very difficult, if not impossible, since it requires that the shareholders tender their shares for exchange.

the form of the reverse triangular merger, with the result that after the inversion, USco becomes a wholly-owned subsidiary of Bermudaco.[21]

The corporate law requirements to carry out the transaction are generally straightforward. The merger will require a vote of the shareholders of USco,[22] and the terms of the merger will be that shares of USco will become shares of Bermudaco, and USco will become a wholly-owned subsidiary of Bermudaco.[23] Since, as a publicly-held corporation, the stock of USco will be registered under the Securities Exchange Act of 1934, the vote of the shareholders of USco will fall under the proxy rules and the associated disclosure requirements.[24]

The reverse triangular merger, if qualified as a reorganization,[25] would normally result in nonrecognition of gain or loss by both the shareholders of USco and by USco itself.[26] However, the usual nonrecognition rules applicable to reorganizations are substantially modified when the reorganization involves a foreign corporation (i.e., when it includes an outbound transfer of assets or stock). In that case, the shareholders will be required to recognize any realized gain on the exchange, but will nevertheless be denied the ability to recognize any loss thereon.[27] Therefore, when the shares of USco have

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[21] Share inversions include Helen of Troy Ltd., Prospectus/Proxy Statement January 5, 1994; Triton Energy Corporation, Prospectus/Proxy Statement February 23, 1996; Fruit of the Loom, Inc., Prospectus/Proxy Statement October 15, 1998; Everest Group Re. Ltd. Proxy Statement/Prospectus January 2000; Nabors Industries, Prospectus/Proxy Statement March 22, 2002; Weatherford Industries, Inc., Prospectus/Proxy Statement April 5, 2002.

[22] See, e.g., Del. Gen. Corp. L. § 251(c).

[23] See Del. Gen. Corp. L. § 251(b)(5), which allows the merger agreement to provide for conversion of the shares of a constituent corporation to a merger into "cash, property, rights or securities of any other corporation or entity."

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

[25] See IRC § 368(a)(2)(E).

[26] IRC § 354 (nonrecognition by exchanging shareholders); IRC §§ 361, 362 (nonrecognition by corporations).

[27] Treas. Reg. § 1.367(a)-3(c). These are the regulations, discussed earlier – see text at note 13, supra – that were adopted in response to the Helen of Troy transaction.

substantially appreciated prior to the planned share inversion, it would appear that shareholders will pay – as the price or "toll charge" of the inversion – potentially significant taxes on their gains. On the other side, when the shares of USco have substantially declined in price prior to the planned share inversion, it would appear that shareholders would lose the immediate benefit of recognizing any losses on the exchange.

A closer examination of the share ownership of inverting corporations may raise questions about these initial conclusions. Of course, in periods of stock market decline, the inversion is likely to produce no gain for the exchanging shareholders; moreover, appropriate tax planning – in particular, structuring the transaction to disqualify reorganization treatment[28] – can assure that shareholders are able to recognize any realized losses. But even in periods of stock appreciation, it can normally be expected that 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 so-called "zero bracket" institutional investors[29] – such as pension funds – that pay no taxes on current income or capital gains. Second, a significant portion of the stock is usually held by short-term traders, whose basis (purchase price) is often at or close to the market. Third, when the former U.S. parent has a relatively small group of founding shareholders, who own significant blocks of appreciated stock, the exchangeable share technique might be used to postpone the shareholder level tax.[30] Finally, some long-term holdings are usually held by the heirs of the original purchasers, with the result that the basis of the stock in their hands – though not necessarily at the current market price – is nevertheless considerably higher than its

[28] One of several ways to assure non-reorganization status is to structure the transaction as a disqualified, or "broken" reverse triangular merger under IRC §368(a)(2)(E). This is readily achieved, for example, by issuing in excess of 20% "boot" in the transaction.

[29] See the discussion at note 191, infra.

[30] These transactions allowed U.S. shareholders to exchange their stock in USco for units, each consisting of a stock of Bermudaco and one share of convertible preferred in USco. The recognition of the gain allocated to the newly issued exchangeable stock is postponed until the effective exchange into Bermudaco stock. This technique was used by Fruit of the Loom, Gold and Triton Energy. See Hicks, op cit supra note 3 at 910-911.

original purchase price.[31] In short, the threat of a "toll charge" is not likely, in most circumstances, to act as a significant deterrent to an inversion transaction, since most shareholders will not have to pay it.

B. *Asset inversions*

In contrast to share inversions that partially change the corporate structure, by superimposing a foreign corporation over the existing U.S. corporation, an asset inversion is a complete corporate restructuring that eliminates the former U.S. parent (USco) and replaces it with the new foreign parent corporation (Bermudaco). Foreign corporations held directly in a chain by USco prior to inversion are controlled foreign corporations (CFCs) which therefore generate a U.S. tax liability on USco with respect to certain categories of passive or highly mobile types of income, i.e., Subpart F income. When USco is converted into a non-CFC foreign corporation[32] these foreign subsidiaries held in the chain are also converted, eliminating any Subpart F exposure with respect to the income of these companies.[33] However, while this type of inversion may de-control more controlled foreign corporations than a share inversion, it does so at a significant corporate tax cost.

For corporate law purposes, an asset inversion is typically carried out as a two step reincorporation. First, USco –generally a Delaware corporation -- re-incorporates in a state that does not require a 100% shareholder approval for a domestic-to-foreign reincorporation,[34] and then it "continues" or reincorporates in a foreign jurisdiction. The

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[31] See IRC § 1014, which provides for a step-up in basis with respect to stock passing through a decedent's estate.

[32] The new foreign parent corporation is publicly held which will facilitate the avoidance of CFC shareholder status for its shareholders. The anti-deferral rules are examined below: see text at note 88, infra.

[33] Controlled foreign corporations held through U.S. subsidiaries will, however, retain their CFC status after the transactions.

[34] See, e.g., Ariz. Rev. Stat. §§ 10-3226 (transfer of domicile of corporation), 10-1003 (majority shareholder vote required, as in amendments of articles of incorporation) (2003); Tex. Bus. Corp. Act arts. 5.17 – 5.20 (conversion), 5.03 (two-thirds shareholder vote required, as in a merger) (2003);

U.S.- foreign reincorporation cannot be carried out through the use of the Delaware continuation procedure, with the consequence that the advantages of Delaware law are lost at this point.[35] The second step of the transaction may be facilitated if the jurisdiction has a statutorily recognized continuation procedure. Bermuda, the preferred target destination of inverting corporations, has such a continuation statute.[36] As a result of the transaction USco is automatically converted into Bermudaco, the new Bermuda parent, and USco's outstanding stock is automatically converted into stock of Bermudaco.[37]

The transaction carries a substantial tax cost. For federal income tax purposes the continuation should qualify as an F reorganization,[38] provided it meets the technical and doctrinal requirements thereof. The reorganization must meet the continuity of interest and continuity of business enterprise tests and have a valid business purpose. While the transaction would normally meet the continuity tests, a potential issue, given the prominence of U.S. tax planning, is whether the transaction has a valid business purpose. Asset inversions undertaken to date seem to have assumed that the business purpose test was satisfied,[40] despite what appear – on the face of the disclosure documents – to be essentially exclusively tax-saving motivations. The business purpose test is particularly

[35] 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. Del. Gen. Corp. L. §390.

[36] § 132C 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 and financial statements, and payment of a fee. For the analogous Cayman Islands continuation procedure, see § 222 Cayman Islands Company Law (2001 revision).

[37] Examples of this type of transactions include Xoma Corporation, Prospectus/Proxy Statement, November 30, 1998; White Mountain Insurance Group, Prospectus/Proxy Statement, September 23, 1999.

[38] Alternatively, the transaction might qualify as a C or non-divisive D reorganization.

[40] Commentators have raised the question whether asset inversions would qualify as valid F reorganizations in the absence of a compelling business purpose. See, e.g., NYSBA Report at 138; Hicks, op. cit. supra note 3 at 912.

important: if that requirement is not met, the reincorporation will be taxed at both shareholder and corporate level.

If the reincorporation qualifies as an F, C or non-divisive D reorganization, the shareholders of USco should be entitled to non-recognition of gain or loss on the transaction,[41] and § 367(a) will not impose any tax at the shareholder level.[42] However, the reincorporation is fully taxable to USco at the corporate level, since the reorganization involves a deemed transfer of assets by USco to Bermudaco. USco, the former U.S. parent, is effectively treated as having sold all its assets to Bermudaco, the new Bermuda corporation. This outbound asset transfer is taxable.[43] If USco owned controlled foreign corporations, it will also incur dividend income as result of the deemed sales of the stock thereof pursuant to § 1248.

This high tax cost is likely to make asset inversion impracticable in the absence of offsetting tax attributes. When USco has offsetting tax attributes – such as net operating losses or excess foreign tax credits – the § 367(a) tax cost may be minimized. Because of the costs, asset inversions have been infrequently chosen as a form of corporate restructuring. Not surprisingly corporations that inverted using this structure – White Mountain Insurance[44] and Xoma[45] – chose this structure since they incurred minimal or no tax cost through the use of offsetting tax attributes..

C. *Combined Inversions*

[41] IRC § 354(a).

[42] In the absence of an "indirect stock transfer" an outbound F reorganization does not involve a § 354 stock transfer that is subject to § 367(a).

[43] § 367(a)(5) provides that an outbound C, D or F reorganization may not be rendered tax-exempt by § 367(a)(2) and § 367(a)(3), and therefore the transfer is fully taxable under § 367(a).

[44] Tax cost were estimated to be between \$5 million and \$20 million. White Mountain Insurance Group, Prospectus/Proxy Statement, September 23, 1999.

[45] Xoma corporation had accumulated considerable net operating losses prior to the inversion. This trend was expected to change with the imminent approval of a new product developed by the company. The inversion was scheduled to occur while the corporation was still a loss corporation. Xoma Corporation, Prospectus/Proxy Statement, November 30, 1998.

Combined inversions bring together elements of both share inversions and asset inversions.[46] The intention is to combine the various transactions to minimize the overall tax costs while attaining optimal tax efficiency. The first step of the transaction is structured in substantially the same way as an asset inversion. The parent corporation (USco) reincorporates in a U.S. jurisdiction that allows U.S.-to-foreign reincorporation without unanimous shareholder consent, and subsequently "continues" by reincorporation (e.g., as Bermudaco) in a foreign jurisdiction. The second step of the transaction consist of the transfer of certain assets deemed received by Bermudaco to a newly formed U.S. subsidiary (USnewsub) in exchange for the stock of USnewsub. The choice of the assets 're-transferred' to USnewsub depends on the overall mix of the assets originally held by USco, the appreciation of the assets and the availability of tax attributes that may offset the gain inherent in appreciated assets. Assets without a significant built-in gain (e.g. recently purchased foreign subsidiaries, financial instruments) will generally be retained by Bermudaco. By contrast, appreciated assets and U.S. assets will generally be re-transferred to USnewsub.

The initial continuation of USco, structured as an F, C or nondivisive D reorganization, is a taxable transaction at the USco corporate level, as seen in the case of asset inversions. However, the asset drop-down changes the character and the tax consequences of a portion of the transaction.

Related asset drop-downs may occur in certain reorganizations without affecting the characterization of the top tier reorganization.[47] Combined transactions have traditionally been treated as an outbound C reorganizations followed by a § 368(a)(2)(C) drop.[48] In the first step, USco reincorporates abroad directly, or through a jurisdiction that facilitates reincorporation without unanimous shareholder consent. This step is

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[46] The NYSBA Report, at p. 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." This transaction is also referred to as a "drop down transaction;" see Treasury Inversion Report at ¶ 17.

[47] See IRC § 368(a)(2)(C), which on its face is applicable only to A, B, C and G reorganizations.

[48] Examples of this type of transaction include TransOcean Offshore, Prospectus/Proxy Statement April 12, 1999; Foster Wheeler Corporation, Prospectus/Proxy Statement, March 9, 2001.

analogous to the asset inversion. In the second step, as part of the same transaction, the offshore parent corporation drops some of its assets to USnewsub, the newly formed U.S. subsidiary. The transaction might be characterized as an outbound D reorganization followed by a § 368(2)(C) type drop.[50]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.[51]

The overall transaction is viewed as containing two elements: (a) an outbound transfer by USco of all its assets to Bermudaco, *except those assets deemed re-transferred to USnewsub*, and (b) an indirect outbound transfer by the shareholders of USco of domestic stock – *the stock of USnewsub as a partial successor of USco* – to the extent of the assets retransferred by Bermudaco to USnewsub. Accordingly, the transaction generates tax at both the shareholder and the U.S. parent corporation level. The assets retained by Bermudaco (the new offshore parent) are considered transferred in an outbound asset transfer, with gain recognition by USco (the formerU.S. parent).[52] The other part of the transaction -- the deemed exchange of stock by U.S. shareholder to the extent of assets deemed 're-transferred' to USnewsub (the newly created U.S. subsidiary), generates tax liability at the shareholder level.[53] The resulting corporate level tax may be minimized by limiting the assets effectively transferred to Bermudaco to those without substantial built-in gain and by the use of offsetting tax attributes. The shareholder level tax might be less significant to the extent that the shareholder base contains tax exempt investors or the share prices reflect built-in losses.[54] Because of the

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[49] § 368(a)(1)(C)

[50] See Rev. Rul. 2002-85, 2002-52 IRB 968, confirming that a subsequent drop-down will not disqualify a D reorganization.

[51] For the characterization of these transaction See Hicks, op. cit supra note 3 at 913-915; NYSBA Report at ¶ 17.

[52] IRC § 367(a)(5).

[53] Treas. Reg. §1.367(a)-3(c).

[54] It has been suggested that the shareholder level tax liability can be reduced if USnewsub assumes liabilities of USco which will drive down the value of USnewsub. See Hicks, op. cit. supra note 3 at 915.

tax costs that are imposed at both shareholder and corporate level, and the complexity imposed by the tax planning techniques designed to minimize these costs, combined inversions are relatively infrequent forms of outbound corporate restructuring.

D. *Associated transactions to carry out the objectives of outbound corporate restructuring.*

Generally, the inversion in and of itself does not carry out completely the objectives of the outbound corporate restructuring. Inversions aim to minimize tax liability on foreign source income and reduce tax liability on U.S. source income. These objectives, their relative importance and the legal framework in which they operate will be examined in detail in the next part of this article. The first objective of an inversion is to restructure the multinational to minimize tax exposure on income earned abroad. In order to achieve this objective the inversion is often combined with related CFC and other restructuring. The second objective is to reduce tax liability on U.S. source income. In order to achieve this objective the inversion is frequently accompanied by base erosion techniques.

