Why incorporate in Delaware: race to the top, race to the bottom or race to the tax haven?

Why do so many U.S. corporations incorporate in Delaware? This paper will provide a short review of the literature concerning both the tax and non-tax considerations that play a role in corporations’ choice of place of incorporation. Hopefully, this review will contribute to the current policy debate in Europe concerning both corporate competition and tax competition among European Union Member States.

Delaware is the unchallenged corporate law capital of America[1]. This small State – which has a population of less than one-third of one percent of the nation – is the State of incorporation for more than fifty percent of U.S. public companies and more than sixty percent of the Fortune 500[2]. Moreover, on an ongoing basis seventy five percent of all initial public offerings in the United States are incorporated in Delaware[3]. Why do so many U.S. corporations incorporate in Delaware? There is not one answer to this question, but many. This question has been for a long time the topic of a substantial body of research in the legal finance literature and recently begun attracting the attention of tax scholars[4]. This paper will provide a short review of the literature concerning both the tax and non-tax considerations that play a role in corporations’ choice of place of incorporation. Hopefully, this review will contribute to the current policy debate in Europe concerning both corporate competition (since European corporations have become free to choose their country of incorporation among the European Union[5]) and tax competition (since tax competition among European countries has increased following the gradual removal of barriers to the mobility of capital in the European community)[6].

1. Non-tax considerations in incorporating

A central feature of the US corporate environment is the presence of regulatory competition in corporate law. This competition is the result of the internal affairs doctrine, under which the “internal affairs” of corporations are governed by and are subject to the corporate law of the State in which they have chosen to incorporate[7]. Whether this competition works well has been one of the most hotly debated questions among corporate law scholars in the last quarter of a century[8]. While there is no doubt that Delaware is the winner of this “race”, the question is still whether Delaware’s dominance has been the result of a “race to the bottom” or a “race to the top” competition.

1.1. The “race to the top” approach

The “race to the top” approach suggests that States compete to offer corporate law rules that maximize shareholder value. On this view, “States will compete by seeking to make their corporate law attractive to shareholders. States successful in attracting incorporations would be those that offer rules that maximize shareholder wealth”[9]. According to this view, Delaware’s dominance flows from its success in providing the best, most efficient set of governance laws available. More specifically, the claim is that there is a mix of tangible and non-tangible factors that make Delaware so appealing to shareholders (and other stakeholders) of corporations (and other business forms).

The Delaware General Corporation Law is claimed to constitute a significant strength that attracts corporations to incorporate in Delaware. The law is allegedly “the most advanced and flexible business formation statute in the nation”[10]. For example, the law allows limiting the liability of directors in the corporate charter and by that helps mitigating the problems related to the high cost of liability insurance for directors and officers that threatened to deprive businesses of able leader[11]. In addition, it is claimed that Delaware’s law is more agile and adaptable than the laws of sister States or of the federal government, since it enjoys comparative political ease in which its corporate law can be modified to meet developments in business[12]. Delaware’s stable court system is claimed to be another significant strength that attracts corporations to incorporate in the State. The claim is that the Delaware court system provides for efficient results by requiring all corporate law issues to be brought before a specialized non-partisan Court of Chancery, where there are no juries[13]. Over time, the Court of Chancery developed expertise in corporation law matters. Its reputation for expertise led to more cases being brought to the Court and, over time, more expertise. Its reputation and importance have also permitted the Court to attract even better lawyers (or even the best in the nation) to serve in the
court[14]. The absent of juries (and punitive damages) also minimizes emotional and uncertain outcomes[15]. It is also claimed that further efficiency is obtained by Delaware’s appeal process. Appeals of corporate law issues are heard directly by the Delaware Supreme Court and this structure provides certainty by enabling rapid resolution of corporate law issues[16]. Moreover, Delaware’s stable court system enables the legislator to state the statutory standards in general terms, leaving courts to fill in the interstices and by that avoiding odd and unintended result which are created by “bright line rules”, which are more common in other jurisdictions[17].

Other strengths of the Delaware system include the “business-friendly” Delaware’s State Government that puts a high priority on corporation law matters; Delaware’s Division of Corporation, which is “a model state-of-the-art efficiency”[18] and a staff that “provides prompt, friendly and professional service to clients, attorneys, registered agents and others”[19].

In sum, under the “race to the top” approach, due to a mix of strengths (and the synergies between them) Delaware has the best and most efficient set of corporate governance laws, resulting in a corporate law framework that efficiently serves the interests of the shareholder[20].

