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# Relationships between Corporate Inversions and the Tax Cuts & Jobs Act

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Corporate Inversions and the Tax Cuts & Jobs Act

Peter T. Paul College Honor's Thesis

Relationships between Corporate Inversions and the Tax Cuts & Jobs Act

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## INTRODUCTION

The purpose of this research paper is to analyze Corporate Inversions and the effects and changes of them since the most recent tax reform, the Tax Cuts & Jobs Act. Corporate Inversions have been a hot topic in the media, and many of the recent administrations have made efforts to prevent or eliminate them from occurring. A review of literature was completed to discuss the largest effects on companies and their decisions to invert, as well as generally discussing the U.S. tax system compared to other developed foreign countries. The frequency of inversions has picked up in the past two decades until the recent legislation, it is key to watch out for changes to see what legislation largely effects company's decision making. This is an important topic as millions of U.S. tax dollars could be lost if companies choose to invert to a foreign country. Cases of past inversions will also be discussed to further analyze the motives of companies.

## WHAT ARE CORPORATE INVERSIONS?

Corporate Inversions are one form of tax avoidance that United States companies can implement to decrease their overall tax paid. tax avoidance has become a popular topic in recent years for everyone from individuals to large companies. Years ago, tax avoidance would cause many companies to have scandals in the news, and for many it would affect how shareholders and the general public would see them. There has been a change from this in recent years, where most of the tax avoidance 'scandals' have ended up non-scandalous (Bank, 2017). One of the reasons that tax avoidance is possible in the first place is because the tax code is made up of both hard law and soft law. Hard laws refer to binding laws, meaning that they must be followed. If hard laws are not followed while paying taxes you may be accused of tax evasion, which is much

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more serious than being accused of avoidance. Soft laws are the laws that are not seriously binding, but still have legal significance. Many will make soft law decisions based upon corporate social responsibility, or also the different incentive factors to save their company money. Corporate Inversions are a form of tax avoidance that is highly frowned upon by all parties in the government but is still considered legal in the eyes of the law (Murray, 2019).

A Corporate Inversion is when a company sets up its headquarters in a foreign country with either lower tax rates or a territorial tax system to reduce the amount of global tax they have to pay (Murray, 2019). In most cases an inversion will not change the operational structure of a company, and rarely leads to the loss of American jobs (Pomerleau, 2014). Corporate Inversion is considered a tax loophole in many senses but is not considered tax evasion as it is still within the tax laws (Murray, 2019). Only around 58 companies have chosen to do some sense of inversion since 1982, but it is still an incredibly controversial topic in the media (Mider, 2017). If a corporation is able to invert, it would no longer be considered a U.S. corporation and would not be liable for paying U.S. taxes on foreign earned profits (Pomerleau, 2014). Politicians in both the Democrat and Republican party discourage corporate inversions, but their strategies on how to reduce them differ between parties. Democrats want to increase regulations to keep companies in the U.S. and penalize the companies that attempt to leave. Republicans want to lower tax rates to keep them from wanting to leave in the first place (Stewart, 2016).

### WHY DO COMPANIES CHOOSE TO INVERT?

U.S. companies choose to invert to another country to reduce their total global tax paid each year. Until the recent tax reform (Tax Cuts & Jobs Act) the United States followed a global (also known as worldwide) tax system. This would mean that any U.S. company that earns

foreign profits would have to pay the foreign income tax as well as an additional tax when the income is brought back into the United States equal to the difference between the U.S. tax rate and what was already paid. This results in the U.S. firm always paying the 34% on their income, regardless of where that income was earned (Pomerleau, 2014). The U.S. had one of the largest corporate tax rates in the world, sometimes as much as 20% higher than other countries (Murray, 2019). The greatest benefit of a company inverting to a country with a lower tax rate is that the company would have to pay a tax rate that is significantly lower than the U.S. corporate rate of around 34%. Another benefit of inverting to another country is that most other countries follow a territorial tax system. The tax paid when you reside in a territorial tax country is to wherever your company makes their income. This would mean that the companies would only pay taxes once, so the inverting company would only be liable to the U.S for the income that was actually earned in the United States, not all of the income earned worldwide. This can significantly reduce global tax paid, and many companies choose to invert to territorial countries with low corporate tax rates (Pomerleau, 2014). Ireland has a corporate tax rate of around 12.5% making it one of the most popular destinations to invert (Stewart, 2016), visualized in Exhibit 2.

