



## **FISCAL POLICY MEMO**

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# **Corporate Inversions: An Introduction to the Issue and FAQ**

## **Introduction**

What do Seagate Technologies—the new economy, quick paced, digitally charged, California-based, computer disk maker—and Stanley Works—the 159 year old, steady-as-she-goes, well respected, New England stodgy, manufacturer of handy man tools—have in common? Executives of both felt it necessary to incorporate at least a portion of their business outside the United States in order to compete in today's global marketplace.

Seagate and Stanley are not alone. A host of U.S. corporations, in various industries, have or are considering re-incorporation in another country. The list includes:

- Weatherford International Inc., an oilfield services company headquartered in Texas;
- Cooper Industries, manufacturer of electrical products, tools and hardware based in Texas;
- Fruit of the Loom, a basic apparel manufacturer now owned by Berkshire Hathaway and headquartered in Kentucky;
- PricewaterhouseCoopers Consulting, the international management consulting arm of the leading accounting firm;
- Ingersoll-Rand, a maker of industrial and commercial equipment based in New Jersey;
- Nabors Industries, the nation's largest oil well services company headquartered in Texas;
- Foster Wheeler, an industrial manufacturer located in New Jersey; and,
- Tyco International, a diversified manufacturer headquartered in New Hampshire.

The primary reason these and other major corporations have or are considering re-incorporation

overseas (a process also known as inversion or derisively, expatriation of profits) is to reduce their effective tax rate on income earned from foreign sources. As a recent preliminary report from the Office of Tax Policy within the U.S. Department of the Treasury finds, "The documents prepared for shareholder approval and filed with the Securities and Exchange Commission cite substantial reductions in overall corporate taxes as a key reason for the [re-incorporation] transactions."

That same report from the Treasury states, "The ability to achieve a substantial reduction in taxes through a transaction that is complicated technically but virtually transparent operationally is a cause for concern as a policy matter." This sentiment has been echoed on Capitol Hill by numerous lawmakers who have introduced legislation aimed at stopping U.S. companies from re-incorporating overseas. No fewer than five bills have been introduced since the beginning of March. In releasing his bill, co-sponsored with Senator Charles Grassley, Senator Max Baucus, Chairman of the Senate Finance Committee, stated, "Prominent U.S. companies are literally re-incorporating in off-shore tax havens in order to avoid U.S. taxes. They are, in effect, renouncing their U.S. citizenship to cut their tax bill. ...This is very troubling, especially now, as we all try to pull together as a nation." Senator Grassley, ranking Republican member of the Finance Committee has called re-incorporation "immoral." And in response to his home-state-based Stanley Works re-incorporation in Bermuda, Representative James Maloney (D-CT) said, "Connecticut hasn't seen such a shameful day since Benedict Arnold sailed away."

It is tempting, and politically easy, to tag U.S. companies considering re-incorporation as unpatriotic tax dodges and attempt to stop this popular new transaction through federal legislation. But, to do this would be to ignore the underlying reasons that corporate executives feel such a complicated arrangement is necessary, even in the face of potentially negative press. Specifically, policy makers should be looking at fundamental reform of the existing U.S. corporate income tax code, which has become overly burdensome and mind-numbingly complex, thus penalizing American firms that compete in the global marketplace.

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## Frequently Asked Questions

### **Q: What, exactly, is an inversion?**

In its simplest form, an inversion is simply the process by which a corporate entity, established in another country, "buys" an established American company. The transaction takes place when the overseas entity purchases either the shares or assets of a domestic corporation. Some inversions involve the purchase of both the shares of ownership and the corporate assets. The shareholders of the domestic company typically become shareholders of the new foreign parent company. In essence, the legal location of the company changes through a corporate inversion from the United States to another country. An inversion typically does not change the operational structure or location of a company.

### **Q: How does an inversion benefit the U.S. corporation?**

The change in legal residence from the United States to another country allows the company to take advantage of certain laws in that country. Typical advantages that draw U.S. companies to re-incorporate in another country include lower tax rates, more accommodating corporate governance rules, and more flexible banking laws.

