REMAPPING DEBATE
Asking "Why" and "Why Not"

Congress fiddles while Treasury burns

Original Reporting | By T.J. Lewan | Corporations, Taxes

June 25, 2014 — Corporate "inversions," as they're known in accounting parlance, are transactions in which U.S. corporations take over smaller foreign rivals from low-tax countries and allow those rivals to replace the American firm as parent of the corporate group. On paper, the newly incorporated entity — though controlled by Americans and headquartered in America — appears to be foreign, and thereby can avoid paying U.S. corporate tax.

Few members of Congress will admit to being sanguine about these tax ploys: Congress' bipartisan Joint Committee on Taxation projects $19.5 billion of tax revenues lost to inversions over the next 10 years, a dismal prospect for a country with a strained social safety net already struggling to balance its books.

> The bill represents a "major disincentive for corporations looking to invert primarily for tax benefits." — Edward Kleinbard

When and how to stop companies from renouncing their U.S. "citizenship" — that's where opinions diverge. Republicans refuse to act outside of a broad makeover of the tax code, which they say should include lowering the domestic corporate rate and scrapping taxes on profits generated by U.S. companies overseas. Some Democrats, while not discounting the need for broad reforms, want to stop inversions immediately before any more corporate tax revenues find their way offshore; many others, however, appear content to stand by and watch while the corporate tax base erodes further.

Companion legislation introduced in Congress in May by Michigan Democrats and brothers Sen. Carl Levin and Rep. Sander M. Levin, the "Stop Corporate Inversions Act of 2014," would stop the bleeding, disallowing any more inversions for at least two years while Congress retools what everyone agrees is an outdated tax code. (The Senate version includes a two-year expiration date to stop the expatriation of companies while Congress works out a "grand bargain" on tax reform. The House version of the bill would stop the practice permanently.)

The bill, which mirrors a proposal in President Obama's 2015 budget, wouldn't be the first time Congress took on inversions; in 2004, legislation to deter companies from doing this was signed into law by President Bush. But if that effort was a STOP sign to companies looking for ways to avoid paying taxes, this bill appears to be the equivalent of a concrete divider placed across a highway, for it strengthens the current law in three ways: First, through a more stringent "shareholder" test; second, through a new "business activities" test; and finally, through an unprecedented "headquarters" test that would require companies to move most of their executives and management overseas if they wanted to escape U.S. taxation.

The $19.5-billion question is: Will it work? Is this the best way to get after corporate deadbeats and stop the erosion of the U.S. corporate tax base? Or will companies find loopholes in this legislation or other means to dodge the taxman?

Consulting with international tax experts, economists, lawmakers, and others, Remapping Debate found an overwhelming consensus on three points:

First, the Levin bill is, indeed, close to “loophole proof” and would likely save the Treasury billions of dollars for years to come; second, it would reduce the competitive disadvantage that smaller U.S. companies suffer to large, well-heeled multinationals able to exploit overseas tax havens to amass profits; third, the more time passes without legislative action, the more inversions we are likely to see.

And yet, though new inversions are in the offing, our sources unanimously said the Levin bill is not likely to be voted on this year.

Inversion parade

A decade ago, when a parade of corporate inversions last provoked a public outcry, it was easier for corporations to get out of paying taxes by claiming they were an overseas concern. Essentially, all that was needed was a drop box or a shoebox-sized office staffed by a night watchman in a low- or no-tax country like Bermuda or the Cayman Islands. Typically, they would identify themselves as foreign when they filed their taxes, even though they operated as they always had: policy decided by the same U.S. executives, on behalf of the same shareholders, from the old U.S. headquarters.

In 2004, Congress added Section 7874 to the Internal Revenue Code. It compelled companies seeking to reincorporate overseas to merge with or acquire international companies at least a quarter of their pre-merger size. Likewise, it mandated that foreign shareholders of the combined company wind up with at least 20 percent of the newly created firm’s stock through the merger.

