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## **Corporate Inversions and the Tax State**

**by Richard M. Ebeling**

Before I accepted my present position as a professor of economics at Hillsdale College in 1988, I negotiated my salary with the academic dean responsible for hiring new faculty. At that time I was teaching at the University of Dallas in Texas. Now, a move to Hillsdale was definitely attractive to me. They were offering me an endowed position — the Ludwig von Mises Chair in Economics.

Also I'd be able to teach topics of special interest to me, including a two-semester course each year in Austrian economics. In addition, the college had refused any and all federal funding as a matter of principle to retain its independence as a private institution of higher learning. And Hillsdale's declared political philosophy was a devotion to individual freedom, limited government, the free market, and the teaching of the core traditions and ideas of the West that formed the basis for a society of liberty. This made Hillsdale ideologically very attractive to me.

But at first, Hillsdale's academic dean gave me a salary offer that I had to refuse. I explained to him that Texas had no state income tax, while Michigan had a sizable state income tax. If I were to accept his offer I would be financially worse off in comparison to the take-home pay that I was then living on in Texas. He asked me what salary I would find acceptable to make the move to Hillsdale monetarily rewarding and, luckily, he agreed to the amount that I suggested.

My employment experience is far from unique. Indeed, it goes on all the time for tens of thousands of people in the United States every year. Pleasant working conditions, an interesting and challenging job description, better opportunities for promotion and advancement, and a more desirable geographical location in which to live are all among the factors that most people weigh when deciding whether or not to leave a job and accept alternative employment.

But salary matters too, and for most of us it is given a significant weight in this decision process. All things considered, each of us would rather earn more, on net, than less. Our take-home income is the means by which we have access to all the purchasable goods and services we would like to buy in the market. And the greater our take-home pay the greater the number of things we can acquire that money can buy.

It's not surprising, therefore, that besides the nonmonetary factors that influence employment decisions, people usually investigate, to one degree or another, how local and state taxes will affect their net-income position when deciding whether to move from one place to another. And unless the monetary reward after taxes is sufficiently attractive (or unless the nonmonetary factors are so overwhelming), many of us are unlikely to make a move from one town to another or one state to another when we are comparing job opportunities.

### **Income, taxes, and corporate decision-making**

The same incentives and relative earning opportunities guide business enterprises in selecting locations for their headquarters and their production, service, and distribution facilities among the various states. Because of tax advantages, there are 308,000 companies that are incorporated in the small state of Delaware, including 60 percent of the Fortune 500 and about 50 percent of the companies that are listed on the New York Stock Exchange.

Tax differentials can also influence decisions about the country in which a business will locate its headquarters and facilities. For example, the United States has a corporate profits tax of 35 percent. Among the 26 member countries of the Organization for Economic Cooperation and Development (OECD), 5 — Belgium, Germany, Greece, Italy, and Luxembourg — have corporate income taxes higher than the United States. Three — Mexico, Spain, and the Netherlands — have the same 35 percent rate as the United States. But 17 nations have corporate income tax rates below that of the United States, including Finland (29 percent) and Norway and Sweden (28 percent). In Ireland the rate is 16 percent, in Switzerland it is 8 percent, and in Bermuda it is zero percent.

In addition, the U.S. government taxes overseas business earnings in a way that most of these other countries do not. For instance, suppose that you own and operate your business in one of the leading member countries of the European Union but also have a subsidiary in the United States. You will owe taxes to your home government only on the profits you've earned from sales in your own country. The U.S. government will have already taxed any profits you've earned from

your American operation, and you can then, in general, repatriate those after-tax profits back to your own country without any further tax liability.

If, on the other hand, you are an American company with a subsidiary in any other country, the United States will double-tax you on your foreign earnings. Not only will you have paid corporate taxes in the foreign country in which you've earned those profits, but in most cases the U.S. government will also tax those profits whether or not you repatriate them back to the United States. The fiscal arm of the U.S. Treasury extends all around the globe, claiming to have a right to a portion of anything you've earned anywhere in the world.

### **Tax avoidance and corporate inversion**

To minimize their tax liability within the United States and to try to reduce tax disadvantages, a growing number of American corporations have been moving their headquarters offshore, a procedure known as "corporate inversion." A corporation opens a subsidiary in another country's jurisdiction. That subsidiary then buys up the shares or assets of the parent corporation, becoming the legal "mother company," with the U.S. facility now transformed into the subsidiary. Virtually nothing else changes as a result of this inversion. Manufacturing, jobs, sales, and marketing remain as they were before. It is basically just a paperwork process to shift the company's ownership outside the United States to avoid such fiscal disadvantages as double-taxing of earnings.

It is not costless. The formal selling of the shares by the stockholders results in a capital gains on which they then have a tax liability to the U.S. government, even though those sold shares are merely transferred into shares of the newly relocated company. Yet a growing number of companies have chosen to make this move with shareholder approval because of the long-run tax savings for the corporation.

One company, Stanley Works of New Britain, Connecticut, made this shift to Bermuda because they estimated that while capital gains taxes owed by shareholders to the U.S. Treasury would be as much as \$150 million as a result of the inversion, the company would save as much as \$30 million per year in tax liabilities.