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### GLOBAL VS TERRITORIAL TAXES

As mentioned earlier, the United States followed a Global Tax system up until the newest tax reform. This tax reform changed the U.S. tax system not to a pure territorial system but to more of a hybrid system, a mix of the two. The original global (worldwide) system would work in the sense that a company would be taxed the U.S. corporate rate regardless of where the income was earned. If a company earned income in a foreign country with a lower tax rate, the would have to pay the difference between that countries tax rate and the U.S. corporate tax rate of around 34% to the U.S. government on all income returned to the United States. The U.S.

corporate tax system did not force companies to pay double tax on their income, rather just enforced the high tax rate regardless of the location of earnings.

A territorial system is much more commonly used among developed nations, making the United States even more unique for having a global system. The territorial system allows companies to make income in various foreign countries and leaving them responsible for paying taxes just on the income earned in the respective countries. If the United States implemented a full territorial system, they would not tax the residual income after already being taxed by a foreign country. There would be no tax credits or benefits in the U.S. for paying foreign taxes, but you wouldn't be responsible for the 34% unless the income was actually earned in the United States.

### EXAMPLES OF COMPANIES THAT CHOSE TO INVERT

The majority of inversions in the early years moved their headquarters to Bermuda, but in the past 20 years many of them have inverted to Ireland and England due to their low tax rates and territorial tax systems. A well-known company that merged across the border to avoid paying U.S. taxes on their global earnings is Burger King. Burger King combined with Canadian company Tim Hortons in 2014 in a \$11.5 billion merger (Stewart, 2017). Although Canada isn't generally considered a country to have a low corporate tax rate, at around 26%, Canada is one of the many countries that follows a territorial tax system. Burger King is a fast food chain that can be found internationally, and before the inversion they were a U.S. company. They chose to merge and move their combined headquarters to Ontario, Canada with a strategic approach of tax inversion. This was frowned upon by the U.S. government because they were avoiding their total taxes paid, but they decided to go through with the merger.

Another large merger with intentions of corporate inversions was set to take place in 2016 until the Obama Administration implemented new rules. Pharmaceutical companies Allergan and Pfizer had planned to merge, moving Pfizer to Allergan's headquarters in Ireland and greatly impacting their total tax paid (Bomey & McCoy, 2016). The U.S. Treasury department under the Obama Administration unveiled new rules to curb some of the large inversions, forcing Pfizer to terminate their deal and pay over \$400 million in expenses as a result (Humer & Pierson, 2016). Obama had expressed his opinion on the treasury department's decision and encouraged congress to make changes as well to have a lasting impact on preventing inversions once and for all. The CEO of Allergan Brent Saunders stated, "Treasury's building a wall around the U.S. to keep people in," (Bomey & McCoy, 2016). Saunders is not the only individual that had this view on government regulations for preventing inversions. Up to the most recent tax reform it was commonly believed that the government was trying to prevent any companies from leaving the U.S., the new tax act changed perspectives by trying to persuade companies to want to stay in the U.S.

### WHY ARE INVERSIONS CONTROVERSIAL?

Inversions are a controversial topic because it is a topic that has been agreed upon in the government and reported in the media often. Although the different parties have different ideas for solutions, they do agree that it needs to be addressed (Stewart, 2016). Because this is an issue that has been brought to light by the most recent administrations the Obama Administration and the Trump Administration, it has brought the issue to the press and has shamed many companies considering a move of their headquarters. President Obama had described the tax loophole as 'unpatriotic', Vermont Senator Bernie Sanders has called some of these companies 'corporate deserters', a past House Speaker Paul Ryan said our tax system encourages companies to move



overseas and President Trump had stated that he believed the United States has a huge inversions problem (Stewart, 2016).

