// National Review

February 23, 2004
pp. 26-30

Voting with Their Feet

When companies 'reincorporate abroad,' are they being unpatriotic? Or responsible?

RICHARD W. RAHN

Imagine you are the CEO of a major multinational firm. Your chief financial officer comes to you and says if you move your legal home from the United States to Bermuda the company will have a 20 percent increase in net profits. With the increased profits, the company will be able to expand production, hire more workers, do more R&D and pay stockholders a higher dividend.

However, your VP for government relations tells you that if the company changes its legal home you, as the CEO, will be accused of being unpatriotic by some members of Congress and certain presidential candidates. Even worse, these same politicians will threaten to bar your company from obtaining U.S. government contracts, and demand that the IRS and government regulatory agencies single out your company for special scrutiny.

As the CEO of the company, you know you have a fiduciary responsibility to your stockholders to maximize their economic return by all legal and ethical means. You also know that the proposal to move your company is entirely legal and would be considered good management practice. You are also aware that many of the politicians who are likely to attack you are the same people who attacked managers in other industries, like mutual funds, for not being good custodians of investors' money. Despite what thoughtful people will clearly recognize as hypocrisy, those political attack dogs can cause considerable damage to you and your company as they have to other firms engaged in similar totally legal and appropriate behavior.

The Stanley Works (tools) company, for example, had planned in 2002 to reincorporate in Bermuda, in the hope of lowering its tax bill. The move was ditched, however, after political pressure was brought to bear on the company. Subsequently, Stanley was forced to lay off about 1,000 of its U.S. staff. Other companies that have "inverted" (the technical term for reincorporating the parent company in a lower tax jurisdiction) are also now under political attack.

Politicians who make these irresponsible attacks have the implicit support of the liberal media and government bureaucrats who can make life hell for those with the temerity to cross them. What they all seem not to realize is that business people respond to incentives, whether it is a reward of a government contract, a tax cut, or the punishment of an IRS special audit.

The specific problem of inversion stems from the fact that the U.S. now has the fourth-highest corporate tax rate among the industrialized countries and, unlike most other countries, the U.S. taxes companies on their worldwide income. A company incorporated in America will pay a corporate tax rate of 35 percent plus an average state corporate tax rate of 5 percent for a total of 40 percent on its worldwide income. A German, French, Canadian or even Swedish company will pay a lower corporate tax rate on profits earned in their home country, and little or no tax to its home government on any foreign income. For instance, Ireland has a 12.5 percent corporate tax rate, which means that the German, French or Canadian company only has to pay 12.5 percent on their profits in Ireland, but the American company has to pay 40 percent in tax on its profits in Ireland. The IRS does allow credit for taxes paid to foreign governments so, in the case of a U.S. company earning $100 of profit in Ireland, it would pay $12.50 in tax to the Irish government, $22.50 to the U.S. government ($35 minus a $12.50 credit for the tax paid to Ireland), plus perhaps $5.00 to the government of the U.S. state in which it is incorporated, for a total of $40.

The high U.S. corporate tax rate and its worldwide applicability puts American companies at a considerable competitive disadvantage and makes them more vulnerable to takeover by a foreign company. This is particularly true for U.S. companies with sizable markets in lower-tax countries. Foreign-based companies with this tax cost advantage will tend to grow faster and gain market share from American competitors. To offset this competitive disadvantage a number of U.S. companies decided to reincorporate in Bermuda, the Cayman Islands, and other jurisdictions without any corporate income tax. Under U.S. law, this is perfectly legal because a company need not sell or produce anything in a country that serves as its legal home.

It is important to understand that these corporate inversions do not reduce a company's tax liability on its U.S. earnings. In fact, corporate inversions usually make sense only for companies with substantial foreign profits, since a company selling only in the U.S. market cannot lower its tax liability through a corporate inversion. Consider, though, the company that makes 40 percent of its profits in the U.S. and 60 percent of its profits in other countries. As an American company, it would pay approximately $40 in income taxes on each $100 it earns. However, if it does an inversion by moving its legal home to Bermuda or the Caymans, and if the average corporate tax rate it pays to foreign governments is 20 percent, it will now pay only $28 in taxes on each $100 it earns (40 percent x $100 x 40 percent = $16; 60 percent x $100 x 20 percent = $12; and $16 + $12 = $28).

The above is totally legal, proper and ethical. As Judge Learned Hand said: "Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." Corporate inversions usually only make sense for companies with substantial foreign profits. A company only selling in the U.S. market cannot lower its tax liability through a corporate inversion.

Again, the reason companies choose to move their legal homes is that the U.S. tax system punishes corporate capital and makes U.S.-based multinational companies less competitive. There are constructive and destructive solutions to the problem. Among the constructive solutions is to change the U.S. to a territorial tax system, like most of our foreign competitors, and/or reduce the U.S. corporate tax rate to a rate ideally no higher than Ireland's. Opponents of these solutions will claim that: "we cannot afford them." In fact, we cannot afford to spurn them. If we don't make the necessary changes, more and more U.S. companies will move their legal homes, more U.S. companies will be taken over by foreign competitors, and more and more U.S. companies will lose ground to foreign companies in U.S. markets and those abroad, all of which will cause a drop in corporate tax revenue. Reducing the corporate tax rate will have many beneficial side effects. If corporate taxes are reduced, corporations will benefit consumers by lowering their prices, increase wages, hire more workers, buy more equipment and materials and increase stockholders' dividends. All of these actions mean that individual income tax receipts will go up. Over the long run, the gain in individual tax receipts will probably exceed the loss in corporate tax revenues.

Remember, the corporate tax is a double or triple tax on the same income since the original investment has already been taxed, and the dividends and capital gains resulting from the corporate income are taxed again.

Several proposals have been made to punish companies in one form or another who chose to invert, or to try to outlaw the practice altogether. All these proposals are highly destructive and would cost American jobs as U.S. companies would increasingly fall to their foreign competitors.

From before the time of the American Revolution, it has been our practice to flee from high-tax locales to lower-tax ones. Tax competition among the states has served to give us better government service at lower cost, and more liberty. The same is true in the international arena.

Congressman Ron Paul of Texas has said: "One could argue that it is those who oppose reincorporation who do not grasp the essence of the American system. After all, two of the main principles underlying the Constitution and the Declaration of Independence are limited government and respect for private property. In contrast, opponents of reincorporation implicitly assume that the government owns all of the nation's assets; therefore taxpayers never should take any actions to deny government what the politicians have determined to be their 'fair share.' This philosophy has more in

common with medieval feudalism than with the constitutional republic created by the drafters of the Constitution."

Those running for president or in Congress who advocate restrictions on corporate inversions rather than tax reform will only make worse the problem that they so demagogically attack.

Richard W. Rahn is a senior fellow of the Discovery Institute and an adjunct scholar of the Cato Institute.