

## **Inversions the latest tax-cutting strategy**

*U.S. corporations have been going through a series of reinventions to minimize bite from the IRS*

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It's not often that a tax story gets front page treatment but the movement to erode the U.S. corporate tax base has taken center stage. We've read about inversions, where an American company and a foreign firm combine and the non-U.S. company is the surviving entity.

This is not unlike any foreign takeover of a U.S. company except, in this case, the American company is the instigator of the transaction. Often, it is the minnow swallowing the whale. The general idea is that the U.S. company's shareholders will be better off because going forward, there will be a lower tax burden on profits.

Part of the attraction of getting out of the U.S. tax net is the fact that the U.S. imposes a tax on all income the company makes whether it is earned within or outside of the U.S. That is not how most countries compute income.

There also has been a focus on the U.S.'s 35% tax rate on corporations. Again, the U.S. is at a comparative disadvantage with other countries because we tax corporate earnings twice: once to the corporation and then again as the owners (shareholders) receive payments of those after-tax earnings.

Inversions are just the latest strategy employed by U.S. corporations trying to get out from under the hefty tax burden levied on corporate earnings.

In the 1980s, U.S. companies made an effort to eliminate the corporate level of tax by turning themselves into master limited partnerships. The government, scared by this trend, in 1987 passed IRC Section 7704, which limits the type of income MLPs can earn. Not surprisingly, new MLPs could not operate "active" businesses.

In 2002, Accenture PLC moved to Bermuda and later Ireland to save on U.S. taxes. By 2004 there was legislation that treated companies that simply shifted their addresses out of the country as domestic for tax purposes.

However, there were several exceptions, including if they had "substantial" business in their new home, or if they merged with a foreign company whose shareholders ended up owning at least 20% of the combined firm. Not surprisingly, we see these current inversions conforming to those rules.

At the same time we see some companies inverting, we see other corporations converting to lower their tax bill. As an example, Weyerhaeuser Co. was a tax-paying corporation until it converted to a real estate investment trust a few years ago. A REIT is akin to a mutual fund, but it owns real estate instead

of stocks or bonds. Like a mutual fund it pays no tax as long as the REIT's income is distributed each year.

But, like the inversions of today, the shareholder paid a tax toll for going from a corporation to a REIT. Weyerhaeuser had to distribute whatever earnings it had that had not already been paid out as dividends. Although the shareholders received little cash, they had income of more than \$26 per share by virtue of holding Weyerhaeuser through the transition.

At least these taxpayers paid the toll to enjoy a tax-favored income stream as Weyerhaeuser continues to cut down trees; income received from harvesting trees is considered a long-term gain. Because Weyerhaeuser, like all corporations, treats all gains as ordinary income, this benefit was lost in the corporate form. Before conversion, Weyerhaeuser paid a 35% tax on gains from cutting trees and then its shareholders paid another tax as dividends were paid. A 20% long-term gain rate brings the total tax paid to the U.S. government to 48 cents on the dollar. After conversion, taxpayers now are able to keep 80 cents on the dollar.

We see the rush to eliminate the corporate level of tax going strong in the MLP and REIT arenas as the government issues private letter rulings loosening the rules as to what can qualify to be held in such a non-taxed entity. As a result of these rulings there are now REITs that own prisons, casinos, cell towers and another that owns "server farms". We also see that MLP status was granted to an entity that does nothing more than haul water to and from fracking sites.

We find it ironic that at the same time the government is up in arms about inversions, it is being more expansive with companies that want to spin off or convert to a zero tax environment.

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