Business

Corporate Inversion and the Impact on the United States

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Corporate inversion occurs when companies move overseas or merge with foreign companies to avoid high American taxes. This strategy helps companies save a significant amount of money since the United States, "has the highest tax rate in the developed world, 35 percent" (Merle, 2016). A number of these companies reincorporate with smaller or larger foreign companies. According to the National Tax Journal, this process first began in 1982 when McDermott International moved to Panama (Rao, 2015). Inversions have been gaining popularity since 1982. The United States government has attempted to make inverting more difficult. These efforts have not stopped numerous companies from moving overseas in recent years.

Legal Classification

Corporate inversions are legal. They are considered tax avoidance, not tax evasion. Tax evasion is defined as, "Deliberate failure to pay legally due taxes or to submit required returns and other documents" (Robertson, 2015). Tax avoidance is defined as, "the minimization of an individual's tax liability by taking advantage of legally available tax saving opportunities" (Robertson, 2015). Companies that invert are legally moving their headquarters to a foreign country. This means that they are paying taxes to the country where they have moved. By inverting, companies are avoiding taxes in a legal way, and it is their right to do so.

Types of Corporate Inversion

Companies that choose to invert can do so in four different ways. According to the Virginia Tax Review, the different kinds of corporate inversions are stock transactions, asset transactions, drop down transactions, and spin-offs, (Tootle, 2014). The first three types of inversions involve the company moving the legal headquarters overseas, with the operations staying in the United States (Tootle, 2014). According to the Virginia Tax Review,

1. Stock Transactions

In a stock transaction, the shareholders of a U.S. corporation exchange their shares for stock in a foreign corporation (the "foreign parent"). The result is that the former shareholders of the U.S. corporation own the foreign parent, which in turn owns the U.S. corporation….

2. Reincorporations or Asset Transactions

In a reincorporation or asset transaction, a U.S. corporation merges with the foreign parent and the foreign parent survives. The transfer of the U.S. corporation's controlled foreign subsidiaries to the foreign parent occurs during the merger…

3. Drop-down Transactions

In a drop-down transaction, the U.S. corporation transfers its assets to the foreign parent through a reincorporation, and the foreign parent immediately contributes some of those assets to a newly formed U.S. subsidiary (Tootle, 2014, p. 363).

Essentially any company can participate in a stock transaction, asset transaction, or a drop-down transaction. The fourth type of inversion, a spin-off, occurs when a company creates a foreign subsidiary and runs the desired business through that subsidiary (Tootle, 2014). A spin-off is different from the previous transactions, since it requires a company to be already established in a different country. Each company has specific reasons for inverting, and each company will pick the inversion transaction that is the most appropriate for its situation.

Reasons that Companies Invert

Companies receive several advantages by inverting. The clear reason that companies invert is to avoid high taxes. The United States operates under a worldwide tax system. If a company earns a profit in a foreign country, it must pay taxes to that country, as well as the difference between that tax rate and the United States rate of 35 percent to the United States government (Tootle, 2014). This system and high tax rate can cause a significant tax burden for companies doing business internationally, and thus inverting is beneficial. Inverting to another country lowers companies' tax burdens. Companies need a competitive advantage to be profitable. A United States tax rate of 35 percent makes it difficult for many companies to stay competitive globally.

Companies that have Inverted

Corporate inversions are not limited to a specific industry; there are companies from a number of different industries that choose to invert. In 2014, House Democrats conducted research on inversions and published a chart showing which companies have inverted since 1983 (Douglas-Gabriel, 2014). They found that some of the most popular industries are oil and gas, insurance, engineering, and off shore drilling (Douglas-Gabriel, 2014).

Inversion Locations

Since corporate inversion started in 1982, there has been a shift in the location trend. Companies that are looking to invert select locations carefully. According to The Washington Post, companies inverted to the Cayman Islands and Bermuda prior to 2004 (Douglas-Gabriel, 2014). After 2004, companies began to move to Europe instead of the Caribbean, since most already did business there. In 2004, "Congress said American companies could relocate overseas if foreign shareholders owned 20 percent of their stock" (Douglas-Gabriel, 2014). The new law completely changed the location trends of corporate inversion. It is now rare to see companies choose to move their headquarters or operations to the Caribbean.

