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Quick-Fix Curbs on Corporate Inversions Mask the Real Problem

by Veronique de Rugy

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Viewpoints



Quick-Fix Curbs on Corporate Inversions Mask the Real Problem

by Veronique de Rugy

This commentary is based on written testimony of Veronique de Rugy, Fiscal Policy Analyst, Cato Institute, prepared for the hearings of the U.S. Senate Appropriations Subcommittee on Treasury and General Government, on 16 October 2002 in Washington.

We should all agree it is troubling to witness corporations choosing to renounce the United States as headquarters, but we might disagree on the implications of this trend and the solutions.

It is a fact that a growing number of multinational companies are changing their place of incorporation from the United States to foreign jurisdictions. By doing so, companies are able to reduce taxes paid to the U.S. government on income earned outside the United States. They do not typically change their actual business structure, but most importantly they continue to pay taxes to the federal government on income earned domestically. Despite all the things said about the inversion process, it is essential to keep in mind that these corporations are acting in full compliance with the U.S. tax laws and regulations.

A number of bills have been introduced in Congress to stop such corporate inversions or expatriations. Unfortunately, those bills seek only to punish corporations that reincorporate elsewhere rather than address the motivation behind the corporation's decision to leave: the U.S. corporate tax burden. A recent U.S. Treasury report provides a more thoughtful, though incomplete, response to the corporate inversion trend.¹ The report recognizes that inversions raise broad issues related to corporate income tax burdens and calls for a comprehensive reexamination of U.S. international tax rules. Sadly, the Treasury report fails to acknowledge that if the proposed legislation, because it ignores the reasons why firms are moving abroad, is finally implemented, it will have devastating and long-term effects on the U.S. economy.

¹U.S. Department of the Treasury, "Corporate Inversion Transactions: Tax Policy Implications," May 2002, p. 29.

U.S. firms would not be pursuing inversions unless there was something seriously wrong with the U.S. tax system.

Corporate inversions are part of a broader dynamic of rising global tax competition. U.S. policymakers have so far failed to appreciate this powerful and liberating force in the world economy. Instead, they occasionally apply Band-Aids to corporate tax issues raised by the media, and put off long overdue fundamental tax reforms.

What Are Corporate Inversions?

The United States taxes corporations on their worldwide income. That means, for example, that the profits of a U.S.-owned computer plant are subject to U.S. tax whether the plant is located in Texas or Taiwan. Most other major countries do not tax foreign business income as aggressively as the United States. In fact, about half of the nations that belong to the Organization for Economic Cooperation and Development have territorial tax systems that tax firms on domestic income only.

This difference has important implications for U.S. companies competing in foreign markets. Because of higher tax costs, U.S.-based firms may lose foreign market share, generate lower returns for U.S. shareholders, and hire fewer skilled workers in the United States.

In an effort to remain competitive, some U.S. companies are changing their structure to become foreign-owned firms. In a typical corporate inversion transaction, the U.S. firm places itself under a new foreign parent company formed in a lower-tax jurisdiction. Such transactions generally have no real effect on the company's U.S. business operations. The firm still pays taxes to the U.S. government on all U.S. income, but it no longer pays U.S. tax on its income earned outside the country.

Decisions to undertake such transactions are not taken lightly by U.S. companies. Inversions are highly complex and involve a significant tax cost. The Treasury study notes that "the inversion transaction itself involves significant tax costs in terms of gain recognition at the corporate level, the shareholder level, or both, as well as other significant transaction costs."² U.S. firms would not be pursuing inversions unless there was something seriously wrong with the U.S. tax system.

Corporate inversions are just one of the many ways in which a U.S. firm can end up being owned by a foreign parent company. A forward-looking U.S. startup firm may decide to incorporate abroad to enjoy long-term tax savings. Also, U.S. firms may be acquired by foreign firms, as was the case in the 1998 Daimler-Chrysler transaction. Indeed, foreign acquisitions of U.S. companies have soared from US \$91 billion in 1997 to US \$340 billion by 2000.³

Proposed Legislation Shoots the Messenger

The corporate inversion issue has stimulated a slew of misguided quick-fix proposals. For example, Rep. Richard Neal's (D-Massachusetts) H.R. 3884, Rep. Scott McInnis's (R-Colorado) H.R. 3857, and S. 2119 introduced by Senators Max Baucus (D-Montana) and Charles Grassley (R-Iowa) all generally aim to tax foreign parent companies created for an inversion as if they were U.S. companies, if they retain basically the same structure they had before inversion. Various ownership thresholds and other tests would be created to determine whether particular firms should be treated as foreign or domestic. More recently, the House of Representatives and

²*Ibid.*, p. 21.

³*Ibid.*, p. 19.

