Statement of

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Before the

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Corporate Inversions and Other Tax Games

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Chairman Wyden, Ranking Member Hatch, and Members of the Committee: thank you for inviting me to participate at this hearing. I'm honored to have a chance to address you directly rather than having to write a newspaper or magazine article and hope that you pick it up and read it. Before I proceed, please note that I am speaking for myself alone. I am not speaking for my editors; or for my employer, Fortune magazine; or for Fortune's parent company, Time Inc. I am also not speaking for the Washington Post, which has run my articles for many years.

Part of the way that I have made my living since becoming a business journalist in 1969 is by writing about strange and complicated transactions designed to allow corporations (and on occasion, individuals or families) to minimize or eliminate tax obligations. I try to do this by explaining these transactions in what I call "a language approaching English." For example, when the Smucker jelly company acquired Jif peanut butter from Procter & Gamble in a tax efficient transaction, I called it a merger of peanut butter with jelly, rather than a Reverse Morris Trust. When the RJR Nabisco tobacco-grocery conglomerate tried to turn its food company into an independent entity, I talked about RJR trying to separate cookies from cancer.

When I worked at the late, lamented New York Newsday, which was owned by the late, lamented Times Mirror Co., I specialized in writing nasty stories about the tax-dodging tactics of Times Mirror and its controlling family at the time, the Chandlers. After Tribune Co. bought Times Mirror, the Chandlers grew disenchanted and forced Tribune to sell out to Sam Zell. I knew the Chandlers were really angry with Tribune management, because they agreed to have the company do a taxable transaction with Zell. He calls himself the Gravedancer, but I took to calling him the Artful (Tax) Dodger.

I'm telling you this so you can see that I've been around the tax avoidance business for a long time and that I'm either intellectually honest enough or foolish enough to bite the corporate hand that feeds me. I used to consider corporate tax avoidance an indoor sport of sorts. Up until inversions, many of the transactions I wrote about amused me—but I'm not amused now.

I consider inversions to be a threat not only to the public fisc, but to the public psyche. Enough of a threat for my editorial superiors at Fortune—who aren't exactly anti-capitalist—to have asked me to write what turned into Fortune's recent cover story about inversions, called "Positively Un-American." (I've attached it to the end of this testimony.)

One of the things I find most disconcerting about inversions is that many people aren't scared of them enough. These are something entirely different from the tax dodges I'm going to describe in a bit. They're different from the income-shifting games that companies like Apple and Caterpillar play that have gotten so much attention. Inversions have the potential to totally undermine the corporate tax system, because we're beginning to see the dynamic change from "what's an inversion?" to "sign me up."

I have watched corporations and financial markets for more than 40 years, with the eyes of an English major who has learned about business, as opposed to an economics student who started out with theories. I can sense the corporate stampede out of this country coming. And once it happens—which it will, absent some quick action, followed by fundamental corporate tax reform—it will be irreversible.

You don't have two or three or four years to look at this problem, consider it, listen to all the usual suspects, and legislate. If you don't do something quickly to halt inversions, by the time you get around to dealing with them as part of corporate tax reform, the corporate tax base will have been so diminished that it will be extremely difficult for you to come up with any sort of revenue-neutral program.

To be sure—which I consider the three most dangerous words in journalism--I don't have any statistics to support this. That's because we don't have any reliable statistics—at least, none that I'm familiar with—about how many inversions we've had, how many are pending, how much tax revenue inversions they have cost the rest of us and are likely to cost in the future. (I will elaborate on this problem later in my testimony.) If the projections you hear for individual companies are remotely accurate—I have no idea if that's the case, no one does—the JCT projection of $19.5 billion of tax revenue lost to inversions over the next 10 years absent legislation is way, way low. Make that way, way, way low. It's not the staff's fault—the dynamic has changed.

If I thought inversions were really only a $2 billion a year item—not that $2 billion isn't money—I wouldn't have written what I did. And if this committee thought it was such a relatively small problem, I would not be testifying here today.

Now, to my testimony. I will talk about some tax-dodging games that I have seen and written about over the years, and hope that they will put the current wave of corporate inversions into historical context. I will also try to demonstrate that these inversions are a vastly more serious threat to public well-being than even the most blatant of these transactions. And finally, I will give you my thoughts about how I would deal with the inversion problem if American voters took leave of their senses and elected me to public office.

MORRIS TRUSTS

Until 1997, these were used as a routine, tax-efficient way to separate companies into their component pieces. A company would stick a business it wanted to unload into a new corporation owned by its shareholders, which is a tax-free transaction. A nanosecond later, a buyer would acquire the new corporation in a tax-free stock-for-stock deal. Company holders would thus end up with shares in both the original company and in the buyer of the business being unloaded.

For example, Affiliated Publications, which owned the Boston Globe, had somehow ended up with a bloc of shares of McCaw Cellular, which was becoming more valuable than the newspaper. So Affiliated did a deal with McCaw, in which McCaw traded its shares in return for shares in an Affiliated subsidiary that owned more shares of McCaw than McCaw issued to acquire the subsidiary. So at the end of the day, Affiliated shareholders owned McCaw shares in addition to their Affiliated shares, and McCaw was able to reduce its number of shares outstanding. No harm, no foul, no capital gains taxes.

