Controversy over tax maneuver might help spur reforms, professor says

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In recent years, a number of U.S.-based corporations with significant international holdings have shifted their headquarters overseas in an attempt to lower their tax bills. At 35 percent, the U.S. nominal corporate tax rate is highest among member nations in the Organization for Economic Cooperation and Development (OECD).

The maneuver is known as tax inversion. Officials in the Obama administration have described it as unpatriotic, and are weighing an executive action aimed at limiting the economic benefit.

Harvard Business School's Mihir Desai is an expert on tax policy, international finance, and corporate finance. His work has explored the design of tax policy in a globalized setting, the links between corporate governance and taxation, and the internal capital markets of multinational firms. Desai, the Mizuho Financial Group Professor of Finance, is also a professor at Harvard Law School, and a research associate in the public economics and corporate finance program of the National Bureau of Economic Research.

Desai spoke with the Gazette via email about the factors driving the practice of tax inversion, and also provided links to research around the topic.

GAZETTE: What is a tax inversion?

DESAI: "Simple" inversion involves taking a typical corporate structure and inverting it—a U.S. parent company and its subsidiary in a low-tax jurisdiction switch positions. Such a transaction largely leaves U.S. operations and foreign operations unchanged, but changes the nationality of the parent company. Such transactions can have two tax-related benefits. First, the U.S. employs a worldwide tax system on its citizens and corporations so that income earned globally is subject to tax, after credits for foreign taxes paid, in the U.S. As such, an inversion promises to remove future non-U.S. income from U.S. taxing jurisdiction so that foreign income only faces local taxes. Second, the new transaction may enable corporations to remove income from the U.S. more readily than they did before, via intracompany financings. In a study of the initial wave of these transactions co-authored with Jim Hines, we found that both motives were operative.

The more recent spate of these inversions (PDF) is more complex and more substantive. After the enactment of anti-inversion legislation in 2004, corporations must find a foreign partner with an appropriate domicile and merge with them, in the process changing their domicile to the partner's domicile, in order to access these benefits. Recent transactions have involved some of our largest companies, reflecting the growing incentives to undertake such transactions.

GAZETTE: What is spurring the trend in inversions? The New York Times reported that 22 companies have announced an inversion since 2011, why?

DESAI: The growing frequency and magnitude of these transactions are a manifestation of the changing incentives facing U.S. corporations. On two critical dimensions, the U.S. corporate tax regime is a significant outlier—we employ a worldwide regime and our statutory rate is amongst the highest in the OECD. In the last five years, our exceptionalism has become more pronounced as the U.K. and Japan switched away from a worldwide system. The U.K. cut their rate by 10 points and the third quiver of Abenomics features corporate rate reductions. In short, the rest of the world has moved significantly to lower their rates and moved away from the worldwide regime while we haven't. Aside from these policy changes, there are secular changes in the nature of global firms which also drive these transactions. For example, non-U.S. markets are more important than ever and firms employ more intellectual property (which can easily be relocated) than before. Finally, corporations have figured out how (PDF) to splinter their headquarter functions across multiple jurisdictions, ensuring that they can have many homes.

These transactions are just the most visible manifestation of these underlying changes. Our current corporate tax regime has led to distortions throughout the incorporation, investment, and financing decisions of corporations. First, U.S. corporations have enormous cash balances that are largely overseas (because taxes are only due upon repatriation), locking out funds that could be used for domestic investment. Second, U.S. corporations become targets of mergers that are motivated by relocation incentives, increasing the possibility that higher-wage headquarter jobs are relocated. Third, enormous resources are directed toward non-value-creating tax arbitrage activities. And entrepreneurs and venture capitalists can anticipate the burden of being a U.S. corporation and exercise their flexibility at inception to avoid these consequences.

Most importantly, the incentive to invest in the U.S. is reduced. Given that rising wages for American workers is the clear economic priority today, reforming this system to encourage more domestic investment, which makes our workers more productive, is the most important policy priority. While it tempting to characterize corporate tax reform as a sop to big business, we know that the burden of the corporate tax is borne by shareholders, workers, or customers. And much of the available evidence points to the majority of the burden being borne by workers, a result that is intuitive when one compares the relative mobility of capital, labor, and products. The excellent work done by my colleagues Michael Porter and Jan Rivkin on U.S. competitiveness also highlights how important tax reform is to advancing the desirability of the U.S. as a destination for investment.

GAZETTE: How does what companies in developing nations pay in taxes actually compare to what companies pay in the United States? Is it accurate to say that the United States has the world's highest corporate tax rate?

DESAI: The current system is the worst of all worlds—we have a very high statutory rate (the rate faced by the last dollar of profit) by comparison to the OECD and an average rate (the rate reflecting taxes paid relative to income) that is within the norm of the OECD. The high statutory rate leads to perverse income relocation incentives and can distort investment decisions on the margin while we actually collect amounts that are significantly less than promised by those statutory rates. Similarly, we employ a worldwide regime that is byzantine in its complexity, but we actually raise little revenue from it. Other than allowing for dueling political rhetoric that is somewhat grounded in fact—e.g., "U.S. corporations face some of the highest (lowest) rates in the world"—this system has no winners.

