The Heritage Foundation

BACKGROUNDER

No. 2950 | SEPTEMBER 4, 2014

Business Inversions: Tax Reform Is the Only Way to Curb Them

Curtis S. Dubay

Abstract

A recent surge of interest in U.S. business inversions—when an American company merges with a foreign business and moves the combined business's headquarters to the foreign country—has precipitated calls for Congress to put an end to the practice. Inversions are a problem because they are a symptom of a broken tax system that is hurting the U.S. economy. The policies currently proposed to staunch the flow of businesses from the U.S. will not work because they do not address the cause—the tax code's high business tax rate and antiquated way of taxing multinational businesses (the so-called worldwide system), which puts American businesses at a steep disadvantage. Only modernization, by reducing the business tax rate and moving to a territorial system through tax reform, can stop the wave of inversions.

A recent surge of interest in U.S. business inversions—a process whereby an American company merges with a foreign business and moves the combined business's headquarters to the foreign country—has precipitated calls for Congress to put an end to the practice.

The American public and lawmakers are rightfully concerned about businesses moving their headquarters abroad. As the residents of St. Louis found out when Anheuser-Busch merged with the Belgian company InBev in 2008 and moved the merged headquarters to Antwerp, cities that lose the headquarters of major businesses suffer a reduction of community involvement and, eventually, high-quality jobs.

The policies currently proposed to staunch the flow of businesses from the U.S. will not work because they do not address the cause:

Key Points

- Business inversions—when a U.S. business merges with a foreign company and locates the newly formed business's headquarters in the foreign country—are increasing in the news.
- The anachronistic way in which the U.S. taxes businesses, especially multinational companies, makes the decision to locate a merged business's headquarters abroad a straightforward one.
- The U.S. has the highest business tax rate among developed countries and is one of the few that attempts to tax its companies' foreign income. These factors make it unattractive for a merged business to domicile in the U.S.
- Several proposals put forth in Washington so far will do little to curb inversions, because none of them attempts to fix these prime motivators for inversions.
- Lawmakers desire a quick fix, but there is none. They need to focus their energy on tax reform, because that would allow them to fix the broken tax system that is the root cause of inversions.

This paper, in its entirety, can be found at **http://report.heritage.org/bg2950**

The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

the tax code's antiquated way of taxing businesses, especially multinational ones. Only modernizing the system can stop the wave of inversions.

Pre-Inversion Mergers

Headlines about U.S. business inversions generally focus on the tax impacts of such moves. They miss that the mergers preceding an inversion are pursued for business and economic reasons before the merging businesses consider the tax implications of their merger. In fact, recent mergers that led to inversions tended to involve businesses that saw complementary aspects in each other that would better allow them to exploit new opportunities by joining forces. Once merging businesses agree that combining makes sense, they decide on particulars, such as where to locate the newly formed business's headquarters.

> Foreign businesses have increased profits and efficiency as they enjoy enhanced corporate synergies that come from expanding to new markets. U.S. businesses sacrifice market share and efficiency because the U.S. tax law prevents them from making the same investment.

Once a U.S. business and a foreign business decide that a merger makes sound business sense, the decision to locate the newly formed business's headquarters in the foreign locale is an easy one because of the uncompetitive and outdated way the U.S. taxes multinational businesses. Nevertheless, businesses seldom engage in the tremendous amount of work that a merger requires solely for tax reasons.

Inversions are a problem because they lead to the loss of high-level jobs and community involvement; their negative impact on the overall economy and tax revenues is relatively minimal.

Some believe that inversions result in substantial revenue loss, but inverting only reduces the amount of U.S. tax that U.S. businesses pay on their future foreign income. It does not reduce the amount of tax they owe on the income they earn domestically. A business that inverts still owes the U.S. tax on its previously accrued foreign income, although inverting may reduce that tax liability. As a result, there are revenue losses from inversions, but they are small—roughly 0.4 percent of corporate tax revenue over 10 years.[1]

Job losses from inversions are slight, especially at first. An inversion does not change the functioning of a business, just the address of its headquarters. Job losses could occur because of the restructuring a newly merged business might undertake. Since the merger would probably have occurred regardless of the decision to invert, those job losses would have happened no matter where the business's headquarters ended up. Over time, jobs could be lost as corporate and executive functions migrate from the U.S. to the new foreign location. This is one reason why it is important that Congress fix the underlying cause of inversions.

