The Tidal Wave of Corporate Inversion

By James G. S. Yang, M.Ph., CPA, CMA; Jason Z.-H. Lee, Ph.D.; and Li-Chun Lin, Ph.D.

There is a detrimental corporate movement currently occurring in the United States referred to as corporate inversion. Many U.S. multinational corporations are moving their domicile abroad. They renounce their U.S. legal status and become foreign corporations, taking their tax base away with them.

As a consequence, the U.S. government has lost a tremendous amount of tax revenue. The situation has been deteriorating rapidly and more seriously during the past decade.

What is a Corporate Inversion?

The U.S. government has tax jurisdiction over a U.S. corporation, but not a foreign corporation. When a multinational corporation derives income from not only the United States but also a foreign country, should the U.S. government impose taxation on both sources of income? If the answer is affirmative, it inevitably encourages a multinational corporation to develop a strategy to avoid taxation on its foreign-sourced income. If the tax rate in a foreign country is lower than that of the United States, this strategy can become quite beneficial. A "corporate inversion" is a strategy to carry out this purpose.

Changing the Tax Domicile

The strategy of corporate inversion takes many different forms. In the simplest form, a multinational corporation may just move its tax domicile from the United States to a lower-tax country, but leave all its operations intact. In other words, its headquarters address is changed to a foreign country, but all its production and sales activities remain in the United States.

As before, it has the same income from the United States and the same income from a foreign country. By doing so, this multinational is no longer a U.S.-registered corporation; it's a foreign country registered one. The U.S. government no longer has the authority to tax this foreign country registered corporation. The U.S. government can still impose tax on the U.S.-sourced income, but not on the foreign-sourced income. As a benefit, it has saved this multinational corporation from being taxed twice on its foreign-sourced income. This is an advantage of corporate inversion.

Creating a Foreign Corporation

In a more complicated form of a corporate inversion, a U.S.-parent corporation may have earnings from a foreign-controlled corporation. Both earnings are subject to U.S. taxation. To avoid taxation on the part that is foreign-sourced income, the U.S. parent corporation may form a new foreign corporation, issuing stock to both the U.S.-parent corporation and the foreign corporation it controls. The new foreign corporation now owns both the U.S.-parent corporation and the controlled foreign corporation. The new foreign corporation becomes the parent company of the U.S. parent corporation. The parent-subsidiary relationship between the U.S. parent corporation and the new foreign corporation is now flipped around. As a result, the distribution of the controlled foreign corporation's earnings to the new foreign corporation is not subject to taxation by the U.S. government, because the new foreign corporation is not a U.S. corporation. This is the advantage of employing a foreign corporation as a vehicle to avoid U.S. taxation.

There are other variations on this theme. All of these corporate inversion strategies have the primary objective of saving U.S. tax. The U.S. government stands to lose its tax revenue from foreign-sourced income.

In fact, up to 2016, 76 U.S. corporations have inverted to 14 foreign countries.[1] It has caused the U.S. Treasury Department to lose $19.5 billion in tax revenue.[2]

Factors Influencing Inversion

The rash of corporate inversions did not occur without a good reason. There may be three identifiable causes. They all are rooted in features within U.S. income tax law, as will be discussed below.

Tax Rate Differential

More often than not, the tax rate is one of the most important factors in deciding where to locate a business. The U.S. federal corporate income tax rate is 35 percent maximum.[3] By comparison with other industrialized countries, it is almost the highest. Here are some examples. At the higher end, Japan is at 37 percent, France at 34.4 percent, Brazil and India at 34 percent, Italy at 31.4 percent, Germany at 30.2 percent, Australia and Mexico at 30 percent, and Spain at 29.2 percent. At the lower end, China is at 25 percent, the United Kingdom at 20 percent, Poland at 19 percent, Canada at 15 percent and Ireland at 12.5 percent. In many tax shelter countries, there is no income tax at all, such as Bermuda, the Bahamas and the Cayman Islands.[4]

The above facts clearly demonstrate that the driving force behind the current tidal wave of corporate inversion is undoubtedly the high U.S. tax rate in contrast to those other countries.

