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## CORPORATE INVERSIONS

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### ABSTRACT

Recently, there has been a spate of corporate inversions, where US multinational corporations have combined with foreign companies, arranging their corporate structure to locate the residence of the resulting corporation in a foreign country with an attractive corporate tax climate. Several features of the US tax system provide strong incentives for corporate inversion: a high statutory tax rate, a worldwide system of taxation, and limits on income shifting. Corporate inversions allow more flexible access to foreign cash stockpiles and easier shifting of income out of the US tax base. The recent surge in inversions has likely resulted from the large accumulation of unrepatriated foreign cash together with pessimism about the prospect of policy changes that would reduce the US tax burden associated with cash repatriations. If unfettered, corporate inversions are likely to undermine the US tax base, so swift policy action is likely warranted; inversions can be effectively addressed in a targeted fashion.

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## CORPORATE INVERSIONS

### I. INTRODUCTION

A recent spate of corporate inversions has attracted the attention of both media and policymakers.<sup>1</sup> A typical corporate inversion occurs when a US company combines with a foreign company with the explicit aim of locating the residence of the resulting company in a foreign jurisdiction with a low corporate tax rate and a favorable set of tax rules and treaties. Generally in these inversions, the larger US corporation becomes a subsidiary of the smaller foreign affiliated firm, now the parent. As one observer put it, “the foreign minnow swallows the domestic whale.”<sup>2</sup>

Since 2011, 12 corporate inversions involving US companies have been completed, and at least 10 more prospective deals are in the works.<sup>3</sup> Some of the possible inversions involve prominent US firms, including Mylan, Medtronic, and Abbvie.

This brief will consider the underlying causes of this spate of inversions, examine what prompted this trend, consider the costs of inversions, and discuss the merits of possible policy responses.

### II. WHY INVERSIONS?

The US system of corporate income tax creates large incentives for some corporations to expatriate. Several important features work together to create these incentives: (1) a statutory corporate tax rate of 35 percent, higher than that of most countries, (2) a worldwide system of taxation that taxes the foreign income of US based multinational firms upon repatriation, and (3) “speed limits” intended to reduce the ability of some multinational firms to shift income away from the US tax base. [See the Territorial versus Worldwide Systems of International Taxation box.]

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<sup>1</sup> Corporate inversions come in many varieties, some of which are not technically inversions but still expatriations. For ease of reference, I use the term “inversion” throughout.

<sup>2</sup> See Edward D. Kleinbard, “Tax Inversions Must Be Stopped Now,” *Wall Street Journal*, July 21, 2014. See also the forthcoming *Tax Notes* piece by Edward B. Kleinbard, “Competitiveness Has Nothing to Do with It,” which treats these points at much greater length.

<sup>3</sup> For summaries of recent deals, see Martin A. Sullivan, “Lessons from the Last War on Inversions,” *Tax Notes* (May 26, 2014); Martin A. Sullivan, “Short-Term Inversion Fix May Be Necessary,” *Tax Notes* (June 9, 2014); and Mindy Herzfeld, “What’s Really Driving Inversions? Walgreens Revisited,” *Tax Notes* (July 28, 2014).

## Territorial versus Worldwide Systems of International Taxation

The United States uses a worldwide system of taxation that taxes the foreign income of US resident firms. Still, for most foreign-income, US taxation only occurs when the income is returned to the United States, or repatriated.<sup>i</sup> Corporations also receive tax credits for foreign income taxes paid that they can use to offset US tax liabilities.<sup>ii</sup>

In contrast, under a territorial system of taxation, foreign income is normally exempt from taxation. This has the advantage of avoiding the complexities of taxing resident corporations on their worldwide income. However, it also makes it even more essential to establish the source of income, placing additional strain on the tax system. As just one example, if domestic firms use foreign affiliated firms to hold the intangible intellectual property of the multinational entity in tax-haven countries, this practice will erode the domestic tax base.<sup>iii</sup> In a world of highly integrated global business operations, where important sources of profit are intangible and corporations have discretion among choices of organizational structure, it can be difficult, if not impossible, to establish the true source of income.

Under a territorial system, there is a stronger incentive to shift income out of the domestic tax base than under current US law, since income booked abroad is permanently exempt from domestic taxation instead of being tax-deferred until repatriation. For this reason, some territorial countries have also adopted tough base-erosion protections whereby categories of foreign income are taxed *currently*, even without repatriation. Current taxation may be triggered if the foreign tax rate is less than some threshold rate, or if the host-country tax rate is less than half or three-quarters of the home-country rate.<sup>iv</sup>

Still, a worldwide system has its own disadvantages. Most relevant here is that a worldwide system will encourage US firms to expatriate or change their country of residence to avoid the reach of worldwide taxation. Thus, legislative remedies are likely required to address these expatriation incentives.

