Tax Heavens: Methods and Tactics for Corporate Profit Shifting

By Mark Holtzblatt, Eva K. Jermakowicz and Barry J. Epstein

MARK HOLTZBLATT, Ph.D., CPA, is an Associate Professor of Accounting at Cleveland State University in the Monte Ahuja College of Business, teaching International Accounting and Taxation at the graduate and undergraduate levels.

EVA K. JERMAKOWICZ, Ph.D., CPA, is a Professor of Accounting and Chair of the Accounting Department at Tennessee State University.

BARRY JAY EPSTEIN, Ph.D., CPA, CFF, is a principal with Epstein + Nach LLC, a Chicago-based firm practicing in the areas of fraud investigations and forensic accounting, litigation consulting and expert witness testimony, technical consultations on GAAP, IFRS and GAAS, and training and development for CPA firms.

Taxes paid to governments are among the most significant costs incurred by businesses and individuals. Tax planning evaluates various tax strategies in order to determine how to conduct business (and personal transactions) in ways that will reduce or eliminate taxes paid to various governments, with the objective, in the case of multinational corporations, of minimizing the aggregate of taxes paid worldwide. Well-managed entities appropriately attempt to minimize the taxes they pay while making sure they are in full compliance with applicable tax laws. This process—the legitimate lessening of income tax expense—is often referred to as tax *avoidance*, thus distinguishing it from tax *evasion*, which is illegal. Although to some listeners' ears the term tax avoidance may sound pejorative, the practice is fully consistent with the valid, even paramount, goal of financial management, which is to maximize returns to businesses' ownership interests. Indeed, to do otherwise would represent nonfeasance in office by corporate managers and board members.

Multinational corporations make several important decisions in which taxation is a very important factor, such as where to locate a foreign operation, what legal form the operations should assume and how the operations are to be financed. Corporations can employ different tax-avoidance strategies to lower their taxes by structuring operations and transactions so that they result in the smallest tax burdens. Tax avoidance is thus legal—and wise.

Conversely, tax evasion refers to tax reductions that are illegal (*e.g.*, reducing taxes paid by deceit, subterfuge or concealment). There are certain activities conducted by corporations, however, that have, upon occasion, been classified as either tax avoidance or as tax evasion, or both, often depending on the political perspectives and/or understanding of economics of those making the characterization. In this latter grouping are such practices as those involving using transfer prices to shift income to low-tax affiliates and employing financial structures designed to defer repatriation of foreign-based income.

The U.S. Corporate Tax Rate and the Appeal of Tax Havens

As global operations become an increasingly important aspect of business, multinational corporations are faced with expanded opportunities for lowering their overall tax burden and increasing pressure to do so. There are two major types of taxes affecting the after-tax profits earned by companies conducting operations internationally: employment or withholding taxes on workers' wages, and corporate income taxes. The former are a function of the laws of the jurisdictions where workers are employed, and thus play a part in selecting locations where manufacturing, distribution and administration activities are to be based. These considerations are not addressed in the present article.

Corporate income taxes, the second category of taxation, are generically distinct, since these are subject to various manipulations that may bear little relationship to the volume of manufacturing or other production activities being performed in the local jurisdiction. Rather, these are affected by such decisions as place of incorporation (*i.e.*, domicile), transfer pricing practices, profit repatriations and other strategic management actions. It is this latter group of choices that has recently become the focus of intense political debate, and which will be surveyed in the following discussion.

Differences in corporate tax rates among countries provide corporations with a tax-planning opportunity as they decide where to locate foreign operations, including establishing corporate headquarters. This choice has long existed, but until the disparity between U.S. corporate tax rates and those of most other developed nations became substantially unfavorable, it received scant attention. For the few executives who actually considered what are now called *tax inversions*, the likely benefits did not appear to exceed the immediate costs—such as legal and other administrative expenses—and the risks, including possible reputational ones, as well as the historically real threats of expropriation or radical shifts in host-country tax or domestic ownership policies. Simply stated, there was limited attractiveness to movement to non-U.S. jurisdictions to make this a realistic alternative course of action for most corporate managements.

In more recent times, however, this equation has changed. For one thing, the continuing international trend toward reducing corporate tax rates during the last few decades has achieved high visibility in the business and general press, thus exposing the mounting disadvantage of being a U.S. corporate taxpayer, particularly when the U.S. policy of taxing worldwide income is also factored in. Also, the sharp increase in international trade has provided more managers with first-hand observations of how other nations' tax policies, including lower rates and a territorial system, impact their domestic business managers' decision-making.

A third, and very important, factor has been the integration of formerly nonmarket (*e.g.*, East European) economies into the world economy, expanding the locations in which U.S. corporations are active and offering more possibilities as potential domiciles for them, particularly if capital investments in those places (*via* acquisitions, mergers or simple establishment of facilities) are being contemplated. The growing level of sophistication and expanded economic freedoms enjoyed by the so-called developing nations of Asia and Africa is yet another trend that has increased global awareness of tax, trade and other policy vicissitudes, and thus of opportunities to manage multinational business entities' tax burdens. Last, and certainly not least, the vastly expanded availability of information, *via* the Internet in particular, has been a force for leveling competitive playing fields and facilitating optimization of corporate financial and operational policy choices.

