# “Corporate inversions: are they tax avoidance schemes or the reaction to an unfair tax system?”


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# Corporate inversions: are they tax avoidance schemes or the reaction to an unfair tax system?


## Abstract

In an attempt to bypass the highest corporate taxes levied on businesses in the world, inversions for the US domestic corporations became the innovative strategy implemented throughout the corporate arena. The result of these clever tax avoidance ploys ended in a loss of over $34 billion dollars in lost tax revenue. In an attempt to stench the flow of inversion mania, the House Ways and Means Committee introduced legislation in January 2015 affectionately named the "Stop Corporate Inversions Act of 2015" (Forbes, 2015). The purpose of the legislation is to close a loophole in the IRC section 7874 rule which had unsuccessfully stemmed the avalanche of inversion tax avoidance mergers and acquisitions.


**Keywords:** inversions, corporate taxes, off-shore earnings.
**JEL Classification:** G3, G31, G34.

## Introduction

The current tax policy in the United States has essentially rewarded domestic corporations by legally allowing them to avoid paying US corporate taxes. The statutory corporate tax rate in the United States is 35%, significantly higher than their international counterparts. No one, including corporations, wants to pay income taxes the only difference is large corporations are provided the loopholes in the Internal Revenue Code or IRC that the individual is denied. A plethora of profitable domestic businesses have been busy stockpiling enormous cash deposits in offshore accounts in an attempt to defer the paying of US taxes. Now, thanks to the newly fabricated game called Corporate Inversions, those monies are creatively returning to the U.S. disguised as dividends.

The United States tax policy is currently acting as a deterrent to profitability. The extremely high statutory income tax rate of 35% compared to the more favorable 12.5% rates found in Ireland, for example, has contributed to the plethora of U.S. corporations implementing a common tax avoidance strategy called INVERSION. This process of tax avoidance was formerly known by the moniker expatriation (Hungerford, 2014). The Inversion process is akin to legally dodging the tax burden of U.S. corporations placed upon them via the IRC. The process is actually quite simple. A United States corporation acquires an international business entity which creates then a new domicile for the US corporation and a new country as the business address. The U S corporation re-emerges as a newly re-incorporated foreign entity. Magically, the U.S. tax burden is lifted by the mere changing of an address to the international arena. In 2004 Congress attempted to close the gapping loopholes driving the international merger mania by enacting IRC 7874 (Hungerford, 2014). Unfortunately, the problem was not solved because the legislation did virtually nothing to impede the cascading tax avoidance strategy of many of the U.S. based corporations. The IRC 7874 regulation merely required that the newly created foreign entity be limited to a less than 80% ownership in the international company by the U.S. corporation. Ironically, this legislation did not act as a deterrent because the U.S. corporation continued to maintain significant control over the foreign entity and the resulting reward of tax avoidance continued uninterrupted.

These newly minted mergers were labeled "acquisition inversions" and interestingly, the upper management of these foreign entities remains in the United States (Martin, 2014). In addition, rarely is any business activity moved from the United States to the new international tax avoidance haven (Hungerford, 2014). Essentially, the business remains the same as it was prior to the merger with one major incentive, a drastic reduction in the corporate tax payment.

## 1. The justification for inversion mania

Why would profitable corporations voluntarily relocate their business from the United States to Europe, for example? The primary motivating factor for any business decision is ultimately decided by the bottom line results. Stakeholders demand increased revenue and the resulting enhanced profitability from corporate decision-makers. In the recent problematic economy encountered by the United States since 2007, the ability to generate both revenue and profits has been undermined. There are always two solutions to the profit conundrum: either increase revenues or reduce expenses. Acquisition Inversions provided a viable option for the management team by reducing their income tax expense and thereby creating additional profitability. Corporations relied on the advice provided by their sophisticated accountants and lawyers, who advised them to essentially stash profits in the international community and, thus, avoid taxes (Sommer, 2014). The result has been an overwhelming cascade of support from

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the corporate investors. However, not everyone is applauding this tax avoidance strategy. President Obama essentially labeled parties to the tax inversion game as being unpatriotic (Sommers, 2014). Apple and General Electric are examples of two major corporations that have profited by their overseas tax strategy. Ironically, Walgreens has suffered financially from their decision to *not* embark on an international merger in response to consumer backlash.

