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POLICY RESPONSES TO CORPORATE INVERSIONS

Close the Barn Door *Before* the Horse Bolts

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Introduction and executive summary

The U.S. corporate tax base is slowly leaking out of the country. U.S. multinational corporations have increasingly begun to merge with much smaller foreign corporations so as to move the corporation to a lower-tax country—a maneuver known as a *corporate inversion*. In essence, the corporations are giving up U.S. "citizenship" to avoid paying U.S. taxes.

A number of firms have been in the news recently for pursuing inversions, including Medtronic, a Minnesota firm, which wants to become an Irish firm; AbbVie, a Chicago-based firm, which wants to become a U.K. firm;[1] and Mylan, a Pittsburgh firm, which wants to become a Dutch firm. Walgreens toyed with the idea of becoming a Swiss firm, but ultimately decided against the move, almost surely in part because of the public outcry that ensued.

This report examines some of the issues and policy options regarding corporate inversions. It explains what corporate inversions are, explores common tax features of proposed inversions, analyzes why many corporations are now pursuing inversions, and assesses various policy options to prevent inversions. The report's main conclusions are:

- The primary reason for a corporate inversion is simply to lower the tax liability faced by the firm.
    - Inverting firms generally argue that they are trying to escape the world's highest corporate tax rate. The U.S. *statutory* corporate tax rate is 35 percent. Few firms, however, actually pay this statutory tax rate. The average *effective* U.S. corporate tax rate—the rate paid after various deductions and credits are applied—is about

27 percent. This is not much different from the effective tax rate paid by corporations in many advanced industrial countries that are not tax havens.

  - Most of the firms seeking to invert have a large stash of tax-deferred earnings sitting offshore. These earnings are subject to the U.S. corporate income tax (with a credit for foreign taxes paid) but only when they are repatriated to the U.S. parent as dividends. By inverting and then using a variety of tax avoidance schemes, the firms can have access to these earnings virtually free of U.S. taxes. This is undoubtedly the primary motivation to invert.

- Changes in tax *regulations* (which the U.S. Treasury Department could promulgate without congressional approval) are a necessary stopgap measure to reduce the outflow of the U.S. corporate tax base.
- However, only targeted *legislation* that reduces the incentives and ability of firms to invert can truly protect the corporate tax base.
  - Possible responses include allowing U.S. corporations to invert only if they truly become a foreign firm. This means current shareholders of the U.S. firm would have to own less than 50 percent of the new merged foreign firm, compared with the currently legislated 80 percent threshold.
  - Additional measures that would likely be required to prevent inversions from further eroding the corporate tax base include preventing the practice known as "earnings stripping" and preventing corporations from using tax-deferred offshore cash in ways that benefit U.S. shareholders without paying U.S. taxes.
  - If Congress does not settle on a targeted legislative fix and do it soon, the United States could essentially lose much of its corporate tax base.

What is a corporate inversion?

A corporate inversion (also known as expatriation) is basically the process of a firm incorporated in one country changing its official country of residence (i.e., incorporating in another country). In the case of the United States, the U.S. corporation essentially becomes a publicly held corporation residing in another country.[2] Prior to 2004, several U.S. firms became foreign corporations domiciled in well-known tax havens such as Bermuda and the Cayman Islands (see the text box for more information).

No loyalty, no responsibility

Before the enactment of Internal Revenue Code (IRC) section 7874 in 2004, several U.S. corporations inverted to either Bermuda or the Cayman Islands through what was known as a *naked inversion* (as is discussed in more detail elsewhere in the paper). Kontrimas (2010) lists 20 major corporations that inverted before 2004. The firms were in various industries ranging from oil-industry contracting and drilling (e.g., Transocean) to business consulting (e.g., Accenture). One of the major stated reasons for the inversions was to reduce the corporations' effective tax rates. Six of these firms are listed in **Table 1** along with the year and country of inversion.

