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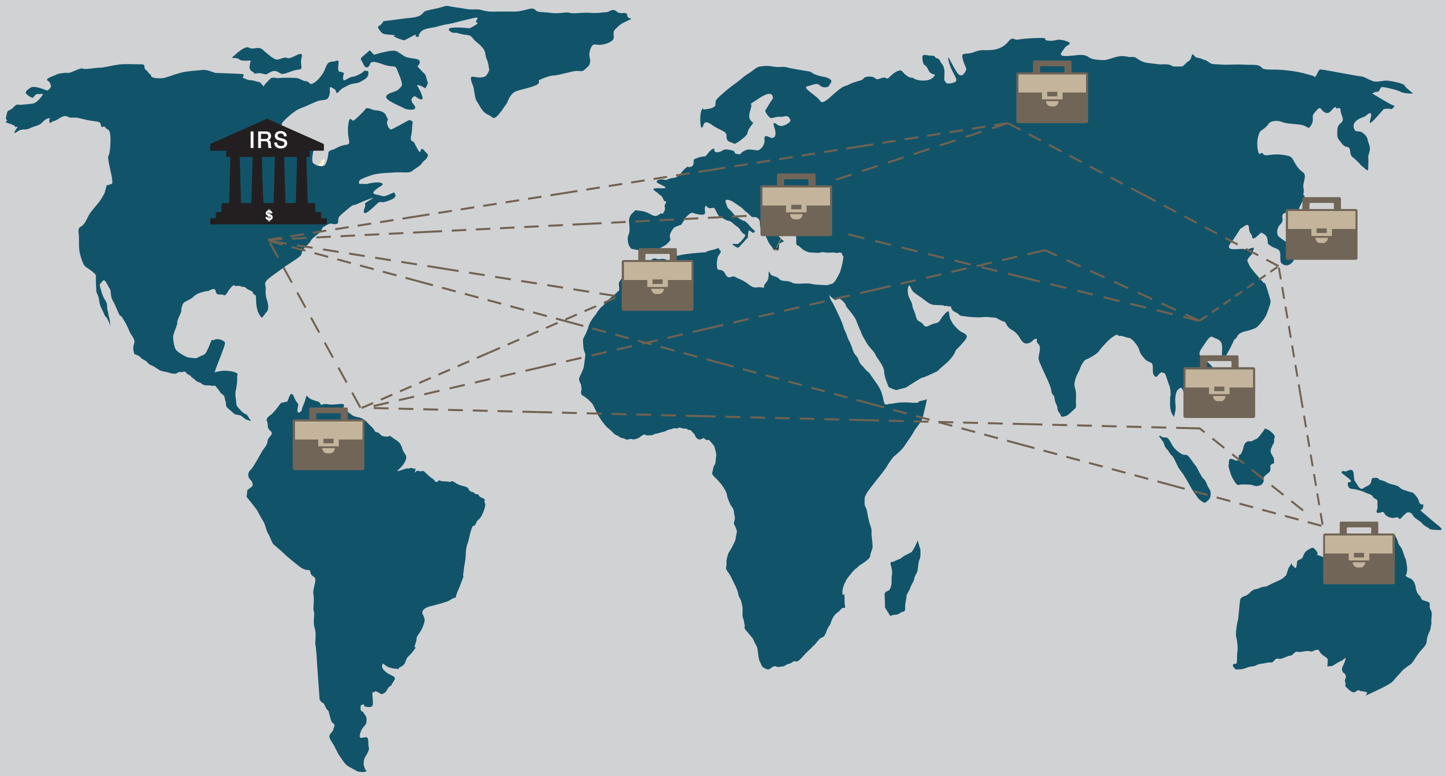

Corporate Inversions Are the Symptoms; Poor Tax Policies Are the Disease

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Corporate Inversions Are the Symptoms; Poor Tax Policies Are the Disease

Wayne Winegarden, Ph.D.

In response to several high profile corporate restructurings known as corporate inversions, politicians have been looking for ways to punish any company considering such a restructuring. Hillary Clinton's ill-conceived exit tax exemplifies the types of harmful policies that are being proposed.

