# CORPORATE TAXATION AND INTERNATIONAL CHARTER COMPETITION

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*Corporate charter competition has become an increasingly international phenomenon. The thesis of this Article is that this development in corporate law requires a greater focus on corporate tax law. We first demonstrate how a tax system's capacity to distort the international charter market depends both upon its approach to determining corporate location and upon the extent to which it taxes foreign source corporate profits. We also show, however, that it is not possible to remove all distortions through modifications to the tax system alone. We present instead two alternative methods for preserving an international charter market. The first-best solution involves severing the markets for corporate law and corporate tax law through coordination of locational rules under each regime, with a "place of incorporation" rule for corporate law and a "real seat" rule for corporate tax. The second-best solution relies on a properly designed federal structure. The crucial design elements for such a federal system are the allocation of substantive law between the federal and subfederal levels, corporate and corporate tax locational rules, and the taxation of corporate migration and foreign source corporate profits. With due attention to these details, an international charter market can avoid the potentially distorting effects of corporate taxation. In the final part of the Article we apply our analysis to the United States, Canada, the European Union, and Israel, and show how difficult it is, in the real world, to separate corporate charter and corporate tax competition.*

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## INTRODUCTION

The "race to the top/race to the bottom" debate about competition for corporate charters has gone global. What had been largely a U.S. debate about charter competition among the several states (with the occasional European pejorative reference to the "Delaware syndrome") has increasingly become a serious discussion of international charter competition. The basic thesis of this Article is that the internationalization of charter competition in *corporate* law requires a greater focus on the influence that *corporate tax* law has on the market for corporate charters.

Recent experience in both the United States and the European Union highlights the important ways in which these two bodies of law can play off one another. In the United States, several high profile corporate "inversion" transactions have brought to prominence the effect that corporate tax law can have on the international competition for corporate charters. Such transactions, which typically involve reincorporating the parent company of a U.S. multinational offshore, are unabashedly all about tax reduction. But the desired tax benefits require shifting to a different, possibly inferior, corporate law regime. In this way, corporate tax can channel firms into a suboptimal jurisdiction from the standpoint of corporate law.

In the European Union the interaction between corporate law and corporate tax has gained increased salience because of a string of European Court of Justice decisions that provide firms much greater leeway in choosing which member state's corporate law will govern their activities.[1] For existing firms, however, corporate tax consequences of migration can make the cost of choosing the desired corporate law prohibitive. In this way, corporate tax can trap firms in a suboptimal jurisdiction from the standpoint of corporate law. More recent E.U. developments redress this problem but may overshoot the goal of corporate and tax law neutrality.

The world need not look this way. As a conceptual matter, corporate law and corporate tax law do not have to interact at all. Consistent with the evidence just mentioned, though, they often intersect. Both place at least some substantive weight on the determination of corporate location. Where the criteria underlying that determination overlap, the two bodies of law come into contact.

The problem (and likewise the solution) is that because corporations are legal rather than natural persons, corporate location is inherently arbitrary. The dark side of this arbitrariness can be observed in the world around us—a grab bag of corporate and tax locational rules that, as we show, are likely to lead to persistent distortions of the international market for corporate charters. If there is a redemptive side to arbitrary rules, however, it is that once we understand the relationship between their content and their undesirable consequences, we may be able to manipulate the rules with ease, at least relative to legal rules that have a more concrete connection to surrounding facts. With that possibility in mind, we strive in this Article not only to understand the sources of tax-induced distortion to the international market for corporate charters but also to recommend possible remedies.

A variety of people have looked at charter competition alongside taxation.[2] Extant scholarship adopts one of two approaches. The first approach is comparative in spirit. Scholars writing in this mode view corporate law and tax law as creating markets that spur two distinct species of interjurisdictional competition. The question is whether it is possible to understand one species of competition by examining its similarities and differences with the other. This type of inquiry need not consider the substantive interactions of the two fields of law. The second approach, in contrast, begins to tackle the interactive question. Under this approach, commentators have recognized the deterrent effect that exit taxation may have on corporations seeking to relocate to a jurisdiction with a preferred regime of corporate law.[3]

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1. Case C-167/01, Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd., 2003 E.C.R. I-10155; Case C-208/00, Überseering BV v. Nordic Constr. Co. Baumanagement GmbH (NCC), 2002 E.C.R. I-9919; Case C-212/97, Centros Ltd. v. Erhvervs-og Selskabsstyrelsen, 1999 E.C.R. I-1459.

2. *See, e.g.*, William W. Bratton & Joseph A. McCahery, *Tax coordination and tax competition in the European Union: Evaluating the code of conduct on business taxation*, 38 COMMON MKT. L. REV. 677 (2001); Wolfgang Schön, *Playing different games? Regulatory competition in tax and company law compared*, 42 COMMON MKT. L. REV. 331, 359–60 (2005); Joel P. Trachtman, *International Regulatory Competition, Externalization, and Jurisdiction*, 34 HARV. INT'L L.J. 47 (1993).

3. *See, e.g.*, Jens Dammann, *A New Approach to Corporate Choice of Law*, 38 VAND. J. TRANSNAT'L L. 51, 77–79 (2005).

Our approach fits within the second type of inquiry. We make four basic contributions to the literature. First, we undertake a more comprehensive analysis of tax law in the cross-border setting than has been provided to date. For example, in considering tax effects on decisions about corporate migrations (i.e., changes of corporate location), we stress that one must consider the tax effects on both future *and* past profits, not just on the latter as has been customary in the literature. This simple observation can stand the conventional wisdom on its head. Specifically, although it is common to view exit taxes as necessarily bad from the standpoint of fostering charter competition, we describe how exit taxes can actually have pro-competitive results.

Second, we show that the optimal way to preserve charter competition in a world where jurisdictions compete globally for their tax bases is to coordinate rules across jurisdictions to require distinct locational rules for corporate law and corporate tax purposes. In that case, the markets for corporate law and corporate tax law would be severed from one another in virtue of the substantive rule of location. Although such equilibrium is unlikely to arise spontaneously through domestic law alone, we suggest that one could achieve the required coordination through treaties.

Third, we show that even where the substantive criteria underlying the corporate and tax locational rules continue to overlap, one may still be able to create the conditions necessary for undistorted charter competition with an appropriately designed federal structure. This strand of our analysis suggests that the existence of charter competition in the American system may be serendipitous, resulting in part from the particular type of federal structure present in the United States. It also allows us to understand how E.U.-style federalism can support charter competition.

Fourth, our analysis highlights a long-run efficiency cost of tax competition that has not been previously noted. In the standard account of the "race to the bottom" in the tax literature, the supposed consequence of competition in the long run is distributional, as between the public and private sectors. From this perspective, a "race to the bottom" in corporate taxation should not lead to long-run efficiency costs.[4] To be sure, in the short run tax competition may lead to suboptimal allocations of real capital, as jurisdictions use tax preferences to lure capital away from other jurisdictions. To the extent that governments losing capital enact countervailing preferences, however, capital allocations should revert to their original state. Thus efficiency consequences are removed in the long run, though each jurisdiction will collect less in tax revenue than would have been the case in the absence

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4. *See* Julie Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, 89 GEO. L.J. 543, 554 (2001). Roin explains:

> One of the tenets of the tax harmonization argument is that competition will force all jurisdictions to lower their tax rates to the same low (or zero) levels, such that no country will offer investors a "better" tax deal relative to other countries. Thus, tax competition transfers wealth from national treasuries to taxpayers without having the beneficial effect of directing business . . . toward "better" locations.

*Id.* (footnote call number omitted).

of any tax preferences. Indeed, proponents of tax competition see the possibility for efficiency *gains* here, to the extent that one believes that such gains generally follow from a shrinking of the public sector.[5]

By contrast, this Article links the phenomenon of tax competition to a potential long-run efficiency *cost*. Specifically, we show that tax-motivated corporate locational decisions can lead to an efficiency cost to the extent that corporations are steered into suboptimal legal regimes from a corporate law standpoint. Moreover, unlike the standard tax competition story, we should expect these efficiency costs to be long-lived, at least under current market structures.

Having introduced claims about "suboptimal" corporate law, we should come clean about our normative commitments at the outset. We take a robust market for corporate charters to be a desirable goal.[6] Lest we lose half our audience before we have even begun, though, we would add that much of the analysis in this Article will be of interest whether or not one shares our normative outlook. Much of our analysis is devoted to the task of understanding how the interactions of two complex bodies of law affect corporate decision making and to the task of identifying which revisions to the relevant legal systems are most likely to dampen the effects of such interactions. That part of the analysis does not hinge upon our normative commitments. Of course, the same cannot be said of the specific recommendations that we espouse, which are crafted with an eye to eliminating the distortions. But the content of the recommendations should be of interest across the board as well. If we devise here a key to show how to revise legal systems to bolster an international market for corporate charters, those with the opposite normative commitments should be quite interested in the analysis, though we would expect them to view the distortions themselves as welcome, and the cure problematic.

Our normative commitments on tax law are less settled. In this Article we are agnostic about the normative arguments for and against conformity of national tax-systems.[7] Rather, we take it as a fixed feature of the discussion that national tax-systems do, and for the foreseeable future will, manifest significant disparities with respect to rate and base. In a world with such disparities, we expect jurisdictions to exploit such differentials to attract

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5. *Id.* at 546.

6. *See* Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 280–81 (1985); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977). *But see* Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1441 (1992); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

7. At the most abstract level, corporate law and tax law look like the same type of market for law. That is, each can be seen as a package of governmental benefits (the product) associated with a certain government-imposed cost (the price). In spite of this similarity, one need not hold the same normative commitments regarding the merits of competition in the two markets. The most important distinguishing feature of the two markets for law is that tax law is an important tool in achieving broad society-wide redistributional goals. This makes competition less-obviously desirable than in the corporate law case.

capital (i.e., tax competition) and we expect corporate taxpayers to structure their affairs so as to reduce their tax burdens (i.e., tax avoidance). We also expect that, in a dynamic setting, jurisdictions will take countermeasures to reverse the effects of tax competition and tax avoidance so as to protect real capital allocation as well as tax base.

The Article proceeds as follows. In Part I we briefly describe the ways in which legal systems may ascribe corporate location, provide background on the mechanics of corporate migration, and introduce a moderately formal way of describing tax-induced distortions to the corporate charter market. In Part II we explain the ways in which different types of corporate tax systems affect charter choice differently. We also argue that one cannot preserve the international charter market simply by modifying the corporate tax rules. In Part III we offer theoretical analyses of the first-best and second-best approaches for segregating the international market for corporate charters from the market for corporate tax law. In Part IV we turn to real world evidence, applying our theoretical constructs to shed light on the status of charter competition observed in the United States, Canada, the European Union, and Israel.

## I. Location, Migration, and Tax Distortion

### A. *Rules for Determining Corporate Location*

Legal systems typically assign corporate location for a variety of different purposes. Two important contexts are corporate law and corporate tax. In corporate law, one needs to know under which jurisdiction's laws a corporation has (or has not) been formed. This is for a variety of reasons. First, because a corporation is a fictional legal person—that is, a creation of the law—the fundamental question of corporate existence requires reference to a particular jurisdiction. Have all the requirements of corporate formation been satisfied? Is the corporation properly registered? Has it filed whatever annual reports or forms required to maintain its existence? Because of the practical consequences of corporate existence or nonexistence (e.g., unlimited liability), there must be a single answer to the question of whether the corporation exists.

Moreover, there are all sorts of questions regarding the running of the corporation that need to be answered. How are directors and officers selected? What are their duties? Have the duties been breached? What liability, if any, is imposed for the breach? What limits are there on the conduct of the controlling shareholders? What liability does the controlling shareholder face? On what issues do shareholders vote and what is the decision rule? To what extent can shareholders initiate action? How do they do so? When can dividends be paid? Thus, as both a practical and a theoretical matter, a reasonably definite and unique answer is needed to the question of what law governs these matters, which are often summarily referred to as the corporation's "internal affairs."

In corporate tax, the location of a corporation likewise bears upon a range of important questions. For example, jurisdictions typically seek to tax a broader base of corporate profits for local entities as contrasted with foreign ones. Corporate location can also determine the source of various types of income streams, such as dividends or interest, which in turn can have substantive tax consequences for the recipients of such payments.

Although different jurisdictions determine corporate location in different ways, the range of options is rather limited. Basically, in locating a corporation, a legal system can adopt either the "place of incorporation" ("POI") rule or some version of the "real seat" ("RS") rule. Under the POI rule, the corporation's location is determined by where it was incorporated, a purely formal criterion. Under the RS rule, a corporation's location depends on some combination of factual elements, such as the location of the administrative headquarters or the location of the firm's center of gravity as determined by the location of the employees and assets. The place of incorporation can also bear on this question, but it is not determinative.[8]

POI and RS rules under corporate law and corporate tax law thus look to the same types of factors to locate the corporation. There is, however, one important difference between locational rules in the two domains of law. Under the real seat doctrine, the existence of the corporation, as well as the rules governing its internal affairs, is determined by the law of the state in which the corporation's headquarters is located, not by the law of the state of incorporation. Because every jurisdiction currently views corporate existence as requiring affirmative steps (as distinguished, for example, from the existence of a partnership), an RS locational rule effectively requires that the corporation be incorporated in the jurisdiction where it has its real seat. To see why this is so, consider what would happen if business planners placed the headquarters in a real seat jurisdiction but incorporated the firm in another jurisdiction. In that case, creditors in the jurisdiction of the headquarters could claim that the firm is not properly incorporated and thus the investors are not entitled to limited liability; meanwhile, shareholders might fight over whether significant transactions need to be approved by the majority required in the headquarters jurisdiction or the jurisdiction of incorporation, and so forth. Indeed some jurisdictions, such as Germany, require the firm to be incorporated locally if the real seat is in the jurisdiction.[9]

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8. The RS rule is thus, in fact, a family of different rules. Depending on the importance given to the place of incorporation, an RS rule can, in practice, approximate a POI rule. Nonetheless, POI and RS represent two different types of locating rules (formal v. factual) that are worth keeping separate.

9. The key statutory language in both the AG and GmbH statutes has been interpreted to require that the registered seat be in Germany. 3 BUSINESS TRANSACTIONS IN GERMANY (FRG) § 24.02[1] (Bernd Rüster ed., 1983); 2 BUSINESS TRANSACTIONS IN GERMANY (FRG) § 23.02[5] (Bernd Rüster ed., 1983). The GmbH statute, including its locational provision, is in the process of being reformed in order to stem the tide of incorporation of German private companies in the United Kingdom. Ulrich Seibert, *Close Corporations—Reforming Private Company Law: European and International Perspectives*, 8 EUR. BUS. ORG. L. REV. 83, 89–90 (2007).

Corporate tax, in contrast, has more flexibility because it is not constitutive. Unlike the case with corporate law, there is no conceptual or practical barrier to more than one jurisdiction claiming a corporation for tax purposes. Indeed, depending on tax rules, a corporation may even actively seek to claim tax residence in more than one nation.[10] Thus, for tax purposes, one may well observe one jurisdiction applying a POI locational rule to claim a corporation, while another jurisdiction applies an RS locational rule to claim the same firm.

### B. *Corporate Migration*

Corporations are the creation of a particular jurisdiction. How corporations can "move" from one jurisdiction to another will vary with regard to both emigration and immigration and will depend on whether corporate location is determined by formal or factual criteria.[11]

When the criterion is formal, that is, for companies from POI jurisdictions (corporate law or corporate tax), companies migrate by means of several mechanisms. The simplest mechanism permits migration by shareholder vote. For example, in Canada, a corporation can move its jurisdiction while preserving legal personality (i.e., all legal rights and obligations continue), upon a two-thirds vote of shareholders.[12] When a corporation fulfills this straightforward requirement, it ceases to be, for example, an Ontario corporation and starts to be an Alberta or a federal corporation. This is not a taxable transaction. However, this simple, direct approach is highly unusual.

A second mechanism allows a corporation to migrate by merger. In the United States, for example, the simplest mechanism commonly used to change a corporation from being, say, a California corporation to being a Delaware corporation is by means of a merger between the original California corporation and a newly established, wholly owned Delaware subsidiary, with the Delaware corporation designated as the surviving corporation. Shareholders of the California corporation would receive the same percentage of ownership in the Delaware corporation as they had in the California corporation. Under U.S. state and federal tax law, this is a tax-free transaction at both the company level and the shareholder level. Note that this mechanism requires several elements. Both the old and new jurisdictions must have the

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10. To the extent that tax residence is conjoined with greater jurisdiction to tax, such a preference seems odd. Claiming dual corporate residence, however, can be beneficial where the relevant tax issue is the claiming of deductions, as distinguished from the reporting of net income. For a discussion of such "dual resident companies," see Mitchell A. Kane, *Strategy and Cooperation in National Responses to International Tax Arbitrage*, 53 EMORY L.J. 89 (2004).

11. For excellent treatments of traditional modes of corporate migration in the E.U. context, see R.R. Drury, *Migrating Companies*, 24 EUR. L. REV. 354 (1999) and Karsten Engsig Sorensen & Mette Neville, *Corporate Migration in the European Union: An Analysis of the Proposed 14th EC Company Law Directive on the Transfer of the Registered Office of a Company from One Member State to Another with a Change of Applicable Law*, 6 COLUM. J. EUR. L. 181 (2000). As discussed below, recent developments in E.U. law have rendered these analyses somewhat out of date.

