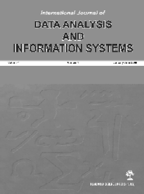
Research Science Press

International Journal of Data Analysis and Information Systems
VOLUME 8 • NUMBER 1 • JUNE 2016
journal homepage : serialsjournals.com

ISSN : 2229-5887


Impact of Corporate Inversions

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ABSTRACT

In recent years, there has been a proliferation of U.S. Corporations changing their legal location to a low or no tax foreign corporation's domicile via a sale, merger or repurchase of shares. As a foreign corporation, the high U.S. tax rate is only applicable to the portion of its income earned in the U.S. However, its non-U.S. source earned income is no longer subject to high U.S. taxes. Hence, in addition to many added benefits, the Corporation reduces its U.S. tax obligation but still maintains its material operations in the U.S. These practices are considered to be legal and strategic business practices. Nevertheless, these inversions are seen as contributing to huge lost revenue to the U.S. economy and should be curtailed. This paper discusses economic, political and other considerations related to corporate tax inversion strategies. Several possible solutions to curb these tax avoidance tactics are presented and discussed and could be of significant benefit to legislators, standard setters, researchers as well as a host of other interested parties.

Keywords: *Multinational Corporation (MNC), repatriation, tax inversions, tax havens, tax avoidance, tax evasion, double Irish arrangement, trapped earnings, earnings stripping, skinny-down, cash-boxing and un-repatriated foreign earnings.*

INTRODUCTION

Minimization of taxes through a practice known as "corporate inversions" has now become a common and pervasive practice among large Multinational corporations (MNCs). It is a strategy where a U.S. Corporation strikes a deal with a foreign entity, re-incorporates overseas and changes its domicile to a low tax jurisdiction. However, the corporation continues to operate in the U.S. and enjoys all of the rights and privileges provided by the U.S. without all of the taxes. Thus, the major benefit of an inversion is avoidance of U. S. taxes on foreign source earned income. Other benefits that accrue to a corporation are synergies of operations, economies of scale, ability to release trapped cash and long-term shareholder benefits.

In this paper, we discuss ways in which a corporate inversion is accomplished, reasons for inversions, the political, economic and other implications of corporate tax inversions. We also provide several examples of recent inversions. Further, we discuss the controversy surrounding these tax avoidance tactics. Finally, we explore possible strategies that can be utilized to curb corporate tax inversions. Issues examined in this paper can be useful to stakeholders, corporate managers, tax standard setters, legislators, researchers and others.

2. BACKGROUND

The U.S. has a worldwide approach to taxation. Hence, all of a U.S. Corporation's earned income is subject to U.S. taxes, no matter whether it is from U.S. sources or from foreign sources. Hence, a U.S. Corporation's earned income is taxed at the rate of 35% and income earned in foreign jurisdictions is taxed when it is repatriated (brought back) to the U.S. This may result in the earnings of a foreign subsidiary being taxed in the foreign jurisdiction and also being later subject to U.S. tax. Despite the fact that the U.S. Corporation may receive a credit or a deduction on taxes paid in the foreign jurisdiction, this may still sometimes result in double taxation of some of the Corporation's income.

However, a major objective of most MNCs is to minimize their costs in order to retain more of their income. Since tax is a real cost of doing business, engaging in tax avoidance strategies results in paying as little tax as possible and assists in achieving the cost minimization objective. One such tax minimization strategy is the utilization of corporate tax inversions.

3. WHAT IS A CORPORATE INVERSION?

Generally, a corporate tax inversion transpires when a U.S. corporation makes a deal with a foreign corporation and changes its legal domicile to that of the corporation located in a low tax foreign jurisdiction or tax haven. In many cases, the foreign corporate subsidiaries of the U.S. corporations are the buyers. Thus, the U.S. Corporation's shares are sold, dissolving its existence. Shares of the company are repurchased by the foreign corporation, with the formation of a new foreign domiciled corporation. In other cases, the U.S. Corporation remains in existence but the foreign subsidiary is flipped to become the parent of the U.S. Corporation. Alternatively, the U.S. Corporation becomes the new subsidiary. Further, the inversion is sometimes accomplished by transferring ownership of the target to the new foreign corporation or merging the U.S. Corporation into a foreign corporation so the U.S. Corporation goes out of existence. Despite the method used to achieve the corporate inversion, the purpose is to achieve the tax minimization objective. Hence, the newly formed foreign corporation continues to operate as usual in the U.S. The main purpose is to avoid U.S. taxes on the corporation's foreign source income. In some cases, the two corporations may be unrelated but have similar lines of business.

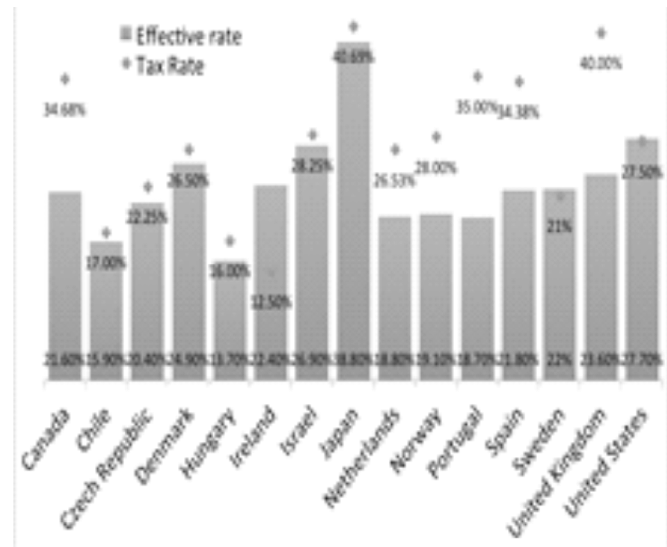
3.1. Tax Benefits of a Corporate Inversion

While there are many benefits to corporate inversions, a Multinational Corporation (MNC) can also benefit in a host of ways. The most obvious is in terms of tax savings. The U.S. imposes taxes on a Corporation's worldwide income, hence income earned in the foreign jurisdiction are also subject to U.S. tax. Further, the U.S. has a 35% tax rate. As compared to many other countries, the U.S. tax rate is considered to be very high (See Exhibit 1).

By relocating its domicile to a low tax jurisdiction or a tax haven country, the MNC can realize significant tax savings.

