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# Tax Inversions- The Real Costs

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# Tax Inversions – The Real Costs

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## Introduction

On July 29 2013, Allegan-based Perrigo Company announced the acquisition of Elan Corporation, PLC located in Dublin, Ireland. Perrigo manufactures and distributes over-the-counter and generic prescription pharmaceuticals and is the world's largest manufacturer of over-the-counter pharmaceutical products for the store brand market. Elan is a biotechnology company with its biggest product being a multiple sclerosis drug, Tysabri. One of the primary reasons for this acquisition, as stated by Perrigo, was the "opportunity for substantial after-tax annual operating expense and tax savings of more than $150 million." Let's take a look at how the tax savings for these transactions are realized and the effect these transactions have on the U.S. economy.

## Background

U.S. companies spend a lot of time, effort and money to minimize their tax costs. There is no downside in pursuing avenues to reduce tax costs. In fact, it is a corporation's responsibility to do so to increase shareholder returns. The U.S. has the highest statutory tax rates in the world, with a marginal federal tax rate of 35% (plus state taxes puts the rate at 38% to 40%). Certainly no significant corporation pays taxes at anywhere near the highest rates because of various tax rules and regulations that allow for deductions and deferrals. However, these rates compare to tax rates of 29.65% in Germany, 26.5% in Canada, 20% in the United Kingdom (recently reduced from 25%), 33% in Japan and a very low 12.5% in Ireland. There are certain smaller "tax haven" nations that have a zero corporate tax rate, notably Bermuda and the Cayman Islands.

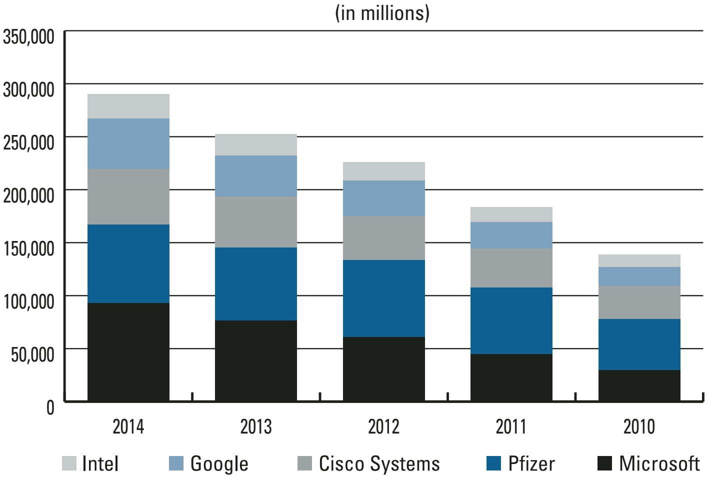
One tax reduction structure used frequently by U.S. corporations is a tax inversion. A tax inversion involves purchasing a company in a low tax jurisdiction, such as Ireland, and moving the company headquarters to that jurisdiction. "Moving company headquarters" is fairly subjective and typically requires only limited activity at the foreign headquarters. In 2004, the U.S. legislated restrictions on this strategy mandating that any merger be with a company that is at least 25% of the acquirer's fair market value. In recent years, (some prior to 2004) many of the largest U.S. corporations have implemented tax inversions, including Apple, Cisco Systems, Facebook, Google, Microsoft and Twitter.

Whereas U.S. corporations pay taxes on worldwide earnings at U.S. tax rates (less foreign taxes paid), this tax inversion structure allows the company to reduce taxes by paying lower rates for international sales and activities. These earnings are "trapped" overseas and cannot be remitted to the U.S. company, as dividends, without paying substantial additional taxes. This typically forces investment of these funds in operations or investments outside the U.S. In fact, many of these apparently "cash rich" companies have to borrow funds because of the amount of cash trapped overseas. For example, in June 2014, Microsoft, with cash and short investments of $86 billion, had long term debt of $21 billion.

**Historical Table of Corporate Tax Rates from Selected Jurisdictions**


SOURCE: kpmg.com

**Indefinitely Invested Earnings of Foreign Subsidiaries**
(in millions)



Estimates of these trapped amounts, often called "indefinitely invested earnings of foreign subsidiaries," exceed $1 trillion. In its 2014 Annual Report, Microsoft stated that it had $92.9 billion in "permanently invested earnings of foreign subsidiaries." Below is a graph of the "indefinitely invested earnings of foreign subsidiaries" for five of the larger U.S. corporate tax inversions, Google, Microsoft, Cisco, Pfizer and Intel.

