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Tax Inversion: What is it Good for?

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Author Note:

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Tax Inversion: What is It Good for?

Introduction

Taxation is often regarded as one of the most complex aspects of modern society. With a tax code that is now over 70,000 pages long, it is no wonder that many have little to no understanding of how taxation works in the United States. In spite of the length and depth to which the code explains tax procedure, there are still individuals that find ways to exploit loopholes. In the past 30 years, the technique of *tax inversion* has become an incredibly popular way for companies to reduce the amount of tax they have to pay each year.

In simple terms, tax inversion is the practice of a company relocating its headquarters to another country in order to fall under the tax laws of that country. The moving of the headquarters allows the company to use the tax rate of the new country, while generally making the same amount of profit as before. This a much-abbreviated version of what tax inversion is, but it reveals the root of the problem. The problem being that companies are still earning large profits, but are avoiding much of the tax burden they would normally incur. Each year millions are lost in tax revenue due to tactics such as this. Measures to discourage this kind of behavior are put into place year after year, with some success, but they still do not stop the problem completely.

One of the most recent examples of this behavior is the acquisition of Tim Hortons by Burger King. As a result of the deal, Burger King will relocate its headquarters to Ontario, Canada. Burger King claims that it is doing so to fulfill its desire to become a larger player in the market for fast food breakfast and to expand their business in Canada and abroad further. Only upper level management of Burger King

knows the true intentions, but many speculate that the move was made to help lower their tax payments.

Along with the financial issues brought up by tax inversion, issues of morality are also presented. Like other companies that have made similar changes, it is difficult to discern if they are doing so because they want to help the company that they are merging with, or if they are doing it for more monetarily related goals. There are a handful of issues regarding this topic, but this paper will primarily focus : what tax inversion is, how the companies inverting will benefit, and reform suggestions for the U.S. to help stop companies from inverting for the wrong reasons.

Tax Inversion Described

In order to discuss the effects of tax inversion, it is necessary that it be described with more detail. The U.S. Treasury describes a corporate inversion as, "transaction in which a U.S. based multinational restructures so that the U.S. parent is replaced by a foreign parent, in order to avoid U.S. taxes" (U.S. Department of the Treasury, 2014). As previously described, the merger of Burger King and Tim Hortons shows this. Burger King (BK), a larger, U.S. based company, purchased Tim Hortons, a smaller, foreign company, and relocated its headquarters of the merged company to Canada.

The U.S Department of Treasury and the Internal Revenue Service (IRS) are constantly trying to come up with new ways to block tax related inversions from occurring. They must do so, however, without discouraging cross-border mergers that are driven by business strategies and economic efficiencies. The most recent update to the anti-inversion laws occurred in September of 2014. This notice edited the laws in a way to prevent companies from accessing a foreign subsidiary's earning tax free, prevent

inverted companies from restructuring a foreign subsidiary to access its earnings tax free, close a loophole that allows for cash and property to be transferred to the subsidiary tax free, and make it more difficult for companies to invert by changing the ownership percentage requirement for the U.S. company (U.S. Department of the Treasury, 2014).

The tactics mentioned in the notice provide some of the largest benefits to companies that have undergone inversion. The new laws have already blocked a few inversions from occurring including, most notably, the controversial purchase of AstraZeneca by Pfizer. These laws continue to block many companies from inverting, but there are still many companies that continue to get around the laws each year. Unfortunately, for the U.S., there is no real solution right now for companies that have inverted to be brought back to the United States. At this point, those companies are now considered citizens of another country.

Inversion Techniques

Companies would not engage in inversion if it were not for substantial benefit to them financially. Tactics used in an inversion are quite simple in nature, but the way in which they are executed is anything but. They exploit loopholes that are embedded in the United States tax system for the financial gain of the company. This raises some questions of the morality of an inversion because there are no rules that say a business cannot engage in these practices, but, at the same time, it is difficult to determine where the intentions of these companies lie.

A few of the main ways that inversion lessens the tax burden for companies is by: the relocation of the headquarters, or domicile to a country with a different tax structure, the technique of earnings stripping, and the technique of transfer pricing. These

techniques address both how to reduce tax on both foreign income earned by the company and the income earned in the United States (Marples, 2008).

First, how companies reduce their tax burden through the relocation of their domicile will be discussed. The legal definition of a domicile is "a permanent legal residence" (Marriam-Webster). It is simply a company moving its legal residence out of the U.S. to another country. Using the BK - Tim Horton's merger as an example, BK moved its domicile from the United States into Canada. When a company shifts its domicile, it is now under the jurisdictions of that country, including the tax laws.