EXHIBIT I. 2014 CORPORATE TAX RATES

Australia	30.0
Austria	25.0
Belgium	33.9
Canada	15.0
Chile	20.0
Czech Republic	19.0
Denmark	24.5
Estonia	21.0
Finland	20.0
France	34.4
Germany	15.8
Greece	26.0
Hungary	19.0
Iceland	20.0
Ireland	12.5
Israel	26.5
Italy	27.5
Japan	28.1
Korea	22.0
Luxembourg	22.5
Mexico	30.0
Netherlands	25.0
New Zealand	28.0
Norway	27.0
Poland	19.0
Portugal	30.0
Slovak Republic	22.0
Slovenia	17.0
Spain	30.0
Sweden	22.0
Switzerland	8.5
Turkey	20.0
United Kingdom	21.0
United States	35.0

Source: The Organisation for Economic Co-operation and Development, *www.oecd.org/tax/tax-policy/tax-database.htm#C_CorporateCapital.*

In 1986, the United States led the way in sharply reducing its top marginal corporate tax rate, from 46 to 34 percent (raised slightly, to 35 percent, in 1993). Although this rate reduction had a significant positive impact over the next decades, this advantage began to erode over time because of actions taken by other nations. Indeed, as corporate tax rates around the world have gradually fallen over the last decades, today the U.S. has been left with the highest corporate tax rate in the developed world, notwithstanding those reductions. Exhibit 1 shows 2014 effective tax rates in selected developed countries.

Tax Havens

Tax havens are defined as tax jurisdictions with abnormally low corporate income tax rates or having no corporate income tax at all, which are used by corporations and individuals to minimize their worldwide income taxes. The term does not connote illegal activity, *per se*; although in the popular mind, this has been conflated somewhat with actions by companies or individuals that actually are illegal, such as not reporting income earned in such havens to their respective domestic taxing authorities, particularly if those jurisdictions impose taxes on worldwide income.

Revenue-hungry taxing authorities have commonly disparaged low-tax jurisdictions and have even demanded that they take steps to make themselves less attractive. For example, the Organisation for Economic Co-operation and Development (OECD)—a now-54-year-old association of mostly developed nations that seeks to promote policies that would improve the economic and social well-being of nations and peoples world wide—established criteria for tax jurisdictions to ensure that they are not being used to avoid legitimate taxation by other countries. It initially defined the following as being characteristic of tax havens: no or low effective tax rates, absence of effective exchange of information, lack of transparency, and absence of requirements for substantial activity to qualify for local taxpayer status. However, because the OECD lacks enforcement power, it relies upon member countries to pressure tax haven jurisdictions for changes in their tax regimes.

The OECD in 2000 created an initial list of over 40 tax havens (*www.oecd.org*)—a grouping that has changed over time—of which almost all have subsequently signed agreements promising increased tax transparency and more effective informational exchanges. Interestingly, however, the OECD list focused exclusively on so-called offshore havens and excluded such low-tax jurisdictions as Ireland, Luxemburg and Switzerland, which were (and are) OECD members, although they share some tax haven attributes.

The recent financial crisis and the scandals surrounding such venerable institutions as Swiss bank UBS AG (UBS) and the Liechtenstein Global Trust Group (LGT), which resulted in legal actions by authorities in several countries, including the United States, increased the focus on international tax issues, primarily the quality of information sharing and the occurrence of tax evasion by individuals. At an economic summit in 2009, the *Group of 20* (the "G-20") industrialized and developing nations agreed to end "an era of banking secrecy," rooting out hundreds of billions of dollars estimated to be hidden from tax authorities in offshore banks. The G-20 proposed sanctions, and in response a number of countries, faced with the prospect of penalties for their companies to do business overseas, began to commit to information sharing agreements. At the request of the G-20, on July 21, 2014, the OECD published the Standard for Automatic Exchange of Financial Account Information in Tax Matters (referred to as the *Common Reporting Standard*, or CRS). More than 40 jurisdictions have committed to early adoption of the CRS, with reporting to start in 2017. Exhibit II presents countries listed as tax havens on various lists.

EXHIBIT II. COUNTRIES LISTED ON VARIOUS TAX HAVEN LISTS

Caribbean/West Indies:	Anguilla, Antigua and Barbuda, Aruba, Bahamas, Barbados, British Virgin Islands, Cayman Islands, Dominica, Grenada, Montserrat, Netherlands Antilles, St. Kitts and Nevis, St. Lucia, St. Vincent and Grenadines, Turks and Caicos, U.S. Virgin Islands.
Central America:	Belize, Costa Rica, Panama
Coast of East Asia:	Hong Kong, Macau, Singapore
Europe/Mediterranean:	Andorra, Channel Islands (Guernsey and Jersey), Cyprus, Gibraltar, Isle of Man, Ireland, Liechtenstein, Luxembourg, Malta, Monaco, San Marino, Switzerland
Indian Ocean:	Maldives, Mauritius, Seychelles
Middle East:	Bahrain, Jordan, Lebanon
North Atlantic:	Bermuda
Pacific, South Pacific:	Cook Islands, Marshall Islands, Samoa, Nauru, Niue, Tonga, Vanuatu
West Africa:	Liberia

Source: Gravelle, J., G. (2013). Tax Havens: International Tax Evasion and Avoidance, Washington, D.C.: Congressional Research Service , 4.

According to the Congressional Research Service, accusations of serving as tax havens have not been limited to offshore locations such as the Channel Islands or to small, finance-oriented nations such as Luxembourg. In fact, some have identified the United States and the United Kingdom as having at least some tax haven characteristics. Luxembourg Prime Minister Jean-Claude Junker urged other EU member states to challenge the United States for its alleged tax havens of Delaware, Nevada and Wyoming. One website offering offshore services mentions, in its view, several overlooked tax havens which include the United States, United Kingdom, Denmark, Iceland, Israel and Portugal's Madeira Island. (Others on this list, and not included in Table 1, were Hungary, Brunei, Uruguay and Labuan [Malaysia]). As regards the United States, the research mentions the lack of reporting requirements and the failure to tax interest and other exempt passive income paid to foreign entities, the limited liability corporation which allows a flexible corporate vehicle not subject to taxation, and the ease of incorporating in aforementioned states—Delaware, Nevada and Wyoming.[1]

Methods of Corporate Profit Shifting (or Tax Avoidance)

Although tax inversions have received the lion's share of press coverage in recent months, it is only the latest in the string of strategies that have been advocated for legally lowering a reporting entity's income tax burden. The more popular of these are discussed in the following paragraphs.

