

Johnson Controls and Inversions: Robert Misesy's Op-Ed Published in Milwaukee Journal Sentinel

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Some people are concerned about the merger of Johnson Controls into Tyco and the inversion resulting in an Irish company owning a U.S. company. Their concerns stem from a misunderstanding of the tax impact of inversions and the motivation of companies to invert.

Inversions simply turn a U.S.-based company into a U.S. subsidiary of a foreign parent. Instead of Johnson Controls being a U.S.-based publicly held company, Johnson Controls will be a U.S. subsidiary of Tyco, a publicly held Irish company.

Contrary to the rhetoric recently seen and heard, inversions do not result in a loss of U.S. taxation of U.S. earnings. Johnson Controls, which would become a U.S. subsidiary, would still pay U.S. tax on its U.S. earnings. An inversion results in the United States only losing the ability to tax a foreign subsidiary's earnings.

Developed countries provide one of two mechanisms to reduce double taxation of dividends received from foreign subsidiaries. Most countries (e.g., Ireland) exempt a foreign subsidiary's dividend from income, resulting in the foreign earnings only incurring tax at the foreign country's presumably lower rate. A small minority of countries (e.g., the United States) impose a complex foreign tax credit system that ultimately results in a dividend of the foreign subsidiary's earnings incurring tax at the U.S. corporate rate of 35%.

Suppose, for example, that Johnson Controls owns UKSub, a United Kingdom subsidiary that pays tax at a 21% rate. If UKSub earns \$100 of income, UKSub will pay \$21 of U.K. tax. When receiving a \$100 dividend from UKSub, Johnson Controls has income of \$100, receives a foreign tax credit of \$21, and pays the residual \$14 to the United States. As a result, UKSub's earnings incur tax at a 35% rate — \$21 to the United Kingdom and \$14 to the United States.

After the merger, Tyco would own UKSub. Accordingly, any dividend Tyco receives from UKSub would be exempt from Irish corporate income tax. UKSub's earnings would still incur tax of \$21 in the United Kingdom. There would not be any additional Irish tax on a dividend that Tyco receives.

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The tax goal of inversions is to avoid the 35% rate on earnings of foreign subsidiaries distributed to U.S. companies. U.S. companies such as Johnson Controls invert because the high U.S. corporate tax rate and the credit system subjects all repatriated foreign earnings to a 35% rate of tax. The merits (or demerits) of the high U.S. tax rate can be argued another day. Nevertheless, if the president were serious about eliminating inversions, he would propose to replace the credit system and its regulations (containing 41 pages of fine print) with an exemption system. A move to an exemption system would provide several benefits.

An exemption system would level the playing field for U.S. companies operating abroad. If a U.S. company were to pay tax at only a 21% rate on earnings of UKSub, just as an Irish company would pay, the U.S. company would be in a better position to compete abroad.

An exemption system would result in greater distributions of cash dividends to the United States. Many U.S. companies are reluctant to take dividends from a foreign subsidiary because the credit system results in tax at the high U.S. rates. As a result, the cash stays abroad in the foreign subsidiary for investment abroad. An exemption system would remove this obstacle to repatriating cash in the form of dividends. An increase in dividends will increase cash available for investment in the United States. An increase in U.S. investment will mean greater economic growth in the United States and additional jobs that this economy desperately needs. Economic growth also would produce additional tax revenues to help balance the budget.

Washington should replace the credit system with an exemption system. Although this will not occur before the November elections, this fix to the Internal Revenue Code should be a high priority during the lame duck season before the end of the year. Meanwhile, we can rest assured that Johnson Controls is not doing any nefarious tax planning — it still will pay U.S. tax on its U.S. earnings.

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