Although Inversions are completely legal and reduce the amount of global tax paid by the company on their total income earned, it reduces the amount of income paid to the United States. Most of these companies do the majority of their business in the United States, even after inverting, so a common argument is that they receive all of the benefits of a U.S. company without having to pay proper U.S. taxes. Although this could hurt a company's brand reputation, most of the time the benefits of moving their headquarters for tax purposes cover all of the costs that would negatively affect the company. Most important, the U.S. government wants to prevent U.S. companies from leaving the United States, making it a relevant topic in the news and among politicians.

### HISTORY OF PREVENTATIVE LEGISLATION

The first company to invert was in 1982, although over 50 corporations have inverted in the time passed. The majority of inversions have been in the past decade, picking up in 2012 (Stewart, 2017). Tax avoidance prior to the 1970's was considered scandalous, but in more recent years and once inversions started picking up it didn't have much of an effect on a company's image in the long run (Bank, 2017). In 1984 Section 1248(i) was included in the internal revenue code referencing the U.S. global tax system and that all foreign profits need to pay U.S. taxes regardless of where income was earned. Exhibit 1 shows all of the inversions that have occurred since 1982, and the rise in frequency in the past decade. The various legislations that have been put in place as preventative measures include the American Jobs Creation Act in 2004, Obama Administration new tax rules in 2014 and 2016 and the Tax Cuts & Jobs Act.

## AMERICAN JOBS CREATION ACT

In 2004 the American Jobs Creation Act (AJCA) was put in place and legislators promised that it would 'end the practice of inversion' (Mider, 2017). A new section of the Internal Revenue Code was created specifically with inversions in mind by now considering all firms as domestic firms if they own at least 80% of the new inverted company. This act required that if companies merges or are acquired it should be at least 20% - 25% of its original size. Another rule was that active operations must now take place in the new headquarters. This stopped companies from inverting to countries like Bermuda where it was common to just put paperwork in a filing cabinet and be considered a foreign company. The company would actually be forced to build a headquarters in another country and have some of their business actually take place in that country. This made it harder for companies to invert initially, as a move would now be costlier to the inverting company.

The AJCA also created a one-time tax holiday for corporations to repatriate their profits at a reduced rate. Many companies hold their money overseas to avoid paying additional U.S. tax on their foreign profits. In section 965 of the act it allowed companies to repatriate at the rate of 5.25% rather than the existing tax rate of 35%. Although over 9,700 companies were eligible for the holiday, only 843 firms participated bringing back around one third of their cash held overseas. The intent of the holiday was for the companies to reinvest the money into their company, promoting innovation and creating more American Jobs. The \$312 billion that was brought back was generally used to pay dividends, repurchase shares and buying other companies shares. The tax holiday was a disappointment to many in the democratic party, as it is estimated that around 20,000 Americans lost their jobs in the process (Cox, 2017).

## OBAMA ADMINISTRATION EFFORTS

In 2014 and 2016 the Treasury Department under the Obama Administration added new rules to the internal revenue code. In many of his budgets that were sent to congress President Obama proposed to fully close the loophole that allows for corporate inversions. Unfortunately, Congress didn't take any action immediately when the President had proposed it; the Treasury Department stepped in adding new rules and made it more difficult for companies to invert (Zients & Hanlon, 2016). The Treasury department attempted to close the tax loophole in two main ways; these did not stop inversions entirely but reduced the benefits of when a company inverts. One of the biggest changes made was a rule to prevent serial inversions, this is when a recently inverted company acquires another U.S. company. Another new rule was focused on preventing earnings stripping, so that companies can no longer artificially shift their profits to another country and pay off loans and interest. Although both of these changes intended on closing the loophole, the amount of inversions did not decrease significantly throughout the Obama Administrations, visualized in Exhibit 1.

## WHAT IS THE TAX CUTS & JOBS ACT?

The most recent legislation put into effect was the new tax reform the Tax Cuts & Jobs Act (TCJA). On December 22, 2017 the Trump Administration placed one of the biggest tax legislation changes since the Tax Reform Act of 1986, generally the changes for corporations are to the corporation's benefit. The largest effect that the new tax reform had on corporate taxes was that it changed the corporate tax rate from an incremental rate of around 34% to a flat rate of 21%, placing the United States among the average for developed nations. It also changed the tax

system to where the worldwide income of U.S. corporations was only taxed on income earned within the United States (York, 2018).