12. Douglas J. Cumming & Jeffrey G. MacIntosh, *The Rationales Underlying Reincorporation and Implications for Canadian Corporations*, 22 INT'L REV. L. & ECON. 277, 279 (2002).

institution of mergers of corporations, must permit one of the firms to be the "surviving" entity, and must permit cross-border mergers. Although common features of U.S. corporate laws, these are hardly universal elements of corporate laws elsewhere.[13]

A third mechanism is to establish a new corporation in the target jurisdiction, then to sell the assets of the old corporation to the new corporation in exchange for shares of the new corporation to be paid out pro rata to the shareholders of the old corporation upon dissolution. Because this mechanism only needs permission for cross-border sales of assets, it is legally simpler than the merger mechanism. But this sort of migration does not preserve a corporation's legal personality and triggers the winding up of the old corporation, with a variety of unhappy consequences. Existing creditors have to be paid, taxes may have to be paid on accumulated gains, property has to be transferred, licenses may have to be renewed with new license payments, and so forth. There are likely to be similarly unhappy consequences at the shareholder level.

A fourth mechanism is to establish a new corporation in the target jurisdiction, with the new corporation then exchanging its shares for shares of the old corporation in a share-for-share exchange. Once the transaction is complete, the old corporation will still exist but as a wholly owned subsidiary of the new corporation. This may avoid the winding up of the old corporation but may be viewed as a taxable sale of shares by the old shareholders.

In sum, POI jurisdictions permit a variety of legal mechanisms to allow corporations to migrate. The legal transactions may be complex, and avoiding taxable consequences is likely to require detailed attention to reorganization statutes under the tax law, but these hurdles can be, and frequently are, overcome.

By contrast, when the criteria of location are factual, as in RS jurisdictions, changing jurisdictions (for either corporate law or corporate tax) is often so costly as to be prohibitive. Although there is no conceptual bar to doing so, in RS jurisdictions, typically no provision is made for migration that preserves the legal entity. For example, in Germany, a RS jurisdiction, even if a corporation were willing to incur the costs of moving its real seat to England, that would still technically not result in a migration of the historic entity because, under German law, the movement of the real seat would be deemed a dissolution of the corporation, with all of the consequences that flow from corporate liquidation.[14]

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13. In many jurisdictions, cross-border mergers are not provided for in the local corporate law. Joseph A. McCahery & Erik P.M. Vermeulen, Understanding Corporate Mobility in the EU: Towards the Foundations of a European 'Internal Affairs Doctrine' 9 (June 27, 2007), *available at* http://www.bdi-online.de/Dokumente/Recht-Wettbewerb-Versicherungen/Panel_I_WorkingPaper_UnderstandingCorpMob.pdf.

14. Drury, *supra* note 11, at 358–59 (pointing to France, Greece, and Spain). But see *infra* note 81 for a discussion on the European Union's Societas Europaea (SE) structure and the way it permits corporations from RS jurisdictions to migrate.

### C. *A Method for Valuing Tax Distortion to Corporate Location*

As the above discussion makes clear, corporate tax and corporate law are relevant to firm decisions regarding both initial incorporation and subsequent migration. The central goal of this Article is to understand how tax law-induced decisions will distort corporate law-induced decisions as we move towards a global market for corporate charters. A preliminary task, then, is to clarify what exactly we mean by a tax law-induced effect on locational decisions.

For these purposes we introduce a stylized example involving two jurisdictions, Alpha and Beta. We assume that a corporation is assigned a location to one of the jurisdictions under each of two regimes of law: corporate law and corporate tax law. These two bodies of law may, but need not, assign the same location to the corporation. Further, we assume that the jurisdictions are identical, other than differences in the two bodies of law under consideration. With these assumptions in place, the next step is to determine how location in one jurisdiction or the other affects the value of the corporation. Because of the assumption that the jurisdictions are otherwise identical, we assume that valuation differences stem strictly from the differences in corporate law and tax law.

Consider corporate law first. Clearly corporate law can affect the value of the corporation. Let us suppose that a corporation located in Alpha has a different value from an identical corporation located in Beta *strictly* because of differences in the applicable corporate law. We will use the term "corporate surplus" to describe the amount of any such difference in valuation. A couple of clarifying points are necessary here.

First, the corporate surplus is a net concept. That is, we consider both the benefits or value-augmenting features of the corporate law, as well as certain costs. This is in keeping with the corporate law "race to the top/race to the bottom" literature, in which corporate decisions are cast on the demand side as a balancing of the benefits of a given corporate law against the costs of entering and operating under that regime.[15]

Second, some of the costs associated with the application of a specific jurisdiction's corporate law may be termed "taxes." For example, incorporation in Delaware makes a corporation subject to Delaware's business franchise tax.[16] Incorporation in other jurisdictions may render a corporation

15. There are debates in the corporate law literature over a variety of points relevant here, including whether states in fact compete for corporate charters, *see* Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002); whether any competition that does exist leads to law that is better or worse for shareholders, *see* Bebchuk, *supra* note 6; Romano, *supra* note 6; and, if competition leads to more valuable firms, what the amount of increased value is, *see* Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001). *But see* Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L. ECON. & ORG. 32 (2004). For the purposes of this Article, we assume that charter competition leads to more valuable firms.

16. For details, see Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1205, 1218–32 (2001).

subject to capital levies.[17] Unfortunately, the reference to such costs as "taxes" is likely to breed confusion in the analysis we discuss here. These taxes are *not* what we have in mind when we refer to the "tax law" or when we set out to analyze tax-induced distortions to corporate location. We take such levies simply to be a cost of buying into the relevant corporate law regime. Our approach, then, is functional and divorced from whether something is called a "tax" or whether it is codified as part of the corporate law or tax law. Specifically, we count a government levy as part of the corporate law if it is best analogized to a benefits tax, with the relevant benefits deriving from the substantive corporate law and allied administrative or judicial institutions. The Delaware franchise tax is a good example of this type of government levy. By contrast, we count a government levy as part of the tax law if it is best characterized as a redistributive tax. The U.S. corporate income tax is a good example of redistributive taxes.[18]

Finally, we need to say more about the relation between what we call corporate surplus and the market for corporate charters. We take corporate surplus as a quantity that represents increased shareholder wealth. Thus proponents of a "race to the top" theory would expect corporate migrations from one jurisdiction to the second if there is a corporate surplus in the latter jurisdiction. Proponents of a "race to the bottom" theory deny this claim and argue that firms will tend to migrate to those negative surplus jurisdictions which are pro-management.

Although we come at this problem from the "race to the top" side of this debate, we hope that adherents to the contrary view recognize that there is nothing in the analytical structure of our argument that depends upon this commitment. We are interested in identifying cases in which the tax law, as we define it, deters corporations from selecting what strictly from a corporate law perspective would have been the first choice. If the reader thinks that the first choice would have been in the interest of shareholders, and thus produced a corporate surplus in our terms, then deterring that selection will represent a bad result. On the other hand, if the reader thinks that the first choice would have been a locational decision that harmed shareholders, then he or she might be quite happy to have the distortion arise.

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17. For example, Canada once imposed such a levy on large corporations, though the tax has been repealed. Income Tax Act, R.S.C., ch. 1, § 181.1(1)–(1.1) (1985) (repealed 1994) (Can.). Luxembourg currently levies a 0.5% net worth tax on the unitary value of Luxembourg companies. *International Updates*, INT'L TAX REV., May 2006, at 53.

18. Many real world levies, of course, have both a benefits character and a redistributive character. This does not undermine the basic distinction drawn in the text. Indeed, this basic distinction would seem to fuel much of the controversy over the normative appeal of tax competition more generally. To the extent that "tax competition" means competition over benefits taxes, which are really just prices, it should become less controversial that competition is beneficial. Conversely, to the extent that "tax competition" means competition over taxes that are redistributive, the competition may well become more problematic, depending on one's view about the merits of the underlying redistribution. *Compare* Roin, *supra* note 4, at 570 ("[P]roponents of tax harmonization have overstated the seriousness of their redistributive claims just as they have understated the benefits to be gained from tax competition."), *with* Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1625 (2000) (arguing that tax competition can limit the ability to use taxes on capital for redistributive purposes).

Set next to the concept of corporate surplus, we also consider a quantity which we will refer to as the "tax surplus." Roughly speaking, the tax surplus represents the increase in a corporation's value from achieving tax location in one jurisdiction, rather than another, under the relevant tax law as we have defined it above. Again, a few clarifying comments are necessary. First, the tax surplus must take account of tax ramifications with respect to business activity that *precedes* a corporate locational decision. Obviously, this will be an issue where a corporation is migrating from one jurisdiction to another, but not where the corporation is newly forming and trying to determine in which jurisdiction to locate. Most commonly, this type of tax issue will arise with respect to an exit tax imposed by a jurisdiction on a corporation that moves to another jurisdiction. The exit tax is meant to capture tax on unrealized gains or deferred taxes of the corporation with respect to activity that has taken place within that jurisdiction (or foreign activity that would have been taxed if conducted by local firms). An exit tax in Alpha would make migration to Beta more costly and thus *decrease* any tax surplus in Beta. Similarly, an exit tax in Alpha makes remaining in Alpha relatively cheap, as compared to migration, and thus *increases* any tax surplus in Alpha.

Second, the tax surplus must also take account of tax ramifications with respect to business activity that *follows* the locational decision. This creates obvious problems because we are interested in analyzing corporate locational decisions at some moment in time, but the amount of tax will depend on many future contingent states of the world, most obviously the amount of profit that the corporation could earn in various locales and the various modifications that may occur in the world's tax systems. Although these consequences are clearly difficult to calculate in practice, we adopt the following approach in order to make the analysis tractable. With respect to tax on future activities, we treat the corporation as estimating the present value of all future tax liabilities if located in perpetuity in Alpha or Beta. The amount by which the cheaper tax jurisdiction is less than the costlier jurisdiction is reflected in the amount of the tax surplus in the cheaper jurisdiction.

Finally, we treat both the corporate surplus and the tax surplus as zero sum in our two jurisdiction example. Thus a total surplus of $x$ in Beta necessitates a surplus of $-x$ (or a deficit of $x$) in Alpha.

With these concepts in mind it is now relatively easy to describe tax distortions to corporate location. A simple numerical example will assist in the demonstration. Suppose that a corporation is currently located in Alpha for both corporate and tax purposes. The corporation considers the merits of Beta from a corporate and tax law perspective. Suppose that strictly from a corporate law perspective the corporation has a higher (net) value (a corporate surplus in our terms) in Alpha of $2 million. From the tax perspective, the corporation must consider exit taxes and taxes on future profits. Suppose that migration from Alpha to Beta creates an exit tax of $5 million. The estimate of future tax costs in Alpha is $100 million and of future costs in

Beta is $90 million. Beta thus represents a tax surplus of $5 million ($10 million – $5 million exit tax).

If the corporation shifts corporate location *and* tax location to Beta, then there will be a net gain of $3 million. Yet, the corporation will have sacrificed the corporate surplus ($2 million) available in Alpha. This loss of corporate surplus is what we have in mind by tax-induced distortions to charter competition on the demand side. There is a separate issue about how such distortions operate in the aggregate to dampen the market for corporate charters on the supply side. Obviously, if tax always drowns out corporate considerations, then we would expect the market for corporate charters to dry up completely. But, as we show in the discussion below, tax need not crowd out corporate law in such a way.

It is not difficult to see that in these circumstances a corporation would like to realize both the corporate surplus *and* the tax surplus. That is, the corporation would like to be located in Alpha for corporate law purposes and in Beta for tax law purposes, thereby achieving $7 million of combined corporate and tax surplus.[19] Is that solution available? If so, under what conditions? Answering these questions involves a detailed analysis of the ways in which the corporate and tax law intersect on the question of location. It is to that analysis we turn in the following Parts.

## II. Corporate Tax Law and Location

As we have just seen, distortions to the market for corporate charters may arise where securing the tax surplus requires a corporation to locate in a suboptimal jurisdiction for corporate law purposes. We turn here to developing a better understanding of just when such a distortion can be expected to arise. To do so we must analyze the legal mechanism that ties the determination of *location* with the creation of tax surplus. As an initial matter, it is helpful to think of corporations as making a locational decision at some point in time. Then we can distinguish between the taxation of activity that occurs *before* that locational decision and the taxation of activity that occurs *after* that locational decision. We can think of the former class of taxes as exit taxes and the latter class of taxes as relating to the matter of ongoing profits. Of course, if the chosen point in time is simply the time of the corporation's creation, then there will be no issue with respect to exit taxes. The analysis below will show how different substantive and locational tax rules

19. An even more attractive outcome would be a partial migration for tax purposes, involving realizing the ten million dollar tax surplus in Beta without having to pay the exit tax to Alpha. That solution will generally not be available, because it would require inconsistent locational determinations under the tax law with respect to the past and future profits. It is difficult to see why any tax system would impose an exit tax and allow that possibility. Of course, a corporation could escape the exit tax by not moving corporate location and still try to gain the benefits of the low-tax jurisdiction by shifting profits to that jurisdiction. That result, however, would generally require the corporation to move assets and functions in addition to the mere shift of corporate location. We put aside the possibility of real asset shifts in this Article (other than those accompanying a shift in real seat) because we wish to focus on the narrow question of the intersection of tax and corporate locational decisions. Real assets shifts run orthogonally to that question because they may occur with, or without, accompanying locational shifts.

interact to create tax surplus with respect to "new" profits and "old" profits. Our goals in this Part are twofold. First, not all regimes of corporate taxation distort equally, for the simple reason that location matters more in some systems than others. We seek here to develop an understanding of which systems are likely to distort more and which less. Second, we hope to show that the solution to the problem cannot lie in isolated changes to the tax law, as distinct from the corporate law. One simple reason is revenue constraints. A subtler reason is that policy prescriptions here would point in nearly opposite directions for the case of new profits and old profits. Assuming we cannot feasibly implement different tax regimes for the two situations, we will have to look to other types of modifications to preserve the integrity of a global market for corporate charters.

### A. *The Problem of "New" Profits*

We consider first the question of what we will call "new" profits, i.e., profits that arise subsequent to some arbitrary point in time at which we consider the decision regarding corporate location. In the cross-border setting, jurisdictions may tax either on a worldwide basis (in which case the jurisdiction may tax all of the profits of a corporation located therein, with relief from double taxation through a foreign tax credit) or on a territorial basis (in which case the jurisdiction taxes only corporate profits arising in the jurisdiction). The corporate locational decision thus has importantly different consequences in the two types of systems. In a worldwide system, location opens the door to taxation of *foreign* source corporate profits; in a territorial system, this is generally not the case.

The conjunction of two possible locational rules (POI or RS) and two possible substantive regimes of taxation (worldwide or territorial) yields four possible combinations of rules for any given jurisdiction. If we were to consider a full specification of the substantive tax consequences in the two jurisdiction example described above, each of the four possibilities in Alpha could be paired with one of the four possibilities in Beta. A full specification would thus require analysis of sixteen different possibilities.[20] To simplify the analysis, we adopt the following streamlined approach. We will consider the problem from the perspective of a single jurisdiction—Alpha.[21] The

20. A full specification requires sixteen possibilities because the laws of Alpha and Beta are not interchangeable when analyzing migrations. That is, one could get different results depending on whether a certain substantive regime applied to the exit jurisdiction versus the target jurisdiction.

21. Limiting the analysis to the law of one jurisdiction is essential. We suspect that no reader would tolerate a systematic analysis of sixteen different combinations of various substantive tax and locational rules across jurisdictions. But the problem is actually much worse than that, for we have yet to introduce the complication of corporate locational rules. Recall that we make the initial assumption that corporate and tax locational rules can be the same or different. This means that for each jurisdiction there are four possible combinations of tax and corporate locational rules. If we couple this with two substantive tax regimes, this yields eight possible regimes for any given jurisdiction. Thus a full specification of all of the possibilities in a two-jurisdiction world would require analysis of sixty-four possible combinations of rules. The basic problem we address here is complicated, but it need not be *that* complicated. Thus we will focus on the law of one jurisdiction, taking

question we pose is the following: How will the conjunction of tax locational and substantive rules in *Alpha* affect the tax surplus with respect to tax location in *Beta*? We can fruitfully analyze this question from the perspective of a hypothetical legislator in Alpha who is concerned about migrations to, or initial incorporations in, Beta. Such a legislator's task would be to understand how Alpha's locational and substantive tax rules are likely to affect the prospect of tax surplus arising in Beta.[22]

Limiting ourselves to the law of Alpha, we are left with only four possibilities, as summarized in the decision matrix below.

