Haven or Hell: Securities Exchange Listing Standards and Other Proposed Reforms as a Disincentive for Corporate Inversion Transactions

John Kelly*

INTRODUCTION

In the past several years, there has been increasing publicity and outrage over the number of U.S. corporations undergoing corporate tax inversion transactions.[1] An inversion transaction is a transaction in which a U.S. corporate parent reincorporates in a foreign low-tax or no-tax country to escape U.S. tax liability.[2] Though inversions have increased significantly in recent years, they are not a new phenomenon. The first highly publicized inversion transaction took place in 1983 when McDermott International relocated to Panama.[3] In 1994, Helen of Troy shifted its parent corporation to Bermuda.[4] Since Helen of Troy, the number of inversion transactions has exploded.[5]

---

* J.D. Candidate 2005, University of Minnesota Law School; B.S. 2002, University of Wisconsin-Madison. I would like to thank Professor Robert T. Kudrle for his suggestion of this topic, Professors Brett McDonnell and Gregg Polsky for commenting on an earlier draft, and the editors and staff of the Minnesota Journal of Global Trade for all of their assistance.

1. *See infra* note 69 and accompanying text (discussing how many people have called recent inversion transactions unpatriotic).

2. *See infra* text accompanying notes 11–20.

3. *See* Carol P. Tello, *The Upside Down World of Corporate Inversion Transactions*, 30 TAX MGM'T INT'L J. 161, 167 n.66 (2001).

4. *See id.*

5. Companies undergoing these transactions include: Triton Energy (1996), Tyco International (1996), Everest Reinsurance Holdings (1999), Fruit of the Loom (1999), PXRE Corporation (1999), White Mountain Insurance Group (1999), XOMA (1999), Applied Power (2000), Transocean (2000), Coopers Industries (2001), Foster Wheeler (2001), Ingersoll Rand (2001), Global Marine (2001), Nabors Industries (2002), and Weatherford Corporation (2002). *See* Reuven S. Avi-Yonah, *For Haven's*

The primary purpose behind these inversion transactions is to reduce U.S. tax liability.[6] It is not completely clear, however, why inversions have increased so significantly in recent years. One explanation is that increased shareholder turnover leads to less appreciation in shares, reducing shareholder taxation in the transactions.[7] The recent decline in the stock market also reduces shareholder taxation.[8] Still another explanation is an increased market acceptance of the practice.[9] While these benefits may save corporations and shareholders tax dollars, many agree that inversion transactions harm the U.S. government by reducing tax revenues.[10]

This Note presents an overview of the major proposed reforms related to inversion transactions, and suggests using U.S. securities exchange listing standards as a disincentive for corporations looking to move overseas. Part I describes how inversion transactions function, and explains the effects of inversions on inverted corporations, shareholders, and the U.S. government. Part II discusses a number of reforms proposed by lawmakers and commentators. Finally, Part III proposes a concerted rule by the U.S. securities exchanges prohibiting the listing of inverted corporations.

I. HISTORY OF INVERSION TRANSACTIONS

A. TAX INVERSION TRANSACTIONS

In general terms, a corporate tax inversion is a transaction in which a U.S. corporation is reorganized so that a newly-formed foreign corporation becomes the parent of the corporate group.[11] The new foreign parent is usually formed in a low-tax

---

Sake: Reflections on Inversion Transactions, 27 TAX NOTES INT'L 225, 225 nn.4 & 6–9 (2002); John M. Peterson & Bruce A. Cohen, *Corporate Inversions: Yesterday, Today and Tomorrow*, 81 TAXES 161, 179 (2003). There have also been numerous start-up corporations initially incorporated in low-tax or no-tax jurisdictions. *See* Peterson & Cohen, *supra* at 26.

6. *See* discussion *infra* Part I.B.1.

7. Corporate Inversion Transactions: Tax Policy Implications, 2002 W.T.D. 103-88, 17 (Office Tax Pol'y May 2002) [hereinafter *Treasury Report*]. For a discussion of shareholder tax liability under inversion transactions, see discussion *infra* Part I.B.3.

8. *See* Peterson & Cohen, *supra* note 5, at 161.

9. *See* Avi-Yonah, *supra* note 5, at 226.

10. *See* discussion *infra* Part I.C.

11. *See generally New York State Bar Association Tax Section Report on Out-*

or no-tax jurisdiction.[12] Jurisdictions requiring little or no income tax are sometimes labeled "headquarters tax havens,"[13] and their number has grown substantially in recent decades.[14]

Inversion transactions take place in three primary forms. In a stock inversion transaction, a newly-formed foreign holding corporation acquires the stock of the U.S. parent company, and the U.S. parent becomes a subsidiary of the new foreign parent.[15] The shareholders then exchange their U.S. parent stock for stock in the new foreign parent.[16] In an asset inversion transaction, the U.S. parent transfers its assets to a new foreign parent before being eliminated.[17] As with a stock inversion, the shareholders exchange their stock of the U.S. parent for stock of the new foreign parent.[18] Finally, an inversion may take place through a "Drop Down Transaction," which is a combination of

---

bound Inversion Transactions, 2002 N.Y. ST. B. ASS'N TAX SECTION 1 [hereinafter *NYSBA Report*] (providing an overview of inversion transactions).

12. *Treasury Report*, *supra* note 7, at 4.

13. *See* Robert T. Kudrle & Lorraine Eden, *The Campaign Against Tax Havens: Will it Last? Will it Work?*, 9 STAN. J.L. BUS. & FIN. 37, 40–41 (2003). Headquarters tax havens usually offer low-tax or no-tax regimes in order to attract foreign multinational enterprises (MNEs). *See* Reuven S. Avi-Yonah, *Treating Tax Issues Through Trade Regimes*, 26 BROOK. J. INT'L L. 1683, 1687–88 (2001). Many of these havens were listed in the OECD's 2000 report identifying harmful tax regimes. *See* Organisation for Economic Co-operation and Development, *Report to the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs, Towards Global Tax Co-operation: Progress in Identifying and Eliminating Harmful Tax Practice* ¶ 17 (2000), *at* http://www.oecd.org/dataoecd/9/61/2090192.pdf (last visited Oct. 10, 2003) [hereinafter *OECD 2000 Report*]. The OECD listed the following countries as tax havens: Andorra, Anguilla, Antigua and Barbuda, Aruba, Commonwealth of Dominica, Gibraltar, Grenada, Guernsey/Sark/Alderney, Isle of Man, Jersey, Liberia, The Principality of Liechtenstein, The Republic of the Seychelles, St. Lucia, The Federation of St. Christopher & Nevis, St. Vincent and the Grenadines, Tonga, Turks & Caicos, U.S. Virgin Islands, and the Republic of Vanuatu. *Id.*

14. *See* Kudrle & Eden, *supra* note 13, at 42. Kudrle and Eden propose additional reasons for the increase, including the growth of MNEs and improvements in transportation and communication. *Id.* at 43. Ronen Palan offers four explanations behind the recent growth of tax havens: the increasing regulation and taxation in OECD countries, the critical role of havens in developing financial globalization, corruption and crime in other countries, and haven jurisdictions' use of haven activity as a strategy for economic development. RONEN PALAN ET AL., STATE STRATEGIES IN THE GLOBAL POLITICAL ECONOMY 175 (1996).

15. *See Treasury Report*, *supra* note 7, at 4; Peterson & Cohen, *supra* note 5, at 164.

16. *See Treasury Report*, *supra* note 7, at 5; Peterson & Cohen, *supra* note 5, at 164.

17. *See Treasury Report*, *supra* note 7, at 5; Peterson & Cohen, *supra* note 5, at 165.