Over the last ten years, approximately 50 corporations have enjoyed the benefits reaped by the tax avoidance inversion game (Ohlemacher, 2014). The income essentially earned internationally and thus not subject to the U.S. IRC is accumulated in an overseas account. These funds are subsequently "loaned" to the U.S. inverter as a means of receiving the use of the funds without triggering the resultant tax. Not only does the U.S. inversion result in tax avoidance for the inverted corporation, but any interest expense incurred due to the "loan' is tax deductible to the inverter. That would essentially be deemed a "win-win" by the stakeholders and management team of the inverted entity. Not only does the tax expense decline dramatically, but additional interest expenses are recognized to further reduce any remaining tax burden. In addition, any differences between the income tax expense reported on the income statement, and the actual tax paid according to the corporate tax return, is merely reported as a deferred tax liability. Tax deferred liabilities are regarded by many investors as a debt that will rarely, if ever, be satisfied. Accumulated and future foreign income can also be repatriated to the U.S. stakeholder tax-free through dividend payments once again disguised as loans.

The first corporations to embark on the inversion process prior to the 2004 legislative restrictions imposed by IRC 7874 technique, proved to be a success story for both the tax avoider and the stakeholders. According to data collected on the first group of inverters, their stocks outperformed the financial markets in a clear justification for the behavior (Sommers, 2014). Anytime a corporation can reduce expenses, regardless of the ethical component of the decision, Wall Street cheers. Increased profitability, even at the expense of U.S. economic strength is viewed as a positive in a capitalistic economy. The corporate manager is viewed as merely doing their job.

## 2. The impact of tax inversions on the US economy

The result of U.S. corporations fleeing to international domiciles in an attempt to reduce their perceived tax burden has devastating consequences for the U.S. economy. The argument that the inequitable tax system in the United States places the domestic based corporations at an economic disadvantage in the international arena provides the rationale for the questionable behavior (Hungerford, 2014). Many critics of the inversion mania state that the inverted U.S. corporations are unfairly benefitting from the U.S. economy without paying for those services. The issue of tax avoidance has resulted in a loss of over $90 billion in income taxes resulting from the change of address process, according to the 2014 Tax Fairness Briefing Booklet. In addition, they state that over $2.1 trillion in profits are being held off-shore to once again, avoid the payment of any tax on these earnings. This continuing trend serves to deplete the U.S. Treasury Department of billions of dollars in tax revenue annually. The ability of a corporation to merely move from being a domestic entity to an international one, albeit in name only, is tantamount to tax fraud (Sloan, 2014).

The inversion mania is essentially serving to undermine the entire premise of the U.S. Internal Revenue Code, and, it is being enacted legally. The current worldwide tax system embraced by the United States is cited as a primary motivating factor in addition to usurious tax rates, according to inverters (Pomerleau, 2014). If the inversion process allows a company to reduce and in some cases eliminate their tax expense, the resulting increased profitability is an irresistible outcome. The ability for a company to essentially justify tax evasion and rename it an acquisition inversion clearly delineates the problem with the current United States Tax Code. Whenever tax policies essentially serve as a deterrent to business, the overall economy will suffer. Not only are U.S. corporations fleeing to more tax friendly havens, investors are reluctant to provide the much needed capital necessary for economic growth for fear of negative tax consequences. Well-known companies, namely Burger King and General Electric have essentially jumped on the inversion bandwagon and have served to undermine the financial resources of the U.S. Treasury.

## 3. Impeding the inversion conversion mania

The United States must plug up this giant loophole or the flow of domestic corporations fleeing to international tax havens will not subside. According to the Cato Institute, corporations are "inverting out of this country" because of the great disparity in global tax rates. Corporate tax rates range from a high of 40% in the United States to a low of 19.7% according to an analysis prepared by a leading international accounting firm KPMG (Edwards, 2014). Embedded in the global averages for the over 134 countries included in the KPMG data, is places like Ireland, where the average tax rate is a mere 12.5% (Holder, Boland, Politi, 2014). In addition, recent tax changes, enacted by the British Government labeled "business-friendly reforms" have only made the UK a more desirable destination for the U.S. inversion seekers (Holder, Boland, Politi, 2014). Clearly, the incentive to invert is overwhelming and irresistible to U.S. based entities. In addition, the profits currently trapped off-shore in an attempt to avoid taxes provides an additional incentive for U.S. corporations to invert. This issue was stated as the primary motivating factor in General Electric's inversion acquisition of Alstom of France. The reduction of corporate income taxes through creative tax loopholes has provided the U.S. Corporation with the tools necessary to achieve the desired result.

