Role of Earnings Stripping as an Elaborate Tool to Avoid Corporate Income Taxes…. Should Congress Impose an Exit Tax to thwart the Tax Avoidance Scheme…

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Corporate America has used elaborate tools to constantly find creative ways to avoid corporate income tax throughout the past few years. The primary motivating factor has been the view that the United States Corporate Tax Rates are too high. In essence the excessive corporate taxes force the hand of management to find solutions to reduce their onerous tax burden. A newly minted strategy has taken the form of inversions…a creative way to create a foreign entity purely to avoid the US tax assessment. Is it time for Congress to resolve the issue: Is the Internal revenue Code unfair to Corporate America?

INTRODUCTION

Should we impose an exit tax on US corporations who are creating safe havens from tax through the Inversion process? For many years now, many profitable corporations in the United States have creatively found ways to reduce their corporate taxes. One of the more problematic solutions has been the Corporate Inversion process. In an Inversion, US Corporations from partnerships with international business in an attempt to create a nexus for earnings…and the resulting imposition of taxes…in a more "tax friendly" environment. Ireland, for example, has become the refuge of many US Corporations because their tax rate is significantly lower than the United State's tax rate. The top federal corporate tax rate in the US is 35% as compared to 12.5% in Ireland. For a profitable corporation, the incentive to save 22.5% of taxable income is intoxicating.

Unfortunately, the 35% tax rate is only for the federal portion of the tax obligation, when we add the state tax portion; many corporations are faced with a 40% tax rate which is problematic at best. The game of playing "hide and seek" with corporate earnings has been a problem domestically within the United States for years. Many profitable corporations play the game of "where do I earn my revenue?" with the state tax departments in attempt to reduce the state and local tax burdens. Many corporations have moved to *"friendly"* tax states in attempt to reduce their state tax expenses. That game has merely moved from within the United States to the international arena where the rates are even more disparate.

In this paper we will discuss the following issues:

1. Are United States Corporate Taxes too high?
2. Are corporations who attempt to avoid paying taxes 'unpatriotic?
3. What is the real tax burden US corporations are confronted with?
4. Viable solutions to the problem…. Is an Exit Tax the Best Solution?

ARE DOMESTIC TAX RATES TOO HIGH?

The primary goal of any *for-profit* entity organized under a capitalistic economy is to provide their stakeholders with the greatest return possible. Therefore, corporate decision-makers are constantly engaging in strategies aimed at meeting that ultimate goal. Increasing revenue and reducing costs will ultimately result in the desired outcome of increased profitability. Costs, that are viewed as non-value added, will be the primary focus of the cost cutting strategy. Apparently, Corporate America does not view paying taxes as adding value to their organization as their goal of reducing taxes is a preeminent cost reduction strategy. Additionally, the tax rates in the United States are significantly higher than in many other parts of the world (Costa & Gravelle, 2010.)

The top corporate tax rate of 35% is the primary motivating factor driving domestic corporations in their attempt to reduce these expenses. Corporations engage in tax reduction strategies that will result in the lowest cost allowable. One simple solution to a perceived onerous tax policy is to avoid the process completely by in essence "outsourcing" the earnings process. If a corporation can increase their profitability by simply relocating where their revenue is earned is an appealing solution. Ireland, for example, with a top corporate rate of 12.5% is clearly a viable solution to the "outsourcing" of revenue technique resulting in tax savings of 22.5% (NY Times, 2014). Any business strategy that results in a reduction of 22.5% of expenses is clearly an attractive option.

It is apparent that many corporations have implemented different strategies in order to accomplish the goal of reducing tax costs. The creative tax reduction process involves a myriad of complex accounting transactions implemented both domestically and internationally. Earnings stripping, transfer pricing and tax haven locales are all part of the cost reduction strategy aimed at circumventing the high U. S. corporate tax burden.

WHAT IS EARNINGS STRIPPING?