Inversions abated for a time, but by 2011 they were back in vogue, with many U.S. corporations merging with firms big enough to meet the 20-percent stock threshold but too small to actually control the new entity. (Indeed, 14 of the 41 U.S. companies that have reincorporated overseas to lower their tax bills have done so since 2011; Medtronic Inc., the medical device manufacturer that aims to invert to Ireland, is one of many more in the pipeline.)

> Though Democrats publicly grouse about tax loopholes for big corporations, many appear content to stand on the sidelines while inversions go on. In the Senate, where they have a majority, fewer than half of all Democrats are co-sponsors of Levin’s bill.

The Levin bill aims to modify Section 7874 to raise the foreign stockholder threshold above 50 percent – a change that represents a “major disincentive for corporations looking to invert primarily for tax benefits,” as Edward Kleinbard, a professor at the University of Southern California’s Gould School of Law, put it.

Kleinbard, who has served as chief of staff on the U.S. Congress's nonpartisan Joint Committee on Taxation, said that were the Levin bill adopted, "you'd have to find a foreign merger partner that's 101 percent bigger than your company, not one that's just 25 percent of your size. That's a huge difference."

Two new tests

The bill also creates two other tests that, until now, have never been part of U.S. law. The first empowers the IRS to treat inverted companies as American for tax purposes if they continue to conduct "significant" business activity within the United States. ("Significant," according to the bill, means that a company has 25 percent of its workforce, employee compensation, and income and assets "located," "incurred," or "derived" in the United States.) The second stipulates that the headquarters of the newly merged entity — together with "substantially all of the executive officers and senior management" — may not remain "primarily" within U.S. territory.

"This legislation would put the lid on inversions." — Carol P. Tello

What does "substantially all" and "primarily" mean? Here the legislation gets a little hazy, leaving it to the U.S. Treasury to define those qualifiers more precisely. Still, might U.S. corporations, and the armies of accountants and tax lawyers they hire, find wiggle room in this wording?

Reuven S. Avi-Yonah, a professor at the University of Michigan law school and a lawyer who specializes in international corporate taxation, said such vague terms — carryovers from the 2004 law — "could be a problem" down the road.

While welcoming the headquarters test, which, in his view is "the most meaningful provision in there," Avi-Yonah told Remapping Debate that he would have preferred to see a "red line" in the legislation on what constitutes a headquarters. "There has to be a better definition — the CEO and three quarters of the executive officers, for example — than the word 'substantial.'"

Nevertheless, most everyone we interviewed agreed the legislation was fairly airtight and would likely reduce the number of tax-motivated inversions to a trickle — if not dry them up altogether.

Linda Swartz, chair of the tax group at Cadwalader, Wickersham & Taft LLP, a New York City law firm that helps clients do global mergers and acquisitions: "Fewer companies will do inversions, most likely, if this law is enacted."

Carol P. Tello, a partner at Sutherland Asbill & Brennan LLP, a firm that counsels multinationals on cross-border tax planning with offices in the United States, United Kingdom, and Switzerland: "This legislation would put the lid on inversions."

Thomas L. Hungerford, director of tax and budget policy at the Economic Policy Institute and a former economist at the General Accounting Office: "This would stop a lot of companies from even thinking about inversions."

Where's Congress on Inversions?

If Congress took on inversions once before without a total overhaul of the tax code, why would it be a stretch for lawmakers to do so now?

First, unlike a decade ago, there appears to be zero Republican appetite for targeted anti-inversion legislation — not even from Sen. Charles Grassley (R-Iowa), who, as a ranking member of the Senate Finance Committee in 2002, declared that inversions "aren't illegal, but they're sure immoral."

Now, however, Jill Gerber, Grassley's press secretary, confirmed to Remapping Debate that Grassley was unprepared to deal with the inversion problem outside of broader changes to the tax system.