Contribution of Equity, Allocation of Debt and Earnings Stripping

An equity contribution to a foreign subsidiary is usually the first step in shifting profit out of the United States.[2] For example, if a U.S. parent contributes $1 billion of cash to a tax-haven affiliate, and the affiliate invests the $1 billion at a 10-percent rate of return, the U.S. parent has effectively shifted $1 billion x 10% = $100 million of income out of the U.S. annually, assuming, of course, that these earnings are not repatriated (*i.e.*, not brought back to the United States by means of a dividend from the foreign subsidiary to the parent, with a concomitant movement of cash). Using such a device, the U.S. parent will have to maintain the foreign earnings outside the United States, which may or may not be consistent with its other investing and financing desires. In practice, some companies have combined this strategy with loans to the parent, so that the parent company has access to cash for its various investing or other purposes, but this creates the risk that the combination of actions will be found to be a taxable repatriation of foreign earnings, subject to full imposition of U.S. corporate income tax.

Another approach to shifting profits, assuming that the foreign subsidiary has current, valid investment options (building a plant, adding inventory, *etc*.), is to borrow more in a high-tax jurisdiction and less in the low-tax jurisdiction and use the proceeds to finance some or all of the foreign entity's operations. Doing this will not change the overall debt exposure (*i.e.*, leverage) of the firm, although it might incur certain risks (such as currency exchange rate risk) that it would not otherwise have faced. It might also run afoul of tax laws—and indeed a current proposal in the U.S. Senate would limit interest deductions permitted under certain such circumstances. In practice, U.S. multinationals often allocate more interest to high-tax jurisdictions by operating subsidiaries with all-equity financing in a low-tax jurisdiction and take all of the interest on the overall firm's debt as a deduction in higher-tax domains.[3]

The foregoing practice, known as earnings stripping, is described in Code Sec. 163(j). It involves loading up a U.S. subsidiary of a foreign-domiciled company (which can be the former U.S.-domiciled entity that became a subsidiary of a foreign entity under terms of a tax-inversion transaction) with debt. When the U.S. subsidiary pays interest to the foreign parent, the payments are deductible for purposes of determining U.S. income tax liability. The effect is to remove earnings from the U.S. high tax rate environment. This is one of the major benefits of engaging in a corporate inversion.

Tax Inversion

Tax inversion itself is the controversial tactic that allows a U.S.-based multinational company to restructure so that the U.S. parent is replaced by a foreign parent, in order to avoid paying U.S. taxes on some or all of its profits. Thus, a company that does most of its business in the United States can cut its federal tax bill by merging with or acquiring an overseas company in a lower-tax country, then relocating its headquarters there. The new company is still exposed to the high U.S. tax rate on its U.S. earnings of course, but the profits it earns overseas—previously subject to U.S. taxes upon transfer back to the United States—are subject to the lower foreign rates, with no tax penalty attaching to then investing those profits in the United States. Additional shifting of taxable profits is accomplished through the high leverage rates for U.S. subsidiaries with interest payments deducted from U.S. taxable income. Inversions, arguably done solely for tax-avoidance purposes, should be distinguished from genuine cross-border mergers, executed for strategic business purposes, which benefit the U.S. economy.

The impact of earnings stripping received increased attention after a number of U.S. firms inverted—that is, arranged to move the parent firm abroad so that U.S. operations became a subsidiary of that parent. Many of these took place in the pharmaceutical industry. Several efforts have already been made to discourage or penalize such tactical moves by U.S. businesses, and further actions have recently been announced by the Treasury and the IRS, as discussed later in this article.

The American Jobs Creation Act of 2004 (the Act) denied a company the tax benefits of an inversion if the original U.S. stockholders owned 80 percent or more of the new enterprise. This Act effectively ended moves to tax havens where no real business activity took place and when there was not a significant dilution of old ownership interests resulting from the transaction. However, two avenues for inverting remained available.

Firstly, the Act allowed a firm to invert if it had substantial business operations in the country where the new parent company was to be located. Regulations at one point set a 10-percent level for those business operations, meaning the post-transaction business could have been as much 90-percent comprised of the old U.S.-based company's. Several inversions relying upon the business activity test occurred, and these resulted in the Treasury issuing regulations in 2012 that increased the activity requirement to 25 percent, severely limiting the appeal of this method.

Secondly, firms could invert by merging with a foreign company, provided that the original U.S. stockholders owned less than 80 percent of the new firm.[4] Depending on the value being contributed to the new enterprise by the foreign partner, this could offer a workable solution even if most of the actual business being conducted by the post-transaction merged entity arose from the former U.S. company.

Recently, several high-profile companies, including Pfizer, have indicated plans to merge or an active interest in merging with a non-U.S. headquartered company. Pfizer, for example, was interested in merging with a smaller British enterprise, AstraZeneca, and moving headquarters to the United Kingdom. For Pfizer, which has accumulated substantial profits in subsidiaries in low-tax foreign countries that would be taxed if remitted to the U.S. parent, the territorial tax system is likely seen as the most important tax benefit from such a merger (although it is not clear that such a transaction would protect the as-yet-unrepatriated but already-accumulated foreign earnings from U.S. income tax). This recent, "second wave" of inversions again has raised concerns about an erosion of the U.S. tax base.[5]

The case of Medtronic, the Minneapolis-based medical technology company, is also instructive. Its currently pending acquisition of Ireland-based Covidien reveals that corporate inversions can also let businesses invest more in the United States. By adopting Ireland as its legal headquarters, Medtronic, holding $13 billion in cash abroad, in return plans to bring $1 billion or more back to the United States without penalty, apparently by using Covidien's accumulated earnings rather than its own. Medtronic's funds are all subject to extra taxation once it crosses the U.S. border, unlike the Covidien money.[6] Given the fact that money is fungible—and it is therefore difficult or impossible to prove which bucket a dollar was withdrawn from—this plan might yet be challenged by U.S. tax authorities, who might argue that the funds invested were pre-merger, previously unrepatriated earnings of a Medtronic subsidiary and are now subject to full U.S. corporate income tax.