The Tax Cuts & Jobs Act does not just apply to companies and their corporate tax rate, it also applies to many other stakeholders paying taxes. Most of the changes within the TCJA take effect in 2018 and expire after 2025. Because of how recent the TCJA was passed into law, it is hard to tell immediately the positive or negative impact on corporate inversions although many new rules were created specifically with inversions in mind.

### WHAT WAS THE INTENT OF THE ACT?

Before the Tax Cuts and Jobs Act in 2017 the United States followed a global tax system, forcing a company to pay a U.S. tax rate on all international earnings. This encouraged companies to move their legal headquarters out of the country. The TCJA significantly changed the way in which U.S. based global companies would be taxed on their foreign earnings, generally now being referred to as a territorial tax system. This new system utilizes features from a territorial and a global system, more of a hybrid tax system than a pure territorial tax system (Pomerleau, 2018).

The tax reform also incentivized large corporations to bring some of their foreign held profit back to the United States. Before the reform many companies would hold all foreign profits outside of the U.S. as it was the easiest way to defer tax paid to the U.S. and reduce global taxes altogether. Corporations brought back over \$350 billion after the tax cut, and the hope is that they reinvest it in the U.S. economy by increasing wages for employees and increasing research and development (Nutting, 2018).

Although many changes were made with inversions in mind, the tax reform has been the largest reform since 1986 and changed many other aspects in the U.S. tax system as well.

Throughout the Trump presidential campaign in 2016 inversions were mentioned and frowned upon, so it was definitely taken into consideration when designing and implementing the new rules.

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### NEW HYBRID SYSTEM

The United States hasn't changed their tax system or corporate tax rate in many years, while the majority of other developed nations have cut their corporate tax rates over the last four decades (Pomerleau, 2014). Under the Tax Cuts & Jobs Act the U.S. finds itself among the average corporate tax rates of developed nations. This is very different than just two years prior when the U.S. was one of the highest in the world. One of the biggest changes in legislation from the TCJA was the 'participation exemption'. This exempts companies from domestic taxation when their foreign profits are paid back to the United States. Any dividends paid from foreign profits to the U.S. parent company are fully deductible. This is the largest change that moved the U.S. system from a global system to more of a territorial tax system (Pomerleau, 2018).

### GENERAL REACTIONS/MOVES

An interesting case of related to corporate inversion is auto parts supplier Dana, Inc. and their intention to move to the United Kingdom. They had offered to merge with CKN PLC's axle business for automobiles, although their own headquarters would still stay in Toledo. Although the new Tax Cuts and Jobs Act lowered the corporate tax rate to 21%, and that the tax rate in the U.K. is 19%, Dana intended on leaving the United States. Dana, Inc. had announced the inversion before the reform was implemented, and originally, they decided to move forward with

the inversion as they believed the benefits of leaving the U.S. and moving to a territorial tax system country would be great. Politicians were surprised to see another inversion so soon because the tax rates were so similar (Dawson & Francis, 2018). Soon after all of the media coverage, CKN PLC decided to pull out of the deal, preventing the inversion from going through. It is unclear what the tax impact would have been exactly on Dana, Inc. if the inversion had occurred.

Because the corporate tax rates have decreased significantly, repatriation of foreign income has increased. Per the Tax Foundation “More earnings have been repatriated in the first [six] months of 2018 than in 2015, 2016 and 2017 combined.” (York, 2018). This in turn is expected to boost investment and economic growth in the long-run.

