



Research

The Economic Risks of Proposed Anti-Inversion Policy: An Update

DOUGLAS HOLTZ-EAKIN, GORDON GRAY, SUSMITHA KUDARAVALLI | APRIL 1, 2016

Introduction

The U.S. tax code is outdated and internationally uncompetitive, which discourages companies from locating headquarters in the U.S. Further, as long as this uncompetitive tax regime persists, current U.S.-based companies are both targets for purchase by international competitors or induced to relocate overseas. Reflective of this is the recent trend for American companies to merge and relocate with companies located in countries with reformed tax systems. Past legislative and regulatory efforts have curbed the practice of reincorporating in overseas tax havens for pure tax purposes (so-called “naked” inversions), but corporate inversions in other forms, specifically foreign mergers and acquisitions, have continued apace. New legislative and regulatory proposals aimed to curb these transactions will likely leave U.S. firms further disadvantaged and may actually hasten these corporate relocations as long as the uncompetitive U.S. tax code is left unreformed.

Recent inversions have been completed in the context of cross-border mergers and foreign acquisitions, most notably the Pfizer-Allergan merger. In many instances, the fundamental incentive to merge is driven by global market considerations and the intrinsic business case for the merger or acquisition. However, once the decision is made to merge, the inversion offers the U.S. firm easier access to overseas earnings and the potential to reduce its tax burden.

As long as foreign markets continue to grow, and the U.S. maintains a comparatively uncompetitive code, the incentive to relocate headquarters abroad will remain, especially as more OECD countries lower their corporate tax rates. Worse, recent policy proposals that ignore this reality will further harm U.S. competitiveness and jobs. Although highly uncertain, the analytics suggest that recent anti-inversion proposals could put 41,000 U.S. jobs at risk.

U.S. Corporation Taxation

The United States has the highest corporate tax rate among all major developed economies. The U.S. corporate tax rate is largely unchanged since 1986, when a significant rate reduction was enacted.^[1] Prior to 1986, the U.S. levied corporate taxes in excess of the Organization for Economic Cooperation and Development (OECD) average. By 1988, when the 1986 reform was fully implemented, the combined U.S. statutory rate had fallen below the OECD average. Since then, the U.S. has become steadily less competitive as other countries lowered their rates.

While statutory tax rates are critical to firm investment and location decisions, other measures of corporate taxation also warrant consideration.^[2] A firm's *effective* tax rate includes other facets of the corporate tax code, such as credits and deductions, which figure in the determination of a firm's tax burden. While less stark than top statutory rates, an international comparison of effective corporate rates still paints the U.S. in an unfavorable light. According to The Business Roundtable, US companies face an effective tax rate of 27.6 percent, whereas other OECD headquartered companies face an average of only 15.4 percent. The average tax rate faced by companies in non-OECD countries is 16.6 percent.^[3]

The United States fails another competitiveness test in the design of its international tax system. The U.S. corporation income tax applies to the worldwide earnings of U.S. headquartered firms. U.S. companies pay U.S. income taxes on income earned both domestically and abroad, although the U.S. allows a foreign tax credit up to the U.S. tax liability for taxes paid to foreign governments. Active income earned in foreign countries is generally only subject to U.S. income tax once it is repatriated, giving an incentive for companies to reinvest earnings anywhere but the U.S. This system distorts the international behavior of U.S. firms and essentially traps foreign earnings that might otherwise be repatriated back to the U.S.

Domestic firms also face the challenge of staying competitive on the world market. Many major firms, both U.S. and international, relocate to tax friendly countries for higher rates of cash flows available for reinvestment. This either leaves US firms disadvantaged or further incentivizes them for relocation abroad.

While the U.S. has maintained an international tax system that disadvantages U.S. firms competing abroad, many U.S. trading partners have shifted toward a territorial system; that system exempts entirely, or to a large degree, foreign source income. Of the 34 economies in the OECD for example, 28 have adopted such systems, including recent adoption by Japan, the United Kingdom and New Zealand.^[4] According to a 2015 study by the Tax

Foundation, the US ranks last in corporate income tax competitiveness compared to OECD countries.[5]

Taxes and Inversions

Maintaining the U.S. worldwide system compounds the incentive for firms to keep earnings offshore in the face of high domestic rates. The combination of high rates and an increasingly outmoded worldwide tax system disadvantages U.S. firms abroad, where market opportunities are growing.