According to the Glossary of International Tax terms. Earnings Stripping is defined as:

"….a process by which a firm reduces its overall tax liability by moving earnings from one taxing jurisdiction, typically a relatively high-tax jurisdiction, to another jurisdiction, typically a low-tax jurisdiction. Often, earnings stripping arrangements involve the extension of debt from one affiliate to another. Debt is accumulated in a high-tax jurisdiction that allows a company to deduct interest payments from their taxable income (Tax Foundation, 2015). "

The actual goal of this corporate strategy is to reduce corporate profits by essentially "pretending" their revenues are earned in tax haven locales. This activity is akin to tax avoidance as a response to the onerous US Internal Revenue Code mandating high corporate taxes. The process of transferring revenue from one reporting arena to another involves a strategy of inversion which is defined as:

"….the process by which a corporate entity, established in a low-tax country, 'buys' an established US domestic company. The transaction takes place when the overseas entity purchases either the shares and/or assets of the domestic corporation. The shareholders of the domestic corporation typically become shareholders of a new foreign parent company. In essence, the legal location of the company changes through a corporate inversion from the domestic to the foreign country. An inversion typically does not change the operational structure or location of a company, however (Tax Foundation, 2015)."

This corporate strategy became more problematic as the number of major corporations embarked upon this strategy in an attempt to enhance profitability by reducing corporate taxes. In 2004, legislation aimed at limiting the benefits by treating firms that subsequently inverted as domestic entities was adopted (Sharman, 2006.) The American Jobs Creation Act attempted to resolve the inversion issue, but failed as newer and more innovative tax avoidance strategies were explored by the multinationals (McIntyre, 2009.) The tax avoidance strategies flirted with being labeled as tax evasion tactics but the multinational entities carefully constructed activities that complied with the Internal Revenue Code (Gnaedinger, 2009.) There is a narrow difference between the avoidance vs. evasion strategy, with avoidance corrected through enforcement of existing tax law. Unfortunately the incentive to reduce costs by corporations will always provide the incentive to creatively interpret any required guidelines, including the Internal Revenue Code.

The process of tax avoidance is the result of U.S. multinational corporations not being subjected to tax until it is repatriated to the United States (Gravelle, 2007.) The multinational subsidiary would normally pay a dividend to the domestic parent and thus trigger a taxable event but inversion strategy defers payment of any earnings to the domestic parent. In place of dividends, the parent would "borrow" monies from the foreign subsidiary and avoid any tax completely. The parent, would not only reduce their corporate taxes by calling a dividend a loan, they were also entitled to deduct any interest paid on the loan which reduced their taxes further (Zucman, 2013.)

This tax avoidance strategy proved extremely successful for the domestic entities because the overall value of the combined entity remained unchanged by the loan process as the parent's payable was canceled by the subsidiary's receivable (Sullivan, 2009.) Ironically, the current Internal Revenue Code does not address interest deductions and earnings stripping (Congressional Research Service, 2015.)

WHAT IS TRANSFER PRICING?

Another innovative strategy implemented to further reduce corporate taxes is a process called transfer pricing. Transfer pricing is defined as:

…."a price that is assumed to have been charged by one part of a company for products and services it provides to another part of the same company, in order to calculate each divisions profits and losses separately. Generally, transfer pricing rules indicate that one affiliate must charge another affiliate the same price as would be demanded in an 'arms-length' transaction. A transaction between two related or affiliated parties that is conducted as if they were unrelated, so that there is no question of a conflict of interest (Tax Foundation, 2015.)"

The inverted entities, which are clearly related party parent-subsidiary relationships, engage in raising and lowering prices depending upon the tax rate of the reporting entity. The parent, usually a domestic entity subjected to a high tax rate, will have the goods and services price lowered and their international partner, in a low-tax environment will be charged a higher price. Therefore, the "profit" is essentially earned in the low-tax jurisdiction rather than domestically and the goal of income shifting is achieved.