(1) Controlled foreign corporation restructuring.

The United States subjects to current taxation, through its anti-deferral rules, certain types of income earned abroad by foreign subsidiaries of the U.S. multinational which qualify as controlled foreign corporations .[55] The inversion transaction has the objective of elimination or reduction of this taxation by decontrolling the foreign subsidiaries through transferring their ownership to the foreign parent or sister corporations.

However, the share inversion by itself does not produce any change in the status of the existing controlled foreign corporations. The transaction merely superimposes a new offshore parent over the pre-inversion U.S. parent, which, absent any other restructuring, continues to hold all existing foreign subsidiaries. Of course, newly

[55] The operation of the anti-deferral rules to the extent necessary for an understanding of viewpoints developed in the inversion debate is discussed at text at note 88 infra.

established foreign operations can be structured to be held directly by the new Bermuda parent corporation with no U.S. tax liability attaching.

Asset inversions, by contrast, de-control all foreign subsidiaries held directly or through a chain of CFCs, by eliminating the pre-inversion U.S. parent corporation and replacing it by the new Bermuda parent. However, to the extent that U.S. corporations are maintained in the chain of ownership (i.e., U.S. subsidiaries of the pre-inversion U.S. parent) tax liability may still attach with respect to the foreign subsidiaries held directly in the chain by these U.S. corporations. Thus the asset inversion is likely to de-control all or a part of the foreign subsidiaries, but – as we have seen – at considerable tax cost.

The combination inversion contains elements of both inversions. This transaction may de-control certain foreign subsidiaries by keeping them, after the initial outbound transfer of assets, at the Bermuda parent level and not re-contributing them to the newly created U.S. subsidiary.

In short, the basic inversion transaction often leaves many CFCs still subject to the U.S. anti- deferral regime. Therefore companies undertaking inversions often engage – simultaneously with or subsequently to the inversion -- in transactions designed to restructure their CFC ownership and foreign operations.

A preferred technique for de-controlling CFCs as part of a stock-inversion transaction has been the creation of a cross-ownership structure through the use of so-called "hook" or "tail-and-hook" stock.[56] In this transaction USco (the former U.S. parent corporation, now a subsidiary of Bermudaco) transfers stock of the foreign CFCs to Bermudaco or to a foreign affiliate thereof. Immediately before 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 of Bermudaco. The stock received in the exchange is non-voting stock that carries the same rights as the common stock received by USco's shareholders in the stock inversion.[57] The resulting structure is open to

[56] Examples of this type of transaction include Ingersoll Rand Company, Ltd., Prospectus/Proxy Statement, December 2001; Coopers Industries Inc., Registration Statement, March 8, 2002.

[57] See Treasury Inversion Report at ¶19.

possible criticism, since it results in cross-ownership: USco becomes both a stockholder and a subsidiary of Bermudaco.[58]

Disclosures have generally taken the position that a share inversion accompanied by a transfer of CFCs for tail-and-hook stock does not generate a substantial tax liability at the corporate level, without providing any further explanation. The public disclosure documents are ambiguous about the characterization of these transactions. The transfer may take the form of a contribution of property under § 351 of the Code, provided the statutory conditions are met.[59] The basis for this position would appear to be that a single § 351 transaction occurs, consisting of two parts. One 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 have control of Bermudaco immediately after the transfers within § 368(c) and therefore, arguably, qualify as § 351 transferors. If this characterization is respected, USco is deemed to have exchanged foreign stock for foreign stock in a § 351 transaction, without having incurred tax liability (except the § 1248 amount, if any, embedded in the transferred shares) provided it enters into a gain recognition agreement. Alternatively the proxy statements may make the factual assumption that, absent a transaction that warrants non-recognition treatment, the fair market value of the stock received in the exchange (i.e. the amount realized in the exchange) is not materially greater than the basis of the stock given up in the exchange.[60] There is some ambiguity in the basis of the positions taken by the companies and commentators.

CFCs may also be de-controlled through transactions that occur after the completion of the (share or combined) inversion. The stock of the foreign corporation

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[58] 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 was raised with respect to the inversion of Ingersoll-Rand which put in place a tail-and-hook structure in which 45% of Bermudaco was owned by USco and its U.S. subsidiaries.

[59] See NYSBA Report at 133. IRC § 351 allows tax free contribution of property to a controlled corporation.

[60] See Coopers Industries, Inc., Registration Statement, March 8, 2002. asserting that the stock received in the exchange had the same value.

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 seems to be the most frequently contemplated technique for de-controlling CFCs post-inversion.[61] 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 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.[62]

(2) Transactions to optimize U.S. base erosion.

Inversions are often accompanied by transactions that involve the creation of inter-company indebtedness, generating future interest expense that reduces the taxable income for the U.S. members of the post-inversion multinational. Several techniques are available to inject tax efficient leverage into the inverted corporation. These techniques have been discussed elsewhere in detail and therefore, we will refer only to a few that are frequently used.[63]

One technique that USco may employ is to contribute an existing (high basis intercompany) loan to Bermudaco in exchange for a second class of Bermudaco common stock. This type of transaction will likely involve stock with characteristics similar to the tail-and-hook stock used to de-control CFCs (i.e. stock that carries rights similar to other common stock, but restricted voting power). Alternatively, 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 U.S. corporation or corporations, thereby reducing taxable U.S. income.

III.` The Tax Effects of Corporate Inversion

A. *Introduction.*

[61] See Fruit of the Loom, Prospectus/Proxy Statement supra note 23, TransOcean Offshore, Prospectus/Proxy Statement, supra 48.

[62] See, e.g. Del. Gen. Corp. L. § 271(a) (requiring majority shareholder vote).

[63] See Hicks, op. cit. supra note 3 at 916-919.

An outbound corporate inversion has been described as a technically complicated but operationally essentially transparent transaction.[64] It does not bring about any meaningful change in the management or operations of the multinational corporation. While the inverted corporation has a new residence for corporate law purposes in a low-tax or non-tax jurisdiction (usually Bermuda) and usually establishes residence for treaty tax purposes in a jurisdiction that allows access to the U.S. treaty network (usually Barbados) the locations of its economic operations worldwide remain unchanged. Furthermore, it is likely that the effective control of its operations continues to be exercised from the United States. SEC filings often explicitly state that the transaction does not carry any material change with respect to the operation and management of the inverted corporation.[65]

The inversion also does not bring about any change with respect to the inverted corporation's access to U.S. capital markets. Since foreign corporations that comply with the U.S. accounting and disclosure rules have direct access to the NYSE, the inverted corporation maintains its NYSE listing under the ticker symbol used prior to inversion.[67] The inverted corporation does not incur any substantial additional cost to maintain its NYSE listing. Moreover the corporations continues to be eligible for inclusion in the Standard & Poor's 500 index by virtue of its trading on the NYSE.[68] The inverted corporations' continued listing in the S&P 500 secures its eligibility for investment by index investors. The inverted corporations as Bermuda corporations would otherwise

[64] Treasury Inversion Report at ¶ 5..

[65] See, e.g., Cooper Industries, Inc., Registration Statement, supra note 56; Ingersoll-Rand, Prospectus/Proxy Statement, supra note 56.

[66] In contrast to the prior practice of trading through depository receipts.

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

[68] Continued listing in the S&P 500 was initially subject to ambiguity. Subsequently 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 www.standardpoors.com and www.spglobal.com

have no access to a system of indices, and would be excluded from an index investor's portfolio.[69]

Outbound corporate inversions are carried out for the purpose and with the expectation of obtaining considerable immediate and future tax savings.[70] The inverted corporation's tax liability on its foreign source income will decrease as result of the inversion. This effect will be referred to as *post-inversion tax saving on foreign source income*. Although theU.S. taxing jurisdiction extends over the worldwide operations of U.S. based multinationals, its taxing jurisdiction over foreign based multinationals is limited to their U.S. operations. The inverted corporation's tax liability on U.S. source income may also be reduced through certain base erosion techniques not available to U.S. multinationals. This effect will be referred to as *post inversion saving on U.S. source income*. Since the inverted corporation is taxed only on its U.S. source income, the inversion opens up the prospect of effectively reducing U.S. income through so-called earning stripping and through inter-company transactions which create foreign income and corresponding U.S. expense items. The expenses reduce U.S. taxable income, while the corresponding foreign income items are structured to fall outside the reach of the U.S. taxing jurisdiction.

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 raise concerns with respect to the removal of non U.S. source income from the ambit of U.S. worldwide taxation and the creation of what

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[69] Bermuda has no index system, as part of the global system of indices. Id. Studies estimating the effect of being listed by the S&P 500 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. R. J.Bos, *Event Study: Quantifying the Effect of Being Added to an S&P Index* (2002), available at www.spglobal.com/EventStudy.pdf

[70] E.g. Ingersoll-Rand reported an expected annual saving on U.S. taxes of $40 million; see Ingersoll-Rand Company, Ltd., Prospectus/Proxy Statement/, April 5, 2002. Cooper Industries expected a reduction of its effective tax rate by 12% - 17%, amounting to an expected annual saving of $54 million; see Coopers Industries, Ltd., Prospectus/Proxy Statement, July 27, 2001. Stanley Works reported an expected reduction of its effective tax rate by 7%- 9%, amounting to expected tax savings of $30 million; see Stanley Works, Prospectus/Proxy Statement, April 2, 2002.

has been called “self-help territoriality.”[71] It has been argued that these techniques are employed in response to the “competitive disadvantage” faced by U.S. multinationals because of the worldwide reach of U.S. taxing jurisdiction.[72] One suggested approach to this issue is reevaluation of the principles of international taxation. By contrast, post inversion tax savings on U.S. source income have as their objective diminution of the multinational’s taxable income from U.S. sources, achieved through the use of base erosion techniques, devices to reduce or erode the U.S. income tax base of the multinational. One solution to this problem that has been suggested is to eliminate the base erosion benefits for inverted corporations by strengthening already applicable technical tax rules.[73] Outbound corporate inversions appear to be clearly motivated by both objectives, and it is difficult to ascertain the relative importance of each.

Post inversion tax savings on foreign source income provide a quantifiable, although often distant future benefit. Inverting corporations disclose the estimates of this benefit and rely on this benefit to seek the approval of their shareholders. By contrast, the post-inversion tax savings on U.S. source income, which represent the most immediate benefit of the transaction, are not quantified and relied upon in the disclosure documents. There appear to be two reasons for this omission. First, it is a difficult and complex task to measure savings inherent in future inter-company transactions. Second, the expected tax saving are realized through the erosion of the U.S. tax base by employing tax avoidance techniques, and therefore their disclosure might not be the best strategy for the corporation wishing to protect its potential post-inversion tax savings.

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[71] See Treasury Inversion Report at ¶ 97.

[72] The competitive disadvantage faced by U.S. companies was brought to broad public attention as a result of the inversion debate. For a 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) (hereinafter, the “JCT Report on U.S. Competitiveness”). The competitiveness argument is addressed in the conclusion of this article, text at note 247, infra.

[73] A proposal for the reform of the earning stripping rules, IRC § 163(j), is in advanced stage if legislative consideration. See the Administration Year 2004 Budget Proposal.

[74] The post inversion tax savings on foreign source income may be a result of avoiding repatriation taxes or of avoiding the interest expense allocation rules. These are discussed below.

Earlier inversion transaction generally focused on the first benefit of the transaction, avoidance of U.S. tax on foreign income.[75] Subsequently it became clear that "notwithstanding the longer-term competitive 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".[76] Indeed, it has been argued that inversions would continue to be carried out even in the absence of potential savings on foreign source income.[77] In short, the post inversion reduction of tax on U.S. source income seems to be more important than the corporate disclosures suggest, and even when not emphasized therein, it may have a significant market effect.

Post inversion reduction of tax on foreign source income is a future benefit. Even the tax savings with respect to income on *existing* foreign operations held by the U.S. parent become available only when those foreign operations are removed from the U.S. holding company's reach. This often occurs – as previously described – as a second step, concomitantly with or subsequently to the stock inversion, and it may result in tax costs at the corporate level. Tax savings with respect to income on *future* foreign operations is likely to be realized without additional tax costs, as new foreign subsidiaries will be 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 is sufficient, in and of itself, to create a corporate structure in which inter-company transactions may be undertaken to reduce the U.S. tax base.

Empirical analysis of the share price changes associated with announcement of corporate inversions may shed some light on the reasons that motivate inverting corporations. One economic study[78] of corporate inversion performed a detailed

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[75] See NYSBA Report at 134. Notice 94-46 appeared to focus on the domestic corporation's removal of its foreign earnings from application of the anti-deferral rules of Subpart F and the NYSBA Report on Notice 94-46 focused on tax avoidance relating to "outbound investment".

[76] Treasury Inversion Report at ¶ 66.

[77] See R. S. Avi-Yonah, For *Haven's Sake: Reflections on Inversion Transactions*, 93 Tax Notes 1793 (2002).

[78] See Desai & Hines, op. cit. supra note 15.

empirical analysis of share price changes associated with the inversion announcement -- as well as the subsequent announcement to abandon the inversion plan -- of Stanley Works.[79] The study showed that the market reacted with a nearly $200 million increase in value to the inversion announcement, in which Stanley Works estimated thatpost inversion tax savings on foreign source income were likely to be in the $53-$83 million range.[80] It is likely that the market reaction factored in the expectation that Stanley Works 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.

The outbound corporate inversion changes the U.S. based multinational company into a foreign based multinational. This, in turn, creates the framework for (generally taxable) transactions that carry out the removal of foreign assets and foreign business activity from the existing U.S. corporate structure, thereby effectively eliminating U.S. taxes on any income they generate. Similarly, the inversion creates a corporate structure in which subsequently acquired assets and activities that generate foreign income can be located in the corporate structure outside the ambit 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.[81]

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[79] 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. See Desai & Hines op. cit supra.note 15 at 423.

[80] In its February 8 inversion announcement, Stanley Works disclosed that it expected a reduction of effective tax rate from the pre-inversion 35% to 22-23%. Id at 425-427.

[81] An analysis of the size and structure of inverting corporations may lead to the conclusion that post inversion tax savings on foreign source income is 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. Since the U.S. system of taxing the worldwide incomes of American companies is particularly costly for firms with sizable interest expenses, as well as

However, despite this general rule, the foreign tax exposure of a U.S. based multinational is a considerably more complex issue. The United States assertion of taxing jurisdiction over the worldwide (including foreign) income of U.S. companies is coupled with important tax policy objectives. One important objective is thatexcessive tax burdens not discourage U.S. corporations from optimizing their globaleconomic performance through foreign active investment. A competing objective, however, is that U.S. corporations should not be encouraged to locate their active investments in low tax foreign jurisdictions for primarily tax saving objectives.