Taxation on Worldwide Income

If a corporation is taxed on both domestic income and foreign-sourced income, it is known as the "worldwide income tax system." Whereas, if it is taxed only on its domestic income, but not on foreign-sourced income, it is termed the "territorial income tax system."

Throughout the world, 26 countries adopt the former, while only eight the latter.[5] The United States is one of the countries that adopted the worldwide income tax system.[6]

Following is an example to illustrate the difference between the territorial income tax system and the worldwide income tax system. A Canadian corporation earns $100 million income from Canada and an additional $20 million income from the United States. What is its taxable income in Canada? The answer is $100 million. The $20 million of income from the United States is not taxable in Canada, though it is still subject to taxation in the United States, because Canada adopts the territorial income tax system.

In another example to the contrary, a U.S. corporation earns $100 million income from the United States and an additional $20 million income from Canada. What is its taxable income in the U.S.? The answer is $120 million. The $20 million income from Canada is not tax free in the United States, because the United States adopts the worldwide income tax system. Nevertheless, the $20 million income from Canada is still subject to taxation in Canada, but the tax paid to the Canadian government can be claimed as a tax credit against the United States tax liability.

This tax advantage has motivated U.S. multinational corporations to move to Canada. In fact, out of 76 corporate inversions, five chose Canada.

Allowing Deferred Tax on Foreign-Sourced Income

Notwithstanding the detrimental nature of United States tax law, there is a rather intriguing tax loophole. Although foreign-sourced income is taxable in the United States, the tax payment can be deferred until cash dividends are remitted back to the United States. In other words, the tax liability is based on the foreign-sourced income earned, but the tax payment depends on cash dividends received. It implies that if no dividends are remitted back to the United States, no tax liability shall occur. This tax loophole practically neutralizes the ill effect of the worldwide income tax system; essentially, it becomes the same as the territorial income tax system. A great many multinational corporations take advantage of this tax loophole by setting up a controlled foreign corporation.

Here is how it works. A U.S. multinational corporation earns $100 million income from Canada, but remits only $80 million cash dividends back to the United States. What is its tax liability and tax payment, respectively, assuming its tax rate is 35 percent? The tax liability is $35 million ($100,000,000 x 35%), while the tax payment is $28 million ($80,000,000 x 35%). The deferred tax liability is $7 million ($35,000,000-28,000,000). The untaxed foreign income is $20 million ($100,000,000-80,000,000). If this multinational corporation never remits this $20 million income back to the United States, it will never incur any tax payment. As a result, the tax liability would be the same as that under the territorial tax system, i.e., $28 million ($80,000,000 x 35%).

The amount of untaxed foreign earnings still sitting abroad is not small. It now amounts to $2 trillion, resulting in $20 billion of losses in tax revenue in 2012 alone. In practicality, this tax deficiency is another form of a corporate inversion. A multinational corporation can earn income from abroad, but if it never remits cash dividends back to the United States, it never pays income tax.

Purposes of a Corporate Inversion

It should be noted that a multinational corporation can earn profits abroad. However, as long as these earnings are earned by a controlled foreign corporation and not distributed back to the United States, no tax will be paid on the earnings. By the 1980s, these undistributed earnings have been accumulating to an amount that was astronomic, as discussed above. There was an urgent need to distribute these earnings back to the United States without paying tax.

The strategy was to create a new foreign corporation to serve as a vehicle to enable a controlled foreign corporation to shift its earnings to this new foreign entity. It then avoided paying tax.

Escaping United States Tax on Foreign-Sourced Income

Another purpose of a corporate inversion exploits the difference in tax rates. The U.S. corporate tax rate has remained unchanged throughout its long history. By simply changing its headquarters' address from the United States to a foreign country, a corporation has legally changed its tax domicile.

continued on next page

However, this strategy only escapes tax on foreign-sourced income and not the U.S.-sourced income, because this income is always taxed in the United States. If the difference in tax rates between the United States and a foreign country is large, the tax savings can be very substantial. Most of the corporate inversions in recent years belong in this category.

