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Don’t Increase Holding Incentives

By Calvin H. Johnson

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Shire/Baxalta Is Not a Tax-Driven Deal, Writer Says

To the Editor:

Of the many bad arguments in favor of territoriality, perhaps the worst is that the U.S. tax code encourages foreign takeovers of U.S. companies, like the recent attempt by Shire PLC to acquire Baxalta for $30 billion. (Related coverage: p. 614.) This has led *The Wall Street Journal* to argue that ''the Shire offer adds to a mountain of evidence that an un-competitive tax system has made the US an undesirable location for corporate headquarters and investment.''[1] The *Journal* then cites the recent Senate Permanent Subcommittee on Investigations (PSI) report into the Valeant/Salix and Burger King/Tim Hortons transactions, arguing that it proves its case.

Except that the PSI report proves the opposite. Valeant and Burger King are both U.S.-headquartered companies, and they remain substantively U.S.-headquartered after their inversions. Thus, the transactions involving them are of one U.S.-headquartered company buying another (in the case of Valeant) or merging with a foreign company (in the case of Burger King). The tax code may have motivated the choice of Canada as the formal location of incorporation for both, but that has nothing to do with ''corporate headquarters and investment.'' Moreover, if the Obama administration's anti-inversion proposal were adopted, both companies would still be regarded as U.S. tax residents, because the test for residency would depend on the substantive location of headquarters. Those are not so easily moved: Even in the aborted Pfizer/Astra Zeneca deal, in which the CEO of the acquiring company (Pfizer) was a U.K. citizen, the combined headquarters would have stayed in New York even though tax residence would have been in the United Kingdom.

The Shire/Baxalta transaction is different because Shire is a genuine Irish company, having moved its headquarters to Dublin from the United Kingdom. But what does this deal have to do with inversions? There have always been acquisitions of U.S. companies by foreign ones (BP/Amoco, Daimler/Chrysler, and so forth), and those are generally regarded as beneficial to the United States because they involve inbound investment. Moreover, these deals are hardly tax driven because the Baxalta operations in the United States remain subject to U.S. tax, and if Shire wants to access cash in Baxalta's CFCs, these funds are not subject to U.S. tax.

You could make an argument that we should discourage foreign takeovers of U.S. companies because they lead to lower tax revenue for the United States because of earnings stripping and to outward migration of intellectual property. But in that case the solution is to tighten the earnings stripping rule (adopted in 1989 precisely to address such concerns) and to make sales of large participations in U.S. companies (10 percent or more) taxable to the seller, like many other countries do and like the proposal advanced in 1992 by House Ways and Means Committee Chair Dan Rostenkowski.[2]

Sincerely,

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Aug. 5, 2015

Don't Increase Holding Incentives

To the Editor:

Hillary Clinton has released a tax plan to stagger in capital gains preference according to how long the stock is held. Taxpayers would get down to the current 20 percent rate only after holding for 7 years. For less than 2 years holding, the current ordinary rates would apply. In the interim, between 2 and 7 years, the rate would drop by 4 percent per year of holding.

Current law already gives an incentive to holding because the net present value of tax on sale goes

[1] Editorial, ''Abetting Foreign Takeovers: More Evidence That the U.S. Tax Code Is Aiding Overseas Buyers,'' *The Wall Street Journal*, Aug, 5, 2015.

[2] *See* Avi-Yonah, ''Money on the Table: Why the U.S. Should Tax Inbound Capital Gains,'' *Tax Notes Int'l*, July 4, 2011, p. 41.

down by delaying the taxable sale. Capital gains tax also goes away upon death because heirs get a step up in basis at death. Mortality risk is not very high for young ones, but it gets attention as mortality grows near, for us elderly ones, and builds up over time. With deferral of tax and forgiveness at death, the law creates a ski slope under which the expected tax impact drops steadily and is expected also to get to zero, all at once.[1] So stock owners hold to avoid tax.

That structure does terrible harm because taxpayers hold on to middling investments that they ought to sell, because of the tax incentives to hold. My grandfather bought stock of playing cards and railroads as a young man, and died with that stock. Terrible investments, did not grow very fast, neither was a cutting edge technology by the time he matured. But every day, he faced the incessant message of ''hold on just a bit and the capital gains tax will go down, and ultimately disappear.'' So he held.

Publicly traded stock is a cash equivalent and tax treatment should reasonably follow the lead of the accountants on this and tax the gains (and allow the losses) every year. That would stop the lock-in of capital into poorly managed corporations that twaddle along because of the tax incentives. It would also reduce lock-in dramatically if there were not that amnesty from capital gains tax at the end of life. Adding explicit drops in rates, as the Clinton proposals do, on top of the time value of deferring the sale and the mortality amnesty, would exacerbate the lock-in problem.

There is one interest group that loves lock-in, and that is the old entrenched management of firms that cannot compete in the market. Standard financial theory today is that takeovers are the only effective discipline that entrenched management needs to worry about. Corporate raiders will buy up the stock, for short-term quick profits, if the stock is underperforming. This proposal seems well designed to protect entrenched management from their biggest threat. If ''long term'' means insulated from market discipline, and able to disregard fair market value, it is a synonym for entrenched management feathering their own nests. The market is a discipline but it shows itself just in day-to-day market trades. Shareholders are perfectly willing to trust Apple, Google, Microsoft, and Amazon through years of no earnings. So the market is no enemy of long foresight. So it is the old, inefficient management that will whine most about market discipline they cannot satisfy, and they ask for protection.

We might encourage better management if management got their bonuses only after 20 years, provided, however, they also suffer losses as shareholders suffer losses. But that is probably not best run as a tax program. Tax design probably works best if you try to develop a system that describes the taxpayer's standard of living, without penalty or subsidy. It is hard enough to make tax describe economic income without lots of other extraneous things going on.

Respectfully submitted,

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Aug. 5, 2015

[1]Calvin H. Johnson, ''The Undertaxation of Holding Gains,'' *Tax Notes*, May 11, 1992, p. 807, *reprinted in part in The Capital Gains Controversy* D-14, J. Andrew Hoerner, ed. (Tax Analysts 1992).