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US taxes are far too high – no wonder companies are fleeing

The fact is, America has the highest corporate tax rate in the developed world

By Daniel J Mitchell
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Many politicians in Washington are angry that some American companies are redomiciling in the UK, Canada and elsewhere. These "inversions" generally occur as a result of mergers with foreign firms, with tax being a big reason why the non-US company winds up as the "parent" firm in the new union. This is what Pfizer was attempting with AstraZeneca, for example.

So what is it about the American business tax regime that makes it so attractive for companies to give up their corporate citizenship?

There are two factors driving the new wave of inversions.

First, the United States has the highest corporate tax rate in the developed world (and the highest in the entire world, according to KPMG, if you ignore the United Arab Emirates' severance tax on oil companies).

How high? The central government in Washington imposes a 35pc rate on corporate income, with most states then adding their own levies, with the net result being an average corporate rate of 39.1pc. This compares with 37pc in Japan, which has the dubious honour of being in second place, according to the tax database of the Organisation for Economic Co-operation and Development (OECD). Other G7 nations have even lower tax rates on businesses, with the United Kingdom being the most competitive of that group, with a rate of 21pc and falling.

And if you broaden the analysis, it becomes even more evident that the United States has fallen behind in the global shift to more competitive corporate tax systems. The average corporate tax for OECD nations has dropped to 24.8pc. For EU nations, the

average corporate tax is even lower, with a rate of less than 22pc. And don't forget the Asian Tiger economies, with Singapore, Taiwan and Hong Kong all clustered around 17pc, as well as the fiscal paradises that don't impose any corporate income tax, such as Bermuda and the Cayman Islands.

But America's onerous corporate tax rate is only part of the reason why companies are seeking greener pastures.

The second factor driving inversions is America's "worldwide" tax system. Unlike the "territorial" systems in most other nations, the US tax code requires American-domiciled companies to pay tax on income earned (and already subject to tax) in other nations.

Consider what this means. Let's imagine that an American company is competing for business in the United Kingdom against a local firm, a Canadian firm and a Dutch firm. All the companies have to pay a 21pc tax to HMRC on their UK-sourced income, but the American company then has to declare that same income on its US tax return and pay an additional layer of tax to the Internal Revenue Service (IRS).

This might not be a major problem if the corporate income tax rate in America was reasonable but that's obviously not the case, so worldwide taxation puts the American company at a significant competitive disadvantage, not only against the UK-based firm, but also against the other two companies, since Canada and the Netherlands maintain territorial tax systems for their businesses.

The US company does get a credit for taxes paid to the UK government, so the combined tax paid to HMRC and the IRS theoretically doesn't climb above the American tax rate, but this merely limits the additional tax penalty.

American companies also have the ability to postpone the extra layer of tax in some instances, but this policy of "deferral" requires them to keep money overseas (and with multinational firms sitting on nearly $2 trillion of unrepatriated earnings, this is not a trivial issue).

But it gets worse. High tax rates and worldwide taxation may be the most noticeable warts on the American tax code, but the entire internal revenue code is a convoluted and punitive mess.

A study by German economists ranked the United States 94 out of 100 nations for overall "business tax attractiveness", behind countries such as Pakistan, Greece, Russia and Nigeria.

Given these bad policies – a high tax rate and a worldwide tax system – imagine you are a major investor in, or senior manager of, an American-domiciled company that competes in global markets. If you can somehow take your corporate charter (and thus your legal HQ) out of a filing cabinet in the United States (most likely in Delaware) and shift it to a filing cabinet in a nation with better tax policy, that one step can

substantially benefit shareholders, with secondary benefits for employees and customers. Hence that's why US firms are buying foreign ones and then relocating themselves abroad. It's important, however, to understand that there are limits to what an inversion can achieve. No matter where a company redomiciles, for instance, that doesn't change the fact that it will still owe tax to the IRS on US-sourced income. But no longer having to pay tax on non-US-sourced income is more than enough reason to consider a new home.

The motive to invert is especially strong since other nations are engaged in a tax competition-fuelled shift to better tax policy. With each passing year, more nations reduce their corporate tax rates and shift further in the direction of territorial taxation.

In the United States, however, there is no reasonable hope in the near future for pro-growth reform. Indeed, the Obama administration has actually proposed to make the system even less competitive by curtailing deferral. This would mean immediate application of worldwide tax on the foreign-sourced income of US-domiciled firms.

Some on the left hold out hope that anti-tax competition campaigns from the European Commission and the Paris-based OECD will "solve" the problem. But the EU has been trying for decades to harmonise corporate tax rates with no success, while the OECD's more limited "base erosion and profit shifting" initiative hasn't gained much traction.

So it's reasonable to assume that tax policy outside America will continue to improve, which means the incentive for inversions will grow. Unless, of course, American policymakers may impose protectionist policies to hinder the mobility of American companies.

Could that happen? There are two options. President Obama is threatening to change the law unilaterally, something he's already done several times with "Obamacare".

The affected companies almost certainly would challenge that kind of extra-legal step and it's quite likely that the courts eventually would slap down the White House. In the interim, though, the number of inversions presumably would slow to a trickle.

It's also possible that Congress and the President might agree on a legislative response. That seems improbable, since Republicans control the House of Representatives and support territorial taxation and a lower corporate tax rate, which makes any compromise with Obama seem unlikely.

But this is where politics may play a role. Voters don't like inversions because of misguided assumptions that companies are evading tax and moving jobs out of the country. So Republican politicians may decide to support bad policy for short-run political gain, which is what they did last decade in response to an earlier wave of inversions.

Blocking inversions, though, is like breaking the thermometer because you don't like the temperature. It simply masks the underlying problem. In the long run, the United States

will lose jobs and investment because of bad corporate tax policy, regardless of whether companies have the right to invert.

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