18. *See Treasury Report*, *supra* note 7, at 5; Peterson & Cohen, *supra* note 5, at 165.

stock and asset transfers.[19] Whichever form of inversion, the transaction has no immediate effect on the operations of the corporation.[20]

B. EFFECTS OF INVERSION TRANSACTIONS ON INVERTED CORPORATIONS AND SHAREHOLDERS

1. *Reduction of Corporate Tax Liabilities*

While an inversion transaction does not immediately affect a corporation's operations, it does cause other significant consequences. These consequences stem largely from the overall purpose of an inversion transaction, reducing a corporation's worldwide tax liabilities.[21] Under Subpart F of the Internal Revenue Code,[22] a U.S. parent corporation is taxed on income earned by a foreign subsidiary operation, regardless of whether the income returns to the United States.[23] In order to avoid double taxation of foreign-source income, however, the United States provides a tax credit for income taxes paid to foreign countries.[24] A post-inversion corporation avoids U.S. tax liability by shielding foreign operations' income from U.S. income tax,[25] and by deducting interest or royalties paid from the U.S. subsidiaries to the foreign parent, often called "earnings stripping."[26]

After an inversion transaction, the U.S. operations of an inverted corporation are still subject to U.S. taxes.[27] The foreign operations, however, escape the reach of U.S. taxes. Instead, the foreign operations of the inverted corporations become subject to the taxes of the jurisdiction in which they take place and the jurisdiction of the foreign parent corporation.[28] Because the

---

19. *See Treasury Report*, *supra* note 7, at 5; Peterson & Cohen, *supra* note 5, at 167.
20. *Treasury Report*, *supra* note 7, at 5.
21. *See* Peterson & Cohen, *supra* note 5, at 163.
22. I.R.C. §§ 951–64 (1994).
23. *Treasury Report*, *supra* note 7, at 11–12.
24. *See* I.R.C. § 901 (2003); William G. Gale, *Notes on Corporate Inversions, Export Subsidies, and the Taxation of Foreign-Source Income*, 27 TAX NOTES INT'L 1495, 1497 (2002).
25. *See* Lee A. Sheppard, *Preventing Corporate Inversions, Part 2*, 95 TAX NOTES 816, 816–17 (2002).
26. *See id.*
27. *Treasury Report*, *supra* note 7, at 12.
28. *Id.* at 29.

new foreign parent of an inverted corporation is typically located in a low-tax or no-tax jurisdiction,[29] the inverted corporation is able to reduce significantly its tax liability on foreign operations.[30]

An inverted corporation may also reduce its U.S. tax on U.S. operations through "earnings stripping."[31] Under section 163,[32] if an inverted corporation creates indebtedness between the U.S. subsidiaries and the foreign parent corporation, interest payments from the U.S. subsidiaries to the foreign parent are deductible for U.S. tax purposes.[33] Thus, an inverted corporation's U.S. subsidiaries can be loaded up with a disproportionate amount of intercompany debt to decrease U.S. taxes. Earnings stripping is maximized when the foreign parent corporation is located in a no-tax country with a tax treaty with the United States, such as Bermuda, because the interest is not taxed in the foreign jurisdiction.[34] While earnings stripping can offer an inverted company substantial U.S. tax savings,[35] section 163(j) does limit the allowable deduction.[36] If a U.S. subsidiary's debt-to-equity ratio exceeds 1.5 to 1, and its net interest expense exceeds 50% of its adjusted taxable income, section 163(j) limits the deduction of interest in excess of 50% of adjusted taxable income.[37]

Earnings stripping may also be accomplished by transferring intangible assets, such as patents, from U.S. subsidiaries to a foreign parent.[38] If a foreign parent in a tax treaty jurisdiction

---

29. *See supra* notes 12–14 and accompanying text.

30. *See Treasury Report*, *supra* note 7, at 29.

31. *Id.* at 21, 29.

32. I.R.C. § 163 (2003).

33. Peterson & Cohen, *supra* note 5, at 163. This indebtedness can be easily accomplished by an inverted corporation, such as by issuing an intercompany note. *See Treasury Report*, *supra* note 7, at 21.

34. *Treasury Report*, *supra* note 7, at 22. In the absence of an income tax treaty, a U.S. withholding tax of 30% is applied to the interest payments. *Id.* at 24. Even if the foreign parent is located in a jurisdiction that imposes a tax, there will be some benefit as long as the foreign tax on the interest income is less than the value of the U.S. tax deduction for interest payment. *Id.* at 22.

35. Earnings stripping is the largest component of tax savings in an inversion transaction on a present-value basis. Sheppard, *supra* note 25, at 816–17. While the tax savings on foreign operations take place in the future, savings from earnings stripping take place immediately. *Id.*

36. I.R.C. § 163(j) (2003). Section 163(j) was enacted in 1989 in response to concerns about abuse of section 163.

37. I.R.C. § 163(j)(2) (2003). Any interest exceeding the 50% limit, however, may be carried forward indefinitely and used in another year. *Id.*; *Treasury Report*, *supra* note 7, at 23.

38. *See* Sheppard, *supra* note 25, at 816–17.

owns U.S. intangible assets, the royalty payments paid by a U.S. subsidiary may be deductible for U.S. tax purposes.[39] These transactions can raise significant problems if the prices abuse the "arm's length" standard of section 482.[40]

By transferring foreign operations to the umbrella of the foreign parent and performing earnings stripping, inverted companies can reduce significantly their annual tax liabilities.[41] This reduction in tax liabilities may enable inverted multinational enterprises (MNEs) to increase their competitiveness domestically and abroad.[42] Because tax liabilities are a substantial cost to corporations, a reduction in taxes helps an inverted corporation lower its prices and capture a greater market share.[43] This increased competitiveness may also lead to a "snowball" effect, producing pressure on other corporations to invert.[44]

2. *Increased Share Price*

Inversion transactions may further benefit shareholders of an inverted corporation by increasing the price of their shares. Some studies have demonstrated an increase in the share prices of corporations after the announcement of a planned inversion transaction.[45] Positive share price reactions may be the result

39. *See* I.R.C. § 161 (2003); Peterson & Cohen, *supra* note 5, at 176–77.

40. *See* I.R.C. § 482 (2003); *Treasury Report*, *supra* note 7, at 25. The United States imposes rules requiring that transfer prices are set as if the transaction was at arm's length. Gale, *supra* note 24, at 1497. "Arm's length" refers to a transaction between two parties who are "not related or not on close terms." BLACK'S LAW DICTIONARY 42 (2d pocket ed. 2001). These rules, however, are difficult to enforce. Gale, *supra* note 24, at 1497.

41. Ingersoll-Rand reportedly saved $50 to $60 million in taxes in 2002 as a result of its inversion. Phyllis Plitch, *Activists Engage Ingersoll-Rand About Tax Haven*, WALL ST. J., May 28, 2003, at B6E. Tyco International stated that it saved $400 million in 2001 because of its inversion. David Cay Johnston, *U.S. Corporations are Using Bermuda to Slash Tax Bills*, N.Y. TIMES, Feb. 18, 2002, at A1. Coopers Industries has stated that it expects its inversion to reduce its annual effective tax rate by 12–17%. Avi-Yonah, *supra* note 5, at 226 n.17 (citing Coopers Industries Proxy Statement (July 27, 2001)).

42. *See* Ken Brewer, *Treason? Or Survival of the Fittest? Dealing With Corporate Expatriation*, 95 TAX NOTES 603, 605–06 (2002).

43. *See id.*

44. Jonathan Weisman, *Patriotism Raining on Tax Paradise; Lawmakers Are Chafing at Firms that Exist Offshore Only on Paper*, WASH. POST, Aug. 21, 2002, at E1 (stating that Stanley Works considered inverting only after two of its major competitors, Cooper Industries and Ingersoll-Rand, inverted to Bermuda in 1997).

45. *See* Mihir A. Desai & James R. Hines, Jr., *Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions*, 55 NAT'L TAX J. 409,

of stockholder recognition that after-tax earnings will be higher.[46] Any price increases, however, appear relatively small.[47] At least one study disputes any positive market reaction to inversion transactions.[48] In any event, there is not enough information to suggest that increased share price creates a serious motive for corporations to undergo inversion transactions.

3. *Taxation of Realized Gains in Inversion Transactions*

Despite the potential benefits, inversion transactions are not without costs to shareholders and corporations. Depending on whether the inversion transaction is a stock or asset transfer, shareholders and inverted corporations may be subject to U.S. taxes on any capital gains.[49] In a stock transfer, under section 367(a),[50] U.S. persons are taxed on realized gain when they transfer appreciated stock from the U.S. corporation to the new foreign parent.[51] Conversely, shareholders with a loss on the stock cannot recognize the loss for tax purposes.[52] These "anti-inversion regulations" were adopted in response to early inversion transactions.[53] The anti-inversion regulations do, however, allow for tax-free treatment if certain conditions are met.[54]

---

430 (2002); Jim A. Seida & William F. Wempe, *The Market's Reaction or Nonreaction to Corporate Inversions*, 96 TAX NOTES 1146, 1149 (2003) (stating that their findings suggest "investors reacted favorably (on average) to shareholder approvals of pre-Autumn 2001 inversion transactions").