1.2. The “race to the bottom” approach
The “race to the bottom” approach is more skeptical with respect to whether and to what extent the regulatory competition works well. Under this approach, competition encourages States to provide rules that are too favorable to corporate managers and controllers with respect to issues that have an effect on the private benefits of managers and controllers. The claim is that States have an interest in maximizing the number of companies that are incorporated within their jurisdiction and that managers (more than shareholders) have significant control over reincorporation decisions. Hence, so goes the argument, States desire to satisfy managerial interests. Where there is a divergence of interest between managers and shareholders, this desire to satisfy managerial interests is of great concern. The concern is that the regulatory competition process allows managers to benefit at the expense of the shareholders, at least in areas that have an effect on the private benefits of managers and controllers are “hostile takeovers”. The notion is that management of a corporation that is the target of a hostile takeover has an interest in having a legal regime that allows it to use defensive tactics to defeat tender offers (e.g., if the hostile takeover takes place, the managers will probably not retain their jobs). Indeed, the supporters of the “race to the bottom” approach claim that the competition process caused (all) States to allow many forms of defensive tactics to defeat tender offers, including poison pills[22]. This view of State competition in takeover law suggests that State competition provides strong incentives for States – including Delaware – to restrict takeovers excessively. It is important to note that this approach does not necessarily claim that Delaware has the worst set of governance laws – from the shareholder perspective – but rather that the competitive pressures have moved the States as a whole, including Delaware, in a negative direction in some areas of the law where there is a divergence of interest between managers and shareholders. In sum, the “race to the bottom” approach provides the presence of regulatory competition in corporate law creates an incentive for States to provide rules that are too favorable to corporate managers and controllers with respect to areas of the law where there is a divergence of interest between managers and shareholders (e.g., issues that have an effect on the private benefits of managers and controllers).

2. Tax considerations in incorporating: “Domestic Tax Haven” approach
The tax considerations that play a role in a United States (hereafter U.S.) corporation’s choice of place of incorporation attract the attention of tax scholars in the last few years[23]. Several articles in the popular press and some tax scholars even named Delaware as a “Domestic Tax Haven”[24]. Why Delaware is so attractive to U.S. corporations from the tax perspective? One main reason is a special income tax exemption that Delaware grants for corporations whose activities are limited to owning and collecting income from intangible assets (Delaware Holding Companies)[25]. This exemption was repeatedly exploited in many tax avoidance schemes. In the most common scenario, a corporation which has subsidiaries in high tax jurisdictions transfers its intangible assets to a subsidiary corporation it has created in Delaware[26], which is often referred to a “passive investment company” (hereafter PIC). The subsidiaries located in a high-tax State then pays royalties to the PIC for the right to use the intangibles (e.g., to display the PIC’s logo and trademarks). These royalties are tax-deductible for the subsidiaries located in the high-tax jurisdictions[27] and hence can be used to mitigate the corporate income tax liability in the States in which the corporation is actually operating and earning its profits. On the same time, the royalty payments are exempted by Delaware[28]. This notorious tax shelter was used most famously by Toy’s “R” Us, where a Delaware PIC generated $55 million of royalty income in 1990 with corresponding royalty deductions taken by Toy’s “R” Us in other high-tax jurisdictions[29]. The sums involved in this strategy were in some cases enormous as an illustrated by a case where a retail conglomerate shifted more than $949 million from high-tax jurisdictions (Ohio and North Carolina) to a Delaware company in royalties[30]. Another tax strategy became famous in a series of articles in the Wall Street Journal[31].
which exposed how Walmart saved millions of dollars in State income taxes by transferring real estate to a special entity and then renting exactly the same real estate from that entity[32]. While some high-tax jurisdictions have tried to close Delaware's tax loopholes (e.g., passing specific legislation to deal with The Toy's "R" Us loophole), Delaware has responded and made "efforts to keep a firm hold on its reputation as the nation's foremost corporate tax haven[33] by creating new loopholes (e.g., approving and promoting a new corporation category: "Headquarters Management Corporation", which was already described in a popular press article as a 'new kind of tax shelter')[34]. It should be emphasized that rather than being an 'International Tax Haven', Delaware is mainly a "Domestic Tax Haven" that helps U.S. corporations to avoid paying taxes to other U.S. States. As such, a U.S. Corporation will pay the same taxes both to the U.S. federal government and to other countries, whether it is located in Delaware, New-York or Michigan[35].