If the goal of the firm is to expand its operations into another continent, for example, into Europe, then the MNC may consider relocating to Ireland, the Netherlands or some other low tax or tax friendly European country. In this manner, the MNC can then

Exhibit 1 – Tax Rates in Selected Countries



(http://home.kpmg.com, 2015)

benefit from reduced tax expense while at the same time having a local base from which to conduct business. Further, the new company could also use accumulated foreign earnings for future U.S. investments without having to pay any repatriation taxes. Hence the major benefit of corporate inversions is lower taxes, which equates to an increased bottom line.

One popular location for corporate tax inversions is Ireland. Unlike the U.S. that has a worldwide taxation approach, Ireland has territorial taxation. Hence, Ireland does not levy taxes on income booked in subsidiaries of Irish companies that are outside of Ireland. Its attractiveness also is the use of the English language combined with its common law traditions and attractiveness of incorporation laws. Further, of great significance, is Ireland's low corporate income tax rate. As can be seen in Exhibit 1, the Irish nominal tax rate on corporate earnings is 12.5 percent and its effective tax rate is 22.4 percent. These rates are substantially lower than many other developed countries.[1]

Usually, the effective tax rate in a country is lower than its nominal tax rate. However, a few countries, like Ireland, have a higher effective tax rate than its nominal tax rate. The reason for this is due to the mix of rates utilized in the calculations as well as the methodology utilized to calculate a country's effective tax rate. Further, there are many approaches utilized for the calculation of a country's effective tax rate.

Notwithstanding the methodology utilized to calculate a country's effective tax rate, due to the numerous tax incentives, credits and tax relief often provided in jurisdictions, many inverted companies

pay extremely low taxes. For example, inverted companies domiciled in Ireland often pay as little as 0 to 2 percent tax on earnings to the Irish government. For example, it was alleged in the U.S. Senate hearings that Apple negotiated a 2 percent tax rate with the Irish revenue commissioners and through the use of two Irish companies, known as a 'double Irish,' Apple pays only .05 percent tax on foreign profits. The double Irish arrangement is a tax strategy used by MNCs to lower their corporate tax. It is called double Irish because the arrangement uses two Irish companies. One of the companies is a tax resident in a tax haven country, like Cayman or Bermuda. This tax minimization structure was first used by Apple Inc. and other companies in the 1980s. In 2013, the Irish government stated that companies which incorporate in Ireland must be residing there. This measure to thwart the double Irish arrangement became effective in January 2015 for newly incorporated companies and will take effect in 2020 for companies with existing operations in Ireland.

3.2.Tax Benefit of Inversion

Example 1: (000's). The following example illustrates the tax benefit emanating from a corporate tax inversion:

A U.S. Corporation has $60,000 of U.S.-source income and $40,000 of Irish-source income. The Irish Corporation has $20,000 of U.S.-source income and $80,000 of Irish-source income. The U.S. practices the "worldwide income tax" policy at a rate of 35%. However, Ireland practices the "territorial income tax" policy at a rate of 12.5%. What is the total tax liability for these two corporations without and with a corporate inversion, respectively? What is the amount of tax savings by engaging in a corporate inversion in this scenario? All data and results are summarized in Table 1 below:

	Income	*Tax Without Inversion*	*Tax with Inversion*	*Tax Savings*
U.S. Corporation:				
(a) U.S. Source	$60,000	$21,000(35%) (a)	$21,000 (35%) (e)	0
(b) Irish Source	$40,000	$14,000(35%) (b)	$5,000(12.5%)	$9,000
Irish Corporation:				
(c) U.S. Source	$20,000	$7,000(35%) (c)	$7,000(35%0(g)	0
(d) Irish Source	$80,000	$10,000(12.5%) (d)	$10,000(12.5%) (h)	0
TOTAL	**$200,000**	**$52,000**	**$43,000**	**$9,000**

3.2.1. Results without a Corporate Inversion

(a) Without a corporate inversion, the U.S. Corporation pays $21,000 ($60,000 x 35%) tax to the U.S. government for its $60,000 U.S.-source income.

(b) Without a corporate inversion, the U.S. Corporation pays $5,000 ($40,000 x 12.5%) tax to the Irish government for its $40,000 Irish-source income. Since the U.S. government adopts the "worldwide income tax policy," the U.S. Corporation must pay $14,000 ($40,000 x 35%) tax to the U.S. government for its $40,000 of Irish-source income. However, the U.S. Corporation can claim the $5,000 tax paid to the Irish government as a "foreign tax credit" against the $14,000 tax liability to the U.S. government, resulting in a net tax payment of $9,000 ($14,000 – 5,000). The total tax payment for the U.S. Corporation is still $14,000 ($9,000 + 5,000) for the $40,000 Irish-source income.

(c) Without a corporate inversion, the Irish Corporation pays nothing to the Irish government for its $20,000 U.S.-source income, because the Irish government has adopted the "territorial income tax policy." However, the Irish Corporation must pay $7,000 ($20,000 x 35%) tax to the U.S. government for its $20,000 U.S.-source income.

(d) Without a corporate inversion, the Irish Corporation pays $10,000 ($80,000 x 12.5%) tax to the Irish government for its $80,000 Irish-source income. However, the Irish Corporation pays no tax to the U.S. Government, because it is not U.S.-sourced income.

The total tax payment for these two corporations together without a corporate inversion is $52,000 ($21,000 + 14,000 + 7,000 + 10,000).

3.2.2. Results With a Corporate Inversion

(e) With a corporate inversion, the combined corporation pays $21,000 ($60,000 x 35%) to the U.S. government for its $60,000 U.S.-source income under the old U.S. Corporation.

(f) With a corporate inversion, the combined corporation pays $5,000 ($40,000 x 12.5%) tax to the Irish government for its $40,000 Irish-source income under the old U.S. corporation.

(g) With a corporate inversion, the combined corporation pays $7,000 ($20,000 x 35%) to the

U.S. government for its $20,000 U.S.-source income under the old Irish Corporation.

(h) With a corporate inversion, the combined corporation pays $10,000 ($80,000 x 12.5%) tax to the Irish government for its $80,000 Irish-source income under the old Irish Corporation.

The total tax payment for these two corporations together with a corporation inversion is $43,000 ($21,000 + 5,000 + 7,000 + 10,000).

