BerkeleyLaw
UNIVERSITY OF CALIFORNIA

Berkeley Center for Law, Business and the Economy

University of California, Berkeley
School of Law
2850 Telegraph Ave, Suite 500
Berkeley, CA 94705-7220

Ph: 510.642.0532 – Fax: 510.643.7095
E-mail: BCLBE@law.berkeley.edu
http://www.law.berkeley.edu/bclbe.htm

Earning Stripping, Tax Inversions, and the Gaming of America's Corporate Tax System.

By Kristofer Hatch J.D. Candidate 2017 | February 22, 2016

Earning stripping and tax inversions are allowing US-based corporations to shelter their tax burdens outside of the reach of the IRS. In an inversion, a US-based company relocates their corporate headquarters overseas, allowing them to lower their domestic tax bill. A key element of this scheme is earning stripping. Earning stripping works by having a company complete their inversion deal, moving their headquarters outside of the US for tax purposes, while retaining their operations within the US. The US subsidiary then borrows large amounts of money from the foreign parent. The US subsidiary can then use the interest payments they make for the foreign parent to offset the American earnings, thus lowering the amount they are taxed domestically.

Earning stripping saw its first action this year in the merger between Waste Connections (WC), a US-based company, and Progressive Waste (PW), a Canadian-based company. Under the deal, WC took on PW's Canadian address, creating a tax synergy allowing the merged company to lower its effective tax rate. Prior to the merger, WC's effective tax rate was 40% on its US earnings, and PW's was 18% on its earnings. Post-merger, the combined company pays now pays an effective tax rate of 27%. Another example is the Johnson Controls and Tyco merger earlier this year that moved JC's tax headquarters to Ireland. Shareholders of JC will own 56% of the company: just below the 60% threshold required for the Treasury Department's inversion rules to kick in, allowing JC to reap significant tax benefits via an inversion scheme.

These practices have garnered significant political exposure leading up to this year's election. Democratic hopeful Hillary Clinton has been quite outspoken about her distaste for earning stripping practices. On the other side of the aisle, Republican hopeful Donald Trump called the practice of tax inversions "disgusting," and that politicians should be "ashamed" for allowing it. Hillary Clinton's camp alleges that a crackdown on earnings stripping could bring in about $60 billion in tax revenue over 10 years, representing an increase in corporate tax revenues by an average of 1.5% each year.

Several solutions have been put forward to help mitigate the issues of tax inversion and earning stripping. One of these is to pass an exit tax that would levy taxes on foreign earnings when an inversion takes place. Another strategy is to raise the number of shares a U.S. company must sell to foreign shareholders to shift its tax address above its current threshold of 20 percent.

From a value as high as 33% of all tax revenue in the 1950s, to as low as 9% today: the tax-avoidance strategies of earning stripping and tax inversions are just one of several ways in which US-based corporations are cementing us into an era where less and less of the United States' tax revenue comes from the corporate sector.