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Obama blocks corporate tax 'inversions' spawned by high rates

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WASHINGTON – The question at the heart of President Barack Obama's recent directive ordering the Treasury Department to pump the brakes on U.S. companies gobbling up smaller foreign businesses to take advantage of a friendlier overseas corporate tax climate is whether America's corporate tax rate is too high.

For those who may have missed the news, Obama last week effectively killed a $160 billion merger involving New York-based pharmaceutical giant Pfizer, which had agreed to buy Dublin-based Allergan. The transaction would have let Pfizer move its legal domicile from the U.S., home to a 35 percent corporate tax, to Ireland and that nation's 12.5 percent tax rate.

"This directly goes at what's called corporate inversions," Obama said last week during a White House briefing. "Simply put, in layman's terms, it's when big corporations acquire small companies, and then change their address to another country on paper in order to get out of paying their fair share of taxes here at home.

"When companies exploit loopholes like this, it makes it harder to invest in the things that are going to keep America's economy going strong for future generations – it sticks the rest of us with the tab – and it makes hard-working Americans feel like the deck is stacked against them," the president said.

The destroyed deal also resulted in Pfizer having to fork over $150 million to Allergan to cover its deal-related expenses, the Associated Press reported.

Last week's episode marks the third time the Obama administration has tried to clamp down on the tax-dodging strategy. In September 2014, Obama tightened inversion rules but as the Wall Street Journal pointed out, six companies still managed to find ways to execute deals, compared with the nine successful inversions completed before the rule changes.

Obama directed the Treasury Department to enact another new set of rules governing inversions in November 2015.

Yet the Journal also pointed out that foreign acquisitions of U.S. companies – which can produce the same benefits as inversions for their new owners – exceeded $379 billion in value in 2015 alone, more than twice the amount of tax savings generated that year by so-called inversion deals.

Last week's technical changes in the rules regulating inversions were strong enough to erase most or all of the benefits expected from the Pfizer-Allergan deal, and may reduce future deals designed based on the tax advantages, according to a Treasury Department statement.

The maneuver thrust U.S. corporate tax policy back into the spotlight. Both conservative and liberal analysts cite the loophole-riddled tax code as a major reason that inversions were created in the first place, but there is little agreement over whether the 35 percent nominal corporate tax rate is too high.

The simple fact is that the 35 percent federal tax rate on corporate profit isn't the end of the story, since for many the real tax level checks in at 39 percent after state levies are included, according to Organization for Economic Cooperation and Development figures for 2015.

The 39 percent rate makes U.S. corporations the most heavily taxed in the developed world.

But a study from the left-leaning Citizens for Tax Justice, completed between 2008 and 2012, shows that "many corporations pay far less, or nothing at all, because of the many tax loopholes and special breaks they enjoy" in the U.S. tax code. The study claims that 288 of Fortune 500 companies "paid an effective federal income tax rate of just 19.4 percent over the five-year period."

The study caught the eye of progressive lawmakers like Massachusetts Sen. Elizabeth Warren. In a National Press Club speech in November, the Cambridge Democrat frequently referred to the report.

"So what's the problem with our corporate tax code?" Warren asked in the speech. "It's not that taxes are far too high for giant corporations, as the lobbyists claim. No, the problem is that the revenue generated from corporate taxes is too low."

Not so, says Daniel Mitchell, a senior tax reform fellow at the libertarian Cato Institute, a public-policy think-tank in Washington. In 2014, Mitchell theorized that the high American corporate tax rate is only part of the reason why companies are increasingly looking to flee to countries such as Ireland.

Mitchell pointed out that the U.S. relies on a "worldwide" tax system, meaning that American companies doing business overseas must pay taxes on income earned abroad, minus any levies paid to host nations.

This means that an American company competing for business in a country like Ireland, while already paying that country's 12.5 percent tax, must also "declare that same income on its U.S. tax return and pay an additional layer of tax to the IRS," Mitchell wrote.

Countries that are based on a "territorial" tax system have a distinct advantage in that they pay the local tax and do not have to pay an additional tax to their native country on earnings from operations abroad.

Mitchell points out that American companies can "defer" or postpone paying that extra layer of tax but the practice means that they must keep the money earned out of the U.S. an amount estimated at around $2 trillion at the time. Apple, for instance, reportedly has $100 billion in profits stashed abroad.

Economists argue that this represents a significant loss to America's productive capacity, as the capital kept offshore can't be used to invest in additional production facilities at home. The uninvested money means fewer American jobs are created, for instance.

Obama has previously called on Congress to enact a tax on profits held overseas, without success. Last week, he focused in the news briefing on urging Congress to act to shut off inversions for good.

"While the Treasury Department actions will make it more difficult and less lucrative for companies to exploit this particular corporate inversions loophole, only Congress can close it for good," Obama said.

He later blasted "Republicans in Congress" for their inability to act and described the loopholes as "insidious."

But congressional leaders told the Associated Press last week that what is really needed is a complete overhaul of the corporate tax code which is unlikely this year.

"We really need to scrub the whole code," Senate Majority Leader Mitch McConnell, (R-Ky.), told reporters on Tuesday, AP said. "The chances of doing a tax reform this year are pretty slim."