SUBSTANTIVE CORPORATE TAX LAW AND LOCATION

SUBSTANTIVE TAX REGIME

| | | *Worldwide* | *Territorial* |
|---|---|---|---|
| TAX LOCATIONAL RULE | *POI* | 1 | 2 |
| | *RS* | 3 | 4 |

Our basic claim with respect to this decision matrix is that each box leads to a different amount of tax surplus in Beta. Thus we may observe different levels of potential interference with the market for corporate charters, depending on the tax locational rule and substantive tax regime in Alpha.[23] For the avoidance of confusion, we stress that in analyzing the connection between location and tax surplus, we mean to capture the tax consequences that follow from the location of the legal person, as distinguished from locational decisions about real capital. Of course, corporations have clear incentives to locate real capital in jurisdictions based on tax rates. A factory constructed in a low-tax jurisdiction may produce a larger after-tax profit than one constructed in a high-tax jurisdiction. Because we are interested in the intersection of corporate tax and corporate law, however, we are not particularly concerned with real capital allocations, other than to

up discussion of four possible scenarios here. In the next Part, we introduce corporate locational rules, again limiting the analysis by focusing on a single jurisdiction.

22. Aside from the simplicity gained from examining only one jurisdiction's law, there is a good substantive reason for this approach as well. Simultaneously examining the tax law of both jurisdictions produces the following result: locational distortions will be minimized where the tax law of the jurisdictions is the same, thus removing incentives to locate on tax grounds. That is a result that is obviously not on the table. The interesting question is how one can unilaterally minimize tax locational distortions in a world where we expect the tax laws of jurisdictions to differ.

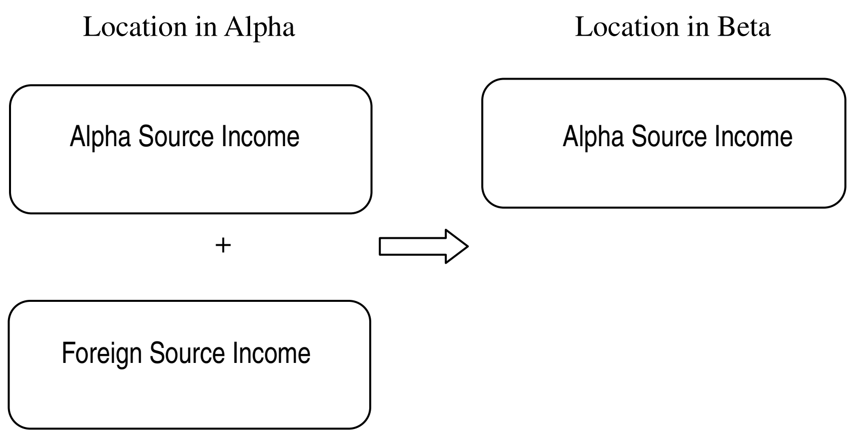
23. We use the qualified phrase "may observe" because the final level of distortion depends on how tax and corporate law locational rules intersect. If these locational determinations were always 100% independent, we would not expect different incentives regarding tax location to have any feedback into the corporate locational decision. The task of the next Part, though, will be to show why determinations are likely *not* to be independent.

the extent that the corporate locational rule itself *compels* a particular real capital allocation.

*Box 1*.

Box 1 (POI + worldwide taxation) roughly corresponds to the United States. The basic tax advantage of locating the corporation in Beta in this scenario is to restrict the Alpha tax base to only that income that arises in Alpha. We represent this relationship below schematically. In reviewing this diagram and the ones to follow, recall that what the diagrams capture is the modification of the *Alpha* tax base, depending upon location in Alpha versus Beta. Thus, the greater the curtailment of the tax base as we shift from Alpha to Beta, the greater the tax surplus in Beta.[24]

Alpha Tax Base—Box 1




As this diagram makes clear, because the corporation is moving foreign-source income out from the Alpha tax base, the potential for tax savings arises.[25]

*Box 2*.

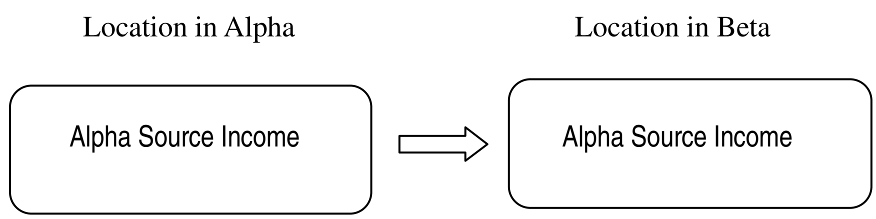
The relevance of corporate location in Box 2 (POI + territorial taxation) is substantially different than in Box 1. As we have just seen, the essential

24. Because the whole point of this exercise is to capture the comparative import of POI and RS locational rules, our assumption here is that location in Beta means placing *only* the incorporation in Beta, while the real seat is located in Alpha.

25. We should stress that in keeping with our focus on one jurisdiction to keep the analysis tractable, the diagram in the text relates *solely* to taxation in Alpha. Still, it is worth noting those features of the Beta tax system that would be necessary to create a tax surplus in the first place. A tax savings would generally materialize from location in Beta only if Beta-source income (or income from a third jurisdiction) is taxed by the source jurisdiction at a lower rate than the Alpha rate. Otherwise, Alpha's foreign tax credit should fully remove any residual Alpha tax on this income in the first instance.

gain to the locational decision in Box 1 is to move foreign source income out from the Alpha tax base. In Box 2, Alpha—which taxes on a territorial basis—already exempts foreign-source income from taxation. Thus there would generally be no gain to a different locational decision, even with respect to low-taxed foreign-source income. We can depict this schematically as follows.

ALPHA TAX BASE—BOX 2




As this diagram makes clear, the collection of rules in Box 2 would generally not create incentives for relocation.[26]

*Box 3*.

The analysis in Box 3 (RS + worldwide taxation) initially tracks the analysis of Box 1 (POI + worldwide taxation). Because Alpha applies worldwide taxation, a corporation once again may, by locating in Beta, move foreign-source income out from the Alpha tax base. This is not the whole story, however, because here Alpha applies a locational rule of RS. Thus, the prerequisites for ensuring location in Beta may themselves feed back into substantive tax liability. Recall that an RS test is relatively substance driven as compared to a POI test. In order to achieve location in Beta, a corporation must locate real tangible factors therein. Which factors must be located in Beta will depend on the contours of Alpha's implementation of the RS rule. Whatever the implementation, though, placing real factors in a jurisdiction tends to have substantive tax consequences. This follows because, all else being equal, the location of factors in Beta would increase the amount of Beta-source income relative to Alpha-source income. This additional twist is captured in the following diagram.

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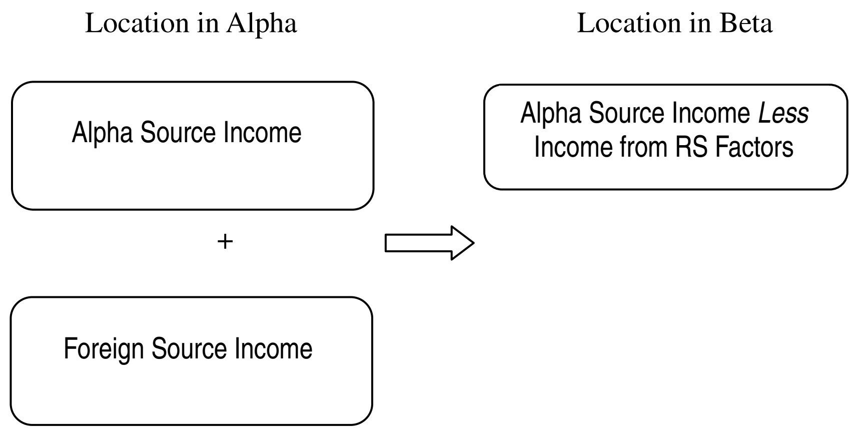
26. The qualification is necessary because real world territorial systems typically do *not* exempt all forms of foreign source income. Also, migration from a territorial system could allow for incremental earnings strippings. Thus, corporate location will remain relevant even in Box 2 situations.

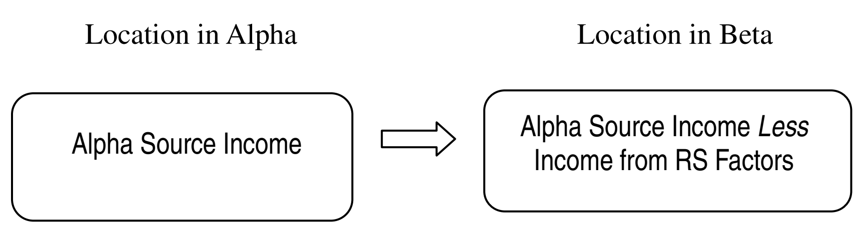
Alpha Tax Base—Box 3




*Box 4*.

The analysis of Box 4 (RS + territorial taxation) follows from what we have said above. In accord with the analysis of Box 2 (POI + territorial taxation), there is generally no gain from locating in Beta with respect to non-Alpha-source income insofar as this income would have already been exempt under the territorial system. Following the analysis in Box 3 (RS + worldwide taxation), however, locating in Beta necessitates moving real factors to Beta, thus reducing Alpha-source income relative to a case with a POI locational rule.

Alpha Tax Base—Box 4




We are now in a position to rank these four scenarios in terms of how relevant the determination of corporate tax location is to tax surplus. It is clear that, for any given corporate tax rate, Box 3 presents the greatest potential for tax-induced locational distortion, and Box 2 presents the least. The relative ordering of Box 1 and Box 4 are theoretically indeterminate, because it depends on whether the tax savings from removing foreign-source income from the tax base in Box 1 is greater than the tax savings from the reduction of domestic-source income as a result of relocation of the real corporate factors in Box 4. This is a function, in part, of the mix of

Alpha-source income and non-Alpha-source income, which will obviously vary from case to case. Although there may be exceptions, we suggest that Box 1 will generally implicate a larger tax surplus than Box 4. We base that conclusion on two factors. First, although RS tests are more substantive than POI tests, RS tests still may not be all that substantive. For example, an RS test might be satisfied simply by locating board meetings in another jurisdiction. In such a case, the shift of RS factors should not cause a substantial shift in the tax base. Second, in those cases where RS tests are quite substantive, the possibilities of shifting the tax base will increase. But this comes at a cost. Specifically, to enjoy the relevant tax benefits, the corporation must now bear the economic costs associated with moving real substantive factors to a new jurisdiction. By contrast, the tax surplus available in a Box 1 situation, because it involves a POI rule, will not be eroded by the cost of moving real factors.[27]

## B. *The Problem of "Old" Profits*

With respect to new profits we have just seen two important results. From the perspective of Alpha's tax law, worldwide systems produce greater potential tax surpluses in Beta than territorial systems, and RS locational rules produce greater surpluses than POI locational rules. The analysis of what we will call "old" profits is notably different. First, regarding the distinction between worldwide and territorial systems, the results are exactly the opposite. This is not surprising. The reason that worldwide systems yield greater surpluses for future profits is that the regime produces a larger tax base in Alpha and thus there is more to gain by escaping the reach of Alpha's tax jurisdiction. But with old profits there may well be no escape. That is the whole point of exit taxes.[28] Thus the larger the historic base, the *larger* the exit tax and the lower the tax surplus in Beta. Second, regarding

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27. In keeping with the general framework of our analysis in this Article, we are once again considering *only* tax effects from shifts in location, thereby ignoring shifts in real assets except where mandated by the applicable locational rule, as may be the case with the RS rule. Of course, where Alpha is a Box 1 jurisdiction there is nothing precluding the taxpayer from moving the RS factors to Beta to achieve a tax advantage, even if such shift of factors is not required by the POI locational rule. For the reason just noted we ignore this prospect in the text because the shift is not mandated by the locational rule. In practice, though, if there is a tax advantage from shifting the factors we would expect to observe this where Alpha is a Box 1 jurisdiction. This simply means that in practice the theoretical indeterminacy drops away and tax surplus in Box 1 should always be greater than in Box 4.

We also ignore the other major means of moving income out of the corporate tax base, namely, creating deductible intra-company payments. Because the potential for deductible interest payments arises equally with respect to all four scenarios just canvassed, however, it should not change the relative ordering of potential tax surplus in the four scenarios.

28. By "exit taxes," we mean taxes due on exit from the jurisdiction, either explicitly or because exit triggers dissolution of the corporation and payment of tax on deferred profits. Provisions that provide the old jurisdiction with security that taxes owed will be paid at some later date bear some similarities to, but should be distinguished from, exit taxes. Such provisions will not discourage exit as directly as exit taxes but may nonetheless penalize exit. For example, a firm whose taxes owed are fixed and collateralized upon exit and then suffers losses will likely be worse off than a firm that did not exit.

the distinction between POI and RS locational rules, the analysis is more complicated. If Alpha applies territorial taxation, then the analysis of old profits is again exactly the opposite of the analysis of new profits. That is, the RS locational rule may involve the location of more substantive factors in Alpha and thus would generally enlarge the scope of the tax base as compared to the POI locational rule. In other words, where Alpha applies a POI locational rule and territorial taxation, some or all of the RS-related factors may already be outside of the Alpha tax base. The larger tax base associated with the RS rule yields greater exit taxes and, as just noted, smaller tax surpluses in Beta. By contrast, if Alpha applies worldwide taxation, one would not observe POI and RS locational rules yielding opposite results with respect to old and new profits. As we have just seen, the RS locational rule produces a larger tax base in Alpha when some or all of the RS-related factors are already outside the RS Alpha tax base. But with a worldwide system this is not possible. Income from the RS-related factors would be in the Alpha tax base irrespective of location. Thus at least for worldwide systems, tax surplus for old profits should not depend on the choice of locational rule.

### C. *Comparing the Old and the New—The Futility of Isolated Tax Law Changes*

The above analysis points to some important results for attempts to preserve an international market for charter competition. To the extent that the charter competition literature has focused on taxation at all, the general approach has been to view exit taxation as an impediment to corporate migration to jurisdictions with more desirable corporate law.[29] That can certainly be true in any given case, but if we place too much emphasis on this isolated piece of the puzzle, we are likely to lose our way. The natural conclusion to draw from the focus on exit taxation would seem to be that if one were to preserve space for the charter competition market, one must reduce or eliminate the exit tax. But we view this conclusion as problematic.

First, reducing exit taxation imposes a real fiscal cost to the jurisdiction that would need to relax the exit tax. Thus jurisdictional incentives will run exactly counter to the prescribed medicine for saving the market. Second, even if one could remove all exit taxation from the table, this would do nothing to address the incentives corporations face to locate in one jurisdiction or another with respect to favorable taxation of new profits. To remove those incentives, one would need to achieve substantial harmonization of different national corporate tax systems, which is clearly not on the table for the foreseeable future, if ever. So long as corporations migrate not just for corporate reasons but also for tax reasons—i.e., low taxation of new profits—then the desire to migrate is itself potentially distorting the charter market. In this case exit taxes may in fact turn out to be *good* for the charter market. That is, from the perspective of the market for corporate charters, we *want* to trap corporations that would migrate to Beta, where Beta has

29. For a discussion of the case with the European Union, see *infra* Section IV.C.

undesirable corporate law but sufficiently low taxes on future profits to outweigh the bad corporate law. On the other hand, consistent with the conventional wisdom, exit taxes *can* also have an undesirable effect on the charter market. If tax surplus in Alpha is larger than available corporate surplus in Beta, a distortion to the charter market will still be present. From the standpoint of removing tax-induced distortions to the charter market, then, it is impossible to say that exit taxes are either categorically good or bad. It all depends on the relative values of corporate surplus in Alpha and Beta (as well as the magnitude of tax surplus available in Beta with respect to new profits).[30]

If we make the very practical assumptions that jurisdictions will be reluctant to cede the power to impose exit taxation (thus making corporate relocation costly with respect to old profits) and that jurisdictions will insist on their rights as sovereigns to set their own tax rates (thus making corporate formation or relocation in relatively low-tax jurisdictions attractive), the question that arises is what sorts of ameliorative changes to tax systems *are* potentially on the table. Here, one might have thought that the natural place to look would be either tax locational rules or methods of double-tax relief. For example, during the recent wave of corporate migrations out of the United States, it was observed that the problem had been aggravated by the fact that the United States applies worldwide taxation and applies a POI locational rule.[31] This combination appears lethal because it both makes tax migration easier as compared to an RS rule and makes tax migration more beneficial as compared to a territorial system. So why not shift the United States towards territorial taxation and a locational rule of RS? Unlike suggestions that we simply get rid of exit taxation or harmonize taxes across the board, this option is plausibly on the table. There are other good reasons to favor territorial taxation and RS locational rules.[32] Perhaps the preservation of a market for corporate charters should operate on the margin to tip the balance in favor of such a package of tax law.

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30. If exit taxes were the only tax at issue, then we would, of course, necessarily remove tax-induced distortions by getting rid of the exit taxes. What makes the problem so difficult here is the prospect of tax distortion arising from the differential tax systems of Alpha and Beta with respect to new profits. Thus to eliminate tax-induced distortions completely one would need to structure the exit tax so that it exactly offset any tax surplus in Beta arising from new profits. Then tax surplus would be at zero in each of Alpha and Beta, and we could be confident that firms would make locational decisions on corporate surplus grounds alone. But exit taxes could never perform this function of completely offsetting tax surplus from the differential treatment of new profits. To see the point most easily, consider the case of the newly incorporated firm, for which exit taxes are never an issue. For these purposes, relatively young firms approximate the position of the newly incorporated firm. The historic tax base would simply be too small for exit taxes to perform the required function.

31. *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, 410 (2002).

