Treasury’s Tax Regulations Will Dampen Domestic Investment

Ike Brannon

June 21, 2016

Representatives of both political parties agree that the current tax laws inadvertently create an incentive for multinational corporations to invest abroad. The high domestic tax rate on corporate income, combined with our worldwide tax system that double-taxes profits made overseas and then brought home, results in less money returned to the U.S. and incentivizes multinationals to do more foreign investment and less domestically.

One way to fix this problem would be to reduce the corporate tax rate while reforming the overall tax code to make it more amenable to economic growth. Corporate taxes happen to be a spectacularly inefficient way to generate tax revenue, anyway, in terms of lost investment, growth, and jobs.

Rather than having serious discussions toward that goal, the Treasury Department instead passed what it deemed "emergency" regulations, which effectively prohibit "inversions"—larger U.S. companies merging with smaller foreign ones and establishing a foreign tax home—as well as arbitrarily punishing corporations that might seek to move more operations abroad in the future.

The new rules essentially re-characterize certain types of debt as equity, thus changing the tax consequences of the investment. The rules also give the IRS power to examine the transaction that created the debt instrument to begin with and, if the tax authorities deem it appropriate, bifurcate the transaction into part-debt and part-equity.

There are two problems with such a draconian move by Treasury. The first is that it doesn't really address the overarching problem, which is that we have an increasingly uncompetitive tax code. Instead, it attacks a symptom of the tax code—the predilection of companies to figure out ways to avoid bringing their profits back into the United States.

Inversions don't allow U.S. companies to avoid paying taxes on their U.S. income. All these transactions do is allow companies to return foreign profits to the U.S. without any tax consequences, which is how nearly every other country's tax code functions.

Banning inversions has little effect on tax revenue. It merely results in more money kept abroad.

The other problem with Treasury's actions goes beyond merely discouraging future inversions. By re-characterizing the debt of various companies as equity— which Treasury now has the power to do because of the changes it made to Section 385 of the Internal Revenue Code—it's now more difficult for multinationals to do efficient tax planning. This change won't necessarily generate more tax revenue for the United States, but it could result in U.S. companies paying more taxes to other countries.

Treasury has quietly acknowledged that its regulations went further than it had originally intended and engaged in discussions with companies to pare them back a bit. But there might not be enough time in the current administration to get such mitigation accomplished, and asking Congress to fix a complicated problem that affects only wealthy U.S. multinationals is a tad difficult this late in the game.

The net result is that the United States has just made it even more attractive for U.S. companies to go beyond a mere inversion and instead relocate entire operations abroad. As a tax officer for a major U.S. corporation once remarked, most companies domiciled in the U.S. are here merely because of an historical accident.

Fortunately, some Members of Congress do understand the concerns of the business community. Connecticut representative John Larson, a member of the Ways and Means Committee, worried that "in casting a broad net, businesses that have legitimate concerns are being caught up." More lawmakers from both parties should raise greater scrutiny on this serious case of federal overreach into private businesses' everyday transactions.

The current administration has spent the last two years putting preconditions on any corporate tax reform in a way that made it clear it had no interest in pursuing real change. If the next administration plays the same game, we may see a sharp rise in the number of companies that give up hope of having our corporate tax code fixed and respond by moving their domicile and their major operations abroad. And then there will truly be hell to pay—not so much for the companies as for the politicians who encouraged the departures.

Ike Brannon is a visiting fellow at the Cato Institute.