But instead of simply confining themselves to tax-efficient separations, which no rational person could oppose, Morris Trusters over reached. They created the "Cash-Rich Morris Trust," in which corporations got lots of cash in what in effect was a tax-free sale masquerading as a corporate split-up. Disney's sale of the newspapers it acquired when it bought Capital Cities Communications, and General Motors' sale of its defense business got the most ink, part of it from me. Congress tightened the rules. But loophole openers then created…

REVERSE MORRIS TRUSTS

These require that shareholders of the selling company end up with a majority stake in the acquiring company — a big disincentive to buyers. But P&G managed to find buyers for three such deals: Smucker in 2002 for Jif; and in 2008 for Folger's coffee, enhancing Smucker's breakfast brand presence; and in 2011, a company called Diamond Food for Crisco. I calculated that these transactions saved P&G a combined $2 billion in capital gains taxes. Fortunately for the public fisc, Diamond stock fell apart, the Crisco deal collapsed and P&G unloaded Crisco in what I think was a straight-up, regular sale.

SPLIT-OFFS

This is another common technique that morphed from being an efficient way to split up companies into something excessive.

A corporation that owned a business that it no longer wanted would turn that business into a new, independent company. Then it would offer shares in the new company to its shareholders in return for some or all of their shares. At the end of the day, the company would have disposed of the business it didn't want, and reduced the number of its own shares that were outstanding. It was really sort of neat. It was equivalent to a company selling the unwanted business for cash,

and using the cash to buy in some of its own shares. But a sale would have generated taxes. A split-off didn’t.

Some notable split-offs were Loews Corp., a conglomerate (in which I now own stock) that did a split-off with its big stake in Lorillard tobacco. McDonalds with Chipotle Mexican Grill. Bristol Myers Squibb with Mead Johnson, which makes baby food. These are all reasonable deals in which a company unloaded an unwanted business in a tax-efficient way, setting the business free to find its destiny.

But naturally, companies—and their advisors—weren’t satisfied with a tax-free separation. So they created….

CASH-RICH SPLIT-OFFS

These are much more like a sale than a simple, tax-efficient separation. The first one of these was in 1999, when the Janus mutual fund company swapped its 28% stake in DST Systems for a small DST business and $999 million of cash. It was a sale in a split-off’s clothing, and the business, which was barely a rounding error in the overall transaction, was a necessary part of the deal to make it tax-free. Liberty Media swapped cash and a few properties to Comcast for $1 billion of Liberty stock that Comcast owned. Time Warner traded a bunch of money and the Atlanta Braves to Liberty for a big piece of Time Warner stock.

Congress got annoyed, and in 2006 passed legislation requiring that from May 17, 2006 through May 17, 2007, the business thrown into the pot had to be “somewhat more than a quarter” of the consideration being paid, and since then, it has had to be “somewhat more than a third.” So now you’ve got deals tip-toeing right up to that line.

The one that comes screaming to mind involves Graham Holdings (the old Washington Post Co.) and Berkshire Hathaway (which needs no introduction). The exact numbers aren’t yet available, but earlier this month, Graham swapped about $400 million of Berkshire Hathaway stock that it owned, plus about $388 million of cash, plus a TV station that it valued at something like $394 million, for about $1.2 billion of Graham Holdings stock that Berkshire had owned for 40 years or so, and in which it had an ultra-low cost basis. This saved the firms a total of close to $700 million of taxes. (I own shares in both companies, and I like and respect both Don Graham and Warren Buffett.)

The way to stop this silliness is to require that the operating business be at least 80 percent of the transaction. But that’s not our topic today.

This brings us to…..

INVERSIONS

There’s a huge, huge difference between these games that I’ve described involving Morris Trusts, Cash-Rich Morris Trusts, Reverse Morris Trusts, Split-Offs and Cash-Rich Split-Offs and inversions.

All of these transactions are generally one-time things. They don't involve a company renouncing its corporate citizenship to save money, but expecting to be treated as if it were a regular, legitimate American company.

The attached article, which underwent rigorous editing (unlike this presentation), explains the history and workings of inversions far better than I could in this testimony. It also has some telling examples of intellectual inconsistency—I don't want to violate Senate decorum by using the term "hypocrisy"—that the package's primary editor uncovered with the aid of several of our Fortune colleagues. Plus, the graphics are pretty good.

We've now got a tidal wave of inversions—or we will have them unless the people at the podium in this room and your colleagues do something about it. Quickly. Inversions beget inversions, both for competitive reasons and because there's now a critical mass of players such as corporate raiders (who like to call themselves "investor activists") who care only about getting a stock's price up today; investment bankers who get fees from these deals; and all sorts of hangers-on.

We will end up with almost every company capable of doing an offshore deal doing it, and putting increasing pressure on every corporate manager of an inversion candidate who wants to do the decent, economically-patriotic thing, and finds this kind of behavior abhorrent.

Let me offer up a telling piece of history.

The first inversion was in 1983 when McDermott International, a builder of offshore drilling platform and underwater pipelines, moved its domicile to Panama.

In its April of 1984 issue, Fortune carried a short story about McDermott, and mentioned that it had been thrown out of the Fortune 500 for no longer being an American company. It also noted that two Canadian companies—Inspiration Resources and Lafarge Corp.—had moved their domiciles to the U.S., and were added to the 500. You don't see companies inverting into the U.S. these days, which is a sign that things have changed.