46. Bruce Bartlett, *Why the Inversion Aversion?*, *available at* http://www.nationalreview.com/nrof_bartlett081202.asp (Aug. 12, 2002).

47. *See* Desai & Hines, *supra* note 45, at 430 (stating that out of nineteen inversion transactions studied, stock prices had increased on average by 1.7% over a five-day period following the inversion announcement).

48. *See* C.B. Cloyd et al., *Market Nonreaction to Inversions*, 98 TAX NOTES 259, 259–61 (2003) (arguing that Seida and Wempe's conclusion is faulty and that there is no significant positive market reaction to an inversion transaction).

49. *See Treasury Report*, *supra* note 7, at 7. For a detailed and technical examination of the tax consequences of various inversion transactions, see Gregg D. Lemein & John D. McDonald, *Taxable Inversion Transactions*, 80 TAXES 7 (2002).

50. I.R.C. § 367(a) (2003).

51. *See* Treas. Reg. § 1.367(a)-3(a), (c) (2004); Lemein & McDonald, *supra* note 49, at 7–8; Tello, *supra* note 3, at 164.

52. *See Treasury Report*, *supra* note 7, at 8.

53. *See* Tello, *supra* note 3, at 167. The McDermott and Helen of Troy inversion transactions attracted significant attention in the United States. *Id.* at 167 n.66; *see supra* notes 3–4 and accompanying text.

54. There are four requirements that must be met for a transfer of stock to escape taxation. First, the new foreign stock received by the shareholders must be less than 50% of the total voting power and total stock value of the foreign corporation.

Section 367(a) may thus impose a tax cost to shareholders and act as a disincentive for inversion transactions. In a stock market decline such as has occurred in recent years, however, many shareholders will see little if any realized gains.[55] Thus, in low stock markets, the section 367(a) costs may be greatly outweighed by the present value of future tax savings from the inversion.[56] This imbalance may be true even in "bull" stock markets since the expected tax savings of inverted corporations have been so large.[57]

Conversely, in an asset transfer inversion transaction, the U.S. corporation is taxed on gains recognized on any assets transferred.[58] The gain is calculated as if the assets had been sold at the time of the transaction for their fair market value.[59] The shareholders are not taxed on their transfer of stock, and will hold the shares of the foreign parent with the same basis that they had in the stock of the U.S. corporation.[60]

4. *Corporate Governance Concerns*

An inversion transaction may also raise corporate governance concerns for shareholders by weakening shareholder rights. If the parent corporation is moved to a foreign jurisdiction, such as Bermuda, the inverted corporation becomes subject to the corporate governance laws of Bermuda and is no longer subject to the laws of the state of the former U.S. parent.[61] This change in law may create problems for shareholders if the corporate governance laws of the foreign jurisdiction are more lax than the laws of the former U.S. jurisdiction. In Bermuda, for example, there are major problems with laws affecting share-

---

Treas. Reg. § 1.367(a)-3(c)(1)(i) (2004). Second, 50% or less of the total voting power and total stock value of the foreign corporation is owned by former directors, officers, or 5% shareholders of the U.S. corporation. *Id.* § 1.367(a)-3(c)(1)(ii). Third, each 5% shareholder must enter into a "gain recognition agreement." *Id.* § 1.367(a)-3(c)(1)(iii)(B). Finally, the foreign corporation must satisfy an active trade or business requirement. *Id.* § 1.367(a)-3(c)(3). For a detailed explanation of the inversion regulations requirements, see Tello, *supra* note 3, at 168–70.

55. *See* Brewer, *supra* note 42, at 605–06.

56. *See id.* at 605.

57. *See supra* note 41 and accompanying text.

58. I.R.C. § 367(a) (2003); *Treasury Report*, *supra* note 7, at 9.

59. *Treasury Report*, *supra* note 7, at 9.

60. I.R.C. §§ 358(a), 1223(1) (2003); *Treasury Report*, *supra* note 7, at 9. In order for the shareholders to avoid tax liability on their share transfer, the transfer must qualify as a section 368 reorganization. *See* Treas. Reg. § 1.367(a)-3(a), (d)(3) (Example 12) (2004); *Treasury Report*, *supra* note 7, at 9.

61. *See Treasury Report*, *supra* note 7, at 16–17.

holder rights, including: (i) a general inaccessibility of the law, since court decisions are not assembled and publicly reported; (ii) an absence of limitations on insider trading; (iii) no requirements of prior shareholder approval before a corporation enters into major actions such as selling assets; and (iv) the restriction on shareholder derivative suits.[62]

C. EFFECTS OF INVERSION TRANSACTIONS ON THE U.S. GOVERNMENT: EROSION OF THE U.S. TAX BASE

As a result of the number of recent inversions[63] and the inverted companies' reduction in U.S. tax liabilities,[64] inversion transactions are likely reducing U.S. corporate tax revenues. These revenues are vital because the U.S. government depends on corporate taxes for about 9% of its total revenue.[65] While there is some disagreement over the extent to which inversion transactions cost the government,[66] there is little doubt that if the number of inversions increases, U.S. tax revenues may substantially decrease.[67] In addition, as inverted corporations shift activities to foreign jurisdictions, tax compliance may decrease.[68] The fear of declining tax revenues has even led many to challenge the patriotism of corporations that undergo inver-

62. *Corporate Inversions: Hearing Before the House Comm. on Ways and Means*, 107th Cong. 32–34 (2002) (statement of the American Federation of Labor — Congress of Industrial Organizations).

63. *See supra* text accompanying note 5.

64. *See supra* note 41 and accompanying text.

65. Robert T. Kudrle, *Are There Two Sides to the Tax Haven Issue?* (forthcoming).

66. *See Corporate Inversion: Hearing on S. 2119 Before the Senate Subcomm. on Treasury and General Government of the Comm. on Appropriations*, 107th Cong. 10 (Oct. 16, 2002) (statement of Pamela Olson, Dept. of the Treasury) (stating that inversions cost the government "billions" annually); Reuven S. Avi–Yonah, *Commentary*, 53 TAX L. REV. 167, 172 (2000) (stating that recent studies have shown a 15% drop in the effective foreign tax rate of U.S.-based MNEs from 1984–92). *But see* Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1597 (2000) (stating that U.S. corporate tax revenue losses have been relatively small); Martin A. Sullivan, *The U.S. Congress's Inversion Odyssey: Oh, the Places You'll Go*, 27 TAX NOTES INT'L 150, 151 (2002) ("Using revenue estimates as guides, corporate inversion activity in dollar terms is not even a billion dollar a year issue.").

67. *See* Samuel C. Thompson, Jr., *IRC Section 367: A 'Wimp' for Inversions and a 'Bully' for Real Cross-Border Acquisitions*, 26 TAX NOTES INT'L 587, 598 (2002) ("[I]f Congress and the Treasury do not act quickly to address this situation, there will be a significant erosion in the corporate income tax base.").

68. *See* Kudrle & Eden, *supra* note 13, at 44 (citing U.S. General Accounting Office estimates that tax compliance rates of 90% drop to 30% for foreign-source income due to the absence of withholding or effective information exchange).

sion transactions.[69]

II. INVERSION TRANSACTIONS: PROPOSED REFORMS

In response to the recent increase in inversion transactions,[70] many lawmakers and commentators have called for legislation to end the practice.[71] While some argue that the best course is simply to do nothing,[72] the potential decrease in U.S. tax revenues[73] and the concerns over corporate governance[74] weigh in favor of taking action to halt inversion transactions. This section will survey various proposed reforms to stop or decrease inversion activity. It will further list the generally cited advantages and disadvantages of each reform.

A. CUTTING CORPORATE TAXES

The existing U.S. corporate tax rate of 35%[75] has been cited as a cause of inversion transactions.[76] Perhaps the most straightforward solution to inversion transactions would be to simply lower this rate.[77] Tax cuts of sufficient proportion would

---

69. *See* Brewer, *supra* note 42, at 607–08; Johnston, *supra* note 41, at A1 (stating that a partner with an accounting firm has cited patriotism criticisms as the only potential problem to inversion decisions). Congress's view that inversion transactions are unpatriotic is apparent from the titles of many bills introduced in response to inversion activity. *See* Corporate Patriot Enforcement Act, H.R. 3884, 107th Cong. (2002); Save America's Jobs Act, H.R. 3922, 107th Cong. (2002); Uncle Sam Wants You Act, H.R. 4756, 107th Cong. (2002); No Tax Breaks for Corporations Renouncing America Bill, H.R. 4993, 107th Cong. (2002). House Bill 3884 actually makes September 11, 2001, its retrospective effective date. H.R. 3884.