If the primary motivating factor in the inversion mania is the excessive U.S. corporate income tax rate, the answer appears to be very simple: lower the rate. Many U.S. Legislators have recommended that Congress reduce the rate to between 28%-25%. In addition, the IRC needs to be revised so the loopholes are eliminated and the U.S. tax reach ceases to be worldwide. Other critics of the inversion mania have suggested that the original IRC 7874 legislation be revised and to allow inversions <u>only</u> if the U.S. based corporation actually becomes a foreign entity (Hungerford, 2014). Furthermore, the percentage of U.S. based ownership allowed in the foreign entity should be reduced to less than 50%. Therefore, the foreign entity would actually "control" the newly formed company. Another proposal aimed at correcting the inversion mania attempts to limit the tax benefits derived by certain inverted entities. For example, if the inverted company continues to be managed and controlled from the United States, it would continue to be classified as a domestic entity regardless of the legal address of the business (Marples, Gravelle, 2014).

Another problematic issue pertains to a process called "earnings stripping." This transaction is implemented when the newly inverted foreign entity essentially "borrows" money from the U.S. company's off-shore account. These funds are then distributed to the stockholders in the U.S. disguised as a dividend. Clearly, this process which enables the U.S. company to have access to its off-shore funds without ever recognizing them as income or paying the requisite income tax must be rectified (Marples, Gravelle, 2014). The tax loophole revisions must include the limiting of an interest deduction on a tax return if, the sole purpose of the loan triggering the interest, was to avoid taxes. In addition, another proposal under consideration recommends the reclassification of the debt, borrowed from the international inverted entity and used to pay dividends, should be reclassified as equity. The reclassification from debt to equity would provide the transparency so needed in the corporate inversion process and provide accuracy in the financial reporting process (Marples, Gravelle, 2014). If the primary purpose for a company to engage in a business transaction is the avoidance of taxes, then that activity must be regulated and properly reported to the worldwide investing community.

## 4. Is tax reform a viable solution?

The ***Stop Corporate Inversions Act of 2015*** proposes that the prohibition of corporate inversions for tax purposes be allowed if the foreign corporation owns 50% or less of the new combined corporation. This is a marked increase from 20% to 50% (Goldberg, 2015). In addition, the legislation attempts to thwart the tax avoidance scheme by disallowing the inversion if the newly inverted combined entity continues to have significant business in the United States and continues to be managed and controlled in the US as well. However, the new legislation would also include an exclusion if the newly formed inverted entity would continue to maintain substantial business activities in a foreign locale. The ability to prevent corporations from finding loopholes in any legislation is an overwhelming problem which essentially results in tax avoidance maneuvers.

The best solution to the tax avoidance loophole problem rests in the tax reform arena. Corporations will continue to creatively interpret, with the assistance of their accounting and legal arsenal, any newly minted legislation aimed at increasing the corporate tax burden through the closing of the innovative loopholes. Therefore, congress must begin the arduous task of reforming the 1986 Internal Revenue Code in order to make the tax avoidance game stop. Clearly, the fact that the United States corporate income tax rate exceeds all other countries is the motivating factor in the inversion mania. Attempts to thwart the inversions by labelling the players as lacking in patriotic principles is merely a public relations campaign aimed at stopping a tidal wave of future loss of tax revenue. The corporate stakeholders will eventually embrace the concept of the unpatriotic corporate strategy if increasing profitability is the end result. The only way to stop the inversion mania is to correct the problem causing the behavior. No one can deny the primary motivating factor is the fact the US corporate taxes are "too high".

## Conclusion

The Internal Revenue Code is complex and overly complicated. There are many provisions that are deemed to be punitive in nature. Worldwide business entities have access to sophisticated accounting and legal maneuvers that will allow them to rectify whatever elements of the Internal Revenue Code they deem problematic. A plethora of loopholes that are implemented to avoid taxes viewed as impeding the earnings process, are a common occurrence. Corporate managers and decision-makers are rewarded for business activities that generate profits. They are not rewarded for abiding by the intent of the Internal Revenue Code. Therefore, as long as a domestic entity can find a way to reduce their tax expense, whether it is viewed as evasion or avoidance, they will do so. The job of the regulatory arm of the government is to ensure that all taxpayers, individual and corporate, pay the minimum tax required under the Internal Revenue Code. If taxpayers are able to evade their tax obligation through the implementation of a loophole, then the deficiency lies with the rules, not the taxpayer (Goldberg, 2015). The incentives to avoid taxes, provided by loopholes in the tax code, are irresistible to any taxpayer, both individual and corporate. The current inversion mania is merely a symptom of a larger problem: the Internal Revenue Code.

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