The U.S. treasury loses most of the tax revenue associated with international earnings of these companies. However, that's not the only cost of tax inversions.

Let's examine all of the costs by looking at Perrigo Corporation and its recent tax inversion.

**Perrigo Case Study**

**Perrigo Consolidated Balance Sheets**

| | 6/27/15 | 6/28/14 Post-merger | 6/29/13 Pre-merger |
|---|---|---|---|
| **Assets** | | | |
| Current Assets | 3,183 | 2,551 | 2,237 |
| Fixed Assets, net | 932 | 780 | 681 |
| Goodwill / intangibles | 15,341 | 10,331 | 2,332 |
| Other non-current assets | 265 | 219 | 101 |
| Total Assets | 19,721 | 13,880 | 5,351 |
| **Liabilities and Shareholders' Equity** | | | |
| Current Liabilities | 1,694 | 1,075 | 749 |
| Long-term Debt | 5,247 | 3,091 | 1,928 |
| Other non-current liabilities | 2,117 | 1,021 | 341 |
| Total Liabilities | 9,058 | 5,187 | 3,018 |
| **Shareholders' Equity** | | | |
| Common Stock | 8,622 | 6,678 | 539 |
| Retained Earnings | 1,938 | 1,875 | 1,716 |
| Other | 103 | 140 | 78 |
| Total Shareholders' Equity | 10,663 | 8,694 | 2,333 |
| Total Liabilities and S/H Equity | 19,721 | 13,880 | 5,351 |

### 1. Lower Effective Tax Rate

Perrigo's merger with Elan Corporation was finalized in December 2013. As stated in Perrigo's 10-K report for the year ended June 28 2014, "due to changes to the jurisdictional mix of income and the new corporate structure…, the Company was able to reduce its effective tax rate." This is the first and most obvious benefit of a tax inversion. There is definitely a lot of activity and complexity that goes into calculating taxes for large international corporations, and the effective tax rates change every year for a multitude of reasons. For approximately six months of activity after its reincorporation in Ireland, Perrigo's effective tax rate went from 27.3% for fiscal 2013 to 24.7% for fiscal 2014. This saved more than $7 million in tax expense. The lower taxes relate to international (non-U.S.) earnings that were taxed at lower rates in Ireland.

To better estimate the taxes saved since 2013, it's fair to use the increase in "undistributed earnings of foreign subsidiaries" of $2.8 billion as a starting point. A portion of these undistributed earnings were a component of the Elan acquisition.

### 2. Earnings Trapped Overseas

From fiscal 2013 to fiscal 2015, Perrigo's "undistributed earnings of foreign subsidiaries" went from $640 million to $3.4 billion. These amounts can only be transferred to the U.S. entity as dividends, which would require paying U.S. taxes on any amounts repatriated.

### 3. Change in Dividend Policy

The amounts trapped in "undistributed earnings of foreign subsidiaries" reduces cash available to the company and impacts the ability to freely pay dividends from earnings.

### 4. Higher Acquisition Potential

Perrigo, being domiciled in Ireland, has now become a more attractive acquisition target. This was confirmed by the recent unsolicited buyout offer from Mylan NV, which was spurned by Perrigo. If they are acquired by another company, surely a good portion of their Michigan facilities will be redundant and eliminated. If the acquirer is a foreign company, there will be a dramatic decrease in the U.S. taxes paid by the foreign company.

**Recommendations**

### a. Lower corporate tax rates

Lowering corporate tax rates, in line with other countries, would eliminate the benefit of moving income outside of the U.S. The United Kingdom has done just that by lowering its corporate tax rates from 28% to 20% over the last seven years. The revenue lost due to lower tax rates would be recovered by fewer tax inversions by U.S. companies.

### b. Reduced tax rate on foreign dividends

This has been done in the U.S. before (in 2004 as a one-time incentive) but doesn't address the core issue of vastly different corporate tax rates. Companies would only bring funds into the U.S. if they don't have better or equivalent investment options internationally.

Other, less substantive, potential tax legislation has been kicked around, but it's clear that the only way to address this issue long term is for Congress to reduce corporate tax rates so they are more in line with international standards. Once this is done, companies won't have the incentive to move their domicile outside the U.S., and there won't be restrictions to moving their assets and investments to geographic areas where the returns are the highest. ■