Short-Term and Long-Term Tax Motivations for Inversions

There are both short-term and long-term reasons why the U.S. tax system motivates a U.S. business that merges with a foreign one to invert. Both reasons play a role in the current surge of inversions, but it is unclear which one is larger.

Short-Term Motivation. When a business inverts, it lowers the total amount of tax it pays. This reduces its effective tax rate, boosts after-tax earnings, and raises share prices. This makes shareholders happy and makes managers look more successful.

This is a short-term motivation because the bump in profitability happens soon after the inversion, and its benefits accrue to shareholders and management quickly. For those predisposed to believe that management acts for immediate benefits, this explanation fits neatly.

As explained above, the amount of tax that the business pays falls because it no longer has to pay U.S. tax on its future foreign earnings. The U.S. has the highest corporate tax rate among developed nations in the Organization for Economic Co-operation and Development (OECD). In conjunction with the worldwide system that the U.S. employs, this means that U.S. businesses pay that high rate on their global income. Inverting allows them to escape that high rate on their foreign income going forward.

1. Kyle Pomerleau, "How Much Will Corporate Tax Inversions Cost the U.S. Treasury," Tax Foundation *Tax Policy Blog*, August 14, 2014, http://taxfoundation.org/blog/how-much-will-corporate-tax-inversions-cost-us-treasury (accessed September 2, 2014).

The U.S. ended up with the highest rate because other industrialized countries sharply reduced their rates in the process of modernizing their systems for the 21st-century global economy beginning more than 20 years ago. During that time, the U.S. has done nothing to update the way it taxes its businesses.

Inverting can also lower the business's taxes by increasing earnings stripping. That is a process where U.S. businesses take out loans from foreign affiliates, on which the American companies pay interest. The interest is income for the foreign lender, and a deductible expense in the U.S., hence it "strips" income from the U.S. and sends it to a lower-taxed jurisdiction. This reduces tax owed to the U.S.

There is evidence that inversions lead to increased earnings stripping.[2] However, that evidence came before Congress passed anti-inversion legislation in 2004.[3] The extent to which those policies have reduced the ability of businesses to strip income has yet to be determined.

Inversions can also allow U.S. businesses to repatriate accumulated foreign earnings that business hold offshore and avoid triggering U.S. tax. The U.S. taxes foreign earnings only when they are brought back to the U.S. An inversion can potentially facilitate bringing that money back tax-free through a complicated string of financial maneuvers known as hopscotching.[4]

Long-Term Motivation. The other explanation is long term in nature because it concerns how the worldwide tax system that the U.S. employs reduces the competitiveness of U.S. businesses looking to compete in the global market.

The U.S. tax system taxes businesses headquartered in the U.S. on the income they earn abroad. Only a handful of other developed countries use such a system, and those that do have tax rates on par with other developed nations.[5] Therefore, because non-U.S. businesses domiciled in countries that have worldwide tax systems pay tax on their foreign income to their home country based on the difference between the taxes they paid in the foreign country in which they earned the income and what they would have paid had they earned it at home, the worldwide systems in these businesses' home countries are less of a problem because those businesses pay little extra tax on their foreign income. U.S. businesses pay the same differential on their foreign income, but the U.S. tax rate is the highest in the developed world and far above the average of other developed countries in the OECD. Therefore, U.S. businesses owe the U.S. government significant tax on their foreign earnings. That makes the worldwide system a substantially larger problem for U.S. businesses.

The vast majority of countries in the OECD, 27 of 34,[6] use a territorial system that taxes businesses (headquartered domestically or abroad) only on the income they earn within the country's borders. Many of these countries made the move to territorial systems when they modernized their systems in recent years.

When U.S. businesses look to expand in growing foreign markets, the worldwide system puts them at a steep disadvantage compared to businesses headquartered in these countries, and the few with worldwide systems but lower rates. The extra tax that U.S. businesses would owe if they made the investment in a new and growing market raises the pre-tax rate of return that the businesses need the investment to meet in order to justify taking the risk. This threshold is known as the hurdle rate.

A higher hurdle rate causes U.S. businesses to bypass certain investments that they would have made in the absence of the worldwide system. Unencumbered by an extra layer of tax levied by their home countries, the American firms' foreign competition can make those investments.

