Vol. 8, Issue 28
August 29, 2014

Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

Unless you have purposely avoided the business news this week, you have undoubtedly heard about Burger King buying Tim Horton's, the Canadian doughnut and coffee chain. After the acquisition, the combined firm will move the holding company headquarters to Canada, while keeping the Burger King headquarters in Miami. Such a move is called a "corporate inversion." While the company has officially said this isn't for tax purposes, no one seriously believes otherwise.

After all, as George Will aptly pointed out in his syndicated column of August 15, 2014:

> "Which brings us to "inversions," whereby in the past decade approximately 50 U.S. companies have merged with foreign firms and located their headquarters overseas, becoming subject to that country's lower corporate taxation. The U.S. system, unlike those of most major nations, taxes the profits that domestic corporations earn overseas, even though these profits are also taxed overseas. This double taxation is one reason that approximately $2 trillion in U.S. corporate earnings is being kept abroad rather than brought home for domestic investment."

Perhaps what Burger King should have said was: "We are not planning this inversion to miraculously shrink our tax bill, as much as free our overseas' profit from the grip of the IRS." Therefore, you could rightly argue Burger King is moving its holding company headquarters to Canada to avoid US tax policy rather than US taxes. After all, it will still have to pay the appropriate taxes on profit generated in the United States.

Still, the proposed move has spurred much debate and even greater indignation, with the words 'unpatriotic' and even 'traitorous' bandied about. So much so, more than one article I have read has urged the Administration and/or the Congress to 'do something' about corporate inversions, and close the supposed loopholes which allow such things to happen. Some of the more strident have espoused making them illegal, with or without a vote or any sort of process which would resemble anything I learned in civics class.

Therein lies much of the problem.

There is something called the Index of Economic Freedom. According to Wikipedia, it is: *"The Index of Economic Freedom is an annual index and ranking created by The Heritage Foundation and The Wall Street Journal in 1995 to measure the degree of economic freedom in the world's nations. The creators of the index took an approach similar to Adam Smith's in The Wealth of Nations, that 'basic institutions that protect the liberty of individuals to pursue their own economic interests result in greater prosperity for the larger society.'"* While the Heritage Foundation is a right-leaning organization and one would assume the Wall Street Journal is pro-business, it seems to be a pretty fair summation of things.

In 2014, the US ranked 12th out of 175 countries surveyed. That probably doesn't stand out that much to anyone. 12th? I am sure the more conservative among us think we should probably be lower, while the more liberal are amazed we aren't in the Top 10, at the least. However, consider what the Heritage Foundation / Wall Street Journal had to say in its summation:

> Over the 20-year history of the Index, the U.S.'s economic freedom has fluctuated sig-

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nificantly. During the first 10 years, its score rose gradually, and it joined the ranks of the economically "free" in 2006. Since then, it has suffered a dramatic decline of almost 6 points, with particularly large losses in property rights, freedom from corruption, and control of government spending. The U.S. is the only country to have recorded a loss of economic freedom each of the past seven years. The overall U.S. score decline from 1995 to 2014 is 1.2 points, the fourth worst drop among advanced economies.

Substantial expansion in the size and scope of government, including through new and costly regulations in areas like finance and health care, has contributed significantly to the erosion of U.S. economic freedom. The growth of government has been accompanied by increasing cronyism that has undermined the rule of law and perceptions of fairness.

Here is the address for the website with all the data from all the countries in the survey: http://www.heritage.org/index/ranking

Then there is this data/table from the Cato Institute's Economic Freedom of the World: 2013 Annual Report:

United States	1980	1985	1990	1995	2000	2005	2010	2011
	Rating Rank)	Rating Rank)	Rating Rank)	Rating Rank)	Rating Rank)	Rating Rank)	Rating Rank)	Rating Rank)
OVERALL	**7.92 (3)**	**8.11 (3)**	**8.35 (3)**	**8.50 (4)**	**8.65 (2)**	**8.21 (8)**	**7.75 (16)**	**7.74 (19)**
Area 1. Size of Government	**5.08 (49)**	**5.94 (28)**	**6.71 (24)**	**6.88 (28)**	**7.03 (34)**	**7.13 (45)**	**6.39 (61)**	**6.83 (47)**
Area 2. Legal System and Property Rights	**8.35 (1)**	**8.35 (3)**	**8.35 (10)**	**8.76 (16)**	**9.23 (9)**	**7.51 (29)**	**7.12 (33)**	**6.93 (38)**
Area 3. Sound Money	**9.22 (5)**	**9.36 (9)**	**9.68 (7)**	**9.76 (3)**	**9.78 (2)**	**9.76 (1)**	**9.68 (6)**	**9.30 (36)**
Area 4. Freedom to Trade Internationally	**8.77 (7)**	**8.73 (8)**	**8.77 (11)**	**8.83 (18)**	**8.78 (22)**	**8.28 (17)**	**7.93 (31)**	**7.92 (30)**
Area 5. Regulation	**8.11 (4)**	**8.09 (5)**	**8.23 (4)**	**8.29 (5)**	**8.43 (2)**	**8.37 (6)**	**7.64 (19)**	**7.75 (17)**

I apologize if the table is hard to read; it required more work than you can imagine to format it to look even that good.