Hence, the U.S. Corporation by inverting with a foreign corporation, the combined corporation domiciled in a low tax foreign corporation realizes a total tax savings of $9,000 on its total income of $200,000. This savings emanates primarily from the foreign sourced income which is no longer subject to the high U.S. tax rate that resulted from the U.S. worldwide income approach.

3.3. Additional Benefits of a Corporate Inversion

Other than tax savings, there are additional reasons why corporations engage in inversions. Some of these are higher net income, synergies of operations particularly for manufacturing companies and economies of scale in the case of pharmaceutical companies. By inverting, corporations may also be able to release cash that has been trapped in foreign countries and use it to expand their business. Further, the MNC may be able to distribute cash and dividends to shareholders and realize increased stock price and long-term shareholder value. Generally, the new firm simply gets a small tax home office in the foreign jurisdiction. Hence, after inversions, the operations of most American companies remain undisturbed since their U.S. offices are not transferred to its new tax home. Further, the employees of the pre-inversion company continue to work in their U.S. home offices within the newly-formed firm just as they did in the past. Hence, it may be noted though that in many cases, tax inversions are undertaken by the MNCs without any intention of expanding the company's operations.

4. HISTORY OF CORPORATE INVERSIONS

The first documented tax inversion was McDermott, Inc., an American oil and gas company. In 1982, McDermott declared its subsidiary in Panama as the parent company and its new tax location. The U.S. Corporation remained in existence but its existing foreign subsidiary with accumulated earnings was flipped to become the parent of the U.S. Corporation. This corporate plan was challenged by the U.S. tax authorities but resulted in no tangible effect. By flipping the corporate structure, McDermott was able to avoid paying taxes on earnings accumulated in the Panama-based subsidiary. These accumulated earnings are what are referred to today as "trapped earnings." These earnings are not subject to U.S. taxes until they are distributed and repatriated back to the U.S.

The next noteworthy inversions were Helen of Troy Limited in 1994 which did the same as McDermott with a newly formed subsidiary and Tyco International in 1997, both to Bermuda, followed by Fruit of the Loom to Cayman Islands in 1998. These were also challenged by the U.S. authorities again without any effect. Subsequent inversions were accomplished either by transferring ownership of the target company to a new foreign corporation or merging the U.S. Corporation into a foreign corporation, dissolving the U.S. Corporation. Nevertheless, in either case, the transaction falls outside of the 60 or 80 percent tests in order to not still qualify as a U.S. Corporation for tax purposes. Since that time, over seventy-five (75) inversions have taken place. Further, the controversy over these transactions remains even more relevant today than the first inversion (Hwang, 2015) (See Figure 1).

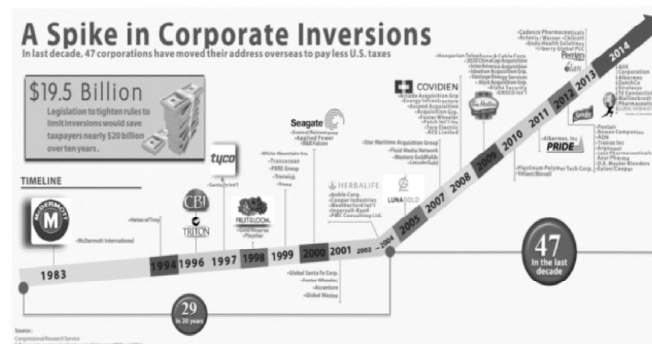


Figure 1: Inversions from 1983 to present

Congressional Research Service

4.1. The Pfizer/Allergan Deal

The most recent U.S. Corporation in the headlines planning to "relocate" overseas is Pfizer, Inc. which planned to merge with Allergan plc, located in Ireland, to form Pfizer plc. At $160 billion, the Pfizer/Allergan deal was slated to be the largest tax inversion deal in history (See Exhibit 2).

Before the proposed deal, Allergan had previously merged with a host of smaller companies (See Exhibit 3). Hence, at $160 billion, the Pfizer/Allergan deal was considerable. After the merger, the new combined corporation's global operations were to remain headquartered in New York while its principal operations were to be operated in Dublin, Ireland, Allergan's tax home and continue to operate as Pfizer, plc. Under this deal, Pfizer expected to cut its tax rate to 17-18 percent from its current 25 percent rate.

Exhibit 2: Largest Tax Inversion Deals

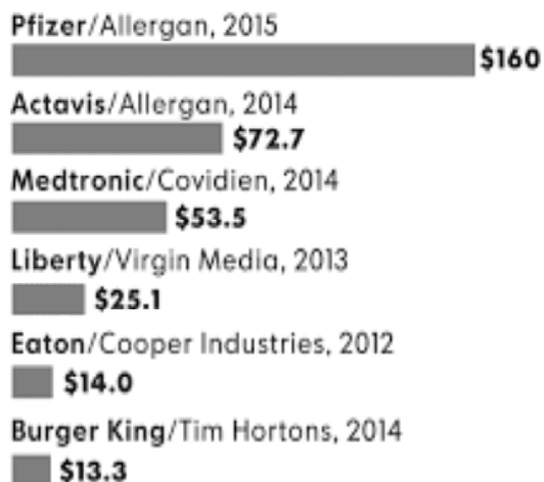


Exhibit 3: Previous Mergers of Allergan PLC.

4.2. Pfizer/Allergan May Not Technically Have Been Classified as a Corporate Inversion

Although it has all of the characteristics of a corporate tax inversion, Pfizer contended that the deal was not technically a corporate inversion due to the way in which the particular deal was formed. The Pfizer/Allergan deal was structured with the smaller Allergan taking over Pfizer with Allergan shareholders controlling 44 percent of the combined company and Pfizer controlling 56 percent. With this controlling percentage, the deal was structured well below the 60 to 80 percent of most inversions. Therefore, while the combined Pfizer/Allergan Company was not technically structured as what is traditionally known as a tax inversion, it is clear that the Pfizer-Allergan deal achieved the same goal of lowering the Corporation's tax rate (www.nytimes.com, 11/24/2015).

5. UNITED STATES TREASURY RULINGS

In an attempt to crack down on Corporate Inversions, the U.S. Treasury has passed several rulings.