A corporate inversion is a type of acquisition where a U.S. company purchases a foreign owned company and registers the new entity outside of the U.S. It is important to note that while the uncompetitive U.S. tax code is an important incentive driving corporate inversions, typically the tax benefits alone are insufficient to justify the transaction. Instead, corporate inversions typically require other justifications (such as improved operational efficiencies) in order for the restructuring to make sense. Recent examples of corporate inversions include the Burger King and Tim Horton's deal, or the Pfizer and Allergan deal that is pending. In the Burger King-Tim Horton's deal, Burger King purchased Tim Horton's and located the combined company in Canada where the statutory corporate tax rate is 26.5 percent (compared to the average statutory corporate tax rate in the U.S. of 39.1 percent).

Attempts to punish companies that are pursuing corporate inversions misdiagnose the problem and, in so doing, make a bad situation worse. The uncompetitive U.S. corporate income tax code is the root cause of the problem. The U.S. corporate income tax code imposes large economic costs on U.S. companies and dis-incents economic growth. Economic efficiency is best promoted when business decisions are based on economic fundamentals, not tax considerations. Unfortunately, the uncompetitive U.S. corporate income tax code ensures that this cannot be the case.

Within all of the current sub-optimal choices available to a company, corporate inversions are an improvement over the status quo. Following the restructurings, the incentives and ability for the new company to invest in the U.S. economy has improved, leading to greater income and job growth in the U.S. economy. Therefore, punishing companies that are restructuring via a corporate inversion creates additional barriers to economic growth.

The costs of the U.S. corporate tax code

The combined federal and average state statutory corporate income tax in the U.S. is 39.1 percent – 35.0 percent federal corporate income tax rate and an average 4.1 percent state tax rate.[1] Perhaps even worse than levying the highest corporate income tax rate compared to the major industrial economies, the U.S. corporate income tax system violates most of the principles of a sound tax system. A growth enhancing tax system is simple, transparent, and treats similarly situated taxpayers similarly.[2] In contrast, the U.S. corporate income tax system

1. is overly-complex, difficult to understand, and full of special interest carve-outs;
2. taxes the same income multiple times;
3. levies a globally high marginal tax rate on a narrowing tax base; and,
4. reduces economic growth.

The exceptionally high and complex corporate income tax system harms U.S. economic growth, regardless of the tax systems of other major countries. As noted by the Congressional Budget Office,[3] the anti-growth aspects of the U.S. corporate income tax reduces overall economic efficiency, regardless of its global competitiveness, because corporate income taxes:

- are levied against capital income and therefore diminish the incentive to save and reduce overall capital investment and economic growth;
- distort how businesses are organized, potentially inhibiting economic efficiency in order to promote tax efficiency;
- distort financial markets (for instance, encourage debt financing over equity financing and encourage capital gains over dividends) diminishing the efficiency of the financial markets;
- treat various asset classes differently, distorting the efficiency of production; and,
- distort resources away from productive activities and toward tax compliance and tax minimization efforts.

The negative impacts that the current U.S. tax system imposes on economic growth is widely recognized. For instance, according to President Barack Obama's *2015 Economic Report of the President*:

> The current system of business taxation reduces productivity, output, and wages through its impact on the quantity of investment, the location of production and profits, the means of financing new investments, and the allocation of investment across assets and industries. The high statutory rate and complicated rules for taxing income in different countries discourage locating highly profitable investments in the United States. Reduced investment in turn reduces U.S. productivity and output.[4]

Other studies have also linked the corporate income tax to negative economic outcomes. For instance studies have found that:

- The corporate income tax reduces the return to labor and owners of capital.
    - According to a 2006 Congressional Budget Office (CBO) study, "domestic labor bears slightly more than 70 percent of the burden of the corporate income tax. The domestic owners of capital bear slightly more than 30 percent of the burden. Domestic landowners receive a small benefit."[5]
    - A 2010 study found that a 1 percent increase in corporate tax rates leads to a 0.5 percent decrease in wage rates. These results also hold for effective marginal and average tax rates.... wages are as likely to be influenced by the top statutory corporate tax rate, as by the effective marginal and average tax rates."[6]
- The corporate income tax reduces the total amount of investment into the U.S. economy – a necessary condition for generating sustainable economic growth. For instance, according to a 2008 National Bureau of Economic Research (NBER) working paper, a "10 percent increase in an effective tax rate reduces the aggregate investment to GDP ratio by 2 percentage points."[7]

