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Corporate Tax Centre - In this article, Vern Krishna discusses tax inversions with examples from American companies in the headlines, such as Burger King's inverted takeover of Tim Hortons in Canada, and argues that only the harmonization of tax laws, rates and treaties will keep companies from seeking lower tax rates abroad.

Tax Inversions (Vern Krishna)

Date: September 19, 2014

Tax Inversions

By

Vern Krishna

American companies are 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 move away from the home of the Whopper to Canada illustrates how market efficiencies prevail in the long run over legislative bungling and wrangling.

International tax rates vary considerably, as each country seeks 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 percent—the highest headline corporate tax rate in the developed world—into a lower tax jurisdiction—such as, Canada, which has a federal rate of 15%, or Britain with 20%, Ireland with 12.5%, or Barbados with 2.5%. Thus, inversions, which are popular in the pharmaceutical industry, where many companies have substantial overseas profits, are now spreading to other business sectors to take advantage of the differential rates.

Burger King's effective, as opposed to its nominal, tax rate will drop by only about 1 percent from 27 to 26 percent. However, there are other reasons for inversions, which can allow corporations to charge their expenses (such as, interest) in the high tax jurisdiction and their revenues in the lower tax country. The leaky U.S. corporate tax system encourages companies (for example, Apple Inc.) to park their profits offshore to reduce the corporation's effective overall global tax rate.

American companies pay tax on all of their worldwide income at 35 percent (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. Better to park the money offshore.

For example, a US company with $100 foreign income that pays tax at 20% will pay tax at 35% on the $100 when it repatriates its income to the United States and claim a foreign tax credit of $20. Hence, it will end up paying an additional

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15% by repatriating its income. Hence, according to Moody's Analytics, US nonfinancial companies had parked $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 percent. 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 operations—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 to maximize their ROEs in order to satisfy fiduciary obligations to their shareholders. Politicians do not always like the conduct induced by the rules they enact. President 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 is unlikely to resolve lawful tax avoidance. The tax arrangements are a response to laws enacted by Parliament and Congress.

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.

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