Assuming a 2.5 percent interest rate, over 10 years this would result in a savings of \$263 million in present-value terms. At the same time, Stanley Works estimated that the higher profitability of the firm resulting from the inversion could increase the market value of the company's stock by as much as 11.5 percent.

## **Corporate inversion**

In response, the political establishment has come out of the woodwork and attacked companies that have taken advantage of the corporate-inversion process. Rep. Richard Neal (D-Mass.) has called these companies “unpatriotic” and “corporate financial traitors.” Sen. Charles Grassley (R-Iowa) declared that, while inversion was perfectly legal under U.S. law, “I take a position that it is immoral and unethical.”

In the spring and early summer of 2002, several bills were submitted in the Congress to either ban or heavily penalize corporate inversions. As John S. Barry, chief economist with the Tax Foundation pointed out in a Fiscal Policy Memo (May 30, 2002), at the core of these bills,

“is a provision that would treat foreign corporations created with the sole purpose of buying a domestic firm — i.e., conducting an inversion — as a domestic corporation for tax purposes. In other words, each of the bills would simply ignore that the inversion ever took place and that the new parent company is incorporated in a foreign country.”

Critics of these bills have rightly pointed out that corporate inversions are perfectly legal and no different than a company’s decision to move, say, from Iowa where the top corporate tax rate is 12 percent to Kansas where the corporate tax rate is 4 percent, or a person’s decision to change his residence from North Dakota, with its 12 percent personal income tax, to South Dakota, which has no personal income tax at all.

And these critics have been equally correct to suggest that a far better solution would be to significantly lower corporate taxes and eliminate the double tax on earnings by American companies from their foreign subsidiaries.

That would greatly reduce, if not eliminate, the fiscal and competitive disadvantages facing many American companies in the global marketplace.

As Bruce Bartlett of the National Center for Policy Analysis concluded in an opinion piece entitled “Moving Offshore” (August 8, 2002), “The inversion phenomenon should be viewed as a warning that U.S. rates are too high” and that “in the future, newly established corporations will find places like Ireland much more hospitable countries in which to incorporate in the first place.”

The real heart of the problem, however, is deeper and more fundamental than these insightful and correct observations and policy suggestions. The Austrian economist Joseph A. Schumpeter suggested in an essay entitled “The Crisis of the Tax State” (1919) that a nation’s fiscal system can serve as a useful basis for a history of that country’s rise and fall, since the tax system and its structure reflect the political and ideological ideas of that society through time.

### **Freedom versus collectivism**

Many of the classical liberals of the 19th century believed that what a man had earned through his own production and market exchange was his “natural right” to keep. Many of the classical economists of this time, from a more utilitarian perspective, reinforced this view by emphasizing that taxing income and capital weakened incentives for work, saving, and investment, thus reducing the growth of capital, and therefore retarded increases in the standard of living for all in society. Many of them argued that both justice and compassion, especially a concern for the condition of the poor, required that those who had produced and earned should be allowed to keep the fruits of their labor, with expenses of a strictly limited government funded through a variety of low indirect taxes. The ideal of a low tax system to fund minimal government with the fewest infringements on market incentives was the fiscal regime of an earlier historical era more devoted to the principles of individual freedom and a respect for private property.

The rise of socialist, interventionist, and welfare-statist ideas in the late 19th and 20th centuries created a totally different fiscal regime. Government was to use its taxing power as an avenging sword to abolish the exploitation of the poor by the rich. It was to rectify and reduce inequalities in income that were considered socially unjust. Government was to use its taxing authority to influence and indirectly determine the amounts, types, and locations of investment and job creation in various parts of a country. It was to use its fiscal tools to make agricultural countries more industrialized and make industrial countries more agrarian. It was to use customs duties to control the flow of imports and investments into the country and subsidize or restrict the export of certain goods and services out of the country. Taxes were made into an instrument of social engineering and a device for special-interest power politics.

In such an era and regime of fiscal collectivism, nothing is more detested by the political authority than any attempt by the tax-paying public to escape from the clutches of the tax collector and the government’s thirst for the private wealth created and earned by the members of society through their peaceful and voluntary market transactions. Even a legal avoidance of taxes

such as the corporate inversion process threatens to reduce the fiscal blood supply of the political vampires who live off the productive efforts of others and prosper from them.

How can those in political authority redistribute income, how can they foster their various schemes for environmental development, how can they manipulate and control the direction of investment, manufacturing, and employment within the country — what in the 1950s and 1960s the French called “indicative planning” through the tax structure — how can they have the financial resources to bestow privileges on some and impose financial hardships on others in the pursuit of re-election through the pandering to special-interest groups? How can they do any of these things, as well as many others, if the tax base is reduced by corporations moving out of the government’s immediate jurisdiction and therefore out of the direct control of the power of that state?

The recent political campaign against corporate inversion, therefore, is really an assault on a remaining freedom through which private citizens attempt to retain more of the wealth and income that they have produced and earned in the market. It is a campaign to keep the American people captive behind a fiscal Berlin Wall over which there is to be no escape.

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