It was also claimed that Delaware attracts corporation due to the ability to form corporations almost anonymously[36] and that Delaware is one of the few States which "took an early lead in offshore secret incorporations, and remain leaders today"[37]. The formation of companies with hidden owners can be and is being used, among other, to facilitate underreporting of income, fictitious deductions, non-filing of tax returns and participating in listed transactions[38]. In July 2006, a report of the Financial Action Task Force (hereafter FATF), an international body that sets standards for the fight against money laundering, terrorist financing and other threats to the international financial system, criticized the U.S. for failing to comply with a FATF standard on the need to collect beneficial ownership information[39]. The report mentioned that under Delaware's laws "there is no obligation to file the name of any shareholder or beneficial owner when establishing either a corporation or an LLC [...]"[40] and that "In the case of the states visited [i.e. Delaware and Nevada], the company formation procedures and reporting requirements are such that the information on beneficial ownership may not be adequate and accurate, and competent authorities would not be able to access this information in a timely fashion"[41]. Following the FATF report, Senator Carl Levin introduced in 2008 the "Incorporation Transparency and Law Enforcement Assistance Act", which mandates the collection of beneficial owner information[42]. The bill, that was introduced again before the 113th Congress (2013-2014) mentions that very few States obtain meaningful information about the beneficial owners of the corporations and that "A person forming a corporation or limited liability company within the United States typically provides less information to the State of incorporation than is needed to obtain a bank account or driver's license and typically does not name a single beneficial owner". As for the situation in Europe, the bill notes that: "In contrast to practices in the U.S., all 28 countries in the European Union are required to have formation agents identify the beneficial owners of the corporations formed under the laws of the country". In a statement before the 113th Congress (2013-2014) on August 1st 2013 Senator Levin referred to the "race to the bottom" between U.S. States concerning corporate secrecy and noted: 'I wish the States could solve this low enforcement problem on their own, but ongoing competitive pressures make it unlikely that the States will do the right thing. It's been nearly seven years since our 2006 hearing on this issue... with no progress to speak of, despite repeated pleas from law enforcement' [43]. Senator Levin also referred to the lack of consistency in the U.S. approach and said "if we want to stop inappropriate corporate secrecy offshore, we need to stop it here at home as well" [44]. However, so far this bill has languished in Congress and is currently sitting in the Committee on the Judiciary, because of opposition by the States and other parties. Among the concerns expressed by the opponents is privacy issues, the corporate "tradition" of States like Delaware, differences over the definition of the term "beneficial owner", the perception that the bill is an unfunded mandate and the fear that new corporations will be formed outside the U.S.[45].

In sum, the "tax heaven" approach provides that Delaware attractiveness as a place of incorporation partly derives from tax consideration and particularly from Delaware's special tax rules for investment income and the ability to form corporations almost anonymously. Under this approach, tax competition (or "race to the bottom") creates an incentive for small States to offer tax rules which are (too) favorable to corporations who operate in other high-tax jurisdictions.

3. Conclusion

There is no one explanation as to why Delaware became home of so many corporations, including a majority of U.S. public corporations. As noted above, Delaware dominance as a place of incorporation can be the result of either a "race to the top" or a "race to the bottom" with respect to regulatory competition in corporate law. Tax competition may also play a role in its attractiveness of Delaware for corporations. While there is no consensus among scholars as to which explanation is correct, this controversy concerning corporate and tax competition is highly relevant for current policy debate in Europe, as European corporations have become free to choose their country of incorporation among the European Union and as tax competition among European countries had forced them to forgo tax revenue. Hopefully, this paper will contribute to this needed debate.
Elenco delle fonti fotografiche:
http://upload.wikimedia.org/wikipedia/commons/thumb/9/91/Delaware_in_United_States_(zoom)_1848.svg/1280px-Delaware_in_United_States_(zoom)_1848.png [25.07.2014]
[40] Id. 231.
[41] Id. 236–237.
[42] U.S. Senate Bill S.2956 and see similar bills: U.S. Senate Bill S.1483, U.S. Senate Bill 1465 and House Bill H3416.
[44] Id. A recent article at the New York Times also referred to secrecy laws of Delaware and to this lack of consistency: “Our State and Treasury Departments routinely identify countries that are havens for financial crimes. But, whether because of shortsightedness or hypocrisy, we overlook the financial crimes that are abetted in our own country by lax state laws. While the problem is concentrated in Delaware, there has been a «race to the bottom» by other states that have enacted corporate secrecy laws to try to attract incorporation fees” (Cassara John A., Delaware, Den of Thieves?, New York Times, November 1, 2013).