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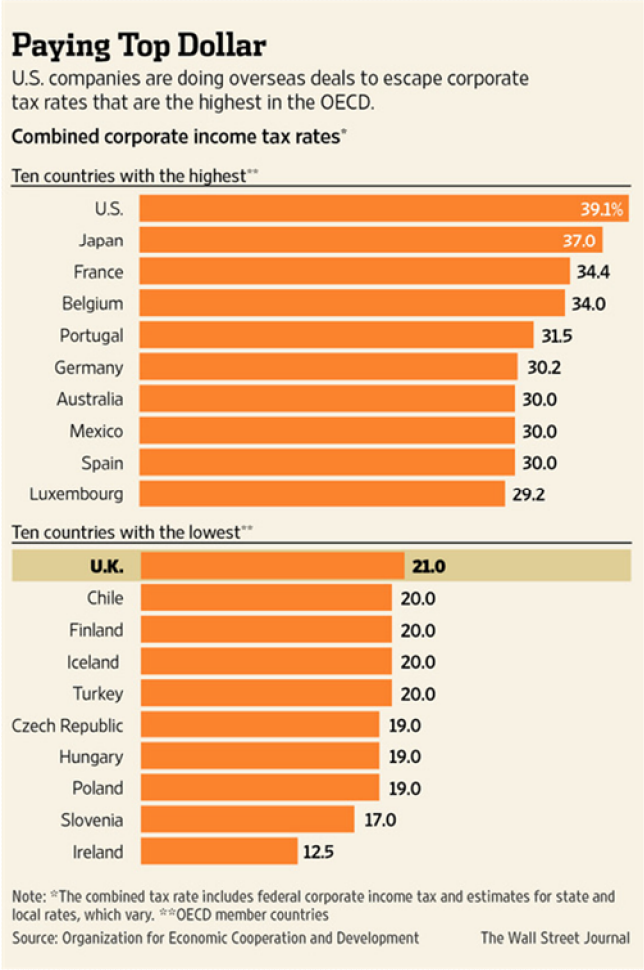
INVESTMENT UPDATE

There's been a lot of talk recently about US corporations moving their operations overseas in order to reduce the taxes they pay to the IRS. Some would argue that companies that do this are no better than tax cheats—that these firms are using technicalities in US and foreign tax laws to avoid paying the taxes that they owe the US government. Others defend the practice as a logical and legal means of maximizing after-tax income, income that is retained by the company to be used to pay dividends to shareholders or reinvest in their business.

We can appreciate both sides of the argument, but remain uncomfortable with the practice. We believe that it is every citizen's (and corporation's) responsibility to pay taxes to support the national, state, and local governments that provide the infrastructure and services that a modern, law-abiding society needs to survive. As Supreme Court Justice Oliver Wendell Holmes wrote in 1927, "Taxes are what we pay for civilized society."

The practice in question, known as "tax inversion," has been around for decades, but its popularity has soared recently; according to Thomson Reuters, 66% of the largest merger and acquisition deals announced in 2014 have been tax inversions, compared to just 1% in 2011. In a typical tax inversion, a US company acquires a company headquartered in a country with a lower corporate tax rate (Ireland is the most popular destination in these schemes, as its corporate tax rate is only 12.5%, as the table here shows). Through the acquisition mechanism, the US company legally (but typically, not physically) moves its assets to the foreign country, acquiring the target company's country of residence for legal and tax purposes. From that point forward, income earned from overseas business lines are taxed at the rate of the country where the company is now headquartered. The company may also transfer certain intangible but income-producing assets to the new country to further reduce its tax burden.



The driving factor for tax inversions is that US-headquartered companies with global operations are levied taxes on their foreign earnings at a rate equal to the difference between the US tax rate and the statutory rate paid to the country in which those earnings were earned. In simple terms, Coca Cola will have to pay an additional 5% to the IRS on earnings from their business in Spain, the difference between the US corporate tax rate (35%) and Spain's. Most other OECD countries do not employ this practice, and instead follow a "territorial" system, where foreign earnings aren't subject to additional taxes over and above what was paid to the country where the earnings originated.

In order to avoid paying these additional taxes, US companies have been allowing foreign-earned cash to pile up on the balance sheets of their foreign subsidiaries. But this only defers the tax liability of the company—once the company "repatriates" these foreign earnings and transfers them to the corporate financial statements in the US, they will have to pay these back taxes. Estimates of non-repatriated cash in US subsidiaries is well over $1 trillion—money that the US Treasury is understandably eager to see returned back here.