In addition, US multinational firms often argue that the worldwide system puts them at a disadvantage relative to firms based in territorial countries. This claim may be true with respect to *some* territorial systems, but other territorial systems have tough base-erosion protections that limit the ability of foreign multinational firms to reduce their global tax burdens.

Further, the US system enables the creation of “stateless income” through check-the-box regulations and other rules; these allow firms to generate income that does not fall under any taxing jurisdiction. Thus, the data do not support the notion that US multinational firms are less competitive than their counterparts in territorial countries.<sup>v</sup>

<sup>i</sup> This is the case for most types of income, but some income, including “passive” income, is taxed currently under subpart F, the US controlled foreign corporation rules.

<sup>ii</sup> The tax credit is limited to the US tax liability.

<sup>iii</sup> This practice also erodes the tax base under worldwide systems, but the accumulation of foreign profits and the residual US tax liability upon repatriation provide “speed limits” to this practice.

<sup>iv</sup> See Joint Committee on Taxation, *Background and Selected Issues Related to the U.S. International Tax System and Systems That Exempt Foreign Business Income*, (JCX-33-11) May 20, 2011.

<sup>v</sup> See Edward D. Kleinbard, “Stateless Income,” *Florida Tax Review* 11 (2011): 699–773. For a detailed explanation of the competitiveness issue, see Edward D. Kleinbard, “Competitiveness Has Nothing to Do with It,” *Tax Notes* (forthcoming).

Still, both the high US tax rate and the worldwide system of taxation have more bark than bite. In particular, agile US based multinational firms with substantial global operations often pay effective tax rates that are much lower than 35 percent. Effective tax rates in the teens are common, and some global corporations even pay rates in the single digits.<sup>4</sup> Also, our worldwide system of taxation does not tax foreign income until it is repatriated to the US parent corporation. This feature led President Obama’s top economic advisor to aptly describe our system as a “stupid” territorial system, since firms can self-help themselves to the territorial outcome of

<sup>4</sup> For example, General Electric (GE) pays an effective tax rate of 4.2 percent. See Mindy Herzfeld, “News Analysis: GE’s Acquisition of Alstom Stands Out Amid Recent Deals,” *Tax Notes* (July 7, 2014). GE’s 2012 effective tax rate was higher, at 14.6 percent. As Herzfeld notes, “According to its Form 10-K, GE’s effective tax rate is low because active business income earned and indefinitely reinvested outside the United States is taxed below the US rate. A significant portion of its effective tax rate reduction depends on a provision of US tax law that defers the imposition of US tax on some active financial services income until that income is repatriated to the United States as a dividend.”

untaxed foreign income, but only by careful tax planning, which creates its own inefficiencies.<sup>5</sup> Indeed, some purportedly territorial countries tax foreign income more heavily than our system does because of tougher controlled foreign corporation rules that immediately tax income earned in some low-tax jurisdictions without deferral until repatriation.<sup>6</sup>

Still, because the US system taxes foreign income upon repatriation, many US corporations have found themselves prey to their own tax-planning success, as they now have billions of dollars “trapped” abroad that cannot be used for dividends or repurchasing shares.<sup>7</sup> Estimates indicate that nearly a trillion dollars is held by US corporations abroad, accumulated over time from booking income in low-tax countries. These funds are often held in US financial institutions, and are thus available to US capital markets, but US multinational corporations are constrained in their use of these funds. These funds are assets of the firm that increase the firm’s credit worthiness; however, firms cannot return the cash to shareholders as dividends or share repurchases without incurring US corporate tax liabilities upon repatriation.