Different policies apply to income realized from passive investment, which is highly mobile and has little or no connection with the underlying local economic activity. The incentive to hold and reinvest passive income in low tax jurisdictions is great, and it has little connection – apart from tax savings – with optimizing the global economic performance of the company. Therefore, protection of theU.S. tax base is warranted by recourse to an anti~~-~~ deferral regime – of a complexity matched by the complexity of the underlying transactions – thatimposes current taxation on certain types of passive income realized abroad by U.S. persons.[82]

Implementation of these different policies results in different tax treatment for active business income as opposed to passive income subject to the various deferral regimes. Accordingly the pre-inversion foreign income of a U.S. based multinational corporation that is effectively subject to U.S. taxation -- and thatmay therefore be removed through inversion -- includes (i) income from active business activities, subject to residual U.S. tax only upon repatriation, and (ii) 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

firms facing low foreign tax rates, this behavior is consistent with allocation rules playing an important role in the decision to give up U.S. identity. Desai & Hines, op. cit. supra note 15 at 427-430.

[82] The anti-deferral rules target, in principle, passive income. However, technically their reach is broader. This is considered below in the detailed discussion of passive/Subpart F income, text at note 88.

Analysis of the principles that underlie U.S. taxing jurisdiction is essential for an understanding of the motivations of a decision to invert. These principles, as well as the technical rules that purport to implement them, have frequently been questioned by tax scholars and practitioners in the course of the inversion debate. It has been argued that the policies supporting U.S. taxing jurisdiction of the worldwide income of U.S. based multinationals unduly discriminate against these corporations. Alternatively, while the policies may be sound, the technical rules that implement them undermine their objectives and place U.S. based multinationals at a competitive disadvantage.

The United States has a worldwide tax system.[83] Domestic corporations generally are taxed on all income, whether derived in the United States or abroad. 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 on such income is thus deferred until the repatriation. [84] The possibility of deferring taxes on income earned abroad until repatriation confers a valuable benefit on U.S. based multinationals with operations in low-tax foreign jurisdictions.[85] However, deferral is not without limitations: U.S. anti-deferral rules may cause the domestic parent corporation to be taxable on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed

[83] About one half of the OECD countries use a worldwide tax system. M. J. Graetz & P. W. Oostehuis, *Structuring an Exemption System for Foreign Income of U.S. Companies*, 54 National Tax Journal 771 (2001).

[84] As an example of the benefits offered through consider the case of an American corporation, P, with a foreign subsidiary, S, that earns $1,000 in a country with a 25 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. However P does not pay U.S. taxes on any part of the $350 earned abroad and retained by S. However, if S 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.

[85] 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 J. Buckley & A. Davis, *The ETI / Corporate Inversion Debate: Will Myths Prevail*", 27 Tax Notes Int'l 443, 446-47 (July 27, 2002).

as a dividend to the domestic parent corporation. The anti-deferral regime that has a direct impact on the operation of U.S. based multinationalsis the controlled foreign corporation rules of subpart F which causes certain income earned through their foreign subsidiaries to be currently taxable.[86] 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.[87]

Subpart F,[88] applicable to controlled foreign corporations and their shareholders, is the main anti-deferral regime of relevance to a U.S.-based multinational corporate group. A controlled foreign corporation is generally defined as any foreign corporation in which U.S. persons own --directly, indirectly, or constructively-- more than 50 percent of the corporation's stock, measured by vote or value,[89] considering for this purpose only those U.S. persons that own at least 10 percent of the stock.[90] Under the subpart F rules, the United States generally taxes the U.S. 10-percent shareholders of a controlled foreign corporation on their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), without regard to whether the income is distributed to them.[91]

Subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another.[92] It includes foreign base company income, insurance income, and certain income relating to international boycotts and other violations of public policy. Foreign base company income, in turn, consists of

[86] IRC §§ 951-964.

[87] IRC §§ 901- 902, § 960.

[88] IRC §§ 951-964.

[89] IRC § 957.

[90] Measured by vote only. See IRC § 951(b). Stock ownership is determined applying the constructive ownership rules of IRC § 958.

[91] IRC 951(a).

[92] See JCT Report on U.S. Competitiveness.

foreign personal holding company income, which includes passive income (e.g., dividends, interest, rents, and royalties), as well as a number of categories of non-passive income, including foreign base company sales income, foreign base company services income, foreign base company shipping income and foreign base company oil-related income.

To the extent that subpart F includes active income, as noted above[93] it has the effect of taxing non-repatriated *active* foreign income realized by U.S. corporations abroad, a result that appears to be contrary to the legislative intent of permitting deferral of taxation on active income until its repatriation.[94] The inversion debate focused attention on and criticized the reach of the anti-deferral regime over certain forms of active income.[95] This criticism applies particularly with respect to foreign base company sales and service income,[96] which are targeted by the anti-deferral rules on the rationale that tax considerations, rather than operational reasons, determine the corporate structure.[97] In this instance, the anti-deferral rules are aimed at sales and service income realized through a foreign subsidiary that does not have sufficient ties to its country of organization (likely a low tax jurisdiction) and that arguably is being used simply to keep the income out of the United States. However, while these corporate structures may have the effect of reducing or delaying the ultimate U.S. tax exposure of the parent on

[93] The Treasury Inversion Report at ¶ 5 singled out shipping in support of the criticisms leveled against the anti deferral regime in the context of outbound corporate inversions.

[94] See JTC Report on U.S. Competitiveness.

[95] Legislative proposals for excluding, with some exceptions, related party sales and service income from the subpart F regime are pending. See e.g. H.R. 2896.

[96] Income from sales of goods by a foreign corporation located in a foreign country that is neither the origin nor destination of the goods is subpart F income if the goods are either purchased from or sold to a related party. Similarly, income from services performed for or on behalf of a related party outside the foreign country in which the foreign corporation is organized is subpart F income.

[97] In the case of foreign base company sales income Congress was primarily concerned with income of a selling subsidiary "that has been separated from manufacturing activities of a relating corporation merely to obtain a lower rate of tax for the sales income". S. Rep. No. 1881 at 790.

repatriated foreign earnings, there are operational reasons for this type of structuring in an increasingly global marketplace, and they are increasingly common..

The U.S. parent corporation (in the absence of an inversion) is treated as having received a current distribution of the subpart F income of its controlled foreign corporations. In addition, the U.S. parent corporation is required to include currently in income for U.S. tax purposes its pro rata shares of the foreign controlled corporations' earnings invested in U.S. property.

(3) Operation of the foreign tax credit.

The United States generally provides a credit against U.S. income taxes for foreign income taxes paid or accrued.[98] 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 it receives an actual or deemed distribution of the underlying earnings from the foreign subsidiary.[99] The FTC serves the purpose of mitigating double taxation of foreign-source income without offsetting the U.S. tax on U.S.-source income.[100] Accordingly the FTC has two main constraints, namely (i) it is limited to the amount of the U.S. income tax liability on the taxpayer's foreign source income, and (ii) the taxpayer's foreign source income is determined according to principles of U.S. tax law, notably allocation of certain expenses

Since the foreign tax credit is intended to alleviate international double taxation, and not to reduce U.S. income taxes otherwise payable on worldwide income, the foreign tax credit is limited to the amount of the U.S. tax liability on foreign–source income.[101] When the taxpayer's foreign tax payments exceed the U.S. tax liabilities applicable to

[98] IRC § 901.

[99] IRC §§ 902, 960.

[100] IRC §§ 901, 904.

[101] For example, a U.S. corporation with $1,000 of foreign income that faces a U.S. tax rate of 35 percent has a foreign tax credit limit of $350 (35 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. However, if the corporation pays, for example, $400 of foreign taxes, it will be permitted to claim no more than $350 of foreign tax credit.

their foreign incomes the taxpayer is deemed to have "excess foreign tax credits." Taxpayers whose foreign tax payments are smaller than their foreign tax credit limits are said to 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.[102]

The foreign tax credit limitation is applied separately to different types of foreign-source income, in order to 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, then the earning of the untaxed or low-taxed passive income could expand the taxpayer's ability to claim a credit for the otherwise non-creditable excess foreign taxes paid to the high-tax jurisdiction, 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. Thus, the passive income and the active income are placed into separate limitation 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.[103] Present law provides nine separate baskets as a general matter, and effectively many more in situations in which various special rules apply.

(4) Further limitation on the FTC -- allocation of expenses.

The foreign tax credit, as noted above, is limited in amount to the U.S. tax liability on the taxpayers foreign source income. An essential component of determining the foreign source income for FTC calculation is the way in which it is affected by 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 and overhead expenses, are required to allocate these expenses

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[102] IRC § 904(c).

[103] IRC § 904(d)(2).

between domestic and foreign sources. The concept underlying this allocation process is that such functions as raising investment capital, generating innovations, and managing firm operations all contribute proportionately to themultinational's worldwide income. The intention of the U.S. allocation rules is to allow the tax benefit of the deductibility of such expenses against domestic income only to that portion of the expenses proportionately connected with producing income that is taxable by the United States. U.S. tax rules attempt to implement this principle by assigning a certain fraction of general expense items to domestic source, with the rest being assigned to foreign source, based on complex and ever–changing formulas.

Interest expenses are generally the largest of these allocable expenditure of U.S. based multinationals. Therefore the interest expense allocation rules are considered to be the single most relevant factor which distorts the availability of FTC. Under present law, interest expense that a U.S.-based multinational corporate group incurs in the United States is allocated to U.S. and foreign sources based on the gross assets located in the United States relative to those located abroad (measured either by basis or by fair market value), without regard to any interest expense that foreign corporations within the group may incur abroad.[104] Thus, a U.S.-based multinational with a significant portion of its assets overseas must allocate a significant portion of its U.S. interest expense against foreign-source income, thereby reducing the foreign tax credit limitation and thus the credits allowable. This allocation is required even if the foreign corporation undertakes its own debt financing abroad. Further, the allocation applies despite the fact that the interest expense incurred in 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.

The expenses that are allocated to foreign source reduce the magnitude of foreign income for the purpose of calculating the foreign tax credit limit. This is costly for firms with excess foreign tax credits, and not costly for firms with deficit foreign tax credits. Since interest expense is typically a firm's largest allocable expense, firms with heavily–taxed foreign income and considerable U.S. interest expenses are likely to incur

[104] IRC § 864(e); Temp. Reg. § 1.861-11T.

significant costs associated with the inability to receive the full benefits of interest expense deductions.

The availability of FTC may be reduced further by the taxpayer's foreign losses. If a taxpayer generates an overall foreign loss ("OFL") for the year -- whether as the result of business losses or expense allocations under U.S. tax rules -- it will not be able to claim foreign tax credits for that year, since it will have no foreign-source income and thus will have a foreign tax credit limitation of zero. Moreover, if the taxpayer does generate foreign-source income in later years, some portion of such income will be "recaptured," or re-characterized as U.S.-source, thus reducing the foreign tax credit limitation in later years.[105] The rationale for OFL recapture is that the foreign-source losses offset U.S.-source income in the year generated, thereby reducing the U.S. tax collected with respect to U.S.-source income. The U.S. fisc would not be made whole when the taxpayer subsequently earns foreign-source income if the U.S. taxes on such income were completely offset by foreign tax credits.

C. *Post-inversion savings on U.S. source income.*

(1) <u>The tax objectives.</u>

Outbound corporate inversions are typically accompanied by earning stripping and inter-company transactions designed to reduce the inverted corporation's U.S. source income.[106] Earning stripping is achieved when USco the pre-inversion parent, and/or U.S. subsidiaries of Bermudaco make deductible interest payments to BermudacoInter - company payments may take the form of management fees, licensing fees or royalties. The inversion transaction also creates the opportunity to reduce U.S. taxable income by moving assets and functions to an offshore parent or sister corporation. The inversion will also create a structure in which – even in the absence of a transfer– the foreign affiliates

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[105] IRC § 904(f). These rules also operate on a category-by-category basis.

[106] See Treasury Inversion Report at ¶¶ 63-66; NYSBA Report at 135.

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. [107]

Interest payments are likely to be the most significant method of reducing post inversion U.S. source income. Share inversion transactions, as earlier discussed, are often 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.[108] 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 even inconvenient. Indeed, 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.[109]

From a worldwide tax standpoint, the newly-injected leverage is designed to be tax efficient, based on at least three relevant factors: (1) deductibility of payments, (2) avoiding or minimizing U.S. withholding tax, (3) avoiding or minimizing local country income tax.[110] Stripping income out of the United States through, e.g., foreign related party debt will be effective only if the receipt of the interest payment generates less tax

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[107] NYSBA Report at 135. Income stripping may also occur where 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., D.R. Hardy, *Assignment of Corporate Opportunities: The Migration of Intangibles*, 100 Tax Notes 527 (July 28, 2003).

[108] Economists noted that inverting firms have lower leverage than their industry average before the inversion , but similar leverage afterward, suggesting that inverting firms increase leverage once a favorable tax structure is in place. C.B. Cloyd, L.F. Mills & C.D. Weaver, *Firm Valuation Effects of the Expatriation of U.S. Corporations to Tax Haven Countries*, J. American Taxation (forthcoming, 2003). For a presentation of the techniques used to inject additional leverage in the corporate structure, see Hicks, op. cit. supra note 3 at 916-918.

[109] See R.E. Culbertson & J.E. King, *Rules on Earning Stripping: Background, Structure and Treaty Interaction*, 29 Tax Notes Int'l 1161 (Mar. 24, 2003); L. Sheppard, *News Analysis: Preventing Corporate Inversions,Part 3*, Tax Notes (June 24, 2002).

[110] 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, op. cit. supra note 3 at 916.

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 30% withholding tax in the United States and they 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 payable to a recipient located in a tax haven jurisdiction with no corporate tax or a low corporate tax rate. 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 forinterest expense. The jurisdiction of choice in this respect is usually Bermuda, which has no corporate tax. Minimization or avoidance of U.S. withholding tax may be achieved if the payee (Bermudaco, the new parent corporation) takes advantage of special U.S. tax treaty provisions by becoming 'resident' in a country like Barbados. This structure is facilitated by the differences in the definition 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).[111]

(2) <u>Earning stripping through foreign related party debt.</u>

The potential to use foreign related party debt to reduce liability on U.S. source income – thereby eroding the U.S. tax base – is of course not unique to inversion transactions. Foreign based multinationals – whether created as such from their inception or by inversion – can use inter-company loans to reduce U.S. source taxable income. Concern about the effects of this technique prompted the enactment of IRC § 163(j) in 1989. The provision addresses these concerns by denying U.S. tax deductions for certain interest expense 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 expense exceeds 50% of its adjusted taxable income (computed by adding back net interest expense, depreciation, amortization and depletion and any net operating loss deduction).