70. *See supra* text accompanying notes 3–5.

71. *See* Samuel C. Thompson, Jr., *Inversion Hearings Focus on Wrong Issues*, - 27 TAX NOTES INT'L 193, 194 (2002) ("[I]t would be irresponsible for Congress to decide not to immediately shut down inversions.").

72. *See Corporate Inversions Reveal Deeper Tax Code Flaws, Cato Analysts Say*, 27 TAX NOTES INT'L 178, 178 (2002) [hereinafter *Cato Analysts*]; Daniel J. Mitchell, *Corporate Expatriation Protects American Jobs,* HERITAGE FOUND., (2002) *at* http://www.heritage.org/Research/Taxes/em829.cfm (arguing that there should be no legislation adverse to inversions so that corporations can legally invert and take advantage of "self-help" territoriality).

73. *See supra* text accompanying notes 63–69.

74. *See supra* Part I.B.4.

75. I.R.C. § 11 (1986).

76. *See* Bartlett, *supra* note 46 (stating that Congress should lower the corporate tax rate because the "inversion phenomenon should be viewed as a warning that U.S. [corporate] rates are too high"); *Cato Analysts*, *supra* note 72, at 178.

77. *See* Scott A. Hodge, *The Economics of H.R. 5095*, TAX FOUND., (2002), *at* http://www.taxfoundation.org/hr5095.html (arguing that a tax decrease as low as 5% would prevent most inversion transactions).

reduce U.S. corporations' tax liabilities, removing the benefit of inversions.[78] Yet, while this may discourage inversion transactions, it would only further lower U.S. tax revenues.[79] Thus, it would only exacerbate the undesirable consequences of inversion transactions. Because this is probably not a viable solution, few commentators have advocated this approach.

B. REDOMESTICATION

Several members of Congress have proposed legislation to treat inverted corporations as U.S. corporations for U.S. tax purposes.[80] This change in tax definition is termed "redomestication."[81] Each of these bills defines an inversion transaction as one in which (i) a foreign corporation acquires substantially all of the shares or assets of a U.S. corporation, and (ii) more than 50% or 80% (depending on the bill) of the foreign corporation's stock is held by former shareholders of the U.S. corporation.[82] In addition, some of the bills require that the foreign corporate group not have "substantial business activities" in its country of incorporation.[83]

The main benefit of the redomestication approach is that it offers a bright line test that effectively stops the reduction of U.S. tax revenues by inversion transactions. This approach, however, presents several additional problems. First, as currently proposed, the redomestication reform fails to address the problem of start-up companies that incorporate in no-tax or low-tax jurisdictions from the beginning, even though most of their business is located in the United States.[84] The start-up prob-

78. A corporate tax reduction could also (i) make the U.S. tax rate comparable to those of major trading partners, (ii) reduce the domestic costs to U.S. exporters, making their products more competitive in the global market, (iii) encourage multinational corporations to increase the amount of dividends that they send back to the United States, and (iv) serve as an incentive for more foreign direct investment in the United States. *See id.*

79. *See supra* text accompanying notes 63–69.

80. *See* Corporate Patriot Enforcement Act, H.R. 3884, 107th Cong. (2002); H.R. 3857, 107th Cong. (2002); Save America's Jobs Act, H.R. 3922, 107th Cong. (2002); Uncle Sam Wants You Act, H.R. 4756, 107th Cong. (2002); S. 2050, 107th Cong. (2002); Reversing the Expatriation of Profits Offshore Act, S. 2119, 107th Cong. (2002).

81. *See* Lee A. Sheppard, *Preventing Corporate Inversions*, 95 TAX NOTES 29, 30 (2002).

82. Avi-Yonah, *supra* note 5, at 227.

83. *See, e.g.*, Reversing the Expatriation of Profits Offshore Act, S. 2119, 107th Cong. (2002).

84. *See* Peterson & Cohen, *supra* note 5, at 180. Today, it is common for start-

lem, however, could probably be solved by a modification of the domestication approach, as advocated by Robert Kudrle.[85] The United States could refuse to recognize incorporation in a foreign jurisdiction if a minimum amount of the corporation's shares are not owned by the foreign jurisdiction's citizens.[86] Kudrle does not address the danger that a corporation legitimately incorporated in a foreign jurisdiction could fail the test if, for some reason, its shareholders are not primarily citizens of that jurisdiction.[87] Still, by setting the citizenship requirement at an appropriate threshold, say 5%, legitimate incorporations could be protected. Inverted corporations would be denied incorporation because the capital required for citizens of a no-tax or low-tax country like Bermuda to own 5% of a MNE's shares would be too high.[88]

Both of these reforms present several problems. First, the citizenship requirements may be difficult to administer and enforce since publicly-traded shares constantly change hands.[89] Second, the "substantial business activities" requirement of some bills[90] is somewhat vague.[91] Disagreement over what constitutes "substantial business activities" could lead to increasing litigation.[92] Finally, the redomestication bills may be politically unfeasible because, despite substantial support,[93] none were ultimately passed by Congress.[94]

---

up companies that are likely to become MNEs to consider incorporating in no-tax or low-tax jurisdictions from the beginning. *See* Brewer, *supra* note 42, at 604. Moreover, limiting inversion reform to the definition used in the redomestication bill may actually encourage more start-up companies to incorporate in foreign jurisdictions. *See Treasury Report*, *supra* note 7, at 20.

85. *See* Kudrle, *supra* note 65, at 8.

86. *See id.*

87. *Id.*

88. E-mail from Robert T. Kudrle, Professor, University of Minnesota, to John Kelly (Nov. 14, 2003, 19:45 CST) (on file with author).

89. Avi-Yonah, *supra* note 5, at 228.

90. *See, e.g.*, Reversing the Expatriation of Profits Offshore Act, S. 2119, 107th Cong. (2002).

91. *See* Avi-Yonah, *supra* note 5, at 228.

92. *See id.*

93. *See* Thompson, *supra* note 71, at 194 (stating that Congress should immediately adopt S. 2119). House Bill 4993 had 93 co-sponsors. Sullivan, *supra* note 66, at 154.

94. The bills were dropped after lobbying by business groups and complaints by House Republicans. *See* John D. McKinnon & John Harwood, *Tax Shelters Come Under Fire: Democrats Push Crackdowns, Hope to Cut Bush Approval Ratings*, WALL ST. J., June 6, 2003, at A4.

C. CHANGING THE DEFINITION OF HEADQUARTERS: THE "MANAGED AND CONTROLLED" TEST

Another proposed reform is the "managed and controlled" test of corporate residence, similar to the standard used in the United Kingdom.[95] Under this approach, a corporation's residence for U.S. tax purposes would be changed from the place of incorporation to the jurisdiction in which it is managed and controlled.[96] Most commentators, however, agree that the United States should not adopt the identical U.K. version, which generally treats the location of board meetings as the residence.[97] The U.K. standard has been abused by corporations hiring outside directors who stage meetings in the jurisdiction of incorporation while the corporation's operations take place elsewhere.[98] Few boards mind meeting a few times a year in a tax haven such as Bermuda.[99] Instead, most commentators advocating the "managed and controlled" test contend that it should focus on the jurisdiction in which the principal officers of a corporation manage the business on a daily basis.[100]

The benefit of this approach is that since few inverted companies manage their operations from the foreign parent jurisdiction, inverted companies operating primarily in the United States would still be subject to U.S. taxes.[101] This tax treatment would make inversion transactions pointless.[102] Another benefit of this approach is that it would be hard to avoid or abuse because it would be very costly for principal officers, both personally and monetarily, to move to a foreign jurisdiction to run an inverted corporation.[103] Furthermore, unlike the redomestication approach, this test applies to start-up companies incorporating in foreign jurisdictions from the beginning.[104]

While the "managed and controlled" test would be consis-

95. *See* Finance Act, 1988, c. 39, § 66, sched. 7 (Eng.).

96. Peterson & Cohen, *supra* note 5, at 184.

97. *See id.*

98. Sheppard, *supra* note 81, at 31. Interestingly, the United Kingdom has now supplemented the "managed and controlled" test with a place of incorporation test. *See* Avi-Yonah, *supra* note 5, at 229.

99. Avi-Yonah, *supra* note 5, at 229.

100. *See id.*; Peterson & Cohen, *supra* note 5, at 184.