Bermuda is one of the most popular destinations for corporate inversions for several reasons. The primary driver is the fact that Bermuda does not have a corporate income, profit, or dividend tax and does not tax capital gains.

### **Q: What is the impact of an inversion on employees?**

A corporate inversion does not typically change the operational structure of a company. In most cases, an inversion simply means the addition of a small office in the company's new foreign "home." Therefore, a re-incorporation rarely, if ever, leads to the loss of American jobs. In fact, to the extent that a corporate inversion leads to significant savings from a lower tax burden, employees may benefit through increased wages or more jobs.

**Q: Isn't this essentially the same reason that most large U.S. companies are currently incorporated in Delaware?**

Yes. The practice of shopping around for a business-friendly environment in which to incorporate is nothing new. For decades, corporations (and non-profit organizations) have flocked to Delaware as the best place to incorporate because of that state's well-established legal precedents, relatively open corporate governance regulations, and fully-developed insurance market. More than 308,000 companies are incorporated in Delaware, including 60 percent of Fortune 500 firms and 50 percent of the corporations listed on the New York Stock Exchange. Clearly, most of these companies do not have their headquarters or even a significant presence in Delaware. A company's state (or country) of incorporation merely provides a point of presence by which the company can take advantage of certain laws and policies to better fulfill its mission of serving customers, employees, and shareowners.

**Q: How can an inverted corporation be used to reduce a company's income from U.S. sources?**

if structured properly, a corporate inversion can be used to reduce a company's taxes on domestically earned income. This may be accomplished in several ways. In some inversion transactions the U.S. company issues debt to its foreign parent company in exchange for additional equity in the foreign company. The domestic firm can then deduct the interest expenses associated with the debt from its taxable income. However, since the U.S. corporation owns equity in the foreign company, the overall value of the domestic company does not change. Another popular method of reducing a company's tax burden is to transfer ownership of intangible assets to the new foreign parent company. These assets continue to produce income in the United States, but that income is attributed to the foreign company which faces a lower tax rate, because of that entity's ownership of the asset.

**Q: Why are inversions not a form of tax evasion?**

Tax evasion is the avoidance of taxes through illegal means such as misrepresenting income on a tax return. When a company's shareholders choose to re-incorporate in another country, it is a business decision like thousands of others that executives and shareholders must make every year. Judge Learned Hand in 1934 wrote, "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury. There is not even a patriotic duty to increase one's taxes."

**Q: What is the underlying cause of the recent trend in corporate inversions?**

As global operations become an increasingly important aspect of business, multinational corporations are under increasing pressure to lower their overall tax burden. There are two specific problems with the current corporate income tax that corporations are attempting to overcome through re-incorporation transactions:

- The United States corporate income tax rate, 35 percent on most corporate income, is relatively high by international standards. Only five Organization for Economic Cooperation and Development (OECD) countries—Belgium, Germany, Greece, Italy and Luxembourg—have a higher corporate income tax rate than the United States. Three have the same, 35 percent rate—Mexico, Netherlands, and Spain. The remaining 17 countries impose a lower corporate income tax rate than the United States. The average corporate income tax rate for the 26

OECD countries is 32 percent. The relatively high corporate income tax rate imposed by the federal government places U.S. companies at a distinct disadvantage and creates an environment in which corporate executives find it necessary to search for tax savings wherever available.

- Economist Paul Krugman recently wrote in the New York Times, "...U.S. companies don't necessarily pay higher taxes than their foreign counterparts; Germany's corporate tax rate is significantly higher than ours, France's rate is about the same, and Britain's is only marginally lower." Claiming that U.S. corporate income taxes are not high by comparing them to a select group of countries with even higher rates is a weak argument. Consider this analogy: You are in the market for a new dishwasher and looking through the Sunday paper find the model you want at three local stores. According to the ads, the exact same model is \$299.99 at Store X, \$450 at Store Y, and \$460 at Store Z. You certainly wouldn't say that Store Y's price is relatively low just because the price at store Z is \$10 higher. You'd more likely say that the prices at Stores Y and Z are both high because Store X is offering the same model for \$150 less. The United States corporate income tax rate IS high precisely because there are countries out there that have much lower corporate income tax rates (Ireland (12%), Switzerland (8%), and the Bermuda (0%) all come to mind).
- The United States taxes domestic companies on their world-wide income, while most other countries tax their domestic companies only on domestically-earned income. This means that U.S. companies are ensured of facing a marginal tax rate of at least 35 percent on every dollar earned whether earned domestically or abroad. The Internal Revenue Code does allow for the deduction of some foreign-earned income from taxable income through a series of complex rules and regulations. However, the compliance costs associated with taking advantage of these allowances are extremely high.