TABLE 1

Selected pre-2004 corporate inversions and subsequent relocations

Company	Year of inversion	Country	Subsequent relocation	
			Year	Country
Covidien (Tyco International prior to 2007)	1997	Bermuda	2010	Ireland
Transocean	1999	Cayman Islands	2008	Switzerland
Seagate Technologies	2000	Cayman Islands	2010	Ireland
Accenture	2001	Bermuda	2009	Ireland
Noble Corp	2002	Cayman Islands	2009	Switzerland
Cooper Industries	2002	Bermuda	2009	Ireland

Source: Kontrimas (2010)

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In the early 2000s, members of both parties in Congress grew concerned about these inversions. Sens. Baucus (D-Mont.) and Grassley (R-Iowa), respectively the chairman and ranking minority member of the Senate Finance Committee, questioned the morality of a U.S. firm relocating to a tax haven country for the sole purpose of avoiding paying taxes owed to the U.S. government. This bipartisan push eventually led to the addition of IRC section 7874. However, this did not completely solve the problem of inversion, nor salve ill feeling against the firms that inverted to tax havens.

As a senator, Barack Obama was a major sponsor of anti–tax haven legislation, which never came to a vote. After the 2008 election, several of the inverted firms feared that anti–tax haven legislation would stand a better chance of being enacted with a Democratic Congress and President Obama in the White House (Casselman and Drucker 2008). Consequently, some firms relocated from Bermuda and the Cayman Islands to tax havens that have tax treaties with the United States—Ireland and Switzerland are two examples (see the table). By relocating to countries with official tax treaties with the United States, the firms felt that they would be insulated from risks associated with U.S. tax law changes regarding tax havens.

Two of these firms—Cooper Industries and Covidien—have again been involved with inversions. Ohio-based Eaton Corporation "moved" to Ireland in 2012 by acquiring Cooper Industries. Cooper Industries was a Texas-based company until it inverted in 2002 to Bermuda; its administrative headquarters, however, remained in Texas. Worried about proposed anti–tax haven legislation, Cooper Industries again "moved" in 2009, this time to Ireland.

Medtronic, a Minnesota-based medical device manufacturer, is shifting its home to Ireland by buying Covidien, an Irish medical device maker. Until 1997, Covidien was a U.S. corporation known as Tyco Healthcare and part of Tyco International. In 1997, New Jersey–based Tyco inverted to Bermuda. After Tyco CEO Dennis Kozlowski was dumped (and eventually convicted of grand larceny), the new Tyco management spun-off Tyco Healthcare as Covidien. In 2010, Covidien relocated to Ireland, apparently for the same reason as Cooper Industries.

In both of these cases, large U.S. corporations have inverted or are in the process of inverting by merging with a smaller "foreign" firm that has its administrative headquarters in the United States and used to be a U.S. corporation. In essence, U.S. corporations are becoming foreign corporations by merging with ostensibly U.S. corporations.

Achieving tax savings through a corporate inversion became more difficult after the enactment of the American Jobs Creation Act of 2004, which added section 7874 to the tax code. IRC section 7874 and subsequent regulations have shut down one avenue of inverting for tax purposes known as the *naked inversion* (such inversions are also discussed in the text box). In a pre-2004 naked inversion, a U.S. firm would form a new holding company in a tax haven country, and the public shareholders of the U.S. firm would become the public shareholders of the new tax haven holding company. Almost no business activities were shifted to the tax haven—the operating headquarters remained in the United States, and shares continued to be traded on U.S. stock exchanges.[3]

IRC section 7874 only allows a naked inversion if the U.S. firm has "substantial business activities" in the foreign country. Substantial business activities are defined as the firm having 25 percent of the employees, assets, and income located in, or derived from, the relevant foreign country.[4]

The primary avenue left open for a corporate inversion is merging with a foreign firm.[5] The current and controversial proposed corporate inversions (of which AbbVie, Medtronic, and Mylan are examples) are cases where a large U.S. corporation acquires a much smaller foreign corporation, but the resulting merged corporation is incorporated in the foreign country, which, unsurprisingly, has a lower statutory tax rate than the United States.