101. Avi-Yonah, *supra* note 5, at 229.

102. Because of the "managed and controlled" test, there have been relatively few inversion transactions in Europe. *Id.* at 229 n.37.

103. *Id.* at 229.

104. *Id.*; Peterson & Cohen, *supra* note 5, at 184.

tent with international norms,[105] it would be a radical change from traditional U.S. tax policy.[106] Moreover, unlike the redomestication approach, this test does not offer a bright line test.[107] In large MNEs, officers may perform a number of different duties in different countries. Finally, this test may present a disincentive for MNEs to manage operations in the United States, since it would cause them to become subject to U.S. taxes.[108] The domestic management of MNEs confers substantial benefits on the United States apart from corporate income taxes.[109]

D. PROHIBITING FEDERAL CONTRACTS WITH INVERTED CORPORATIONS

A few recent bills have proposed banning federal contracts with inverted corporations. The Reclaiming Expatriated Contracts and Profits Act attempted to ban all federal contracts with inverted corporations.[110] In addition, the initial Homeland Security Bill banned the U.S. Department of Homeland Security from contracting with inverted corporations.[111] These proposals would provide a substantial disincentive for corporations considering inversions.[112] Like other inversion bills, however, these bills may be politically infeasible because they never manage to get passed into law.[113] Also, since these bills use the same definition of inverted corporations as the redomestication bills, they are faced with the same problems: determining shareholder residency, failure to address start-up corporations, and vagueness in the "substantial business activities" prong.[114]

105. Peterson & Cohen, *supra* note 5, at 184.

106. *Id.*; Avi-Yonah, *supra* note 5, at 229.

107. Avi-Yonah, *supra* note 5, at 229.

108. *See* Peterson & Cohen, *supra* note 5, at 184.

109. *See id.* (stating that the benefits of U.S. management of MNEs include the employment of executives who pay U.S. taxes, the use of U.S. services in other industries, and the support for charities and cultural institutions).

110. *See* S. 3120, 107th Cong. (2002); Amy Hamilton, *Finance Asks: Is Accenture an Expatriate?*, 98 TAX NOTES 894, 894–95 (2003).

111. H.R. 5005, 107th Cong. (2002); Patti Mohr, *Corporate Inversion Language Stripped From Homeland Security Bill*, 31 TAX NOTES INT'L 1148, 1148 (2003). The Homeland Security issue was later revisited when a Homeland Security funding bill again attempted to ban federal contracts with the agency. *Id.*

112. *See* Mohr, *supra* note 111, at 1149 (quoting Congressman Richard E. Neal, who stated that inverted corporations win $2 billion a year in federal contracts).

113. *See id.* at 1148; Kudrle & Eden, *supra* note 13, at 68 n.5.

114. *See supra* text accompanying notes 82–83.

E. DIFFERENTIAL TAX TREATMENT FOR INVERTED CORPORATIONS

Some proposals have attempted to increase U.S. taxes on certain components of inverted corporations. One approach is to impose a surtax on the dividends or the proceeds of stock sales of inverted corporations.[115] This tax increase would impose a substantial disincentive for inversions and recapture some of the lost U.S. revenues. While this approach appears credible, there have been no proposals as to what criteria would be used to define an inverted corporation.

A second reform, proposed in the American Competitiveness and Corporate Accountability Bill, would impose a 20% excise tax on all stock options held by executives and directors of an inverted corporation.[116] This tax would provide a disincentive specifically for those in the position to make the inversion transaction decision.[117] Those with stock options, however, have an interest in seeing their share prices increase, and an increase in share prices due to a post-inversion reduction in tax liabilities might outweigh the costs of the tax.[118]

F. REFORMING SECTION 163(J) FOR EARNINGS STRIPPING

In its 2002 report, the U.S. Treasury Department suggested several changes to section 163(j) in order to decrease earnings stripping.[119] First, the Treasury suggested comparing the debt-equity ratio of a U.S. subsidiary to the debt-equity ratio of the worldwide group of which it is a part to determine whether the U.S. corporation is leveraged disproportionately.[120] Alternatively, the Treasury suggested that the debt-equity ratio could be eliminated, and the allowable interest deduction calculation could be made solely by comparing interest expense to taxable income.[121] In addition, the Treasury further suggested reducing

---

115. *See* Kudrle, *supra* note 65, at 8.

116. H.R. 5095, 107th Cong. (2002).

117. *See* Peterson & Cohen, *supra* note 5, at 186.

118. *Id.*; *see* discussion *supra* Part I.B.2 (discussing the increase of share prices following an inversion transaction).

119. *See Treasury Report*, *supra* note 7, at 22–25; *supra* text accompanying notes 33–37.

120. *Treasury Report*, *supra* note 7, at 23.

121. *Id.* The treasury stated that the 1.5 to 1 debt-equity ratio "effectively operates as a safe harbor for corporations with debt-equity ratios of 1.5 to 1 or lower." *Id.*

the 50% limitation on adjustable taxable income.[122] Finally, the Treasury suggested rethinking the indefinite carryforward of each year's non-deductible interest expense.[123] Recently, the American Competitiveness and Corporate Accountability Bill proposed similar reforms.[124]

Reforming section 163(j) as the Treasury suggested could substantially fix the underlying tax rule inadequacy and curb earnings stripping by inverted corporations. Some commentators, however, argue that the proposed reforms are much too broad.[125] Since the rule and proposed reform do not consider the reasons behind a U.S. subsidiary's above-average debt level, firms with a legitimate purpose behind their high debt levels that are not engaging in earnings stripping could be affected.[126] This concern is further exacerbated if the 50% limitation on adjustable taxable income is tightened.[127] At the same time, this reform may be too narrow for the inversion problem. While it may help to prevent interest earnings stripping, the Treasury's proposal does not address deductions for payments on intangible assets.[128] This reform also does not address inverted corporations' ability to avoid U.S. taxes on foreign operations.[129]

---

122. *Id.*

123. *Id.* at 23–24.

124. H.R. 5095, 107th Cong. (2002). The bill proposed the following changes: (i) eliminate the 1.5 to 1 debt-equity ratio requirement, (ii) reduce the carryforward allowance to five years, and (iii) reduce the acceptable deductible interest expense from 50% to 35%. *Id.*

125. *See* Peterson & Cohen, *supra* note 5, at 187–88; *cf. Cato Analysts*, *supra* note 72, at 178 (citing Dan Mitchell of the Heritage Foundation who argued that the Treasury's reforms would discourage foreign firms from investing capital in the United States).

126. *See* Peterson & Cohen, *supra* note 5, at 187–88. For example, the U.S. subsidiary might have incurred the debt in order to finance an acquisition, or the U.S. subsidiary might be engaged in a different industry that typically incurs greater debt than the rest of the worldwide group. *Id.* at 188. In order to partially mitigate these concerns, Peterson & Cohen suggest providing a "business purpose exception" to § 163(j). *Id.* at 187–88.

127. *See id.* (stating that reducing the interest limitation from 50% to 30% would cause the United States to have tighter restrictions on interest deductibility than any of its major trading partners). The Treasury itself cautioned that tightening debt thresholds may be problematic since business cycle fluctuations could substantially change a corporation's taxable income, thus impacting interest deductions of corporations not engaging in earnings stripping. *See Treasury Report*, *supra* note 7, at 23.

128. *See* Sullivan, *supra* note 66, at 154.

129. *See supra* text accompanying notes 27–30.

G. TERRITORIAL TAX SYSTEM

Many commentators believe that inversion transactions are merely a symptom of fundamental flaws in U.S. international tax policy, and that broader reforms are needed.[130] An oft-cited reform would have the United States switch from its modified worldwide taxation system to a territorial system.[131] Generally, the United States taxes income of its corporate residents at U.S. rates regardless of where income is earned, giving credits for any foreign taxes paid.[132] A territorial system would only tax "source" income earned within U.S. borders, exempting foreign income.[133] Since one effect of inversion transactions is to shield foreign income from U.S. taxes,[134] inversions can thus be seen as a way for corporations to achieve *de facto* territorial taxation.[135]

From this line of reasoning, a move to a territorial system could eliminate a substantial benefit of inversion transactions. This reform would affect U.S. corporations considering inversion transactions as well as start-ups choosing the jurisdiction in which to incorporate.[136] In addition, proponents of a territorial system argue that a switch would increase the global competitiveness of U.S. MNEs. Many European and Asian countries operate under territorial systems.[137] Unlike U.S. MNEs, MNEs in territorial countries benefit from reduced taxes on operations in lower tax jurisdictions.[138] By switching to a system in which foreign income may be taxed at a lower rate, U.S. MNEs could

130. *See generally* Karen B. Brown, *U.S. International Tax Administration & Developing Nations: Administrative Policy at the Crossroads*, 35 GEO. WASH. INT'L L. REV. 393 (2003) (outlining a number of deficiencies in U.S. international tax policy); Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261 (2001) (arguing that the U.S. international tax system is inadequate, outdated, and needs reexamination).

