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Vern Krishna: U.S. 'patch up' doesn't get to root cause of tax inversions

VERN KRISHNA | October 1, 2014 10:10 AM ET
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Some say the proposed merger between Tim Hortons and Burger King is the latest in a long series of so-called 'tax inversion' deals THE CANADIAN PRESS/Andrew Vaughan

On Sept. 22, the United States Treasury issued new regulations to stem the rush of American companies heading for the exits to reduce their domestic and global tax bills.

The methods vary, but the underlying theme is always the same: maximize global return on equity (ROE). The latest in a long series is Miami-based Burger King Worldwide Inc.'s announced inverted takeover of Canada's Tim Hortons Inc. for about $11.5-billion. The Whopper's move to Canada illustrates how market efficiencies prevail in the long run over legislative bungling and wrangling.

International tax rates vary considerably, as countries seek to attract foreign investment and jobs. The differential rates are attributable to several factors: differences between nominal and effective tax rates, timing rules for taxing income, and rules for repatriating income to the home country.

"Tax inversion" is geek-speak to describe corporate transactions that re-domicile a U.S. parent company, which may be subject to a federal tax rate of 35% in a lower tax jurisdiction such as, Canada, which has a federal rate of 15%, or Britain (20%), Ireland (12.5%), or Barbados (2.5%). By "inverting," a U.S. company can avoid tax on its foreign profits. Although the company will still pay U.S. tax on domestic profits, it can usually reduce such taxes by, for example, loading up on debt in the U.S. and paying interest. Thus, inversions, which have long been popular in the pharmaceutical industry, where many companies have substantial overseas profits, are now spreading like a virus to other business sectors.

In Burger King's case, it's estimated the company's effective tax rate, as opposed to its nominal rate, will drop by only about 1% from

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to 26% from 27%. However, there are other reasons for inversions, which allow corporations to book their expenses, such as interest payments, in the high tax jurisdiction and book their revenues in a lower tax country. The leaky U.S. corporate tax system encourages companies to park their profits offshore to reduce the corporation's effective overall global tax rate. That's why companies like Apple and Google have billions in offshore accounts.

American companies pay tax on all of their worldwide income at 35% (higher in some cases with state income taxes) when they repatriate their overseas income to the United States. Although they can claim a credit for foreign taxes, the credit is limited to the actual tax paid. Hence, differential effective tax rates can increase the overall tax bite in the United States upon repatriation of the foreign income.

For example, a U.S. company with US$100 foreign income that pays tax at 20% will pay tax at 35% on the US$100 when it repatriates its income to the U.S. and claims a foreign tax credit of US$20. Since the company will end up paying an additional 15% by repatriating its income, it's better to park the money offshore. According to Moody's Analytics, U.S. non-financial companies had parked US$950-billion of cash overseas at the end of 2013.

In contrast, an Irish subsidiary of a Canadian parent company operating a business in Ireland will pay Irish taxes of only 12.5%. Better still, Canadian rules allow the parent to repatriate the subsidiary's net foreign earnings to Canada without paying additional income tax. The dividends are exempt from Canadian tax. Thus, our law provides an incentive for Canadian corporations to move their active business operation — such as textiles and technology — overseas to low tax jurisdictions, particularly those that also have lower labor rates. These rules have been written by Parliament and enacted through tax treaties negotiated by Canada with low tax countries. A U.S. parent corporation located in Canada could take advantage of the same rules.

In international tax planning, corporations use disparate tax rates and rules to arbitrage between jurisdictions and maximize their ROEs in order to satisfy fiduciary obligations to their shareholders. Politicians do not always like the conduct that they induce through the rules they enact. U.S. President Barack Obama, for example, says such planning may be legally right, but is morally wrong. He has called on legislators to do something on what he considers to be an "unpatriotic tax loophole."

However, political rhetoric will not eradicate lawful tax avoidance. The tax arrangements are a response to laws enacted by Parliament and Congress. The newly issued "patch up" Treasury regulations are unlikely to resolve the underlying problems of the leaky American tax system. Tax lawyers are now working late into the night to come up with ways to circumvent the patch up rules.

To be sure, the tax on those who remain in the home jurisdiction increases with every tax inversion. At the end of the day, domestic revenues must come from those who remain within the taxing jurisdiction. The solution, however, does not lie in political rhetoric and appealing to the patriotic sentiments of inanimate entities, such as corporations. The solution lies in harmonizing tax laws, rates, and treaties with other countries to blunt the economic incentive to move capital to lower and lower tax jurisdictions. Harmonization and rationalization of tax law will provide more efficient economic incentives in the long run. The power to do so is exclusively in the legislative domain of every country.

Vern.Krishna@TaxChambers.ca

Vern Krishna is a professor in the common law section of University of Ottawa Law School and counsel with TaxChambers LLP.