One reason that inversions haven't attracted much attention until recently is that until Pfizer tried to invert, there hadn't been any big, household-name firm visibly trying to leave the country. Pfizer trying to go offshore by buying AstraZeneca shocked me into paying much closer attention to inversions, and I think it shocked a lot of people.

One of the problems I ran into almost immediately was answering a basic question: how many inversions have we had. Two of the major sources of lists—the Congressional Research Service and Bloomberg—are flawed. Tracking this stuff is extremely difficult. One of my colleagues at Fortune, a research librarian at a major law firm in his previous life, is trying to assemble a definitive database. But it is taking a lot of time and effort.

Part of the problem is what I call the "never-heres": companies whose ancestors were U.S. corporations, but that in their current incarnation have always been offshore. Therefore, they get

upset when you call them inverters—which we at Fortune have decided to do. And that you should do, too. Examples include Accenture when it was spun off from Arthur Andersen; Seagate (in which I bought stock several years ago, not realizing it wasn't a U.S. company) when it was relocated after being acquired in a leveraged buyout; Delphi when it reorganized after its bankruptcy.

A contributing problem is that although we have overall Treasury numbers about how much federal corporate tax is collected, we don't know how much any individual corporation pays for a given year. That's not one of the dozen-plus tax metrics that publicly-traded corporations are required to disclose. That makes it impossible to do a rigorous analysis of the tax situation of any inverting or would-be inverting company. We can solve this problem—or you can—by asking the SEC or the Financial Accounting Standards Board to require publicly-traded corporations to disclose this information by taking two numbers from their corporate tax returns: taxable income for a given year, and taxes paid for that year. This is easily accessible to companies—though not to anyone else—because all they need to do is look at their tax returns. My estimate is that it would take one person-hour a year per company to generate this information, which companies have refused to give me when I asked. FASB and the SEC have basically blown me off, but they won't blow you off.

If you talk to companies about inversions, which my Fortune colleagues and I have been doing for several months, you hear things like "this is only part of our strategy, it's not why we're doing the transaction." Or, "we will continue to pay taxes in America."

This is, forgive me, misleading nonsense. Ask a company why, if inversion isn't a major purpose of the deal with the foreign company, it's not doing a straight-up acquisition. Ask how much it would be paying for the foreign company if inversion weren't part of the package. I haven't gotten answer to this, but you probably could, especially if you asked them these questions in public. You can also ask inverters if their contract with their inversion partners contains a clause giving the inverter to right to modify or cancel the deal if inversion rules change. I think you'll get a "yes."

As for the "we will continue to pay U.S. taxes" story, ask how much the company will pay in U.S. corporate income tax as an inverted company compared to what it would have paid had it not inverted. I can't get answers to this, but you can. I suspect the answers will upset you.

MY SUGGESTIONS

I know little—almost nothing, actually—about the political dynamics that go into the making of tax legislation. The one thing I can see is that the inversion question is becoming even more politically toxic than most things that I write about.

I saw that House Democrats forced an up-or-down vote by trying to attach the Sander Levin legislation to the depreciation-extender bill. It got voted down on a party-line vote. Of course, I saw Secretary Lew's letter. And I saw Senator Hatch's response. With all due respect, this struck me as political theater, not substance. And we need to deal with substance. It would be

absolutely tragic if we let the inversion question descend into soundbites, political rhetoric and attack ads.

Looking at this as an outside observer, I think it's glaringly obvious what need to be done. First, you pass the Levin legislation—I prefer the Senate version, for reasons you'll see in a bit—to enact changes that would require inversions to change management and shareholder control of inverting companies. You adopt the March 8 cutoff date. No, that wouldn't be unfair retroactive legislation. Ever since Senator Wyden's op-ed ran in the May 8 Wall Street Journal, corporate America has been on notice that a May 8 date is on the table. (An aside: when I saw that article in the Journal, I let loose a string of obscenities, because he had written what I had hoped to write as my Fortune-Washington Post column. Being beaten by a competitor is part of the game—but I'd never been beaten to the news by a Senator before.)

If I were you, I would adopt the Senate version of Levin legislation, so that there's a cut-off date, and so that averting inversions for awhile doesn't totally remove the pressure to do something about the corporate tax code reasonably quickly. I found aspects of Rep. Camp's proposal interesting, but I don't pretend to have any expertise in drawing up tax legislation. That's what you do. It's not what I do.

Lookit, as we used to say when I was growing up in Brooklyn. Tax reform has been kicking around Washington for years, but doesn't seem to happen. You have to do something. It's not a partisan issue, it's a national issue.

Inversions are a symptom of the underlying disease, which is the tax code. But as my daughter the ER doctor would tell you if she were testifying, sometimes you have to address the immediate symptom before going on to the cure. If you're bleeding out, you need to put on a tourniquet, then deal with the wound. You can't say, "there's no point in stopping the bleeding if the wound hasn't been healed." You can treat the symptom quickly, and spend some time—but not too much—trying to cure the disease. You shouldn't say that inversions and the code need to be treated simultaneously.

Inversions aren't an obvious emergency, the way that helping people and businesses recover from floods and hurricanes is. But they are an economic emergency whose outlines are becoming clear to anyone willing to see them. Despite the toxic climate around here, you have occasionally managed to surmount partisanship and spin and accomplish worthwhile things. Please do something about this looming financial disaster before it's too late.