Another interesting aspect to the transfer pricing games being played in the international arena involves intangible asset pricing (Mock & Simon, 2008.) The complexity of valuing a patent or other intellectual property assets is problematic because of the inability valuer to compare a unique or original property with another as an indication of 'fair market value." The domestic parent will license the patent/intellectual property at a low valuation allowing the international entity to in essence earn the royalty or other income in the lower-tax arena (Heckemeyer & Overesch, 2013.)

The intangible asset issue is further complicated by the current US Tax Code, which requires all costs, other than capital acquisitions for buildings and equipment, to be expensed immediately. Thus, the domestic entity deducts all costs of creating the patent &/or research and development disbursements in the higher-tax rate country but any future earnings from the intangible will be taxed in the lower-tax affiliate's country. Many domestic entities argue that their international subsidiaries lack the skilled labor or resources to develop the intangible product, therefore supporting the need for the costs to be incurred in the United States, but, once developed, the international subsidiary can handle the earnings piece of the process.

WHAT IS A TAX HAVEN?

Ironically, there is no actual definition of the term "tax haven" but it is usually associated with zero or low tax rates coupled with the lack of transparency regarding transactions taking place within the specified locale (Ekins, 2015.) In addition, the lack of reports and information available further complicates the tax haven designation moniker. There are many different lists of "tax havens" prepared by a myriad of domestic and international governmental agencies, but unfortunately, many low-tax jurisdictions are not included in the list (Gravelle, 2015.) Countries like Ireland and Switzerland are missing from most of the acknowledged tax haven lists because of a lack of consensus on what constitutes a "tax haven" locale. Recently, the Organization for Economic Development and Cooperation (OECD), who initially created a list of tax havens in 2000, has now narrowed the tax haven categories based upon cooperation and information (Gravelle, 2015.) The OECD has developed three lists pertaining to tax haven issues:

- ***A White List**: consisting of countries implementing agreed-upon standards of the international business community*
- ***A Gray List:** consisting of countries that have agreed to the standards*
- ***A Black List:** consisting of countries that have not committed to the agreed-upon standards (Gravelle, 2015.)*

The incentive for tax haven countries to move from the undesirable "Black List" to the less problematic "Gray List" or the most beneficial "White List" was underwritten by the negative publicity resulting from being named on the wrong lists (Faiola & Jordan, 2009). As a result, many of the original countries designated as not in compliance with the agreed-upon standards have now signed agreements to negotiate tax information exchange agreements. Furthermore, legal ramifications of not being in compliance with agreed-upon policies can lead to undesirable outcomes like sanctions from international bodies (Heckemeyer & Overesch, 2013.) Most recently, the OECD has focused its concerns on Profit Shifting issues and has rated tax haven locations as either: compliant, largely compliant, partially compliant or noncompliant (Gravelle, 2015.)

A major issue pertaining to the labeling of countries as "tax havens" is the countries that have been not been included on the list (Gravelle, 2015.) The Netherlands, Ireland, Canada and even the United States are omitted from their activities that many have labeled as tax avoidance friendly countries (Gravelle, 2015.) In reality, any country that with a low tax rate could technically be viewed as a potential tax haven because of the enhanced profitability that will be attained by shifting taxable earnings to those locations. Therefore, the tax havens that exist really should be categorized based on tax rates primarily, as that is the motivating factor for domestic entities to report earnings in those low tax arenas.

HOW DO CORPORATIONS AVOID TAXES?

Any taxpayer is obligated to pay their minimum tax as determined by following the Internal Revenue Code. The tax laws provide incentives and methodologies aimed at lowering the taxable income and resulting tax. Tax avoidance schemes are designed to further expand the availability of deductions and reduction of taxable income by shifting earnings to a lower tax haven destination. The tax liability is only recognized if the foreign earnings are repatriated to the United States (Gravelle, 2015.) The repatriated taxes are allowed a credit for any taxes paid to a foreign government, therefore only the difference between the domestic rate and the tax have n rate would trigger additional taxes owed. The foreign tax credit can only be used as a means of reducing the domestic tax owed and cannot be used to reduce domestic taxes on other income (Gravelle, 2015.) Therefore, the taxes owed in excess of the foreign location will be owed once the income is transferred to the domestic entity. Therefore, the reporting entity needs to continue to find a way to have access to the monies earned in the lower tax haven areas without triggering the additional domestic tax. The answer: have the domestic entity *BORROW* the funds from the international entity, which will not create a taxable event.