It is time that the United States had, in the words of former Treasury Secretary William Simon, a tax code that looked as if it were designed on purpose.

Following substantial, mostly critical, attention from news media and politicians, Walgreens, which recently acquired European drugstore chain Alliance Boots, an operator of drug stores in Britain but headquartered in Switzerland, has abandoned its plans to shift its tax base out of the United States. With the deal as it was structured, Walgreens would have had the opportunity to reduce its U.S. tax bill by a projected $4 billion over the next five years by moving the new company's headquarters in Switzerland, where Alliance Boots is based. However, under pressure from certain lawmakers (including Illinois' senator Durbin, who used his Congressional perch to quip—alluding to Walgreens' well-known advertising slogan—"Is 'the corner of happy and healthy' somewhere in the Swiss Alps?") and activists, it has chosen to remain headquartered in the United States. Although the company explained that it had been unable to find a structure that would have been able to withstand IRS scrutiny, it appears obvious that negative publicity and the possibility of politically inspired retribution played the bigger role in this reversal.

As noted above, the ultimate objective for financial management is to maximize the returns for the entity's investors. Once the decision to eschew the opportunity for a tax inversion was announced, Walgreens' stock price declined about four percent in after-hours trading, and it continued to decline over the next several days. In other words, the market punished the company's management for failing to take legitimate steps available to it that would have provided significant tax savings and increased after-tax returns to the company's investors.

Two features make a country an attractive destination for a U.S. company seeking to arrange a merger that would rationalize a change in domicile: a low corporate tax rate and a territorial tax system that does not subject foreign source income to its income tax. Recently, the United Kingdom joined countries such as Ireland, Switzerland and Canada as targets for inversion transactions when it adopted a territorial tax. At the same time, the United Kingdom lowered its rate (from 25 percent to 20 percent, effective by 2015), making it even more appealing for such transactions.[7]

A May 2014 report on corporate inversions from the Congressional Research Service (CRS) indicated that 47 U.S. corporations have reincorporated overseas through corporate inversions over the last 10 years—a number far greater than during the previous 20 years combined. In total, 75 U.S. corporations have inverted since 1994—with one earlier inversion occurring in 1983. Additionally, there are a dozen prospective inversion deals involving U.S. corporations pending at this time.[8]

The favored domiciles for the new partners are Ireland, the Netherlands, Switzerland, United Kingdom and Canada, which all have relatively low corporate tax rates and a so-called territorial tax system, in which foreign-source income is not taxed. For example, until changes in U.S. government tax policy regarding inversions were imposed in October, AbbVie, North Chicago, Illinois-based, had planned to acquire Shire Plc in a $54.8 billion transaction that would have made AbbVie one of the largest U.S. companies to move its legal address, though not its operations, to the United Kingdom, lowering its tax rate in 2016 to 13 percent from 22 percent.

Burger King Worldwide Inc. in August 2014 announced its $11 billion agreement to buy Tim Hortons, the Canadian coffee-and-doughnut chain. The deal was backed by billionaire Warren Buffet, who has been a public advocate of higher taxes on the wealthy, but who also, in the past, has pursued deals that minimize Berkshire's payments to the government. Burger King investors can choose to receive either common stock in the combined company or units in a newly formed Ontario limited partnership. Choosing the partnership means Burger King would not fall under a 1996 Treasury rule—known as the Helen of Troy rule that requires shareholders to book any gains on shares converted into stock in a new company. Brazilian private-equity firm 3G, owner of Burger King, already

EXHIBIT III. AMERICAN COMPANIES THAT HAVE INCORPORATED OVERSEAS IN THE PAST 4 YEARS

Inversion Year	Company Name	Industry	Country of Incorporation	Revenue
2014	Medtronic	Pharmaceuticals	Ireland	$ 16.5 billion
2014	Chiquita Brands	Produce	Ireland	$ 3 billion
2014	Mallinckrodt Pharmaceuticals	Pharmaceuticals	Ireland	$ 2.2 billion
2013	Cadence Pharmaceutical	Pharmaceuticals	Ireland	$ 110 million
2013	Perrigo/Elan	Pharmaceuticals	Ireland	$ 3.5 billion
2013	Actavis/Warner Chilcott	Pharmaceuticals	Ireland	$ 8.7 billion
2013	Liberty /Global PLC	Cable Company	United Kingdom	$ 17.3 billion
2012	Endo Health Solutions	Pharmaceuticals	Ireland	$ 2.6 billion
2012	Eaton/Cooper	Power Management	Ireland	$ 22 billion
2012	Stratasys	Printer Manufacturer	Israel	$ 486 million
2012	D.E. Master Blenders	Coffee	Netherlands	$ 3.5 billion
2012	Jazz Pharmaceuticals/Azur Pharma	Pharmaceuticals	Ireland	$ 872 million
2012	Tronox Inc.	Chemical	Australia	$ 1.9 billion
2012	AON	Insurance	United Kingdom	$ 11.8 billion
2012	Rowan Companies	Oil Well Drilling	United Kingdom	$ 1.5 billion
2011	Pentair	Water Filtration	Switzerland	$ 7.5 billion
2011	TE Connectivity	Industrial Manufacturer	Switzerland	$ 13.3 billion
2011	Alkermes, Inc.	Biopharmaceutical	Ireland	$ 575 million

Source: WASHINGTON POST, August 6, 2014 announced that it will elect to take partnership units exclusively, which would allow it to defer taxes on its paper gain on Burger King, whose shares have nearly doubled since its 2012 IPO.[9]

Transfer Pricing

Another important technique that allows U.S. firms to shift profits from high-tax to low-tax jurisdictions is the pricing of goods and services sold between affiliates. To properly reflect income, prices of goods and services sold to and by related companies should be the same as the prices that would be paid by unrelated parties. However, a company can minimize worldwide income taxes by recording profits in lower-tax countries. By lowering the price of goods and services sold by parents and affiliates in high-tax jurisdictions and raising the price of purchases it makes from its affiliates, income can be shifted.