5.1. November 2015 Treasury Ruling

On November 19, 2015, just four days before Pfizer made an official announcement, the deal was renegotiated by the two companies. On that same day, the U.S. Treasury also issued new rules aimed at curtailing corporate tax inversions. One rule made it more difficult for the smaller foreign company to take over a larger U.S. company. In the past, most inversions were structured with the U.S. Company owning 60 to 80 percent of the new merged company but still considered to be a foreign company for U.S. tax purposes. Under the Treasury's rule, the U.S. Company must own less than 80 percent of the new foreign company in order to qualify as a foreign company for tax purposes. Hence, when the former American parent's ownership is greater than 60 to 80 percent of the new company, the merger would still be allowed but with significant negative U.S. tax consequences. In other words, the U.S. subsidiary would still be subject to U.S. taxes on foreign sourced income.

In addition to the above requirement, the U.S. Treasury addressed the practice known as 'slimming down.' This is when large dividends are paid out by a U.S. Company just prior to its inversion deal. This essentially results in shrinking the size of the U.S. Company and making it more comparable in size to the foreign company. Alternatively, sometimes steps are taken to 'fatten up' the smaller foreign company just prior to the inversion deal. Under the new U.S. Treasury ruling, the dividends paid out by the U.S. Company will not count towards the size of ownership of the merged company. Hence, this new rule will make it more difficult to avoid the U.S. tax consequences of the merged company.

MNCs only have to pay U.S. tax on their foreign earnings when they are brought back (repatriated) to the U.S. However, inverted companies have been getting around this rule by the use of loans, known as 'Hopscotch Loans.' This is when companies get around paying taxes on dividends by instead distributing their earnings in the form of a loan to the new foreign parent. These funds can then be utilized for capital and other projects in the U.S. with the interest being deductible on U.S. earned income. To avoid this Hopscotch loan practice, the U.S. Treasury passed a second rule that now makes these loans to be treated as dividends in the U.S. and now be taxable to the U.S. subsidiary.

5.1.1. Impact of the November 2015 Treasury Rulings on Tax Inversions

Due to its proposed structure, the Pfizer/Allergan deal was not technically classified as a corporate tax inversion. The reason for this is that the merger is below the U.S. Treasury's requirement to be considered an inversion. Nevertheless, it is important to discuss mergers such as the proposed deal together with corporate tax inversions, because it could help to address the current tax code in deterring domestic corporations from fleeing the U. S. to avoid U. S. taxes. It was reported that the Pfizer/Allergan merger deal was renegotiated as late as only four days before Pfizer's official announcement on November 23, 2015 regarding the planned merger. Ironically, that was the same day that the U.S. Treasury issued rulings regarding the characteristics to qualify as a corporate tax inversion. Based upon the structure of the Pfizer/ Allergan deal, there is no doubt that the MNC's team of experts, including Goldman Sachs and its many advisors including former politicians were swift to fine-tune the details of the merger in order to comply with the newly released 2015 Treasury regulations. This suggests that Corporations are quick to react to any actions and rulings taken by the U.S. Treasury in an attempt to continue their strategies of avoiding U.S. taxes.

5.2.New April 2016 U.S. Treasury Ruling

Pfizer and Allergan were well positioned to execute their deal and their proposed merger caused ripples among officials, investment experts, shareholders and the general public. The deal was all set to be finalized within the next few months. However, on April 4, 2016, the U.S. Treasury Department stopped the Pfizer/ Allergan deal dead in its tracks when it imposed tough new requirements on corporate inversions.

The aggressive Treasury Ruling contained two actions. The first action disregards U.S. assets acquired by such companies over the previous three years in the calculation of the 60 percent threshold. As discussed above, Allergan was a small company (Actavis) that had acquired a host of companies in cross-border deals in the prior three-year period. Under the new Treasury regulations, those deals would be disregarded for the purpose of determining Allergan's size under the tax law (Rubin & Hoffman, WSJ, 4/4/2016). By stripping those previous deals/mergers out of Allergan's market capitalization of $106 billion, the U.S. Treasury reduced the firm's size, making it too small to serve as Pfizer's inversion partner. Hence, it was impossible for Allergan to have been big enough three years prior to the deal to meet the 60 percent requirement in order to qualify for the inversion under the inversion rules.

The new ruling also would limit the financial benefits of the arrangement since to reap the full benefits of inverting, the U.S. company shareholders should own between 50% and 60% of the merged entity. The Pfizer/Allergan deal was carefully structured, so that Pfizer's shareholders would own 56 percent of the company. However, the new percentage under the new ruling would be between 60 and 80 percent. At this point, the benefits of inversions such as accessing foreign profits would be lost.

It appears as if this new April 2016 Treasury Ruling was squarely aimed at the Pfizer/Allegan transaction. The Ruling immediately resulted in the cancellation of the Pfizer/Allergan merger. The two involved corporations contend that the deal had been undertaken in compliance with the U.S. laws that were in effect at that time. However, by passing the new Rulings after the deal was in play, the U.S. had essentially changed the goalpost during the game.

The second action of the U.S. Treasury Ruling limits "earnings stripping." The practice allows inverted companies to lend money to their U.S. subsidiaries. This strategy moves deductible interest from the combined corporations to the U.S. and thus reduces the Corporation's U.S. income subject to the 35 percent tax.

5.2.1. Impact of April 2016 Ruling on Inversions

The new Treasury Ruling became immediately effective on April 4, 2016. Hence it applied to mergers and other deals which were currently in the process as well as all intercompany debt issued after April 4, 2016. This new Ruling has numerous implications for deals that are currently in the process as well as future tax inversions. It also has implications for U.S. MNCs. It will make potential inverters and foreign acquirers think twice before undertaking inversion deals. This new Ruling is considered by many as punitive and demonstrates that the Treasury may come in at any time and change the rules. This type of action may make it more difficult for U.S. MNCs to make future plans. This uncertainty could hurt U.S. companies and discourage mergers, acquisitions and other investments. It will undoubtedly place U.S. MNCs at a competitive disadvantage. In fact, it might give foreign MNCs an advantage over U.S. MNCs in that they can enter the U.S. without having to comply with the same rules that are applicable to U.S. MNCs.

5.3.Discussion of Actions Taken By the U.S. Treasury to Curb Corporate Inversions

Over the years, there has been a host of patchwork measures taken by the U. S. Treasury to curb several

practices utilized in corporate inversion strategies. Some of these measures relate to "earnings-stripping," "cash box" and "skinny down" strategies (Fact Sheet: Treasury Actions to Rein in Corporate Inversions, 2015).