The Internal revenue Code has attempted to limit this activity by placing limitations on the amount of interest an entity can deduct on their corporate tax return. The Internal Revenue Code (163(j)) uses an analysis of the debt-to-equity ratio as a means of limiting the tax deductible of interest payments made on the repatriated loans (Gravelle 2015.) The legislation uses a mix of the debt-to-equity ratio combined with a percentage of taxable income as a means of limiting the tax haven loan scheme benefit.

The impact of corporate tax avoidance through earnings stripping schemes and tax haven implementation is not completely known. The studies conducted are limited and many times focus only on one aspect of the issue. In addition, the results of any analysis are widely disparate in estimated lost tax revenues. One study determined that approximately $100 billion in tax revenues are lost annually, but the estimate is purely speculative at this point (Zucman, 2014.) Much of the information needed to accurately determine the impact of tax avoidance is unavailable due to non-compliance and transparency issues. The strategy of tax avoidance is easier to determine than the impact of those tactics as implemented by many domestic corporations on the United States economy.

WHAT ARE THE SOLUTIONS?

The United States Treasury losses billions of dollars annually in corporate tax revenues as a result of the creative tax avoidance strategies implemented by corporations in their quest to reduce their tax burden (Zucman, 2014.) Congress has attempted to close the ‘loopholes” in the Internal Revenue Code that has sanctioned this tax avoidance behavior. President Obama has labeled corporations that engage in earnings stripping, transfer pricing and tax haven tax reduction strategies as being unpatriotic .

Tax reduction strategies can be viewed as legal tax avoidance tactics or illegal tax evasion schemes depending upon how the subjective Internal Revenue Code is interpreted. Illegality is problematic and difficult to identify due to a lack of available information but, tax avoidance tactics, can be rectified by simply changing the current tax code. There are many viable solutions including the following:

a. ***Reduce the Corporate Tax Rate**: If the top corporate tax rate were reduced to a lower more competitive rate the incentive to engage in tax avoidance strategies would be mitigated.*
b. ***Eliminate the Tax on Dividends**: By eliminating the tax on dividends paid by the international subsidiary to the domestic parent, the incentive to invert would be diminished.*
c. ***Create Exit Taxes**: A new exit tax would be levied against domestic corporations moving their revenues and earnings to a lower tax rate haven in order to invert.*
d. ***Disallow Earnings Stripping Activity**: The primary motivating factor creating the inversion strategy is the benefits of earnings stripping. If the activity is disallowed, the incentive is reduced.*
e. ***Create a Worldwide Tax System**: Create a tax system that taxes domestically incorporated companies on their <u>total</u> earnings from activities domestically and internationally.*

In order for the Internal Revenue Service to achieve voluntary compliance and avoid incentives for creating new tax avoidance tactics the inverted corporations must view *any* solution implemented by tax legislation, as equitable. Perhaps the best resolution would be the reduction of corporate tax rates, which would eliminate the any incentive currently fueling the inversion mania running amok through Corporate America. In addition, the reporting process, coupled with the regulatory requirements must be transparent and participatory.

CONCLUSION

The corporate inversion strategy, as implemented by many domestic corporations, attempts to rectify perceived unfair tax laws and triggers, across the board tax complications resulting from tax avoidance schemes. The tax avoidance strategy is problematic because it creates a dual tax system for those inverted corporations and for those who have opted not to invert. The only plausible solution is to reduce the incentive to invert. Therefore, Congress must reduce the current tax rates levied on corporations, who have implemented a plethora of creative strategies aimed at avoiding high corporate tax. Ironically, research indicates, that by reducing the corporate tax rate currently levied on domestic corporations, the tax revenues collected would exceed the revenues currently collected (Costa & Gravelle, 2008.)

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