**Q: Does re-incorporation lead to large capital gains taxes for shareholders, including employee-shareholders?**

If a company's re-incorporation is accomplished through a stock transaction, in which the overseas corporation purchases significantly all the shares of ownership in the domestic corporation, existing shareholders (whether or not they become shareowners in the new, foreign corporation) may face capital gains taxation at the time of inversion. This is due to section 367 of the U.S. Internal Revenue Code, added in 1998, which requires shareholders to recognize a gain on the exchange of stock for tax purposes. This provision was added to the code as an "exit toll" with the intention of making inversions less palatable to U.S. corporations. Typically, corporate executives anticipate that the savings in corporate taxes from the inversion over the long-term is of greater value than the immediate capital gains hit. Thus, in theory, an inverted corporation's stock should appreciate in value enough to overcome the wealth lost in capital gains tax.

One reason many corporations are considering re-incorporation in another country now is the relatively depressed value of their stock, due in part to the general drop in the broader equity markets. This fact means that shareholder losses to capital gains taxation on the transaction are minimized.

**Q: What is the impact of the recent trend in corporate inversions on federal tax collections?**

There are three separate impacts on federal tax collections that result from a corporate inversion. These are:

- An increase in federal tax collections immediately from the capital gains realization faced by shareowners upon completion of the initial transaction.
- A reduction in federal tax collections over time from a reduction in the tax base as more and more income is realized by the new foreign corporation. This income is not taxable and

therefore an overall reduction in federal corporate income tax collections will result.

- An increase in federal tax collections over time from a larger capital gains tax and corporate income tax base due to the real growth of the firm.

All three of these factors must be considered when determining the total impact of corporate inversions on federal tax collections. For example, Stanley Works executives have estimated that the federal government may receive up to \$150 million in capital gains taxes immediately as a result of the inversion transaction. Additionally, Stanley accountants estimate that the re-incorporation will save the company (i.e. "cost" the Treasury) \$30 million per year. Assuming an interest rate of 2.5 percent over the next ten years, this amounts to \$263 million in present value. Finally, the company estimates that the inversion will increase the value of Stanley stock by 11.5 percent. As of May 22, 2002, Stanley Works had a total market capitalization of \$3.7 billion. Therefore, an 11.5 percent increase would result in a total market capitalization of \$4.1 billion, a capital gain of \$426 million. Assuming an aggregate effective capital gains tax rate of 15 percent, this increase in market capitalization would result in \$59 million in present value terms. Therefore, not accounting for fundamental growth in Stanley Works earnings subject to the corporate income tax, the loss to the treasury as a result of the company's inversion would be \$54 million in present value terms, or roughly \$4.7 million per year over the next decade.

## Appendix A: Major Legislation (a side-by-side)

Several Members of Congress have introduced legislation aimed at curbing corporate inversions. On April 11, 2002, Senator Charles Grassley (R-IA), ranking minority member of the Senate Finance Committee and Senator Max Baucus (D-MT), Chairman of the Senate Finance Committee have co-introduced s. 2119, the Reversing the Expatriation of Profits Offshore (REPO) Act. On March 6, 2002, Congressman Richard Neal (D-MA) along with 18 original cosponsors introduced H. R. 3884, the Corporate Patriot Enforcement Act of 2002. That same day, Representative Scott McInnis (R-CO) introduced H.R. 3857, a bill to "treat nominally foreign corporations created through inversion transactions as domestic corporations."