One of the activities the U.S. Treasury wants to deter is "earnings stripping." "Earnings stripping" is an act of loading up the former U.S. parent (which is now a subsidiary) with debt and stripping it of earnings through the payment of high amounts of interest to the new foreign parent. Since the interest payments are considered tax deductible for U.S. purposes, the inverted U.S. Corporation is able to reduce its U.S. taxable income and its related U.S. income tax. Additionally, it appears that there is a trend being utilized by inverted firms in which some of the American firms are attempting to strip nearly all of their income and is currently trying to implement measures which would reclassify the U.S. subsidiary's debt as equity, effectively transforming the deductible interest payments into non-deductible dividends. To solve this issue, the U.S. Treasury is reclassifying such debt as equity and transforming the tax-deductible interest payments made to a foreign parent into non-tax-deductible dividend payments.

A second tactic often used by U.S. companies during corporate inversions involves a "cash box" concept. "Cash boxing" involves inflating the value of the stock attributable to a foreign "acquirer" through the use of passive assets (cash and marketable securities) in order for the U.S. parent to meet the 80% threshold. Under current rules, if an inverted corporation conducts less than 25 percent of its business in the home country in which its foreign home is located, and the U.S. shareholders continue to have 80 percent or more ownership in the new foreign parent, the newly inverted company is treated as an American firm by the U.S. Treasury. In order to be able to successfully perform an inversion, the firm must reduce the value of the U.S. firm in the newly formed foreign firm to 79 percent or less of the combined MNC, with the foreign "parent" holding the remainder. In order to do so, the firm inflates the value of the foreign "acquirer" by using passive assets such as cash and marketable securities. These assets are generally not being used in the daily operations of the company and thus create a misleading picture as to the true value of the firm. In order to discourage "cash boxing," the U.S. Treasury has implemented a measure attempting at curbing corporations from renouncing the U.S. as their tax jurisdiction. The measure is an imposition of an 80 percent threshold requirement and states as follows:

1) If an inverted U.S. firm conducts less than 25% of its business in the foreign country of its new home office, and
2) The U.S. shareholders continue to have 80% or more ownership in the new foreign parent then the inverted company is treated as a U.S. company for tax purposes.

The goal of this U.S. Treasury measure was to force corporations to disregard the value of stock of the foreign parent attributable to passive assets. It is an attempt to keep the value of the U.S. firm's holdings above the 80th percentile threshold, hence keeping the merged corporations still classified as a U.S. firm for income tax purposes. Hence, the U.S. Treasury's requirement would result in the U.S. government disregarding the value of the stock of the foreign parent attributable to passive assets.

A third strategy utilized by U.S. Corporations just prior to inversions is the payment of extraordinary dividends. This is known as "skinny down" dividends and done in order to reduce the size of the corporation and be able to remain below the 80 percent ownership threshold in order to meet the U.S. Treasury's requirement to qualify for inversion. To curb this practice, the U.S. Treasury issued a new ruling that would disregard the skinny-down dividends in computing the size of the U.S. parent relative to the foreign subsidiary.

5.4. Corporations Response to U.S. Treasury Measures

In response to this 80 percent Treasury requirement, firms like Pfizer/Allergan immediately restructured their inversion deal to fall below the 80 percent requirement so as to still qualify as a foreign corporation and not to still be classified as a U.S. Corporation and subject to U.S. corporate taxes on foreign source income. This is a clear demonstration that Corporations are trying to quickly adapt their strategies in response to the U.S. Treasury's patchwork measures. However, it is clear that there was no way for Pfizer/Allergan to adapt their strategies for actions taken in the prior three years. Hence, the U.S. Treasury succeeded in killing their inversion deal in its new Ruling.

6. IMPACT OF CORPORATE INVERSIONS

When a corporation undertakes a corporate inversion, there are implications to a host of stakeholders, taxpayers and the economy.

6.1. Impact on Shareholders

The question arises of whether MNCs who invert are indeed behaving in the best interest of their shareholders or are just being self-serving. When a corporate inversion is completed, the MNC is able to minimize its tax bill. Since lower taxes equates to

increased income, this income can indeed indirectly pass along to shareholders in the form of increased distributions and dividends. This leads to increased shareholder value. In addition to the tax and other benefits noted above, the tax inversion deal may inject value to the company. Studies have shown that the stock price of an inverted company generally increases subsequent to a corporate inversion. This occurs as a result of the tax benefits which get reflected in the share price of the company's stock. Sutherland (2014) noted that according to data compiled by Bloomberg, of 14 companies that announced or completed deals to shift their domicile since 2010, eight have outperformed the MSCI World Index. Further, the stock prices of all but three companies in the study have gained since announcing their transactions. This suggests that shareholders of the old company may indeed benefit from the higher stock price of the new company reincorporated in the new jurisdiction under the corporate inversion deal.

Notwithstanding the perceived benefits to shareholders, corporate inversions are not treated in a favorable manner by the U.S. government. Inversions are seen as a taxable event. Hence, shareholders are treated as having sold their shares at the time of the inversion and are held liable for taxes on capital gains owed to the government, despite the fact that they continue to hold their shares of the company after the inversion takes place. This shareholder treatment might alienate or anger some investors, who might be planning on minimizing or deferring their capital gains tax liabilities. Hence, some potential investors may refrain from investing in companies that are planning to undergo tax inversions.

6.2.Impact on the Economy & Taxpayers

Corporate inversions have now become a major public policy and political issue since it is resulting in substantial loss of tax revenue to the nation. Tax avoidance strategies utilized by corporations involved in tax inversion deals exempt former U.S. corporations from significant U.S. tax obligations. This shortchanges the U.S. Treasury and poses harm to the economy. They may also discourage U.S. investment. Corporate inversions encourage corporations to hire overseas and therefore have the potential to discourage hiring in the U.S. The consequences of uncollected revenues in the U.S. is that for every dollar not collected by the IRS, either taxes must rise on American citizens or budget deficits must widen. This imposes a heavier burden on members of our society and future generations to pay down the debt.