For the merged corporation to be considered a foreign corporation under U.S. tax law, the current shareholders of the U.S. firm must own less than 80 percent of the merged corporation; otherwise, the merged corporation is treated as a U.S. corporation for U.S. tax purposes. Current shareholders of the U.S. firm typically own 70 to 79 percent of the new merged firm; this way control of the new firm remains with the U.S. firm. This has been described by Edward Kleinbard (2014, 2) as "the foreign minnow swallowing the domestic whale." Often, little or no economic activity is moved from the United States to the new home country. In most of these cases, the U.S. firm has not closed up shop and moved overseas. Almost all of the production and current jobs in the United States tend to remain in the United States (at least initially). Even the headquarters remain in the United States, and the new foreign firms are usually listed on U.S. stock exchanges.

Common tax features of the proposed inversions

Many multinational corporations argue the U.S. corporate tax system places them at a "competitive" disadvantage; their evidence, for the most part, boils down to a comparison of the statutory corporate tax rate in the United States with that of other countries (many of which are well-known tax havens). Kleinbard (2014, 3) shows that these arguments are "almost entirely fact-free." Corporate inversions are all about reducing worldwide tax liability through a variety of tax avoidance strategies. These strategies allow firms to move income from the United States as well as from any other relatively high-tax country to very low-tax countries, thus creating "stateless income."[6] There are three key tax features of a corporate inversion. Each is discussed below in turn.

Lower tax rates

Inversion invariably lowers firms' corporate tax liability. All of the proposed inversions mentioned above will have their new home in a tax haven. Such tax havens include Ireland, Switzerland, and the Netherlands (which has many features of a tax haven but is not usually included on official lists of tax havens). Inverting firms generally argue that they are trying to escape the world's highest corporate tax rate. The U.S. *statutory* corporate tax rate is 35 percent, while Ireland boasts of a 12.5 percent corporate tax rate. Few firms, however, actually pay this statutory tax rate; the average *effective* U.S. corporate tax rate—the rate paid after various deductions and credits are applied—is about 27 percent (PWC 2011 and Gravelle 2014).

According to PWC (2011), this rate is higher than the average effective rates in Ireland (22.4 percent), Switzerland (20.7 percent), and the Netherlands (18.8 percent), but is not that much different from the effective tax rate paid by corporations in many advanced industrial countries that are not tax havens. Interestingly, many of the firms proposing to invert currently pay effective tax rates that are much lower than the U.S. average: Medtronic pays 18.4 percent, AbbVie pays 22.6 percent, and Mylan pays 16.2 percent (according to their most recent SEC 10-K reports).

Not everybody benefits

An important and under-recognized implication of inversions is that some of the current stockholders of the U.S. firms could face unexpected tax bills. Often, current U.S. shareholders (who own 60 to 80 percent of the new merged foreign firm) will owe capital gains taxes on the appreciation in their shares when the shares are converted into the stock of the new company. This is not true, however, for foreign shareholders or tax-exempt shareholders such as 401(k) plans and IRAs, which is why some shareholders controlling large blocks of stock do not oppose inverting even though it may not be in the best interests of all shareholders.

Tax deferred foreign-sourced earnings

Most of the firms seeking to invert have a large stash of tax-deferred earnings sitting offshore. These earnings are subject to the U.S. corporate income tax (with a credit for foreign taxes paid) but only when they are repatriated to the U.S. parent as dividends. According to their SEC 10-K reports, AbbVie notes it has approximately $21 billion in "indefinitely reinvested" offshore earnings, and Medtronic notes it has $18 billion. Occasionally the firms and their lobbyists will argue these tax-deferred earnings are somehow "trapped" offshore by the U.S. corporate tax. The firm, however, chooses to keep the earnings offshore simply *because it does not want to pay the U.S. income taxes it owes*. This is a very

strange definition of "trapped." By inverting and then using a variety of tax avoidance schemes, the firms can have access to these earnings virtually free of U.S. taxes. This is undoubtedly the primary motivation to invert.

Why is there a rush to invert now?

The corporate income tax system has been in place for decades.[7] And the anti-inversion rules have been in the tax code for a decade. So the question is, why the flurry of inversion activity now? There are at least three possible reasons.

