Martin Capital Partners

Quarterly Point of View
Tomfoolery

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Pfizer has been an American company since opening its doors in a building on the corner of Harrison Avenue and Bartlett Street in Brooklyn, New York in 1849. Today, from its headquarters in nearby Manhattan, the company has grown to a pharmaceutical giant with over $50 billion in annual sales and almost 80,000 employees. Just after World War II ended, in a Minneapolis garage, a medical equipment repair company named Medtronic was established. The firm is now the world's largest medical technology company producing over $16 billion in annual sales and employing 46,000 people, while still maintaining its headquarters in a suburb of Minnesota's largest city.

This year however, Pfizer has proposed to become British, while Medtronic will become Irish. These are the two highest profile examples in an accelerating trend to renounce U.S. citizenship for tax reasons.

Companies based in the United States, including Pfizer and Medtronic, have stockpiled almost $2 trillion offshore, according to analysis by Bloomberg News. From a purely economic standpoint, it is easy to see why companies are pursuing ways to unlock these funds in the most tax-advantaged manner. The statutory corporate tax rate in the United States remains the highest of the developed world at 35%, and the U.S. is also one of just a few countries that mandate payment of that rate on all worldwide income brought home, even if profits are generated by a subsidiary in a foreign land with a lower tax rate. The United Kingdom, Canada, and Ireland to name just a few, only tax domestic profits. A perverse side effect is that a U.S. corporation ends up paying more tax than an identical corporation would if it was owned by a foreign parent. This is prompting the acceleration of 'tax inversions', a strategy whereby a company based domestically seeks a foreign merger to obtain a legal address abroad, needing to transfer just 20% of its stock to shareholders of the offshore company to qualify. Enhancing the incentive to do this is a quirk to the U.S. code, allowing the claim to foreign domicile without having to move senior leadership overseas.

In the Pfizer situation, the company sought a $120 billion purchase of British pharmaceutical concern AstraZeneca, only to have a deal – which had been in the works for months – fall apart over price. The last of this story has not been told however, as Pfizer may still seek to change its tax citizenship in the near future. Medtronic is now the biggest firm to renounce their U.S. tax status, and will acquire Covidien PLC – itself an Ireland-based inversion run out of Massachusetts – as part of a $42.9 billion takeover to officially become 'Irish', while management remains in Minneapolis to guide the company.

According to Goldman Sachs, takeovers by U.S. companies of foreign targets in low tax regimes, such as Ireland, where the rate is 65% lower than the Unites States, has doubled as a proportion of all overseas deals since 2010. In May, the Joint Committee on Taxation estimated that future transactions, such as Medtronic's inversion, will result in a loss of almost $20 billion in tax revenue to the United States over the next decade. Senator Carl Levin of Michigan has introduced the Stop Corporate Inversions Bill of 2014, and Senate Finance Committee Chairman Ron Wyden of Oregon said in June he was "not going to sit idly by while companies employ these armies of tax accountants and lawyers, and figure out how to hot-wire a way to tap into a loophole."[1] Given that the Medtronic deal was announced after Levin's bill was put forth with a retroactive date of May 8, 2014, and another high

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profile inversion has since been sought by Chicago-based AbbVie, the overarching opinion is that a stop gap bill of this nature wouldn't have the votes to pass.

All of this tells us we have a problem, and an opportunity. The problem is that this country's tax code is a mess; otherwise this corporate tomfoolery would not be so prevalent and certainly not accelerating in frequency. These maneuvers may make economic sense as discussed, so for that reason we can understand and even applaud managements' interest in serving the *shareholders'* best interests, but they clearly don't serve the idea of corporate social responsibility applied to a broader definition of *stakeholders*. Corporate America is currently highlighting a dysfunctional tax code though, and in many ways doing Congress a favor by forcing it to look at this from a larger perspective.

Structural changes to the corporate tax code are overdue and present an opportunity. The last major reform took place during the Reagan Administration, amid a different economic framework. The proportion of profit earned overseas by U.S. companies has increased significantly, primarily due to increasing market opportunities in emerging economies. From 1980 to 2009, cross-border foreign direct investment increased from less than 6 percent of world GDP to 33 percent.[2] A specific drawback of the U.S. code we've highlighted is that it incentivizes U.S. companies to keep foreign income overseas. These vast, undistributed sums represent a material opportunity cost for our domestic economy as it is capital that could be utilized in various ways to stimulate and support growth at home. Many promote the idea of a tax repatriation holiday, which would be a constructive starting point, but does have potential flaws if viewed as a sole structural solution. Most importantly, steps need to be taken to improve the tax code in a fundamental way so that it reverses the current incentives. Instead, the code should encourage U.S. companies to headquarter and invest here, forgetting the pursuit of expensive and complex tax planning strategies that send tax revenue overseas. By lowering the corporate tax rate and at the same time eliminating special exemptions, credits and loopholes, the United States would facilitate an environment conducive to efficiency and competitiveness, while creating more tax revenue for federal coffers.

The shape of the global economy has changed over the last three decades, and corporate activity is shining a bright light on the need for fundamental tax reform that reflects those changes.

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It is a sincere privilege serving those that have entrusted us with their capital.

Respectfully,

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Statistical and analytical data provided by Thomson Reuters
1. Wall Street Journal, 6/21/14
2. Fiscal Policy Initiative, 2011