Thank you.

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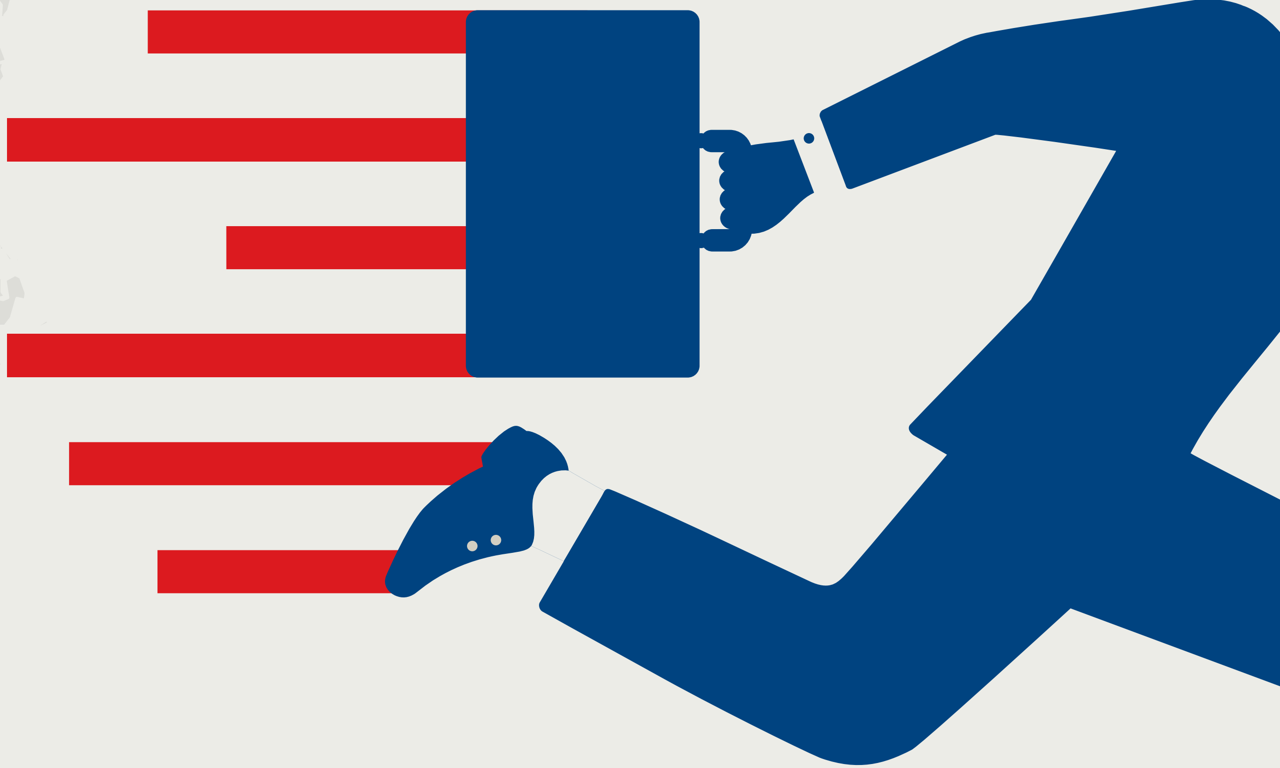

...THAT MEANS THE REST OF US PAY THEIR SHARE.

BY ALLAN SLOAN

INSTAGRAM
Big, bad, and ready to make money
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BIGTIME COMPANIES ARE MOVING THEIR "HEADQUARTERS" OVERSEAS TO DODGE BILLIONS IN TAXES... THAT MEANS THE REST OF US PAY THEIR SHARE.

By ALLAN SLOAN

Ah, July! What a great month for those of us who celebrate American exceptionalism. There's the lead-up to the Fourth, countrywide Independence Day celebrations including my town's local Revolutionary War reenactment and fireworks, the enjoyable days of high summer, and, for the fortunate, the prospect of some time at the beach. ¶ Sorry, but this year, July isn't going to work for me. That's because of a new kind of American corporate exceptionalism: companies that have decided to desert

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PHOTOGRAPH BY **TOM SCHIERLITZ**

our country to avoid paying taxes but expect to keep receiving the full array of benefits that being American confers, and that everyone else is paying for.

Yes, leaving the country—a process that tax techies call inversion—is perfectly legal. A company does this by reincorporating in a place like Ireland, where the corporate tax rate is 12.5%, compared with 35% in the U.S. Inversion also makes it easier to divert what would normally be U.S. earnings to foreign, lower-tax locales. But being legal isn't the same as being right. If a few companies invert, it's irritating but no big deal for our society. But mass inversion is a whole other thing, and that's where we're heading.

We've also got a second, related problem, which I call the "never-heres." They include formerly private companies like Accenture, a consulting firm that was spun off from Arthur Andersen, and disc-drive maker Seagate, which began as a U.S. company, went private in a 2000 buyout and was moved to the Cayman Islands, went public in 2002, then moved to Ireland from the Caymans in 2010. Firms like these can duck lots of U.S. taxes without being accused of having deserted our country because technically they were never here. So far, by *Fortune*'s count, some 60 U.S. companies have chosen the never-here or the inversion route, and others are lining up to leave.