131. *See, e.g.*, Brewer, *supra* note 42, at 609.

132. I.R.C. § 901 (2001).

133. *See id.*

134. *See supra* text accompanying notes 27–30.

135. *See* Peterson & Cohen, *supra* note 5, at 180; Thompson, *supra* note 67, at 589.

136. A territorial system could largely remove taxation as a consideration in the decision where to incorporate. *See* Brewer, *supra* note 42, at 609. Taking into account non-tax factors, a territorial system could make the United States a choice jurisdiction for the incorporation of MNE parents. *Id.* This possibility may be one reason why some economists estimate that switching to a territorial system would increase U.S. tax revenues by up to seven billion dollars annually. *See* Peterson & Cohen, *supra* note 5, at 181.

137. *See* Gale, *supra* note 24, at 1503 (stating that about half of OECD countries operate under territorial systems); Peterson & Cohen, *supra* note 5, at 182.

138. *See* Peterson & Cohen, *supra* note 5, at 180.

lower prices and capture a greater market share.[139]

Competitiveness issues aside, the chief problem with the territorial tax system reform is that it ignores the U.S. tax revenue problems associated with inversion transactions.[140] A territorial system may simply legitimize moving operations to low-tax jurisdictions, making it harder to protect the U.S. income tax base.[141] In addition, a territorial system may actually do little to prevent inversion transactions. Earnings stripping would continue to act as an incentive for U.S. corporations to incorporate in foreign jurisdictions.[142] Finally, a switch to a territorial system would be a difficult and costly transition for the United States.[143]

H. CONSUMPTION TAX SYSTEM

Another proposed fundamental tax reform is to switch to a broad-based, consumption tax system, such as the value-added tax (VAT),[144] or a national retail sales tax (NRST).[145] In general, instead of taxing foreign income, these systems would tax all MNEs on sales of goods in the United States.[146] Like a terri-

139. *See supra* text accompanying notes 42–43; *Treasury Report*, *supra* note 7, at 19. A question remains, however, how much increasing the competitiveness of U.S. MNEs would benefit the U.S. economy. *See* Avi-Yonah, *supra* note 5, at 226–27.

140. *See supra* text accompanying notes 63–69.

141. *See* Gale, *supra* note 24, at 1496 ("Going to a territorial system as a response to corporate inversions is like choosing to reduce the crime rate by legalizing certain crimes.").

142. *See* Lee A. Sheppard, *Preventing Corporate Inversions, Part 3*, 95 TAX NOTES 1864, 1867 (2002); Sullivan, *supra* note 66, at 152; *supra* text accompanying notes 31–43.

143. *See* Gale, *supra* note 24, at 1503 (stating that a transition to a territorial tax system would present difficult issues with respect to deferred income, deferred losses, accumulated tax credits, and the renegotiation of tax treaties). A territorial system may turn out to be quite complex in enforcement. *See id.*

144. The VAT would tax corporations on the difference between the value of the sales of goods and the costs of the purchase of goods. Gale, *supra* note 24, at 1504. For an innovative modification of the consumption system, see Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1670–74 (2000). Avi-Yonah proposes withholding taxes in the "demand" jurisdiction based initially on sales volume convertible into credits for corporate tax liability. *Id.*

145. The NRST would tax corporations on the value of all sales to consumers. Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1670–74 (2000).

146. *See generally* John K. McNulty, *Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform*, 88 CAL. L. REV. 2095 (2000) (presenting a detailed discussion of a number of consumption tax reforms).

torial tax system, a consumption system would remove many of the incentives of inversion transactions. Proponents of the system argue that corporations, without having to worry about high U.S. taxes on foreign income, would make the United States their jurisdiction of incorporation and corporate headquarters.[147] Because of the strength of U.S. consumer demand, proponents maintain that this system would increase U.S. tax revenues and significantly expand the U.S. economy.[148]

Still, a consumption system may also cause problems for the United States. Under a consumption system, some U.S. MNEs could see large increases in their U.S. tax liability,[149] which may present competitiveness issues as previously discussed.[150] Some commentators also question whether a switch would reduce donations to organizations such as charities and universities.[151] In addition, as with the territorial system reform, a transition to a consumption system may be difficult and entail substantial costs.[152]

I. WORLDWIDE PRESSURE ON TAX HAVENS

A more straightforward proposal to combat inversion transactions may be an agreement with low-tax or no-tax jurisdictions to limit tax competition.[153] For instance, if developed countries and low-tax or no-tax countries could form a multilateral agreement that sets a baseline for corporate tax rates, the foreign income benefits from inversion transactions would essentially disappear.[154] Moreover, a tax rate floor would not

147. *See* Sullivan, *supra* note 66, at 151; *supra* note 133 and accompanying text.

148. *See* Gale, *supra* note 24, at 1505 (stating that papers have suggested that replacing the U.S. tax system with a "*clean, broad-based, low-rate*" consumption tax system would expand the U.S. economy by 1–2% over ten to fifteen years).

149. For example, it has been estimated that under a 19% flat tax, General Motors' tax liability in 1993 would have risen from $110 million to $2.7 billion, an increase that could even be larger under a VAT. Gale, *supra* note 24, at 1505.

150. *See supra* notes 42–43, 134–36 and accompanying text.

151. *See* Sullivan, *supra* note 66, at 151–52.

152. *See* Gale, *supra* note 24, at 1506.

153. *See generally* Joel Slemrod, *Tax Principles in an International Economy, in* WORLD TAX REFORM: CASE STUDIES OF DEVELOPED AND DEVELOPING COUNTRIES 21 (Michael J. Boskin & Charles E. McLure, Jr. eds. 1990).

154. *See* Joel Slemrod & Reuven Avi-Yonah, *(How) Should Trade Agreements Deal With Income Tax Issues?*, 55 TAX L. REV. 533, 552 (2002). This approach was essentially recommended for the European Union by the Ruding Committee in 1992. *See* Commission of European Communities, Report of the Committee of Independent Experts on Company Taxation 203–04 (1992), *available at* LEXIS, 93 TNI 34-8. This approach, however, was never accepted. *See* Slemrod & Avi-Yonah, *supra*, at 553.

harm tax revenues of developing countries, as may be the case with a consumption tax system.[155] Most tax haven activity contributes almost no income to low-tax or no-tax jurisdictions.[156] Because of efficient communication advances, incorporation in tax havens requires little human capital.[157] Any benefits to tax havens come from small fees and taxes.[158]

It is doubtful, however, whether many no-tax or low-tax countries would agree to a multilateral agreement on tax rates.[159] These countries may be hesitant to give up their sovereignty over tax policy.[160] Furthermore, while low-tax or no-tax countries obtain little benefit from being tax havens, they do gain *some* benefit.[161] Of course, developed countries could impose sanctions if countries refuse to cooperate,[162] or else they could offer aid or trade benefits. The question then, however, is what body would enforce the agreement. The Organisation for Economic Co-operation and Development (OECD), with only twenty-nine mostly developed member countries, may simply not be acceptable to low-tax or no-tax jurisdictions.[163] While the WTO is a much broader organization, some argue that it lacks sufficient tax expertise.[164] Collectively, these problems make the feasibility of a multilateral tax agreement doubtful.

---

155. For a brief discussion of a consumption tax system's effects on developing countries, see *supra* text accompanying notes 146–47.

156. *See* Kudrle, *supra* note 65, at 12 (stating that as an income transfer mechanism, tax havens are completely inefficient).

157. *Id.*

158. *Id.*

159. An OECD effort to form a multilateral agreement on international investment failed partially from a lack of agreement among a number of countries. *See* David L. Cleeton, *European Commission Releases Estimates of Economic Benefits From Potential WTO Agreements*, 20 TAX NOTES INT'L 261, 262 (2000).