[111] See Treasury Inversion Report at ¶ 38.

If the corporation exceeds these thresholds no deduction is allowed for interest in excess of the 50% limit that is paid to a related party and that is not subject to U.S. tax.[112]

The earning stripping rules of § 163(j) permit a substantial amount of base erosion before they kick in, since § 163(j) 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 with debt-equity ratios of 1.5 to 1 or lower.[113] This safe harbor allows companies from less leveraged industries to put in place inter-company financing solely for tax reasons, without the threat of loss of the interest deduction. The negative consequences of using a fixed debt-equity threshold under current law may be eliminated by examining the appropriateness of U.S. interest expense deductions in the context of the compared worldwide/U.S. leveraging of the multinational corporation. In evaluating whether the U.S. corporation in question is disproportionately leveraged relative to the corporate group it may be more appropriate to compare the debt equity ration of the U.S. corporation to the debt equity ration of the worldwide corporate group of which it is a part (determined without regard to inter-company indebtedness).[114]

(3) Earning stripping through other inter-company transactions.

A share inversion transaction is often accompanied or immediately followed by a transfer to the new foreign parent or a non-U.S. subsidiary of certain assets or subsidiary companies previously held in the direct ownership chain of the pre-inversion U.S. parent. This transfer may take the form of a dividend or a sale after the inversion is consummated. In addition to the transfer of stock of foreign subsidiaries or intangible and other assets, the inversion is likely to be accompanied by non-traceable transfers of business opportunities, which carry with them future income potential that has thereby

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[112] IRC § 163(j)(2). Special rules apply in the case of interest paid to an unrelated party on debt guaranteed by a related party -- IRC § 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 -- IRC § 163(j)(5)(B).

[113] See Treasury Inversion Report at ¶ 72.

[114] Recent legislative proposals targeted a review of the §163(j) earning stripping rules along these lines. For a summary and analysis of these proposals, see D.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).

been removed from the reach of U.S. taxation. These cross border transfers of subsidiaries and assets give rise to important valuation problems. A post inversion reduction of tax liabilities on the inverted corporations' U.S. source income may also be achieved through payment of royalties or management fees. These ongoing transactions similarly give rise to important income allocation issues. All these transfers put 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 arms' length standard is not applied or enforced, the income shifting that results can further significantly erode the U.S. tax base.[115]

One significant source of such payments, singled out by the Treasury Report on corporate inversions, is associated with the outbound transfer of intangible assets, which raise significant valuation issues.[116] While transactions between related entities are generally evaluated under an arm's length standard pursuant to the transfer pricing rules of § 482, the application of the standard is particularly difficult in the case of intangibles for several reasons. First, it is difficult to determine whether a transfer of a non-legally protected intangible, such as know how or business opportunity, has in fact occurred. Second, the transaction that removes the asset from the reach of U.S. taxing jurisdiction may be structured in different ways (e.g., fractional, territorial or time-limited licenses, joint venture or strategic alliance agreements, etc.) 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, in certain cases, fully comply with the arm's length principles of § 482 and still cause untaxed migration of value out of the taxing jurisdiction. The inversion creates the opportunity to shift functions to the offshore affiliate, and thereafter to impose an arm's length deductible charge for them which may include a profit element that will never be subject to U.S. tax.[117] To address the issue of

[115] IRC § 482.

[116] See Treasury Inversion Report at ¶¶ 80-83; Hardy, op. cit. supra note 107.

[117] NYSBA Report at 135.

untaxed transfer of value through inter-company transactions it has been proposed that post-inversion inter-company transactions be subject on a mandatory basis to § 482 scrutiny for a determined period.[118]

D. *Conclusion.*

The pre-inversion U.S. based multinational is taxable upon repatriation on its active income realized worldwide. By the application of the different anti-deferral regimes the multinational is also currently taxed on its passive income. In both cases the tax liability is supposed to be limited to an incremental tax that reflects the excess of the U.S. tax over the tax imposed by the foreign jurisdiction. In consequence, there should be no double taxation of the inverting corporation's foreign source income, an objective achieved through the operation of the complicated foreign tax credit mechanism. However, these general rules are modified in actual implementation, often resulting in effective double taxation of some portion of foreign source income. Moreover, the detail and complexity of compliance with the U.S. foreign tax system impose high compliance costs. Because the U.S. based multinational is taxed on its worldwide income, certain income allocation / stripping techniques that are available to foreign corporations will not be available to it.

IV. The Corporate Governance Effects of Corporate Inversion

A. *Introduction*

Generally, inversions are viewed by the initiating companies as being purely tax based transactions, with no significant changes to corporate governance. The principal sources of information on the details of inversion transactions – including their underlying motivations – are the proxy statements issued by the inverting corporations, seeking the required shareholder approval therefor, as filed under the proxy rules of the Securities and Exchange Act of 1934.[119] These proxy statements have generally described

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[118] Ibid. See also the REPO Bill.

[119] See Securities Exchange Act of 1934, as amended, § 12, 15 USC § 78o; Securities Exchange Act Regulation 14A: Solicitation of Proxies. Proxy statements and other filings are available on

the corporate governance changes to be brought about by the inversion – often including considerable detail – but they have not highlighted the substantive and practical aspects of corporate governance that might be changed as a result of the transaction.

The inversion proxy statements have generally assumed that post-inversion shareholder rights and protections, usually based on English law, remain essentially similar to those in place prior to the inversion. After an initial assertion to this effect, the statements proceed to an item-by-item comparison of the texts of the relevant corporate laws, comparing the law of the inverting corporation's state of incorporation – usually Delaware – with the law of the new residence jurisdiction, usually Bermuda. While these disclosures appear to be technically complete, the general lack of publicknowledge by U.S. shareholders of the operation of Bermuda law may leave those shareholders unaware of important differences from Delaware or other relevant U.S. state corporate law. Nevertheless, the one reported shareholder challenge to this form of disclosure under the federal securities laws proved unsuccessful.[121]

It should be noted at the outset that none of the inversion proposals suggested that the change of corporate domicile would yield substantial corporate, economic, market or financial advantages apart from tax savings. Indeed, as will be demonstrated below, it would be very difficult to find any such advantages. The issues raised here, however, are

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line through the SEC's EDGAR (Electronic Data Gathering, Analysis and Retrieval) system of filing and retrieval, at http://www.sec.gov/edgar/searchedgar/webusers.htm

[120] *Rosenberg et al v. Nabors Industries,* SD Texas, 2002 U.S. Dist. LEXIS 14255. 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 Section 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 US and Bermuda law provide substantially similar shareholder rights followed by a detailed comparison of the differences – did not violate the federal securities laws.

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the other side of the coin. What, if any, are the corporate governance *disadvantages* of the inversion. Until recently, there was a striking silence on this subject, but then an important shareholder group opened the discussion.

That there are important differences between the corporate laws – and that shareholders may not initially have been aware of them – is supported by the initiation of efforts by major institutional investors, including public pension funds, to re-domesticate several inverted companies. Beginning in 2001, a number of public pension funds began a movement to require inverted corporations to reconsider their decisions to expatriate.[122] The resulting disclosures revealed differences in corporate governance that had not previously been fully examined in the initial tax-centered inversion debate. A number of inverted corporations have since submitted re-domestication proposals to their shareholders, and while the votes in these cases were negative, supportfor re - domestication efforts appears to be on the increase.[123]

In the present post-Enron climate of heightened concern over corporate accountability, the fact that an inversion changes the law applicable to corporate rights, duties and responsibilities should not be neglected. What follows is an attempt, within the limits of available sources on Bermuda law, to inquire in depth into the nature and implications of these differences, which have so far escaped thoughtful study in the inversion debate.

B. *Comparison of Corporate Laws*

Bermuda has been the preferred destination of expatriating companies. In the most recent wave of inversions all but three companies were re-incorporated in

[122] The re-incorporation movement started through the effort of various California public pension funds, eg. 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 www.calpers.ca.gov

[123] 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 45% of shareholders supporting the initiative.

Bermuda.[124] Broadly, the core corporate governance issues center on whether and how the change to Bermuda law of the traded top tier corporation affects the rights of shareholders and the standards to which directors and officers will be held, in law and in practice. The comparison must extend beyond the words of the relevant statutes. Of central importance are the following factors:[125]

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 the commentary thereon.

4. The character of the legal system upon which the law is based, including its practices and traditions.

As will appear in the discussion that follows, comparison between Bermuda and Delaware poses some difficulties. These are associated with the absence or unavailability of case-law, court experience and commentary.

(1) <u>Delaware corporate law</u>

Most of the inverting corporations were incorporated – at the top tier – in Delaware. This is not surprising, since Delaware corporate law is characterized by a modern, regularly revised corporate statute, a sophisticated, efficient and specialized corporate judiciary, an extensive body of case-law precedent, and a multitude of practice and scholarly commentaries. The Delaware General Corporation Law drafted is subject to regular revision and amendment at the initiation of the Delaware Revision Commission.

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

[125] These factors, among others, are elaborated in two leading studies by Roberta Romano, the first examining reincorporation decisions, and the second reevaluating long-standing view concerning the basis for the initial choice of incorporation jurisdiction. See R. Romano, *The State Competition Debate in Corporate Law*, 8 Cardozo L. Rev. 709 (1987); R. 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 R. Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U.L. Rev. 1559 (2002).

For the past half century this has generated many important changes in the statute, often serving as the model for legislative revision in other states. The Delaware Revision Commission and the Delaware legislature can be relied upon to propose and adopt changes to the General Corporation Law to respond to current corporate developments and maintain it at the cutting edge of corporate legislation.

Unlike most other common law jurisdictions, Delaware has maintained separate courts for law and equity. This has particular relevance for corporate law, where the Delaware Chancery court has emerged as the leading specialized corporate law court in the United States. Delaware has followed the practice of appointing expert corporate practitioners to this court and the court itself has adopted rules that assure very rapid hearing and final determination of corporate cases.

By the mid 20th century Delaware had emerged as the dominant jurisdiction of incorporation of major American corporations, and its dominance remains unchallenged. As a result, a significant portion of American decisional and practical law and guidance with respect to corporations is Delaware based. Commentaries, interpretations and practical guidance on the meaning and operation of Delaware corporation law are in abundance.[126]

(2) Bermuda corporate law

While Delaware attracts corporations with its corporate law structure, Bermuda attracts corporations with its lack of corporate income tax. Bermuda law is designed to accommodate though its corporate law the influx of these corporations by granting them the status of exempted company and automatic continuation.[127] As of the end of year 2002 there were 12,000 exempted companies incorporated in Bermuda, most of which had no assets, personnel, operations or substantial economic ties with Bermuda. Under general conflict-of-laws principles, however, issues of corporate governance with respect

[126] See S.M. Bainbridge, *Corporation Law and Economics* 14-16 (2002); J.E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. Cinn. L. Rev. 1061 (2001).

[127] An "exempted company," though subject to the Companies Act, does not carry on business or own property within Bermuda, with limited exceptions. See generally §§127 - §132C Companies Act 1981; for the continuation procedure see §132C Companies Act 1981.

to these corporations would normally be decided on the basis of Bermuda corporate law. This principle remains applicable even when – as is the likely and usual case -- the relevant lawsuit is brought in a country other than Bermuda, and is based on act of directors or officers unconnected with Bermuda. Thus, when a Delaware corporation inverts, substituting a Bermuda corporation as the top tier, it abandons the previously applicable law and practice of Delaware, substituting in their place the corporate law and practice of Bermuda with respect to directors and officers.

The publicly available materials reveal a very sparse record of corporate litigation and precedent in Bermuda. There is similarly very little published commentary on Bermuda law or practice. Bermuda corporate law purports to be based on English law, but there is a very limited body of case law that interprets the meaning and application of the major aspects of Bermuda corporate law within the English law context.[129] As a result, at least to the outside observer, a comprehensive and detailed view of the meaning and the operation of Bermuda corporate law is unobtainable.[130] It is legitimate to ask, therefore, whether Bermuda law can offer effective guidelines to corporate executives on a day-to-day basis. Some sense of the opaqueness of the Bermuda law guidance will emerge from the analysis below, which in most instances must be limited to a discussion of the bare statutory language.

C. Comparative analysis of director's duties and liabilities

The duties of directors and officers under Delaware law are based principally on case law, rather than statutory language. The Delaware courts have consistently held that corporate directors and officers owe fiduciary duties of care and loyalty to the

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[128] Lawsuits brought against Tyco directors.

[129] See Stena Finance BV, et. al. v. Sea Containers Ltd., et. al., Civil Jurisdiction No. 178 of 1989 (Bermuda Sup. Ct.), which appears to be the only publicly-available reported case interpreting the extent of permissible derivative suits in Bermuda, interpreted under English law.

[130] Cases are written up in a the Royal Gazette, but only in summary form. A few Supreme Court decisions are reported in the West Indian Reports and a few Court of Appeal cases are reported in the British Guyana Supreme Court Reports of Decisions. This study cites decisions available through the only on-line, subscription server (http://www.bdalawreports.net), which contains selected case reports beginning in the 1980's.

corporations upon whose boards they serve. The duty of care, embodied in the "business judgment rule," has been extensively interpreted by the courts. The duty of loyalty, sweepingly described in the case law, [131] has been ameliorated by statutory procedures allowing effectuation of interested transactions. Bermuda law includes a broad statutory statement of these fiduciary obligations, and English company law – which Bermuda practice is expected to follow -- similarly recognizes the existence of a fiduciary relationship between directors and corporations. However, the absence of substantial Bermuda precedent or English interpretive application, combined with certain statutory differences between Delaware and Bermuda corporate law, have led advocates of re-domestication to doubt that Bermuda directors and officers can be held to comparable fiduciary duties applicable to their U.S. counterparts.

(1) <u>The duty of care</u>

The first aspect of the fiduciary obligation of directors and officers is the duty of care. Under Delaware law, the duty of care is subsumed under the business judgment rule, which holds that the courts will not enjoin a board decision, or impose personal liability upon members of the board based on that decision, provided the directors acted in good faith, without self interest, and on the basis of reasonable consideration of the reasonably available material information.[132] This remains true even if the decision was unwise, foolish, or even negligently undertaken.[133] The rule acts as a presumption that the directors acted on an informed basis, in good faith, and in the belief that their action was taken in the best interest of the corporation, in the absence of evidence of fraud, bad faith, or self-dealing.[134] Normally, the business judgment rule will result in substantial deference to directors' actions, even extending to negligence. However, the Delaware

[131] See, e.g., Guth v Loft, Inc., 5 A 2d. 503 (Del. 1939).