Inversion relieves the firm of this burden. Technically, cash accrued before inversion within the firm’s foreign affiliate still is taxable upon repatriation. When the new foreign parent is created, however, the US corporation’s existing foreign affiliates can lend money to the new foreign parent, skipping the US corporation and avoiding the tax due upon repatriation. University of Southern California Law Professor Edward Kleinbard dubs these “hopscotch” transactions, since the money skips over the US corporation.<sup>8</sup> This ability to skip over the US corporation frees up the funds for more flexible use, including for issuing dividends, repurchasing shares, or funding domestic investments. Thus, the foreign successor to the US company can get full use of the “trapped” foreign cash stockpiles without paying US tax.<sup>9</sup>

In addition, once the company is inverted, it also becomes easier to shift income out of the US tax base through earnings stripping. Earnings stripping occurs when corporations use loans between the new foreign parent and the US affiliate to shift income out of the United States. This happens by leveraging the US company, through internal loans within the multinational corporation, up to the limits set by the rules of earnings stripping provisions in section 163(j) of the Internal Revenue Code. Harvard Law Professor Stephen Shay argues that an inverted corporation will be able to shift income out of the United States without running afoul of these

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<sup>5</sup> See Jason Furman, “Keynote Speech at Tax Council Policy Institute’s Tax Symposium,” February 20, 2014.

<sup>6</sup> For examples, see Joint Committee on Taxation, *Background and Selected Issues*.

<sup>7</sup> Of course, the income is not truly trapped if the corporations are willing to pay the tax due upon repatriation.

<sup>8</sup> See Kleinbard “Tax Inversions Must Be Stopped Now” for more detail.

<sup>9</sup> In a 2011 study, Johannes Voget finds that multinational firms facing higher repatriation tax burdens are more likely to relocate their headquarters (Johannes Voget, “Relocation of Headquarters and International Taxation,” *Journal of Public Economics* 95 [2011]: 1067–1081).

provisions.<sup>10, 11</sup> For example, with these sorts of strategies, estimates suggest a planned inversion transaction could have saved Walgreens over \$780 million in taxes in one year alone.<sup>12 13</sup>

Therefore, since corporate inversions allow more flexible access to foreign cash stockpiles and easier shifting of income out of the US tax base, there is a strong incentive for corporate inversion.

### III. WHY NOW?

Given that the main features of the US tax system have been in place for decades, why is this spate of inversions happening now? Two possible factors are likely at play. First, these strategies might simply be becoming more acceptable ways for multinational corporations to achieve lower global tax burdens. As other multinational corporations have demonstrated success with inversion strategies, more and more corporations are lured by similar deals.

Second, the stockpile of unrepatriated foreign cash is growing to towering levels, nearing \$1 trillion. Multinational corporations have often lobbied for temporary or permanent relief from the US taxation of this foreign cash, and there is some precedent for relief. Congress granted a “tax holiday” for repatriation in the 2004 American Jobs Creation Act, temporarily taxing repatriated dividends at 5.25 percent rate.

However, advocates have not been able to bring about a repeat performance of this holiday. In part, this may result from the lack of evidence that the holiday benefited the US economy. Despite the hopeful title of the legislation, there is scant evidence that the repatriation holiday created jobs or investments in the United States. Studies concluded that the extra cash was used for dividends and share repurchases, not job creation or new US investment.<sup>14</sup>

Also, corporations may have given up hope of a quick transition to a territorial tax system that would simply exempt foreign income from taxation. In part, this is because of the revenue constraints that the US government faces. Many legislators are wary of losing revenue through corporate tax reform, yet a territorial system without tough base-erosion protections would lose

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<sup>10</sup> The same logic holds for foreign-headquartered firms more generally.

<sup>11</sup> See Stephen E. Shay, “Mr. Secretary, Take the Tax Juice out of Corporate Expatriations,” *Tax Notes* (July 28, 2014).

<sup>12</sup> Walgreens explored the possibility of a corporate inversion, but recently they decided against expatriation.

<sup>13</sup> Seida and Wempe, find evidence that firms’ effective tax rates decline following inversion because of income shifting through changes in intercompany debt (see Jim A. Sieda and William F. Wempe, “Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion,” *National Tax Journal* 54 (December 2004): 805–28.

<sup>14</sup> For a review of the evidence, see Donald J. Marples and Jane G. Gravelle, *Tax Cuts on Repatriation Earnings as Economic Stimulus: An Economic Analysis* (Washington, DC: Congressional Research Service Report no. R40178, 2011). For example, see D. Dharmapala, C.F. Foley, and K.J. Forbes, “Watch What I Do, Not What I Say: The Unintended Consequences of the Homeland Investment Act,” *The Journal of Finance* 66: 753-787.

revenue by removing much of the remaining constraints on income shifting.<sup>15</sup> Yet serious base-erosion protections are not popular with the business community, and there remains substantial disagreement among policymakers about the merits of adopting a territorial system in the United States.

