How To Stop Corporations From Fleeing U.S. Tax Laws

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Abstract

In a contribution to the *Wall Street Journal's MarketWatch Inc.*, Eric Toder explains why corporations expatriate from the United States. He argues that provisions to stop the current wave of these transactions will provide only temporary relief unless Congress addresses fundamental flaws in the way we tax corporate income and mentions two options for fundamental reform.

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How to stop corporations from fleeing the U.S. tax laws
by Eric Toder

Recently, there has been a surge of corporate expatriation transactions in which a U.S.-resident multinational corporation combines with a smaller foreign business to become a foreign-based company. Examples include Mylan Laboratories (MYL), Medtronic (MDT), and AbbVie (AABV).

Instead of a U.S. company owning a foreign subsidiary, now a foreign-based company owns the U.S. company. (For this reason, this type of transaction has been called an inversion.) Often, this restructuring does not shift the company's production, employment, sales, or even management. And it has little to do with where the shareholders of the corporate group live. But it can substantially reduce the firm's tax liability.

Here's why they expatriate.

All companies, whether U.S.- or foreign-based, owe tax on the income they earn in the United States. U.S. firms also must pay U.S. tax on their overseas profits (with a credit for any foreign income taxes paid) when the profits are repatriated through dividends to the U.S. parent company. Special rules limit the ability of U.S. firms to strip the U.S. income base and defer tax on overseas profits by taxing some types of this income as it is earned.

Expatriation removes the U.S. tax on the foreign-source income of foreign businesses under the new foreign parent company. The foreign parent no longer pays taxes on the foreign profits it repatriates to the United States, whether they are invested in plant and equipment or paid out in dividends to shareholders. The foreign parent also escapes rules that limit the ability of U.S.-based firms to shift reported profits to their affiliates in tax havens. U.S. firms have become skilled at shifting reported profits to low-tax countries, but they may be able to do it even more easily as foreign-based companies.

The Obama administration has proposed several new measures to stop these expatriations. If approved by Congress, these changes could stop the current wave of expatriation deals, just as previous measures have stopped earlier waves.

But until Congress addresses the more fundamental problems, creative corporate tax planners will figure out new ways for their clients to escape U.S.-residence taxation.

What can be done? For starters, we need to recognize that taxation based on corporate residence is unsustainable. Multinational companies have investments, employees, sales, and shareholders throughout the world. Their place of tax residence is increasingly a legal construct with no real economic meaning. We cannot sustain a system that penalizes companies simply for having a tax residence in the United States.

We could follow our major trading partners and go to a territorial system that taxes corporate income based only on where it is earned, but this system has problems of its own.

Today, an increasing share of corporate profits comes from intangible assets such as patents and brand reputation that are not specific to any location. Companies have become skilled at shifting the profits they attribute to these intangibles to low-tax locations. A territorial system would reduce the incentive to expatriate, but only at the cost of giving up the revenue that U.S. residence rules protect.

Instead of a fruitless quest to stop specific transactions, we need to consider more fundamental changes in our corporate tax system.

In a recent article, Alan Viard of the American Enterprise Institute and I proposed two reforms that would sidestep the problems of taxing corporations based on their residence and where they report profits.

One approach would seek agreement with other advanced economies on how to divide up the taxable profits of multinationals. Another would replace the corporate tax with taxation as ordinary income of capital gains and dividends of U.S. shareholders in publicly traded corporations. Such a levy would tax annual changes in share values, not just gains received from the sale of stocks.

Yes, Congress can stop the current wave of corporate expatriations and delay the erosion of the U.S. corporate tax base. But unless we address the core problems with how we tax the income of multinational corporations, the relief will be temporary.

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- Eric Toder

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