All of this threatens to undermine our tax base, with projected losses in the billions. It also threatens to undermine the American public's already shrinking respect for big corporations.

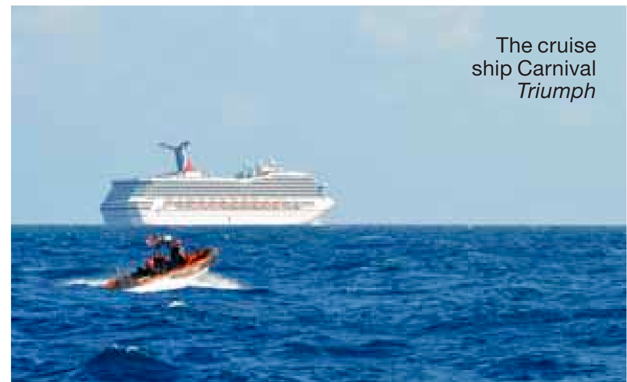
Inverters, of course, have a different view of things. It goes something like this: The U.S. tax rate is too high, and uncompetitive. Unlike many other countries, the U.S. taxes all profits worldwide, not just those earned here. A domicile abroad can offer a more competitive corporate tax rate. Fiduciary duty to shareholders requires that companies maximize returns.

My answer: Fight to fix the tax code, but don't desert the country. And I define "fiduciary duty" as the obligation to produce the best long-term results for shareholders, not "get the stock price up today." Undermining the finances of the federal government by inverting helps undermine our economy. And that's a bad thing, in the long run, for companies that do business in America.

Finally, there's reputational risk. I wouldn't be surprised to see someone in Washington call public hearings and ask CEOs of inverters and would-be inverters why they think it's okay for them to remain U.S. citizens while their companies renounce citizenship. Imagine the reaction! And the punitive legislation it could spark.

10 TOP AMERICAN CORPORATE

The S&P 500 stock index supposedly includes the largest public American companies. It turns out that 28 of them are incorporated in places like Ireland and Switzerland to avoid high U.S. tax rates. These 10 companies sure seem American—except when it comes to paying taxes. For the full list, visit fortune.com/unamerican.



The cruise ship Carnival *Triumph*

SHIP: PAUL MCCONNELL—U.S. COAST GUARD VIA GETTY IMAGES; DONALD: CINDY ORD—GETTY IMAGES; MCGAVICK: PETER FOLEY—GETTY IMAGES

Carnival Corporation

U.S. HEADQUARTERS: MIAMI

CEO Arnold Donald runs this cruise ship giant, which is incorporated in Panama and Britain for tax reasons but benefits from Uncle Sam. When the Carnival *Triumph* caught fire last year, the U.S. Coast Guard helped get the crippled cruise ship to Mobile. Perhaps embarrassed about not paying its fair share of U.S. taxes, the company reimbursed the government.

TAX RESIDENCE: PANAMA

XL Group PLC

U.S. HEADQUARTERS: STAMFORD, CONN.

CEO Mike McGavick likes America, but his giant insurance company, formerly in the Cayman Islands, is now registered in Ireland. In a previous existence, McGavick was the unsuccessful 2006 Republican U.S. Senate candidate in Washington State. His platform: Eliminate the estate tax and deploy more troops in Iraq. Who's going to pay?

TAX RESIDENCE: IRELAND

Fortune contacted every company on our list of tax avoiders (above) and asked why they incorporated overseas. Four of them—Carnival, Garmin, Invesco, and XL—said they were never U.S. companies. In other words, they are never-heres. Five more—Actavis, Allegion, Eaton, Ingersoll Rand, and Perrigo—said they inverted mainly for strategic purposes. The tenth, Nabors, refused to respond to our multiple requests.

Companies that have gone the inversion or never-here route

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TAX AVOIDERS

Eaton PLC

U.S. HEADQUARTERS: CLEVELAND

CEO Alexander Cutler registered his Cleveland maker of circuit breakers and truck transmissions in Ireland to lower taxes. Ironically, he also happens to be a member of the Campaign to Fix the Debt, a nonpartisan organization that advocates cutting government spending and increasing tax revenue. He wants to close tax loopholes—but he sure isn't proposing to return his corporation to full U.S. taxpaying status.

TAX RESIDENCE: IRELAND

Ingersoll Rand PLC

U.S. HEADQUARTERS: DAVIDSON, N.C.

The board of directors of this company, whose jackhammers carved Mount Rushmore, voted to move its domicile to Bermuda barely a month after the 9/11 attacks. CEO Michael Lamach says one place Ingersoll Rand gets its engineering and technical talent is "our U.S. military veteran recruiting program." The company, whose brands include Thermo King, Trane, and Club Car golf carts, subsequently moved to Ireland.

TAX RESIDENCE: IRELAND

Perrigo PLC

U.S. HEADQUARTERS: ALLEGAN, MICH.

The world's largest seller of over-the-counter store-brand drugs is headquartered in Michigan but incorporated in low-tax Ireland. CEO Joseph Papa counts on the (tax-supported) FDA to clear prescription drugs to be sold OTC. Perrigo is suing the FDA (for which the company doesn't pay its fair share) for allegedly not moving quickly enough to allow its testosterone gel to be sold without a prescription.

TAX RESIDENCE: IRELAND

Nabors Industries Ltd.