[132] See, e.g., Gagliardi v. Trifoods International, Inc., 683 A.2d 1049 (Del. Ch. 1996).

[133] Directors who pay no attention to corporate affairs will not be protected by the business judgment rule. See Aronson v. Lewis, 473 A.2d 805 (Del. 1984). Among the most widely-cited cases of director liability following flagrant inattention is a New Jersey decision, Francis v. United Jersey Bank, 87 N.J. 15, 432 A.2d 814 (1981).

[134] Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. 1989).

Supreme Court has held that gross negligence is not protected by the business judgment rule.[135]

Bermuda law similarly subjects the conduct of directors and officers to standards of care and loyalty.[136] The Bermuda standard appears as a statutory requirement under the heading of "duty of care of officers," but it contains two separate requirements. The first – that an officer act "honestly, in good faith, with a view to the best interests of the company" – will be further examined below. The second is the statutory standard of care, that the officer "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances."[137] Unlike Delaware, with its elaborated development of the 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 tests, the court is likely – based on English precedent – to consider the specific skills and knowledge available to the director through his education and experience.[138] On its face, with this limited judicial gloss, the applicable standard appears to be higher than Delaware's, apparently an ordinary negligence test taking into account the expertise of the director, as compared with a standard requiring gross negligence for the imposition of director liability. This may suggest, on first reading, that corporate inversion from Delaware to Bermuda results in an *increase* in the standard of care applicable to officers and directors. However, there remains the open question –

[135] 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., B. Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkum, 41 Bus. Law. 1 (1985); Wander & 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. Gen. Corp. L. § 102(b)(7), discussed in text at note 164, infra.

[136] § 2 Companies Act 1981, defines the term "officer" to include director.

[137] § 97 Companies Act 1981.

[138] See Focus Insurance Company, Ltd. v. Hardy, et al (Civil Appeal No. 15 of 1992): 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." Citing In re City Equitable Fire Insurance Company Limited, 1 Ch. 407 (UK Chancery, 1925).

not resolved in any substantial body of case law – how this standard will be applied in fact. Moreover, the exculpatory provisions permitted by Bermuda law – which may be adopted by inverting corporations – can render the apparently higher Bermuda standard academic. Finally, the effective unavailability of shareholder derivative actions to enforce the directors' standard of care leaves shareholders of the Bermuda corporation without effective remedies to protect their rights.[139] These considerations are discussed in subsequent sections of this article.

(2) <u>The duty of loyalty</u>

The second aspect of the fiduciary obligation of directors and officers is the duty of loyalty, which in general 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 (as in other states) has its principal application in constraining corporate transactions in which one or more members of the board are "interested."

As a general rule a director is "interested" in a corporate decision when there are factors weighing upon hisindependent exercise of judgment thatare inconsistent with uncompromised loyalty to the corporate interests. Decisions in Delaware (and other states) have interpreted "interest" to include – in appropriate fact situations – the following circumstances: (i) a director has a personal financial stake in the decision which is contrary to the corporate interests; (ii)a director contracts or transacts business directly or indirectly with the corporation on whose board he serves; (iii) a director has a material direct or indirect financial interest the entity thatis contracting or transacting business with the corporation; (iv) a director receives a fee or other benefit in connection with an otherwise arms-length corporate transaction;[140] (v) a director serving on two

[139] See text at note 175, infra.

[140] The Delaware Supreme Court affirmed a Chancery Court holding that the director's interest in the challenged transaction must be sufficiently material to have breached his duty of loyalty and "infected" the board's decision. *Cede & Co. v. Technicolor Inc.*, 634 A.2d 345 (Del. 1993). See also Cinerama v. Technicolor, Inc., 663 A.2d 1156 (Del. 1995).

corporate boards has conflicting duties of loyalty with respect to a transaction between the two corporations;[141] (iv) board action is affected by structural bias.[142]

The earliest common law rule with respect to transactions involving the approval of one or more interested directors was that the transactions were void *ab initio,* and later cases softened this rule somewhat to render the transaction voidable at the option of the corporation. The interested director could neither vote upon nor even be counted for quorum purposes with respect to approval of the transaction.[143] Delaware by statute has abrogated these rules,[144] and substituted a structure of disclosure and approval that allows interested transactions to be entered into and to be binding upon all the parties thereto.[146]

The Delaware procedure, now adopted with some variations in most other states, provides in substance three methods for approval of an interested directors' transaction. The transaction does not become void or voidable solely because the director or officer is present at or participates in the meeting which authorizes it if the material facts as to his relationship or interest are disclosed to (or known by) the board, and the board in good faith authorizes the transaction by a majority vote of the disinterested directors.[147] 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 a vote of the shareholders.[148] When neither of these procedures is followed, the

[141] See Krasner v. Moffett, 826 A.2d 277 (Del. 2003)..

[142] The argument of structural bias flows is that in certain instances directors with no direct, or even indirect, financial stake in a corporate decision may so identify with other directors who do have such a stake 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 (Del. 1984).

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

[144] Del. Gen. Corp. L. § 144(a).

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

[146] Del. Gen. Corp. L. § 144.

[147] Del. Gen. Corp. L. § 144(a)(1).

[148] Del. Gen. Corp. L. § 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,

transaction may nevertheless stand if it "is fair as to the corporation as of the time it is authorized,"[149] a determination that in practice can only be made by the court following a hearing.

By contrast with Delaware, the foundation of the duty of loyalty in Bermuda law is statutory: an officer has a statutory duty to act honestly and in good faith, with a view to the best interest of the company.[150] The Companies Act 1981 lists certain types of conduct that *per se* violate the officers' obligations to act in good faith, including f ailure to disclose on request compensation, benefits or a loan received from the company, as well as omission to disclose an interest in any material contract or proposed contract, or any material interest in any person that is a party to such a contract or proposed contract.[151] Materiality as it relates to contracts or proposed contracts is statutorily defined,[152] as is– by exclusion – materiality relating to ownership interests.[153] 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 statutory standard.[154]

However, apart from requiring disclosure to the board, this detailed statutory structure is silent. There is no requirement that the board approve or disapprove the interested transaction, nor is there any indication of whether the interested director or directors may be present during the deliberations or how the vote is to be counted. Neither is there a procedure for shareholder vote – to deal, for example, with the situation when a majority or all of the board are interested – or a standard (such as entire fairness)

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that avoidance of a substantive hearing on fairness requires an affirmative vote of the *disinterested* shareholders. See Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976).

[149] Del. Gen. Corp. L. § 144(a)(3).

[150] § 97(1) Companies Act 1981.

[151] § 97(4) Companies Act 1981.

[152] §97(5)(b) " … the materiality of that contract or proposed contract in relation to the business of the company to which disclosure must be made."

[153] § 97(5)(c) Ownership or indirect control "of not more than 10% of the capital of a person shall not be deemed material."

[154] § 97(5)(a) Companies Act 1981.

for evaluating the validity of the transaction if the necessary disclosures or approvals are not undertaken.

There are further unanswered questions. Conduct potentially violating the director's duty of loyalty under Delaware law might fall outside of the ambit of Bermuda's statutory disclosure requirement, but there remains uncertainty whether such conduct might nevertheless violate the general standard requiring that the director act honestly and in good faith with a view to the best interests of the corporation.[155] 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 arms-length corporate transaction with a third party, or conflicting loyalties involving a transaction between two corporations on the board of which the interested director serves.[156] It is difficult, however, to predict the treatment of these acts, given the unavailability of Bermuda precedent. Lack of transparency in this area is troublesome, since the day-to-day carrying on of business occasionally requires corporate executives to make decisions that probe their duty of loyalty.

Most particularly, the absence of procedures for approval of interested directors' transactions leaves a gap – and an important practical issue – with respect to how to assure the validity of certain desirable corporate transactions that might involve potential fiduciary conflict. Is board knowledge alone sufficient to validate the transaction, or must the board approve the transaction? What vote is required when, for example, several directors are interested? Is a shareholder vote an option?

An interesting contrast is presented with respect to loans to corporate officers, where the Bermuda rules[158] appear on first reading to be more restrictive than those of

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[155] Note that the specific disclosure requirements of § 97(4) are preceded by the phrase "without in any way limiting the generality of subsection (1)," which sets forth the general fiduciary duties of officers.

[156] Provided, in both cases, that the interested director does not own directly or indirectly 10% of the shares of the other contracting corporation. § 97(5)(c) Companies Act of 1981.

[157] § 97(4) states that the listing of acts per se violating the obligation to act honestly and in good faith is not intended to limit the generality of the rule that no such acts will be allowed

[158] See § 96 Companies Act of 1981.

Delaware. Delaware law allows the grant of a loan or the guarantee of an obligation of an officer or director "whenever, in the judgment of the directors, such loan, guarantee or assistance may reasonably be expected to benefit the corporation."[159] A decision on a loan or guarantee of a loan to a corporate officer is not subject to any special approval procedure. By contrast, Bermuda law prohibits loans to corporate officers without the consent of the shareholders holding in the aggregate not less than 9/10 of the total voting rights.[160] There is an exception to this general rule,[161] but Bermuda law appears on its face to limit severely the recourse of officers to corporate funds by way of loans.[162]

The apparently more restrictive attitude of Bermuda law with respect to loans to corporate officers and directors, has often been emphasized in inversion transaction proxy statements. But with the passage of the Sarbanes-Oxley Act of 2002, § 13 of the Securities Exchange Act of 1934 was amended to prohibit, in broad terms, the making of loans to directors and officers of issuers registered under § 12 thereof.[163] For all practical purposes, this federal prohibition has preempted the field, prohibiting such loans for both domestic and foreign registered corporations (with very limited exceptions), and reversing any preexisting differences in applicable corporate law rules.

(3) Exculpatory provisions in the articles or bylaws

An area of sharp contrast between Delaware and Bermuda is the extent to which corporate law allows officers to be relieved by provisions in the articles or bylaws of

[159] Del. Gen. Corp. L. § 143.

[160] § 96 Companies Act 1981.

[161] 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. § 96(7) Companies Act 1981.

[162] Note that there may be questions with respect to this issue – including what transactions are covered by the term "loan" – thatare not addressed by the statutory rules.

[163] See Securities Exchange Act of 1934, as amended, § 13(k), 15 U.S.C. § 78m(k), making it unlawful for any issuer, "directly or indirectly, including through any subsidiary, to extend or maintain credit . . . in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer." Other relevant provisions of the Sarbanes-Oxley Act of 2002 are discussed at text at note 184, infra.

liability for the violation of their duties. As a general rule, Delaware law permits the adoption of a provision in the certificate of incorporation eliminating or limiting the personal liability of a director to the corporations or its stockholders for monetary damages for breach of fiduciary duty as a director, subject to certain exceptions. However, no such provision may eliminate or limit the liability of a director for any breach of the duty of loyalty, for acts or omissions not in good faith or involving intentional misconduct or a knowing violation of the law or for any transaction from which the director derived an improper personal benefit.[164] A recent holding of the Delaware Chancery Court importantly narrowed the protections of permitted exculpatory provisions by determining that conscious and intentional disregard of their responsibilities by directors constitutes either lack of good faith or intentional misconduct.[165]

Bermuda corporate law is – on its face and in its application – very different. It allows an officer to be relieved – through the by-laws or any contractual arrangement with the company – from liability with respect to negligence, default, breach of duty or breach of trust.[166] Only provisions limiting the liability of officers for conduct involving fraud or dishonesty are void under the statutory terms.[167] These statutory provisions have been held to mean that by-laws may indemnify directors for willful default and willful

[164] Del. Gen. Corp. L. § 102(b)(7). Limitation of director's liabilities under Del. Gen. Corp. L. § 174 with respect to unlawful payment of dividends or unlawful stock purchase or redemption is also disallowed.

[165] In re The Walt Disney Company Derivative Litigation, Case No. 15452 (Del. Ch. May 28, 2003), distinguishing Malpiede v. Townson, 780 A.2d 1075 (Del. 2001), as holding that as a matter of law, Del. Gen. Corp. L. § 102(b)(7) bars a claim only if there is only a due care claim, and nothing else. See also McCall v. Scott, 239 F.3d 808 (6th Cir.), *amended by* 250 F.3d 997 (6th Cir. 2001), applying Delaware law, and noting – in rejecting dismissal based on the corporation's exculpatory clause – that reckless or intentional misconduct could constitute breach of the duty of good faith. *Cf*. In re Caremark International, Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996), in which the court held 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; and noting that continued failure to exercise oversight responsibilities could result in director liability based on lack of good faith.

[166] § 98(1) Companies Act 1981. This section permits, as well, similar limitation of the liability of "any person employed by the company as an auditor."

[167] § 98(2) Companies Act 1981.

neglect, as well as ordinary breach of duty. Claims against directors of Bermuda companies having such by-laws must plead detailed particulars of the alleged willful neglect or default to secure relief.[168] It will therefore be difficult to obtain full recovery against directors of such Bermuda companies who are sued in Bermuda.[169] Such contractual limitation of directors' liability to preclude recovery even in the case of willful default or willful neglect – despite the often relied on English origin of Bermuda law – is not rooted in English law. The law of the United Kingdom is clearly to the contrary: by statute, it makes illegal any provision intended to relieve directors of liability for any negligence, default, breach of duty or breach of trust.[170]

This overall comparison of the substantive factors of corporate governance of Delaware and Bermuda law reveals that officers must be guided in their relationship to the corporation and its shareholders by a complex system of rules. Bermuda law contains in certain respects detailed statutory guidance, which is unlikely, however, in the absence or unavailability of interpretative case law to offer a basis for day-to-day decisions by the officers of inverting corporations. It may be argued that this defect may be remedied by consulting the corporation's Bermuda counsel, a solution readily available to the corporate executives, but potentially less to shareholders who wish to scrutinize executive conduct. And, as shown, it is not clear on what basis even Bermuda counsel will give advice. The reach of directors' duties is vague and ambiguous under Bermuda law. Moreover, as will be seen, judicial enforcement mechanisms available to shareholders are incomplete. The statute itself contains very limited administrative enforcement mechanisms. [171]

Against this background, proxy materials and prospectuses describing the corporate law consequences of inversion transactions may be misleading, even if in some

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[168] Focus Insurance Company Ltd. v. Hardy, et al (Bermuda Civil Appeal No. 15 of 1992); Intercontinental Natural Resources Ltd. v. Dill, et al (Bermuda Civil Appeal No. 14 of 1981).

[169] See J. Milliagan-Whyte, *Preventing Bermuda Companies from relocating to the U.S.*, Bermuda Sun, 5/22/2003.