In a 2010 analysis, the Heritage Foundation found that corporate tax reform would eliminate these negative impacts and, consequently, significantly increase overall economic growth. According to the Heritage Foundation's Center for Data Analysis (CDA):

> The CDA analysis of a reduction in the corporate income tax rate to 25 percent shows impressive growth for the U.S. economy. For example:
>
> - The number of jobs in the U.S. would grow on average by 581,000 annually from 2011 to 2020, with 531,000 on average being created in the private sector each year;
> - U.S. real gross domestic product would rise on average by $132 billion per year;
> - A typical family of four's after-tax income would rise on average by $2,484 per year;
> - U.S. capital stock would grow by an average of $240 billion more per year; and
> - Gross private domestic investment would increase by $57.2 billion per year.[8]

Eliminating the costs created by the U.S. corporate income tax system requires the tax rate to be lowered, the numerous special interest loopholes and exemptions to be eliminated, and the global profit basis for corporate taxes to be repealed. Implementing these reforms, and eliminating the gross inefficiencies of the U.S. corporate income tax system, is a necessary pro-growth reform even if the U.S. tax system were competitive with the global system. But, this is not the case.

The 39.1 percent statutory tax rate is the highest among the Organization for Economic Co-operation and Development countries (OECD, a forum of the 34 largest market economies). Additionally, the U.S. imposes this nearly 40 percent tax levy on the global earnings of U.S. based companies. Most OECD countries only tax the profits earned in the home country – an Ireland based company only pays taxes to the government in Ireland on income earned in Ireland, the government does not tax income earned elsewhere in the world. The U.S.' exceptionally high tax rate on global profits creates an additional competitive disadvantage for U.S. companies.

By statute, U.S. companies must pay the difference between the higher U.S. income tax rate on their income earned in Europe, Asia, and Canada and the income tax rate levied by the governments in these countries. Therefore, while competitors to U.S. companies can benefit from the lower tax rates levied by our trading partners on income earned outside of the U.S., U.S. law prevents domestic companies from receiving these benefits. This higher global tax burden for U.S. companies compared to their global competitors creates a significant competitive disadvantage for U.S. companies. And, due to this competitive disadvantage, additional costs are imposed on the U.S. economy. These economic costs include even less job growth, even less capital investment, and even slower income growth. It is within this perspective that the economic consequences from corporate inversions are best understood.

Through a corporate inversion, U.S. companies are able to obtain equal treatment on their non-U.S. based income compared to their global competitors. Furthermore, a corporate inversion does not reduce the income taxes paid by U.S. companies on income earned in the U.S. Following a corporate inversion the income taxes owed by the former U.S. company on its income earned in the U.S. is precisely the same. What is different, however, is that the income that a company earns outside of the U.S. is no longer taxable.

Eliminating the competitive disadvantages facing U.S. companies empowers an inverted company to more profitably invest in the U.S. economy and create more U.S. jobs. In fact, a 2016 analysis of the economic consequences from corporate inversions by economic consulting firm Bates White found that, in general, the evidence "suggests that inversions do not lead to job losses, reduced investment, and weaker companies but more likely the opposite."[9]

As opposed to an economic negative, corporate inversions are a growth enhancing restructuring given that the U.S. corporate income tax code is not being fixed. As a result, punishing companies that are seeking to restructure through a corporate inversion imposes greater economic harm on the U.S. economy.

However, while corporate inversions can be an improvement over the status quo, unnecessary economic inefficiencies exist when corporate structuring decisions are based on tax considerations rather than economic fundamentals. Therefore, while corporate inversions do reduce some of the economic damage created by the uncompetitive U.S. tax system, corporate inversions are no substitute for implementing a growth enhancing corporate income tax system.

