Who Americans Should Really Blame for Corporate Inversions

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In the words of the late Yogi Berra, it's déjà vu all over again. The merger of Johnson Controls JCI 3.49% and Tyco International has triggered a lot of whining and complaining in Washington because the combined company will be based in low-tax Ireland instead of high-tax America.

Not that anyone should be surprised. In almost all cases of high-profile, cross-border mergers, such as the Pfizer-Allergan deal last year and the Burger King- Tim Horton deal the previous year, the new company chooses to be domiciled where there's better tax laws.

Some U.S. politicians respond to these mergers with demagoguery about "economic treason," but that's silly. These corporate unions are basically the business version of a couple in a long-distance relationship that decides to live where the economic outlook is brighter after getting married.

So instead of blaming the victims, the folks in Washington should do what's right for the country by trying to deal with the warts that make America's tax system so unappealing for multinational firms. There are two main problems. The first is that the United States now has the world's highest corporate tax rate. With a 35% levy from Washington, augmented by smaller state corporate taxes, the combined burden is more than 39%. In Europe, by contrast, the average corporate tax rate has now dropped below 24%. And the average corporate rate for Asia's major economies is even lower.

By the way, it doesn't really matter if the "effective tax rate" for a company is lower. From an economic perspective, almost all additional profit is taxed at the statutory rate, so that's what drives incentives.

But high corporate tax rates are just part of the problem. The second challenge is that the IRS also imposes tax on income earned in other nations. Very few nations impose a system of "worldwide taxation," mostly for the simple reason that the income already is subject to tax in the nations where it is earned.

The combination of a high rate and worldwide taxation is like a one-two punch against the competitiveness of U.S.-domiciled firms, so it's easy to understand why inversions are so attractive. They're a very simple step to protect the interests of workers, consumers and shareholders.

Defenders of the status quo say that worldwide taxation is acceptable because companies have some ability to postpone the extra layer of the tax to the IRS and they also get a "credit" for the

taxes paid to other nations. But even if this very complex system worked perfectly (and it doesn't), U.S.-based companies still have a much higher tax rate than their foreign competitors when competing for market share around the world.

Consider what happens when a U.S.-based company competes in Ireland. Just like an Irish company or a Dutch company, it pays a 12.5% tax to the Irish government on Irish-source income. But unlike its competitors, it then faces the prospect of putting that same income on its tax return to the IRS. And that could mean an additional 22.5% tax (the federal government's 35% rate minus a credit for the 12.5% tax paid to Ireland).

In other words, an American company can wind up with a tax bill that is nearly three times larger than its overseas rivals.

To make matters worse, there's a "base erosion and profit shifting" initiative being pushed by international bureaucrats at the Paris-based Organization for Economic Cooperation and Development that will add to the misery of American-domiciled companies. This OECD effort is arbitrarily urging new tax rules that will enable European governments to further exacerbate the competitive disadvantage faced by U.S. companies. Many of these nations, for instance, are now imposing higher tax rates on companies if their research and development facilities are based in the United States, which means that the incentive for "inversions" will become even larger.
The bottom line is that U.S.-domiciled firms are being forced to compete while burdened with a tax code that is uniquely destructive. Until that system is fixed, expect more mergers that lead to companies being based overseas. In the short run, that doesn't really matter since the factories, headquarters, and research facilities generally stay in the United States. All that really happens is that there's a corporate charter in a filing cabinet in Ireland, Switzerland, or the Netherlands rather than in Delaware. But thanks to the OECD's BEPS project, it's now more likely that there will be an incentive to shift actual jobs and investment out of America.

Let's hope politicians put aside class warfare and anti-business demagoguery and fix the tax system before it's too late.

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