Corporate Taxes

Corporate taxes have been in the news recently due to inversions — deals that allow American companies to relocate their headquarters to lower their tax bills. Since 2012, 20 companies have reincorporated in low-tax countries. The most recent is Pfiser, who has agreed to combine with Allegran, based in Ireland.

A related issue is earnings stripping. After a company completes an inversion deal and moves its headquarters for tax purposes outside the United States, the now-foreign company still has operations in the United States. The company arranges for the United States part of its operation to borrow large amounts from the now-foreign parent. The indebted American subsidy will pay interest on the debt to the parent and, under United States tax code, the interest payment can be used to offset the American earnings.

The issue of corporate inversion is one of tax arbitrage, an investment strategy that attempts to profit by exploiting the price differences between tax rates or systems.

The U.S. has the highest marginal corporate tax rate at 35 percent, and state taxes bring the rate to 40 percent. In contrast, the rate in Ireland is 12.5 percent, and the E.U. average is 22 percent. Tax arbitrage also exists in the personal income tax code when different forms of income are taxed at different rates, e.g. capital gains and earned income. The larger the gap between the two rates, the greater the incentive to reclassify earned income as a capital gain, e.g. carried interest.

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The corporate tax is the most inefficient and least defensible of all taxes. The central problem with the corporate income tax is that, ultimately, only people can pay taxes. The burden of the corporate income tax, over time, shifts to workers. With a smaller capital stock to employ, workers are less productive and earn lower real wages. Corporate capital investment has been lagging during the economic recovery and is one reason why productivity and wage growth are low.

Corporate taxation, with its large number of deductions and complexity, distorts the U.S. economy because resources are misallocated. This causes inefficiency as economic activity shifts away from its most valuable opportunities based on tax rates. The average tax rates vary widely by sector, due to the ability of industries to take advantage of preferences embedded in the tax code by Congress.

Enormous disparity in effective marginal tax rates across industries creates economic distortions and inefficiency — reducing economic growth. Tax reform that removes loopholes will improve economic efficiency.

The corporate tax code harms the economy in a number of other ways, including:

- Decreasing the incentive for businesses to invest because it taxes income from capital.
- Increasing the incentive for businesses to organize as sole proprietorships or partnerships, which are not taxed.
- Increasing the incentive for businesses to raise capital by borrowing (debt) versus selling shares, since interest on the debt is tax deductible.
- Biasing some types of capital investments over others because of depreciation rules that allow companies to spread tax deductions for capital assets over its life span.
- Finally, the complexity of the tax code requires businesses to spend large sums of money on tax compliance and planning.

Corporate tax reform is likely when the new Congress and president take office in 2017. The outlines of corporate tax reform may include:

- Reducing the general corporate rate to 20-28 percent.
- Eliminating most of the tax expenditures (special preferences) for businesses.
- Adopting a territorial tax system (taxes domestic income but not foreign income).
- Diminishing the tax code's bias toward debt financing.
- Moderating tax arbitrage by using the principle that firms engaged in similar activities should be taxed at similar rates.

These measures will improve economic efficiency and economic growth. *

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