The Macrotheme Review

A multidisciplinary journal of global macro trends

European Tax Inversions

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Abstract

Tax inversions have recently been called the "hottest trend in M&A," reviving a flat market in corporate mergers and acquisitions. A tax inversion happens when a firm relocates its headquarters to another country and declares that new country as its domicile, primarily for the foreign country's lower tax rate.

Keywords: Tax Inversions

1. Introduction

Critics have called Warren Buffet "un-American" for financing the merger of U.S. fast food chain Burger King Worldwide Inc., with Tim Hortons Inc., a Canadian company. Structured as a "tax inversion," the merger will move Burger King's headquarters to Canada, and allow the new company to take advantage of Canada's lower corporate tax rate. Although Buffet, who is putting $3 billion into the deal, has defended the move as motivated by business rather than tax reasons, the increasing number of tax inversions in the U.S. has caused the government to seek to restrict such activity and condemn such moves as unpatriotic and evasive. In the context of increasing globalization, the tax inversion issue highlights the question of why, despite opposition, are established American companies leaving the U.S., and what that means for the future of U.S. businesses.

Tax inversions have recently been called the "hottest trend in M&A,"[i] reviving a flat market in corporate mergers and acquisitions. A tax inversion happens when a firm relocates its headquarters to another country and declares that new country as its domicile, primarily for the foreign country's lower tax rate. Currently, at 35 percent for corporate tax, the United States has one of the highest corporate tax rates in the world.

The current trend in structuring such moves is to acquire or be acquired by a foreign company, and then adopt the foreign company's headquarters. In reality, however, many firms simply change their headquarter address to a foreign address while keeping their core business operations within the U.S. This was considered a "naked" inversion because the firm relocation lacked business substance.

Styling these moves as "unpatriotic," President Obama has recently condemned tax inversions as nothing more than tax evasion, stating, "They're keeping most of their business inside the United States, but they're basically renouncing their citizenship and declaring that they're based somewhere else, just to avoid paying their fair share."[ii] To address this practice, in 2004 Congress passed Section 7874 under the American Jobs Creation Act to penalize firms that relocate for tax avoidance purposes. Under this Act, when a firm maintains its main business operations within the U.S. effectively changing only its mailing address overseas, the firm is still considered a U.S. firm and subject to the U.S tax code.

However, this has not deterred companies from trying. This year alone, many notable companies such as Burger King, Pfizer, Walgreens, and Abbvie, have attempted to relocate. Experts have forecasted that Treasury will lose approximately $15 to $20 billion from tax inversion over the next 10 years. As a result, tax inversions have become a pressing issue in both the market and with Congress.

Table 1: Recent Tax Inversions

Year	US Company	New Incorporation
Pending	Steris	England
Pending	Civeo	Canada
Pending	Burger King	Canada
Pending	AbbVie	Jersey
Pending	Mylan	Netherlands
Pending	Medtronic	Ireland
Pending	Chiquita Brands	Ireland
Pending	Applied Materials	Netherlands
2014	Horizon Pharma	Ireland
2014	Theravance Biopharma	Cayman Islands
2014	Endo International	Ireland
2013	Perrigo	Ireland
2013	Actavis	Ireland
2013	Liberty Group	England
2013	Tower Group	Bermuda
2012	Stratasys	Israel
2012	Eaton	Ireland
2012	DE Master Blenders 1753	Netherlands
2012	Tronox	Australia
2012	Rowan	England
2012	Aon	UK
2012	Jazz Pharmaceuticals	Ireland

Source: Bloomberg

2. Why Companies Chose Tax Inversions

At 35 percent, the U.S. has one of the highest corporate tax rates in the world. Even after tax breaks and tax credits, U.S. firms still rank some of the highest in corporate taxes owed. In addition, the U.S. is one of the few countries that require corporations to pay taxes on income earned overseas. Most OECD nations, notably the U.K. and Canada, tax only on domestic profits, not foreign income. As globalization increases the reach of U.S. companies, the incentives to move abroad and protect foreign-earned income are understandably attractive.