Senate approved amendments offered by late Sen. Wellstone (D-Minnesota) and Rep. DeLauro (D-Connecticut) that would permanently prevent companies that reincorporated in so-called tax havens from competing for contracts with the Department of Homeland Security. Fortunately, the House has killed this antiexpatriate tax provision but the issue now is pending in Senate. (Military tax cut bill, H.R. 5557.)

It has become so popular these days to condemn corporate inversions that even the new Homeland Security bill (Homeland Security Act of 2002) has its own inversion provision (section 835 — prohibition on contracts with corporate expatriates). The new bill — drafted by the White House and Congressional Republicans — is now being considered in the House and Senate. To the credit of the drafters of the provision, it was substantially watered down compared to the original provision which intended to deny Homeland Security contracts to all businesses that moved or planned on moving their headquarters abroad. In this draft, the provision would only deny contracts to a firm's new foreign parent corporation. In other words, the U.S. subsidiaries could still receive contracts from the Department of Homeland Security. Even though this draft is not as extreme as the ones proposed by late Sen. Wellstone or by Rep. Neal, one has to wonder what a provision on corporate inversion has to do with Homeland Security.

Sponsors of these proposals claim that companies are currently exploiting a loophole that needs to be closed. But the tax advantage that foreign companies have over U.S. companies in world markets is not a loophole. It is a systematic problem with the U.S. tax code. The tax savings that U.S. firms gain by incorporating abroad demonstrate the overly burdensome nature of the U.S. corporate income tax.

Even if anti-inversion legislation passes, the basic tax advantage of foreign firms would remain. As a result, foreign firms will continue to acquire U.S. firms at a rapid pace. U.S. firms will continue to be at a competitive disadvantage in world markets and U.S. firms will have less cash available to hire U.S. workers and pay U.S. shareholders. Such legislation offers no economic benefits; it simply raises tax costs for U.S. companies and complicates the tax code.

Reduce Inversions by Reforming the Tax Code

In a recent press release on corporate inversions, U.S. Treasury Secretary Paul O'Neill noted, "If the tax code disadvantages U.S. companies competing in global markets, then we should address the anti-competitive provisions of the code."⁴ Policymakers can begin right away with two basic steps.

1. Cut the corporate tax rate. The recent rash of corporate inversions is warning that the U.S. corporate tax rate has become dangerously uncompetitive. While the United States led the world in 1986 by cutting the corporate rate from 46 percent to 34 percent, most major countries followed suit and some surpassed us by cutting their rates even further. Meanwhile, the United States raised its rate to 35 percent and piled ever more complex tax rules on international businesses. At 40 percent (federal plus state), the U.S. corporate income tax rate is the fourth highest among the 30 OECD member states.⁵

⁴U.S. Department of the Treasury, Press Release, 17 May 2002.

⁵KPMG, "Corporate Tax Rate Survey," January 2002, http://www.us.kpmg.com/microsite/Global_Tax/TaxFacts.

A substantial cut in the corporate tax rate would greatly reduce the inversion problem.

A substantial cut in the corporate tax rate would greatly reduce the inversion problem and other corporate tax avoidance problems that have concerned policymakers recently. For example, the Treasury study focuses on earnings stripping, which occurs when foreign parent firms lend excessively to their U.S. subsidiaries in order to lower U.S. taxable income with large interest deductions. By lowering the statutory tax rate, the incentive for earnings stripping is directly reduced.

In a global economy with 60,000 multinational corporations and trillions of dollars of investment funds searching for good returns, the high U.S. corporate tax rate is not sustainable. Unless the United States substantially cuts its rate, tax avoidance will increase, complex and uncompetitive legislative responses will ensue, and the performance of the U.S. economic engine will fall short.

2. Adopt a territorial tax system. Along with a lower rate, the U.S. should adopt a territorial tax system. That would eliminate the need for corporate inversions and allow U.S. firms to compete on a level playing field in foreign markets.

A territorial system would be much simpler than the complex worldwide system that has been built piecemeal over decades without a consistent foundation. As the Treasury study notes, "The U.S. rules for the taxation of foreign-source income are unique in their breadth of reach and degree of complexity."⁶ Many of those rules would be done away with under a territorial system. The ultimate solution is to replace our income-based tax system with a low-rate territorial system that has a consumption base. That way, global corporations will be encouraged to move their operations and profits into the United States rather than fleeing for lower-tax climates.

The Treasury report accurately warns that corporate inversion legislation that is "targeted too narrowly would have the unintended effect of encouraging a shift to other forms of transactions to the detriment of the U.S. economy in the long run."⁷ Experience shows that corporate tax quick fixes cause more problems down the road and delay far more important fundamental reforms. ♦

⁶"Corporate Inversion Transactions," p. 2.

⁷*Ibid.*, p. 2.