A global comparison of corporate income tax rates

Comparing the corporate income tax burden across countries is fraught with difficulties. Countries will have different tax bases, different tax exemptions, and different broader tax policies (e.g. variations in how consumption taxes are levied). These differences will impact the effective average marginal tax rate. To adjust for these realities, economists estimate what is known as a marginal effective tax rate (METR). Below, the U.S. corporate income tax rate is compared to the rates levied internationally based on a calculated METR as well as by comparing the statutory tax rates.[10] The current U.S corporate income tax rates are uncompetitive globally whether these tax rates are compared based on the METR or the top statutory tax rate, see Table 1.

Table 1
U.S. Statutory and METR Compared to OECD and Global Averages as of 2014 (weighted by country GDP)[11]

	STATUTORY TAX RATE	METR
U.S.	39.1%	35.3%
Average OECD	25.2%	19.4%
Weighted Average Global	30.6%	22.1%
Weighted Average OECD	32.5%	28.2%
U.S. RELATIVE RATE		
Average OECD	55.2%	82.0%
Weighted Average Global	27.8%	59.7%
Weighted Average OECD	20.3%	25.2%

Source: Tax rates are from: Chen, Duanjie and Mintz, Jack M. (2015) "The 2014 Global Tax Competitiveness Report: A Proposed Business Tax Reform Agenda" University of Calgary School of Public Policy Research Papers, Volume 8, Issue 4, February.

As Table 1 illustrates, whether measured on a statutory or METR basis, the top corporate income tax rate in the U.S. is between 20 percent and 82 percent higher than the global or OECD average. When coupled with the U.S.' global tax basis, these higher marginal tax rates put U.S. companies at a competitive disadvantage.

In order to illustrate this disadvantage, a simplified example that compares the earnings of a U.S. company to an average company located outside of the U.S. (referred to as an OECD company) is presented on the next page. This example abstracts away from many complexities (such as the graduated income tax rates or issues of transfer pricing) to convey the competitive disadvantage more clearly.

For this example, assume there are two hypothetical companies that are directly competing against one another. One company is located in the U.S. while the second company is located outside of the U.S. To put these companies on a comparable operational basis, assume that both companies earn $2 million in gross revenues – $1 million in the U.S. market and $1 million across the average OECD or global markets, see Table 2. After paying all of their expenses except for depreciation and taxes, both companies earn a before tax profit of $300,000 or a 15 percent profit margin ($150,000 in the U.S. and $150,000 in the OECD), see Table 2.

Table 2
Gross Revenue, Expenses and Gross Profit Comparison: U.S. Company versus OECD Company

	U.S. BASED COMPANY			FOREIGN BASED COMPANY		
	AVERAGE OECD	WEIGHTED AVERAGE GLOBAL	WEIGHTED AVERAGE OECD	AVERAGE OECD	WEIGHTED AVERAGE GLOBAL	WEIGHTED AVERAGE OECD
Revenues earned in U.S.	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Revenues earned in OECD	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Gross Revenues	***$2,000,000***	***$2,000,000***	***$2,000,000***	***$2,000,000***	***$2,000,000***	***$2,000,000***
Expenses allocated to U.S.	$850,000	$850,000	$850,000	$850,000	$850,000	$850,000
Expenses allocated to OECD	$850,000	$850,000	$850,000	$850,000	$850,000	$850,000
Total Expenses	***$1,700,000***	***$1,700,000***	***$1,700,000***	***$1,700,000***	***$1,700,000***	***$1,700,000***
Gross Profits U.S.	$150,000	$150,000	$150,000	$150,000	$150,000	$150,000
Gross Profits OECD	$150,000	$150,000	$150,000	$150,000	$150,000	$150,000
Total Gross Profits	***$300,000***	***$300,000***	***$300,000***	***$300,000***	***$300,000***	***$300,000***

Source: Author calculations based on tax rate data from: Chen, Duanjie and Mintz, Jack M. (2015) "The 2014 Global Tax Competitiveness Report: A Proposed Business Tax Reform Agenda" University of Calgary School of Public Policy Research Papers, Volume 8, Issue 4, February.