32. For a recent discussion of the arguments favoring a shift towards a more territorial regime in the United States, see PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 102–05 (2005), *available at* http://www.taxreformpanel.gov/final-report (last visited Jan. 26, 2008). The standard reason for favoring RS locational rules in tax is that they better reflect economic substance.

Much like the prescription to remove exit taxation, however, such modification would fail to take into account the complicated interaction of tax rules regarding old and new profits.[33] As just noted, commentators have tended to view exit taxes as an undesirable phenomenon because they can trap a corporation in a jurisdiction with undesirable corporate law. When the tax cost of exit is higher than the benefit from corporate law available elsewhere, the corporation stays put and sacrifices the potential corporate law benefits. As we have seen, weighing the tax cost of exit against the corporate benefit of migration fails to take account of the distortionary tax impact with respect to *new* profits. If the goal is to remove the tax distortion to charter location, then the way to do that is *not* simply to minimize the cost of exit taxes. Rather, one should strive to minimize the tax surplus available in Beta, the amount of which is dependent on taxation of both old and new profits. Moreover, in attempting to minimize tax surplus in Beta, one must not overshoot the mark, thereby creating tax surplus in Alpha. In practice this dynamic presents an impossible exercise in calibration. Although Alpha's tax law with respect to double tax relief and locational rule can affect the size of tax surplus that accompanies location in Beta, we have seen how the relationships tend to run in the opposite direction. All else equal, we should expect the tax surplus in Beta to vary with Alpha tax law in the following manner:

Tax Surplus (in Beta) from New Profits:

| | | | | | | |
|---|---|---|---|---|---|---|
| Territorial | | Territorial | | Worldwide | | Worldwide |
| + | < | + | < | + | < | + |
| POI | | RS | | POI | | RS |

Tax Surplus (in Beta) from Old Profits:

| | | | | |
|---|---|---|---|---|
| Worldwide | | Territorial | | Territorial |
| + | < | + | < | + |
| RS or POI | | RS | | POI |

Thus any attempt to minimize distortion with respect to past profits that have accrued prior to a locational decision will generally *aggravate* distortions with respect to new profits that accrue after the locational determination.

The lesson here is that although corporate taxation is at the root of the problem, it would be pointless to attempt to address the problem simply

33. This is not to say that a shift towards territorial taxation and RS should not be part of a broader solution to the problem. Indeed, we urge such an approach as part of our broader analysis below. *See infra* Section III.B.1.e.

through modifications to the distortion-inducing tax rules. This holds for major changes to tax systems, such as removing exit taxes altogether, because of revenue constraints, or to harmonizing, because of political constraints related to national sovereignty over tax issues. It is less obvious but no less true with respect to more modest changes, such as adjusting the tax rules regarding location and double tax relief. The problem we have exposed here is that the direction of legal change in this context is different depending on whether the focus is on new profits or old profits.[34] Thus, we are left ultimately with an empirical question about whether the focus should be on new or old profits. We surmise here that a jurisdiction is likely to achieve a greater reduction in distortions by focusing on new profits. We base the claim on two reasons. First, at any moment in time the present value of new profits is likely to dwarf any untaxed old profits in the system. Second, exit taxes on old profits can take on greater or lesser importance in ways that have nothing to do with the method of double tax relief. Specifically, during economic downswings current *losses* may offset old profits. This effect might well drown out the fact that the amount of old profits is likely to vary across worldwide and territorial systems. Thus, if we were forced to decide, we would suggest that the focus should be on new profits, and thus territorial systems would be preferable to worldwide systems—at least in this respect. But we cannot be certain of this claim. And even if we are right, employing a territorial system in a world with different tax rates is obviously only a partial solution because tax surplus will still arise in foreign jurisdictions, thus giving corporations incentives to locate for tax reasons, rather than corporate law ones. Ultimately, the method of double tax relief is but one part of what we consider to be a larger and more complex solution to the problem.

## III. Saving the International Market for Corporate Charters

In this Part we explore ways to preserve the international market for corporate charters beyond focusing on the distortions created by tax law. Our proposals are ultimately rather specific. Before grappling with the details, though, we pause to articulate both the fundamental insight that drives most of what follows and an important caveat.

The insight is that the prospect of efficiency losses in this context derives from the overlapping nature of the corporate law and the corporate tax law described above. Thus, if the basic problem stems from the market for one type of law (corporate tax) interfering with the market for another (corporate), we believe that the basic solution to the problem is to drive a wedge

34. We take it as a given that no jurisdiction is going to adopt *different* methods of double tax relief or a different locational rule for the different situations. The administrative complexities of this would be insurmountable.

between the two markets, thereby allowing each to operate independently of the other.[35]

The caveat is that our general approach in this Article assumes that the corporate law and the corporate tax law intersect *only* on the issue of corporate location, while the broader substantive provisions of the two bodies of law have no overlap. This is an oversimplification. An emerging body of literature on the relationship between tax law and corporate governance has begun to explore a number of ways in which there may be important feedback effects between substantive provisions of tax law and the substantive provisions regarding corporate governance.[36] Scholars believe that these interactions run in both directions. That is, the nature of the governance regime may affect the tax system, and the nature of the tax system may affect the quality of corporate governance.[37]

This emerging literature on the substantive interactions of tax and corporate law is closely related to the question that we address in this Article. If such interactions create value, then the basic question this raises for our analysis is whether one sacrifices some of this value by, as we urge here, untethering tax law from corporate law. We do not believe enough is yet known to analyze this question, though we hope to return to it in future work. For now, we note that there are at least a couple of strands of this literature that may ultimately bolster our claims, while other aspects may counsel some degree of restraint.

One claim in the literature is that strong governance may be good for the tax system. This claim finds support in empirical evidence showing that tax rate increases are only effective to raise additional revenue in jurisdictions with strong governance regimes.[38] The intuition underlying this result is that weak governance makes it easier for managers to divert profits, thereby increasing incentives to engage in tax avoidance. These incentives would make it costlier for the state to collect revenue under the tax system.[39] That

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35. A side effect of this solution is to remove any interference the corporate law market may have on the tax law market. Consistent with our agnosticism on tax competition, we count that effect as neither a benefit nor a detriment of our proposals. Note also that the types of distortion we describe in this paper are not necessarily unique to the interplay between corporate law and corporate tax law. To generalize, any time the factors relevant to locational determinations under tax law play a role in determining the substantive law applicable to the corporation, the type of distortions described in this Article may arise. We take no position in this paper on whether it may be desirable to drive a wedge between the tax law and other domains of law. Nor do we take a position on the degree of flexibility that should be accorded to corporations in opting into or out of such other domains of law.

36. *See* Hideki Kanda & Saul Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 Va. L. Rev. 211 (1991); Saul Levmore, *The Positive Role of Tax Law in Corporate and Capital Markets*, 12 J. Corp. L. 483 (1987); Mihir A. Desai & Dhammika Dharmapala, Taxation and Corporate Governance: An Economic Approach (Dec. 4, 2007), *available at* http://ssrn.com/abstract=983563.

37. *See* Desai & Dharmapala, *supra* note 36.

38. *See* Mihir A. Desai et al., *Theft and Taxes*, 84 J. Fin. Econ. 591 (2007).

39. Note that tax cost identified in the text is somewhat different from the type of efficiency consequence we generally have in mind in this Article. That is, we are centrally concerned with corporate choice of location and the efficiency losses that one might suffer where tax steers corpora-

result, however, seems to run in favor of our arguments, at least to the extent that one approaches the problem from the standpoint of a "race to the top," in which a market for corporate charters is more likely to produce better, rather than worse, corporate law.

A second strand in the relevant literature claims that tax complexity is detrimental from a corporate governance standpoint. Specifically, complex tax systems require managers to create sophisticated transactional structures in order to achieve tax avoidance goals. Complex transactional structures, however, give managers additional capacity to hide self-dealing from shareholders. This raises the possibility that tax migrations into jurisdictions with lower complexity yield a corporate governance benefit. To the extent that separating the tax and corporate law markets facilitates such migrations, there could be additional gains realized from the separation.[40]

A third element of the tax and corporate governance literature that raises a host of deeply interesting and complex questions is the relationship between book income and tax income.

To calculate corporate income tax, the question of income determination is absolutely central because the definition of corporate income feeds directly into the calculation of the substantive tax liability owed. For corporate law, the issue is perhaps not quite as central, but it is still crucial for the reason that accurate financial statements are an important tool to allow shareholders and analysts to evaluate the performance of a firm. As is well known to any tax adviser, corporate goals in one regime often run counter to the goals under another. Specifically, for financial accounting purposes corporations would typically prefer to report higher income, whereas for tax purposes corporations would typically prefer to report lower income. This can create an important "friction" with respect to tax planning.[41] That is, to the

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tions away from the best corporate law, resulting in a loss of what we call corporate surplus. Costs to the tax system that arise because of an increased need to combat aggressive planning do not similarly affect the tax surplus of a corporation. Though they might do so depending on how the jurisdiction passes the increased cost back to the private sector, the literature to date does not explore the ramifications of any such dynamic effect. Still, it is a social cost to the extent that the state must expend more funds to collect a given amount of revenue. *See* Yariv Brauner, *An International Tax Regime in Crystallization*, 56 TAX L. REV. 259, 298 (2003) (arguing that a partial and gradual harmonization of global tax rules will reduce the burden of both tax planning and enforcement costs). Accordingly, a complete analysis of the economic effects of separating the tax and corporate law markets would take account of the relation of this social cost to the type of cost we are generally concerned with in connection with loss of corporate surplus.

40. It is difficult to evaluate this narrow point in isolation from one's overall normative commitments about tax competition. While retaining our agnosticism on the normative question, we would note simply that this factor does seem to provide a novel reason to favor tax competition. Standard arguments for tax competition do not address governance implications but rather focus on factors such as how competitive pressures will restrain the size of the public sector and will enable heterogeneous corporations better to select into jurisdictions with the right blend of public-good provision. *See* Geoffrey Brennan & James M. Buchanan, *Towards a Tax Constitution for Leviathan*, 8 J. PUB. ECON. 255, 258–60 (1977), *cited in* Avi-Yonah, *supra* note 18, at 1614 & n.181. *But see* Wallace E. Oates, *Searching for Leviathan: An Empirical Study*, 75 AM. ECON. REV. 748, 749–50 (1985), *cited in* Avi-Yonah, *supra* note 18, at 1614–15 & n.188.

41. Use of the term "friction" to describe a constraint on tax planning that derives from some domain outside the tax law originates with Professors Scholes and Wolfson. MYRON S. SCHOLES & MARK A. WOLFSON, TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH 7 (1992). The

extent that aggressive tax planning reduces income for tax *and* corporate purposes, the firm may opt not to engage in the tax planning in the first place.[42] Whether this type of friction results in social value or social cost in the aggregate is ambiguous. Frictions can create value where they operate to bolster narrow tax provisions in curtailing wasteful tax avoidance behavior.[43] But frictions can also create social costs. With respect to some taxpayers, for example, frictions may simply raise the cost of socially wasteful behavior rather than deterring it.[44] Given this ambiguity, it is difficult to predict the net effect of separating the tax and charter markets on this particular issue.[45]

As noted, in our analysis below we do not take further account of potential interactions between tax law and corporate governance. Our chief claim is simply that so long as there are *no* substantive interactions between the tax and corporate law other than the locational determination, it makes sense to segregate the markets entirely. To the extent that there are substantive interactions, one should modify the approach accordingly.[46]

Below we initially describe what we consider to be the first-best solution to the problem created by overlapping locational determinations under tax law and corporate law. This solution would require coordination of the tax and corporate locational rules of various jurisdictions. Because such coordination may be difficult to achieve, we next turn to the use of federal structures as a second-best approach to this problem.

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concept was then developed at length by Dean Schizer. David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312 (2001).

42. Schizer, *supra* note 41, at 1333.

43. *Id.* at 1323.

44. *See* Louis Kaplow, *Optimal Taxation with Costly Enforcement and Evasion*, 43 J. PUB. ECON. 221, 233 (1990).

45. The difficulty is twofold. One is the standard problem, mentioned in the text, of determining whether any given package of tax-law-plus-corporate-law friction yields a social cost or a social benefit in the aggregate. The additional problem is that it is exceedingly difficult to determine ex ante what package one should consider. There is uncertainty here because the final package of tax and corporate law depends on the operation of markets, rather than a combination of legislative acts of a single sovereign. This last point does, however, point to one unambiguous cost of segregating the markets: sovereigns sacrifice the ability to leverage the tax and corporate law against one another. In other words, it may be possible to use frictions affirmatively to accomplish goals that one cannot accomplish as easily through direct drafting of tax legislation. *Cf.* Schizer, *supra* note 41 (contrasting the effectiveness of I.R.C. section 1260, where frictions are relatively strong, with the general ineffectiveness of I.R.C. section 1259, where frictions are relatively weak).

46. Note that this would call for a case-by-case analysis of the particular substantive interaction. If the interaction is value enhancing where the laws of a single jurisdiction apply, this does *not* counsel against severing the markets. This conclusion depends on a comparative analysis of how the interaction plays out where the markets are separate and the corporation is unhindered in its ability to pair tax law from one jurisdiction and corporate law from another jurisdiction. Conversely, if the substantive interaction is value reducing where the laws of a single jurisdiction apply, this does *not* necessarily provide an argument for severing the markets. Again, the answer depends on the comparative question regarding the consequences of the substantive interaction with segregated markets.

### A. *The First-Best Solution—Segregating the Market with the Rule of Location*

The central design issue in establishing a wedge between corporate law and corporate tax law is the selection of proper locational rules. The fact that there are two possible locational rules for each of two regimes again yields a decision space with four possibilities, which can be captured in the following diagram:

LOCATIONAL RULES IN CORPORATE LAW AND CORPORATE TAX LAW

CORPORATE LAW

| | | *POI* | *RS* |
|---|---|---|---|
| CORPORATE TAX LAW | *POI* | 1 | 2 |
| | *RS* | 3 | 4 |

We can make a couple of general observations about these four possibilities.

First, if corporate and tax surplus arise in the same jurisdiction, then there will generally be no problem of distortion. If that were always the case, we would not need to worry about separating the market for tax law from the market for corporate law, and the locational rules would not matter.[47] If the locational rules are the same, then obviously the corporation will locate in the same jurisdiction for corporate and tax purposes and will choose the jurisdiction that has a surplus. Even if the locational rules are different, the corporation should still have no problem locating in the surplus-creating jurisdiction for both corporate and tax purposes. For example, suppose we are in Box 3 and corporate and tax surpluses both exist in Alpha. A corporation in this case would simply be sure to place both POI and RS factors in Alpha, thus capturing the surplus under both domains of law.

Second, if corporate and tax surpluses arise in different jurisdictions, then the potential for distortions arises. This will clearly be the case whenever the locational rule for corporate law and tax are the same, either both POI (Box 1) or both RS (Box 4). In that case the corporation must be located in the same jurisdiction for both corporate and tax purposes. It should choose to locate in the jurisdiction where it captures the higher surplus, thereby sacrificing the other surplus. The case that interests, of course, is

47. This is true, at least, in a static but not dynamic sense. That is, if tax surpluses typically trump corporate surpluses, then the overlap at time 1 will prevent any future competition for charters from emerging.

when the tax surplus is higher than the corporate surplus, and the corporation thus must sacrifice the benefits of the optimal corporate law.

It follows from these points that the way to separate the two relevant markets for substantive law is simply to make the corporate and tax locational rules different. Thus Boxes 2 and 3 are preferable to Boxes 1 and 4. Box 2, however, does not in fact offer the possibility for a corporation to be located in different jurisdictions for corporate and tax purposes. As noted above,[48] due to the constitutive nature of corporate law, business planners in jurisdictions that follow the RS doctrine for corporate law will inevitably incorporate the firm in the jurisdiction where the real seat is located. This limits the possibility of multiple jurisdictions claiming the same firm for corporate law purposes.[49] A firm incorporated out of the jurisdiction, but whose real seat is located within the jurisdiction, will be viewed as a defectively incorporated firm: its investors will not enjoy limited liability, the firm will not have legal personality, and so forth.[50] Put somewhat differently, the property law aspects of corporate law (principally limited liability and asset lock-in) necessitate a constitutive act of incorporation which, among other things, provides notice to third parties.[51] The effect of the RS doctrine on corporate existence and limited liability will thus force almost all firms having their real seats in the jurisdiction to be incorporated there.[52]

Thus the preferred combination of locational rules is Box 3—POI for corporate purposes and RS for tax purposes. With this set of rules, the markets for corporate law and corporate tax law could in principle operate entirely independently of one another. Of course, there would still be tax-motivated shifts in location. New corporations could be expected to locate their real seat in low-tax jurisdictions. Existing corporations could be expected to migrate their real seat in cases where the benefits from lower future taxation exceed the costs of exit taxation, if any. But these issues

48. *Supra* Section I.A.

49. It is, however, relatively common for jurisdictions to attempt to impose specific requirements on "pseudo-foreign" corporations. *See, e.g.*, Cal. Corp. Code § 2115 (West 2008). The constitutionality of such provisions in a federal system is inevitably subject to controversy. For the United States, see *VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108 (2005). For the European Union, see the discussion below of *Centros*, and subsequent cases, *infra* Section IV.C.1.a.