Impact on the United States

When companies invert, the United States loses a significant amount of tax revenue. According to The Wall Street Journal, the United States could lose an estimated $20 billion in tax revenue due to corporate inversions (Walker, 2014). This loss of revenue has a negative impact on the United States' economy. When companies invert, there is a possibility of moving their operations overseas. If this happens, companies may be more likely to hire overseas workers, which would decrease the number of jobs for Americans. Due to the combination of losing tax revenue and the potential loss of American jobs, corporate inversion is detrimental to the United States economy.

Action Taken

Since corporate inversion has such a negative impact on the United States economy, there have been multiple attempts to decrease the number of inversions. This is done by passing laws to make it more difficult for companies to invert. A significant law was passed, which prevents companies from inverting unless foreign shareholders owned at least a 20 percent stake in the company (Douglas-Gabriel, 2014). New rules regarding corporate inversions were passed in 2015 to, "go after a technique known as 'stuffing', in which the non-U.S.

company is artificially made bigger before a merger to comply with that 80% threshold" (Rubin, 2015). Lawmakers are hopeful that this new rule reduces the number of corporate inversions in the future.

Tax Codes 1248(i) and 163(j)

There are four tax codes that aim to make inversions more difficult. The first is section 1248(i). According to the Virginia Tax Review, "Section 1248(i) requires shareholders to recognize gain on some inversion transactions, but is easily avoided" (Tootle, 2013). Since it is easily avoidable, this section is not very effective in preventing corporate inversions. The second section is 163(j). According to the Virginia Tax Review, "Section 163(j) denies corporations the benefits of interest stripping, but its application is limited to the point that the provision is ineffective as a deterrent" (Tootle, 2013). Both the 1248(i) and the 163(j) sections of the Tax Code are ineffective at preventing corporate inversions, since they can be easily avoided.

Tax Codes 367(a) and 7874

The next two sections of the Tax Code that attempt to hamper inversions are sections 367(a) and 7874. In contrast to section 1248(i), section 367(a) regulates shareholders by making them recognize all gains in an inversion (Tootle, 2014). This section is harsher on shareholders, since all gains must be recognized, instead of just some. Code 7874 is more complex, and it is also the most effective at regulating inversions. The section is broken down into two parts,

> (1) less than 25 percent of the new multinational entity's business activity is in the home country of the new foreign parent, and (2) the shareholders of the old U.S. parent end up owning at least 60 percent of the shares of the new foreign parent (Treasury Fact Sheet, 2014).

If these requirements are fulfilled, the tax consequences are determined by the new ownership percentage. If the ownership percentage is equal to or more than 80 percent, it is a U.S. company, and if the ownership is at least at 60 percent, but below 80 percent, then it is a foreign company (Treasury Fact Sheet, 2014). If companies moved overseas to avoid taxes, only to still be considered a U.S. company based on their ownership, there would be few advantages to moving.

Johnson Controls Inversion

A recent inversion that occurred is Johnson Controls. Johnson Controls is a manufacturing company that produces heating and air systems for commercial buildings. The headquarters was located in Milwaukee, Wisconsin. The new headquarters will be in Cork, Ireland. To complete the inversion, Johnson Controls is merging with Tyco International, which is another manufacturing company. The merger will create an entirely new company. In the merger, "Johnson Controls shareholders will own about 56% of the new company, which will be renamed Johnson Controls PLC but will maintain Tyco's Irish legal domicile" (Mattioli & Tita, 2016). According to The Wall Street Journal, this new company is projected to save $150 million in taxes each year of operation (Mattioli & Tita, 2016).

Conclusion

Corporate inversions allow companies to reincorporate in another country or merge with a foreign company. The high American tax rate has caused this trend to gain popularity in recent years. Several additions to the Tax Code attempt to make corporate inversions more difficult. Corporate inversions have a negative impact on the number of jobs available to American citizens and the amount of tax revenue in the United States.

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