The IRS has, of course, long been alert to such maneuvers and is diligent in examining related-party transactions among entities in differentially taxed jurisdictions. If the parent is U.S. based, of course, worldwide taxation applies and intercompany transfers not yet realized through arm's-length sales to nonrelated parties would not have the hoped-for salutary effects on tax liabilities. However, if transactions involve a non-U.S. parent entity, or if foreign subsidiary earnings are not repatriated, a variety of transfer pricing schemes might avoid or at least defer the incidence of taxation.

A particularly difficult issue of transfer pricing involves the transfers of rights to intellectual property or of other similar intangibles. Specifically, establishing an appropriate arm's-length price by reference to comparable transactions is relatively straightforward for the vast majority of cross-border transactions involving transfers of goods or services. But enforcing the arm's-length standard in situations in which a U.S. company shifts to an offshore affiliate the rights to intangible property that is at the very heart of its business ("core intangibles") is difficult. In fact, over the past decade, applying Code Sec. 482 in these types of cases has been the IRS's most significant international enforcement challenge.[10] This is because when the rights to the core intangibles of a business are shifted offshore, enforcement of the arm's-length standard is challenging for two reasons:

- Transfers of a company's core intangibles outside of a corporate group rarely occur in the market, so comparable transactions are difficult, if not impossible, to find.
- A business's core intangible property rights are by their nature very "risky" assetso projecting cash flows from these assets and the appropriate discount rate requires an inherently challenging assessment of the underlying risk and how, and by which party, that risk is borne.[11]

Investments in intangibles are favorably treated in the U.S. because costs, other than capital equipment and buildings, are expensed as research and development, which are also eligible for a tax credit. In addition, advertising to establish brand names is deductible. Overall, these treatments tend to produce an effective low, zero or even negative tax rate for many investments in intangibles (that is, in the near term; in the long run, profits are expected to be generated from these investments, and these will not enjoy the tax shelter of amortization and many other up-front costs, as those were already deducted). Thus, there are significant incentives to initially make these investments in the United States, where the research and development costs can be expensed quickly, but later, if and when the resultant product becomes successful, to use another strategy, such as licensing, to attempt to shift profits to a low-tax jurisdiction. Transfer pricing rules with respect to intellectual property may be further complicated because of cost-sharing agreements, in which various affiliates contribute to the costs of development.[12]

Companies have developed various techniques to take advantage of tax laws in other countries to achieve a productive operation while shifting profits to no-tax or low-tax jurisdictions, even in cases where those countries may not have the skilled labor and other resources to credibly undertake the activity. One such approach is the so-called "double Irish, Dutch sandwich" method that has been used by some U.S. firms, including Google.[13]

In this arrangement, the U.S. firm transfers its intangible asset to an Irish holding company. The Irish company has a sales subsidiary that sells advertising (the source of Google's revenues) to Europe. However, sandwiched between the Irish holding company and the Irish sales subsidiary is a Dutch subsidiary, which collects royalties from the sales subsidiary and transfers them to the Irish holding company. The Irish holding company claims that the company's management (and thus its tax home) is in Bermuda, which has a zero-percent tax rate, for purposes of determination of its corporate income tax.[14]

This arrangement relies on the fact that Irish tax law imposes territorial taxation, and hence does not levy taxes on income booked at subsidiaries of Irish companies that are outside of the state. In the late 1980s, Apple Inc. was among the pioneers in creating this tax structure. The addition of a Dutch sandwich to the double Irish scheme further reduces tax liabilities because Ireland does not levy withholding tax on certain receipts from European

Union member states. Revenues from sales of the products shipped by the second Irish company are first booked by a shell company in the Netherlands, taking advantage of generous tax laws there. This scheme allows the Irish operation to avoid even the lower (than U.S.) Irish tax of 12.5 percent, and the remaining profits are transferred directly to Cayman or Bermuda. Thus, if the two Irish holding companies are thought of as the "bread" and the Netherlands company as the "cheese," this scheme is referred to as the "Dutch sandwich." There are also equivalent Luxembourgish and Swiss sandwiches.[15] Companies such as Amazon, Apple, Facebook, GE, Google, IBM, Microsoft and Starbucks are using this scheme.

Recently, according to by the Bermuda Supreme Court, three Bermuda subsidiaries of Microsoft Corp. have become involved in a tax inquiry launched by another country. The authorities are reportedly looking into the three shell companies, the existence of which Microsoft does not acknowledge in public filings with regulators, and this comes as the technology giant is under pressure for its low tax bills. Two of these previously undisclosed companies are affiliated with Microsoft's Irish subsidiaries, which eight years ago were alleged to have helped the company shave its tax bill.

As with other reputed tax havens, Bermuda's financial system is notoriously secretive. But in 2005, under international pressure, the Bermuda government that enables foreign governments to request detailed information about shell companies domiciled there as part of their own tax investigations. The Microsoft subsidiaries were targeted through an order under this Tax Information Exchange Agreement—or TIEA.

The existence of this inquiry was first noted by[16] a newsletter widely read by those interested in the Caribbean-centered business of tax avoidance and evasion. After the inquiry was mentioned recently in the newsletter, the cases were removed from the public record. "They're not available," Peter Miller, assistant registrar at the Bermuda Supreme Court, told The Huffington Post. "Rescinding orders were made with respect to the TIEAs. ... Orders of the court were made to seal them."

The Bermuda filings do not reveal which country originated the inquiry. Over the summer, the OECD began looking into the tax strategies of global technology giants, with a specific emphasis on transfer pricing.