This incentive has led to 47 tax inversions in the last ten years, more than double the previous two decades combined.[iii] Firms are able to save a significant amount of cash through tax inversion; for example, by moving to Switzerland, Walgreen could reduce its effective tax rate from 37 percent to 24.2 percent, which would mean estimated savings of $797 million in taxes in 2016 fiscal year.[iv] Corporate expatriations lower tax expenses and result in increased cash flow and earnings for balance sheets. Studies have also found that when corporations do invert, CEO compensation has increased; as if corporate tax savings and increased cash flow were not enough, such likelihood of increased compensation provide an additional incentive for upper management to promote inversion.[v]

Moreover, corporate expatriations have restructured companies to avoid paying U.S. taxes on their foreign earnings. Because the taxable event is triggered when companies move cash back to the U.S., many U.S. listed firms have retained their cash abroad, where their profits are earned. Not surprisingly, the amount of cash overseas is at a record high, estimated to be $1.64 trillion.[vi] In addition, when firms need to move some part of their cash into the U.S., they have often needed to structure loans to their domestically owned or affiliated corporations in order to skirt the repatriation tax. However, a significant amount of the cash often remains trapped in the foreign location. Tax inversion avoids this logistical hurdle and allows firms to move cash more freely across borders.

3. Government's Recent Attempts to Capture Foreign Income

To penalize firms that relocate for tax avoidance purposes, Congress issued Section 7874[vii] under the American Jobs Creation Act. This regulation became effective for all firms that inverted after March 4, 2003. Congress specifically tried to target firms that relocated for tax saving purposes by using a surrogate foreign corporation. Under Section 7874, after a corporation or partnership acquires another foreign corporation or partnership, if 80 percent or more (by vote or value) is still held by former shareholders and partners of the expatriated U.S. entity and has substantial business activities within the U.S., then that entity is still subject to the U.S. tax code. However, if only 60 percent or less (by vote or value) is held by U.S. shareholders and the core business operations remain in the U.S., then the corporation or partnership may be deemed a foreign entity for tax purposes. However, for the following ten years, that corporation or partnership would still be subject to certain U.S. tax regulations, such as taxing inversion gain and the ability to offset gains with tax credits, net operating losses, and other exclusions.

Section 7874, as implemented in 2004, was vague and difficult to interpret, especially as to how one determines whether a firm had "substantial business activities" abroad. Accordingly, the U.S. Treasury issued the 2006 Regulations, which mentioned factors such as such as historical and current conduct of the business activities, performance in the foreign country by upper management based in the foreign country, and ownership by foreign or domestic residents. In addition, the 2006 Regulations articulated a "safe harbor" test to determine whether a firm had substantial business activities overseas. The safe harbor test stated that "substantial business activity abroad" required at least 10 percent of a firm's global employees, assets, and revenue be located in the foreign country.

Three years later, the U.S. Treasury closed more loopholes by issuing the 2009 Temporary Regulations, focusing on a few more elements. First, it prevented firms from acquiring multiple entities to circumvent Section 7874; instead, for tax purposes the Regulations treat all entities as one. Secondly, the 2009 Temporary Regulations eliminated the 2006 safe harbor test and required a "facts and circumstances" test to determine whether substantial business activities were overseas. Furthermore, the 2009 Temporary Regulations also addressed treatment of certain stock when determining ownership and insolvency with debtors.

Despite such regulation, firms continued to invert to foreign locations. As a result, in the summer of 2012, the U.S. Treasury created the 2012 Regulations, rescinding the 2006 Regulations and replacing the former 10 percent test with a bright-line test. The bright-line test specifies 3 different requirements to determine if the company is subject to U.S. tax:

1. The number of employees based in the foreign country is at least 25 percent of the total number of employees worldwide, and the foreign employees' compensation is at least 25 percent of the total employee compensation worldwide.
2. The value of the assets in the foreign country must be at least 25 percent of the total assets for the firm worldwide.
3. Income from the foreign country is at least 25 percent of the total income for the firm worldwide.