The 1990's and early 2000's saw a series of corporate "expatriations" whereby U.S. firms re-domiciled abroad to reduce their tax burden. This phenomenon was the subject of Congressional hearings and attention from the Bush Treasury Department.[6] The American Job Creation Act of 2004 (AJCA) included important anti-inversion measures that remain in force today. The AJCA sought to preclude the "top-tier" foreign corporations from tax benefits as a result of the inversion transaction unless the transaction met certain criteria – the goal being to limit the benefits of purely tax-driven expatriations without undue infringement on business activity.

One of the key determinations for being subject to the strictures of the AJCA anti-inversion measures is the ownership stake of the top-tier entity by the formerly U.S.-domiciled corporation. Under current law, the foreign top-tier entity would not be recognized as a foreign corporation for tax purposes if the original U.S. shareholders own 80 percent or more of the foreign corporation (the "80 percent test"). The AJCA also imposes lesser sanctions if the original shareholder ownership stake in the foreign, top-tier entity is at least 60 percent but less than 80 percent ("60 percent test"). For transactions meeting these criteria, the foreign domicile of the top-tier entity is recognized, but certain tax benefits (for example offsetting losses) are denied.[7] For example, when U.S.-based Eaton merged with Ireland-Based Cooper to form Eaton Cooper, Eaton shareholders held a 73 percent stake in the new entity.[8] Lastly, under current law, a company must have a "substantial business presence" in the company in which the new top-tier entity is domiciled. Through the regulatory process this definition has expanded from 10 to 25 percent of firm's employees, group assets, and group income.[9]

Recently Passed Regulations

In response to the continued political firestorm that accompanies inversions, the Treasury Department issued new guidance in November aimed at curbing them.[10] The Treasury's latest guidance follows up on related guidelines issues in September of 2014. Specifically, the latest notice broadly addresses a class of inversions falling between the 60 and 80

percent ownership bands. The latest guidance would apply three new changes to transactions falling in this 60-80 percent band, all designed to limit the ability of U.S. firms to relocate abroad for tax purposes. In general, these new regulations would restrict expatriated firms from relocating to a third party nation, tighten the existing law test of what constitutes “substantial business activity,” and restrict the ability of firms’ to alter their valuations in determining the applicability of the 60-80 percent ownership tests.[11] While lacking force of law or a formal rule, guidance is generally not ignored by regulated entities, and Treasury has promised to follow-up these notices with rulemaking.

Legislative Proposals

The president’s FY2017 budget, as well as proposals in the House and Senate have all included measures that advocates claim would staunch inversions. Among other provisions, these proposals would reduce the proportion of corporate shares that a U.S. company may own of a foreign entity to be considered as a foreign-domiciled firm. At present this stands at 80 percent, while these proposals would reduce it to 50 percent. As a result, if, under an expatriation transaction, the original shareholders have a majority stake in the foreign, top-tier corporation, that corporation is viewed as a domestic corporation for tax purposes.

These proposals also share a key feature related to management and control that would ultimately incentivize shipping corporate headquarters jobs overseas. All of these proposals would add a management and control test to the determination of the tax treatment of a firm. In essence, if a firm keeps its headquarters in the United States, and does not have a large footprint in the new foreign home, it will be taxed as a U.S. firm. To the extent the U.S. tax code otherwise incentivizes these firms to expatriate, this test will push these firms a step further - shipping their headquarters off-shore.

These proposals, both regulatory and legislative, would further incentivize more substantial offshoring of U.S. jobs. Whereas past “naked inversions” essentially changed mailboxes for tax purposes, new regulations and legislation in the current tax climate incentivize moving headquarters and associated jobs overseas. Imposition of stricter “managed and controlled tests” would further spur this trend. Even existing regulations are informing the structure of these transactions as foreign acquisitions. Acquisitions by foreign firms, with existing headquarters infrastructure, endangers U.S. headquarters employment.