U.S. HEADQUARTERS: HOUSTON

Anthony Petrello is CEO of Nabors, a major oil and gas drilling company domiciled in Bermuda for tax reasons that benefits greatly from fracking technology. But you know what? Fracking would not have been a commercially viable process without heavy R&D investment by the federal government. The industry also receives substantial federal subsidies.

TAX RESIDENCE: BERMUDA

Garmin Ltd.

U.S. HEADQUARTERS: OLATHE, KANS.

Gary Burrell and Min H. Kao founded Garmin in 1989 in Kansas. Today the company, a leading maker of GPS systems, has its headquarters in Olathe but registered in Switzerland for tax reasons. Guess who invented the GPS? Would you believe Uncle Sam? You should. And by the way, the company's first customer was the U.S. Army.

TAX RESIDENCE: SWITZERLAND

Invesco Ltd.

U.S. HEADQUARTERS: ATLANTA

This Atlanta-based investment firm, which has $791 billion under management, is incorporated in Bermuda for tax purposes. Does that bother CEO Martin Flanagan, who in a 2007 speech at Terry College of Business in Atlanta, said, "If we're not financially sound as a country ... you become much less competitive in the global marketplace ... Ultimately it is a situation that's not sustainable for a country"? Apparently not.

TAX RESIDENCE: BERMUDA

Allegion PLC

U.S. HEADQUARTERS: CARMEL, IND.

This $2-billion-a-year maker of locks (the Schlage brand) and steel doors, which was spun off from Ingersoll Rand in 2013, is domiciled in Ireland. CEO David Petratis, though, happily accepted $2 million in tax credits from Indiana for keeping its North American headquarters in Carmel.

TAX RESIDENCE: IRELAND

Actavis PLC

U.S. HEADQUARTERS: PARSIPPANY, N.J.

CEO Paul Bisaro incorporated his New Jersey pharma company in Ireland for tax purposes but decided to keep the company headquarters close to where he lives. "Everybody loves New Jersey too much," Bisaro told analysts on a conference call announcing the deal. "Nobody's willing to go." His office remains in Parsippany.

TAX RESIDENCE: IRELAND

CUTLER: JIN LEE—GETTY IMAGES; PETRATIS AND LAMACH: RICHARD DREW—AP PHOTO; FLANAGAN: STEPHEN YANG—GETTY IMAGES; PETRELLO: DAVE ROSSMAN—AP PHOTO; BISARO: MARYANNE RUSSELL—AP PHOTO

but that act American include household names like Garmin, Michael Kors, Carnival, and Nielsen. Pfizer, the giant pharmaceutical company, tried to invert this spring, but the deal fell through. Medtronic, the big medical-device company, is trying to invert, of which more later. Walgreen is talking about inverting too—it's easier to boost earnings by playing tax games than by fixing the way you run your stores.

Then there's the "Can you believe this?" factor. Carnival, a Panama-based company with headquarters in Miami, was happy to have the U.S. Coast Guard, for which it doesn't pay its fair share, help rescue its burning Carnival *Triumph.* (It later reimbursed Uncle Sam.) Alexander Cutler, chief executive of Eaton, a Cleveland company that he inverted to Ireland, told the City Club of Cleveland, without a trace of irony, that to fix our nation's budget problems, we need to close "those loopholes in the tax system." Inversions, I guess, aren't loopholes.

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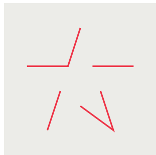


Before we proceed, a brief confessional rant: The spectacle of American corporations deserting our country to dodge taxes while expecting to get the same benefits that good corporate citizens get makes me deeply angry. It's the same way that I felt when idiots and incompetents in Washington brought us to the brink of defaulting on our national debt in the summer of 2011, the last time that I wrote anything angry at remotely this length. (See "American Idiots" in the Sept. 5, 2011, issue or on Fortune.com.) Except that this is worse.

Inverters don't hesitate to take advantage of the great things that make America America: our deep financial markets, our democracy and rule of law, our military might, our intellectual and physical infrastructure, our national research programs, all the terrific places our country offers for employees and their families to live. But inverters do hesitate—totally—when it's time to ante up their fair share of financial support of our system.

Inverting a company, which is done in the name of "shareholder value"—a euphemism for a higher stock price—is way more offensive to me than even the most disgusting (albeit not illegal) tax games that companies like Apple and GE play to siphon earnings out of the U.S. At least those companies remain American. It may be for technical reasons that I won't bore you with—but I don't care. What matters is the result. Apple and GE remain American. Inverters are deserters.

Even though I understand inversion intellectually, I have trouble dealing with it emotionally. Maybe it's because of my background: I'm the grandson of immigrants, and I'm profoundly grateful that this country took my family in. Watching companies walk out just to cut their taxes turns my stomach.

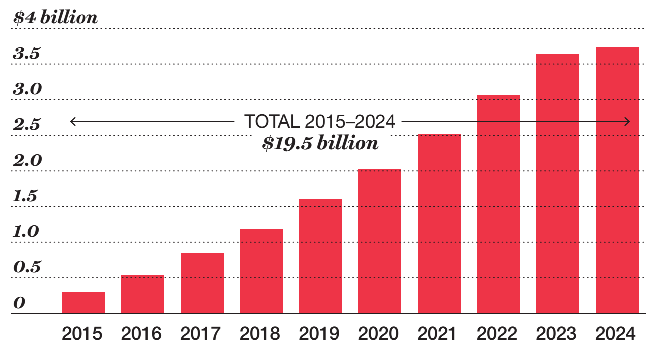
Okay, rant over.