Given this example, and based on the METR, both the U.S. company and the OECD company will pay $52,950 in taxes based on $150,000 of profits earned in the U.S. Furthermore, both the U.S. company and the OECD company will have to pay taxes on the $150,000 in profits earned outside of the U.S. Depending upon the average tax rate applied (see Table 1), this tax burden will range between $29,100 and $42,300.

For the OECD company, that is all the taxes it has to pay. But, not for the U.S. company. The U.S. company will then have to pay taxes on its income earned outside of the U.S. once these earnings are repatriated. In total, these taxes would impose an additional $10,650 to $23,850 tax burden that the U.S. company must pay to the U.S. government. This additional tax burden is unique to the U.S. company – the OECD company does not face these additional taxes, see Table 3.

Table 3
Gross Profit, Taxes Paid, and After-tax Profit Comparison: U.S. Company versus OECD Company (Based on METR)

	U.S. BASED COMPANY			FOREIGN BASED COMPANY		
	AVERAGE OECD	WEIGHTED AVERAGE GLOBAL	WEIGHTED AVERAGE OECD	AVERAGE OECD	WEIGHTED AVERAGE GLOBAL	WEIGHTED AVERAGE OECD
Total Gross Profits	***$300,000***	***$300,000***	***$300,000***	***$300,000***	***$300,000***	***$300,000***
Taxes on U.S. Gross Profits	$52,950	$52,950	$52,950	$52,950	$52,950	$52,950
Taxes on OECD Gross Profits	$29,100	$33,150	$42,300	$29,100	$33,150	$42,300
U.S. Taxes on OECD Gross Profits	***$23,850***	***$19,800***	***$10,650***	***$0***	***$0***	***$0***
Total Taxes Paid	*$105,900*	*$105,900*	*$105,900*	*$82,050*	*$86,100*	*$95,250*
After-tax Profits Earned in U.S.	$97,050	$97,050	$97,050	$97,050	$97,050	$97,050
After-tax Profits earned in OECD	$97,050	$97,050	$97,050	$120,900	$116,850	$107,700
After-tax Profits	***$194,100***	***$194,100***	***$194,100***	***$217,950***	***$213,900***	***$204,750***

Source: Author calculations based on tax rate data from: Chen, Duanjie and Mintz, Jack M. (2015) "The 2014 Global Tax Competitiveness Report: A Proposed Business Tax Reform Agenda" *University of Calgary School of Public Policy Research Papers*, Volume 8, Issue 4, February.

Therefore, while the overall tax burden for the OECD company would range between $82,050 and $95,250 (depending upon the average tax rate applied), the U.S. company must pay $105,900 in taxes. This higher tax burden means a lower after-tax rate of return for the U.S. company even when its before-tax rate of return is exactly the same.

Based on these illustrative assumptions, the U.S. company earns an after-tax profit of 9.71 percent on its global revenues based on the METR. In comparison, the OECD company earns an after-tax profit between 10.24 percent and 10.90 percent on global revenues based on the METR, see Table 4. Using the statutory tax rates instead of the METR changes the numbers slightly, but the conclusions are the same – U.S. companies face a significant competitive disadvantage due to the U.S. corporate income tax system.

Table 4
Comparison of Alternative After-Tax Returns: U.S. Based Company versus International Company

	STATUTORY TAX RATE			METR		
	AVERAGE OECD	WEIGHTED AVERAGE GLOBAL	WEIGHTED AVERAGE OECD	AVERAGE OECD	WEIGHTED AVERAGE GLOBAL	WEIGHTED AVERAGE OECD
U.S. Company after tax return	9.14%	9.14%	9.14%	9.71%	9.71%	9.71%
OECD Company after tax return	10.18%	9.77%	9.63%	10.90%	10.70%	10.24%
U.S. relative rate	-10.24%	-6.52%	-5.14%	-10.94%	-9.26%	-5.20%

Source: Author calculations based on tax rate data from: Chen, Duanjie and Mintz, Jack M. (2015) "The 2014 Global Tax Competitiveness Report: A Proposed Business Tax Reform Agenda" *University of Calgary School of Public Policy Research Papers*, Volume 8, Issue 4, February.