50. Drury, *supra* note 11, at 357 & n.7.

51. Henry Hansmann & Reiner Kraakman, *The Essential Role of Organizational Law*, 110 Yale L.J. 387 (2000).

52. As we discuss below, part of our first-best solution involves coordination of locational rules across jurisdictions. If one could achieve coordination it might seem that the effect described in the text drops away. That is, if *all* jurisdictions applied an RS rule for corporate law purposes, then it would become impossible for one jurisdiction to claim a corporation on the basis of real seat while some other jurisdiction (applying a POI rule) claims the same corporation solely on the basis of local incorporation. The possibility of conflicting bodies of corporate law applying to the same firm would seem to dissipate. Matters are more complicated than this simple formulation, however. Precisely because the RS rule is factual rather than formal, one could observe conflicts even in a case where all jurisdictions applied an RS rule for corporate law purposes. That could be the case either if the jurisdictions looked to different factual elements under the RS test or if the jurisdictions just applied the same test differently to a given set of facts. To avoid this possibility, jurisdictions adopting an RS rule should continue to view firms with local headquarters but foreign incorporation as defectively incorporated entities. Box 2 thus remains unavailable as a solution.

would be tax issues alone. Jurisdictions could take countermeasures to shore up the tax base, such as increasing exit taxes or making it more difficult to pay deductible interest out to foreign parents, thus reducing the tax surplus for low-tax foreign jurisdictions. The central observation, though, is that even if jurisdictions made no such moves—or if such moves were only partially effective to deter tax-motivated locational decisions—the market for corporate charters would still remain free of interference from the market for corporate tax law, because companies could incorporate in the jurisdiction of choice without cost to their tax position.[53]

There are, however, two potential problems with the combination of locational rules in Box 3. First, it is not clear that a domestic regime of RS (tax) plus POI (corporate) represents a stable political equilibrium. For example, a jurisdiction with this package of rules that is suffering tax migrations of corporations that remain locally incorporated (because of high quality local corporate law) might be tempted to adopt a disjunctive POI *or* RS rule for tax purposes.[54]

Second, for the markets to be entirely separate one would need coordination of locational rules across jurisdictions. That is, no single jurisdiction could eliminate the distortion to the market for corporate charters simply by moving to the preferred set of locational rules, namely RS for tax law and POI for corporate law. A simple example demonstrates the point. Suppose that one jurisdiction opts for just that set of rules, but a tax haven applies POI for corporate and tax purposes. If a company were to find the tax surplus in the tax haven sufficiently attractive to move there for tax purposes, it would be obligated to shift its place of incorporation to the tax haven. If the tax haven has low-quality corporate law relative to the other jurisdiction, then corporate surplus will be sacrificed.[55]

The first-best solution to this problem, then, would be universal adoption of a POI rule for corporate law and an RS rule for tax. It is conceivable that we might address the problems of instability and coordination through bilateral or multilateral treaties. No such treaties are imminent, however. And, for the time being at least, many jurisdictions depart from this ideal, applying

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53. We mean tax in our limited sense. "Taxes" such as the Delaware franchise tax would of course still be relevant.

54. *See infra* Section IV.C.2.

55. Havens may well use corporate locational rules as part of an overall strategy to maximize revenue. For example, a haven might apply a relatively favorable tax regime where a POI rule is satisfied, while maintaining a different and relatively onerous tax regime where a conjunctive POI *and* RS rule is satisfied. This strategy would preserve full tax collections for "real" domestic firms, while also capturing some incremental tax revenue from foreign firms. The Organization for Economic Co-operation and Development ("OECD") has strongly criticized such a strategy of "ring-fencing," which it views as a feature suggesting a harmful preferential tax regime. The foreign taxpayer enjoys the jurisdiction's infrastructure at a reduced cost, and by barring domestic taxpayers from the regime, the community is protected from the otherwise harmful effects of the ring-fenced tax regime. COMM. ON FISCAL AFFAIRS, ORGANISATION FOR ECON. CO-OPERATION & DEV. [OECD], HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE paras. 59, 62 (1998), *available at* http://www.oecd.org/dataoecd/33/1/1904184.pdf.

either POI for tax or RS for corporate law. It is therefore useful to analyze other possible, though admittedly inferior, remedies to the problem.

### B. *The Second-Best Solutions—Federal Structures*

This brings us to the question whether it is possible to ameliorate distortions in some manner that does not rely on international coordination of locational rules for corporate law and corporate tax. We believe there is a way to do this. Returning to the basic insight that the goal should be to separate the markets for corporate and tax law, our claim is that the most feasible way to achieve this goal is through the use of an appropriately designed federal structure. Our methodology for the remainder of this Part is as follows. We describe two different types of federal structures, each of which we suggest could form the starting point for a legal structure that would resolve, to a great extent, the conflicts between tax and corporate law that can thwart an international market for corporate charters. For each of the structures, we deal with five basic design elements: (1) allocation of substantive corporate and tax law between federal and subfederal units; (2) choice of location rule (POI or RS) for each domain of law; (3) tax treatment of migration of the place of incorporation; (4) tax treatment of migration of the real seat; and (5) the method of double-tax relief under the tax system.

In describing the outlines of two types of federal systems here, we have roughly in mind the broad outlines of federalism as implemented in the United States and the European Union. Structurally, these implementations are our starting point, but we stress that what we describe here are ideals not currently implemented in either the United States or in the European Union. With these ideals in mind, we turn in the last Part of this Article to analysis of real-world federalism in the United States and European Union. With the groundwork we lay here we can accomplish two tasks. First, we can test our hypotheses to some extent. That is, we predict that departures from the ideal we describe in this part should lead to breakdowns in the international market for corporate charters. Second, we can propose some medicine. As part of this discussion, we will also undertake an analysis of a unitary system (Israel) and a federal system similar to that of the United States (Canada) in order to further test our claims.

#### 1. *Federal Structure 1: (U.S.-Style Federalism)*

##### a. *Allocation of Substantive Law*

As already noted, the goal in implementing a federal structure in this context is to drive a wedge between the markets for corporate and tax law. One way to construct such a wedge is to have the markets operate at different levels of the federal structure. That is, one market could operate at the federal level and the other could operate at the subfederal level. The major design issue that arises under this type of federal structure is the level (federal or subfederal) at which one locates the substantive tax law and the level at which one locates the substantive corporate law. This question has a fairly clear answer, at least if one shares our basic normative commitments stated at the outset. Recall that our reliance on a federal structure is a second-best solution to the problem. In the first-best solution of worldwide separation of locational rules, it is possible to let the markets for corporate and tax law each run unfettered. In virtue of the distinct locational rules, neither market will affect the other. In the second-best solution we do not have the luxury of unfettered competition for both markets. Specifically, competition with jurisdictions outside the federal system threatens distortions (because of the threat of uncoordinated locational rules). In essence, one should strive to design the federal structure so as to achieve robust competition among the subfederal units in one market, while simultaneously attempting to stifle competition in the other market with jurisdictions outside the federal system.

As stated at the outset, we are in favor of a market for corporate charters and agnostic regarding the merits of tax competition. If one shares those commitments, then the obvious design choice is to place the substantive corporate law at the subfederal level and the primary substantive tax law at the federal level.[56] This allows the subfederal units to compete for corporate charters.

### b. *Locational Rules*

The second design issue lies in the selection of tax and corporate locational rules. The corporate law case is simple. A rule of POI facilitates the market for corporate charters because establishing incorporation in a jurisdiction is less expensive than establishing a real seat there. The choice of tax locational rule raises a more subtle issue. In one sense the choice of tax locational rule no longer matters, because under the proposed federal structure we have separated the tax and corporate law markets across different levels. But this conclusion would hold only if the relevant federal structure operated as an island without regard to the law of jurisdictions *outside* the federal system. Once we take such extra-federal jurisdictions into account, it is clear that the preferable rule for tax location is a rule of RS. This can best be seen by discussion of the possible consequences that follow from the contrary rule. Imagine that the tax locational rule is POI. In that case, corporations would have to incorporate in another jurisdiction in order to realize tax surplus there. If the other jurisdiction has inferior corporate law, then the corporation will sacrifice the corporate surplus that would have been available within the ideal jurisdiction of incorporation in the federal structure. In

56. There could be reasons to disfavor such an arrangement that have nothing to do with markets for corporate charters. If one is suspicious of centralized power, then one may well not want the main revenue collection system operated at the federal level. We express no opinion on this issue, though we would note that the key feature of our system is that the substantive tax law is uniform while the corporate law is not. There is a fair amount of leeway to address the centralized power concern even within our system by, for example, delegating spending decisions back to the subfederal units.

contrast, the RS rule of tax location at least leaves open the possibility of realizing the tax surplus *and* the corporate surplus. Specifically, if the favored jurisdiction for tax purposes also has a locational rule of RS, then the corporation could move its real seat to that jurisdiction, while remaining incorporated in the preferred jurisdiction within the federal and subfederal structure. Thus the ideal arrangement of locational rules in this type of structure would be POI for corporate law purposes and RS for tax purposes.

#### c. *Taxation of POI Migrations*

The third design issue is the appropriate tax treatment of POI migrations. Given the locational rules are as described above (POI for corporate law and RS for corporate tax law), the ideal tax treatment of a POI migration is straightforward. In that case a POI migration would be motivated by an attempt to capture corporate surplus. The migration should thus not be a taxable event. The reason is perhaps most obvious within the federal system itself. The market for corporate charters on this model will exist as between the subfederal units. If mergers across those units are taxable at the federal level, then this will deter corporate migrations that would move corporations from lower-quality to higher-quality corporate law. Put another way, taxation at the federal level on POI migrations would remove the benefit of segregating the tax and corporate substantive laws across different levels of the federal system. What goes for migrations within the federal system holds for POI migrations outside the federal system as well. That is, precluding taxation for such migrations to jurisdictions outside the federal system simply broadens the potential charter market.

But what if the locational rules depart from the ideal described above? For example if the federal system adopts a POI rule not only for corporate law purposes but also for corporate tax purposes, then matters become substantially more complicated.[57] Our suggestion here is that one can actually use limited taxation to counteract the deficit in the locational rules. Specifically, the federal system should be structured to permit tax-deferred POI migrations of entities across subfederal jurisdictions but should apply some form of exit taxation for migrations from a subfederal jurisdiction to a jurisdiction outside the federal system. The rationale for this approach is subtle.

Observe first that with POI locational rules for both corporate law and corporate tax purposes at least some POI migrations are likely to be tax motivated. If a corporation were to contemplate shifting its place of incorporation to another jurisdiction on the grounds of favorable taxation of future profits, thus augmenting tax surplus, we cannot say for sure whether the migration would be to a jurisdiction with higher-quality or lower-quality corporate law. That is, migration to a jurisdiction with the highest tax surplus may or may not also involve corporate surplus. Thus, from the standpoint of capturing corporate surplus, it is ambiguous whether we

57. We take some time to analyze this possible departure from the ideal because this in fact describes the current situation in the United States.

would want to encourage such migrations or deter them. Assuming that we cannot do both (i.e., that we cannot write a tax rule that permits tax-deferred mergers just in those cases where there would be corporate law surplus but otherwise not), we suggest that the optimal structure should *deny* the benefit of tax-deferred migrations to jurisdictions outside the federal system. For the reasons similar to those discussed above, we think exit taxes actually serve a positive role here. That may seem somewhat surprising because one way of viewing exit taxes is that they trap corporations in jurisdictions with inefficient corporate law. But one must consider this issue within the broader contours of the federal structure that we describe here. Where tax-motivated migration would lead to migration to lower quality corporate law, exit taxes can play an important role in deterring the migration.[58]

What about the flip side, where migration to a jurisdiction with better corporate law is deterred? Should this not ultimately be an empirical question about which type of migration is more prevalent? We think not. The key to resolving this issue is to separate the supply side and demand side considerations at play. To be sure, on the demand side exit taxes might deter migrations that would have led to individual corporations securing some amount of corporate surplus. But this is hopefully a short-run phenomenon. If the appropriately designed federal structure secures a robust market for corporate charters across the subfederal units then we would predict that in equilibrium there should be some subfederal unit that offers corporate law of equal, or near equal, quality to jurisdictions outside the federal system. Put simply, internationalization of the market for corporate charters does *not* mean that one needs all jurisdictions in the world competing for charter revenue in order to produce the best quality corporate law.[59]

58. Note that the point in the text is that a jurisdiction can affirmatively use tax law to protect corporate surplus in certain cases where it has departed from the ideal arrangement of locational rules. The flip side of this is that the jurisdiction may be tempted to use corporate law to meet its tax goals. In other words, the jurisdiction might like that bad corporate law in a low-tax jurisdiction operates as a disincentive for the corporation to shift location for tax purposes. That disincentive can only arise, though, if the corporate and tax locational rules are the same. This dynamic could put pressure on the jurisdiction to adopt the nonideal package of POI locational rules for both corporate and tax purposes. The United States is a case in point. For example, one might defend the U.S. package of rules by reference to the fact that it could put some brake on tax-motivated corporate-inversion activity. But this comes at the cost of distorting the charter market in ways that can lead to the sacrifice of corporate surplus. Thus if the jurisdiction is concerned about preserving tax base, we believe a better approach is to rely on exit taxes alone rather than falling back on the conjunction of nonideal locational rules and corporate incentives regarding the quality of corporate law. We discuss below other ways in which the motivation to preserve tax base can create political pressures to depart from the ideal arrangement of locational rules. *See infra* Section IV.C.2.

59. Our analysis in the text holds only where the conditions in the federal system are in fact sufficient to support robust charter competition within the federal system. In federal systems where charter competition is sparse or does not emerge at all, such as in Canada, one would need to pay additional attention to the sacrifice of potential corporate surplus that could be realized in jurisdictions outside the federal system.

#### d. *Taxation of RS Migrations*

The fourth design issue relates to the taxation of RS migrations. The analysis here is straightforward. So long as the jurisdiction follows the ideal specification of locational rules (POI for corporate law and RS for corporate tax), then the taxation of RS migrations should not bear upon the workings of the charter market. This is the precise benefit of segregating the markets by locational rule. There may, of course, be good reasons for imposing exit taxes in certain cases. For example, the jurisdiction may seek to impose an exit tax when the migration involves shifting the real seat out of the federal jurisdiction, given the greater administrative problems with collecting deferred taxes on foreign corporations. But this would be strictly an issue of tax policy.[60]

#### e. *Method of Double Tax Relief*

The lesson of the preceding discussion is that one can use exit taxes to affirmatively constrain the incentives of corporations to migrate for tax purposes to jurisdictions in ways that might require them to come under lower-quality corporate law. Obviously, this is not a viable solution with respect to initial incorporations, in which case there will be no historic profits of the corporation—and likewise no exit taxes—on the table. Our suggestion here is that one could put the jurisdiction's method of double tax relief to affirmative use to check the distortions that can arise from tax-motivated initial incorporations. Specifically, a federal jurisdiction interested in ameliorating distortions to the market for corporate charters should adopt a system of territorial rather than worldwide taxation.

Recall from the discussion above that the effect of a jurisdiction's method of double tax relief has opposite effects, depending on whether we are analyzing old profits and exit taxes, or future profits and future taxes. All else equal, for old profits a territorial system tends to increase tax surplus from migration (relative to a worldwide system) and thus *augment* the possibility for distortions. But, all else equal, for new profits a territorial system tends to decrease tax surplus from incorporating in a different jurisdiction (relative to a worldwide system) and thus *diminish* the possibility for tax-induced distortions to the corporate charter market. Given this conflict, how should one choose the ideal method of double tax relief? For the reasons discussed above we surmise that territorial taxation is a superior option here.

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60. Note that we do not take up here, as we did with POI migrations, the case in which the jurisdiction departs from the ideal package of locational rules and applies instead a POI rule for both corporate law and corporate tax law purposes. Obviously in that case the issue of RS migrations drops out of the picture altogether, as a migration of a real seat no longer has legal import under either domain of law.

### 2. *Federal Structure 2: (E.U.-Style Federalism)*

#### a. *Allocation of Substantive Law*

In the second type of federal structure we describe, the allocation of substantive law across the federal system is importantly different. Specifically, we describe here a federal structure that places both the substantive tax and corporate law at the subfederal level. As compared to the federal structure described above, this basic allocation of substantive law authority produces two important consequences. First, from the perspective of preserving space for charter competition, it *lacks* the basic merit of the federal structure described above. By placing the substantive law at the same jurisdictional level (i.e., subfederal) we have failed to use the federal structure itself to drive a wedge between the markets. Thus we will have to look to other design features, discussed below, to address this problem. Second, and somewhat subsidiary to the main thrust in this Article, note that the flip side of placing tax and corporate law at the same level is that we now do have a space for tax competition within the federal system. Under the first federal structure it was generally necessary to curtail (all) tax competition to the extent possible in order to preserve the market for corporate charters. Under the second federal structure that is no longer the case. The system allows for tax competition within the federal system but, for the same reasons discussed above, should strive to curtail competition outside the federation. If the reader thinks tax competition is a good thing (we express no opinion on the matter), this feature alone would be a good reason to prefer this type of federal structure to the one described above.