The Economic Risk of Current Anti-Inversion Proposals

One recent estimate on the macro-economic effects of fundamental tax reform, authored by John Diamond and George Zodrow, examined how Chairman Camp’s draft bill would affect capital flows compared to current law.[12] In the long-run, the authors estimated that a

Camp-style reform that lowered corporate rates and moved to an internationally competitive divided-exemption system would *increase* U.S. holdings of firm-specific capital by 23.5 percent, while the net change in domestic ordinary capital would be a 5 percent increase. It is important to note that these are relative measurements - they are relative to current law. Current law is inducing capital flight. Moreover, to the extent that the rest of the world has reduced its corporate rates and moved to a territorial system, a Camp-style reform may merely move the U.S. to the middle of the pack in terms of its tax climate. Accordingly, the 23.5 percent and 5 percent *increases* in firm-specific and ordinary stock, respectively, may be interpreted in part as the effect of precluding future tax inversions.

Company Name	Market Cap in \$ Billions	HQ Employees	Company Name	Market Cap in \$ Billions	HQ Employees
Apple Inc.	725	16,000	Procter & Gamble Co	221	14,000
Alphabet Inc.	375	20100	Pfizer Inc.	214	14,650
Exxon Mobile Corp	357	1169	Verizon Communications Inc.	198	10,000
Berkshire Hathaway	357	25	Chevron Corp	197	6,391
Microsoft Corp	334	33, 792	Oracle Corp	188	6,524
Wells Fargo & Co	280	15,080	The Coca-Cola Co	177	8,761
Johnson	280	14,500	AT&T Inc.	169	15,800
Wal-Mart Stores Inc.	265	9,500	Merck & Co	163	5,000
General Electric	250	500	Bank of America	162	15,000
JP Morgan Chase & Co	226	20,000	Visa Inc.	161	3,207

Placing a value on this potential equity flight is uncertain, but based on these estimates, roughly 15 percent, or \$876 billion in U.S. based capital is at risk of moving overseas.[\[13\]](#)

To the extent this economic inducement remains by maintaining the current tax code, anti-inversion laws that include management and control tests would push the capital overseas and headquarters jobs would follow suit. The largest American firms have nearly 280,000 headquarters employees, many of which would be at risk for having their positions relocated abroad. If roughly 15 percent of U.S. based market capital is at rest, it suggests a proportional overseas relocation of 41,000 U.S. jobs.

[1]

http://www.oecd.org/document/60/0,3746,en_2649_34533_1942460_1_1_1_1,00.html#C_CorporateCapital

[2] Alan J. Auerbach, Michael P. Devereux, and Helen Simpson, "Taxing Corporate Income," National Bureau of Economic Research Working Paper No. 14494, November 2008.

[3]

<http://businessroundtable.org/media/news-releases/bottom-line-u.s.-effective-corporate-tax-rates-rank-among-the-highest>

[4]

http://businessroundtable.org/uploads/studies-reports/downloads/Taxation_of_American_Companies.pdf

[5] http://taxfoundation.org/sites/taxfoundation.org/files/docs/TF_ITCI_2015.pdf

[6] <http://waysandmeans.house.gov/legacy/fullcomm/107cong/6-6-02/107-73final.htm>;
<http://faculty.law.wayne.edu/tad/Documents/Country/Treasury%20inversion%20report%20%2017%2002.pdf>

[7]

<http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf>

[8]

<http://democrats.waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/CRS%20report%20on%20inversions.pdf>

[9] http://www.irs.gov/irb/2012-28_IRB/ar10.html#d0e2458

[10] <https://www.irs.gov/pub/irs-drop/n-15-79.pdf>

[11]

[https://www.americanactionforum.org/insight/understanding-treasurys-newguidance-on-inve
rsions/](https://www.americanactionforum.org/insight/understanding-treasurys-newguidance-on-inve
rsions/)

[12]

[http://businessroundtable.org/sites/default/files/reports/Diamond-Zodrow%20Analysis%20fo
r%20Business%20Roundtable_Final%20for%20Release.pdf](http://businessroundtable.org/sites/default/files/reports/Diamond-Zodrow%20Analysis%20fo
r%20Business%20Roundtable_Final%20for%20Release.pdf)

[13] Note, this is based on PWC, “Global Top 100 Companies,” March 2015 and is noted as merely instructive and does not attempt to capture total market cap at present. HQ Employees figures are drawn from public sources available on request. Where otherwise unavailable, HQ employment figures have been estimated based on Collis, David; David Young; and Michael Goold. “International Differences in the Size and Roles of Corporate Headquarters: An Empirical Examination;” Working Paper 10-044; Harvard Business School; 2008.