In a Senate floor speech in May, Sen. Orrin Hatch (R-Utah), the ranking minority member on the Senate Finance Committee, said "arbitrary inversion restrictions" imposed on companies would only complicate "the goal of comprehensive tax reform." (Several phone messages left by Remapping Debate requesting an interview or clarification from the senator at his office in Washington, D.C. went unanswered.)

And though Democrats publicly grouse about tax loopholes for big corporations, many appear content to stand on the sidelines while inversions go on. In the Senate, where they have a majority, fewer than half of all Democrats are co-sponsors of Levin's bill. Even less support is visible in the House; there, just 11 of 199 Democrats have attached their names to the legislation.

Of the 16 Democrats who form a minority on the tax-writing Ways and Means Committee in the House, just seven originally co-sponsored Rep. Sander M. Levin's legislation. Remapping Debate telephoned and emailed the staff of the nine representatives who hadn't, to ask why not. We also emailed the staffs of four senior Republican members of the committee, to ask what benefit there was to closing the inversion loophole later, rather than now. The only substantive response was from the chief of staff to Rep. Allyson Schwartz (D-Pa.), who advised us that Schwartz had added her name to the legislation.

Even Sen. Ron Wyden (D-Ore.), the chairman of the Senate Finance Committee, has backed away from what many saw as initial support for the bill. Two weeks before the anti-inversion legislation was introduced on May 20, Wyden wrote an op-ed in The Wall Street Journal, saying he would consider a short-term fix to the problem. But in June he told reporters he preferred to deal with inversions as part of comprehensive tax reform.

Lindsey Held, a spokeswoman for Wyden in Washington, D.C., reaffirmed that position in an interview with Remapping Debate last week: "We think it's a much better approach to do it in one large, comprehensive effort, rather than just piecemeal."

Why? "Because it's not easy," she said. "Doing tax reform is an extremely heavy lift." But what is there to gain by waiting to do everything later, as opposed to at least closing the inversion loophole today? "My boss," she replied, "has been down this road before and done a good job in coming up with a bipartisan approach, which we also think is critical."

Still, wouldn't it make sense to stop the erosion of the corporate tax base with at least a temporary fix while negotiating a solution to the larger problem? Held wouldn't respond directly, saying only that "there is a way to do this in a retroactive manner."

But if a "bipartisan approach" is what is sought by Wyden, the prospects for retroactivity seem dim. The Levin bill, as it happens, provides that any inversions completed after May 8, 2014 would be annulled. Republicans have fiercely criticized that provision, with Hatch, for one, attacking it in his Senate floor speech. "Retroactive changes to the law…are the antithesis of stability and predictability," he declared.

The Levin bill is effective precisely because it is multi-layered, said Steve Wamhoff, legislative director for Citizens for Tax Justice, a nonprofit advocacy group in Washington, D.C., and a policy analyst at the Institute on Taxation and Economic Policy.

"Under these rules, you'll have to hand over the ownership of the majority of your company, do less than a quarter of your business in the United States, and move your management overseas." The headquarters test — which would put the United States more in line with how many foreign governments define the nationality of companies for tax purposes — is, in Wamhoff's view, the nail in the coffin for those tax-motived inversions he describes as "offensive."

The bill would force top executives and senior managers of corporations that sought to change their tax status to pack up and move abroad themselves, he says. That "is such a dramatic step for many companies that I just don't see it happening."

Collateral damage?

Michael L. Schler, a partner in the tax department at Cravath, Swaine & Moore LLP in New York City, says the headquarters and business activities tests are so broadly worded that foreign multinationals could conceivably fall into the U.S. tax net in a way the bill likely never intended.

Right now, Schler told Remapping Debate, the bill "seems to say that if you're a pre-existing foreign company that is already managed from the U.S. and already has some business activities in the U.S., and you buy a U.S. company, no matter how small, for cash in a deal that has nothing to do with an inversion, then you, the foreign parent, could now get treated as a U.S. company for tax purposes."