160. The Ruding Commission proposal was rejected primarily because it was viewed as interfering with countries' ability to determine their own taxes. Kudrle, *supra* note 65, at 12. *But see* Avi-Yonah, *supra* note 13, at 1692 (stating that this problem could be mitigated by adopting the GATT regime rule, which requires a consensus on all decisions).

161. *See supra* text accompanying notes 153–55.

162. *See* Slemrod & Avi-Yonah, *supra* note 154, at 552.

163. *See* Avi-Yonah, *supra* note 13, at 1692 (stating that the OECD is "identified as the rich countries' club").

164. *See generally* William M. Considine, *The DISC Legislation: An Evaluation*, 7 N.Y.U. J. INT'L L. & POL. 217 (1974); Robert E. Hudec, *Reforming GATT Adjudication Procedures: The Lessons of the DISC Case*, 72 MINN. L. REV. 1443 (1988). *But see* Avi-Yonah, *supra* note 13, at 1690 (stating that this problem could be solved by the WTO hiring tax experts).

III. PROPOSED SECURITIES EXCHANGE RULE PROHIBITING LISTING OF INVERTED CORPORATIONS

U.S. securities exchanges offer issuing corporations unparalleled benefits in listing securities.[165] Yet, it seems unfair that inverted corporations enjoy these benefits after engaging in inversion transactions with the primary purpose of avoiding U.S. tax liability. If U.S. securities exchanges act in concert to enact a rule prohibiting the listing of corporations or start-up corporations that undergo inversions transactions, they could act as a substantial disincentive for these transactions.[166] Because a prohibited corporation would be deprived of the numerous advantages of listing on a U.S. exchange, this reform would act as a significant penalty and effectively end inversion transactions.[167]

U.S. securities exchanges offer listing corporations access to considerable amounts of cheap and liquid equity capital.[168] In addition, access to U.S. markets can enhance a corporation's visibility and prestige.[169] A U.S. listing also benefits shareholders. Empirical studies have demonstrated that foreign corporations' shares typically increase in value when they cross-list on a U.S. exchange.[170] As a result of these and numerous other bene-

---

165. *See supra* text accompanying notes 168–71.

166. A rule enacted by the securities exchanges would be better than one enacted by the SEC since an SEC prohibition on the listing of inverted corporations would likely be struck down by the courts. *Cf.* Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (holding that the SEC had exceeded its authority to regulate stock exchanges in promulgating a rule prohibiting the listing of a domestic company that takes action to restrict voting rights).

167. *See* Amir N. Licht, *Cross-Listing and Corporate Governance: Bonding or Avoiding?*, 4 CHI. J. INT'L L. 141, 147 (2003) (stating that, in the context of corporate governance listing standards, "issuers will not delist, because they would then lose the great advantages of listing on the NYSE as the market to which issuers from all around the world 'herd' to").

168. *See id.* at 141; James A. Fanto & Roberta S. Karmel, *A Report on the Attitudes of Foreign Companies Regarding a U.S. Listing*, 3 STAN. J. L. BUS. & FIN. 51, 52, 65 (1997) (stating that foreign companies observed that a U.S. securities listing was necessary to raise large amounts of equity capital).

169. *See* Fanto & Karmel, *supra* note 168, at 65.

170. *See* Craig Doidge et al., *Why are Foreign Firms Listed in the U.S. Worth More?*, SSRN Working Paper (2001), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=285337 (last visited Nov. 4, 2003). *See generally* Gordon Alexander et al., *Asset Pricing and Dual Listing on Foreign Capital Markets: A Note*, 42 J. FIN. 151 (1987); Gregory B. Kadlec & John McConnell, *The Effect of Market Segmentation and Illiquidity on Asset Prices: Evidence from Exchange Listings*, 49 J. FIN. 611 (1994). One explanation for the increased share price is favorable shareholder recognition of the more strict disclosure and corporate governance standards in U.S. exchanges. *See* John C. Coffee, Jr., *The Future as History: The Prospects for Global*

fits,[171] the threat of a delisting from a U.S. securities exchange presents a significant disincentive for inversion transactions and start-ups that incorporate in foreign jurisdictions.

The purpose of this Note is not to argue that changing securities exchange listing standards is the best reform. Indeed, this proposal does not address fundamental U.S. tax policy flaws underlying inversion transactions.[172] It does, however, offer an immediate, low-cost, and effective solution until the policy flaws can be remedied.[173]

A. MODIFYING LISTING STANDARDS FOR U.S. SECURITIES EXCHANGES

U.S. securities exchanges operate under a system of government-supervised self-regulation created by the Securities Exchange Act of 1934 (Exchange Act).[174] The New York Stock Exchange (NYSE), American Stock Exchange (AMEX), and NASDAQ require corporations to enter into listing agreements in order to list stock.[175] These listing agreements are essentially private contracts between an exchange and an issuer.[176]

When proposing a new listing standard, section 19(b) of the Exchange Act requires a securities exchange to file a copy of the proposed rule with the SEC for approval.[177] The SEC is required to approve proposed rules as long as they are consistent with the requirements of the Exchange Act.[178] Courts have interpreted this "consistency" language to require that rules sat-

---

Convergence in Corporate Governance and its Implications, 93 NW. U. L. REV. 641, 674 (1999); Licht, *supra* note 167, at 142.

171. Foreign corporations have also noted that a U.S. listing facilitates U.S. acquisitions and pleases major U.S. strategic partners. *See* Fanto & Karmel, *supra* note 168, at 64–65.

172. *See* discussion *supra* Parts II.A, II.B, II.C, II.F, II.G, II.H.

173. *See* discussion *supra* Parts I.B.1, II.G, II.H.

174. Codified as 15 U.S.C. §§ 78a–78kk; Douglas C. Michael, *Untenable Status of Corporate Governance Listing Standards Under the Securities Exchange Act*, 47 BUS. LAW. 1461, 1461 (1992).

175. Coffee, *supra* note 170, at 687. Some examples of listing requirements include minimum standards for market capitalization, minimum number of shares and shareholders, disclosure rules, and corporate governance standards. Michael, *supra* note 174, at 1463–64.

176. American Bar Association, Committee on Federal Regulation of Securities, *Special Study on Market Structure, Listing Standards and Corporate Governance*, 57 BUS. LAW. 1487, 1503 (2002) [hereinafter *ABA Study*].

177. Exchange Act § 19(b)(1), 15 U.S.C. § 78s(b)(1) (2000). The SEC first publishes the proposed rule for comment from interested parties, and then considers approval after the requisite period. *Id.*

178. Exchange Act § 19(b)(2), 15 U.S.C. § 78s(b)(2).

isfy section 6(b),[179] particularly section 6(b)(5), of the Act.[180] Most of section 6(b) applies to rules regarding securities exchanges and members, however, and listing standards for issuers likely must only be "not designed to permit unfair discrimination between . . . issuers."[181] In practice, review of proposed rules under section 6(b) is quite limited, and the SEC usually finds that listing standards satisfy sections 19(b) and 6(b).[182]

U.S. securities exchanges thus have broad power to enact listing standards.[183] Considering its limited review, the SEC would probably find that a rule prohibiting the listing of inverted corporations is consistent with the Exchange Act. Under section 6(b)(5), the listing standard would not be designed to permit "unfair discrimination" against issuers. It would be a stretch to consider prohibiting corporations that exploit tax loopholes in order to avoid U.S. tax liability unfair. Adding further support to the "consistency" of this proposal is Section 2 of the Exchange Act, which states that one of the Act's purposes is the protection of "the Federal taxing power."[184]

Even if the exchanges have the power to enact a listing standard prohibiting inverted corporations, there is still a question of whether they have any incentive to do so. At first glance, prohibiting inverted corporations seems to help the U.S. government maintain tax revenues. It is, however, in the exchanges' best interests to preserve a positive public image.[185]

---

179. Exchange Act § 6(b), 15 U.S.C. § 78f(b).

180. *See, e.g.*, Clement v. SEC, 674 F.2d 641, 646 (7th Cir. 1982); *see also ABA Study*, *supra* note 176, at 1518–20.

181. Exchange Act § 6(b)(5), 15 U.S.C. § 78f(b)(5); *see ABA Study*, *supra* note 176, at 1520 (stating that a Task Force of the American Bar Association found the nondiscrimination standard to be the only limitation on a securities exchange adopting corporate governance listing requirements) (internal citations omitted). The legislative history of section 19(b) demonstrates that Congress was primarily concerned with the SEC's supervision of exchange rules relating to members, not listing standards. *See* S. Rep. No. 94-75, at 30–32 (1975).