The main difference between the corporate tax structure in Canada and the corporate tax structure in the U.S. is the way in which corporate taxes are assessed. In this U.S., the amount of tax that is paid by the corporation is determined by the total amount of profit that they make. The more they make, the more they have to pay in tax. Companies that are the size of BK generally have to pay a tax rate of 35% (tax rate if income lands between 10m-15m or exceeds 18,333,333m) or 38% (tax rate if income falls between 15m - 18,333,333m), depending on the amount of taxable income (Internal Revenue Service). For companies based in the U.S., the location of the domicile in the does not matter. If the domicile is in the U.S., these are the federal tax rates that must be used along with any taxes that are owed to the state their domicile is located. The U.S. tax system is what is known as a "worldwide" tax system meaning that any income earned by a U.S. based company, regardless of where it was earned, will be subject to U.S. tax (Senate Republican Policy Committee, 2012) .

Unlike the U.S., Canada uses a "territorial" tax system. A territorial tax system has two main components to it: the tax rate that is issued by the government and the tax

rate that is issued by the territory that the domicile is located it. Unlike the worldwide system, in a territorial system only the profits earned in that country are subject to taxation. To illustrate this description using the BK - Tim Horton's example, in Canada the government administers a tax rate of 15%. The territory of Ontario has a tax rate of 11.5% (KPMG, 2015). The combination of these two rates (26.5%) is the rate of tax that must be paid on all profits made by BK in Canada. If BK were to earn money outside of Canada, it would only be subject to the tax of the country the money was made in.

After all the credits and deductions, most companies whose domiciles are located in the U.S. do not end up paying the full 35% or 38% tax. For example, in 2013, BK's effective tax rate was 27.5% (Rocha & Ho, 2014). Even though the tax rates are comparable, BK will save money in the long run due to the fact that their revenues earned in a foreign country will not be subject to the tax of their home country. Overtime, these savings will add up, as they are no longer being double taxed on their earnings.

Relocation of the domicile helps to lessen the burden of taxes for companies but it is not the only way that companies save by inverting. Earnings stripping remains to be a powerful tool in helping companies minimize tax paid. Earnings stripping is the technique of the shifting the earnings made by the U.S. counterpart of a corporation to its foreign parent (Marples, 2008). The shifting of these earnings most often comes in the form of an intercompany loan. A loan of this nature, loaning money from the foreign parent to the U.S. subsidiary, allows for the U.S. subsidiary to reduce its tax burden by deducting the interest payments that are made to the foreign parent.

According to U.S. Code Section 1441, interest payments of this kind by the foreign parent are subject to U.S. withholding tax to the tune of 30% (Internal Revenue

Service). This tax, in many cases, can be eliminated or reduced by already existing tax treaties. Knowing this, many corporations structure loans of this type so that they are made to a related lender in a treaty country, thus avoiding taxation (Holtzblatt, Jermakowicz, & Epstein, 2015).

Earnings stripping is not the only type of transfer that can be made between subsidiaries for benefit to the corporation. Another way is by the U.S. subsidiary contributing a large amount of equity, something that the corporation owns like cash, equipment, or land, to the foreign parent. Most of the time the equity contribution takes the form of a cash contribution. The foreign parent would then be able to invest this money, removing it from the grasp of U.S. taxation (Holtzblatt et al., 2015). These earnings will continue to remain exempt from U.S. tax so long as they are not repatriated, brought back the U.S. (Holtzblatt et al., 2015), but they could return to the U.S. in the form of a loan that is intended to be used for earnings stripping.

Earnings stripping is not the only type of intercompany transfer that helps corporations reduce their tax burden. The technique of transfer pricing also allows companies to shift profits between countries with different tax rates (Holtzblatt et. al, 2015). A transfer price "is the price one subunit charges for a product or service supplied to another subunit of the same organization" (Horngren, Datar, & Rajan, 2011). The price at which this transfer is recorded by each unit is set by management, and the buying and selling of these subunits affects the operating income of each subunit respectively (Horngren et al., 2011). The shifting of income comes into play when the company has its subsidiaries or parent in a lower tax jurisdiction raise the transfer price charged for its

goods and has the subsidiaries or parent in a high tax jurisdiction lower the transfer price charged (Holtzblatt et al., 2015).

As a result of these transfers, the operating income of each affiliate is changed. The high tax jurisdiction affiliates have lowered their income, effectively lowering their tax burden, and the low tax jurisdictions have increased their income. The corporation as a whole will still make the same, or close to the same, amount of income, but that income has been moved around to a more favorable tax jurisdiction. This technique has been in use for a long time, and the IRS, as a result, is very diligent in examining these related party transactions (Horngren et al., 2011). "Code section 482 gives the IRS the authority to adjust taxable income between two related parties to more accurately reflect the income earned by each party" (McKinley & Owsley, 2013). The criteria used to determine the true taxable income of the U.S. based subsidiary is called the "arm's length principle." The arm's length principle, as described in Sec. 1.482-1(b), states that, "a controlled transaction meets the arm's length principle if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances". In essence, this part of the code is saying that in order for the arm's length standard to be met, the results that occurred from this transaction would have been the same regardless if the two parties were related or not. Basically, was the transfer appropriately priced? If the arm's length standard were to be violated, the IRS would adjust the transaction accordingly.