GAZETTE: President Obama has called companies that use inversion "unpatriotic." Could you envision a type of backlash against these corporations by U.S. consumers?

DESAI: While I share the frustration over these transactions, the use of the term "unpatriotic" always makes me cringe, given its historic use. Jawboning them into staying may well be effective in the short run, particularly for consumer-facing companies. But, it does little for improving the underlying situation more broadly.

The political turn that is required is the one that occurred in the U.K., where the departure of several corporations led to significant reform founded on the idea that firms that succeed globally are a source of national economic well-being. Being home to such companies has important economic benefits and, moreover, penalizing their foreign operations is not consistent with the economic facts. In work co-authored with Fritz Foley and Jim Hines, we show that firms expanding abroad also expand domestically, undercutting the common intuition that global expansion by firms comes at the expense of domestic interests. While there will always be examples of harm done to domestic interests, it does not appear to be the case on average, and indeed, one can quickly intuit why working for a globally successful company (or university, for that matter) expands the opportunity set of workers and managers. Domestic headquarters, R&D activity, and export activity can all benefit from firms that are flourishing abroad. So the broader political issue (PDF) is to avoid a new form of protectionism and to embrace the idea that being home to globally successful organizations is a good thing.

GAZETTE: Can you foresee reforms to address these issues? What kind of corporate tax reform would be desirable?

DESAI: In the very short run, there will be a great temptation to pass legislation that targets these specific transactions by disallowing mergers unless the foreign partner is much larger and/or the resulting merged entity is managed abroad. As I indicated in recent testimony (PDF) to the Senate Finance Committee, such efforts give rise to unintended consequences. By "increasing the bar" on the transactions that will qualify as mergers, such laws—as with the anti-inversion legislation in 2004—may simply lead to more substantive transactions with consequences that are adverse to American interests. Additionally, my colleague Steve Shay has suggested there are regulatory actions that one could take without legislation that would help, particularly toward the threat of our tax base eroding.

There is a fair amount of consensus about where we should end up, so I'm optimistic that we're close to significant reform. It is important to acknowledge that the better long-run solution is a movement to a consumption tax base with progressivity implemented in a variety of ways, à la the Graetz Plan (PDF). Given current political realities, my proposed changes stay within the frame of the current corporate tax and are revenue-neutral.

First, switch to a simple territorial regime (where income only faces local taxes) from the current worldwide regime. As described above, the current system is generating little revenue and causing numerous distortions. Moreover, taxing only profits earned within one's borders, rather than globally, has a sound theoretical justification. Worldwide regimes with credits for foreign taxes paid were historically motivated by the intuition that foreign direct investment involves one-for-one substitution between domestic and foreign destinations and that productivity differences across firms don't exist. Under these conditions, a worldwide regime ensures that investment is only guided by pretax factors. In fact, several decades of scholarship on multinational firms has highlighted that heterogeneity in firm productivity is central and the research mentioned above suggests that foreign and domestic activity can be complementary. With these conditions, it becomes much more desirable that tax systems leave the identity of owners unchanged to ensure that the most productive firms flourish, a result ensured if local taxes are the only taxes faced by firms. Efforts to incorporate alternative minimum taxes within territorial regimes should be avoided as they are effectively backdoors to a worldwide system.

Second, drop the corporate rate to 16 to 18 percent to ensure that we are within the norm of OECD rates for the foreseeable future. Such a reduction will sharply limit unproductive profit relocation activity motivated by large statutory rate differences. Of course, these first two changes will cost us tax revenue. The corporate tax is not a great tax relative to other fiscal tools, but I still think it's important to fund these changes within the context of business income. Two additional changes will accomplish that in a productive way.

Third, corporations that pay the corporate tax (so-called C-Corps) now represent less than half of all business income, down from over 80 percent in the late 1980s. There has been tremendous growth in pass-through entities as legal and financial engineers have figured out ways a) to shoehorn partnerships into the requirements for publicly listed companies and b) to divide corporate income into operating income and property income to avail themselves of pass-through entities. As a result, corporate taxes are increasingly paid only by publicly listed multinational companies and there is a large untaxed business base. Charging a relative modest tax on these entities would level the playing field across organizational forms and raise considerable revenue.

Fourth, aligning the way firms report profits to capital markets and tax authorities would both raise considerable revenue and restore credibility to the corporate tax system. We have a parallel universe for reporting profits to tax authorities which, unsurprisingly, means that it is not uncommon for some of our best-known firms to routinely report large profits to capital markets while reporting limited profitability to tax authorities. Ultimately, the economic position of shareholders and tax authorities are the same—they are claimants on pretax corporate profits. Ensuring a relatively common notion of profits that piggybacks on the considerable advances made by the accounting profession will raise revenue and make it less likely that corporations are seen to be paying limited taxes while reporting considerable profits to shareholders.

As I said, I'm optimistic—these inversion transactions will hopefully highlight just how broken things are and that's the first step in getting to a better system.

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