The consequences are not immaterial. Although both companies earn the same gross revenues, and both companies earn the same gross profit, the U.S. company's after-tax profits are smaller than the global company's after-tax profits – between 5.1 percent and 10.9 percent smaller. Importantly, this after-profit disadvantage is not a one-time event, it is a recurring competitive disadvantage inhibiting the U.S. company each and every year.

The tax advantage for the global company improves its competitive position vis-à-vis its American competitor. The global company may use this advantage to provide its shareholders with a higher dividend than its American counterpart. Perhaps the company will create a more efficient production process by investing in its workers or by investing in new and better equipment. Or, perhaps the company will lower its prices in an attempt to take market share away from its U.S. competitor.

Regardless of which action the global competitor takes, the U.S. tax system is creating a competitive advantage for global companies at the expense of U.S. companies. And, this scenario is all too real for far too many U.S. companies. Whether the competitors are from Canada, Ireland, or South Korea, the U.S. corporate tax system is making it more difficult for U.S. companies to compete against their international rivals.

The consequences from these adverse tax incentives (as discussed above) are less job growth in the U.S., slower U.S. income growth, and a less vibrant U.S. economy. Therefore, even starting from an equal position, due to the higher U.S. tax rates based on global profits, the U.S. company will earn less in net profits and thus be at a competitive disadvantage.[12] In other words, the corporate tax system in the U.S. is the only advantage a non-U.S. company requires in order to out-compete an otherwise comparable U.S. company.

Corporate responses to anti-growth tax policies

Instead of facing a tax burden that can be three times as high as some of their competitors (companies located in Ireland), and suffer the competitive disadvantages illustrated above, U.S. companies will adjust their behavior to minimize these costs. For instance, many multi-national companies do not repatriate the income earned overseas. According to U.S. tax law, the additional taxes on foreign income is not taxed until the income is brought home – a logical requirement. However, this incentivizes companies to keep money overseas and not repatriate these profits back to the U.S.

Currently it is estimated that over $2.1 trillion of U.S. multi-national profits are held overseas.[13] Money that is held overseas cannot, by definition, be invested into the U.S. economy. And, if not for the punitive U.S. tax code, much of this income may be reinvested in the domestic economy. However, based on the average OECD corporate income tax rate based on the METR (19.4 percent), any U.S. company that reinvested this income in the U.S. economy loses, approximately, an additional 15-cents on the dollar. Penalizing companies for investing in the U.S. does not lead to greater domestic investment.

Another route is for U.S. companies to pursue a corporate inversion. Post-merger the U.S. company still pays a marginal tax rate of nearly 40 percent on its profits earned in the U.S. However, profits that are earned outside of the U.S. are not subject to U.S. taxes – creating equity between U.S. companies and foreign owned companies.

The corporate inversion does not require any change to the operational structure of the company. The newly inverted company can continue operating all of its U.S. based facilities, and maintain all current employees. There is one important difference, however. Following the inversion the new company is now better positioned to invest in the U.S. economy than before the inversion – the primary economic benefit generated for the U.S. economy. Post-inversion the new company can now invest its foreign earnings (e.g. earnings from operations outside of the U.S.) into the U.S. economy without facing a tax penalty. There are significant domestic economic benefits when earnings from abroad are invested in the U.S.

To get a sense of these benefits, it is instructive to look at the economic impact from the investments of foreign-owned firms in the U.S. For example, the automobile manufacturers from Japan have invested a total of $41 billion in manufacturing plants located across the U.S. through 2014.[14] As of 2014, these investments have led to the creation of over 731,000 U.S. based manufacturing jobs.[15]

Applying the Japanese automobile manufacturing job impact to the $2.1 trillion in corporate profits of U.S. companies currently held overseas, if this money were all brought home and invested in U.S. based manufacturing, more than 37 million jobs would be created.

While corporate inversions will not enable all of this money to be repatriated, nor would all of the resources that are invested back in the U.S. be devoted toward job creating investments or investments that are as productive as the Japanese automobile manufacturers' projects, the calculation illustrates that large economic benefits follow when companies can allocate global investments based on economic efficiency not tax efficiency. Corporate inversions empower U.S. corporations to invest in the U.S. based on their economic efficiency and are, therefore, growth enhancing.