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[170] § 310 U.K. Companies Act 1989.

[171] One such mechanism, interestingly, is a $1,000 fine which may be imposed on an officer who fails to make the required disclosure of interested transactions. See § 97(6) Companies Act 1981.

senses they may be technically accurate. For example, by contrasting the duty of loyalty under Delaware law (permissive) to the prohibition to grant loans to executives under Bermuda law, the proxy material may convey the potentially misleading impression that a more stringent duty of loyalty standard applies to executives under Bermuda law.[172] In fact, as we have seen, loans to corporate executives are transactions that receive special treatment under both legal systems, independently of the general duty of loyalty. A similarly misleading impression may be conveyed by reference to the intended implementation of a permissive statutory provision, without a detailed description of its operation. For example, a statement that the corporation after inversion will exempt directors from liability to the fullest extent allowed by the applicable law –just as it did prior to the inversion – implies that the same standards will apply to executive conduct and its susceptibility to liability.[173] However as we have seen, by contrast to the pre-inversion scenario, corporate executives may conceivably breach the duty of loyalty, perform acts or omissions not in good faith or engage in any transaction from which they derive an improper personal benefit and be more broadly exonerated from liability by the by-laws. In particular, by contrast with Delaware law, the by-laws apparently may exonerate them from liability, provided only that their acts do not amount to fraud or dishonesty.[174]

(4) <u>Shareholders' action for enforcement</u>

The corollary of the substantive duties of corporate executives is the enforcement of shareholder's rights, which in the U.S. is primarily through derivative actions.

Shareholders of the inverted (now Bermuda) corporation may be able to pursue either of two options for the enforcement of their rights post-inversion. The shareholders may initiate a suit in Bermuda in the support of their rights, or alternatively they may start proceedings in a U.S. court, and thereafter apply for the recognition and enforcement of the U.S. judgment in Bermuda if that is necessary. A choice between these tactics is

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[172] See Xoma, Prospectus/Proxy Statement, supra note 37.

[173] See White Mountain Prospectus/Proxy Statement, supra note 37.

[174] See text at note 167, supra.

important when the suit seeks a money judgment. In that case 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 find that it is not easy to initiate a derivative action in a Bermuda court. There is no statutorily defined derivative action in Bermuda law, and Bermuda courts are ordinarily expected to follow English precedent. English law follows the rule in *Foss v. Harbottle*,[175] which holds that – with limited exceptions – only the company can initiate an action. These common-law exceptions permit the a derivative action when (i) the complained act is *ultra vires* or illegal; (ii) the complained act constitutes fraud against the minority, with the majority using its position to prevent company action against wrongdoers: (iii) the shareholder approval for the act was below the percentage required by the law for a valid approval, or (iv) the complained of act violates the company's memorandum or articles of association. These narrowly defined exceptions do not on their face include any claimed violation of the directors' duties of care and loyalty. Interestingly, in the general absence of case law confirming the use of English precedent on derivative actions in Bermuda courts, inversion prospectuses and proxy statements discuss the possibility of initiating a derivative suit in conditional language. They 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.[176] Of course, inverting corporations could in their by-laws provide alternative devices, such as arbitration, to facilitate the enforcement of shareholder rights. Inverting corporations could also put in place a structure allowing shareholders to alert the corporation, and possibly obtain its support, prior to recourse to litigation, such as a litigation or oversight committee of the board of directors. Inverting corporations do not follow any such practice and limit disclosure to the summary

[175] Foss v. Harbottle, 2 Hare 461 (1843), discussed by the Bermuda Supreme Court in Stena Finance BV, et al v. Sea Containers Ltd., et al, Civil Jurisdiction No. 178 of 1989, at pp. 25-28 (Bermuda Sup. Ct.).

[176] See, e.g., Xoma Prospectus/Proxy Statement, op. cit. supra note 37, at 29 (citing and describing the rules of *Foss v. Harbottle, supra*); White Mountain Prospectus/Proxy Statement, op. cit. supra note 37, at 36 (listing the same rules without case citation); Nabors Industries Prospectus/Proxy Statement, op. cit. supra note 21, at 36 (listing the same rules without case citation).

description of the English practice to initiate a derivative action likely to be followed by Bermuda courts.

The probability that dissatisfied shareholders of inverted corporations would attempt to enforce their rights through the Bermuda court system is low. Alternatively, the common way to enforce shareholders rights is through an action brought in U.S. courts, provided service of process can be effected.[177] The litigation involving corporate governance issues would require the court to apply Bermuda law as the governing corporate 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. Alternatively, 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 U.S. courts.[178] These particular proceedings are unlikely to involve any problem of enforcement, since they are corporate actions directed against the individual executives whose assets are probably located in the U.S. However, a U.S. judgment targeting the Bermuda corporation itself or any of its officers without substantial U.S. presence and U.S. assets may raise Bermuda enforcement problems.

There is no treaty between the United States and Bermuda governing the mutual recognition and enforcement of judgments. Inverting corporations frequently emphasize that in the absence of a treaty, Bermuda courts would enforce money judgments granted by United States courts following the common-law rules on the enforcement of foreign judgments. The common-law allows the recognition of a foreign *in personam* judgments

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[177] 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 Mountain Prospectus/Proxy Statement, supra note 37, at 10; Nabors Prospectus/Proxy Statement, supra note 21, 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 Mountain Prospectus/Proxy Statement, id. 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 US jurisdiction.

[178] A summary of actions awaiting trial in U.S. courts appears in *On the Docket, Where the Fallen Stand Now,* Wall Street Journal (Sept. 25, 2003), p.C1.

provided that (i) the issuing court properly assumed jurisdiction and the *judgment is not* (ii) obtained by fraud, (iii) contrary to public policy or (iv) converse to natural justice.[179]

The extent to which these rules may lead to denial of the enforcement of a U.S. judgment is uncertain. First, the recognition of U.S. court decisions on corporate disputes that involve the application of the federal securities laws may encounter obstacles on public policy grounds. Certain remedies available under the U.S. federal securities laws may not be enforced in Bermuda courts as contrary to public policy.[180] Second, the existence of two forums where disputes may potentially be litigated may result in complexities that threaten the ultimate recognition or enforcement of the judgment in the alternative forum. As an example, Bermuda courts may grant antisuit injunctions in support of their jurisdiction, following English precedent.[181] For example, an antisuit injunction may be granted against proceedings started in the United States in violation of an arbitration clause providing for Bermuda arbitration. If the U.S. litigation nevertheless proceeds further and results in a final judgment,[182] this judgment will not be recognized or enforced in Bermuda, on the ground that it violates natural justice. This is not a hypothetical scenario. Indeed, in an analogous case the Supreme Court of Bermuda has held that a U.S. judgment granted in violation of a Bermuda antisuit order is not enforceable in Bermuda.[183]

Perhaps the concurrent jurisdiction of U.S. and Bermuda court over disputes centered on corporate governance issues may not lead to such drastic results in average cases. Perhaps even in the face of general unavailability of derivative actions in Bermuda, shareholders rights can be enforced. Nevertheless, it is likely in all these cases that the

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[179] Dicey & Morris on the Conflict of Laws, 11th ed. P.421

[180] See White Mountain Prospectus/Proxy Statement, supra note 37.

[181] An antisuit injunction will direct the defendant to refrain from proceeding with an alternative suit in another jurisdiction.

[182] An antisuit injunction is directed against a litigant who commenced the U.S. proceedings. It has no binding effect on the U.S. court itself.

[183] Nassau Insurance Company (in liquidation) v. Andra Insurance Company (Civil Jurisdiction No. 484 of 1995) (Bermuda Sup. Ct.).

costs and complexities of enforcement of shareholder's rights will increase considerably as a result of the inversion.

D. *Conclusion*

Proxy statements and prospectuses associated with inversions assert that shareholders will continue to have fundamental rights and enforcement alternatives with respect to the new parent corporation. We have seen that Bermuda law includes prohibitions, limitations and protections that constrain the conduct of corporate officers and directors; and we have seen, as well that there is a basis for shareholder enforcement of these duties. Nevertheless, our detailed comparison reveals clearly one distinguishing element of post-inversion corporate governance and shareholders' right enforcement -- *uncertainty*. Thus while executives of Bermuda corporations clearly have duties of care and loyalty, the metes and bounds of those duties are, unlike those in Delaware, not made clear by case-law practice or commentary. Further, 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 Bermuda law ambiguity. Finally, corporate transparency is impaired by the complexities involved in accommodating to a different system of law. Directors and officers must face the difficulty of adjusting their conduct to comply with the rules of a two different system. Shareholders, in turn, must contend with the complexity of assessing and attempting to enforce their rights under the possibly conflicting and inconsistent rules of the state law of corporations in the U.S. (generally Delaware) and Bermuda company law.

While the change in applicable corporate law may affect standards of corporate governance, federal securities laws continue to apply and thereby to regulate some aspects of both corporate conduct and shareholders' remedies. While these laws are primarily focused on issues of corporate disclosure, recent amendments – most notably some aspects the Sarbanes-Oxley Act of 2002 – incorporate some components of corporate governance.[184] These would equally apply to inverted corporations.[185]

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[184] See, e.g., Sarbanes-Oxley Act of 2002 (P.L. 107-204) § 301(a) (Requirement that CEO and CFO reimburse incentive and equity compensation if accounting restatement is required), §302 (CEO and CFO certification of annual and quarterly reports), § 402, amending Securities

Nevertheless it is a fundamental principle of the federal securities laws that they are not directed to the regulation of traditional, state law based areas of corporate governance or to their remediation.[186] Thus the central issues discussed above, the duties of directors and officers and their enforcement, are not addressed by federal law.

V. The legal and economic framework facilitates corporate inversions

Outbound corporate inversions would not be favored as a method to achieve tax savings in the absence of a legal and economic framework that facilitates these transactions. Certain factors that favor inversions, such as increased public acceptance of inverted corporations, are the product of the development of market structures in the past two decades. Other factors, including inadequate enforcement of measures designed to halt certain types of tax motivated transactions, emerged as the recent wave of outbound inversions accelerated. It is unlikely that inversions would have been possible without the interaction of multiple factors, the most notable of which have been: (a) modest transactional tax costs; (b) continued access to capital markets, continued market acceptance and continued eligibility for government contracts after inversion; (c) special decisional motivations on the corporate and shareholder level, including inadequate emphasis on corporate governance changes; (d) non-enforcement of potential anti-inversion measures, such as the business purpose doctrine and § 269; and (e) 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, although without emphasis on their interaction. The impact and combined effects of these factors in creating a pro-inversion tax and economic environment are detailed below, together with a consideration of the major features of legislative proposals addressing these issues.

Exchange Act of 1934, as amended, § 13, 15 USC § 78m(k) (Prohibition of loans to directors and officers of registered companies).

[185] With limited exceptions (e.g., the requirement for audit committee in § 301, which is limited to *listed* companies), the provision of the Sarbanes-Oxley Act of 2002 applies – pursuant to § 2(7) thereof – to all *issuers* registered under the Securities Exchange Act of 1934 §12A.

[186] See Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977).

A. *Transactional tax costs*

The recent increase in inversion activity suggests that the transactional tax costs presently imposed on corporate inversions are too low to constitute an effective disincentive to this type of corporate restructuring.

As demonstated earlier in this article, inversions are generally structured as stock for stock exchanges accompanied -- or possibly followed by – transfers of stock and/or operating assets to foreign affiliates designed to remove these assets from the ambit of the CFC rules. Section 367(a) imposes a toll-charge on the transaction by taxing the exchanging shareholder on the capital gain realized in the exchange of the stock.[187] The § 367(a) toll charge appeared to be an effective deterrent immediately after its adoption, and with some exceptions no outbound corporate restructuring occurred from the time of its adoption until the most recent wave of inversions.[188] As a result of several developments, however, the resulting shareholder level tax has become much less significant today than contemplated as of its enactment. Most importantly, stock prices have fallen considerably in the past years.[189] This 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 gain.[190] There has also been a significant increase in shareholdings by entities that are either not subject to, orless sensitive to, U.S. capital gains tax, including tax exempt entities and mutual funds.[191]

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[187] IRC § 367(a) may, however, act as a deterrent to certain legitimate transactions while it overlooks certain abusive transactions. See S.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).

[188] E.g. An exception was Triton Energy: inversion announced on 2/8/1996 and completed on 3/25/1996. See also NYSBA Report at 131.

[189] See Treasury Inversion Report at ¶ 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 had dropped respectively approximately 20%, 30% and 70% from their all time highs reached in 2000.

[190] NYSBA Report at 132.

[191] 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

While 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 generally high.[192]

These developments undermined the effectiveness of the § 367(a) capital gains tax as a deterrent to outbound inversions. In addition, some tax planning techniques offer the possibility for a further reduction of the shareholder level tax.[193] Subsequent transactions designed to remove the foreign subsidiaries from the CFC net, though taxable, are individual transactions that allow the transferring corporation some planning potential to time and structure the transaction so as to minimize its tax cost.[194]

As noted earlier, asset inversions are fully taxable at the corporate level, the inverting corporation being treated as having sold all its assets to the resulting entity. However, in a manner similar to tax planning for transactions thataccompany share inversions, inverters may use strategic planning to time and structure the transaction to obtainthe most tax efficient result. Xoma Corporatio n carried out this type of inversion virtually tax-free,[195] while White Mountain Insurance Group incurred relatively minimal tax cost through the reorganization.[196] Tax minimizing techniques are available when the

generally appear to be less sensitive to tax considerations, though their investors are liable to tax on their allocable shares of income and capital gains.

[192] 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, Mills & Weaver, op. cit. supra note 108, at

[193] E.g. the exchangeable share technique, discussed in text at note 30, supra.

[194] Operating assets may be transferred in a § 351 transaction and qualify for the § 367(a)(3) active foreign business exception. Sale of assets to foreign subsidiaries is available when the asset has no substantial built in gain. On the potential available to structure these transactions in a tax-efficient manner see Hicks, op. cit. supra note 3.

[195] The inversion took place when the corporation had substantial net operating losses, just prior to the approval of a new drug developed by the corporation. See Xoma, Prospectus/Proxy Statement, op. cit. supra note 37 at

[196] The corporate level tax was estimated to be between $5 and $20 million. See White Mountain Insurance, Prospectus/Proxy Statement, discussed in text at note 33, supra.

inverting U.S. 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 U.S. taxes by an inverting corporation.