The foreign businesses that are free to make the investments (that the worldwide system prevents U.S. businesses from making) see their profitability

2. U.S. Department of the Treasury, "Report to Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties," November 2007, p. 21, http://www.treasury.gov/resource-center/tax-policy/Documents/ajca2007.pdf (accessed August 26, 2014).
3. American Jobs Creation Act of 2004, Public Law 108-357.
4. Edward Kleinbard, "'Competitiveness' Has Nothing to Do with It," USC Gould School of Law, August 5, 2014, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2476453## (accessed August 13, 2014).
5. Curtis S. Dubay, "A Territorial Tax System Would Create Jobs and Raise Wages for U.S. Workers," Heritage Foundation *Backgrounder* No. 2843, September 12, 2013, http://www.heritage.org/research/reports/2013/09/a-territorial-tax-system-would-create-jobs-and-raise-wages-for-us-workers.
6. Ibid.

and their efficiency rise as they enjoy enhanced corporate synergies that come from expanding to new markets. U.S. businesses, by contrast, lose market share and fall behind on efficiency because the U.S. code shuts them out of making the same investment.

If this process plays out long enough, in enough potential markets, it can destabilize the U.S. business's position in its industry and put the company at risk for takeovers or worse. Given this heightened risk, it is understandable why businesses are eager to get out from under the anachronistic U.S. corporate tax code.

Inverting allows U.S. businesses to compete on equal footing with their industry rivals because, once re-domiciled in a country with a territorial system, their future earnings outside the U.S. no longer face the extra tax imposed by the U.S. worldwide system. Inverting removes the artificial tax barrier to investing in new markets created by the worldwide system.

Often forgotten in stories about inverting businesses is that it would make little sense for a U.S. business and a foreign one to be headquartered in the U.S. after a merger. If they located in the U.S., they would subject all the foreign business's income earned outside the U.S. to U.S. tax for the first time because of the worldwide system, spreading the uncompetitiveness of the U.S. system.

Current Plans in Congress Will Not Stop Inversions

Instead of focusing on reforms that would reduce the short-term and long-term incentives for businesses to invert, Members of Congress have proposed three plans that will be unlikely to stop inversions.

Raising the Foreign Ownership Threshold. Senator Carl Levin (D–MI) proposes raising the percentage that a newly merged business must be foreign owned before it can invert its headquarters abroad from 20 percent foreign ownership to 50 percent.

Businesses eager to shake free of the burdensome U.S. corporate tax system will find ways around the higher ownership requirement, even when the foreign firm is smaller than the U.S. business. Making such deals work is what investment bankers exist to do.

The higher foreign ownership threshold could be dangerous because, instead of stemming the tide of inversions, it could ramp up the outright acquisition of U.S. businesses by foreign ones. If U.S. businesses are frustrated in their efforts to invert and shake free of the onerous U.S. tax code, they could become, most likely willingly, prime takeover targets for large foreign businesses. If they are bought, instead of inverted, the U.S. will see more significant job losses because more functions of the business will relocate abroad more quickly than under an inversion.

Inverting allows U.S. businesses to compete on equal footing with their industry rivals because, once re-domiciled in a country with a territorial system, their future earnings outside the U.S. no longer face the extra tax imposed by the U.S. worldwide system.

The Levin plan could also have the perverse effect of increasing inversions, even if it is retroactive. It could send the signal to businesses that Washington is not serious about fixing the broken tax system, and that it will become more hostile to them as they seek to minimize its negative impact. Businesses that had hoped for the relief of tax reform, and that find ways around the higher ownership threshold, therefore might see inverting as a more inviting prospect than they do today.

Denying Federal Contracts to Inverted Businesses. Another proposal by Members of both the House and Senate—Representative Rosa DeLauro (D–CT), Senator Levin, Representative Lloyd Doggett (D–TX), Senator Dick Durbin (D–IL), Representative Sander Levin (D–MI), and Senator Jack Reed (D–RI)—would deny federal contracts to businesses that invert. This is a vindictive measure. It would only punish businesses for doing something of which Congress disapproves. Businesses that invert are not breaking any laws.