#### b. *Locational Rules*

As above, the locational rule for corporate purposes must be POI if we are to preserve the market for corporate charters. The analysis of the tax locational rule is somewhat different, though. In the above discussion we suggested it was desirable to have a tax locational rule of RS because this allows some tax-motivated location outside the jurisdiction without distorting the corporate law choice. In the second federal structure, by contrast, it is not merely desirable but essential that the subfederal units apply a rule of RS to determine tax location. In other words we can achieve bifurcation of the tax and corporate law markets (within the federal system anyway) by using the locational rule, rather than by placing the substantive law at different levels of the federal system. This result is just to preserve the basic observation driving what we presented above as the first-best solution. If the locational rules for tax and corporate law are uniformly different, then those two markets can operate independently without distortion. On the global scale we take that to require an unlikely degree of international coordination. But within the confines of a federal system, such coordination seems much more plausible, though by no means guaranteed. By definition, under this structure it is the subfederal units that have the authority to make substantive corporate and tax law. In such a structure, it would be natural to assume that the locational rules under these bodies of law are likewise made at the subfederal level, and thus the possibility for divergent rules would immediately arise. Still, whether the federal structure involves a federal rule restricting subfederal authority on the issue or the process develops through more informal coordination, it still seems to us that there is a far better chance of coordination than in the global setting.

#### c. *Taxation of POI Migrations*

The analysis of POI migrations is the same as above. At least where the locational rules follow the ideal (POI for corporate law and RS for corporate tax law), there should be no exit taxes imposed on POI migrations. Because such migrations would be driven by corporate law considerations alone, imposing a tax threatens the loss of corporate surplus. This reasoning applies both with respect to POI migrations within the federal system and outside of it.

#### d. *Taxation of RS Migrations*

The analysis of taxation of RS migrations again tracks the above discussion. So long as one has complete separation of the locational rules, taxation of RS migrations should not affect the charter market. The decision to tax RS migrations becomes solely one of tax policy. The only point of departure from the discussion of the first type of federal structure is that the political dynamics are likely to be different. We mentioned above the sound tax administrative reasons for imposing an exit tax on an RS migration to a jurisdiction outside of the federal jurisdiction. Note that in the second type of federal structure the same administrative considerations come into play on RS migrations *within* the federal jurisdiction, because it is the subfederal units that are applying the substantive tax law. Thus we can expect a greater push for exit taxation in this type of federal structure. In theory, any increased exit taxation should still not distort the charter market, which is operating on the basis of a different locational rule.[61]

#### e. *Method of Double Tax Relief*

The importance of the method of double tax relief in this type of federal structure is similar to that discussed above. The central issue here relates to distortions with respect to initial incorporations *outside* the federal system. It is those incorporations that raise the potential for inferior corporate law, to the extent the low-tax jurisdiction outside the federal system requires the corporation to incorporate therein. As we have seen, the incentives for such tax-induced incorporations can be reduced to some extent through the adop-

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61. As we will see below, however, the theory breaks down in the case of the European Union. *See infra* Section IV.C.

tion of a territorial system of taxation because this will tend to reduce the amount of tax surplus available from incorporating elsewhere. We would add, however, that as compared to the first federal structure this consideration may well take on less importance here. The reason is that this type of federal system has room for tax competition as between the subfederal units. Assuming that federal rules do not prohibit such competition, we would expect that some subfederal units would enter into tax competition. Thus in this type of federal structure there may well already be certain low-tax alternatives within the federal system and thus less of a drive, as compared to the federal structure described above, to incorporate outside of the federal system for tax reasons.

## IV. The Evidence

We turn in this Part to an analysis of real-world evidence. We discuss first the United States, assessing its federal structure against the ideal arrangements that we have just derived. We then turn to Canada, where we ask whether our analysis sheds any light on the fact that no market for corporate charters appears to have emerged in this federal jurisdiction. We then discuss the federal structure of the European Union. Finally, we close with a discussion of Israel, where we highlight the challenges faced by a unitary system.

### A. *The United States*

The United States resembles the first type of federal structure described above. Corporate law is primarily, or at least substantially, a matter of state law; corporate tax is largely federal. To the extent that states have an interest in taxing corporations, they are constrained. For example, Delaware has a corporate tax of 8.7%, but it is only imposed on in-state profits.[62] Delaware has little choice but to take its profits in chartering revenues rather than corporate tax receipts. If it tried to tax non-Delaware sources of income, firms would surely leave to a more favorable state. In the terminology we have described above, Delaware's charter "tax" revenue is part of what we consider to be corporate law, not corporate tax law. Some states do tax corporate income, irrespective of charter location, but this power is constrained by the Commerce Clause because states may not tax non-resident corporations at a higher rate than resident corporations.[63] Thus, in terms of its federal structure, the United States represents a somewhat imperfect instantiation of the ideal we describe above. That is, there is not a complete split of the tax and corporate law across the central federal government and the subfederal units respectively. There is *some* imposition of tax at the subfederal level, and

62. Del. Code. Ann. tit. 30, § 1902(a)–(b) (2003), *cited and discussed in* Dammann, *supra* note 3, at 71 & nn.90–91.

63. S. Cent. Bell Tel. v. Alabama, 526 U.S. 160, 170–71 (1999), *cited in* Dammann, *supra* note 3, at 71 n.92.

there is *some* corporate law at the federal level through federal securities laws. But on the question of federal structure, the U.S. structure is largely good enough. It is, as a practical matter, not essential that one have complete and total segregation of the markets. Rather, it should be sufficient that where the corporate law and tax law markets overlap (here at the subfederal level) the tax law is sufficiently curtailed that it does *not* drown out the corporate law market, as we would expect it to do if the two markets were in full-fledged competition.[64] In practical terms, in the United States this means that it is only necessary that corporations choose the state of incorporation based on the tradeoff of corporate law benefits and associated costs and *not* on the basis of state corporate taxes (again, in our sense of the word). The historical record certainly suggests that this is the case. Moreover, consistent with the ideal structure, the United States permits tax deferral on POI migrations within the federal system. It is precisely this combination of factors that has been observed in the emergence of Delaware as the preferred state of incorporation for U.S. corporations.

But once we expand our gaze beyond the borders of the federal system, we see that the package of rules in the United States comes up short in several ways. First, contrary to the conclusions we draw above, the United States applies a rule of POI rather than RS for tax purposes. It also applies a regime of worldwide taxation rather than territorial taxation. We predict that this combination of rules is more likely to lead to a breakdown of the market for corporate charters than would be the case with a tax locational rule of RS coupled with a regime of territorial taxation.[65]

More concretely, the U.S. approach to corporate tax location, when combined with the U.S. policy of taxing a "local" corporation's worldwide

64. A majority of states that collect corporate income taxes have enacted portions of the Uniform Division of Income for Tax Purposes Act (UDITPA), and a number of others have adopted its business income/nonbusiness income distinction. Jerome R. Hellerstein & Walter Hellerstein, State Taxation I: Constitutional Limitations and Corporate Income and Franchise Taxes ¶ 8.03 (3d ed. 1998). Under UDITPA, "business income" is apportioned between the states in which the company operated. Unif. Div. of Income for Tax Purposes Act §§ 1(a), 2, 9, 7A U.L.A. 147 (2002). "Nonbusiness income" is allocated in several different ways. For nonbusiness rents, royalties, or capital gains, from real property and tangible personal property, the income is allocated to the state in which the property is located or utilized, respectively. *Id.* §§ 5(a)–(b), 6(a)–(c). Nonbusiness interest and dividends are allocated based on commercial domicile. *Id.* § 7. Nonbusiness patent and copyright royalties are allocated either by utilization or, if not taxed in the state utilized, in the state of the taxpayer's commercial domicile. *Id.* § 8(a). While the apportionment formulas and allocation rules do vary between states, a corporation's *legal* domicile is not a factor. Though states are not constitutionally precluded from using a "legal domicile" test for allocation of profits from nonbusiness intangibles, no state currently does so. Hellerstein & Hellerstein, *supra*, ¶ 9.03[2] n.41.

65. Our call for territorial taxation is based on our supposition that jurisdictions will do better to focus attention on new profits rather than old profits. Standing alone, the analysis in Part II would suggest that a jurisdiction should adopt territorial taxation coupled with a POI rule, because this is the set of rules that minimizes tax surplus in the foreign jurisdiction. Why, then, do we propose a locational rule of RS? The reason is that there is a tradeoff here. The RS rule is undesirable in the sense that it augments tax surplus because the company must locate real factors, to which taxable income must be allocated, outside the jurisdiction. On the other hand, the RS rule is desirable because it allows the corporation to locate in a low-tax jurisdiction *without* changing place of incorporation, with an accompanying shift in applicable corporate law under the described federal structure. We think the second factor is by far the most important here.

income, provides a significant incentive for firms to incorporate in, or migrate to, lower-tax jurisdictions. Moreover, this is a fairly easy goal to accomplish, at least as a technical matter, because of the tax POI rule. When the POI rule is used to define corporate tax "residence," the corporation need not locate its headquarters or any real operations outside of the United States.

This is the lesson of the last spate of so-called "corporate inversions" from the United States, in which U.S. multinationals restyled themselves as foreign multinationals by achieving foreign residence for a surviving parent company. The conventional wisdom regarding corporate inversions is that the U.S. rules aggravated the drive to relocate for tax purposes.[66] Furthermore, the tax-motivated relocations created a reduction in tax *collections* from the governmental side, leading to the widespread condemnation of the offending companies in both the political sphere and the popular press.[67]

Our interest in this phenomenon is different. We accept that corporations were motivated to undertake inversions because the transactions increased corporate value by reducing future tax liabilities. But although corporate value may have increased on a net basis, what can we say about the loss of *corporate* surplus from these transactions? Did U.S. corporations also lose some value simply because they became subject to a different regime of corporate law? We suspect that the answer is yes. This result, if correct, follows at least in part because of the departure of the U.S. rules from the ideal that we describe above. Because the corporate and tax locational rules are the same in the United States (i.e., both POI), relocation for tax purposes necessitates relocation for corporate law purposes. We have little doubt that the sacrifice of corporate surplus is smaller than it would have been before it was possible to list a non-U.S. company on the New York Stock Exchange ("NYSE"). Indeed, it may well be that before doing so was possible, the corporate surplus from location in the United States could well have outweighed the tax surplus from location outside of it, even if exit taxes were zero. Otherwise we would have expected to witness many more initial incorporations outside the United States. Nonetheless, even though the NYSE listing possibilities substantially reduce the corporate surplus from location in the United States, we are also confident that there is still some sacrifice of corporate surplus that arises from relocating a corporation that

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66. These tax savings can be very large. *See, e.g.*, Ingersoll-Rand Co., Registration Statement under the Securities Act of 1944 (Form S-4), at 18 (October 30, 2001) ("As a result of the reorganization, we expect to realize annual, incremental net earnings of at least $40 million and expect to realize a one-time benefit to net earnings in the fourth quarter of 2001 of $50 million to $60 million, net of costs to effect the reorganization.").

67. *See* John D. McKinnon, *Senators Plan to Curb Relocations to Bermuda, Other Tax Havens*, WALL ST. J., March 22, 2002, at A4 (quoting Sen. Max Baucus as saying "When a criminal gets off because of a technicality in the law, people are outraged. . . . I am just as outraged when a corporation takes a technical, manipulative reading of the tax code and robs the rest of the taxpaying public"); David Rogers, *Capital Climate Discomfits Multinationals—Business Frauds, Patriotic Fever Dominate Debates on Offshore Havens, Tax Breaks*, WALL ST. J., July 25, 2002, at A4 (quoting Sen. Charles Grassley as saying "We have to send a clear signal that these corporations ought to get their hearts into America or their rear ends out").

would benefit from high-quality Delaware corporate law to Bermuda and subjecting it to the lower-quality corporate law there.[68]

Conversely, if the United States had adopted the simple expedient of a locational rule of RS for tax purposes, then the loss of corporate surplus may well have been avoided in this context. The application of the RS rule for tax purposes would have opened the possibility of a U.S. parent corporation moving its real seat to a low-tax jurisdiction that also applied a tax locational RS rule. The place of incorporation, and governing corporate law, could have remained in Delaware. Of course, this change in rules would make it more costly to migrate out of the United States. But we would make two observations here. First, a barrier to migration out of the United States is likely to be considered a good thing strictly from the jurisdiction's view of tax policy. Second, and notwithstanding the first point, the basic conflict is still likely to present itself. The companies that did perform corporate inversions came up with predicted tax savings that were almost certainly larger than the costs they would have incurred even with a shift of the real seat.[69]

There is one other interesting piece of empirical support for our theoretical analysis to draw from the U.S. experience. We noted above that exit taxes can be used to counteract the defect in a regime that applies a POI rule for both tax and corporate purposes. This observation is borne out by the experience with corporate inversions. Why have these transactions occurred cyclically? One key stimulant for the last round of such transactions was the existence of losses, because of a down economy, at both the corporate and shareholder levels. These losses operated to offset what could have otherwise been hefty exit taxes.[70] As discussed, where exit taxes are present, they can counteract the effects of a suboptimal locational rule. But this is an imperfect solution. Sometimes exit taxes are not large enough to deter tax-motivated migrations. More seriously, exit taxes are not present at all with initial incorporations. Although the contemporary debate on exit taxes has focused on tax and revenue consequences, the corporate law consequences have clearly been recognized. In a March 1999 Senate Finance Committee hearing, Robert Perlman, a former vice-president for tax at Intel, testified that "if Intel were to be founded today, I would strongly advise that the parent company be incorporate [sic] outside the United States."[71] Accenture and Seagate Technologies both avoided the barriers to corporate inversions by

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68. *See* Michael S. Kirsch, *The Congressional Response to Corporate Expatriations: The Tension Between Symbols and Substance in the Taxation of Multinational Corporations*, 24 VA. TAX REV. 475, 553–57 (2005); Orsolya Kun, *Corporate Inversions: The Interplay of Tax, Corporate, and Economic Implications*, 29 DEL. J. CORP. L. 313, 346–58 (2004); James Mann, Note, *Corporate Inversions: A Symptom of a Larger Problem, the Corporate Income Tax*, 78 S. CAL. L. REV. 521, 534–37 (2005).

69. *See supra* note 66 regarding the size of tax savings.

70. *See* Kirsch, *supra* note 68, at 495 & n.66.

71. *International Tax Issues Relating to Globalization: Hearing Before the S. Comm. on Finance*, 106th Cong. 11 (1999) (statement of Robert H. Perlman, Vice President, Tax, Licensing and Customs, Intel Corporation).

initially incorporating outside the United States.[72] This preference for incorporating outside the United States will be true even if the low-tax jurisdiction has inferior corporate law. In issuing its report on corporate inversions, the U.S. Treasury clearly recognized the possibility of tax avoidance skewing initial incorporation decisions, though likely failed to grasp the possible costs associated with driving companies to be governed by lower-quality corporate law:

> As we formulate a response, however, we must not lose sight of the fact that an inversion is not the only route to accomplishing this type of reduction in taxes. A U.S.-based start-up venture may incorporate overseas at the outset. An existing U.S. group may be the subject of a takeover bid, either friendly or hostile, from a foreign-based company. In either case, the structure that results provides tax-savings opportunities that are similar to those provided by an inversion transaction. Moreover, these transactions can have significant adverse effects on the U.S. economy in the long term, as decisions affecting the future location of new investment, operations and facilities, and employment opportunities are made by what is a foreign-based company rather than a U.S.-based company. Thus, the policy response to the recent corporate inversion activity should be broad enough to address the underlying differences in the U.S. tax treatment of U.S.-based companies and foreign-based companies, without regard to how foreign-based status is achieved. *Measures designed simply to halt inversion activity may address these transactions in the short run, but there is a serious risk that measures targeted too narrowly would have the unintended effect of encouraging a shift to other forms of transactions to the detriment of the U.S. economy in the long run.*[73]

With the added focus on initial incorporations, it becomes clear that the U.S. system could be improved, from the perspective of international charter competition, by moving towards the ideal we described above. Specifically, a shift to territorial taxation would dampen the incentives to relocate outside the United States; and a shift to a tax locational rule of RS might make such relocations, when they occur, irrelevant for corporate law purposes.

### B. *Canada*

Canada's federal system poses a puzzle for our analysis, and for any other analyses of charter competition. Canada follows the POI rule for corporate law, with an even broader domain of choices than the United States because there is a federal corporate statute in addition to provincial statutes. Migration within Canada is easy and can be direct: a business can change its jurisdiction of incorporation while preserving legal personality without having to use the indirect U.S. mechanism of merger with a subsidiary.

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72. Elizabeth Chorvat, *You Can't Take It With You: Behavioral Finance and Corporate Expatriations*, 37 U.C. DAVIS L. REV. 453, 456 n.6 (2003).

73. OFFICE OF TAX POLICY, U.S. DEP'T OF TREASURY, CORPORATE INVERSION TRANSACTIONS: TAX POLICY IMPLICATIONS 2 (2002) (emphasis added), *available at* http://www.treas.gov/press/releases/docs/inversion.pdf.

