The real story behind corporate (tax) inversions

October 16, 2014 by stevenyoder Leave a Comment

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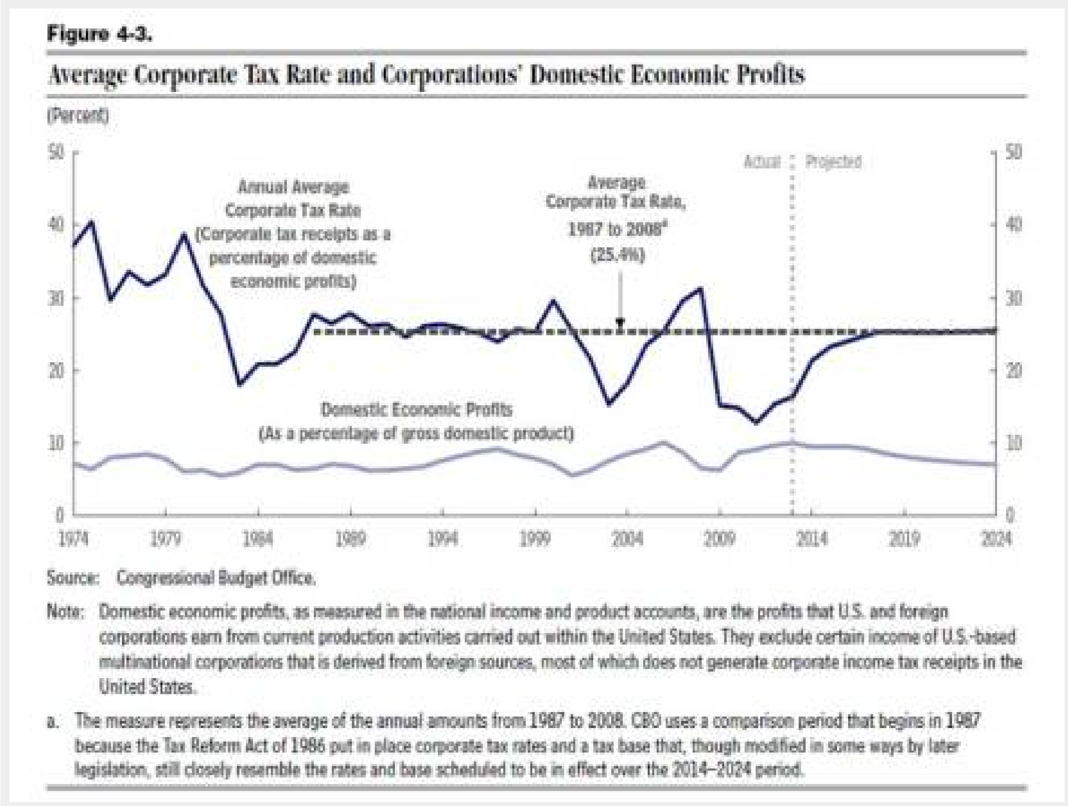

Figure 4-3.

Average Corporate Tax Rate and Corporations' Domestic Economic Profits

Source: Congressional Budget Office.

Note: Domestic economic profits, as measured in the national income and product accounts, are the profits that U.S. and foreign corporations earn from current production activities carried out within the United States. They exclude certain income of U.S.-based multinational corporations that is derived from foreign sources, most of which does not generate corporate income tax receipts in the United States.

a. The measure represents the average of the annual amounts from 1987 to 2008. CBO uses a comparison period that begins in 1987 because the Tax Reform Act of 1986 put in place corporate tax rates and a tax base that, though modified in some ways by later legislation, still closely resemble the rates and base scheduled to be in effect over the 2014–2024 period.

Pity drug company Mylan. This summer, the *New York Times* ran a piece on the firm's decision in July to merge with a European drug maker and relocate to the Netherlands, where tax rates are lower. With the move, Mylan's effective rate will go from its current 25 percent to the high teens. Mylan CEO Heather Bresch told the *Times* that she entered the deal reluctantly.

About 22 U.S. companies have over the last three years have made deals like that–so-called "corporate inversions." In those transactions, a U.S. multinational renounces its U.S. citizenship by combining with a smaller company in a foreign country–ostensibly to lower its tax rate. But the real story is more complicated.

Buried in the *Times* article inside parentheses is a curious sentence: "Ms. Bresch insists that the merger is being driven mostly by its strategic merits, and that the lower tax rate is just an added benefit."

That's not just spin, say experts–**other factors indeed are driving these inversion deals**.

Federal Reserve policy is one. U.S. stocks are at all-time highs and interest rates near all-time lows. That makes mergers and acquisitions cheap and ubiquitous at the moment, according to international tax law expert Adam Rosenzweig of Washington University in St. Louis. So if a company has the cash or access to cheap credit to do a merger, it makes sense to also do an inversion at the same time.

Another is a peculiar American tax policy, but not the one that the mainstream press continues to blame–high corporate tax rates. American companies are taxed on profits that they earn overseas. But a loophole in U.S. law allows them not to pay what they owe the IRS until they send those profits back to their U.S. parent company. As a result, corporations keep their profits offshore to avoid paying U.S. taxes. It's sometimes known as the "deferral loophole."