In short, transactional tax costs as presently structured and applied have been ineffective in deterring expatriating corporations.[197] However, the potentialfunction of transactional tax costs may be more extensive. In this connection, 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. The answer appears to be affirmative, though no commentator to date has attempted a quantification of the removed benefits. From the outset, the now foreign-based multinational is "in the position of benefiting from the goodwill and going concern accumulated by the U.S. company prior to the inversion."[198] In addition the foreign subsidiaries of the group are in the position to benefit from corporate opportunities that attached to the pre-inversion multinational by virtue of economic characteristics that likely developed in conjunction to its original status as a U.S. corporation.[199] 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".[200] Post-inversion inter-company dealings, if not adequately monitored for compliance with the arm's length standards, may achieve a similar result.

It is essential that corporate expatriations be so taxed as to disallow tax free removal of tangible and intangible property, including goodwill and corporate opportunity, from U.S. taxing jurisdiction. Several proposals targeting inversions have reflected on this problem, but none have suggested a comprehensive solution. One

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[197] NYSBA Report at 131.

[198] See, e.g., NYSBA Report at 139, noting specifically the benefit of using the corporate name.

[199] For an overview of this topic See D. R. Hardy *Assignment of Corporate Opportunities; The Migration of Intangibles*, 100 Tax Notes 527 (July 28, 2003).

[200] Treasury Inversion Report at ¶ 80.

possible approach is to view the inversion as a deemed liquidation of the U.S. multinational followed by establishment and transfer of all asset to the foreign multinational. However, deemed liquidation treatment would not provide the argument – under present tax law – for imposing taxation on accumulated goodwill and corporate opportunities transferred in the inversion. Moreover the taxation of the appreciation inherent in the assets of the U.S. multinational could still be minimized through the use of offsetting tax attributes. A further difficulty of the deemed liquidation argument is that the inversion transaction -- specifically the share inversion -- does not of itself accomplish the tax reducing transfers. It merely creates a structure for subsequent carrying out of transactions that remove CFCs from U.S. taxing jurisdiction or that reduce U.S. source income.

It has also been suggested that inverting companies should be disallowed the use of offsetting tax attributes,[201] which would result in imposing an inescapable tax cost on the removal of tangible and intangible property from the U.S. taxing jurisdiction. Such a 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. Included in these transactions would be contributions of stock of the foreign subsidiaries to new foreign affiliates, as well as transfers of intangibles designed to create the framework for inter-company licensing payments.[202] However, transfers of corporate opportunities would nevertheless remain non-taxable, since the tax law at this stage does not appear to have adequate means of dealing with them.[203]

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[201] E.g. S. 2119 known as Reversing the Expatriation of Profits Offshore Act (the "REPO Bill") proposed that no offsetting tax attributes – such as net operating losses and other credits – could be applied to reduce tax on gain realized by the domestic corporation on the inversion transaction or on subsequent transfer of stock or property to related foreign corporations.

[202] Specific follow-on inter-company transactions, including inter-company sales of assets fall within the reach of § 482. Inversion studies and legislative proposals suggest that a mandatory post-inversion § 482 audit would be appropriate to monitor post-inversion migration of value. See e.g., NYSBA Report at 140; the REPO Bill, supra.

[203] See Hardy, op. cit. supra note 199, addressing different ways of taxing transfers of corporate opportunities.

B. *Continued access to capital markets*

Inverted corporations enjoy the same access to U.S. capital markets as they did prior to the inversion; their stock continues to be listed on the NYSE and the S&P 500, securing access to investors, including index investors. [204] Offshore companies have similarly experienced increased market acceptance in the past decade and "appear not to be regarded by capital markets with suspicion, as they once were."[205] Investment bankers are increasingly supportive of transactions involving stock of offshore corporations.[206]

There is a strong basis for arguing that the access to the U.S. capital markets held by inverted corporations is at least in part a product of their previous U.S. corporate status. Many inverting corporations started their operations as small U.S. businesses decades earlier, even at the end of the 19th century,[207] and grew along with growth in the U.S. economy. It would be unreasonable to suggest that this factor alone should warrant continued subjection to U.S. taxation irrespective of subsequent changes in their structures and operations. However, it is at least arguable that those corporations received an asset – a value not then available to foreign corporations either in foreign or in U.S. capital markets – in their original opportunity to raise and grow capital in the U.S. markets, a value they retain today in their existing capital structure. And if there is such an asset, there may be justification for U.S. taxation, either on its transfer through inversion or by some other mechanism.

The inversion debate highlighted 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, nevertheless, from the U.S. capital market structure, *but not in the same way as inverting corporations.* It is not likely, for example, thata start-up Bermuda corporation will raise any significant portion of its

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[204] See discussion at text at note 116, supra.

[205] NYSBA Report at 132.

[206] See J. R. Zavoli, *High Tech Firms Going Public: Benefits of Listing as a Foreign Issuer in U.S. Capital Markets,* 10 J. Int'l Taxation 7 (1999).

[207] E.g Stanley Works claims a corporate history of 160 years See www.stanleyworks.com. Ingersoll-Rand claims a corporate history dating back to 1871. See www.irco.com.

capital in the jurisdiction of its incorporation.[208] Capital would likely be raised through an IPO in the United States, facilitated by increased acceptance of foreign incorporated companies by the U.S. investment banking community within recent years. Still, it is not clear that a newly-formed company incorporated in Bermuda would have – at the outset – equivalent investor acceptance as a Delaware corporation. One clear evidence of this is that the standards that would apply to a Bermuda entity in obtaining a NYSE listing are higher than those applicable to U.S. corporations,[209] including inverting companies. Thus, the preferred market status secured by inverting corporations by virtue of their initial U.S. status would be available to foreign start-ups only by incurring higher 'costs'.[210]

Inversion similarly leaves unaffected the eligibility of the inverted corporation to obtain U.S. or state government contracts.[211] It is at least arguable that companies outside the taxing jurisdiction of the United States (which might include not only inverted corporations but also those initially incorporated outside the U.S.) having excluded 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

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[208] The sources of investment capital in Bermuda are limited. Only two of the companies that underwent inversion transactions were listed on the BSE [Tyco and Global Crossing], which is a fully electronic market, and both were listed as well on the NYSE. As previously indicated, there is no Bermuda index system analogous to S&P 500.

[209] Section 103.01 of the Listed Company Manual, NYSE Listing Rules.

[210] 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, global marker capitalization, etc. -- to be listed on the NYSE.

[211] 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 $2.7 billion in federal contracts (roughly 2.6% of all contracts) to the following four companies: McDermott International, Inc. ($ 1.885 Billion); Foster Wheeler, Ltd. ($286.3 million); Accenture Ltd. ($279 million); Tyco International Ltd. ($206.4 million). BNA, Daily tax Report, Oct. 3, 2002

inverted multinationals for governmental contracts, although widely criticized, has not yet been statutorily addressed.[212]

C. *Special motivating factors for the decision to invert*

The corporate inversion, as the earlier discussion demonstrates, substantially affects corporate governance, most importantly by the introduction of uncertainty and ambiguity concerning the duties and liabilities of corporate officers and directors. Bermuda law, which is frequently the governing corporate law after the inversion, does not provide guidance for corporate acts of the same clarity and comprehensiveness as Delaware law. Accordingly, the new governing corporate law may not provide adequate guidance for shareholders to monitor compliance with director's duties and may not offer satisfactory means of enforcement. This is especially relevant in the economic climate of the past few years, when large scale corporate frauds have focused concentrated governmental and public attention on the accountability of corporate executives.

Corporate inversions are based, of course, on the affirmative vote of the shareholders, who may wish to exchange a degree of transparency and certainty in the accountability of corporate executives for tax benefits.[213] Absent overriding public policy considerations, the shareholder decision should not be subject to question, provided that it reflects an informed choice. The discussion earlier in this article raises, however, serious questions with respect to the informed nature of the shareholder inversion votes. 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.[214]

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[212] Lawmakers have recently proposed that inverting firms should be ineligible to bid for contracts from the Department of Homeland Security's $29 billion budget. See House Appropriation Committee amendment, reported on www.tax-news.com (June 25, 2003).

[213] Shareholder approval percentages of inversions are very high (generally in the 85%-95% range). See C.B. Cloyd, L.F. Mills & C.D. Weaver, *Market Nonreaction to Inversions*, 98 Tax Notes 259 (Jan. 13, 2003) (summary report of Cloyd, Mills & Weaver, op. cit. supra note 108).

[214] The NYSBA Report and the Treasury Inversion Report, for example, do not discuss the consequences of the corporate law change.

Actions undertaken to raise public awareness on the corporate governance changes inherent in the transaction were notably absent from the inversion debate, with the exception of a movement initiated by several California pension funds seeking the re-domestication of several inverting corporations. Shareholder awareness of the effects of post-inversion corporate governance changes could affect the expatriation decisions.[215] The Stanley Works inversion plan attracted a narrowly positive shareholder vote, following increasing negative public pressure, and the company abandoned the plan after it was challenged by the Connecticut Attorney General. Ingersoll Rand shareholders recently showed a high, although insufficient, support in favor of re-domestication.[216] In this context, the importance of public awareness of corporate governance changes caused by the inversion cannot be sufficiently emphasized.

The initiative to invert originates from the multinational's management and is subject to shareholder approval, and it should therefore be expected thatmanagement will advance an inversion proposal after careful analysis and with the intention to maximize shareholder value. Recent corporate law scholarship suggests thatthe decision to change the jurisdiction of incorporation may be based on different considerations and incentives from those that apply in the initial choice of the place of incorporation. U.S. corporations generally prefer to incorporate in Delaware for initial public offering, and it appears that the choice of Delaware law adds measurable share value. [217] Subsequent change of the jurisdiction of incorporation (as by inversion) – resulting in the loss of the advantages of Delaware corporate law – may reduce shareholder value, but it is not clear to what extent the reincorporation decision is motivated by maximizing shareholder value. The

[215] At least two inverting corporations, McDermott International and Tyco, announced an expatriation review process in response to the Calper's initiative.

[216] Ingersoll Rand vote on re-domestication was supported by 45% of the shareholders. This is in sharp contrast with the original 89% vote in favor of inversion.

[217] See R. 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); R. Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L.. Rev. 1559, 1603-1604 (2002) (Concluding that "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.").

decisions to re-incorporate may place less emphasis on shareholder value maximization than the pre-IPO choice of incorporation.

With respect to outbound corporate inversions, the question is whether the loss of the framework of Delaware corporate law may have any negative effect on shareholder value, and to what extent this is considered by corporate executives proposing the inversion. Economic studies have not yet explored this question and, indeed, they have not reached a consensus on the effects of inversions on shareholder wealth and share prices.[218]

Moreover, 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.[219] Furthermore, to the extent that share prices react positively to the inversion, managers may exercise their stock options, diluting further share values for existing shareholders.[220]

D. *Imperfect enforcement of measures designed to halt inversion type transactions*

Corporate expatriations are carried out as reorganizations, and in order to be respected for tax purposes, must be satisfy the requirement of a business purpose. The requirement that the transaction be based on business reasons is contained in the judicially developed and statutorily confirmed business purpose doctrine. A separate statutory rule, § 269 of the Internal Revenue Code, provides for the denial of benefits and

[218] It has been argued that the inversion announcement does not cause a positive share price reaction. See Cloyd, Mills & Weaver, op.cit supra note 108 at 14-20. 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. Id. at 22. But there is no consensus about share prices reacting negatively to inversions. See Hines & Desai, op. cit. supra note 15 at 430 – 436, finding mixed stock price reactions to inversion plan announcements, but concluding (based on their empirical data) that share prices are "consistent with rational tax planning on the part of inverting firms and managers maximizing shareholder wealth rather than share prices."

[219] For example, the compensation plans for Nabors Industries gave the top two executives 8% of the company's cash flows. Nabors Industries, Proxy Statement/Prospectus, op. cit. supra note 21.

[220] See Cloyd, Mills & Weaver op.cit supra note 108 at 22.

deductions with respect to transfers of assets unless the business reasons therefore outweigh the tax motivations. There is considerable reason to question whether outbound corporate inversions satisfy these requirements. Indeed the question appears to be more fundamental, as the NYSBA Report articulates: whether inversions are shams.[221]

The inversion changes dramatically the tax liability of the inverted multinational without altering in substance any of the factors relevant to its operation. The location of economic operations and business practices are not affected, and the place where the operational decisions are taken, the corporate headquarters, remain unchanged. The inversion proxy statements invariably emphasize, when seeking shareholder consent, that the inversion does not produce alterations in the operational structure of the inverted corporation. The inverted company maintains its attractiveness to investors since it has the same access to the U.S. capital markets and its operation – including in a limited way corporate governance – remains subject to the federal securities laws. Thus, despite the lack of substantive business changes the entire tax structure of the inverted multinational changes. The inverted corporation achieves foreign status by filing for continuance in a tax haven jurisdiction, usually Bermuda. In addition, in order to be eligible for benefits under a bilateral income tax treaty, the inverted corporation will claim residence for treaty purposes in a third country, usually Barbados, through what can be seen as minimal contracts with that jurisdiction.[222] Post inversion payments that take place between the USco and Bermudaco will be taxed under the regime of the bilateral U.S. – Barbados tax treaty.[223]

The dramatic difference between pre- and post-inversion tax treatment without a corresponding substantive operational or structural change raises important tax policy concerns. On a general level, it is open to question whether these transactions should be disregarded as shams. On a technical level the question is why the regulatory tax

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[221] NYSBA Report at 135.

[222] Under Barbados law it will be sufficient for the expatriated corporation to conduct director's meetings in Barbados to be able to claim residency.

[223] U.S. bilateral income tax treaties exempts large public companies from the limitation on benefits article. See L. Sheppard, *Preventing Corporate Inversions. Part 3*, Tax Notes (June 24, 2002).

measures designed to halt abusive tax transactions – notably the business purpose doctrine and §269 -- were not brought into play to question corporate inversions.

(1) The business purpose doctrine

The business purpose doctrine, as applied to reorganizations, provides that reorganization status will be denied when a transaction is 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"[224] It will not suffice for the transaction to meet only the technical terms of the statute, since the reorganization must partake of those characteristics "which underlie the purpose of Congress in postponing tax liability."[225] While the mere presence of tax planning will not cause a reorganization to fail the business purpose requirement, the taxpayer has the burden of proving the existence of a non-tax oriented business purpose.[226] The business purpose supporting the reorganization need not be its principal motivation and it need not exceed in importance the tax avoidance purpose; the business purpose doctrine requires only that the business purpose for the reorganization be real and substantial.[227]

The disclosure documents accompanying inversions have generally been vague in their description of the purposes of restructuring.[228] Inverting corporations have invoked a number of reasons in support of their decision to expatriate. Among these are that the inversion improves the inverting firm's global tax position, and that itcreates a new

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[224] Treas. Reg. § 1.368-2(g).