"ALL OF THESE CORPORATE INVERSION STRATEGIES HAVE THE PRIMARY OBJECTIVE OF SAVING U.S. TAX."

Actual Cases of a Corporate Inversion

Corporate inversion is not a new phenomenon. It started in 1982. To date, a total of 76 corporations have done so. Each one is unique, with its own purpose. Which companies have actually inverted? They can be classified into the two groups as outlined above. Following are examples of some major ones.

In 2015, Medtronic was a U.S.-registered corporation in the medical technology industry. It accumulated $13 billion from earnings in many foreign countries. It merged with Covidien, another medical concern, in Ireland. Medtronic renounced its U.S. citizenship and moved its tax domicile to Ireland. The use of the $13 billion fund in Ireland or even in the United States would not trigger the U.S. tax.[7]

Pfizer was a U.S.-registered corporation in the pharmaceutical industry. It sells its medical products around the world. In 2015, it was holding $74 billion untaxed earnings in many foreign countries. A distribution of those earnings within the U.S. would entail a tax payment of $21 billion. It merged with Allergan in Ireland in a whopping $150 billion deal. By moving its tax domicile to Ireland, it escaped the huge tax bill.[8] Unfortunately, on April 4, 2016, the Treasury Department issued new rules on corporation inversion that take effect retroactively, back for three years. As a result, the Pfizer-Allergan deal was cancelled immediately thereafter.

Coca-Cola Enterprises is a U.S.-registered corporation in the bottling business, selling its products around the world, including Spain, Germany and Great Britain. In 2015, it acquired both Coca-Cola Iberian Partners of Spain and Coca-Cola Erfrischungsgetranke of Germany, but it moved its tax domicile to Great Britain. As a benefit, its earnings from Spain, Germany and Great Britain are no longer subject to U.S. taxation. In one move, it has covered three foreign countries.[10]

All of these companies share the same purpose: Avoid U.S. tax by forming a new foreign corporation or by moving their tax domicile to a foreign country. This is the essence of a corporate inversion.

Regulations Under IRC §7874

In 2004, Congress enacted Internal Revenue Code (IRC) §7874.[11] IRC §7874 provides that only when a foreign corporation derives at least 25 percent of its revenue from a foreign country of incorporation can it be treated as a foreign corporation.[12] If not, and only if the United States shareholders own less than 60 percent of the total stock, can it also be treated as a foreign corporation? If the U.S. shareholders own at least 60 percent, but less than 80 percent, it would be treated as a "surrogate foreign corporation," which means all restrictions in this section will apply.[13] If the ownership is least 80 percent, the entire combined corporation must be treated as a U.S. domestic corporation.[14]

If the foreign corporation attempts to dilute the U.S. shareholders' ownership by issuing more stock to the open market, this additional stock does not count toward the calculation of the ownership.[15]

Restrictions Under Notice No. 2014-52

Over the next 10 years, the corporate inversion problem became worse. On Oct. 14, 2014, the Internal Revenue Service (IRS) issued Notice No. 2014-52.[16] It concerns the transactions between a controlled foreign corporation and the U.S. parent corporation that may attempt to evade tax. For example, a foreign corporation may give an inter-company loan to the U.S. corporation. In substance, it is not a loan, but a distribution of earnings from the controlled foreign corporation to the U.S. parent corporation, so is taxable.

Example: The U.S. parent corporation may set up a new foreign corporation that in turn owns the controlled foreign corporation and the U.S. parent corporation. The controlled foreign corporation can now distribute its dividends to the new foreign corporation without going through the U.S. parent corporation. The new foreign corporation can then use the funds to purchase assets or stock from the U.S. parent corporation. Nonetheless, this distribution is taxable in the United States.

Example: To circumvent the 80 percent criterion mentioned above, before a merger, the foreign corporation may intentionally acquire a great deal of nonessential assets such as cash, marketable securities or passive assets so as to reduce the U.S. shareholders' relative ownership of the foreign corporation. This transaction is void.