> "The U.S. has the highest corporate tax rate in the developed world and still uses an outdated system of international taxation." — Alliance for Competitive Taxation

That, he said, would unnecessarily restrict routine business activity. "The bill literally tells foreign companies, 'It's okay to keep all your existing management in the U.S. as long as you don't buy any U.S. corporation regardless of its size, but if you do, then you the foreign parent automatically becomes a U.S. corporation for tax purposes.' Well, that's a pretty extreme result, and it doesn't make a lot of sense."

One solution, Schler said, would be to drop the U.S. management test altogether. Another: Keep the management test but not have it apply if the acquired U.S. corporation was purchased for cash or was sufficiently smaller than the foreign corporation.

Kleinbard, the University of Southern California professor, disagreed. "I believe that foreign companies whose management is substantially in the United States should be considered U.S. firms tax-wise going forward — full stop. If Michael doesn't — fine, we can have that argument."

But that debate, Kleinbard said, should come later when Congress at last takes up large-scale tax reform. "Deal with the immediate abuse of the inversions law now and protect the tax base, while still maintaining the pressure on getting fundamental reform done."

On balance, the provision "probably is on the aggressive side," said Tello, the international tax attorney in Washington, D.C., "but it does show how strongly the Levins feel about this issue. And I guess there is some indignation that you would take your company offshore for tax purposes and yet keep your headquarters here."

Bad for competition?

The Levin bill's most outspoken critics say they oppose the legislation because it doesn't address what they say is the real reason corporations renounce their U.S. citizenship — that America's tax system makes them less competitive against rivals based in foreign countries with lower rates.

> In 1952, levies on business accounted for 32.1 percent of all federal tax revenues. Nowadays, U.S. corporations contribute less than a tenth of federal tax revenues.

As the Alliance for Competitive Taxation, a coalition of multinationals including Google Inc., Cisco Systems, Inc., the General Electric Co., Pfizer, Inc., and The Coca-Cola Company, declared in a statement issued the day the Levins introduced their bill: "The U.S. has the highest corporate tax rate in the developed world and still uses an outdated system of international taxation…If we want to encourage companies to locate, invest, and create jobs in the U.S., then we have to address the root cause — America's broken tax code."

The Levin bill, "would do nothing to address the competitive disadvantages inherent in our tax code," the statement added, "and could lead to even more jobs and businesses leaving America."

The United States is one of only six industrialized nations that taxes domestic corporations on worldwide income, and its statutory corporate rate, 35 percent, is the highest in the developed world. However, the effective corporate rate for large corporations is considerably less — 12.1 percent in 2012, the nonpartisan Congressional Budget Office says — because of tax breaks unique to the U.S. code. (In 2011, America collected less in corporate tax relative to its Gross Domestic Product — 2.3 percent — than the 3 percent average collected by the 33 other members of the Organisation for Economic Cooperation and Development, the Paris-based club of leading market economies, according to a February report by the Congressional Research Service.)

Americans should worry less about how corporate titans such as General Electric, Boeing, and Microsoft are faring against foreign competitors and more about tax fairness between large and small U.S. businesses, says Frank Knapp Jr., co-chair of the American Sustainable Business Council, a coalition of 70 business organizations that advocates for 200,000 U.S. companies and 325,000 executives, owners, and investors.

Small business owners are well aware that U.S. multinationals legally escape paying much, and often all, of the highly publicized 35-percent corporate rate, Knapp told Remapping Debate, adding that his members aren't happy about it.

In a March 2013 poll of members, he said, the ASBC found that 80 percent of the more than 500 small business owners surveyed strongly agreed that the use of accounting loopholes such as inversions was contributing to our nation's budget problems and should be stopped; three-quarters said these practices wound up harming their own small businesses. Asked if foreign earnings of U.S. corporations should be taxed after receiving credit for foreign taxes paid, about two-thirds of small business owners said yes. The poll's margin of error was 4.4 percent.