Thus, with little prospect of a tax holiday on dividend repatriation or a change in the tax system, some multinational firms have sought to self-help through corporate inversions. In addition, frequent stalemates in Congress likely increased confidence that prospective corporate inversions would not be inhibited by new legislation.

Still, it is important not to overstate the magnitude of this trend. Not all corporations will benefit from corporate inversions, and there are some natural and legislative limits on inversions under current law. For example, as Herzfeld notes, giant General Electric (GE) would have a hard time finding a foreign target large enough for an inversion, since anti-inversion provisions in current law (section 7874(a)) treat a foreign company as a domestic company unless there is a greater than 20 percent change in ownership of the expatriating company.<sup>16</sup> In other words, if 80 percent of GE remains unchanged in ownership after an inversion, the new company would not be deemed a foreign company for tax purposes.<sup>17</sup>

Corporate inversions can also generate bad public relations. Earlier waves of corporate inversions gave rise to political campaign references to “Benedict Arnold” corporations, and politicians often paint such corporations as insufficiently patriotic. Though most economists do not view firm responses to tax incentives in moral terms, the public may well differ, which can have consequences for corporate reputations. For example, in 2002, reputation concerns led Stanley Works to abandon plans to expatriate.<sup>18</sup>

#### **IV. COST OF INVERSIONS**

Despite some limits on the magnitude of this trend, corporate inversions are undermining the US tax base. A Joint Committee on Taxation estimate suggests one proposal to limit inversions would raise \$19 billion over 10 years. Further, this estimate may be too low given both the recent wave of enthusiasm for corporate inversions and the potential for tax base erosion through earning stripping.

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<sup>15</sup> Without the fear of incurring US tax liabilities on income repatriated from low-tax countries, there would be even less constraint on shifting income abroad.

<sup>16</sup> See Herzfeld, “News Analysis: GE’s Acquisition of Alstom Stands Out Amid Recent Deals.”; Kimberly A. Clausing, “Multinational Firm Tax Avoidance and Tax Policy.” 62 *National Tax Journal* 4 (December 2009): 703–25; Kimberly A. Clausing, “The Revenue Effects of Multinational Firm Income Shifting.” *Tax Notes* (March 2011): 1580–86; Jane Gravelle, *Tax Havens: International Tax Avoidance and Evasion*. CRS Report for Congress. (Washington DC: Congressional Research Service, 2013).

<sup>17</sup> However, a large firm might still be attracted to some types of inversions in which it spins off parts of the firm to merge with a suitable foreign target. Observers have dubbed these “spinversions”.

<sup>18</sup> See Vanessa Houlder, “Tax factor beats patriotism in WPP relocation,” *Financial Times*, October 6, 2008.

Corporate inversions also affect the real and perceived fairness of the tax system, as corporations that invert have tax advantages that other companies and taxpayers are unlikely to enjoy. Further, though cross-border mergers and acquisitions are a normal part of globalization, and not generally a cause for alarm, many of the latest corporate inversions would not have occurred absent tax savings. As just one example, Medtronic's agreement with Covidien explicitly includes a provision that Medtronic may cancel the deal if tax laws are changed to render the merged corporation a US taxpayer.<sup>19</sup>

Of course, the current tax system causes multinational firms to spend a lot of time and money on wasteful tax planning efforts, and some multinational corporations may find that undertaking the tax planning required to do a corporate inversion reduces the tax planning required to manage large accumulations of untaxed foreign earnings.

While inversions may make tax planning easier, it is important to distinguish this motivation from that of competitiveness. As discussed in the box above, the evidence does not indicate that US resident corporations are at a systematic competitive disadvantage relative to their peers in most countries. The effective tax rates US resident firms pay are far less than the statutory rate and similar to that firms from many other countries pay.<sup>20</sup>

## V. WHAT TO DO

Given these considerations, policy action is likely warranted. Some policymakers, including Senator Wyden, the chair of the Senate Finance Committee, seem open to targeted legislation that would tackle the inversion problem without waiting for broader corporate tax reform. The Obama administration is also willing to take a targeted approach. As Secretary of the Treasury Lew notes, the Administration favors increasing the legal standard for a foreign affiliate to become a parent to 50 percent ownership of the newly merged company, an increase from the 20 percent standard set by the previous anti-inversion provisions. With a 50 percent threshold, if 50 percent (rather than 80 percent) of the new firm remained unchanged in ownership after the inversion, the new company would be deemed a US company for tax purposes.