Microsoft, whose most recent filings with the U.S. Securities and Exchange Commission list no subsidiaries operating in Bermuda, declined to comment for the record. Corporations are only required to list "significant subsidiaries" on their SEC filings. For more than a decade, Microsoft has chosen to disclose only a reduced number of subsidiaries. the company listed all 81 subsidiaries in operation at the time. it listed only 13, the ones it deemed significant, and it has continued to list roughly that number in the years since.

Avoiding Subpart F Income—Check-the-Box and Hybrids

Tax deferral is a major motivator to conducting business abroad. The profits of a subsidiary of a U.S. parent generally will not be subject to tax in the United States until they are repatriated. Thus, as long as the foreign jurisdiction's tax rate is lower than the tax rate in the United States, a U.S. parent operating through a foreign subsidiary can benefit from the deferral of U.S. tax on foreign income, even as a foreign branch or a U.S. domestic company cannot.

Subpart F was enacted by Congress to limit the tax-deferral benefit of operating abroad through a subsidiary. It was originally designed to tax passive income, such as interest, dividends and income related to intangible assets, earned by foreign subsidiaries of U.S. multi-national corporations (MNCs). However, various techniques can be used to avoid Subpart F income; these include using the "check-the-box" regulations, the CFC look-through rule, the manufacturing exemption and, to a lesser extent, the same country exception.[17]

"Check-the-box regulations" allow a U.S. MNC to "check the box" and indicate which entities (foreign subsidiaries) would be disregarded for tax purposes, since that entity may be taxed in one tax jurisdiction and would either be a pass-through or a disregarded entity in the other tax jurisdiction. This creates a hybrid entity and avoids Foreign Base Company Sales Income (FBCSI). The "*CFC look-through rule*" permits re-characterization of what would otherwise be Subchapter F income (dividends, interest and royalties). After application of the CFC look-through rule, the interest income from a tax haven subsidiary would be recharacterized as operating income because the interest is being paid from an operating entity.[18] The *contract manufacturing exemption* allows supervision of contract manufacturing to qualify for the exemption (no physical plant is required to get exemption). The *same country exception* applies if two foreign subs are in the same country, so that dividends or interest received between the two are not taxable.

Hybrid entities, whereby an entity can be regarded as a corporation by one jurisdiction but not by another, can create unintended consequences. Among the most fundamental uses of a hybrid entity in Subpart F tax planning is earnings stripping through a disregarded loan. For example, a U.S. parent's subsidiary in a low-tax jurisdiction can lend to its subsidiary in a high-tax jurisdiction, with the interest deductible as a business expense because the high-tax jurisdiction recognizes the firm as a separate corporation. Normally, interest received by the subsidiary in the low-tax jurisdiction would constitute passive income subject to current U.S. tax under Subpart F. However, under "check-the-box" rules, the high-tax corporation can elect to be disregarded as a separate entity, *i.e.*, a disregarded entity from the U.S. perspective and a corporation from the perspective of the low-tax jurisdiction. Thus, the loan and the interest payments (which would normally constitute Subpart F income) are also disregarded, because they occur within a single entity.

In addition to hybrid entities, hybrid instruments that are considered as debt in one jurisdiction and equity in another can achieve tax benefits.

Foreign Tax Credit

The foreign tax credit is designed to mitigate the effects of double taxation of foreign income. Thus, the foreign tax credit allows the U.S. taxpayer to credit the payment of some foreign income taxes against their U.S. tax liability. The rationale for such a credit is that, absent the credit, tax consequences could distort a taxpayer's business decision to operate domestically or abroad.

Again, hybrid entities have been used to produce unintended results. A reverse hybrid entity (*i.e.*, one viewed as a corporation from the U.S. perspective and a partnership or disregarded entity from the perspective of Country A) can be used to allow U.S. corporations to benefit from the foreign tax credit without having to recognize the underlying income. For example, a U.S. parent can set up a holding company in a country that treats it as a disregarded entity, and the holding company can own a corporation that is treated as a partnership in another foreign jurisdiction. Under flow-through rules, the holding company is liable for the foreign tax, and because it is not a separate entity, the U.S. parent corporation is therefore liable, but the income can be retained in the foreign corporation that is viewed as a separate corporate entity from the U.S. point of view.[19]

Cross crediting allows the use of excess foreign taxes paid in one jurisdiction or imposed on one type of income to offset U.S. tax that would be due on other amount or source of income. Although the foreign tax credit limit was proposed on a country-by-country basis, that rule proved to be difficult to enforce given the potential to use holding companies. Foreign tax credits have subsequently been separated into different baskets to limit cross crediting; these baskets were reduced from nine to two in number (one active, the other passive) in the American Jobs Creation Act of 2004.

Having a choice of when to repatriate income, companies can structure realizations to maximize the benefits of the overall limit on the foreign tax credit. Consequently, firms that have income from jurisdictions with taxes in excess of U.S. taxes can also elect to realize income from jurisdictions with low taxes and use the excess credits to offset U.S. tax due on that income. Studies suggest that between cross crediting and deferral, U.S. multinationals typically pay virtually no U.S. tax on foreign-source income.[20]

Problems Attributable to the U.S. Tax Code

Many experts have opined that the U.S. corporate tax rate is too high compared with other developed nations' rates and that the Internal Revenue Code is too complex. The myriad tax breaks, deductions and credits available in our tax code mean that the nominal tax rate needs to be kept higher to collect the necessary amount of revenue. These complications impose a number of different costs on our economy, including misallocation of resources and the expenses incurred by taxpayers and their tax preparers and advisors in completing filings and maintaining records.