The responses were identical among Republicans, Democrats, and Independents. "This resonates with everybody," said Knapp, who is also president and CEO of the South Carolina Small Business Chamber of Commerce. "Now, when we find such a contentious issue on which small business owners overwhelmingly agree, regardless of partisan leanings, our elected leaders in Washington ought to pay close attention."

National interests vs. corporate interests

In 1952, long before anyone fretted about American companies becoming corporate runaways, levies on business accounted for 32.1 percent of all federal tax revenues. They've come a long way down since then.

Nowadays, U.S. corporations contribute less than a tenth of federal tax revenues. Wage workers, according to a February report by the Congressional Research Service, have made up the difference: From 1952 to 2012, payroll taxes as a share of federal revenues have risen from 9.7 percent to 34.5 percent, it said.

> An American Sustainable Business Council poll found that 80 percent of the more than 500 small business owners surveyed strongly agreed that the use of accounting loopholes such as inversions was contributing to our nation's budget problems and should be stopped.

James S. Henry, a senior economic advisor to Tax Justice Network, an international coalition of activists who study corporation taxation, said numbers like these ought to have Americans asking two fundamental questions when it comes to inversions:

One: What is an American company?

Two: Should our national interests be subordinated to corporate interests?

American corporations, Henry told Remapping Debate, take much for granted: the protection of the U.S. armed forces; a stable political system; a legal structure that protects patents and fosters capital

transparency; an education system that draws university students from around the world; a federal government that spends enormous sums of money on basic research for the nation's health, energy, agriculture, and pharmaceutical industries. "Without these and other investments made for generations, American companies wouldn't create the kind of wealth they do."

And yet, Henry said, "We've got some of the biggest, most successful companies on the planet doing things like offshoring their headquarters, offshoring their intellectual property, transferring essential value abroad that was created in the United States. That should not be their prerogative. They shouldn't be able to transfer these valuable assets offshore and not pay any tax. It's not patriotic. To put it bluntly, it's just plain bad citizenship."

Knapp, of the Sustainable Business Council, was blunter: "Nobody likes a freeloader, and that's what small business owners feel these big U.S. corporations are doing with their inversions — freeloading on the backs of the rest of us."

With corporate and overall tax revenues running markedly below their historic averages relative to GDP, Congress should focus on wringing more money out of big companies — not less, or even the same amount, said Nick Jacobs, a spokesman for the Financing Accountability & Corporate Transparency Coalition, a nonprofit in Washington, D.C. that analyzes money laundering and tax evasion practices while promoting transparency in the global financial system.

"The bills still have to be paid," he said. "You can advocate all you want for lower corporate tax rates, but if corporations pay less, the burden has to shift to somebody, and that means individuals and small, domestic businesses. That's actually what's been going on for the last sixty years."

It's worth remembering, says Rebecca Wilkins, a senior counsel at the nonprofit Citizens for Tax Justice, that after corporations invert, they wipe out not only their future U.S. tax liability on foreign earnings but make it much easier for themselves to avoid ever having to pay U.S. tax on the vast sums they've already booked offshore as American companies, doing so through complicated accounting and restructuring transactions. (Current U.S. law allows companies to defer paying taxes on overseas profits until those profits are brought home. As of last year, General Electric held $108 billion in offshore accounts, while Pfizer had $73 billion, according to a 2013 data analysis by the Bloomberg news agency.)

Were Congress to clamp down on inversions, it is likely that the same corporations would probably seek, and very possibly find, other legal means to dodge taxes, Jacobs conceded. "They've got armies of accountants, lawyers and tax advisors looking for every work-around imaginable." Still, he said, that's no reason not to do the right thing here.

"If they try other accounting tricks, we expose and shut those down, too," he said, "one loophole at a time."

This content originally appeared at http://www.remappingdebate.org/node/2277