Furthermore, tax inversion is subject to abuse and in many cases manipulation may be practiced. This essentially involves shifting accounting profits from high tax to low tax jurisdictions. Thus, the amounts involved in tax inversion deals may be exaggerated in an effort to pay only minimum taxes and increase the overall income of the corporation. In effect, this translates to the movement of one nations' tax revenue to another. In many cases, the amounts involved in these tax inversion transactions may be material at not only the transaction level, but also may be significant from a global economic perspective with respect to the total amount of intra-firm transactions across national borders.

A comparison of the breakdown of federal revenues from taxes in 1952 versus 2014 is shown in Exhibit 4 below, which clearly demonstrates that the contribution of taxes to the economy from corporations has decreased significantly from 32 percent in 1952 to only 9 percent in 2014, whereas the individual income tax contribution has remained the same at 42 percent and the payroll tax contribution has increased from 10 percent to 40 percent. This clearly shows that the corporations may be shirking their responsibility while the burden is being passed on to citizens through increased payroll and other taxes. Federal Revenue is derived from many sources, including taxes. Essentially, an individual citizen is obligated to pay proportional taxes in relation to the individual's income base. Similarly, a corporation is responsible for paying taxes in relation to its income base. With the proliferation of companies avoiding U.S. tax by inverting to foreign countries and with the tax contribution of corporations decreasing from 32 percent of Federal revenue to only 9 percent, it is possible that corporations may not be paying the amount of taxes in relation to their income base. Therefore, they may not be paying their fair share of taxes to the U.S. government but at the same time, they continue to operate in the U.S. Hence, the burden of any shortfalls in the Federal budget and tax revenue are being borne by the U.S. citizens.

Exhibit 4: Comparison of Source of (U.S.) Federal Revenue – 1952 versus 2014

Source	*1952*	*2014*
Corporate tax	32%	9%
Individual income tax	42%	42%
Payroll tax	10%	40%
Other taxes	16%	9%

Corporate inversions present a formidable challenge to the U.S. economy in the form of an erosion of a corporate tax base and declining government tax revenue stemming from corporate income taxes. The

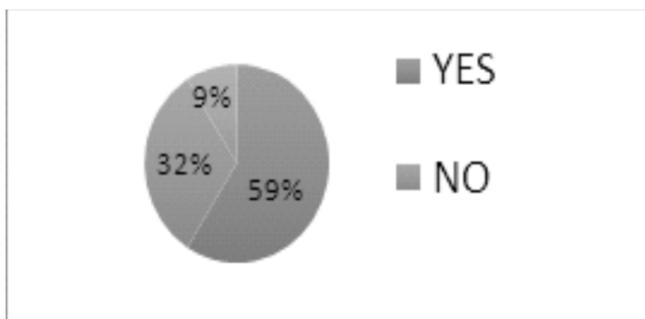
U.S. government has been trying to minimize the number of inversions by patching up the loopholes and passing regulations intended to make the economical concept of inversion less appealing to corporations. The European Union is considering a minimum corporate tax rate. However, there is great opposition, particularly from Ireland.

Some would argue that there is a need to reduce international corporate tax rate disparities through a system of universal registration and declaration of income particularly in that while the U.S. imposes a corporate tax on all sources of corporate income earned, other countries use a regime of proportional corporate taxation based on the region in which it is earned. A question here is whether the U.S. should adopt the proportional corporate income earned standard or look to universal adoption of its universal tax rate system.

7. POLITICAL REACTION

The marked decrease in tax revenue and the proliferation of corporations renouncing their citizenships through corporate inversions has been under significant scrutiny from politicians and citizens alike. The question arises of whether or not Congressional action should be taken. According to the results of one public policy poll of registered voters (See Exhibit 5 below), approximately 59 percent of registered voters nationwide believe that Congress should act to 'penalize and discourage companies' from engaging in inversions (Zarht, 2015). It is evident that Americans believe that corporations should be discouraged or penalized from the practice of corporate inversions.

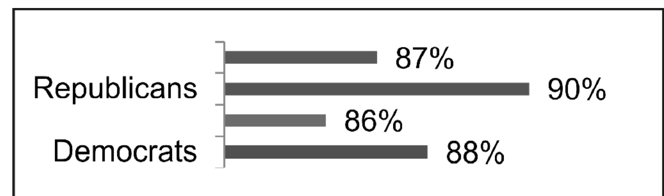
Exhibit 5: Survey Question – Should Congressional action be taken to curb Corporate Tax Inversions?



Treasury Secretary Jacob Lew stated that the aim of the Treasury is to further reduce the benefits of inversions and to make them even harder to achieve, ultimately reducing their attractiveness to corporations. However, the strategy may be flawed since it does not appear to be curbing corporate inversions.

Based upon the huge current political debate, it is evident that the majority of Republicans and Democrats agree that there needs to be some legislative action to address inversion tactics. House Speaker Paul Ryan's view is that a broad corporate tax reform is needed. He states that the corporate tax rate needs to be lowered and the U.S. needs to tax corporations on a territorial basis with only the income earned in the U.S. territory being subjected to U.S. taxation. Also, the majority of Republicans and Democrats agree that a legislative action needs to be taken in order to prevent corporate inversions. In addition, the general consensus is that the current U.S. tax code needs to be updated. A survey of respondents of politicians to this question is shown in Exhibit 6 below:

Exhibit 6: Question of Politicians - Should the U.S. Tax Code be updated?



A review of Exhibit 6 above clearly demonstrates that most of the politicians also agree that the U.S. tax code needs to be updated. However, there is no agreement of the solution between the Democrats and Republicans. Hence the political debate continues. In the meantime, the current tax system which deprives the government of needed tax revenues continues to prevail. By inverting, corporations are basically just manipulating the U.S. tax system and eroding the nation's tax base. Hence, it is evident that it is urgent that action needs to be taken in order to address the growing wave of inversions and the erosion of the nation's tax base.

To date, the government has undertaken several measures but only enjoyed modest success in curbing corporate inversions and other corporate tax saving tactics. It is apparent that their measures are not working. It is evident that extensive research needs to be undertaken regarding the practice of corporate inversions, the reasons for inverting as well as the corresponding impact on levels of investment, economic growth and per capita income. Only then can educated and effective strategies be undertaken and policies enacted to address the negative effects emanating from corporations inverting to foreign corporations in order to avoid U.S. taxes. However, proper identification and solution to this problem must be undertaken in concert with corporations, standard

setters, academics, citizens and other interested parties. Failure to include all interested parties will continue to result in a patchwork of ineffective measures.