The current poster child for inversion outrage is Medtronic Inc., the multinational Minnesota medical-device company that once exuded a cleaner-than-clean image but now proposes to move its nominal headquarters to Ireland by paying a fat premium price to purchase Covidien, itself a faux-Irish firm that is run from Massachusetts except for income-tax-paying purposes. For that, it's based in Dublin. That's where the new Medtronic PLC would be based, while its real headquarters would remain on Medtronic Parkway in Minneapolis. Of course, the company is unlikely to return any of the $484 million worth of contracts the federal government says it has awarded Medtronic over the past five years.

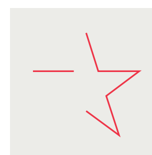
If the Medtronic deal goes through, which seems likely, it will open the floodgates. Congress could close them, as we'll see—but that would require our representatives and senators to get their act together. Good luck with that.

$19.5 BILLION

U.S. TAX REVENUE THAT COULD BE LOST TO FUTURE INVERSIONS



GRAPHIC SOURCE: CONGRESS'S JOINT COMMITTEE ON TAXATION



Now let's have a look at some of the more interesting aspects of the proposed Medtronic-Covidien marriage. I'm not trying to pick on Medtronic—but its decision to become the biggest company to invert makes it fair journalistic game.

Medtronic is one of those U.S. companies with a ton of cash offshore: something like $14 billion. That's money on which U.S. income tax hasn't been paid. Medtronic told me it would have to pay $3.5 billion to $4.2 billion to the IRS if it brought that money into the U.S.: That's the difference between the 35% U.S. tax rate and the 5% to 10% it has paid to other countries. Among other things, inverting would let Medtronic PLC use offshore cash to pay dividends without subjecting the money to U.S. corporate tax.

I especially love a little-noticed multimillion-dollar goody that Medtronic is giving its board members and top executives. Years ago, in order to discourage inversions, Congress imposed a 15% excise tax on the value of options and restricted stock owned by top officers and board members of inverting companies. Guess what? Medtronic says it's going

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to give the affected people enough money to pay the tax.

We're talking major money—major money that I'm glad to say isn't tax-deductible to Medtronic. The company wouldn't tell me how much this would cost its stockholders. So I did my own back-of-the-envelope math, starting with chief executive Omar Ishrak. Using numbers from Medtronic's 2014 proxy statement and adjusting for its stock price when I was writing this, I figure that his options and restricted shares are worth at least $40 million, and the "equity incentive plan awards" that he might get are worth another $23 million. Allow for the fact that Medtronic will "gross up" Ishrak et al. by giving them enough money to cover both the excise tax and the tax due on their excise tax subsidy, and you end up with $7.1 million to $11.2 million just for Ishrak. And something more than $60 million for Medtronic as a whole.

Why does Medtronic feel the need to shell out this money? The company's answer: "Medtronic has agreed to indemnify directors and executive officers for such excise tax because they should not be discouraged from taking actions that they believe are in the best interests of Medtronic and its shareholders."

But you know what, folks? These people are fiduciaries, who are legally required to put shareholders' interests ahead of their own. If they believe that inverting is the right thing to do (which, it should be obvious by now, I don't) they ought to pay any expenses they incur out of their own pockets, not the shareholders'. It's not as if these people lack the means to pay—the directors get $220,000 a year (and up) in cash and stock for a part-time job, and Ishrak gets a typical hefty CEO package.

One more thing: Normally, a company's shareholders don't have to pay capital gains tax if their firm makes an acquisition. But because this is an inversion, Medtronic shareholders will be treated as if they've sold their shares and will owe taxes on their gains. However, the deal won't give them any cash with which to pay the tab.

The company asked me to mention that its executives and directors, like other holders, will be subject to gains tax on shares that they own outright, and Medtronic won't compensate them for it. Okay. Consider it mentioned.

Second, the company contends that this deal will be so good for shareholders that it will more than offset their tax cost triggered by the board's decision to invert. Well, we'll see.

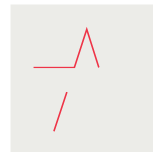
A major barrier to inversion used to be that companies moving offshore were kicked out of the Standard & Poor's 500 index. Given that more than 10% (by my estimate) of the S&P 500 stocks are owned by indexers, getting tossed out of the index—or being added to it—makes a big, short-term difference in share price. In 2008 and 2009, S&P, which has a few never-heres, tossed nine companies off the 500 for inverting. But four years ago, S&P changed course,

THE SPECTACLE OF U.S. CORPORATIONS DESERTING OUR COUNTRY TO DODGE TAXES WHILE EXPECTING TO GET THE SAME BENEFITS AS GOOD CORPORATE CITIZENS MAKES ME DEEPLY ANGRY.

for business reasons. Companies were angry at being excluded, and index investors wanted to own some of the excluded companies. Moreover, S&P feared that a competitor would set up a more inclusive, rival index.

So in June 2010, S&P changed its definition of American. Now all it takes to be in the S&P 500 is to trade on a U.S. market, be considered a U.S. filer by the Securities and Exchange Commission, and have a plurality of business and/or assets in the U.S.

