

Corporate Inversions and the Definition of an “American” Corporation

[adapted from Michael S. Kirsch, *The Congressional Response to Corporate Expatriations: The Tension Between Symbols and Substance in the Taxation of Multinational Corporations*, 24 VIRGINIA TAX REVIEW 475 (2005)]

In the past few years, several well-known U.S.-based multinational corporations engaged in restructurings known as “inversions.” Congress’s response to this phenomenon raises significant questions regarding the proper definition of an “American” corporation in an increasingly globalized economy.

Pursuant to an inversion, a corporate group changes the parent corporation’s place of incorporation from a U.S. state, such as Delaware, to a foreign country, such as Bermuda or the Cayman Islands. The transaction generally does not involve any change in the physical location of the corporate group’s management headquarters, manufacturing operations, or other activities. It merely reflects a change in the country in which the parent corporation’s articles of incorporation are filed. Although the change in place of incorporation appears to be a mere formality, it can have significant tax consequences. Under the Internal Revenue Code, the distinction between a “domestic” corporation and a “foreign” corporation depends on the place of incorporation. Because domestic corporations are subject to more comprehensive taxation than are foreign corporations, particularly with respect to foreign income earned through subsidiaries, U.S.-based multinationals pursued inversions in order to lower their tax bills. Indeed, several large corporations bragged to their shareholders that an inversion would save more than \$50 million per year in U.S. taxes.

The prospect of large multinational corporations reincorporating abroad to escape U.S. tax liability attracted significant media attention. Not surprisingly, it also became a hot political topic. In 2002, Congress enacted legislation that purported to punish inverting corporations by preventing them from entering into certain federal government contracts. However, that legislation, even after a 2003 amendment, contained exceptions that largely eviscerated its applicability. In this regard, the legislation was prototypical symbolic legislation, enabling its Congressional supporters to assure the public that Congress was “doing something” to stop a perceived problem (corporate inversions), yet doing so in a manner that did not actually impose instrumental costs on the purported target (the politically powerful group of inverted corporations).

In response to continued concerns about corporate inversions, Congress ultimately enacted an instrumentally effective tax provision in late 2004. That provision treats the post-inversion foreign-incorporated parent as a domestic corporation for tax purposes if both (i) certain ownership continuity exists between the pre-inversion and post-inversion shareholders, and (ii) no member of the corporate group has substantial

business activities in the foreign country in which the post-inversion corporate parent is incorporated. As a result, the tax code now has a two-tiered definition for determining whether a corporation is domestic or foreign. The traditional place-of-incorporation rule continues to apply to the large majority of corporations, while some foreign-incorporated entities resulting from inversions are treated as domestic if they run afoul of the ownership continuity and no substantial business activity tests.

The normative justifications offered for this two-tiered approach cast significant doubt on the continuing viability of the general place-of-incorporation rule. In particular, the very reasons given for the special rule for inverted corporations imply that the place-of-incorporation rule should be reconsidered and, perhaps, abandoned. According to the Senate Finance Committee report, the reason for enacting a special test for inverted corporations is that these transactions, by merely changing the place of the parent’s incorporation, generally result in “little or no” substantive non-tax consequences. Similar statements by supporters of the 2004 legislation suggest that an inversion transaction is a mere paperwork formality involving the filing of a sheet of paper (the articles of incorporation) in a foreign filing cabinet, and should therefore be disregarded for tax purposes. This lack of confidence in the tax code’s place-of-incorporation test is furthered by the “no substantial business activity” test of the 2004 legislation. By calling off the special domestic taint if a member of the corporate group conducts substantial business activities in the country in which the post-inversion parent is incorporated, the provision implies that the location of a corporation’s business activities may be a more legitimate determinant of residence than is the place of incorporation.

If, as the supporters of the new provision imply, a change in the corporate parent’s place of incorporation is mere “paperwork” involving a new “sheet of paper,” the logical



Michael S. Kirsch

question is why does the general rule in the U.S. tax code focus on a corporation's place of incorporation as the touchstone for defining residence? While the rhetoric regarding "mere paperwork" might have been overstated—at least some limited substantive non-tax consequences depend on place of incorporation—it seems difficult to justify imposing such significant tax consequences based solely on that factor (and other possible factors, such as administrative simplicity). Indeed, in an apparent acknowledgement that place of incorporation is not a sufficient determinant of a corporation's residence, a recent protocol to the U.S.-Netherlands tax treaty adopts a test focusing on the corporation's "primary place of management or control" to determine eligibility for treaty benefits.

The corporate inversion phenomenon focused significant attention on U.S. tax policy—in particular, the manner in which the United States taxes corporations in an international setting. Like a Rorschach test, legislators projected their own tax policy belief systems when interpreting the causes of, and appropriate responses to, corporate inversions. Some politicians viewed inversions sympathetically as an understandable response to a flawed and overreaching U.S. tax system. Accordingly, they advocated a change in the underlying tax system that would reduce the tax burden of U.S.-based

multinational companies and thereby eliminate the incentive to invert. Others viewed inverting corporations as unpatriotic traitors, improperly taking advantage of a loophole in the tax code. Accordingly, they advocated legislation, as evidenced by the recently-enacted provision, that would close this loophole by continuing to treat a post-inversion corporation as domestic.

Perhaps both sides in the Congressional debate misinterpreted the inversion ink-blot, projecting too much of their own pre-existing notions regarding appropriate tax policy. Rather than demonstrating the need for a radical overhaul of our international tax system or the need to selectively target corporations exploiting perceived loopholes, the inversion phenomenon primarily demonstrates the need to reexamine the definition of what is a U.S. corporation for tax purposes. The inversion debate rhetoric reflects a significant gap between the place-of-incorporation standard for determining a corporation's status and the public's and Congress's perception of what is an American company. Given the tenuous normative underpinnings of the place-of-incorporation rule and its ability to be manipulated, the definition of what makes a corporation domestic should be revisited across-the-board, not merely when enterprising corporations seek to turn the rule's shortcomings to their advantage.