7.1. President Obama's Proposed Solutions

Undoubtedly, cross-border mergers are generally good for the corporation as well as the country in that it allows U.S. to invest overseas and encourage foreign investments to flow into the U.S. This Foreign Direct Investment activity results in making the U.S. economically stronger. It is therefore clear that genuine cross-border mergers are good for the economy. President Obama has declared Corporate Inversions as unpatriotic (Fact Sheet: Treasury Actions, 29 Nov, 2015). Corporations, in turn, responded by pointing out that the high corporate income tax rate in the United States makes them less competitive on the global scale. They argue that inversions have nothing to do with patriotism but serve to protect the interests of shareholders, (Hiltzik, 2015). In 2014, President Obama offered suggestions that were supposed to help curb the practice of corporate inversions. One of his proposals involved ending the right for corporations to defer the taxes paid to the U.S. government until the profits are repatriated to the U.S. The aim of this action was to force the companies to make business decisions based on the business location factors as opposed to tax rates. In other words, he wants to make the domicile of a corporation to be based on other business factors as opposed to tax rates.

Another one of President Obama's proposed solutions was to reduce the corporate tax rate from 35 percent to 28 percent and close the loopholes that offset any U.S. losses. This suggestion was quite controversial, since the lower corporate tax rate would reduce the tax revenues by $840 million over the following ten years (Pozen, 2015). The president, however, argued that if the government will be able to close some of the loopholes within the corporate tax law, these losses from the lower tax rate could largely be offset.

One of his most innovative proposals was to issue a minimum global tax rate of 19 percent. If this proposal were enacted into a law, an MNC paying 15 percent in taxes to a foreign government would have to remit an additional 4 percent in taxes to the IRS. This strategy would generate approximately $206 billion over ten years and could discourage multinational corporations from moving to tax havens (Pozen, 2015).

Obama has also proposed to impose a 14 percent tax on previously earned but un-repatriated (income held overseas) foreign earnings.

While many of President Obama's suggestions could play a role in discouraging U.S. Corporations from inverting, the dysfunction and bickering in Congress has unfortunately resulted in the bills being considered "dead on arrival" (International Tax Review, 2015).

Possible Solutions to Curb Corporate Tax Inversions

There are a host of proposed solutions to end the flow of capital out of the country resulting from the proliferations of U.S. corporations that are relocating to lower tax or no tax jurisdictions. However, this problem is not new. It was an issue that was previously experienced by the United Kingdom (U.K.) and tax reform had to be undertaken to address the problem.

8. THE UNITED KINGDOM (U.K.) INVERSION EXPERIENCE

While there may be no direct solution, we can look to the U.K., which has recently reformed its tax code. There were many similarities between the U.S. and the U.K. before an overhaul of the U.K. tax system took place. Both countries imposed a worldwide approach to taxing its constituents. Both had the highest corporate tax rates in 1980 with the U.K. imposing a corporate tax rate of 52% and the U.S. imposing a 46% rate. When the U.K. imposed a corporate tax rate of 52 percent in 1980, it suddenly experienced a rush of companies inverting to more tax friendly countries. By 2015, tax reforms made by the U.K have reduced the corporate tax rate to only 20 percent. That is 15 percent lower than the current corporate tax rate in the U.S., which is a great improvement. The U.K. also replaced the worldwide tax system with a territorial one. These measures developed a more competitive and favorable market for corporate activity in the U.K and allowed it to reduce the number of corporations undergoing inversions, thus helping its corporate sector to expand and reverse the tide of corporate inversions. It is possible that the U.S. can benefit from similar changes, as well as from the broadening of its tax base, which has been shrinking over the past few decades.

The reforms may have allowed the U.K. to remain competitive since the number of corporations domiciled in the U.K is rising, while they are falling in the U.S. (See Figure 2 below).

Following the U.K's lead, one solution for the U.S. would be to lower the corporate tax rate from 35 percent to 20 percent. This may possibly stop the erosion of the corporate tax base and reduce incentives for corporate inversions. It may also make the U.S. more competitive with tax haven countries, reduce the amount of indefinitely deferred overseas revenue, increase the volume of corporate tax revenue and make the U.S. tax system resemble that of other countries. It is possible that if the rate differential were removed, it

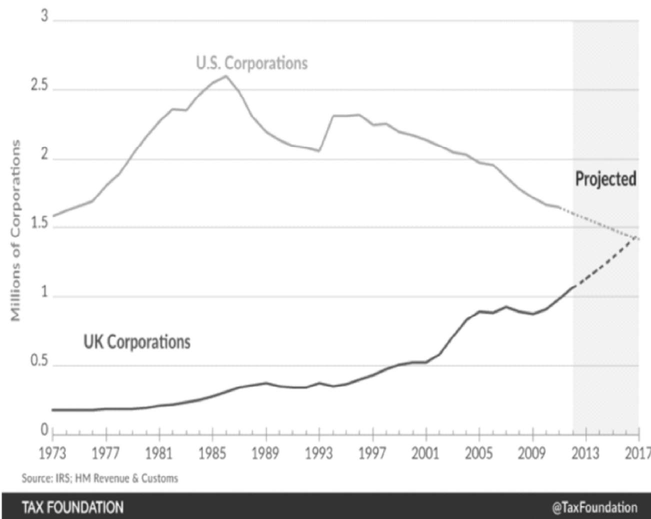


Figure 2: Number of Corporations Falling in the U.S., Rising in the UK

may not be worth the effort for U.S. corporations to invert.

9. SHOULD THE U.S. CORPORATE TAX RATE BE LOWERED?

Many parties suggest that the easiest solution to preventing corporate inversions would be to simply lower the income tax rate. The question then arises of whether the U.S. should follow the lead of the U.K and lower its corporate tax rate. It may be noted that most corporations do not pay the 35 percent tax rate anyway. Further, due to various tax credits and incentives, some corporations do not pay any tax at all. In fact, the average effective income tax rate paid by U.S. corporations is about 28 percent. Since corporations that invert must still pay tax on income earned in the U.S. their effective tax rate could be greater than the marginal tax rate of their new home country depending on the tax laws of the new countries in which they operate.