Corporate inversions and policy responses

The evidence discussed above leads to three conclusions. First, the U.S. is experiencing economic harm from the current corporate income tax system and this harm will only be effectively addressed by comprehensive corporate income tax reform. Second, the corporate income tax system puts U.S. corporations at a significant competitive disadvantage vis-à-vis their international competitors. Third, corporate inversions help U.S. companies reduce these competitive barriers empowering them to compete more effectively against their foreign rivals and invest greater resources into the U.S. economy.

As a result, schemes, such as Hillary Clinton's plans to impose an unprecedented exit tax on companies that are restructuring their operations through a corporate inversion, compound the economic harm. Companies engage in a corporate inversion as a best response to the anti-growth U.S. corporate tax code. Penalizing companies seeking to restructure through a corporate inversion makes it more difficult for U.S. companies to obtain a level playing field with international competitors when competing in the global marketplace. As a consequence, any greater economic investment in the U.S. that would have occurred because of the inversion will not occur. Attempts to punish corporate inversions does not solve the competitiveness disadvantages facing U.S. companies and ultimately imposes greater economic harm.

Instead of further penalizing companies, the right way to reduce the number of corporate inversions is to eliminate the incentives driving companies to restructure in the first place. As an example of the type of reforms needed, Rep. Devin Nunes' American Business Competitiveness (ABC) Act, if enacted, would lower the top federal tax rate to 25 percent, transform the U.S. into a territorial based tax system (only taxes U.S. companies on income earned in the U.S.), simplify the current complex federal corporate income tax code, and allow investments to be 100 percent written off in the year in which they are made (significantly improving the incentive for firms to invest in new equipment).

As is true for most political compromises, the ABC Act is not ideal; including provisions such as the 5 percent transition tax on un-patriated foreign earnings and the elimination of the interest deduction. However, the net result from the ABC Act would be a significant improvement in the incentives for U.S. based corporations to grow and expand.

The expected economic result from the ABC Act is enhanced growth and greater economic opportunity. According to an analysis by the Tax Foundation, if the ABC Act were implemented, 1.2 million jobs would be created, the U.S. economy would be 6.8 percent larger, wages would be 5.7 percent higher, and total investment would be 20 percent larger.[16] These changes make the U.S. corporate income tax rate significantly more competitive as compared to the tax system in the other major OECD economies.

Conclusion

The current U.S. corporate income tax system violates the principles of a sound tax system. As a consequence, it imposes large economic costs on the U.S. economy including lower wages, less investment, and less overall economic growth.

There is an additional competitive disadvantage created by the U.S. corporate income tax system because the tax rate is significantly higher than the global average and the U.S. (unlike our major trading partners) taxes the global earnings of U.S. corporations.

Unfortunately, it appears that effective tax reforms will not be implemented in the near-term. Corporate inversions, while less beneficial than comprehensive tax reform, allow companies to restructure and remove some of the competitive disadvantages created by the inefficient and overly-burdensome U.S. corporate income tax system. The result will be a lessening of the economic costs created by the current U.S. tax system.

As such, policy proposals aimed at penalizing and/or discouraging corporate inversions are economically harmful and should be avoided. Instead of penalizing firms that are attempting to eliminate impediments to competition, policymakers should focus on effective corporate income tax reform that will lower the marginal tax rate, simplify the tax system, enable the expensing of capital expenditures, and reform the tax basis to a territorial tax system.

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Dr. Winegarden's columns have been published in the *Wall Street Journal, Chicago Tribune, Investor's Business Daily,* Forbes.com, and Townhall.com. He was previously economics faculty at Marymount University, has testified before the U.S. Congress, has been interviewed and quoted in such media as CNN and Bloomberg Radio, and is asked to present his research findings at policy conferences and meetings. Previously, Dr. Winegarden worked as a business economist in Hong Kong and New York City; and a policy economist for policy and trade associations in Washington D.C. Dr. Winegarden received his Ph.D. in Economics from George Mason University.

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