Corporate migration is tax free within Canada, while, as in the United States, offshore reincorporation triggers taxation at both the company and shareholder levels. Corporate taxes are source based (i.e., based on where firms do business rather than where they are either incorporated or where their real seat is). The Canadian structure is thus conducive to intra-Canadian choice of charter jurisdiction because, as with the United States, there are domestic choices and the tax influences have largely been removed. Why, despite these nearly perfect conditions, does there seem to be no evidence of charter competition? Several explanations have been offered. It could be that there are too few jurisdictions, that no jurisdiction has the kind of incentives Delaware has, or because of some "cultural" factor related to being Canadian.[74]

For the purposes of this Article, Canada provides a cautionary tale: charter competition seems to be quite fragile. Even a small counterforce, including perhaps a tax-induced counterforce, may well quash it.

### C. *The European Union*

The European Union is an example of the second type of federal structure we describe above because the bulk of substantive corporate law and substantive tax law is located at the subfederal level. Our analysis suggests that in this type of federal structure, a properly functioning charter market should possess three features: (1) a uniform corporate law locational rule of POI and a uniform corporate tax locational rule of RS; (2) tax-deferred POI migrations; and (3) uniform territorial taxation. Historically, there was no market for corporate charters in the European Union. We can understand this phenomenon in part as stemming from departures from certain of the above conditions. Some important jurisdictions applied a rule of RS to corporate location, and tax-deferred cross-border mergers were not generally available, although matters have decisively changed in recent years. Nonetheless, while the European Union is moving in the direction of enabling effective charter choice by separating the tax and corporate law location rules, it is not there yet.

In this Section, we first examine the details of how the legal landscape is evolving in a direction that should favor international charter competition. We distinguish here among three cases: initial incorporations, migrations to capture corporate surplus, and migrations to capture tax surplus. Initial incorporations primarily involve the question whether the combination of federal and subfederal law yields the desired mix of locational rules. Migrations are more complex. They implicate not only issues relating to coordination of locational rules but also issues of exit taxation and, in the case of corporate-surplus-motivated migrations, the rules regarding cross-

74. *See, e.g.*, ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 118–28 (1993); Cumming & MacIntosh, *supra* note 12, at 277; Ronald J. Daniels, *Should Provinces Compete? The Case for a Competitive Corporate Law Market*, 36 MCGILL L.J. 130 (1991).

border mergers.[75] Following the discussion of initial incorporations and migrations, we next describe a number of persisting distortions which pull against complete separation, which we argue is optimal. The complexities described here demonstrate the difficulties of implementing a complete separation of charter and tax in a federal system in which each is, in the first instance, a matter of subfederal law.

### 1. *The Evolution Toward International Charter Competition*

E.U. member states have traditionally been divided between POI jurisdictions and RS jurisdictions for corporate law purposes. Overall it is pretty clear which jurisdictions fall into which categories (e.g., the United Kingdom is a POI jurisdiction while Germany is the classic RS jurisdiction), yet there are some middle cases. For example, the Netherlands is officially a POI jurisdiction, but has in some cases adopted an RS rule.

With respect to corporate tax, on the whole, E.U. member states apply an RS location rule. Again, there is blurring around the edges as we discuss in more detail below. Thus member state domestic law instantiates the desired mix of locational rules in some circumstances but clearly falls short in others. The crucial question, then, is the extent to which the federal overlay pushes the law towards the ideal.

#### a. *E.U. Law on Initial Incorporation*

A number of member states adhere to an RS location rule for corporate law under their domestic law. This has resulted in denial of full recognition to corporations in two circumstances: (1) where the real seat is in the jurisdiction but the place of incorporation is elsewhere, and (2) where the real seat is outside the jurisdiction but the corporation incorporates or tries to incorporate within the jurisdiction. For example, traditionally Germany would refuse to recognize the corporate existence of either sort of entity, with the effect that such entities would not have legal capacity and moreover would not enjoy limited liability. Such attempts to apply an RS location rule for corporate law purposes have been successfully challenged, however, in a series of cases.

Under *Centros*[76] and subsequent cases such as *Überseering*[77] and *Inspire Art*,[78] the European Union has moved very far towards mandating, in the

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75. We do not further analyze the actual rules on double-tax relief, which is the last aspect of our proposed ideal arrangement for this type of federal structure. This is for two reasons. First, many E.U. jurisdictions already apply territorial taxation. Second, as discussed above, the method of double-tax relief takes on relatively less importance where, as in the European Union, there is some tax competition within the federal system.

76. Case C-212/97, Centros Ltd. v. Erhvervs-og Selskabsstyrelsen, 1999 E.C.R. I-1459.

77. Case C-208/00, Überseering BV v. Nordic Constr. Co. Baumanagement GmbH (NCC), 2002 E.C.R. I-9919.

78. Case C-167/01, Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd., 2003 E.C.R. I-10155.

cross-border E.U. context, the functional equivalent of a "place of incorporation" regime for corporate law purposes, at least with respect to initial incorporations. Consider these three key cases. In *Centros*, the European Court of Justice ("ECJ") precluded a member state (Denmark) from refusing to register a branch of a company formed in accordance with the law of another member state (the United Kingdom) even when it did not conduct any business in that member state. Indeed, the ECJ made clear that it would reach the same result even if the whole purpose of incorporating in another member state was to enable the company to carry on its business in the member state while avoiding the more burdensome rules such as minimum capital requirements that govern corporate formation. In the *Überseering* case, the ECJ barred a member state (Germany) from applying its local "real seat" doctrine to determine legal capacity to sue, at least so long as the change in the actual center of administration did not impair the corporate existence in the member state in which the firm was incorporated (the Netherlands). In *Inspire Art*, the ECJ held that a member state (the Netherlands) could not impose additional requirements such as minimum capital on pseudo-foreign corporations incorporated in another member state (the United Kingdom) to bring the requirements to the same level as domestic corporations. In other words, the Netherlands sought to apply certain corporate law provisions based on a Dutch real seat test but was precluded from doing so.

As has been widely noted, the combined effect of these rulings is to establish, through the doctrinal rubric of freedom of establishment, what amounts functionally to a POI rule for company law purposes with respect to initial incorporations *inside* the European Union.[79] At the start-up stage, the *Centros* line of cases removes any cost to firms of incorporating in the country with the most suitable corporate law, placing the real seat in the country with the most suitable corporate tax regime, and operating wherever it likes within the European Union. This means that a firm can incorporate in the United Kingdom to take advantage of the company law, while putting the real seat of a subsidiary that holds its intellectual property in Ireland to take advantage of the lower Irish corporate tax rates, and still conduct business throughout the European Union. Indeed, there is evidence of an increasing use of the United Kingdom as the place of initial incorporation for German private companies.[80]

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79. The qualification "inside the European Union" is essential. Contrary to the sloppy formulation of some, the *Centros* line of cases has *not* established the POI doctrine as the company law choice of law rule in the European Union. Thus, for example, there is no basis for thinking that a company formed in a non-E.U. POI state without a bilateral recognition treaty with Germany, but with its real seat in Germany, will be recognized as a properly constituted corporation with legal capacity to sue in Germany. This is the sense in which Professor Wymeersch is correct to insist that *Centros*, *Inspire Art*, and *Überseering* are freedom of establishment cases, not company law cases. Eddy Wymeersch, Centros*: A Landmark Decision in European Company Law*, *in* CORPORATIONS, CAPITAL MARKETS AND BUSINESS IN THE LAW 629, 631 (Theodor Baums et al. eds., 2000).

80. *See* John Armour, *Who Should Make Corporate Law? EC Legislation Versus Regulatory Competition*, 58 CURRENT LEGAL PROBS. 369, 386 (2005) (providing data on so-called "GmbH limited" companies—German businesses incorporated as English private-limited companies); Luca

b. *E.U. Treatment of Migrations to Capture Corporate Surplus*

While *Centros* and its progeny go a significant way towards implementing a POI locational rule for new incorporations, they do not address the question of already existing corporations and their ability to migrate. We consider first migrations motivated by corporate surplus and examine tax-surplus-motivated migrations thereafter.

A company seeking to migrate within the European Union for corporate law reasons faces two hurdles. First, the relevant corporate law must allow for migration. Second, the migrating company must navigate the issue of exit taxation.

We begin our analysis with the options for cross-border mergers from a company law perspective. There are two alternate routes, with importantly different consequences. The first route relies upon use of the Societas Europaea ("SE").[81] Suppose that a corporation desires to migrate from member state X to member state Y. Under the European Company Statute, it can pursue the following steps: transform the domestic X company into an SE of X, merge the SE of X with an SE of Y, then transform the SE of Y to a domestic Y company.[82] Under the statute, however, for an SE of X to become an SE of Y it must move *both* its real seat *and* its registered office.

Consider the case of a company that wishes to remain a U.K. company for tax purposes but to be governed by Dutch corporate law. Under the SE merger structure, it must move its real seat to the Netherlands in order to be governed by Dutch corporate law once it becomes a regular Dutch company; but in doing so it will lose U.K. tax treatment. The prospect of this loss will lead some companies to accept suboptimal corporate law in order to continue to enjoy optimal tax treatment or to accept suboptimal tax treatment of future profits in order to enjoy optimal corporate law. This is a distortion to

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Enriques & Martin Gelter, *How the Old World Encountered the New One: Regulatory Competition and Cooperation in European Corporate and Bankruptcy Law*, 81 TUL. L. REV. 577, 600–06 (2007); Alexander Schall, *The UK Limited Company Abroad—How Foreign Creditors are Protected after* Inspire Art *(Including a Comparison of UK and German Creditor Protection Rules)*, 2005 EUR. BUS. L. REV. 1534, 1535 (reporting estimates that there are more than 20,000 United Kingdom limited companies (Ltds.) with their real seats in Germany); Marco Becht et al., *Where Do Firms Incorporate?* 3 (European Corporate Governance Inst., Law Working Paper No. 70/2006, 2006), *available at* http://ssrn.com/abstract=906066 (providing evidence on other Member States' businesses' incorporations in the United Kingdom).

81. The SE is a relatively new entity established by the European Company Statute in 2001. It can be created by merger, creation of a holding company, creation of a joint subsidiary, or conversion of an existing company set up under the laws of a Member State. It cannot be created from scratch, and it has a minimum capitalization requirement of 120,000 euros. While it must have its real seat in its place of registration, it allows an SE from an RS jurisdiction to migrate without dissolution and reincorporation. Council Regulation 2157/2001, On the Statute for a European Company (SE), tit. 1, art. 8, 2001 O.J. (L 294) 1; Eric Engle, *The EU Means Business: A Survey of Legal Challenges and Opportunities in the New Europe*, 4 DEPAUL BUS. & COM. L.J. 351, 398 (2006). For further description of the SE, see Europa—Glossary: European Company, http://europa.eu/scadplus/glossary/eu_company_en.htm (last visited Jan. 26, 2008).

82. Luca Enriques, *Silence is Golden: The European Company Statute as a Catalyst for Company Law Arbitrage* 5 (European Corporate Governance Inst., Law Working Paper No. 07/2003, 2003), *available at* http://ssrn.com/abstract=384801.

charter competition driven by the political compromise that led to the European Company Statute, a compromise that was criticized at the time.[83]

The second route for cross-border mergers involves the merger of entities formed under member state domestic law. In this connection, the relevant materials are the Cross-Border Merger Directive,[84] the Merger Tax Directive,[85] and two important post-*Centros* cases: *Huges de Lasteyrie du Saillant v. Ministère de L'Économie des Finances et de l'Industrie*[86] and *SEVIC Systems AG*.[87]

The goal of the Cross-Border Merger Directive is to equalize treatment of cross-border and domestic mergers: "The laws of the Member States are to allow the cross-border merger of a national limited liability company with a limited liability company from another Member State if the national law of the relevant Member States permits mergers between such types of company."[88]

In implementing this goal, the directive limits its application to companies that can merge under domestic law[89] and provides a basic structure governing the effectuation of the merger, including terms of the merger agreement,[90] publication,[91] a board report,[92] an independent expert's report,[93] approval by the shareholders,[94] and preservation of employee participation rights.[95] Importantly, unlike the SE-based merger structure described above, the migrating company need not change its real seat. Because the real seat would not have to shift, this should permit a company to move its corporate law location without moving its corporate tax location, at least so long as member states adhere to an RS location rule for corporate tax.

The catch here is that the Cross-Border Merger Directive has not yet gone into effect. The ECJ, however, has jumped the gun in implementing the

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83. The defect, in terms of our recommendations in Section III.B., *supra*, is a failure to separate the corporate law and corporate tax markets through the locational rule. In effect, the European Company Statute layers an RS rule back into the corporate law.

84. Council Directive 2005/56/EC, On Cross-Border Mergers of Limited Liability Companies, 2005 O.J. (L 310) 1 [hereinafter Cross-Border Merger Directive].

85. Council Directive 90/434/EEC, On the Common System of Taxation Applicable to Mergers, Divisions, Transfers of Assets and Exchanges of Shares Concerning Companies of Different Member States, 1990 O.J. (L 225) 1 [hereinafter Merger Tax Directive], *amended by* Council Directive 2005/19/EC, 2005 O.J. (L 58) 19 [hereinafter Merger Tax Directive Amendment].

86. Case C-9/02, Hughes de Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie, 2004 E.C.R. I-2409.

87. Case C-411/03, SEVIC Sys. AG, 2005 E.C.R. I-10805.

88. Cross-Border Merger Directive, *supra* note 84, at 1.

89. *Id.* art. 4(1).

90. *Id.* art. 5.

91. *Id.* art. 6.

92. *Id.* art. 7.

93. *Id.* art. 8

94. *Id.* art. 9.

95. *Id.* art. 16.

directive's goal of facilitating cross-border mergers by holding in the *SEVIC* case that Germany violated Articles 43 (Freedom of Establishment) and 48 of the EC Treaty by permitting the registration of domestic mergers without also permitting equivalent registration of cross-border mergers.[96] The effect of this holding is to implement and accelerate the mandates of the directive. This holding is important as a practical matter because the only member states which currently permit cross-border mergers as a matter of domestic law are Greece, Italy, Portugal, and Luxembourg.[97]

As far as company law is concerned, then, once the Cross-Border Merger Directive and the *SEVIC* doctrine are fully implemented, it will be possible to change corporate location without changing the real seat. This still leaves the question, though, whether the cross-border mergers are themselves taxable events.

Under the Merger Tax Directive, when cross-border mergers are allowed by member-state law, taxes on such mergers must be deferred (at both the company[98] and shareholder[99] levels).[100] The Merger Tax Directive, however, does not necessarily cover every possible instance in which a corporation might migrate to another state by merger.[101] The limited scope of the Merger Tax Directive presents the questions whether member states can, going forward, impose any exit tax on emigrating corporations, and whether exit taxation that might be permissible within the terms of the Merger Tax Directive might nonetheless violate the freedom of establishment.[102] Although the ECJ has yet to decide these issues, it seems to be heading in precisely the direction of barring exit taxation generally. Specifically, in the *de Lasteyrie* case, the ECJ held that an exit tax imposed on a natural person violated Article 43 (freedom of establishment) of the treaty. Moreover, the mandate in the first paragraph of Article 48 provides an argument for applying that holding to corporate migration:

> Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States.

To summarize, there are still some potential tax-related distortions to corporate-surplus-motivated migrations in the European Union. This can

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96. Case C-411/03, SEVIC Sys. AG, 2005 E.C.R. I-10805, paras. 16–19.

97. McCahery & Vermeulen, *supra* note 13, at 9.

98. Merger Tax Directive, *supra* note 85, art. 4.

99. *Id.* art. 8.

100. The principal restriction of the deferral of tax, at least with regard to SEs and possibly more broadly, is when the registered office is transferred. So long as productive assets remain in place, however, a change of place of incorporation will not trigger any tax on those assets. *Id.* art. 10.

101. For a discussion of the scope of the Merger Tax Directive, see RUTH MASON, PRIMER ON DIRECT TAXATION IN THE EUROPEAN UNION 25–28 (2005).

102. Armour, *supra* note 80, at 382.

happen where a company is forced to shift real seat under an SE-based migration, or where a member state is able to apply an exit tax without running afoul of either the Merger Tax Directive or the Article 43 guaranty of freedom of establishment. These distortions, however, may well be short lived.

#### c. *E.U. Treatment of Migrations to Capture Tax Surplus*

At first blush one might guess that it should be easier to clear the way for migrations aimed at capturing tax surplus rather than corporate surplus. After all, migrations strictly for tax purposes need not navigate the minefield of cross-border mergers. So long as all jurisdictions adopt an RS rule for corporate tax, the migration should be achievable by shifting the RS. No cross-border merger is necessary. Oddly, however, this feature of the transactions conspires to make the problem worse, not better. In particular, absent the presence of a cross-border merger, it becomes much more difficult to ride the coattails of the ECJ's freedom of establishment jurisprudence discussed above. We confront here the problem of the continuing vitality of *Daily Mail*.[103]

In *Daily Mail*, an investment company incorporated in the United Kingdom sought to escape U.K. tax by moving its situs of management and control to the Netherlands, while maintaining its legal identity in the United Kingdom so as to avoid tax on gains on winding up. At the relevant time, U.K. corporate tax used a version of the real seat rule ("situs of management and control"). Under the U.K. Income and Corporation Taxes Act, a company resident for tax purposes in the United Kingdom was prohibited from ceasing to be so resident without the consent of the Treasury.[104] The Treasury refused permission unless the Daily Mail sold a significant portion of appreciated assets (and paid capital gains tax) before it moved.