From a business and economic standpoint, it would have a negligible impact on inversions. However, the discussion of such a policy had a chilling effect on Walgreens' plan to invert. The pharmacy chain had planned an inversion with Alliance Boots, a Swiss pharmacy company of which Walgreens previously purchased a significant share, before some lawmakers put substantial political pressure on Walgreens by suggesting it could lose business it currently enjoys through the Medicare and Medicaid programs. Other businesses that look to invert will likely have less business with the federal government.

This proposal would also set up an unequal circumstance where foreign businesses that never merged with a U.S. business are allowed to secure government contracts, but foreign businesses that did merge with a U.S. business could not.

Reducing Interest Deductions on Loans from Foreign Affiliates. The third set of proposals originates with Representative Levin (co-sponsor of the previous proposal) and Senator Charles Schumer (D–NY). They would make it more difficult for U.S. businesses to take out loans from their foreign affiliates. They would do so by denying interest deductions in circumstances where the U.S. companies had debt over a certain level.

The scopes of their bills vary. The Levin bill would apply to all businesses, whether they inverted or not. The Schumer bill would likely apply only to those businesses that invert, although tailoring the legislation to apply so narrowly will be difficult. Under Senator Schumer's proposal, inverted businesses would have to seek special approval from the Treasury for intracompany loans until 10 years after the inversion.

The plans would also limit "loss carry-forward" amounts. Businesses are rightfully taxed on their average profitability, rather than a 12-month snapshot. As such, if a business has a loss in a previous tax year that is greater than its income, it can carry forward expenses it could not deduct and apply them to future income.

These proposals are about preventing earnings stripping, which is one of the many reasons for inversions. Because of the high rate, businesses that operate in the U.S., regardless of where they are headquartered, have an incentive, and the means, to move income earned in the U.S. to lower-tax countries if they have excess domestic cash flow. Anti–earnings-stripping rules are already in place to prevent businesses from shifting too much of their income abroad using this method. Such policies are necessary under all international tax regimes, including the current worldwide system. If the U.S. moved to a territorial system, those policies on the books would need to remain and might need strengthening.

Instituting the Levin or Schumer plan could put a damper on inversions by lessening one of the many incentives to invert, but neither would remove it completely because the other incentives would remain fully in place. Nor is there any way to know how much more effective the changes would be at reducing earnings stripping than the policies that are already in place.

Furthermore, the debt thresholds over which Representative Levin and Senator Schumer would deny interest deductions appear arbitrary, rather than tied to a measure of economic substance. And the limitation on loss carry-forwards would cause businesses to overstate their incomes in certain years, and therefore pay more tax than they should.

If they apply to more than just U.S. businesses that invert, the plans could have a substantial negative impact on investment in the U.S. by foreign businesses if those businesses are afraid that their current intra-company financing practices will run afoul of the new rules and decide to curtail their activities in the U.S. market. A similar effect could happen if U.S.-domiciled businesses are constrained from borrowing domestically and rely on financing from foreign affiliates. This circumstance is unlikely in the current economic environment, but could become more of an issue in the future. Less investment would slow growth and job creation.

Obama Administration and Treasury Acting Alone

The Obama Administration has signaled that it is looking for ways, through the Treasury Department, that it can act unilaterally using existing rules and regulations to curb inversions.

The actions it may take would include: broadening the already existing penalties that apply to certain international transactions; disqualifying certain types of stock for purposes of determining ownership shifts; expanding subpart F income to include foreign income of inverted businesses; limiting the ability of inverted businesses to take on debt without congressional action; making it more difficult for foreign subsidiaries of U.S. businesses to change their organizational status (out-from-under transactions), which would reclassify them as subsidiaries of foreign affiliates; and limiting access to accumulated foreign earnings after an inversion by preventing hopscotching.[7]

7. Mindy Herzfeld, "News Analysis: What Can Treasury Do About Inversions," Tax Analysts *Tax Notes Today*, August 25, 2014.

It is doubtful that Treasury has the authority to make all of these changes under current law. Even if it does, at best it could only slow down the wave of inversions. These changes could reduce the short-term incentive to invert by making it harder for businesses to reduce their effective tax rates quickly. However, the long-term incentive will remain because the worldwide system would still make U.S. businesses uncompetitive when it comes to investing in growing foreign markets.

Tax Reform Best Fix for Inversions

The plans in Congress and potential actions by the Administration are too ad hoc and piecemeal to reduce the incentives for businesses to invert. They are also unwarranted economic interventions for the most part. Even if they could curtail inversions, they would not be appropriate.

