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Corporate Taxes

by Bruce Bartlett

U.S. corporate income taxes are among the highest in the world and — unlike most developed countries — the United States imposes them on income earned by corporate subsidiaries in foreign countries. In recent years, an increasing number of American companies have reincorporated abroad to avoid these U.S. taxes. Their actions have been under fire. Many people, including members of Congress, are under the impression that jobs and factories are moving abroad, when in fact corporations are only moving their legal residence for tax purposes — a purely paper transaction. Some members of Congress are also concerned that corporations are evading their "fair share" of U.S. taxes. However, punitively taxing these companies would harm U.S. workers and shareholders by making American companies less competitive.

Corporate Inversions and Foreign Acquisitions. Reincorporating abroad is called a "corporate inversion." In effect, a U.S.-based company establishes a foreign entity, which then buys the U.S. company. In the process, it becomes a foreign-based company with a U.S. subsidiary, instead of the other way around. Another increasingly common transaction is the acquisition of U.S. companies by foreign corporations, which achieves the same tax reductions as inversions:

- About two dozen American companies have reincorporated in such tax havens as Bermuda in recent years.
- According to the U.S. Treasury Department, foreign acquisitions have risen significantly, from $90.9 billion in 1997 to $340 billion in 2000.

As more companies realize that a foreign location — even just a post office box — will save them millions of dollars in taxes, corporate inversions will continue to grow.

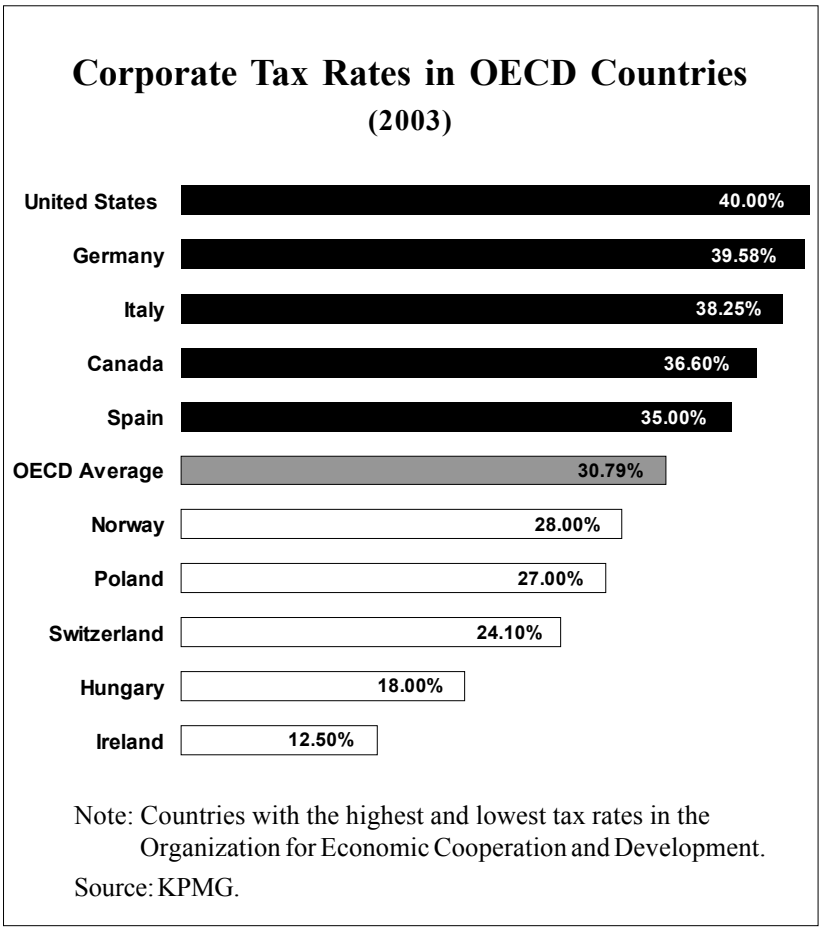
Why Corporate Inversions? There are two types of income tax systems:

- A majority of nations use the "territorial" system of taxation, in which a country taxes income only within its borders.
- The United States' tax system is "worldwide," requiring domestic companies to pay taxes on income earned abroad. Although some countries' tax systems are rooted in a worldwide system, none are as layered or as complex as current U.S. law.

