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Memo to Senate Permanent Subcommittee on Investigations: US Corporations Already Pay a Low Tax Rate

On July 30th, the Senate Permanent Subcommittee on Investigations (PSI) will hold a hearing on the impact of the U.S. tax code on foreign acquisitions of U.S. businesses. It is likely that Subcommittee Chairman Sen. Rob Portman (R-OH) will use the hearing as an opportunity to make a case for lowering the U.S. corporate tax rate and moving to a territorial tax system in order to make U.S. companies more competitive, as he proposed earlier this month in an international tax reform framework[1] along with Sen. Chuck Schumer (D-NY).

Lawmakers cite the 35 percent federal statutory corporate income tax rate to argue that the United States has an uncompetitive corporate tax system. But discussing the statutory rate in isolation conveniently ignores the fact that copious tax breaks and loopholes allow U.S. companies pay a relatively low effective tax rate compared to corporate tax rates in other developed counties. Furthermore, adopting proposals in the Portman-Schumer framework could effectively give multinational corporations even greater incentive to shift profits offshore.

1. U.S. multinationals pay relatively low effective tax rates.

A 2014 report by Citizens for Tax Justice (CTJ) found that the 288 Fortune 500 companies that were profitable in each year between 2008 and 2012 paid an average effective federal tax rate of just 19.4 percent over the five-year period, with 26 companies paying no federal income tax at all during that time.[2] Among those companies that had significant foreign profits, the effective U.S. tax rate on U.S. profits (including federal and state taxes) was actually 2.7 percentage points lower than the effective foreign tax rate on these companies' foreign profits.

According to 2013 data from the Organization for Economic Cooperation and Development (OECD), U.S. corporate taxes as a percentage of GDP were the eighth lowest among OECD countries, with corporate taxes making up 2 percent of GDP relative to the OECD average of 2.9 percent. [3] Similarly, a 2011 study by Rueven Avi-Yonah and Yaron Lahav found that the largest 100 European Union-based multinationals paid a higher average effective tax rate between 2001 and 2010 than the largest 100 U.S.-based multinationals.[4] This evidence suggests that when considering effective tax rates as opposed to statutory rates, U.S. companies are paying substantially less in taxes compared to most of their major foreign competitors.

2. Claims that the U.S. corporate tax system makes U.S. companies vulnerable to acquisitions by foreign companies are unsupported.

While it is true that there has been an increase in foreign acquisitions of U.S. companies in the past several years, both the volume and the aggregate value of acquisitions are now lower than prior to the recession. According to data from a March 2015 Joint Committee on Taxation (JCT) report, there is no clear trend in the volume or value of acquisitions among the United States and other OECD countries between 2006 and 2014.[5] The dollar value of acquisitions involving a U.S. target and another OECD country in 2014 was $155.7 billion, which is higher than 2013 but still lower than the 2007 high of $181.9 billion. Additionally, the ratio of these acquisitions involving a U.S. target to those involving a U.S. acquirer was higher in 2007 to 2009 than in 2014. These data suggest that there is not a growing problem of foreign acquisitions of U.S. companies.

In contrast, a much publicized report from the corporate-backed Business Roundtable prepared by Ernst and Young concluded that the U.S. corporate tax rate and its worldwide system of taxation put U.S. companies at a substantial disadvantage in the market for cross-border mergers and acquisitions.[6] The report suggests that lowering the U.S. corporate rate to 25 percent or switching to a territorial system would have resulted in a net shift of $769 billion in assets from foreign countries to the U.S. However, the report has major methodological issues. First, the analysis used inflated estimates of the effective average tax rates for U.S. companies, leading the report to claim that the average effective rate is essentially the same as the statutory rate, which as discussed above is false. Second, the estimate of the benefits of lowering the U.S. corporate rate only considers the effect of a reduction in the tax rate and does not take into account the effects of the offsetting tax increases required to pay for the rate reduction.

