Business
QuickTake

Tax Inversion

By Zachary Mider
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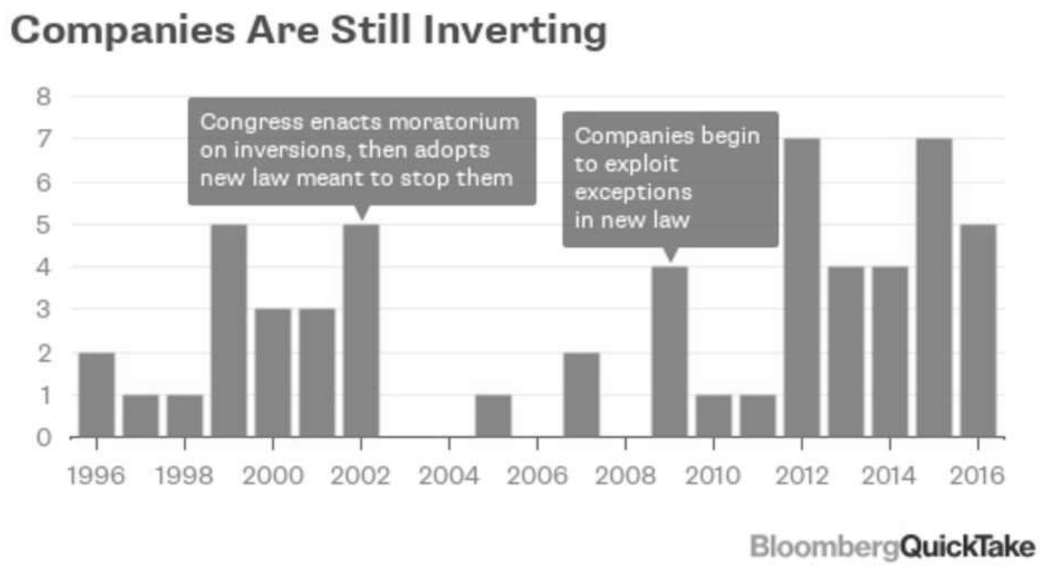
From

Pfizer has been a U.S. company since a German-born chemist by that name opened a red-brick laboratory in the Williamsburg section of Brooklyn in 1849. In 2015, it proposed to become Irish. A financial exercise known as an "inversion" would have allowed it to lower its tax bills by acquiring a legal address abroad. Strange as the idea sounds, it was an inevitable outgrowth of peculiarities of the U.S. tax code and has enjoyed a resurgence in the past few years among American companies. Pfizer would have been by far the biggest to try to join the trend, which has provoked a political backlash.

The Situation

More than 50 U.S. companies have reincorporated in low-tax countries since 1982, including more than 20 since 2012. A lot of drug companies are inverting, and low-tax Ireland is a popular corporate home. They're doing it despite a 2004 law that legislators promised would end the practice. Nowadays, most companies invert by acquiring a foreign company at least 25 percent their size. That's how Medtronic, the medical device giant founded in a Minneapolis garage in 1949, turned Irish and how Burger King became Canadian. Pfizer's plan to become Irish through a merger was blocked only when Barack Obama's Treasury Department crafted rules to stop it. As the inversion trend marches on, President Donald Trump is taking a different tack by focusing on a corporate tax cut that would remove the incentive to invert.



Source: Data compiled by Bloomberg

The Background

The U.S. corporate income tax rate, 35 percent, is the highest in the developed world. The U.S. is also one of the few countries that makes its companies pay that rate on all their worldwide income – although they can defer the bill on profits attributed overseas until they bring the money home. Many nations, including the U.K. and Canada, tax only domestic profits. One perverse result is that an independent U.S. company can end up paying more taxes than an identical U.S. company owned by a foreign parent. By creating or buying a foreign parent, a company escapes U.S. tax on worldwide income. Most importantly, perhaps, companies that invert overseas can take advantage of the generous U.S. system of interest deductions for payments to their own affiliates abroad – benefits that are only available with a foreign parent company. And the change of address doesn't necessarily mean a real move. Companies are free to keep their top executives in the U.S., and most of them do.

The Argument

U.S. lawmakers in both parties dislike inversions and many also acknowledge that only a major corporate tax overhaul is likely to stop them for good. They mostly disagree about what to do in the meantime. President Obama favored short-term fixes to plug holes in a leaky international tax system, while Republicans see such efforts as counterproductive. As a candidate, Trump proposed cutting the corporate tax rate to 15 percent, a move that would end much of the financial incentive to invert – and cost the government billions in foregone revenue. The question companies now face: wager that a tax overhaul can clear Congress, or follow Medtronic's lead and embrace a do-it-yourself fix?

The Reference Shelf

- Here is a list of all the U.S. companies that have reincorporated in low-tax countries since 1982.
- And here is a list of recent tax inversions, from 2005 through 2016.
- Bloomberg News articles on how Congress created a new windfall for CEOs who invert, and how most CEOs of inverted companies continue to run them from the U.S.
- Bret Wells of the University of Houston Law Center argues for tax reform in a 2012 article, “Cant and the Inconvenient Truth About Corporate Inversions.”
- A paper by University of Utah law professor Cathy Hwang on the history of corporate inversions.
- Bloomberg Best (and Worst) ranking, “Biggest Companies Incorporated in Ireland,” notes that 12 of the top 20 had roots in the U.S.
- The Pulitzer Prize website has links to the Bloomberg News articles on inversion that were honored for explanatory reporting in 2015.

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