Tax reform is the best venue to reduce those incentives significantly because it would enable Congress to tackle the problems with the current business tax system that create both the short-term and long-term inducements to invert.

Lower Tax Rate Necessary for Relief of Short-Term Pressures. Congress can best address the short-term desire by businesses to reduce their effective tax rates by lowering the U.S. corporate tax rate. At 39.1 percent when including the average of state rates it is almost 15 percentage points higher than the 25 percent average of other developed countries in the OECD.

Lowering the rate so it is on par with that average would substantially reduce the benefits of earnings stripping and the other factors that increase businesses' effective tax rates.

Territorial Taxation Needed to Limit Inversions. A lower rate would reduce the tax on businesses' future foreign income, but the worldwide system would still remain a problem for businesses and therefore a reason to potentially invert.

As long as the U.S. taxes global income, U.S. businesses will remain at a competitive disadvantage when it comes to investing in new foreign markets even if Congress lowers the rate significantly, because there will still be several countries with lower rates than the U.S. rate. Foreign businesses from countries with territorial systems will retain a comparative advantage in those places. As such, the U.S. needs to institute a territorial system as well.

Under a territorial system, U.S. businesses would pay tax on foreign income only in the countries where they earn that income—just like their foreign competitors.

Under a territorial system, U.S. businesses would pay tax on foreign income only in the countries where they earn that income—just like their foreign competitors. They would no longer owe extra tax to the U.S. on income earned outside its borders, so the hurdle rate on all new foreign investments would fall, making more of them viable. More foreign investment, in addition to relieving pressure to invert, would be a boon to U.S. workers because it would also raise domestic investment, which would raise incomes and create jobs.[8]

Businesses would continue paying the same amount of tax on their U.S. income. It would only reduce taxes on their foreign income. Many claim that a move to a territorial system reduces U.S. tax, but that is only an issue if one believes that it is right for the U.S. to tax the foreign income of its businesses. However, the economics of multinational taxation make clear that the U.S. should not tax income that American businesses earn abroad.[9]

A territorial system, or dividend-exemption method (essentially the same thing), requires strong anti–base-erosion and anti–profit-shifting policies. Without them, businesses could shift income that should be U.S.-sourced income to lower-taxed jurisdictions and unjustifiably lower the U.S. tax that they owe. Chairman of the House Ways and Means Committee Dave Camp (R–MI) recently released a tax reform proposal that would establish a dividend-

8. Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., "Domestic Effects of the Foreign Activities of U.S. Multinationals," *American Economic Journal: Economic Policy*, Vol. 1, No. 1 (February 2009), pp. 181–203.
9. Dubay, "A Territorial Tax System Would Create Jobs and Raise Wages for U.S. Workers."

exemption system for the U.S. He rightfully included such policies.[10]

Conclusion

Lawmakers desire a quick fix for inversions, but, as the proposals put forth so far show, this is not a problem they can resolve in short order. It requires addressing the underlying cause motivating inversions, which is the anachronistic corporate tax system. That is best done through tax reform that lowers the tax rate for businesses and moves to a territorial system.

As long as other countries have lower tax rates and lax income-shifting rules, there will be incentives for businesses to move their headquarters to those countries.[11] Tax competition is helpful in encouraging countries to enact pro-growth tax systems. Tax reform would vastly improve the U.S.'s position relative to other developed nations and be the best thing Congress can do to curb inversions.

Current efforts in Washington fall well short of tax reform. Rather than waste time and effort on policies that will do little to limit inversions, Congress and the Obama Administration should focus their attention on finally overhauling the broken tax code.

*—**Curtis S. Dubay** is Research Fellow in Tax and Economic Policy in the Thomas A. Roe Institute for Economic Policy Studies, of the Institute for Economic Freedom and Opportunity, at The Heritage Foundation.*

10. Discussion Draft, "Tax Reform Act of 2014," Committee on Ways and Means, U.S. House of Representatives, 113th Cong., 2nd Sess., February 21, 2014, http://waysandmeans.house.gov/uploadedfiles/statutory_text_tax_reform_act_of_2014_discussion_draft__022614.pdf (accessed August 13, 2014).
11. Martin A. Sullivan, "Will Tax Reform Stop Inversions," Tax Notes *Economic Analysis*, August 4, 2014, pp. 530–531.