The scenario just described spoke only about the transfer of physical property. One of difficult transfers to valuate is the transfer of intellectual property and other intangibles (Holtzblatt et al., 2015). Transfers of intellectual properties are difficult to

valuate for the following reasons: it is difficult to find similar transactions to compare due to the fact that company's intangibles rarely appear in the market and it is very difficult to assess the underlying risk as well as which party will bear the risk of the intangible (Holtzblatt et al., 2015).

In the U.S., investments in intangibles are treated rather favorably. Any investment in intangibles can be expensed as research and development (R&D). The expensing of these investments, along with the possible tax credit for R&D, can create a low, in some cases zero or negative, tax rate for investments made in these intangibles (Holtzblatt et al., 2015). After the product has been developed, the intangible asset can be transferred or licensed to a different, lower tax jurisdiction, subsidiary (Holtzblatt et al., 2015). Once the asset has been transferred or licensed, the subsidiary that controls the asset may claim the revenue generated by the intangible as its own. Companies, like Google, who receive most of their revenue from advertising greatly benefit from the transfer of these intangible assets. To illustrate, the U.S. component of Google licenses its intellectual and intangible assets to another subsidiary (based in Ireland in this case) who then uses those intangible assets to generate revenue. Like transfer pricing with physical goods, this allows for Google to record expenses in a higher tax jurisdiction, and revenue in a lower tax jurisdiction (Drucker, 2010). This is a very myopic description of the full tax strategy Google employs, but it illustrates the main point.

Of the tax inversion techniques described, the transfer of intangibles is by far the most effective in terms of tax dollars saved. It is estimated that this technique costs the U.S government up to $60 billion a year in revenue (Drucker, 2010). With such high losses, it is no wonder the U.S. is constantly attempting to thwart off inversions that seek

to avoid U.S. tax. As mentioned earlier, the U.S. has done a good job of tightening up the standards, but handfuls of companies has, and continue to, slip through the cracks.

Suggested Solution

Determining an appropriate solution for tax inversion is a difficult one. The fact that inversions still continue to occur, even after changes are made by the IRS and U.S. treasury, suggests that a more powerful or drastic type of change needs to be made. Politicians continue to argue about what type of solution would be most appropriate, but they all agree that a better solution must be found. Many of them do not feel that it is morally right for companies to engage in inversions. President Obama has gone as far as tagging inversions as an "unpatriotic loophole" (Mider, 2014).

As mentioned, it has been, and continues to be, a difficult process to figure out what to do about inversions. Some sides argue that tightening requirements for an inversion to occur will solve the problem while others suggest a more reform based solution. The previous paragraphs have described the most recent attempt at tightening the requirements for inversion to take place, but, as demonstrated by the inversions that still have occurred, they have not provided a long-term solution. Many republican politicians have suggested that the U.S. undertake a rewriting of the tax code in order to fix not only inversions, but also many other problems that exist due to the complex tax code.

This suggested solution is not unique to the Republican Party, however. Many academics have suggested that tax reform is the only real solution to fixing the problem of inversion abuse. Bill George and Mihir Desai, both professors at Harvard, have concluded that the two biggest reasons companies engage in an inversion is due to the

high tax rate that the U.S. has as well as the world-wide tax system that subjects all profits to U.S. tax (Lundeen, 2014a). The difficult question then is to figure out what kind of tax reform would be best to ensure that the U.S. stays competitive with other countries. It is difficult to speculate what would work best, but, according to academics such as Greg Mankiw of Harvard, scaling back both personal and corporate tax rates and switching to a consumption tax in the form of a value added tax, an alternative to traditional sales tax that causes both businesses and consumers to pay tax on products (Investopedia), would solve many of the problems we have (Lundeen, 2014b). Both Desai had similar suggestions, but also encouraged the switch to a territorial system to keep the U.S. competitive (Lundeen, 2014a).

Conclusion

As mentioned previously, tax inversion is a complex topic with more elements than one can shake a stick at. This paper discussed a few of the common techniques that are used by companies inverting, but it does not explain all of the ones that are used. This is most likely the biggest reason why legislation has such a tough time coming up with a way to properly regulate inversions.

There are still substantial benefits for companies to engage in inversion and, until it is no longer of benefit, inversions will still be used. At this time, it seems that the only the real solution for the U.S. is for tax code reform. As exemplified by the constant changing and tightening of regulations, simply changing the current regulations is not cutting it. This does not mean that the currents regulations should not be changed just that these changes may be more effective with some modifications to the current tax system.

It is difficult to say whether a real solution will come anytime soon. Many of the companies looking to invert have deep pockets and can hire strong lobbyists to make sure their best interests are kept in mind. In the end, the U.S. is the biggest loser due to the fact that no solution only brings in less tax dollars due to the discouragement of companies to not be based in the US. A well-crafted solution would not only discourage companies from leaving the US but would also encourage previously inverted companies to return to the US.

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