182. *See* Michael, *supra* note 174, at 1479; Business Roundtable v. SEC, 905 F.2d, 406, 414 (D.C. Cir. 1990) (stating that the SEC's § 19 powers, which do not regulate members and are not related to the purposes of the Exchange Act, are quite limited).

183. As long as a proposed listing standard is not inconsistent with the Exchange Act, it probably does not need to have anything to do with the Act. *See Business Roundtable*, 905 F.2d at 414–15.

184. Exchange Act § 2, 15 U.S.C. § 78(b) (2000).

185. In the past, the exchanges themselves have recognized the great importance of their public image. *See* Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 698 (1986) (suggesting that the primary reason behind the NYSE's decision to preserve a voting rights rule was a "concern about public opinion").

This image is especially important considering how many have challenged the patriotism of inverted corporations following the September 11th terrorist attacks.[186] Even if the incentives are insufficient, the SEC has shown considerable influence in persuading exchanges to adopt listing standards in the past.[187] Using its influence, the SEC could push the exchanges to adopt this reform.

Perhaps a more significant problem is that, over the long term, this reform may decrease the competitiveness of U.S. exchanges and cause corporations to shift their listings to foreign exchanges or Alternative Trading Systems (ATSs).[188] Indeed, technological developments have facilitated the growth of foreign exchanges, causing them to compete increasingly with U.S. exchanges.[189] The numerous benefits of a U.S. listing,[190] however, may outweigh the cost savings from an inversion transaction. Perhaps more telling is that, despite stricter listing standards than most foreign exchanges,[191] the number of foreign securities on U.S. exchanges continues to grow.[192]

This reform would offer an effective remedy to the inversion problem. The costs of being delisted from a U.S. exchange would present a major disincentive to incorporating in a foreign jurisdiction.[193] While the reform acts as a penalty and does not

186. *See supra* note 69 and accompanying text.

187. *See* Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law and Federal Regulation*, 38 WAKE FOREST L. REV. 961, 977–79, 981 (2003) (describing how the SEC has persuaded U.S. securities exchanges to adopt corporate governance listing standards).

188. ATSs are private, for profit electronic trading networks that have been increasingly competing with U.S. securities exchanges. *ABA Study*, *supra* note 176, at 1533–37. ATSs do not impose listing standards. *Id.*

189. *See id.* at 1538. The *ABA Study* reports that twenty-five years ago corporations that traded on the NYSE accounted for 80% of the world's capitalization value, while in 2000, the North American region accounted for only 50% of the world's capitalization value. *Id.* (citing Noelle Knox, *NYSE Expects More Foreign Stocks*, AP ONLINE, Jan. 13, 1999; Int'l Fed'n of Stock Exchs., *Evolution of Market Capitalization by Time Zone* 73, *available at* http://www.fibv.com).

190. *See supra* text accompanying notes 168–71.

191. *See supra* note 170 and accompanying text.

192. *See* Gerard A. Achstatter, *Foreign Companies Flock to the U.S. But Their Stocks Carry Extra Risks*, INVESTOR'S BUS. DAILY, June 2, 1998, at A-7 (noting a 50% rise in foreign listings from 1995 to 1998); Fanto & Karmel, *supra* note 168, at 59.

193. For a discussion of the benefits of listing on U.S. securities exchanges, see *supra* notes 168–71 and accompanying text. The costs of being delisted are so great that some courts have held that delisting constitutes irreparable harm to the shareholders and is grounds for an injunction. *See* Gearhart Indus., Inc. v. Smith Int'l, Inc., 741 F.2d 707 (5th Cir. 1984). *But see* Data Probe Acquisition Corp. v. Datalab,

address the fundamental U.S. tax issues underlying inversion transactions,[194] it can at least be used until the tax policies and traditions, if ever, are changed.

B. TEST FOR INVERTED CORPORATIONS

In order for U.S. securities exchanges to make this reform workable, the exchanges must formulate a test that can distinguish between legitimate foreign issuers and inverted corporations.[195] This Note proposes a flexible, two-part disjunctive test. Specifically, in order to list its securities on a U.S. exchange, a foreign corporation could prove that either (1) a certain percentage, say 5%, of its shareholders reside in the jurisdiction of incorporation, or (2) that the principal officers "manage and control" the corporation on a daily basis in the jurisdiction of incorporation. Prong (1) uses the test advocated by Robert T. Kudrle,[196] while prong (2) uses the "managed and controlled" test described in Part I.D.3.[197] In order to prevent this standard from being easily circumvented and to avoid any costly monitoring body, the burden could be placed on a corporation to prove it has satisfied one of the two requirements.

The test provides a straightforward standard that would be difficult to avoid either by inverted corporations or start-ups incorporating in a low-tax or no-tax jurisdiction. If a corporation undergoes an inversion transaction it will be threatened with delisting.[198] Similarly, a start-up incorporating in a low-tax or no-tax jurisdiction can be barred from listing stock in the first place. Under prong (1), inverted corporations would be denied a listing because the capital required for citizens of a no-tax or low-tax country to own the requisite percentage of a large corporation's shares would be too high.[199] As long as ownership threshold is set at the right level, companies legitimately incor-

Inc., 722 F.2d 1 (2d Cir. 1983) (denying injunction).

194. *See* discussion *supra* Parts I.B.1, II.G, H.

195. *See supra* text accompanying notes 84–88.

196. *See supra* text accompanying note 86.

197. *See supra* text accompanying notes 95–100.

198. Section 12(d) of the Exchange Act requires delistings to be approved by the SEC. Exchange Act § 12(d), 15 U.S.C. § 78l(d) (2000). If a security is delisted, section 12(a) prohibits transactions in that security on the exchange. Exchange Act § 12(a), 15 U.S.C. § 78l(a). Even if an issuer is delisted, however, U.S. investors may still purchase its unregistered securities abroad. 17 C.F.R. §§ 230.901–230.904 (2004).

199. *See supra* Part II.B.

porated in a foreign jurisdiction will likely satisfy prong (1).[200]

If a legitimate foreign corporation could not satisfy prong (1), it would still have the opportunity to satisfy prong (2) before being denied an exchange listing. The "managed and controlled" test would target inverted corporations because it would be very costly for principle officers to move to a foreign jurisdiction to run a corporation.[201] Moreover, this test could distinguish inverted corporations while not radically altering U.S. tax policy, the primary criticism of using this test as a definition of a corporation's headquarters.[202] Although evaluating where the principal officers manage and control a corporation appears somewhat vague, this test could be workable by objectively defining which and how many officers it took to "manage and control" a corporation, and by placing this burden on corporations.[203]

One potential problem with this test is that the anonymous, increasingly rapid trading of shares may make prong (1) difficult to apply.[204] Rule 3b-4 under the Exchange Act, however, currently uses shareholder residency requirements in defining a "foreign private issuer" with no apparent problems.[205] Moreover, since the burden is on corporations to satisfy prong (1), there should be relatively few enforcement difficulties for securities exchanges, and the corporations will have a significant incentive to devote resources to tracking shareholder residency.

Though the U.S. securities exchanges may seem an unusual forum for preventing inversions, they offer a unique advantage in that the enforcement can be performed by the exchanges and not the government. By placing the burden on corporations to prove they satisfy one of the two requirements, it would shift the monitoring costs from taxpayers to foreign issuers. The information could be submitted by filing for an initial listing or with required annual reporting.[206]

---

200. *See id.*

201. *See supra* Part II.C.

202. *See id.*

203. *See id.*

204. *See supra* text accompanying note 89.

205. 17 C.F.R. § 240.3b-4 (2004). The rule provides that a "foreign private issuer" may not be an issuer in which "[m]ore than 50 percent of the issuer's outstanding voting securities are directly or indirectly held of record by residents of the United States." *Id.*

206. *See* Exchange Act §§ 12(b)–(f), 13(a)–(b), 15 U.S.C. §§ 78l(b)–(g), 78m(a)–(b).

CONCLUSION

Although inversion transactions have slowed since the September 11th terrorist attacks, it is probably only a matter of time until they increase again. While it is generally agreed we need to stop inversion transactions, there may be no easy answer to the problem. Proposed solutions range from narrow "fixes" in order to quickly stop inversions to fundamental U.S. tax policy reforms. The best short-term strategy may be a concerted U.S. securities exchange rule prohibiting the listing of inverted corporations. This concerted effort would offer an immediate and effective remedy to the inversion problem until the fundamental tax policies can be addressed.