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Revamping corporate tax code would reduce tax "inversions"


By Mark Zandi, August 31, 2014

What do Burger King, Chiquita, the Eaton Corp., and generic drug maker Mylan have in common?

They no longer are or want to be American companies. They have acquired or are acquiring smaller foreign firms, and moving their headquarters abroad.

What gives? Why have so many companies renounced or considered giving up American citizenship? Is it high labor costs, inadequate infrastructure, or regulatory red tape?

The answer is the U.S. corporate tax code. It is a mess. Some companies pay little tax because of loopholes in the code designed just for them. Financial institutions, energy companies, and some manufacturers make out very well.

But less favored companies pay a lot, at least compared with what they would if they were headquartered overseas. The top federal corporate tax rate is 35 percent, and after state and local taxes are added, the rate rises to almost 40 percent.

The average corporate tax rate in other developed countries - our competitors - is closer to 25 percent.

U.S. firms also pay higher taxes on profits they earn overseas when they bring that income home. This is unique: Other developed nations allow their companies to pay the prevailing tax rate in the countries where they earn profits.

Since U.S. multinationals don't want to pay the high U.S. tax rate on their overseas earnings, they park that money abroad. More than $2 trillion in untaxed U.S. corporate profits now reside in foreign bank accounts.

Companies that have considered so-called tax inversions to avoid all this have been labeled unpatriotic. They aren't. Doing what makes most economic sense is actually very American, and is why the U.S. economy is the most productive on the planet.

Both the Obama administration and Republicans in Congress know this a serious problem, and have negotiated sporadically over reforms to the corporate tax code, with no results.

The administration has proposed changing corporate tax law to make it tougher for U.S. companies to invert. Currently, for a company to pull off this change, it needs only shell a 20 percent stake to a foreign firm. Under the proposed change, the foreign firm's shareholders would need to own more than half.

Such a change would curb tax inversions, at least for a while, but would not solve the fundamental economic problem created by our dysfunctional corporate tax code. Only corporate tax reform will do that.

Reform means scaling back or eliminating tax loopholes for specific companies and industries while lowering rates for all. Doing the former would raise enough extra revenue to allow the broader rate to fall to 28 percent. The rate would still be higher than the developed-country average, but it would be close enough.

Reform also means adopting a so-called territorial tax system, allowing U.S. companies to pay less on their foreign earnings. Most countries require only 5 percent or 10 percent.

This kind of reform would end tax inversions and remove the tax code as a factor in corporate location and expansion decisions. It would also mean a onetime tax windfall, as some of the trillions of dollars parked overseas come home. Taxing those at 5 percent would net $100 billion in onetime revenue for the Treasury.

This windfall could be used to reduce the government's deficit, or, even better, provide seed capital for an infrastructure bank. Such a bank could encourage private investment in roads, bridges, air and seaports, telecommunication systems, and other facilities that clearly need upgrading.

Some suggest we should eliminate corporate taxes altogether. While this is a fantasy in Washington's current climate, it is worth pondering.

Corporations don't pay taxes, people do. The cost of any tax is passed on to the people who work for, buy from, and invest in companies. Indeed, we tax owners of corporations twice: First when a company earns profits, then again when that money is paid out to shareholders.

Our tax code tries to correct for this by taxing dividends and capital gains at a lower rate than ordinary personal income. Currently, the top tax rate on dividends and capital gains is about half the top rate on other income.

This encourages all kinds of tax chicanery by high-income taxpayers. Managers of sophisticated financial institutions are particularly adept at making ordinary income look like capital gains, through something called "carried interest." This and other dodges allow the rich to pay at lower tax rates than Warren Buffett's now famous secretary.

A better fix would be to largely eliminate corporate taxes, and tax dividend income and capital gains on stocks at the higher ordinary income rate. U.S. businesses would be more globally competitive, creating more jobs; the Treasury could be made whole, and wealthy households would pay more taxes on their dividends and capital gains.

Eliminating corporate taxes may not be realistic, but the proposal shows how far our corporate tax code is from where it should be. If a political window ever opens in Washington, some form of corporate tax reform should be among the first things that goes through it.

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