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Inversion Rules Avoid Root Cause Of Problem

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At this year's Masters golf tournament, there were three holes in one on the same day on the same hole — one of which rolled in after colliding with another golf ball! Do you think the odds of that happening are greater than Congress ever approving a corporate tax reform package?

It's a question that corporate America must be asking itself as it watches the Obama administration do everything it can to stop the trend of inversions by U.S. companies. Most recently the U.S. Department of the Treasury and the Internal Revenue Service announced a new set of rules that thwarted a proposed $160 billion merger between Pfizer and Allergan. The expectation was that Pfizer would relocate its corporate headquarters to Ireland, where Allergan is based and the corporate income tax rate is 12.5 percent, and lower its tax bill in the U.S.

That happens to be perfectly legal, but objectionable to the Obama administration. No doubt Pfizer could also point to many business benefits of one pharmaceutical company acquiring another. Indeed, Ian Read, the chairman and CEO of Pfizer, noted in a recent editorial in the Wall Street Journal that this "strategic transaction, driven by strong commercial and industrial logic, would have made it easier to invest in the U.S." But even if there were no benefits, moving a headquarters to benefit from lower taxes is not a criminal act. Companies spent much of the 20th century moving from state to state to pay lower income taxes or reduced property taxes. Today the move for multinationals is across national borders to more reasonable tax situations.

Thwarting inversions by issuing rules is easier than bringing parties to the table to negotiate meaningful change, but that's what needs to be done. One reason that companies want to move their legal headquarters is because the top U.S. corporate tax rate is 35 percent, while the average among European countries is only 20 percent. Additionally, our government taxes income regardless of where a U.S. company earns it, while other countries tax only what was earned within their borders.

While Treasury Secretary Jack Lew has urged Congress to legislate if it wants to stop inversions, the new rules he's proposed are essentially an end run around the law. In fact, Lew has acknowledged that it does not have the authority to address the inversion question. The Treasury Department issued notices in 2014 and 2015 that were largely ignored by companies. This time, Lew decided to crack down. The new regulations refer to "serial inverters," which I might call companies that have engaged in entirely legal transactions more than once. Allergan, for example, has grown through multiple mergers. But that practice is now against the rules of the Treasury and IRS. And because there is a three-year "look-back," it’s not just what you might do that would violate the new rules, but what you’ve already done.

Obviously that isn’t fair, but that’s what happens when we can’t fix our corporate tax structure. The corporate tax code, particularly the international tax rules, is still very much rooted to the 1960s and has not evolved with time. Updating the code by implementing a “territorial” tax system in which we only tax earnings within the U.S. would increase the incentive for companies to reinvest those profits at home. Lowering the top rate from 35 percent to less than 25 percent, would put us closer to the rates of other developed nations and make us more attractive to corporations.

Rather than losing tax revenue due to the lower rate, we’d be gaining tax on the $2.4 trillion that the advocacy group Citizens for Tax Justice estimates was parked overseas in 2015. Instead of punishing U.S. companies for trying to build their businesses and create more jobs, we’d be helping them by making real improvements to the tax code. That’s preferable to unilateral efforts by the administration to stop companies from acting in ways they are entitled to under the law.

When Lew announced the new rules, he pointedly said that the actions were to “further rein in inversions and reduce the ability of companies to avoid taxes.” But what happens next? Pfizer-Allergan wasn’t the only pending inversion. Johnson Controls, the Milwaukee-based international auto parts company, has announced plans to merge with Tyco International and move its headquarters to Ireland, where Tyco is based. Johnson says the merger would save the company about $150 million a year in taxes. There will be more inversions until doing so no longer makes sense to corporate managers from a business perspective.

Actuaries say the odds of an average golfer sinking a hole-in-one are 12,500 to 1. Given the stalemate in Washington for the past eight years, overhauling the corporate tax code might be a similar long shot. But it’s time for Congress and the next president to defy the odds and perform above average. Step up to the tee, drive the ball to the green and roll it into the cup.

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