The result: S&P now has 28 non-American companies in the 500.



How much money are we talking about inverters sucking out of the U.S. Treasury? There's no number available for the tax revenue losses caused by inverters and never-heres so far. But it's clearly in the billions. Congress's Joint Committee on Taxation projects that failing to limit inversions will cost the Treasury an additional $19.5 billion over 10 years—a number that seems way low, given the looming stampede. But even $19.5 billion—$2 billion a year—is a lot, if you look at it the right way. It's enough to cover what Uncle Sam spends on programs to help homeless veterans and to conduct research to create better prosthetic arms and legs for our wounded warriors.

Rep. Sandy Levin (D-Mich.) and his brother, Sen. Carl Levin (D-Mich.), have introduced legislation that would stop Medtronic in its tracks by making inversions harder. Under current law, adopted in 2004 as an inversion stopper, a U.S. company can invert only if it is doing significant business in its new domicile and shareholders of the foreign company it buys to do the inversion own at least 20% of the combined firm.

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The Levins propose to require that foreign-firm shareholders own at least 50% of the combined company for it to be able to invert and also that the company's management change. This would really slow down inversions—but the chances of Congress passing the Levin legislation are somewhere between slim and none.

Conventional wisdom holds that companies are inverting now because they've despaired of getting clean-cut reform that would widen the tax base and lower rates. But John Buckley, former chief Democratic tax counsel for the House Ways and Means Committee, has a different view. Buckley thinks that we're seeing an inversion wave not because there's no prospect of tax reform but because there *is* a prospect of reform. If reform comes, he says, there will be winners and losers—and it's the likely losers-to-be that are inverting. "Even minimal tax reform would hurt a lot of these companies badly," he says.

For example, Buckley says, a company that inverts before reform takes effect will be able to suck income out of the U.S. to lower-tax locales much more easily than if it were still a U.S. company. "A revenue-neutral tax reform requires there to be winners and losers," Buckley says. "But by inverting, the companies that would be losers are taking themselves out of the equation ... They're taking advantage of both U.S. individual taxpayers and other corporations."

If you're a typical CEO who has read this far, about now you're shaking your head and thinking, "What a jerk! Just cut my tax rate and I'll stay." To which I say, "I wouldn't bet on it." In the widely hailed 1986 tax reform act, Congress cut the corporate rate to 34% (now 35%) from 46%, and closed some loopholes. Corporate America was happy—for awhile. Now, with Ireland at 12.5% and Britain at 20% (or less, if you make a deal), 35% is intolerable. Let's say we cut the rate to 25%, the wished-for number I hear bandied about. Other countries are lower, and could go lower still in order to lure our companies. Is Corporate America willing to pay any corporate rate above zero? I wonder.

So what do we need? I'll offer you a bipartisan solution—no, I'm not kidding. For starters, we need to tighten inversion rules as proposed by Sandy and Carl Levin, who are both bigtime Democrats. That would buy time to erect a more rational corporate tax structure than we have now—bolstered, I hope, by input from tough-minded tax techies.

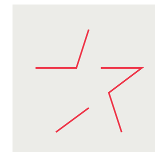
We also need loophole tighteners along the lines of proposals in the Republican-sponsored, dead-on-arrival Tax Reform Act of 2014. One part would have imposed a tax of 8.75% a year on cash and cash equivalents held offshore, and 3.5% a year on other retained offshore earnings.

Another thing we need to do—which the SEC or the Financial Accounting Standards Board could do in a heartbeat, but won't—is require publicly traded U.S. companies and U.S. subsidiaries of publicly traded foreign companies to disclose two numbers from the tax returns they file with the IRS: their U.S. taxable income for a given year, and how much income tax they owed. This would take perhaps one person-hour a year per company.

UNTIL—AND UNLESS—WE GET OUR ACT TOGETHER ON CORPORATE TAX REFORM, COMPANIES WILL KEEP LEAVING OUR COUNTRY.

That way we would know what firms actually pay instead of having to guess at it. Then we could compare and contrast companies' income tax payments.

What we don't need is another one-time "tax holiday," like the one being proposed by Sen. Harry Reid (D-Nev.), to let companies pay 9.5% rather than 35% to bring earnings held offshore into the U.S. It would be the second time in a decade we've done that, and would signal tax avoiders that they should keep sending tons of money offshore, then wait for a tax holiday—presumably not on the Fourth of July—to bring it back.



Until—and unless—we somehow get our act together on corporate tax reform, companies will keep leaving our country. Those that try to do the right thing and act like good American corporate citizens will come under increasing pressure to invert, if only to fend off possible attacks by corporate pirates—I'm sorry, "activist investors"—who see inversion as a way to get a quick uptick in their targets' stock price.

Now, two brief rays of sunshine: one in England, one here.

Starbucks, embarrassed by a 2012 Reuters exposé showing that it paid little or no taxes in England despite telling shareholders it made big profits there, has recently apologized and now makes substantial British tax payments. And eBay, God bless it, decided to bring $9 billion of offshore cash into the U.S. and pay taxes on it.

So I'm feeling a bit better about July than when I started writing this. In any event, a happy summer to you and yours. F

ADDITIONAL REPORTING: ***Marty Jones***
Mehboob Jeelani, Phil Wahba, and Michael Casey

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