



Executive Memorandum

214 Massachusetts Avenue, N.E., Washington, D.C. 20002-4999 • (202) 546-4400 • <http://www.heritage.org>

No. 829

August 29, 2002

CORPORATE EXPATRIATION PROTECTS AMERICAN JOBS

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Corporate executives are being criticized for bad decisions, some of which have crossed the line into criminal behavior. This heightened attention has helped to create a political environment in which all corporate actions are suspect—including decisions by some companies to re-incorporate in low-tax jurisdictions (a step commonly known as inversion or expatriation). At the very least, critics accuse these firms of being unpatriotic. In many cases, they have asserted that such companies are engaged in a questionable form of tax evasion.

Such claims are absurd. The decision to re-incorporate in a low-tax jurisdiction should be viewed as a prudent and responsible business reaction to a tax code that severely hinders the ability of U.S.-chartered firms to compete in world markets. Expatriation allows a company to compete on a level playing field with foreign-based firms while maintaining its headquarters and jobs in America—a combination that advances U.S. interests. And since the company continues to pay tax on all income earned in the United States, the evasion issue is a red herring.

How the Tax Code Makes U.S. Companies Less Competitive. About two dozen companies in the last few years have re-chartered or are in the process of re-chartering in low-tax jurisdictions. In virtually every instance, anti-competitive tax policy is cited as the reason. There are two main reasons why the internal revenue code makes it difficult for

corporations chartered in the United States to compete overseas.

First, the U.S. corporate tax rate is very high. The federal government imposes a 35 percent tax on corporate income, and states on average grab another 5 percent. This cumulative 40 percent tax rate is significantly higher than the 30 percent average corporate tax burden in other developed nations.

Indeed, the tax burden on U.S.-based corporations, which is currently the fourth highest in the industrialized world, will soon be the second highest once Belgium and Italy implement their planned tax rate reductions.

Second, U.S.-chartered firms must pay tax to the Internal Revenue Service on income earned in other nations. This “worldwide taxation” policy puts American-based companies at a disadvantage since many of our trading partners rely on “territorial taxation”—the commonsense notion that governments only tax income earned inside their borders.

Produced by the
Thomas A. Roe Institute for
Economic Policy Studies

Published by
The Heritage Foundation
214 Massachusetts Ave., NE
Washington, D.C.
20002-4999
(202) 546-4400
<http://www.heritage.org>



This paper, in its entirety, can be
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The combination of these misguided policies is crippling U.S. competitiveness. Consider what happens, for instance, when a U.S. company competes against a Dutch company in Ireland. Because Holland has a “territorial tax” system, the Dutch company pays only the 10 percent Irish corporate income tax on its Irish income. The American company, though, must pay the 10 percent Irish tax and the 35 percent U.S. corporate income tax.

The American company can claim a tax credit for the taxes paid to Ireland and the U.S. tax can be deferred under some circumstances, but the ultimate tax burden on the American company is still about three times higher than the tax burden on the Dutch company. Adding insult to injury, America’s international tax rules impose disproportionately heavy compliance costs on U.S. multinationals.

This competitive disadvantage puts American firms in an untenable situation. If U.S.-based companies do nothing, they inevitably will lose market share—which means fewer jobs for American workers and lower returns for American shareholders. Or they can allow themselves to become a subsidiary of a foreign company, which now occurs in 75 percent of cross-border mergers.

What Is the Answer? There are three possible political responses to corporate expatriation:

1. Lawmakers can fix the tax code;
2. They can choose to do nothing; or
3. They can implement fiscal protectionism by prohibiting companies from re-chartering in jurisdictions with better tax laws.

Option #1: Fixing the tax code is the best way of responding to corporate inversions. If lawmakers shifted to a territorial tax system, companies would no longer have any incentive to expatriate. U.S.-based firms could compete on a level playing field with foreign-based companies, and compliance costs would drop significantly. But lawmakers also should reduce the corporate income tax rate. This would substantially improve incentives to create jobs in the United States.

Option #2: Doing nothing is an acceptable option. Bad tax law would still be in place, but companies would be able to sidestep the anti-competitive policy by re-chartering. In effect, expatriation is a “do-it-yourself” form of territorial taxation. Like companies based in many other nations, companies that expatriate would pay just one layer of tax to each nation where profits are earned, including all applicable taxes to the IRS on income earned in America.

Option #3: Some lawmakers want to prohibit companies from expatriating. But fiscal protectionism is the wrong response. High-tax California, for instance, should not be allowed to stop companies from moving to low-tax Nevada, and Vermont should not be able to hinder the flow of businesses to New Hampshire. Barring companies from re-chartering in other jurisdictions is particularly shortsighted, since it condemns U.S. companies to declining market shares and leaves them vulnerable to tax-motivated foreign takeovers.

Conclusion. Corporation bashing may be fashionable, but it is not constructive. Instead of blaming the victim of their poor tax policies, Members of Congress should fix the tax laws that cause companies to expatriate. The United States imposes a higher corporate tax rate than those of Sweden and France, two of the world’s most socialist nations, and it even imposes that burden on income earned in other nations.

If lawmakers choose not to fix the tax code, the best response is inaction. Expatriation helps U.S. workers and shareholders, since the newly formed company still maintains its U.S. operations, but is able to compete more effectively with businesses that operate overseas. Companies that re-charter escape the IRS’s “worldwide” tax system, but they still keep their operating headquarters—and their jobs—in the United States.

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