### CURRENT CLIMATE OF CORPORATE INVERSION

The idea behind the TCJA and corporate inversions is that the new 21% corporate tax rate will incentivize large corporations to stay in the United States. Although this rate is much lower than the 34% - 35% that corporations faced globally just years before, it is still high relative to Ireland’s 12.5% tax rate (Davison, 2018). The incentive that the Trump Administration is trying to convey is that the cost of moving a company’s headquarters is not worth the tax benefit a company might receive on their foreign income. Inversions can be incredibly expensive; Pfizer spent over \$400 million just to back out of a deal and there was much more put into it initially. When the corporate tax rate was much higher, the benefit of moving to a low corporate tax rate country like Ireland was huge if a company had lots of foreign profits. Although it was very difficult for companies to go through the inversion process, in the

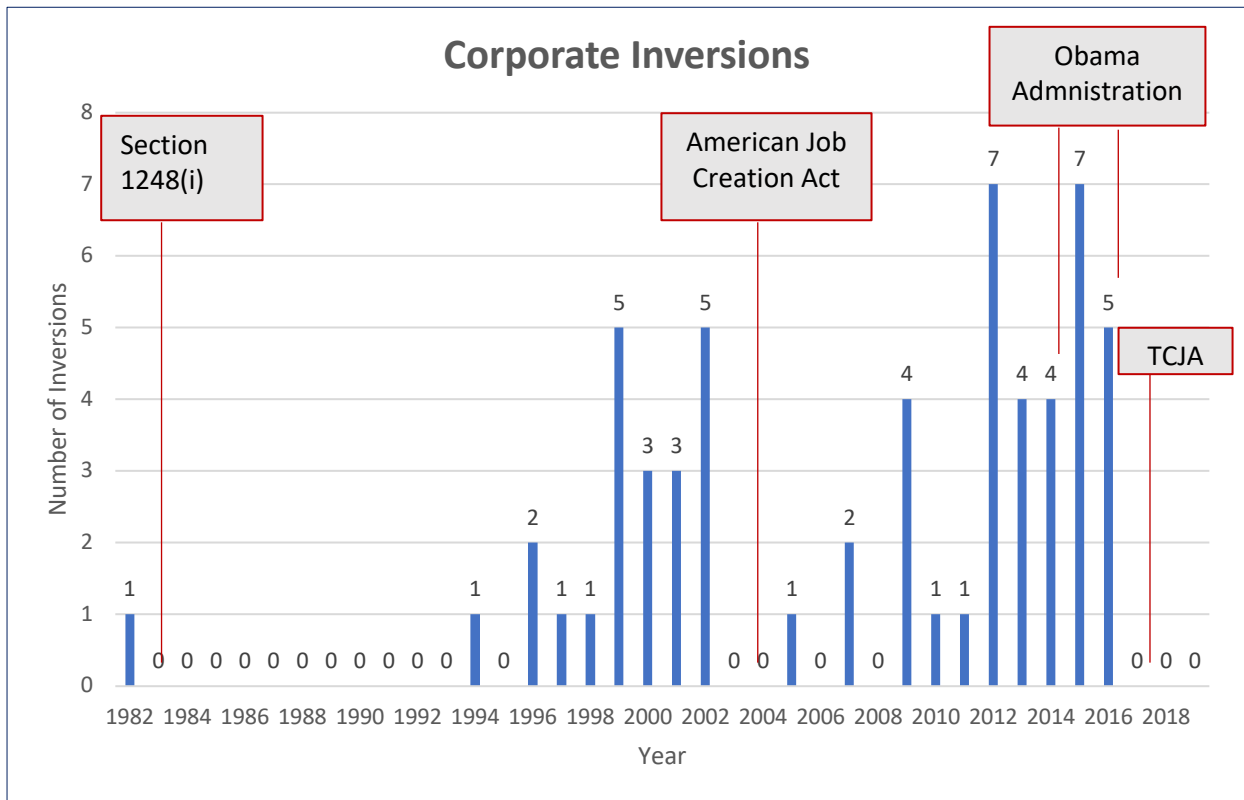
long run it was definitely worth it. The new 21% is making companies consider whether a deal like this would have value as the benefit would be minimal.

There have not been any new inversions since the Tax Cuts & Jobs Acts has been announced, which is definitely considered a short-term success. Although companies have considered it, it isn't clear enough if the benefits would outweigh the costs. Because this is such a recent tax reform it is hard to predict what companies might choose to do in the future. Generally, companies have a lag after new tax rules come out; companies wait to figure out the new system before making rash decisions. It may be a few years before companies choose to invert again. The best way to tell if this tax reform is going to make a lasting impact on reducing and preventing the amount of inversions is with time. As companies figure out the new rules, the government will decide what to keep and what to change.