First, Kimberly Clausing (2014, 5) argues that "[a]s other multinational corporations have demonstrated success with inversion strategies, more and more corporations are lured by similar deals." This is basically an example of the herd following the leader. The implication is that unless an effective policy response begins soon, the erosion of the corporate tax base will become extreme.

Second, it may be the result of the Pandora's Box that Congress opened in 2004 with the enactment of the so-called *repatriation holiday*.[8] Because U.S. taxes are deferred on foreign-sourced earnings until the earnings are repatriated back to the U.S. parent corporation as dividends, firms have an incentive to allow the earnings to accumulate overseas. The earnings are often characterized—by the firms themselves—to be "permanently" or "indefinitely" reinvested overseas,[9] at least until the chance to repatriate at a preferential tax rate appears.

By the early 2000s, a sizable stash of unrepatriated earnings had accumulated. Multinational corporations pushed Congress to enact the repatriation holiday, which allowed U.S. multinationals to repatriate foreign-sourced earnings at a 5.25 percent tax rate rather than at the 35 percent statutory tax rate.[10] Firms responded by repatriating about a third of all offshore earnings (Marples and Gravelle 2011); Redmiles (2008) shows that over 75 percent of the repatriated earnings came from controlled foreign corporations in tax havens.

Although Congress specifically stated that the repatriation holiday would never be repeated, multinational firms and their supporters in Congress continued to push for another holiday. After an attempt failed in 2009, multinational corporations turned their attention toward corporate tax reform to adopt a territorial tax system in which foreign-sourced earnings are not taxed by the United States. Having failed so far in that goal, multinational corporations may have decided that gaining tax-free access to their unrepatriated foreign-sourced earnings through inversion is a useful complementary strategy to avoid U.S. taxes.

Third, multinational corporations may be simply using the threat of inversion so as to pressure Congress to pass a repatriation holiday, a territorial tax system, and/or a lower corporate tax rate.

Policy options

What can be done to stop this erosion of our corporate tax base? Several options have been proposed, ranging from wishful thinking to the realistic.

Comprehensive tax reform

Many in the GOP argue that the only solution is revenue-neutral comprehensive corporate tax reform with a broader tax base and lower tax rate. There are two problems with this strategy. Politically, it seems unlikely to happen soon. And economically, revenue-neutral reform by definition will not affect the overall effective tax rate.

On the political front, when House Ways and Means Committee Chairman Dave Camp proposed a serious (if flawed) tax reform plan earlier this year, it was immediately dismissed by the GOP leadership. It is highly likely that a major portion of the U.S. corporate tax base will have inverted before Congress can agree on a comprehensive tax reform proposal. Hungerford (2014b) argues that it is unlikely that tax reform legislation will be seriously considered before 2017.

Economically, revenue-neutral corporate tax reform does not actually reduce the average incentive to invert (i.e., it does not lower the average effective rate). Instead, it only reduces the *variance* around the average effective rate; there will be winners (firms with lower effective tax rates) and losers (firms with higher effective tax rates). This kind of tax reform, however, will not eliminate the incentive to invert—many of the firms planning inversions could of course end up paying a higher effective rate after tax reform. Consequently, other provisions will need to be adopted to curb inversions.

Regulatory actions

One key channel through which inverted firms deprive the United States of tax revenues is through *earnings stripping*. This occurs when the U.S. subsidiary of the now-foreign firm is loaded up with debt through the issuance of an intercompany note (Department of Treasury 2002). Taxable income of the U.S. subsidiary is reduced because the interest payments to the foreign parent company on the intercompany debt are tax deductible (though there are certain limits spelled out in IRC section 163(j)). Department of Treasury (2007, 8) found evidence that inverted corporations were "stripping substantially all of their income out of the United States." This earnings stripping channel can be economically significant: Seida and Wempe (2004) conclude from their analysis that the main reason for lower post-inversion effective tax rates is earnings stripping. This has led many to question the effectiveness of IRC section 163(j).