The previous provisions were effective at stopping some inversions, in particular the tax-motivated transactions with little or no economic rationale. However, a 50 percent threshold would raise the bar, capturing transactions that currently have enough economic substance to get past the earlier regulations but are still substantially tax-motivated. In a recent op-ed, Secretary Lew suggests that US corporations also should be unable to move abroad for tax purposes if they remained managed and controlled in the United States or if the corporation did not do significant business in the country it claims as its new home.<sup>21</sup>

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<sup>19</sup> See "Tax-driven mergers: Inverse logic," *The Economist*, June 21, 2014.

<sup>20</sup> See Government Accountability Office, *Corporate Income Tax: Effective Tax Rates Can Differ Significantly from the Statutory Rate*. (GAO Report no. 13-520 July 2013). The first appendix of this report also references several other studies on effective tax rates. Kleinbard's forthcoming piece in *Tax Notes*, "Competitiveness Has Nothing to Do with It", also includes some illustrative comparisons.

<sup>21</sup> See Jacob L. Lew, "Close the Tax Loophole on Inversions," *Washington Post*. July 27, 2014.

Another area that could be revised in response to inversions is the earnings stripping rules under section 163(j). Since one of the key drivers behind inversions is facilitating the subsequent shifting of income out of the US tax base, tightening these rules would reduce the lure of inversion. Martin Sullivan of *Tax Notes* has cataloged many previous proposals to tighten these rules.<sup>22</sup> Such changes would also help address the income shifting problem more generally, including in cases in which multinational firms have not inverted.<sup>23</sup>

In addition, one could legislate anti-hopscotch provisions to avoid the easy, tax-free repatriations of cash accrued before an inversion,<sup>24</sup> or even enact explicit exit taxes on repatriating companies that would be based on the US tax due on outstanding stocks of income that have not been repatriated.<sup>25, 26</sup>

These legislative solutions are likely to be effective in forestalling inversions. Also, Stephen Shay argues that the Department of Treasury has regulatory authority to reduce many of the tax benefits associated with inversions, by reclassifying debt as equity under section 385, and by regulatory provisions that would limit “hopscotching.”<sup>27</sup> Still, there are some questions regarding whether section 385 could be used this way, and there may be political concerns about regulatory overreach.

One issue with all of these solutions is whether the effective date of new anti-inversion measures should be retroactive; for example, Senator Wyden has suggested a May 8, 2014 effective date. As noted above, some of the proposed deals have provisions that allow cancellation if the law should change, and there are good arguments for retroactivity. For example, the prospect of retroactivity would deter current plans for new inversions, thus avoiding situations in which firms rush to complete inversions before legislation is enacted. Retroactivity would also reduce (though not eliminate) the “tilt” of the playing field in favor of those firms that had already successfully completed inversions before the legislation.

Also, while systematic corporate tax reform could address the tax incentives behind corporate inversions, targeted legislation on inversions is likely to be quicker. This would protect the tax base now and allow more time for thoughtful corporate tax reform. It would also allow time to

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<sup>22</sup> See Martin Sullivan, “The Many Ways to Limit Earnings Stripping,” *Tax Notes* 144 no. 377 (July 28, 2014).

<sup>23</sup> In Clausing (2009, 2011), I estimate that income shifting by multinational firms reduces US government corporate tax revenue by \$60 to \$90 billion in 2008; given recent escalations in innovative international tax avoidance, this cost is likely higher today. Gravelle (2013) reviews other studies on the magnitude of the income shifting problem and concludes that US revenue losses are likely in the tens of billions.

<sup>24</sup> These provisions are described in more detail in Kleinbard “Competitiveness Has Nothing to Do with It.” Section 956, which causes dividend income if a controlled foreign corporation invests in US property, could be extended to include income from hop-scotch transactions.

<sup>25</sup> For elaboration, see in Daniel Shaviro, “Understanding and Responding to Corporate Inversions,” (blog), July 28, 2014, <http://danshaviro.blogspot.com/2014/07/understanding-and-responding-to.html>.

<sup>26</sup> Shareholders still pay capital gains taxes under typical inversion deals since the merger creates a realization event, but exit taxes would affect tax at the corporate level. Of course, many capital gains are not taxed, if the shareholder is tax-exempt (e.g., nonprofits, pensions, and annuities).

<sup>27</sup> See Shay, “Mr. Secretary, Take the Tax Juice out of Corporate Expatriations.”

reach the necessary political consensus behind such reform—a consensus that presently seems distant.