

Hiding Profits From the Tax Man

On July 14, the Foreign Account Tax Compliance Act became effective, and instantly virtually all foreign banks were required to keep track of, and report on, all assets held by U.S. citizens. Individuals who don't report income on those assets and pay taxes to Uncle Sam face draconian penalties in excess of the actual money in the account.

But hiding income abroad is nothing more than business as usual for large American companies. Some are now ducking through a corporate tax loophole by relocating their tax base overseas. These so-called "inversions" hit the mainstream news media when medical device manufacturer Medtronic bought rival Covidien, which is domiciled in Ireland, and then began stripping income out of the U.S., where the top corporate rate is 35%. The merged firm is paying taxes on most of its net income in Ireland, at a 12.5% rate. This will save the company between \$3.5 billion and \$4.2 billion in overall taxes.

Others are following suit. Wallgreens Co. is purchasing a Swiss company it partially owns, and pharmaceutical giant Pfizer Inc. openly pursued an inversion this year when it sought to purchase British drug maker AstraZeneca. Chicago-based pharmaceutical company AbbVie is buying Irish drug maker Shire, and two U.S.-based pharmaceuticals, Mylan Laboratories and Abbot Laboratories are planning to merge and reincorporate in the Netherlands. Overall, nearly 50 U.S. companies have used this tactic over the past decade. The net effect is to reduce U.S. tax revenues by an estimated \$17 billion over the next decade.

Still others are assigning their valuable patents to a subsidiary in a more tax-friendly locale. For example, Apple, Inc. now generates 30% of its total net profits through an affiliated firm based in Ireland, saving an estimated \$7.7 billion in U.S. taxes in 2011 alone. When the Wall Street Journal examined the books of 60 big U.S. companies, it found that they had shielded more than 40% of their annual profits from Uncle Sam.

An inversion works like this: A U.S. company buys or merges with a smaller company in the same business that happens to be located in a country where the corporate tax rate is lower than the maximum 35% federal rate here in the U.S.-- plus, of course, state taxes. This covers a lot of territory. According to the latest update in Wikipedia, only the United Arab Emirates, Guyana, Japan and Cameroon assess higher corporate tax rates than the U.S.; their rates top out at 55%, 40%, 38% and 38.5% respectively.)

Next, the company is reincorporated, and its global headquarters is shifted to the foreign country. Operations continue exactly as they were before, which may mean that most of the sales and profits are still coming from the U.S. market. But the taxes are now paid at the lower rates of the overseas location.

The net result is to shift tax revenue to Ireland, the Netherlands, Switzerland and Canada, which offer a combination of low corporate tax rates and a territorial tax system, whereby income from foreign sources (like, for instance, the U.S.) isn't taxed at all.

How does this affect you? First of all, you will bear a slightly higher tax burden as the government seeks to recover lost revenues. The Journal report found that if just 19 of the 60 companies had to pay U.S. taxes on their earnings like you or me, the \$98 billion in additional tax revenues would more than offset the \$85 billion in automatic spending cuts that were triggered by the fiscal cliff negotiations. In addition, companies that are holding assets offshore for tax reasons have effectively made that money unavailable to invest in the U.S., which could lower economic growth and cost jobs for the U.S. economy.

More directly, that offshore money is no longer available to pay dividends to shareholders like you and me, or to buy back shares, which raises the value of our stock holdings.

Finally, an inversion could actually trigger higher taxes for its shareholders.

How? When the company inverts or reincorporates abroad, all current shareholders are required to pay capital gains taxes on their holdings in that year, as they are issued new stock in the new company. So if you happen to own \$100,000 worth of Medtronic, and your shares originally cost you \$20,000, you would get a 1099 in the mail saying that you have \$80,000 in realized gains, subject to capital gains taxes immediately. If you had planned to hold those assets until death, and get a step-up in basis for your heirs, well, that strategy is preempted by the company's decision to invert. If you were holding the stock long-term to avoid annual taxation, or trying to shift tax obligations to next year, tough luck. You're paying taxes now, whether you like it or not.

Is there a way bring these assets back into the U.S. tax system? One obvious possibility is to lower our corporate tax rates below the rates of other countries. But there is no guarantee that those nations wouldn't lower their rates in turn,

leading to a global race to the bottom, with the logical outcome that corporations would be essentially granted a 0% tax rate everywhere. And a lower corporate tax rate would, of course, mean higher individual tax rates, which is politically unlikely at the moment. Opponents would note that the share of federal revenues paid by corporations has already fallen from 32% in 1952 to just 8.9% today.

Another possibility is being explored in Congress. A recently proposed bill would require the foreign partner of any inversion tactic to be larger than the American merger partner; otherwise, the company is assumed, for tax purposes, to be domiciled in the U.S. The argument is a good one: these companies want to take advantage of U.S. laws and have full access to the U.S. consumer market, but not have to pay for it.

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