Here is the address for this website: http://www.cato.org/pubs/efw/efw2013/efw-2013-chapter-2.pdf

Now, the kneejerk reaction to this information would almost certainly be: "Come on, Norris. The Cato Institute? That is yet another conservative think tank, which would bias the numbers." You know, maybe there is some bias in there; I don't know. Perhaps the folks at the Cato Institute and the Heritage Foundation are purposely misrepresenting their data sets to humiliate the Administration or what have you. Again, I don't know; however, I can tell the US was #2 overall at the end of Clinton's term while it as #3 during Reagan. I can also see it fell dramatically during the most recent Bush Administration, from 2nd to no less than 8th.

So, I am thinking while there might be some kind of bias in the numbers, it has more to do with government in general, as opposed to political party affiliation. If you can agree with me on that, what have we seen since the end of 2000?

That is right, a pretty substantial decline, in both absolute and relative terms since the end of the Clinton Administration…..pretty much in every category. Then, take a look at how things compare to the end of the Carter Administration in relative rank! The Carter Administration, which has been the poster child for overall government/Washington ineptitude for most of my life.

Don't get me wrong, the United States is still a pretty business friendly country. In absolute terms, it really hasn't changed all that much over the last, you picked the time frame. However, relatively speaking, it has become less business friendly in the global economy. Basically, other countries have become more competitive while we have let things slide just a little, but slide nonetheless.

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You can think of where to locate a headquarters as an insurance policy of sorts. The company decides to operate out of XYZ jurisdiction because it feels the laws and institutions of XYZ will better protect its rights and allow for greater business expansion than those of some other place. The premiums, if you will, of this insurance policy are taxes. The company will gladly pay the taxes/premiums, maybe not gladly, if it feels they are commensurate with the economic benefit it receives by legally operating out that particular jurisdiction.

With this in mind, you would probably be willing to pay a little more for X amount of life insurance IF you were more certain your policy wouldn't lapse or the company was more financially strong than whatever you could get behind Door #3, right? Well, in so many ways, the same applies with the recent spate of corporate inversions.

Some companies are simply voting with their feet: the amount they pay in US tax, and what they would pay in US tax if they repatriate their overseas income, simply isn't worth the economic benefit they get from being legally headquartered in the United States. In essence, the premium is too high. If you want to use the Cato Institute's most recent data, the US comes in 38th in property rights; 36th in monetary soundness, and 30th in freedom on international trade. While these figures aren't awful, they are pretty good really, our corporate tax rates are higher than most of the competition. Therefore, you could argue US companies are paying for Prime filet mignon and getting USDA Choice ribeyes instead. Hey, I love a good ribeye, but I ain't going to pay the same amount for Choice anything as I am for Prime filet.

Whew.

Now, in the recent Burger King situation, potentially moving its holding company headquarters to Canada, consider this: 1) Canada's corporate tax rates are lower and more favorable on foreign earned income, and; 2) it came in 6th in the Heritage Foundation's 2014 survey, compared to 12th for the US, and; 3) it came in 6th in the most recent Cato Institute numbers, compared to 19th for the US.

Going back to our insurance policy analogy: Canada's policy seems to be better and the premiums are also lower. It doesn't mean the US policy isn't any good, it just means the Canadian one is a better overall value. Take note; US companies aren't looking to relocate to Egypt, Cambodia, Russia, or Argentina. They are relocating where both the tax policies are more advantageous **and** the ease of doing business is at least within a reasonable variance with that in the United States.

This is what is actually happening, whether the corporate executives want to admit it publicly. Certain multinational companies can do better elsewhere, and if Washington tries to enact laws to stop corporate inversions you WILL see a flurry of activity until the law goes into effect. Why? Taxes aside, corporations would view such a move as a somewhat capricious violation of the rule of law, thereby knocking the US from 38th (Cato data) down to some number well below.

Then there is the curious situation of people who want to tax US businesses at high rates, arguing loopholes help said companies from paying taxes in any event. This simply isn't accurate. According to the St. Louis Fed's FRED website, 'tax receipts on corporate income' were $384.9 billion in 2013, and are comfortably on pace to be an all-time high in 2014, well north of $400 billion. While that might not be a huge percentage of the overall Federal budget, consider this:

Investors pay a multiple on corporate profits. This is known as a P/E ratio, and it is currently 18.27 on the Russell 3000, a broad gauge. This means US investors pay $18.27 for every $1 of corporate profits. Therefore, you could say that

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$384.9 billion in 'tax receipts on corporate income' is costing investors up to, get this, $7 trillion in lost market capitalization. Okay, not all $384.9 billion came from publicly traded companies, however, a research piece by an Alexander Hess and Michael Saulter released in January 2014 suggests the Top 10 US companies in terms of 'income tax expense' pay roughly $114 billion in tax (most recent fiscal year end), with Exxon leading the way at $31 billion and Chevron next at $20 billion.

Throw that 18.27 P/E multiple on just that, and it comes up to $2.083 trillion. Divide that by the number of people in the country, and let's say 300 million for grins, and voila: taxes paid by the Top 10 publicly traded companies are potentially dampening market capitalization by about $6,943 per person.

As such, having Burger King move to Canada to potentially save a few bucks on its tax bill is putting money into your pocket. How is that for unpatriotic or treasonous? Since the average Burger King Whopper costs about $4, I will gladly tax my newfound wealth in sandwiches….and eat for an entire year! How does the old jingle go: "hold the pickles, hold the lettuce, corporate taxes do upset us." Well, maybe it doesn't go quite that way, but it should.

In the end, we will continue to see more and more US multinationals look to make deals with Canadian and certain European firms, namely Irish and British. There aren't as many deals as you think there would be, but this is a long-term trend, and won't stop until Washington changes its tax policies OR improves the service it provides on its, um, proverbial insurance policies.