# Key Elements of the U.S. Tax System

What are inversions, and how will TCJA affect them?



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**A. An inversion is a transaction in which a US-based multinational company merges with a smaller foreign company and then establishes its residence in the foreign company's country. As a foreign resident, the company can sometimes significantly reduce its taxes without changing the location of any real business activities.**

The current US system treats multinational enterprises whose parent companies are incorporated in the United States (US-resident multinationals) differently from those that are resident elsewhere. The United States imposes a minimum tax on the active profits above a 10 percent rate of return that its multinationals accrue within their foreign affiliates, while our major trading partners have so-called territorial systems that exempt their resident multinationals' active foreign-source income. In addition, US anti-abuse rules limit US-based multinationals' ability to use debt-equity swaps to shift reported income out of the United States, but do not apply the same limits to foreign-resident multinationals. New provisions, however, place limits on these profit-shifting activities by foreign-resident multinationals.

The United States bases its definition of corporate residence on place of incorporation. This definition need not be consistent with where a company's production is located, where its sales take place, where its shareholders reside, or even where its top managers live.

In prior years, the tax benefits of foreign residence, combined with the residence definition's lack of economic substance, led some US-based multinationals to formally incorporate their parent companies overseas. This transaction ("inversion") can often be accomplished without changing the location of any real business activities. Some recent research (Rao 2015), however, finds that inverted companies over time increase their shares of employees and investment overseas compared with companies that did not invert.

In the two decades before enactment of the 2017 Tax Cuts and Jobs Act (TCJA), US multinationals accumulated a large amount of unrepatriated foreign cash, increasing the motivation for inversion transactions (Clausing 2014). The TJCA eliminated taxes on repatriation of foreign-source income, thereby ending the incentive for US companies to retain assets overseas. In lieu of the repatriation tax, the TCJA imposed a minimum tax of 10.5 percent on certain accrued foreign-source income and a one-time transition tax of 15.5 percent for cash assets and 8 percent for non-cash assets accumulated in foreign affiliates before the end of 2017. The transition tax is payable on a backloaded schedule over eight years. These new taxes are payable whether or not a company repatriates its foreign assets, so firms are no longer encouraged to retain assets overseas. In response to the TCJA, US firms reduced their overseas cash holdings, using most of the repatriated funds to pay their shareholders dividends and to repurchase shares.

Over the years, Congress has enacted rules to limit inversions. Simple inversions—a US company establishes a foreign affiliate, which then becomes the parent company—no longer work because the United States would continue to treat the new company as a US resident. A company can still "redomicile," though, by merging with a foreign-based company under certain conditions; these include a requirement that the original foreign company contribute at least 20 percent of the shares of the newly merged company if other conditions are not met.

A recent wave of inversion transactions, like previous waves, generated considerable concern among US policymakers and led to legislative proposals and administrative measures to impose additional limits on merger transactions. The US Department of the Treasury in 2014 issued new regulations to prevent avoidance of the 20 percent threshold on foreign ownership and to make it more difficult for newly merged companies to repatriate earnings accrued before the merger tax-free. In 2016, Treasury issued additional regulations (Shay 2014; US Department of the Treasury 2016) that reclassified certain debt transactions between related parties as equity instead of debt. The regulations deterred foreign-based companies from paying their US affiliates' tax-deductible interest to other affiliates in low-tax countries, a practice known as income stripping.

TCJA included additional measures to deter inversions. The transition tax rate on inverted firms' existing overseas assets was set at the full pre-TCJA rate of 35 percent instead of the reduced rates of 8 and 15.5 percent for other firms' assets. And the dividends shareholders receive from any newly inverted firms are taxable as ordinary income instead of at the reduced rates generally applied to qualified dividends and capital gains.

While Congress and the public have viewed inversions with great concern, changes in existing US corporations' residence are not the only way the share of world output by US-based multinationals can decline over time. Foreign-based multinationals can purchase smaller US companies or divisions of larger ones. New companies can be chartered overseas instead of in the United States. And foreign-based multinationals can expand faster than US-based companies if US tax laws place US multinationals at a disadvantage. In the long run, limits on inversions may be less important in promoting US corporate residence than tax laws in the United States and overseas that create a level playing field between US-resident and foreign-resident companies with operations in both the United States and our major trading partners.

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## Further Reading

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TAXES AND MULTINATIONAL CORPORATIONS

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