Example: Concerning the 80 percent ownership, before a merger, the foreign corporation may deliberately distribute a large amount of dividends to the shareholders. This has the effect of reducing the U.S. shareholders' weight within the combined corporation. This transaction is ignored.

The IRS notice imposes restrictions on these transactions for the purpose of curtailing the potential abuses of a corporate merger.

Additional Restrictions Under IRS Notice No. 2015-79

In another attempt to tackle the problem, on Nov. 19, 2015, the IRS issued Notice No. 2015-79.[17] It imposes three additional restrictions, as follows.

Under IRC §7874, to be qualified as a foreign corporation, it must derive at least 25 percent of its business operations from the country of incorporation. This notice reiterates that the foreign corporation must be a resident of the country of origin.

Also under IRC §7874, there was a concern that a U.S. corporation may just change its tax domicile to a foreign country by merging with a foreign corporation. It provides that if the U.S. shareholders still own at least 80 percent of the combined corporation, it will be treated as a U.S. domestic corporation. There might be an attempt to circumvent this 80 percent criterion by issuing more stock to foreign shareholders. This notice reiterates that the additional stock does not count on the denominator in calculating the ownership.

Further, under IRS Notice 2014-52, there was a concern about the U.S. shareholders' ownership. A foreign corporation may expand its size by issuing more stock for nonessential assets such as cash, marketable or passive assets. These are called "nonqualified assets." This notice expands "nonqualified assets" to include all assets.

The Latest New Regulations on Corporate Inversion

Pfizer's attempt to engage in a merger triggered the Treasury Department to issue new regulations on April 4, 2016, under TD-9761.[18] It contains, among others, two essential points.

First, under §7874, after the merger, if the U.S. shareholders still own at least 80 percent of the combined corporation, this combined corporation will be treated as a U.S. domestic corporation. It will lose the benefit of being a foreign corporation. There may be an attempt to circumvent this rule by issuing more stock to the foreign shareholders for cash before the merger. It has the effect of reducing the ownership by the U.S. shareholders. This strategy is known as "cash box." The new regulations provide that, if this transaction occurred three years before the merger, it is now disregarded in the denominator in calculating the said ownership.

Second, the merger between the U.S. corporation and a foreign corporation may give rise to a situation where the former becomes a subsidiary corporation while the latter the parent corporation. It may serve as a vehicle to shift the U.S. income to a foreign country. For example, a foreign corporation may provide a loan to the U.S. corporation. The latter would pay interest to the former. It has the effect of decreasing the U.S. corporation's taxable income and at the same time increasing a foreign corporation's taxable income, as well. U.S. income now becomes foreign income. This strategy is known as "earning stripping." The new regulation would treat this loan as a stock equity instead of debt instrument. The interest payment from the U.S. corporation to a foreign corporation becomes a stock dividend payment rather than an interest expense. The purpose of the loan is then nullified.

Curtailing Abuses

This article discussed the issues related to corporate inversions. It pointed out that it is a strategy to avoid U.S. tax by moving a tax domicile to a foreign country. It can also be done by setting up a controlled foreign corporation. This article also covered three factors in the U.S. tax law influencing inversion – high tax rate, worldwide income tax and deferral of tax payment – and presented actual cases of corporate inversions. In addition, the article explained the actions taken by the IRS to curtail the abuses of a corporate inversion.

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James G.S. Yang, M.Ph., CPA, CMA is a professor of Accounting at Montclair State University in Montclair, New Jersey. He may be reached at yangg@mail.montclair.edu.

Jason Z.-H. Lee, Ph.D. is an associate professor of Operations and Management Sciences at Marist College in Poughkeepsie, New York. He may be reached at Jason.lee@marist.edu.

Li-Chun Lin, Ph.D. is an associate professor of Management and Chair of the Department of Management at Montclair State University in Montclair, New Jersey. He may be reached at linl@mail.montclair.edu.