



## SETTING THE STORY STRAIGHT: THE TRUTH ABOUT CORPORATE INVERSION

Several Members of Congress have recently proposed offsetting the tax cuts in the Bush Economic Growth Package with something they are referring to as “revenue raisers.” Unfortunately, despite the rosy image that these Members have attempted to create, the revenue raisers are, in fact, nothing more than a list of unjustifiable and unethical tax increases. One of the intended targets of the new legislation is the practice of corporate inversion. However, few Members seem to fully comprehend the issue of inversion, and media coverage of the topic has only further skewed its understanding. The confusion could have dangerous consequences if left uncontested, so it will be critical in the weeks and months ahead to raise public awareness by clarifying the truly negative effect of the tax increase proposal for corporate inversion.

### Unjust Criticism

“Inversion” has unfairly been made a dirty word by the recent portrayal of inverted corporations as skating on taxes and hurting American workers in the process. In reality, the term “corporate inversion” describes a legal transaction through which the corporate structure of a United States-based multinational group is altered so that a new foreign corporation replaces the existing U.S. parent corporation as the head of the corporate group. By relocating their headquarters offshore, American businesses can avoid the high and complex income taxes that their foreign competitors don’t have to pay.

Any logical businessman would view the decision to re-incorporate in a low-tax jurisdiction as a prudent and responsible reaction to a tax code that severely hinders the ability of U.S.-chartered firms to compete in world markets. However, critics accuse these firms of being unpatriotic, and have asserted that such companies may be engaged in a questionable form of tax evasion. An in-depth analysis demonstrates the error of that view. There is nothing unpatriotic about “expatriation” because it is consistent with U.S. tax law, it allows a firm to compete on a level playing field with international peers, and it lets a company’s tax savings be reinvested for the benefit of the firm’s shareholders. Ironically, despite their location, inverted U.S. businesses do not change their actual business structure – they still produce American products and still employ hundreds of thousands of American workers. So, contrary to recent accusations, inversion, in fact, *benefits* U.S. workers and U.S. shareholders.

Senators Max Baucus (D-MT) and Chuck Grassley (R-IA) propose punitive fees and fines for companies that reincorporate offshore, and tax them *retroactively* to the time of the “inversion” even though it was completely legal to take such action at the time. Retroactive taxation has no place in the American tax code. It is simply an unfair political gimmick that will cause more harm than good. Supporters of inversion legislation claim that companies are 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. When companies are fleeing the U.S. tax code to stay competitive abroad, there’s something

wrong with the tax code, not with the companies. Despite the uninformed claims of the critics, the systemic problem lies in the code.

### **The Root of the Problem**

The U.S. tax code puts American firms at a competitive disadvantage by making it difficult for corporations chartered in the United States to compete overseas. For this reason, about two dozen American companies have, in recent years, nominally reincorporated in tax havens like Bermuda to stay competitive. The problem is twofold – the United States imposes a higher corporate tax rate than those of Sweden and France, two of the world’s most socialist countries, and it even imposes that burden on income earned in other nations. First, the U.S. corporate tax rate is very high – the federal government takes 35% while most states take another 5%, for an average of 40%. This is significantly higher than the 30% average corporate tax burden in most developed nations. In fact, the 35% U.S. figure is the fourth highest rate among 26 OECD countries. Second, U.S.-chartered firms must pay tax to the IRS on income earned in other countries, something most other countries don’t require. This “worldwide taxation” policy puts American-based companies at a disadvantage since most of our trading partners rely on “territorial taxation” – taxing only that income earned inside their borders.

Congress itself has even admitted the inherent difficulties in the code, and the need for a long-term solution. The House of Representatives seemed to recognize the real culprit when it passed a tax bill earlier this year that stated -- “it is the sense of Congress that passage of legislation to fix the underlying problems with our tax laws is essential and should occur as soon as possible, so United States corporations will not face the current pressures to engage in inversion transactions.”

Indeed, if Congress was truly concerned with helping U.S. companies improve the current state of the economy, then they would go directly to the source of the problem – the U.S. tax system that drives businesses offshore in the first place. The goal should be to design a tax system that will attract businesses to the United States, rather than push them away. If the tax code disadvantages U.S. companies competing in the global marketplace, then Congress should address the anti-competitive provisions of the code. Penalizing American corporations with offshore headquarters by forcing them to decide between two detrimental options – either pay heavier taxes than foreign competitors or forgo doing business with the U.S. government – only serves to weaken the domestic economy and stimulate foreign competition. Instead, lawmakers should adopt tax rates that encourage firms to remain in the country and switch to a territorial tax system that taxes only income earned in the United States.

### **Remembering the Ultimate Goal**

In a country that prides itself on the principles of capitalism as the cornerstone to success, corporation-bashing will not likely provide a constructive answer to solving the nation’s current economic dilemma. Instead of blaming the victims, Members of Congress should address the underlying problem and start reforming the tax laws that cause businesses to expatriate in the first place. The reality is that U.S. companies are fleeing sky-high rates and an excessively complicated tax regime. The recently proposed legislation addresses neither problem, and amounts to nothing more than a shortsighted knee-jerk reaction that will only damage the economy in the long run.

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