But corporate inversions allow companies to put that hidden offshore money to use by investing it in the new foreign entity, using a range of tax avoidance schemes. That allows them never to repatriate their profits at all, meaning they don't pay what they owe. "This is undoubtedly the primary motivation to invert," notes economist Thomas Hungerford of the Economic Policy Institute in a September 2014 report.

A third, less important factor driving inversions is the pack mentality. Many companies are hoping to move before the government cracks down further on inversions, notes Center for American Progress tax expert Alexandra Thornton. And inversions' political value doesn't hurt either—companies can use the threat of inversions to pressure legislators to lower their taxes.

Much of the media coverage of inversions bolsters those efforts to move policymakers. The point of many inversion stories is that U.S. corporate tax rates are

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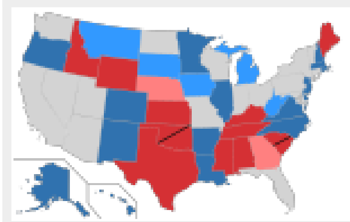

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Commentary: The 2014 US Midterms – The democratic election that wasn't American democracy is predicated on too high, which is forcing companies to flee abroad. An August article in the *Wall Street Journal*, for example, includes a chart labeled “Paying Top Dollar” that shows U.S. corporate tax rates at almost 40 percent (when federal and state rates are included). That gives the United States the highest *nominal* corporate rate in the Organisation for Economic Co-operation and Development, double those in European countries like Britain, Finland, and Iceland.

In fact, a 2014 report from the Congressional Budget Office shows that the *effective* corporate rate (what companies actually pay after their tax breaks are included) is far lower, averaging about 25 percent. That puts the U.S. rate right in the middle among OECD countries. More important, that’s an average, and the most profitable U.S. firms end up paying between and 13 and 17 percent, according to Thornton, which makes them the envy of their counterparts in Europe.

Indeed, even the tax rate that Bresch reported to the *Times*—25 percent—doesn’t match Mylan’s SEC filings. According to its 10-K report, the company’s tax rate was about 16 percent in 2013, 20 percent in 2012, and 18 percent in 2011. That makes its Netherlands inversion deal based on tax considerations a non sequitur.

And there’s evidence that **European countries themselves, the would-be beneficiaries of corporate inversions, may not be as happy about these deals as companies portray**. In July, the *Journal* reported that in Ireland, a key target of inversions because of its 12.5 percent corporate tax rate, policymakers are getting concerned. That’s because U.S. firms relocating to Ireland keep their operations in the United States, so Ireland sees little of the job creation, R&D investment, and economic growth that would accompany actual foreign investment. But because those Irish-in-name-only companies now show up in the Irish Gross Domestic Product, Ireland has to pay a larger share into the European Union.

In fact, Ireland may be starting to tighten its rules. On October 14, the Irish government announced plans to end the policy of allowing corporations to register in

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Ireland but actually reside in countries with no corporate income tax like Bermuda. That practice allows companies like Google to funnel their royalty earnings to their Irish unit and pay no corporate tax on those profits.

Government moves like that could be the beginning of what corporations pushing for lower rates really fear—more cooperation among OECD countries to crack down on corporate tax avoidance and harmonize rates and tax practices so that companies can't take advantage of differentials.

While an overhaul like that isn't on the short-term horizon, in **September the Obama administration announced new rules that may do a lot to curb inversions.** Among other provisions, they prevent companies from using their deferred overseas profits to make loans to the new foreign parent company—those loans now will be treated as U.S. property and therefore taxable. They also prevent inverted companies from keeping their deferred profits forever nontaxable by prohibiting them from using those profits in the new entity without paying U.S. taxes on them.

Those rules already are having an impact. On October 16, the board of drug company AbbVie reversed an earlier decision to merge with Irish drug maker Shire and reincorporate on a British isle that has no corporate income tax. The administration's "unilateral changes to the tax rules" had introduced an "unacceptable level of uncertainty" to the Shire deal, according to a *Los Angeles Times* report.

Beyond the administration's recent rule changes, tax experts agree that the U.S. code needs a sweeping overhaul. Any such reform would include not just lowering corporate rates but slashing through the thicket of exemptions and deductions that companies benefit from. A reworking of the code would create more transparency in the U.S. tax system and lower the *nominal* corporate rate. But it likely would do little to lower the *effective* rate.

And that could well be one of the goals of this year's wave of corporate inversions: to convince legislators that the only way to keep U.S. companies at home is to lower

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nominal corporate rates–while avoiding real tax reform.

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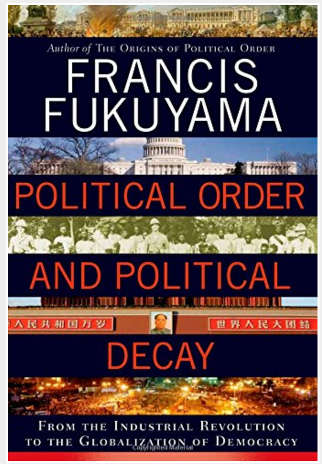

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