## CONCLUSION

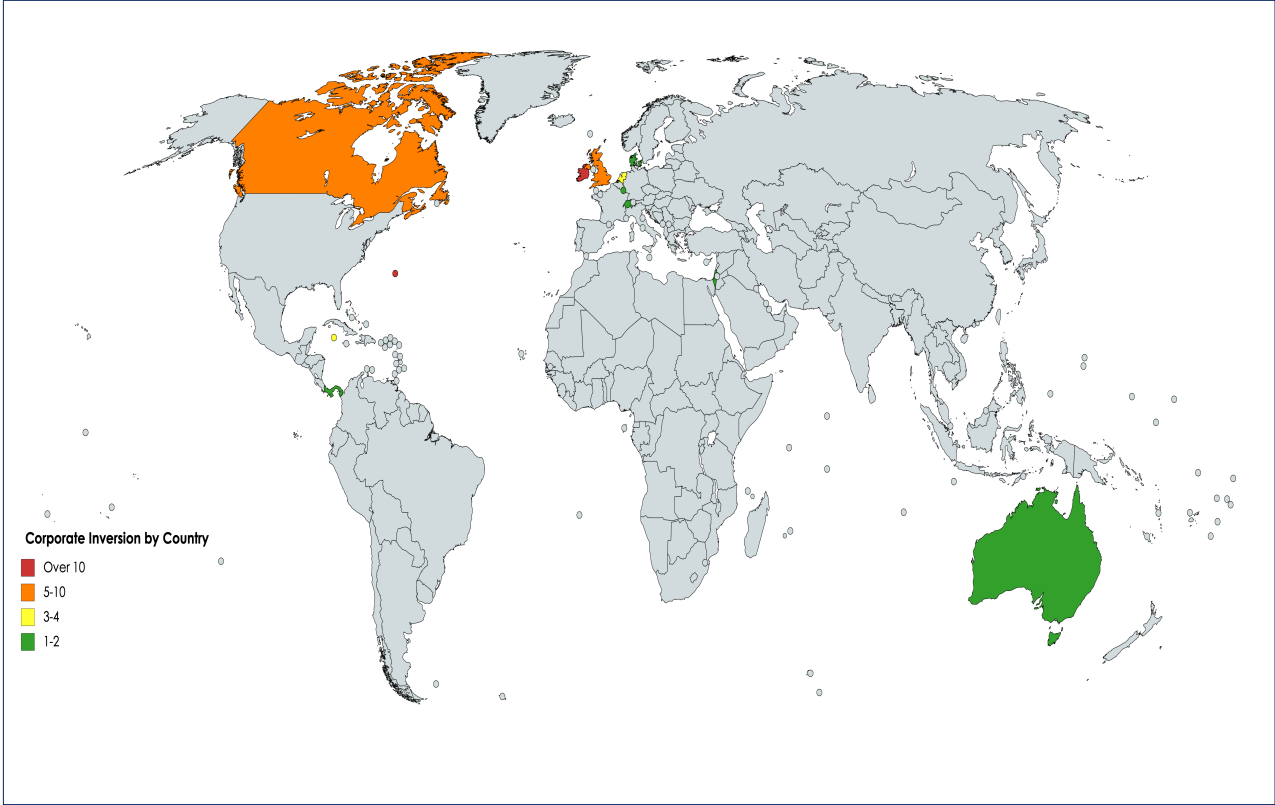
The new Tax Cuts & Jobs Acts has changed the frequency of Corporate Inversions. The new tax legislation changed the tax system in the United States from a global system to more of a hybrid system. This changed how many companies viewed inverting, encouraging them to see the benefits of staying in the U.S. with a low flat global tax rate of 21%. There haven't been any inversions since the TCJA was announced, and the treasury department does not suspect any to happen in the near future. It is incredibly important to follow the next moves of companies, as it is too early to see the lasting impacts on inversions and whether the TCJA could prevent them long term.

EXHIBITS



**Exhibit 1:** Bar Graph of Corporate Inversions throughout the years, identifying changes in legislation.





**Exhibit 2:** Map of where companies have inverted to in the past, color depending on the frequency.

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