The ECJ upheld the U.K. rule, noting that "companies are creatures of the law and, in the present state of Community law, creatures of national law. They exist only by virtue of the varying national legislation which determines their incorporation and functioning."[105] In other words, the restriction on moving the "central management and control" without consent of the Treasury is part of the nature of the legal beast created by incorporating under U.K. law. Tax considerations were clearly central to the analysis.

While the ECJ did not discuss *Daily Mail* in *Centros*, it did arise in both *Inspire Art* and *Überseering*, where it was reaffirmed and distinguished. In *Überseering*, the ECJ stated:

> It must be stressed that, unlike *Daily Mail and General Trust*, which concerned relations between a company and the Member State under whose laws it had been incorporated in a situation where the company wished to transfer its actual centre of administration to another Member State whilst

103. Case 81/87, The Queen v. H.M. Treasury & Comm'rs of Inland Revenue, *ex parte* Daily Mail & Gen. Trust plc, 1988 E.C.R. 5483.

104. Income and Corporations Taxes Act, 1970, c. 10, § 482(1)(a) (U.K.).

105. *Daily Mail*, 1988 E.C.R. 5483, para. 19.

> retaining its legal personality in the State of incorporation, the present case concerns the recognition by one Member State of a company incorporated under the law of another Member State, such a company being denied all legal capacity in the host Member State where it takes the view that the company has moved its actual centre of administration to its territory, irrespective of whether in that regard the company actually intended to transfer its seat.[106]

The court in *Inspire Art* distinguished *Daily Mail* along the same lines.[107]

This is not to say that a modern-day Daily Mail would be powerless to plan around the imposition of tax. Taking a page from the playbook described above in the discussion of corporate surplus motivated migrations, one could attempt to use a merger of either SEs or domestic law entities in conjunction with the Merger Tax Directive to defeat exit taxation. But the cost of such structures is that they would require the company to move both its corporate location and its corporate tax location from the United Kingdom to the Netherlands. This, of course, would result in the company being governed by Dutch corporate law when it might well prefer U.K. corporate law.[108]

We are now in a position to specify precisely the distortionary aspect of the holding in *Daily Mail*. Recall that, in our discussion of ideal forms of federal structures above, we posited that exit taxation with respect to RS migrations should not be relevant to the charter market. We suggested this is really an issue of tax policy alone. But we also noted that this holds only so far as one achieves total separation of the corporate law and corporate tax law markets through distinct locational rules. The E.U. law, however, falls short of total separation here. Specifically, what we observe is that a company can still be charged an exit tax on an RS migration (*Daily Mail*) but can escape this exit tax if it combines the RS migration with a POI migration. Recasting this within the terms of our framework, the indirect effect of the freedom of establishment cases is to bring a POI rule back into the tax analysis. That is, a corporation can escape the exit tax if it undertakes a POI migration, but not otherwise. This is potentially distortionary in the fashion described above.

The solution is not difficult to state. To get rid of the distortion, one should remove the possibility of exit taxation for the RS migration.[109] Then

106. Case C-208/00, Überseering BV v. Nordic Constr. Co. Baumanagement GmbH (NCC), 2002 E.C.R. I-9919, para. 62.

107. Case C-167/01, Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd., 2003 E.C.R. I-10155, para. 103.

108. Under the SE structure it could also trigger a tax because the appreciated shares may no longer be "effectively connected with a permanent establishment" of the SE in the United Kingdom. Merger Tax Directive Amendment, *supra* note 85, at 19.

109. This call for blanket rejection of exit taxes is consistent with our claim that exit taxes are sometimes beneficial. The benefit arises where one has failed to achieve complete separation of the markets through distinct locational rules. Our suggestion is that the European Union should strive to achieve that complete separation (and remove exit taxation on migrations within the European Union). Exit taxes on migrations outside of the European Union could, however, still be beneficial from the perspective of maximizing corporate surplus.

companies would not be driven to change their place of incorporation (possibly sacrificing corporate surplus) to get a tax benefit. Alternatively, one could remove the favorable tax treatment afforded the POI migration so that POI migrations and RS migrations would be subject to the same exit tax. But we reject that approach because it runs exactly counter to the desired result analyzed above with respect to corporate-surplus-motivated migrations. Thus, removing exit taxation on RS migrations seems the only available route. The question is whether one can get to this result doctrinally.

Obviously, *Daily Mail* stands as the biggest hurdle. As noted, the ECJ has specifically distinguished *Daily Mail* in a number of its freedom of establishment cases. On the other hand, it is not clear that the ECJ has yet appreciated the way in which the freedom of establishment cases themselves necessarily change the meaning of *Daily Mail*, even if they do not operate to invalidate exit taxes on shifts of the real seat. In other words, at the time of *Daily Mail*, the options available to the corporation were either to shift the real seat and pay the exit tax or to not shift the real seat. As we have seen, the import of the freedom of establishment cases is to provide a third option: shift the real seat, shift the place of incorporation, and avoid the exit tax. Thus permitting the exit taxes on RS migrations would seem to channel corporations towards changing their place of incorporation. This may ultimately call into question whether or not the exit tax on RS migrations itself violates the freedom of establishment.

#### 2. *Continuing Distortionary Threats*

We have just seen how the European Union is, in many respects, moving toward a legal landscape that can be expected to remove or diminish tax-induced distortions to charter competition, both with respect to migrations and initial incorporations. Below we discuss two ways in which that general trend may be threatened. As we have stressed repeatedly, the way to preserve the charter market in the context of E.U.-style federalism is to drive a wedge between the corporate law and corporate tax law locational rules. To do so, POI must not create tax consequences. Unfortunately, governments sometimes depart from this precept, likely entirely unaware of the adverse effects on the charter market. We take up here two such cases: (1) the adoption of a conjunctive "POI + RS" rule for corporate tax purposes, and (2) the adoption of a disjunctive "POI or RS" rule for corporate tax purposes.

##### a. *The Conjunctive Locational Rule (POI + RS)*

Under the ideal arrangement, the tax location rule should be RS—as is generally the case in the European Union—but there are a variety of aberrations. The United Kingdom is a key example. For corporate law, the United Kingdom is a POI jurisdiction. Until 1988, corporate tax location was determined, according to case law, by the situs of central management and control—a version of the RS rule.[110] According to our discussion above, this conjunction of rules should have been ideal, but for the fact that not all jurisdictions applied an RS rule for corporate tax purposes. This opened up the possibility of so-called "tax arbitrage." In this particular instantiation of that phenomenon, the taxpayer seized upon the fact that while the United Kingdom applied an RS rule for corporate tax purposes, the United States applied a POI rule. Specifically, a corporation with losses would incorporate in the United States while maintaining its situs of central management and control in the United Kingdom. Such a corporation was considered a "resident" of both the United States and the United Kingdom for corporate tax purposes. As a result, losses could be deducted in each jurisdiction.

In one sense, this is no different from the tax-induced distortions to corporate location that we have canvassed above. It was beneficial for tax reasons to move the place of incorporation to the United States. An affiliate with losses was established and incorporated in the United States, but its real seat was in the United Kingdom. This permitted "double dipping": the same losses could be deducted in both the United States and the United Kingdom. A secondary consequence would have been that U.S. corporate law became applicable to the U.S.-incorporated entity. A tax-motivated decision thereby opened the possibility for the sacrifice of corporate surplus.

That possibility arose, notwithstanding the fact that the United Kingdom had implemented our ideal combination of locational rules, because there was a lack of uniformity of locational rules across jurisdictions. Obviously, had the United States followed the same set of rules, there would be no possibility of distortion. What is interesting about the tax arbitrage case from our perspective, though, is that the U.K. response ultimately led to a set of rules that is suboptimal from the standpoint of the market for corporate charters. Though nobody has successfully articulated exactly why tax arbitrage is offensive and should be shut down, governments have taken just that approach. The United Kingdom is a case in point with respect to this version of arbitrage based on corporate location. To combat this form of arbitrage,[111] the United Kingdom changed its rules to provide as follows:

> (1) A company which—
>
> (a) would (apart from this section) be regarded as resident in the United Kingdom for the purposes of the Taxes Acts, and
>
> (b) is regarded for the purposes of any double taxation relief arrangements as resident in a territory outside the United Kingdom and not resident in the United Kingdom,
>
> shall be treated for the purposes of the Taxes Acts as resident outside the United Kingdom and not resident in the United Kingdom.

110. Egyptian Delta Land & Inv. Co. v. Todd, [1929] A.C. 1, 1 (H.L.) (appeal taken from Eng.) (U.K.) ("It is settled by authority that the residence of a company, whether British or foreign, for income tax purposes is preponderantly if not exclusively determined by the place where its real business is carried on.").

111. For a discussion of why either country would care to combat it, see Kane, *supra* note 10.

> (2) For the purpose of deciding whether the company is regarded as mentioned in subsection (1)(b) above it shall be assumed that—
>
> (a) the company has made a claim for relief under the arrangements, and
>
> (b) in consequence of the claim it falls to be decided whether the company is to be regarded as mentioned in subsection (1)(b) above.
>
> (3) This section shall apply whether the company would otherwise be regarded as resident in the United Kingdom for the purposes of the Taxes Acts by virtue of section 66(1) of the Finance Act 1988 (company incorporated in UK to be regarded as resident there) or by virtue of some other rule of law.[112]

The effect of this rule was that to take advantage of U.K. tax residency, a company must both be incorporated in *and* have its real seat in the United Kingdom—i.e., POI + RS. This change in the rules closed the arbitrage possibility. But note that there is a corresponding detriment from the standpoint of the charter market within the federal system. The general structural goal should be to allow tax-motivated moves within the federal system without affecting corporate law. But as the U.K. system currently stands, its conjunctive locational rule thwarts this possibility. A corporation that wishes to enter the U.K. tax system must change both its real seat *and* its place of incorporation. There is no simple answer here, though we have a preference for sticking with a tax locational rule of RS, in part because we believe the tax arbitrage case is anomalous as compared to the much more pervasive possibility of tax-motivated locational decisions within the federal system.[113]

#### b. *The Disjunctive Locational Rule (POI or RS)*

The political and administrative appeal of a "POI or RS" disjunctive rule can be seen in several recent contexts. For example, in erroneous anticipation of a loss in *Daily Mail*, the United Kingdom changed its corporate tax rule from RS to "POI or RS" in order to prevent tax-motivated changes of the real seat.[114] In the U.S. context, one sees a similar reaction in a recent Joint Committee on Taxation report.[115] In response to corporate inversions, Congress enacted section 7874 of the Internal Revenue Code. Broadly, this provision deems a foreign parent corporation to be a U.S. parent corporation when certain conditions are met. Section 7874, however, does not apply to

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112. Finance Act, 1994, c. 9, § 249 (U.K.).

113. Although many types of transactions have been grouped under the rubric of "international tax arbitrage," it is only the single case of that phenomenon related to dual resident companies that is of interest to us. It is of doubtful continuing relevance given that the United States was the chief counterparty—given the size of the U.S. economy and the fact that the United States had a tax POI rule—and the United States has taken its own steps to eliminate the benefits from the tax arbitrage.

114. Finance Act, c. 39, § 66, sched. 7; John Dewhurst, *General Consents*, 6 BRIT. TAX REV. 215 (1988). This was prior to the change to the "POI + RS" rule discussed above.

115. STAFF OF J. COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 178–81 (Comm. Print 2005).

firms that initially incorporate outside of the United States, or to firms that have completed inversion at the time of the legislation. To pull such corporations back into U.S. residency, the Joint Committee has suggested the possibility that the United States adopt a disjunctive POI or RS rule for tax.[116] This would, for example, mean that a new foreign-incorporated company would be treated as a U.S. resident corporation for tax purposes so long as it had a real seat in the United States. The reason to adopt such a disjunctive rule rather than a straight rule of RS for tax is that in cases where a company *is* incorporated in the United States, one realizes the administrative gains from not having to examine the substantive factors that underlie the RS test.[117]

There are similar pressures towards a "POI or RS" rule on the corporate law side with regard to "pseudo-foreign" corporations—corporations organized in one jurisdiction but with all of the operation in a second jurisdiction. *Inspire Art* arose because the Netherlands, generally speaking a POI jurisdiction, sought to level the playing field between domestic businesses that incorporated in the Netherlands and had to comply with Dutch minimum capital requirements and domestic businesses that incorporated in the United Kingdom to avoid those requirements.

In each case, the "POI or RS" rule blurs the separation of corporate tax and corporate charter choice. A firm wishing to move from the United Kingdom to the Netherlands for tax reasons but to retain its U.K. corporate law will be unable to do so if the U.K. or Dutch corporate law or corporate tax locational rule is disjunctive. It will either have to move both or neither. Thus, in an E.U.-style federal system, the federal body will be called upon to guarantee both the possibility of relocation as well as the separation of the two spheres of competition. The European Union and the ECJ have worked hard to establish the POI as the principle for corporate location. But it has not focused equal attention on the maintenance of an RS rule for corporate tax location. Doing so requires both an agreement among member states to apply the RS rule for corporate tax location as well as resistance to the predictable initiatives to modify the rule to block tax motivated moves.

### D. *Israel*

Israel is a unitary jurisdiction with an export-oriented economy and a successful venture capital sector that looks to foreign capital markets for investment and for IPO exits. These unique features of the Israeli economy pose particular challenges to our analysis.[118] For corporate law, Israel is a

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116. *Id.* at 179–80.

117. A shift towards a disjunctive rule in this context would be somewhat different than the type of shift we describe in the text because the baseline nondisjunctive rule is different—that is, POI rather than RS for tax. Still, the example serves to highlight how political forces may drive the legislature to contemplate tweaking the tax locational rule to forward substantive tax-policy goals without much, or any, awareness of the possible ramifications under corporate law.

118. For a fuller discussion of the Israeli case, see Edward B. Rock, *Corporate Flight*, 36 MISHPATIM 161 (2006) (in Hebrew).

POI jurisdiction. For tax, it largely follows an RS approach.[119] Cross-border mergers are restricted: the company law does not contain any provision permitting such mergers; alternative structures for accomplishing the same thing are limited and may require approval of a regulator. Moreover, while such mergers are, at present, nearly tax free at the corporate level, there was a significant period of time during which it was not as favorable at the shareholder level. Finally, the requirement of regulatory approval and the possibility that the tax treatment could change at any time cause planners to worry about the future availability of tax-free emigration.

As noted earlier, barriers to midstream exit—tax or corporate—can reduce the number of firms that initially incorporate in a jurisdiction and impose a cost on both the jurisdiction as well as the corporations who end up with ill-fitting corporate law. This is precisely what seems to happen in Israel. Venture capital-funded startups almost invariably incorporate outside of Israel, usually in Delaware. This strategy preserves the option of going public as a Delaware corporation, but comes at the price of saddling the firm with suboptimal corporate law for the period that it is a private firm. By contrast, Silicon Valley-based startups typically incorporate initially as California firms, with only those that ultimately go public moving to Delaware—a move which, as noted above, is tax free as of right and not dependent on administrative discretion. On the other hand, such barriers to midstream exit may be necessary to keep successful Israeli-incorporated firms from engaging in a "corporate inversion" transaction to move to a low-tax jurisdiction.

Here we see the limitations that a unitary system faces compared to a federal system. Like the United States, Israel is a POI jurisdiction for corporate law and taxes companies on a worldwide basis. Unlike the United States, Israel follows an RS rule for corporate tax. Without the United States's federal structure, and without being a member of the European Union or a similarly structured federal system, Israel cannot take full advantage of charter competition. External competition is likely, but it runs directly up against efforts to protect the corporate tax base, considerations which undermine complete separation and distort both tax and charter competition.

For a unitary system like Israel, it seems, the only way to preserve the separation between corporate charter and corporate tax competition would be an international treaty that adopts RS for corporate tax and POI for corporate law, provides for cross-border migration, and restricts exit taxes. No such treaty is in the offing.

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119. A corporation is considered resident in Israel if it is: "(1) A corporate body registered in Israel whose main activity takes place in Israel; . . . (2) A corporate body the control of whose dealings and their management are performed in Israel." Income Tax Ordinance § 1, *reprinted in* David Gliksberg, *The Effect of the Statist-Political Approach to International Jurisdiction of the Income Tax Regime—The Israeli Case*, 15 MICH. J. INT'L L. 460, 478 (1994). *See generally* Gliksberg, *supra*, at 476–81.

## Conclusion

Legal scholars are well familiar with the various issues that arise from interjurisdictional competition with respect to a particular domain of law. In this Article we have attempted to confront the many complications that arise when the markets for two domains of law—corporate law and corporate tax law—overlap in a global setting. The complications multiply once one takes account of the fact that competition occurs not only across two overlapping domains of law but also as between many different types of jurisdictions. Despite this complexity, our basic conclusions are fairly simple. It should be possible to preserve an international market for corporate charters by severing the market for corporate law from the market for corporate tax law. In the first-best solution, this would be accomplished through global coordination of the locational rules for corporate law and corporate tax law. A second-best, more plausible solution is to rely on a properly designed federal structure to sever the two markets. The historical experience in the United States and the emerging state of affairs in the European Union suggest that this is in fact possible. Corporate taxation can but need not destroy an international charter market.