To deter firms from moving accounts solely to satisfy these requirements, the U.S. Treasury also requires that these tests be met at the expatriation date. Failure to pass this test means the firm must pay taxes. The effect of the 2012 Regulations is that it has become significantly more difficult for companies to successfully invert.

4. Current Trends Toward Relocation

Within the last two years, about a dozen well-known large companies have tried to relocate. Many of these firms are in the pharmaceutical industry, such as Abbvie, Mylan, and Pfizer. The popular destinations for relocation have been Ireland, Canada, Netherlands, and the U.K.

Many firms that have successfully inverted have seen an increase in their overall value, especially in the pharmaceutical industry. However, despite the potential for tax savings, other firms have experienced underperformance after inversion. A recent Reuters study[viii] analyzed 52 completed inversion transactions and has discovered that:

1. 19 out of 52 companies have outperformed the S&P 500 index after inversion;
2. 19 out of 52 companies have underperformed the S&P 500 index after inversion;
3. 10 companies have been bought by competitors
4. 3 companies have gone out of business
5. 1 company has reincorporated back in the U.S.

The underperformance can be contributed to a number of factors: first, the restructuring involved with changing the domicile of a firm can add up to a significant amount of restructuring costs that may not pay off; second, tax savings can potentially help but not ensure stock outperformance; third, firms that invert may be perceived as unpatriotic and lose customer base and loyalty.

Nonetheless, given the continued trend of firms inverting, policy makers have been seeking more regulations to curb this type of activity. Given the potential tax savings firms receive when inverting, the U.S. Treasury and Congress are concerned that a "herd effect" is occurring - that is, companies' success in inverting their corporate domicile have encouraged more firms to seek tax inversion. To address such problem, experts have advised Congress to further change the tax code surrounding inversion and deductions on debt. However, it remains highly uncertain whether Congress will agree upon a new regulation or whether they can stop tax inversion activities through regulation.

Impatient with the Congress' inaction, the US Department of Treasury unilaterally announced new rules on September 22nd, 2014, which will make it harder for US companies to invert. Specifically, the new rules will stop non-US subsidiaries of inverted companies from making loans to their new foreign parent as a way to avoid paying US tax. The Treasury is also making it harder for a US company to meet the current rules for inversion – for example, the new rules prohibit the use of certain assets to drive up the size of the foreign merger partner in order to meet the requirement that the foreign partner must own more than 20 per cent of the new company. Additionally, the new rules also prohibit US companies from paying special dividends or spin off part of their company in order to reduce their own size.

5. Implications for U.S. Businesses

Repeated revisions to a vague and overreaching tax law fails to address the underlying and fundamental problem: the fact that U.S. corporate tax is and continues to be the highest among our trading partners and that it taxes foreign-earned income. In a global market, U.S. companies compete in foreign markets against firms based in other countries that have lower tax rates with exemptions for foreign business income. Inversions help U.S. firms compete by shaving off extra layer of tax on foreign operations.

Instead of name-calling and attacks on the lack of patriotism of U.S. companies and their officers and investors, perhaps we need a rational consideration of U.S. businesses and their ability to compete worldwide. For example, companies based in Europe have an average corporate tax rate of just 20 percent. In Canada, the corporate tax rate used to be 28 percent in the 1990s, but has been lowered to just 15 percent today. If Congress wishes to avoid companies relocating or restructuring their companies to avoid taxation of foreign income, it starts with a recognition that the U.S. cannot continue to charge the highest rate of corporate tax when the global market for hosting corporations is hospitably lower. Moreover, in this fiercely competitive global economy, if U.S. businesses are to remain dominant, Congress must make serious efforts to restructure tax incentives to draw in, rather than drive away, U.S. business.

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