As to this last-cited issue, Gregory Hayes, the chief financial officer of the United Technologies Corporation, testified to the House Ways and Means Committee that his company's federal tax return alone is 19,000 pages in length, and that their headquarters houses a dozen resident IRS agents who continuously audit the company's tax filings. General Electric employs nearly 1,000 tax lawyers to comply with the tax code, and their tax return in 2006 was 24,000 pages long.[21]

Additionally, the corporate tax code encourages that investments be made abroad rather than in the United States. It affects and distorts the behavior of U.S. firms, which has real, if largely unmeasurable, implications for the economy at large. The most costly manifestation of this is the fact that the U.S. system of worldwide taxation, together with deferral of taxes on unrepatriated foreign-sourced income, has trapped as much as $1.5 trillion of capital abroad, according to estimates. Arguably, if these resources were freed up, to be repatriated without onerous tax consequences, the funds could be used to upgrade and expand U.S. manufacturing facilities, hire workers and otherwise contribute to making America more competitive and prosperous.

However, a tax holiday that largely eliminated taxes on repatriations of foreign earnings was tried before, and research suggests that most of the liberated funds were used to pay dividends and to repurchase shares of outstanding stock and not to improve productive facilities, and this finding has dimmed enthusiasm for another such event. In fairness, however, it must be noted that funds distributed to shareholders in stock buy-backs or paid as increased dividends would have found their way back into the overall economy, quite possibly also boosting consumer demand and having other salutary effects, albeit indirectly. If increased consumer spending did occur, logic suggests that increased product demand would eventually stimulate investments in productive facilities, achieving the desired results.

The current corporate tax code not only encourages companies with the high growth potential to invest outside of the United States, but these companies will then actively shun otherwise-attractive U.S. investments in order to avoid the repatriation tax. A survey of senior tax officers from over 400 corporations finds that 20 percent of these companies reported investing foreign earnings in assets with a lower rate of return than they could have received in the United States,[22] but presumably the overall net impact of making such seemingly suboptimal investments, once the avoided repatriation taxes are considered, is positive. Thus, in addition to affecting the investment decisions of firms headquartered in the United States, the tax code discourages companies from investing in the United States.

IRS and Treasury's New Anti-Tax Inversion Actions

The recent acceleration of tax inversions has raised the specter of a rapid hollowing out of the corporate income tax base, which—assuming government spending continues on its present course—would have to be compensated for by imposing other taxes, most likely by raising individual tax rates (and perhaps corporate rates as well, encouraging a self-fulfilling prophesy of corporate flight). In response to this increase in threatened tax-inversion deals, the White House recently called on Congress to take steps to prevent companies from pursuing inversions. Although Democrats and Republicans agree that tax inversions should be discouraged, they have different views on how to act. Some Democrats in Congress believe lawmakers should pass a stopgap measure to deter companies from pursuing the deals, while some Republicans believe the only way to end inversions is through an overhaul of the tax code.

On September 22, 2014, the IRS and the Treasury announced that they are going to take actions against corporate tax inversions. These steps are designed to reduce the tax benefits and therefore the incentives to invert. The new rules eliminate certain techniques used by inverted companies in order to access the foreign subsidiaries' previously accumulated overseas earnings without paying U.S. taxes. As a result, for many corporations considering mergers, inversions will no longer make economic sense. In general, the new rules took effect immediately and will apply to acquisitions or transfers of stock completed on or after September 22, 2014.

The actions taken by the IRS and Treasury include the following:

- Prevent the use of creative loans, which are known as "hopscotch loans" (Code Sec. 956(e)). Hopscotch loans involve repatriation of foreign earnings through post-inversion acquisitions by controlled foreign corporations (CFCs) of obligations of (or equity investments in) the new foreign parent corporation or certain foreign affiliates, bypassing the U.S. firm. In the future, such loans will be considered U.S. property for purposes of the anti-avoidance rule. This would also prevent the avoidance of U.S. tax on pre-inversion earnings and profits of CFCs through post-inversion transactions that otherwise would terminate the CFC status of foreign subsidiaries or substantially dilute the U.S. shareholders' interest in those profits, and limiting the ability to remove untaxed foreign profits of CFCs through related party stock sales (Code Sec. 304).
- Prevent inverted companies from restructuring a foreign subsidiary, in which the new foreign parent buys enough stock in the CFC to take control away from the former U.S. parent, in order to access the subsidiary's earnings without paying tax (Code Sec. 7701(l)). The new parent will be treated as having ownership interest in the former U.S. parent instead of the CFC.
- Close a loophole to prevent inverted companies from transferring cash or property from a CFC to a new parent to completely avoid U.S. tax (Code Sec. 304(b)(5)(B)).
- Make it more difficult for U.S. entities to invert by strengthening the requirement that former owners of the U.S. entity must own less than 80 percent of the new combined entity (Code Secs. 367 and 7874). This will be accomplished by limiting the ability of entities to count passive assets that would inflate the new foreign parent's size; by disregarding certain nonordinary course distributions to reduce their pre-inversion size; and stopping certain transfers of stock of a foreign acquiring entity, for example through a spin-off after an acquisition, by which a U.S. entity would transfer assets to a new foreign entity that it spins off to its shareholders.

In general, the new rules took effect immediately and will apply to acquisitions or transfers of stock completed on or after September 22, 2014. A number of pending mergers and acquisitions were or will possibly be affected by the new rules, including Medtronic Inc. and AbbVie Inc.—the former of which was restructured to eliminate the now banned "hopscotch loans" it was to employ, and the latter of which has been scratched—which would have been the two largest such deals in U.S. history, as well as Salix Pharmaceuticals Ltd's acquisition of a division of Italy's Cosmo Pharmaceuticals SpA, Mylan Inc's pending deal for Abbott Laboratories' overseas generic business and fruit grower Chiquita Brands International and Fyffes PLC.

The congressional Joint Committee on Taxation has estimated that legislation to curb inversions would raise about $20 billion over the next decade. Some experts say that any chilling effect on inversions might not last long because companies may find ways to do the deals despite the new rules. However, the Administration could still attempt to limit more of the benefits of inverting by future rules.