Thus, for example, a territorial company that incorporates in Canada pays taxes only on its operations in Canada. If it has a U.S. subsidiary, the subsidiary pays U.S. taxes on its profits here, but none to Canada. However, due to the U.S. worldwide tax system, the exact same U.S. company with an identical Canadian subsidiary will pay Canadian taxes plus U.S. taxes on its Canadian operations. The U.S. company will pay more total taxes even if the United States and Canada have the same tax rates.

Thus, the U.S. tax system encourages inversions. So do its high tax rates.

Tax Competition. Most attention on inversions has focused on so-called tax havens such as Bermuda, which has no corporate tax at all. However, many



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major countries have corporate tax rates well below the 35 percent federal tax and average state tax of 5 percent. [See the Figure.] Making the U.S. situation even more serious, there is a global trend toward declining corporate tax rates, according to the accounting firm KPMG. This includes countries not typically associated with low tax rates:

- Finland has a corporate tax rate of 29 percent, 11 percentage points below the top U.S. tax rate.
- In Norway, the combined corporate and individual top tax rate on dividends is just 28 percent — less than half the U.S. top rate of 60 percent prior to the recent tax cut.
- The 35 percent U.S. federal corporate tax rate is the fourth highest among the 26 developed countries in the Organization for Economic Cooperation and Development.
- The 40 percent combined average federal-state tax rate is higher than in any other OECD country and significantly higher than the 30 percent average in these developed nations.

The spread is likely to increase if European nations follow the lead of Ireland, which reduced its rate to just 12.5 percent from 16 percent in 2002.

The Cost of Inverting. Inversions are not costless. Shareholders of the original company must, in effect, sell their shares and realize capital gains, which may trigger a tax liability. They then receive new shares in the foreign corporation exactly equal to their old shares. Therefore, although ownership does not change, the inversion process generates tax liabilities for many shareholders.

The tax cost of inversions is probably the major reason why more companies don't do it. The fact that some still do — by a majority vote by shareholders — tells us that the tax savings must be considerable. And indeed they are. A September 2002 National Bureau of Economic Research paper by economists Mihir Desai and James Hines found a significant increase in stock prices for companies announcing inversions. Investors recognize that their after-tax earnings will be higher and bid up stock prices, thereby compensating shareholders for the taxes they incur in the process.

Tax Avoidance, Not Evasion. In the famous 1935 case, *Gregory vs. Helvering*, Judge Learned Hand defended the right of all taxpayers, including corporations, to use all the legal resources at their disposal to pay as little taxes as possible. "Nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions….To demand more in the name of morals is mere cant." By this criterion, corporate inversions are neither illegal nor unethical.

Attempts to close the "loophole" that allows legal corporate inversions will only encourage alternative ways to lower taxes. For example, start-up companies may choose to incorporate abroad and receive the same tax treatment as inverted companies without the stigma of "abandoning" America or the hassle of moving.

State Tax Competition. Competition between taxing jurisdictions occurs within the United States as well as between the United States and foreign countries. U.S. corporations frequently move across state lines for tax purposes. According to the Federation of Tax Administrators (FTA), the top corporate tax rate is 12 percent in the state of Iowa, while nearby Kansas has a rate of just 4 percent. No doubt, over the years, some Iowa companies have reincorporated in Kansas to save 8 percentage points per year in taxes.

Of course, individuals do the same thing. For example, the FTA reports that North Dakota has the highest state income tax rate, at 12 percent, whereas South Dakota has no income tax at all. This may explain why the former's population has been falling, while the latter's has been rising.

Individuals and corporations freely move from one state to another and from one town to another every day, partially in response to different tax burdens in one jurisdiction versus another. Thus tax competition helps restrain domestic as well as international tax rates.

Conclusion. President Bush's original tax plan would have eliminated the double tax on dividends by allowing shareholders to receive them without paying personal income taxes on top of the corporate income tax. This would have significantly reduced the benefit to shareholders from reincorporating abroad. The final tax cut plan cut the top federal income tax rate on dividends from 39 percent to 15 percent, but did not reduce the 35 percent federal corporate income tax.

If laws are passed to prevent inversions by existing companies, start-up companies will find places like Ireland much more hospitable for incorporation in the first place. The best way to curtail the growth of inversions is to eliminate the high corporate tax rates that put U.S. companies at such a competitive disadvantage internationally.

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