At the core of all three of these bills is a provision that would treat foreign corporations created with the sole purpose of buying a domestic firm—i.e. conducting an inversion—as a domestic corporation for tax purposes. In other words, each of the bills would simply ignore that the inversion ever took place and that the new parent company is incorporated in a foreign country. All three bills also apply this domestic tax treatment to "partial inversions," transactions in which an active foreign firm acquires a much larger U.S. firm. The Grassley-Baucus bill would go one step further than either of the House bills in that it would deny newly inverted firms the ability to apply tax credits to any gains from the inversion or new corporate structure. The details of each of these three bills are summarized in Table 1 below.

Additionally, Representative James Maloney (D-CT) has introduced H.R. 3922, the "Save America's Jobs Act of 2002," which is nearly identical in substance to H.R. 3884. Representative Nancy Johnson (R-CT) introduced H.R. 4756, the "Uncle Sam Wants You Act of 2002," which would impose a moratorium on corporate inversions through December 31, 2003. Except for the sunset provision, H.R. 4756 is identical in substance to H.R. 3884.

**Table 1**

Provision	S. 2119	H.R. 3884*	H.R. 3857

<b>Title</b>	"Reversing the Expatriation of Profits Offshore (REPO) Act"	"Corporate Patriot Enforcement Act of 2002"	N/A
<b>Definition of "Inverted Domestic Corporation"</b>	<ul style="list-style-type: none"> <li>• "direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation"</li> <li>• "at least 80 percent of the stock (by vote or value) of the entity is held ... by former shareholders of the domestic corporation"</li> <li>• "the expanded affiliated group ... does not have substantial business activities in the foreign country in which or under the law of which the entity is created or organized"</li> </ul>	<ul style="list-style-type: none"> <li>• "nominally foreign corporation ... acquires ... directly or indirectly substantially all of the properties held directly or indirectly by a domestic corporation"</li> <li>• "immediately after the transaction, more than 80 percent of the stock (by vote or value) of the acquiring corporation is held by former shareholders of the domestic corporation"</li> </ul>	<ul style="list-style-type: none"> <li>• "immediately after a transaction in which property is directly or indirectly transferred by a domestic corporation to such foreign corporation, 80 percent of the stock (by vote or value) of such foreign corporation is held by former shareholders of the domestic corporation"</li> </ul>
<b>Applicable to Partnerships?</b>	Yes	Yes	No
<b>Additional clarifications</b>	N/A	<p>50 percent ownership threshold instead of 80 percent if:</p> <ul style="list-style-type: none"> <li>• foreign corporation "does not have substantial business activities in the foreign country in which or under the law of which the corporation is created or organized, and</li> <li>• "the stock of the corporation is publicly traded and the principal market for the public trading of such stock is in the United States."</li> </ul>	<p>50 percent ownership threshold instead of 80 percent if:</p> <ul style="list-style-type: none"> <li>• "stock in such foreign corporation is publicly traded on an exchange in the United States,</li> <li>• "less than 10 percent of the gross income of such foreign corporation is derived from activities in the foreign country, and</li> <li>• "less than 10 percent of the employees of such foreign corporation are permanently located in such foreign country."</li> </ul>
<b>Partial inversion definition</b>	<ul style="list-style-type: none"> <li>• 50 percent ownership threshold instead of 80 percent</li> <li>• Inversion transaction completed on or before March 20, 2002</li> </ul>	N/A	N/A
<b>Partial inversion provisions</b>	<ul style="list-style-type: none"> <li>• "Credits not allowed against tax on inversion gain"</li> <li>• annual "pre-approval" of deductions required for 10 years</li> <li>• other limitations on using partial inversion arrangements to limit U.S. tax liability</li> </ul>	N/A	N/A

Retroactivity and effective dates	Transactions completed after March 20, 2002	Transactions completed after September 11, 2001	Transactions after December 31, 2001
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\* Representative James Maloney (D-CT) introduced H.R. 3922, the "Save America's Jobs Act of 2002," on March 11, 2002. H.R. 3922 is nearly identical in substance to H.R. 3884. Representative Nancy Johnson (R-CT) introduced H.R. 4756, the "Uncle Sam Wants You Act of 2002," on May 16, 2002. H.R. 4756 is identical in substance to H.R. 3884, except that the restrictions on corporate inversions would expire after December 31, 2003.

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