Lowering the tax rate could be quite costly for the U.S., since as shown in the Figure below, for every percentage point the tax rate is lowered the U.S. could potentially lose approximately $100 billion over a 10-year period (Migdail, 2015) (See Exhibit 6 below). This is largely the main reason why it may be unrealistic for the U.S. to significantly reduce the corporate rate and compete with those of other countries, especially tax haven countries.

Another proposal is to restructure the U.S. corporate income tax rate to match its foreign rivals. Having one worldwide tax consolidation at a fair rate would result in shutting down corporations' efforts to play one country's tax regime off against another.

Other proposed solutions to curb corporate inversions are to impose an exit tax on corporations that invert and tax all un-repatriated earnings when an MNC renounces its U.S. residence.

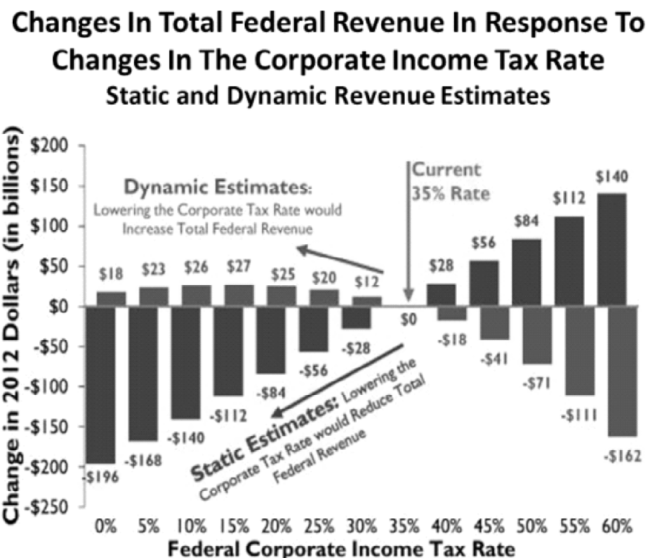
Others have also come forward with other suggestions. One proposal involves barring inverted companies from receiving any kind of government contracts.

Lastly, corporations could also be taxed based on its residence, with the home residence being considered as one in which most of its assets are stored and employees located. This would prevent the firms from simply changing their address to minimize tax liabilities.

It is apparent that most of these proposals will make it more complicated for corporations to relocate their business to another country since their operations would have to move as well. These proposals will make inversions less appealing to corporations instead of banning them outright.

It is important that any comprehensive initiatives to address corporate inversions be taken with caution or else the initiatives could accelerate the very conditions that they are trying to avoid. According to Senator Hatch, any measures taken to deter corporations from inverting "must be prospective, cannot be punitive, must help lower the corporate tax rate and shift to a territorial system" (Migdail, 2015).

Exhibit 6: Impact of Lowering Tax Rate on Federal Revenue



10. IMPLICATIONS OF CORPORATE INVERSIONS

So what can we learn from our mistakes? How can we correct our tax inversion problem? A majority of Americans agree that a tax reform is needed to address

this practice. Also, the majority of Republicans and Democrats believe that a legislative action needs to be taken in order to prevent corporate inversions.

The U.S. Treasury has issued three rulings aimed at curbing corporate inversions. However, their approach to curbing U.S. Corporate Tax Inversions is questionable. The measures undertaken to date are essentially an attempt at patching up the loopholes in the existing regulations. However, by patching up one loophole, the government is only encouraging the U.S. corporations to find new ones. It has been suggested that this matter can only be resolved through legislative action. However, these actions must be taken in concert with legislators, U.S. citizens, and other stakeholders including Corporations. It is therefore apparent that a complete corporate overhaul of the U.S. tax code is needed in order for the U.S. to be able to curb corporate inversions and raise more tax revenue from corporations.

11. THE WAY FORWARD

If the corporate income tax rate were lowered to approximately 20 percent, corporations will have less of an incentive to move their operations overseas. By taxing corporations at a lower rate, the U.S. government will likely benefit more from the volume of corporate taxes collected (even if the per-corporation amount received will be smaller) than it currently does by allowing firms to keep billions of dollars in indefinitely deferred revenue overseas.

The question remains, what should be done to reduce the number of corporations that are moving their tax domicile to a foreign jurisdiction and eroding the U.S. tax base? The U.S. government is using a "patchwork" approach to resolve the corporate migration problem. Further, as can be seen, the Democrats and Republicans believe that legislative action needs to be undertaken to curb corporate tax inversions but are currently in a gridlock as to how it should be accomplished. Without a doubt, it is evident that the only thing that can be done is to have a complete overhaul and reform of the U.S. tax code in order to lower the corporate income tax rate in the U.S. and to institute other measures that will make the U.S. more competitive with the other tax-haven countries. However, this is easier said than done and would require a commitment from politicians, the public sector, corporations as well as other stakeholders alike. This overhaul of the tax code would be a gargantuan task and will have to be tackled expeditiously.

12. CONCLUSION

The billions of dollars lost in tax revenue from the host of Corporations inverting to low tax jurisdictions has become a bone of contention in many circles. The corporate leaders believe that by inverting, they are acting in the best interest of their stakeholders, while politicians and many others believe that these corporations are placing an undue tax burden on the citizens of the U.S. Unquestionably, something must be done to curb these inversions. It appears that the best solution is to have a complete overhaul of the U.S. tax code so as to keep MNCs from inverting to foreign jurisdictions while still enjoying all of the benefits of operating in the U.S.

Biographical Notes

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Notes

1. The effective tax rate of a country depends on the methodology utilized, the sum of all taxes imposed by local, provincial/state, national and foreign governments during the year. It is the tax burden as a proportion of the tax base or income taxes divided by pretax income. This effective rate is calculated on Net Operating Surplus from the National Income Accounts which are produced by the Central Statistics Office, and the tax due as a proportion of Taxable Income from the Corporate Tax Distribution Statistics produced by the Revenue Commissioners. Hence, the effective tax rates in a country is partly the result of differences in the geographic mix of income and the country-specific and industry specific tax rates that apply to such income. Ireland has different rates for different activities: 12.5 percent tax rate on profits from trading accounts, 25 percent for investment, rental and non-trading activities, petroleum, mining and land dealing accounts and 33 percent on capital gains. Hence, this mix results in the effective tax rate of 22.4 percent for Ireland being higher than the nominal corporate tax rate of 12.5 percent on trading activities.

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