Edward Kleinbard, former JCT Chief of Staff and current professor at the USC School of Law, has rejected the argument that the recent wave of corporate inversions is evidence of the anti-competitive effects of the U.S. tax system.[7] He uses as an example the account provided by former vice chair and CFO of Emerson Electric Co. Walter Galvin that Emerson lost in its efforts to acquire American Power Conversion Corp. because its French competitor was able to offer a higher bid due to the advantages of the French system of taxing multinationals. Kleinbard points out that in reality, the French company would have had no real tax advantage in the deal. Emerson's competitiveness argument is further compromised by the fact that several years later, Emerson won a bid to acquire a UK-based firm against a company based in Switzerland, one of the world's most popular tax havens.

3. The Portman-Schumer international tax reform framework will further erode the U.S. tax base and encourage more profit-shifting out of the U.S.

The report of the International Tax Teform Working Group, chaired by Sens. Portman and Schumer, cites the need for the United States to update its system of taxing multinationals to allow U.S. companies to remain competitive in the global marketplace. Allegedly in the interest of this goal, the report proposes a transition to a territorial tax system where corporations are only taxed on the income earned inside the U.S. It also proposes a one-time "deemed repatriation" on

accumulated offshore earnings at a reduced rate and the creation of a "patent box" regime,[8] which would allow companies a lower tax rate on income generated by intellectual property.

In a territorial tax system, companies would have more of an incentive to move earnings offshore to avoid paying U.S. taxes. This could involve moving operations offshore, which would be detrimental to domestic job creation, or it could simply involve companies disguising U.S. income as foreign income thereby eroding the U.S. tax base. Research conducted by Kevin Markle at the University of Iowa found that between 2004 and 2008, multinationals based in countries with territorial systems engaged in more income shifting than those based in countries with worldwide tax systems.[9] Allowing multinationals to completely avoid U.S. taxes on their "foreign" income puts purely domestic companies at a disadvantage relative to multinationals. As the competitiveness narrative has focused primarily on competition between U.S. and foreign multinationals, this second type of competition is largely ignored.

The Portman-Schumer framework also includes a one-time tax on the accumulated offshore profits as part of a transition to the territorial system, which would be at an unspecified rate far below the current statutory corporate rate (President Obama's 2016 Budget proposed a 14 percent rate, while former House Ways and Means Committee Chairman Dave Camp proposed an 8.75 percent rate).[10] This "deemed repatriation" tax is meant to address the estimated $2.1 trillion[11] in tax-deferred earnings that U.S. multinationals are currently holding offshore, but taxing these earnings at a lower rate rewards those companies that have engaged in the most aggressive tax-motivated income shifting.

4. Congress should end the deferral of tax on foreign income and step up efforts to curb base erosion and profit shifting.

Whereas moving to a territorial tax system would exacerbate the problem of offshore profit shifting, ending the policy of allowing multinationals to defer paying taxes on their foreign income until it is repatriated would eliminate this incentive since they would be taxed on their worldwide income as it is earned.[12] Ending deferral may also encourage low- and no-tax countries to increase their corporate tax rates, because they would no longer be able to benefit from U.S. multinationals looking to shelter their income.

Additionally, the U.S. should fully engage in cooperative efforts to curtail harmful international tax competition, like the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project, instead of implementing changes that will make these problems worse. While its proposed reforms should be stronger, the BEPS project has the potential to substantially reduce the damaging tax competition that hurts countries throughout the world.[13]

Congress should also enact reforms to address the problem of tax-avoidance-seeking inversions and foreign acquisitions. First, the tax code should be modified so that inverted companies are treated as American for tax purposes as long as the shareholders of the previous U.S. company own at least a majority share of the new company. In other words, the current 80 percent ownership threshold should be reduced to 50 percent. Second, action should be taken to limit earnings stripping, where the American company (now a subsidiary of the new foreign parent

company) takes out loans from the foreign parent and then deducts the interest to reduce U.S. tax liability. This can be accomplished by placing limitations on the amounts of interest that can be deducted. Third, Section 956 of the tax code needs to be tightened to prevent inverted companies from avoiding tax on the profits of offshore subsidiaries that are repatriated to the U.S. Currently, these offshore subsidiaries can loan their accumulated earnings to the new foreign parent company, which can then invest that money in the company's U.S. operations without being subject to U.S. tax. A 2014 CTJ report explains more thoroughly these three issues related to corporate inversions and the actions Congress can take to address them.[14]

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