[225] See Wortham Machinery Co. v. U.S. 521 F.2d 160 (10th Cir., 1975).

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

[227] See, e.g. Wortham Machinery Co. v. U.S. 521 F.2d 160 (10th Cir., 1975), IRS TAM 89451004 (7/11/89).

[228] Certain statements made in support of the proposed inversions raise questions as to their substantiation, such as the claim that an offshore holding company structure would be beneficial for a future sale of assets, when there is no indication of any contemplated asset sale. See Triton Energy, Prospectus/Proxy Statement, op. cit. supra note 21 at 10; or the claim that the post-inversion structure would offer a better framework for future strategic alliances, when the corporation had no plans for strategic alliances or acquisitions, See Xoma, Prospectus/Proxy Statement, op. cit. supra note 37 at 11.

corporate structure offering greater flexibility in seeking to lower the worldwide tax liability and effective tax rate. These purposes, however, are clearly tax-related. It is also argued that the tax savings will increase the capital that may be committed to international expansion, which in turn will (1) make the corporation more attractive to investors, (2) enhance its ability to compete with non-U.S. firms, (3) enhance its ability to pursue business combinations with non-U.S. entities, and (4) increase its visibility within the investment banking community as a result of the perception of the company's enhanced corporate structure.

It is unquestionable that the net economic value of the corporation will be higher post-inversion, due to lower tax liabilities generated by the change in its tax status and its eligibility for new tax reduction techniques. 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. Such bootstrap reasoning, if generally accepted, would render the business purpose doctrine ultimately ineffectual. Any transaction that carries a tax saving enhances the value of the company or shareholder wealth – and this, in turn, could be claimed to justify the transaction.

A possibly more compelling reasoning in support of an outbound inversion would focus on the location of expansion potentials for the inverting corporation. The inverted corporation may argue that its potential for economic growth is located outside the United States and it desires to exploit that opportunity in a structure that is efficient from the inception of the new foreign operations. The foreign expansion may need additional financing, easier to be raised in a tax efficient corporate structure. Arguably the removal of income generated by *future* foreign operations from the ambit of United States taxing jurisdiction could be viewed more leniently. However, the likelihood of removing business opportunities developed while the pre-inversion corporation fully benefited from the institutional framework, capital markets and economic framework of the U.S., would still exist.[229] Economic studies examining inversion focused primarily on the effect of the inversion transaction on shareholder wealth.[230] There seems to be no indication that

[229] For the implications of the migration of business opportunities See Hardy, op. cit. supra note 199 at .

[230] See Desai & Hines, op. cit. supra note 15; Cloyd, Mills & Weaver, op cit supra note 108. .

inverting corporations would show a higher growth in foreign income than the industry median registered.

In these circumstances, it appears that the compliance of outbound inversion transactions with the business purpose doctrine is, at least, questionable.[231] Since, however, these reorganizations as outbound foreign reorganizations do not enjoy entirely tax-free status, a challenge of the transaction for lack of business purpose may not always be effective. If reorganization status were denied in a stock inversion, there would be little practical consequence since shareholders are in any event taxed pursuant to § 367(a). In the case of asset inversions and combined inversions the denial of tax-free treatment for lack of business purpose would carry additional tax liability. Asset inversions, fully taxable on the corporate level, are carried out without shareholder tax. Combined inversions treat the transfer of assets to a newly created U.S. subsidiary in a drop down that is part of the reorganization as non-taxable. The non-taxable portions of these transactions would be at risk if tax free treatment were denied based on absence of a valid business purpose.

(2) Internal Revenue Code § 269

An outbound corporate inversion that meets the standard of the business purpose doctrine may nevertheless be subject to question under § 269 of the Internal Revenue Code. Section 269(a) grants the IRS authority to disallow deductions, credits or allowances when, among other cases, a corporation acquires property of another corporation, directly or indirectly (e.g., by means of a stock or asset acquisition) and the principal purpose for which such acquisition was made is evasion or avoidance of federal income tax.[232] The purpose to evade or avoid federal income tax is the principal purpose if it "exceeds in importance any other purpose"[233] The determination of the

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[231] See NYSBA Report at 139.

[232] IRC § 269(a). 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." This would normally be the case, for example, in outbound share inversions, in which no gain or loss is recognized at the corporate level, and the asset basis of corporate assets carries over.

[233] Treas. Reg. § 1.269-3(a).

taxpayer's principal purpose is, of course, a question of fact, and the tax avoidance motive is examined against the aggregate of alllegitimate business reason to ascertain whether it is the principal purpose of the transaction. But this complex factual inquiry has caused § 269 to be viewed as a weak tool, without sufficient deterrent effect.[234]

The rules on disallowance of tax benefits on primarily tax motivated acquisitions of property appear on their face to be well suited to dealing with outbound corporate inversions. The origins and the legislative history[235] confirm that the objective of § 269 is "to prevent the distortion through tax avoidance of the deduction, credit, or allowance provisions of the code."[236] An outbound corporate inversion, however, is a transaction directed toward more than the use of deductions, credits and allowances; its object is to alter the entire corporate structure. The sanction of § 269 – denial of deductions, allowances, 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. One possible approach to a § 269 – type remedy might be continued treatment of the inverted corporation as a U.S. multinational;[237] this would represent a denial of the benefits of the "abusive" transaction, but might not fall clearly within the terms of § 269 without legislative amendment or at least the adoption of new regulations. These issues with respect to the application of § 269 prompted the authors of the NYSBA Report to question how it should be given effect in the case of corporate inversions, and to suggest the adoption of an initiative that would include adoption of new regulations to clarify the consequences of applying § 269.[238] However, some commentators have accepted in

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[234] NYSBA Report at 139.

[235] The predecessor to § 269 originated in theR evenue 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)

[236] S. Rep. No, 627, 78th Cong 1st Sess. 58 (1943).

[237] This might take the form, for example, of denying recognition of the transfers of assets, thereby – within thegeneral concept of § 269 – denying the deductions, credits or allowances associated with their transfer.

[238] NYSBA Report at 139.

principle that corporate inversions may, if contested, not withstand scrutiny under § 269 of the Internal Revenue Code.[239]

E. *The tax law's conceptual framework for the taxation of multinationals.*

The inverted corporation claims a tax status that is entirely different from the one applicable prior to inversion, the basis for this being the change, by virtue of the inversion, of the corporation's residence for tax purposes. 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 essentially allows a corporation to claim a jurisdiction of residence by virtue of incorporation, without regard to 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.[240] This approach to corporate residence for tax purposes contrasts with the approach taken by other common law jurisdictions, which adopt as the criterion of residence the location of the management and control of the multinational enterprise. The residence of a corporation is determined in this manner by the location of the operational decisions. Corporate inversions would be less attractive if they would imply some substantial restructuring of the corporation, instead of a mere change in filing jurisdiction. Under this approach, an inversion in which operational decisions remain located in the U.S. would result in no change in the tax residence of the inverting multinational. The multinational seeking recognition of its change of residence would, in effect, be required to shift the locus of its decision making – and therefore, most likely the seat and residence of its board and top management – to the jurisdiction of inversion. The adoption of this criterion has been

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[239] This seems to be the approach taken by the NYSBA Tax Section. See also Hicks, op. cit. supra note 3, and Wollman, op. cit supra note 114 (voicing doubts).

[240] IRC § 7701(a)(5) states that the term foreign, when applied to a corporation or partnership, means a corporation or partnership which is not domestic.

suggested as a long term solution to inversions, an approach that would remedy a conceptual inadequacy of the U.S. tax system.[241]

VI. Policy issues raised by outbound corporate inversions.

Outbound corporate inversions might be viewed as appropriate actions to minimize the negative impact of U.S. tax laws that put U.S. multinationals at a competitive disadvantage with foreign based multinationals.[242] Some commentators, on the other hand, view inversions as unpatriotic acts.[243] On the spectrum of opinions marked by these extremes, a variety of opinions have been expressed as to the nature of inversions. These are extensively discussed in the cited sources, but briefly reviewed here only to the extent necessary to assist in the understanding of the inversion debate.

The negative tax policy impact of outbound corporate inversions is unquestionable. At a technical level, inversion transactions are designed to achieve objectives "[that] are outside the system Congress established for taxation of U.S. corporations".[244] The inverting corporation changes its status for tax law purposes without having undergone 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 represents a potentially serious risk to the U.S. tax system, which is based on voluntary compliance. The inversion phenomenon highlights inadequacies of our tax system that might be attributed to (i) deficiencies of the basic principles and of the conceptual

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[241] See NYSBA Report; Avi-Yonah op. cit. supra note 77; L. Sheppard, *Preventing Corporate Inversions*, Tax Notes (April 1, 2002).

[242] 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 and stating "these expatriations are not illegal, but they are clearly immoral". Press Briefing Memo on REPO Bill, April 11, 2002 reprinted in Daily Tax Report, April 12, 2002 at L-11.

[243] For a critical overview of the approaches articulating that inversion transactions are unpatriotic, see R. Goulder, *Corporate Inversions: Legally Minimizing Taxes or Treason?*, Tax Notes (July 1, 2002) 1.

[244] NYSBA Report at 134.

framework, (ii) gaps of the technical rules and (iii) imperfections of 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 achieve the same tax savings as would be available through a subsequent inversion transaction."[245] Arguably, an acquisition of the U.S. corporation by a foreign corporation may achieve essentially the same result, the removal of the operations from the U.S. taxing jurisdiction.[246]

This reasoning views corporate expatriations as a response to the "disproportionate" tax burdens imposed on U.S. multinationals. According to this approach – endorsed by the Treasury Report on Inversions – "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." [247] These conclusions, while arguable, are not supported by unequivocal statistical data.[248] Nevertheless, the Treasury Report seems to

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[245] Treasury Inversion Report ¶ 54. This technique was recently used by Accenture, Ltd. Prospectus/Registration Statement, July 19, 2001; Seagate Technology, Inc., Prospectus/Registration Statement, April 20, 2002.

[246] Both the NYSBA Report and the Treasury Inversion Report seem to take this position.

[247] Treasury Report ¶¶ 5 – 7.

[248] 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 Ways and Means Committee Explanation of H.R. 5095; Organization of International Investment, *The Foreign Takeover Myth: Facts about Global M&A Activity and U.S. Companies Global Business Ranking*, (July 26, 2002) 2002 WTD 155-33; NFTC, *Report on U.S. International Tax Policy (Part 4)*, Tax Notes (April 5, 2002).

accept the "the excuse of competitive disadvantage"[249] and use it in support of its quest for certain changes in the U.S. foreign tax structure.

The competitive disadvantage excuse is based on the assumption that the United States asserts a more extensive taxing jurisdiction over the income of domestic headquartered companies than other countries. Frequently the argument is used in conjunction with theories advancing the benefits of the territorial taxation.[250] It is important to note, however, that the United States is not unique in asserting jurisdiction over the worldwide income of multinationals headquartered within its jurisdiction and in currently 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 starting business makes locational decisions determined by a variety of factors, which are primarily economic. The decision where to incorporate is often influenced by other factors. For example, the preferred incorporation jurisdiction for a corporation that contemplates an IPO will be one that offers legal certainty and transparency that enhance the value of the corporation. At incorporation, the entity elects into a system of legal rules, administrative and judicial enforcement mechanisms and societal monitoring framework. It similarly elects into the financial market structure of the jurisdiction in which it raises its capital. Therefore, a comparison solely of tax principles may not be conclusive in evaluating the potential advantages and disadvantages of the choice of a legal system.

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[249] See Avi Yonah, op. cit supra note 77, referring to the "competitiveness excuse." For a similar approach, see, M. A. Sullivan, *Congress's Inversion Odyssey: Oh The Places You'll Go*, Tax Notes 1289 (July 1, 2002). It is generally agreed that the competitiveness arguments advanced by the Treasury Inversion Report are not adequately supported by numerical data. See e.g., S. C. Thompson, *Treasury's Inversion Study Misses the Mark*, Tax Notes (June 10, 2002) at 1673.

[250] Inversions were labeled in this context as "self-help territoriality". See Treasury Inversion Report ¶ 28. Some authors seem to disapprove entirely of the use of "territoriality rhetoric" in this context. See, e.g., Sullivan, op. cit. supra note 249 at 1290-1291. Others argue that proposals to consider territorial taxation are appropriate with respect to active income. See e.g. Thompson, op. cit. supra note 249 at 1677.

The inquiry might begin by examining into whether there are economic benefits conferred upon a corporation by virtue of its status as a U.S. corporation. Would such benefits bestow a competitive advantage on the U.S. headquartered multinational which would counterbalance ‘disadvantageous’ tax treatment?[251] In response to the frequently expressed concern that U.S. tax rules operate as a disincentive to corporate location in the U.S., one may ask whether this jurisdiction offers any competing non-tax incentive for foreign corporations to locate their headquarters here. Further, are theredomestic economic benefits offered to domestic corporations that are equally available to foreign headquartered corporations? These questions seem to be justified in conjunction with the principle of ‘benefit based taxation’.[252]

Our overview of the factors facilitating inversions suggests thatlack of distinction between U.S. and foreign headquartered corporations may have contributed to making inversions possible. There are at least two alternative ways of addressing this problem. First, the tax law principles of residence should be re-evaluated to assure that tax residence is substantiated by the economic ties of the multinational corporation with the country that asserts residency-based taxing jurisdiction, the United States. Second, the non-tax regulatory framework should be modified to emphasize the availability of non-tax benefits on a residency basis, when appropriate and feasible. [The ineligibility of foreign corporations for U.S. governmental contracts would be such measure].

Conclusion

Outbound corporate inversions may be facing the prospect of extinction. Heightened public attention, such as that which accompanied the proposed inversion of Stanley Works, together with the threat of imminent legislation, brought a halt to the latest wave of expatriations. As this article is written, direct anti-inversion legislation

[251] This question is in some respects analogous to asking whether there “is a direct relationship between the competitiveness of U.S. multinationals and the competitiveness of the U.S. economy”. See Avi-Yonah, op. cit. supra note 77 at 1795.

[252] The principle of ‘benefit based taxation’ argues 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. The Report emphasized that U.S. citizenship carries rights and benefits that justify the assertion of extraterritorial taxing jurisdiction.

has not yet been enacted, and ancillary anti inversion measures – though at a more advanced stage of legislative consideration – remain to be enacted. If and when enacted, the legislative changes may well render inversions – at least as they have to this date been known – no longer desirable.

But the larger policy questions that the corporate expatriation process has brought to light will not be made to disappear easily. In the world of multinational enterprise, the questions of taxing jurisdiction, economic benefit and corporate governance are fundamental.