Let's be clear: The practice is not illegal. Those who defend tax inversions point to the fact that it's really no different from a company setting up its corporate headquarters in Delaware (as approximately 60% of the *Fortune* 500 have done) in order to find the most "business-friendly" environment. Yet it's hard

for "the man in the street" to understand how a US company could enjoy decades of benefits provided by this country, and then avoid paying for them through a clever legal maneuver. Minnesota-based Medtronic received $484 million in government contracts over the past five years and is now doing an inversion by buying Covidien, another pharma company that already de-camped for tax purposes to Ireland (but whose senior management is still in Boston).

What are the remedies for stopping the practice? The answer depends on whom you ask. CEOs of companies who have executed inversion strategies will point to the fact that, at 35%, the US has one of the highest federal corporate tax rates in the world. As the table on the front page demonstrates, if you include state and local taxes, the US corporate tax rate, at more than 39%, is the highest among all OECD countries. Lower the tax rate (or move to a territorial tax system) these CEOs say, and we won't have to shop around for a better tax deal.

Of course, this statutory tax rate is far higher than the *effective* tax rate paid by the average US corporation, due to the myriad tax breaks enjoyed by the typical US company. When comparing the tax rate that companies actually pay, the US corporate tax rate looks pretty average (at approximately 22%) compared to other major developed economies. And there are industries that pay much, much less—according to the Institute on Taxation and Economic Policy, the average tax rate on electric and gas utilities companies was just 2.8% for the five years ending 2012. And there are many large corporations here in the States who have paid zero taxes in recent years, including Boeing and Verizon.

Clearly, the issue isn't just as simple as reducing the marginal corporate tax rate, as it would be disastrous (and ultimately foolish) to try to compete with Ireland's 12.5% rate—there will always be countries willing to offer a rate lower than ours. What we need is a "truth in advertising" tax structure, where US companies are charged a lower rate, but have few, if any, tax credits or loopholes available to them. The existing US corporate tax policy is entirely too complex, with special treatment for certain industries and not for others. In fact, there is speculation that one of the motivating factors spurring companies to do these tax inversions now is the threat of tax reform—better to lock in a known tax benefit available today than to take the chance that your special US tax treatment may go away tomorrow.

Of course, "tomorrow" there will be no overhaul of the US corporate tax system, nor will there be any true tax reform next week, next month, or probably even next year. Politicians responsible for such reforms have no incentives to do so, even with the highly-critical headlines taking corporate America to task for these tax-avoidance strategies. The problem, as the *New York Times* recently pointed out, is that while there is broad agreement, even between Republican House Budget Chair Paul Ryan and President Obama, that we need a lower rate and fewer tax breaks for corporations, "every loophole has its lover." Special tax rules for farmers, oil companies, hedge funds, defense contractors—all huge industries with thousands of employees and with massive war chests which help fund politicians' re-election campaigns—every Representative and Senator has a special interest that they cater to. It's easy to see the challenge that genuine corporate tax reform faces.

What we're far more likely to see, unfortunately, is a continuation of the scattershot legislation that has contributed to the current mess, although the sights right now are squarely focused on preventing future tax inversions. One such proposal, put forth by the brothers Sandy and Carl Levin (Democratic Representative and Senator, respectively, from Michigan) would make the rules tougher to carry out a tax inversion, stipulating that the foreign partner in an inversion own at least 50% of the new combined company, and that there be a change in management when the inversion takes place. Meanwhile, leading Republicans (led by House Ways and Means Committee Chair Dave Camp) want to allow repatriated foreign earnings to be taxed at a rate of just 1.25%, with the idea that getting those earnings (and associated assets) back to the US, even at a big discount to any reasonable "real" tax rate, will take away the incentive to move the corporate HQ to the Irelands of the world. Obviously, the sides remain very far apart.

If Congress can't agree on legislation that would prevent inversions, it looks increasingly likely that the president will use executive powers to do so, although Treasury Secretary Jack Lew has said only that they are exploring options that would "very materially change the economics of inversions." The advantage, at least theoretically, to the executive branch doing so is that they aren't as tied to powerful special interest groups as Congress, and can put through changes that make economic sense for the broad benefit of the country. But, as we saw all too clearly with health care reform, the executive branch is hardly independent.

Please join us in welcoming Justin Hildebrand, the newest member of Agincourt's team. Justin joins us from a major sporting goods company's corporate office in Pittsburgh, where he worked as a financial analyst for the past four years. A graduate of Wake Forest University, Justin will be assisting us with client reporting, compliance, and consultant communications.