What is left untouched by recent actions, apparently, is the ability of inverted entities to "strip" domestic profits of the U.S. entity in the form of untaxed interest payments to their new overseas parent.[23] "Companies still will be able to access their foreign stockpiles of cash—they'll just reinvest it abroad. In fact, the administration just assured that deferred income in the once foreign subsidiary will never come back to the U.S. to help create income, jobs and economic growth here. Tax inversions are a symptom of a U.S. corporate tax system that is outdated, uncompetitive, and puts American companies and workers at disadvantage with the rest of the world."[24]

Corporate Tax Reform Recommendations

Two aspects of the U.S. corporate tax system are particularly relevant to corporate location decisions: the marginal corporate tax rate and the taxation of foreign-source earnings. The latter creates an incentive for another government to set up a system that does not tax income accrued outside its area in order to attract investments and the accompanying tax revenues they will produce. Consequently, many experts recommend reducing the tax rate and transitioning to a territorial tax system in the United States, in which only the activities that occur within its jurisdiction are subject to taxes, in order to counter these competitive threats.

It has to be assumed that most managers make rational economic decisions that fully weigh these facts, coupled with expectations regarding the prospects for changes in these long-standing policy decisions. This may, *inter alia*, explain why the previous holiday on taxes imposed on repatriated foreign earnings did not have a permanent (or even much of a temporary) effect on corporate investing behavior.

President Obama has referred to tax inversions as "unpatriotic tax loopholes" and urged the Congress to stop them. The President's rhetoric is about "targeting 'corporate deserters'" who have moved their legal address out of the United States, but his proposals would discourage investment from overseas. He has proposed several international corporate tax revisions that relate to multinational corporations, including those aimed at retarding profit shifting, as well as others to address individual tax evasion. Some of the provisions relating to multinationals had earlier been included in a bill introduced in the 110th Congress by then-Chairman Rangel of the Ways and Means Committee. Major revisions to corporate international tax rules are also included in S. 3018, a general tax reform act introduced by Senators Wyden and Gregg in the 111th Congress, and a similar bill, introduced by Senators Wyden and Coats in the 112th Congress. This bill has provisions to tax foreign source income currently, which could limit or eliminate the benefits from corporate profit shifting, given the worldwide income that is taxed in the United States.[25]

Ways and Means Chairman Dave Camp proposed the "Tax Reform Act of 2014," intended to fix America's "broken tax code." This proposed a reduction in the corporate tax rate to 25 percent, combined with a move to a territorial tax system, which would exempt foreign-source income. Because a territorial tax could increase the scope for profit shifting, the proposal contains detailed provisions to address these matters.[26]

According to Congressional Research Service, because much of the corporate tax revenue loss arises from activities that are legal (or appear to be so), it is difficult to address these issues other than with changes in the tax code (CRS, 20013). If a global consensus is possible to achieve within a reasonable period of time and would be effective, it would be the best way forward. The OECD's plan to reduce tax bases and profit-shifting is hugely reliant on the United States making significant revisions to its corporate tax code if it is to have any chance of being successful. Clearly, the United States' corporate tax rate is well above that of most other nations, and this fact alone strongly motivates the behaviors that officials decry. It may, in theory, be patriotic to pay more than one's required share of taxes (individuals have the ability to do so, with excess amounts credited as charitable contributions—few do so, however), but jawboning isn't likely to motivate such behavior—which, if actually done, would represent a departure from responsible corporate management that undoubtedly, and rightly, would be opposed by shareholders.

A variety of recent studies have confirmed that an inverse relationship exists between corporate tax rates and economic growth. One can speculate regarding these findings—*i.e.*, are they simply cause and effect, or are they the twin effects of some other underlying cause(s), such as the increasingly sclerotic and dysfunctional character of older, richer societies that have forgotten the behaviors that proved so successful in their earlier, more dynamic stages of development? Perhaps it is time to propose a corollary to the well-known, often derided but never disproven, Laffer Curve hypothesis: to wit, that not only do very high tax rates cause actual declines in tax receipts (and not simply diminishing marginal tax collections), but also that the existence of parallel attractive alternative investment opportunities actually lowers the inflection point beyond which net economic losses will begin to accrue.

A 2009 World Bank study linked higher tax rates with lower investment and entrepreneurial activity. The OECD report by Arnold and Schwellnus estimates that a 10-percent increase in the user cost of capital lowers investment by seven percent, and from that it infers that lowering the corporate tax rate from 35 to 30 percent would increase annual productivity growth by 0.4 percent per year.[27] Young Lee and Roger Gordon estimate that a 10-percentage-point reduction in the tax rate would increase productivity growth by somewhere between 1.1 and 1.8 percentage points. The implication of this research, suggest William Gentry and Glenn Hubbard, is that the corporate income tax is in a very real way a "success tax" that falls disproportionately on firms that have higher than the average productivity growth.

Government statistics report corporate income taxes paid in 2012 totaled about $242 billion. A cut in marginal rates to 25 percent from 35 percent, *ceteris paribus*, would have cost the Treasury under $70 billion. Using 2012 GDP—$15.68 trillion—the productivity growth posited by Lee and Gordon would have added from $172.5 to $282.2 billion to the economy (and, of course, would have then been taxed). In other words, the prediction would be that the stimulative effect would have been from over two times to almost four times the amount of taxes lost.

It is time that the United States had, in the words of former Treasury Secretary William Simon, a tax code that looked as if it were designed on purpose. Such a tax code would be focused on maximizing economic growth, reflecting the reality that growth is not only the best way to create jobs for all Americans, but also the best and only way for us to afford to help those who are left out of the economy. To that end, such a tax code would have relatively low tax rates on capital to encourage investment, and it would not put U.S. operations abroad at a competitive disadvantage by applying higher taxes on them than on the non-American companies operating in the same market.[28]

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