The 113th Congress has been unable to pass significant legislation and is unlikely to change this record between now and the November election. Some have called for the Obama administration to change Treasury regulations (changes which do not require congressional approval) to curb inversions. For example, Shay (2014) has proposed a change in regulations that could reduce the tax benefits of an inversion, thus reducing, but not eliminating, the incentive to invert; the plan would limit earnings stripping by using regulatory authority (under IRC section 385) to reclassify the U.S. subsidiary's debt as equity. This would "transform a deductible interest payment into a nondeductible dividend" (Shay 2014, 474). The administration was initially skeptical that it had the authority to make the required regulatory changes, but Treasury is now reportedly assembling a list of options (Davis 2014).

Legislation

Another solution is to legislatively fix obvious defects in the corporate tax code by tightening the U.S. anti-inversion rules, which can be done without broader tax reform. Rep. Sander Levin (D-Mich.) and Sen. Carl Levin (D-Mich.) have introduced bills that would amend IRC section 7874 and allow U.S. corporations to invert only if they truly become a foreign firm—current shareholders of the U.S. firm would have to own less than 50 percent of the new merged foreign firm. Furthermore, the new merged firm would be treated as a U.S. corporation if it is managed and controlled in the United States, and has "significant domestic business activities" in the United States.

Kleinbard (2014) argues, however, that this is not enough to completely fix the problem of inversions. He argues for further measures to limit the erosion of the corporate tax base by preventing (1) earnings stripping, and (2) using tax-deferred offshore cash in ways to benefit U.S. shareholders without paying U.S. taxes. Both Rep. Levin and Sen. Charles

Schumer (D-N.Y.) have proposed measures to amend IRC section 163(j) and the controlled foreign corporation rules (IRC section 956) to address some of these issues, which they plan to formally introduce later in September.

Conclusion

While near-term regulatory actions are a necessary stopgap to slow the eroding tax base, over the longer-run legislative changes are needed. For example, only legislation can change the definition of what constitutes a true foreign firm for tax purposes, clamp down on earnings stripping, and strengthen the controlled-foreign-corporation rules. The current House leadership has shown that it does not have much current interest in corporate tax reform, so the passage of fundamental, comprehensive tax reform should not be a precondition for solving the concrete problems raised by accelerating corporate inversions. If Congress does not settle on a targeted legislative fix and do it soon, the United States could essentially lose much of its corporate tax base.

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Endnotes

1. AbbVie, after its merger with Shire, will actually re-incorporate in the small English Channel island of Jersey, which is a British crown dependency and well-known tax haven.

2. Treasury (2002, 1) defines an inversion as "a transaction through which the corporate structure of a U.S.-based multinational group is altered so that a new foreign corporation, typically located in a low- or no-tax country, replaces the existing U.S. parent corporation as the parent of the corporate group."

3. See, for example, Thompson's (2002) description of the Coopers Industries inversion.

4. Treasury Decision, TD 9592, June 12, 2012.

5. This should be distinguished from the situation in which a U.S. corporation is acquired by a larger foreign firm. After the merger is consummated, the shareholders of the U.S. firm own a minority share of the merged foreign firm. Donald Marples and Jane Gravelle (2014) note that this form of inversion is often driven by business considerations, but tax consequences are likely also part of the decision.

6. See Kleinbard (2011) for a description and analysis of stateless income.

7. See Hungerford (2014a) for a description of the corporate tax system.

8. For a description and analysis of the repatriation holiday, see Marples and Gravelle (2011).

9. Much of these permanently reinvested earnings are in U.S bank accounts or invested in short-term U.S. Treasury securities.

10. These monies were to be a "source for funding of worker hiring and training, infrastructure, research and development, capital investments, and the financial stabilization of the corporation for purposes of job retention or creation" (Joint Committee on Taxation 2005, 310). Dharmapala, Foley, and Forbes (2011) found that for each $1 increase in repatriations, multinational firms increased shareholder payouts by 60 to 92 cents, rather than increasing investment by $1. They argue that the fungibility of money undermined the legal provisions that restricted the use of repatriated earnings.

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