Insight

Tax-Based Inversions: What is at Stake?

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Introduction

Pfizer's potential acquisition of AstraZeneca, and its subsequent plans to become a U.K.–domiciled concern has drawn considerable attention to the idea of "inversions" and the role of U.S. international tax rules. The current tax code incentivizes corporate flight from America and the tax minimization strategy outlined by Pfizer. In the absence of meaningful tax reform, the U.S. is at risk of losing 15 percent, or $988 billion, of the equity represented by major U.S.–based industries.

U.S. Corporation Taxation

The United States has the highest corporate tax rate among all major developed economies. The U.S. corporate tax rate is largely unchanged since 1986, when a significant rate reduction was enacted.[1] Prior to 1986, the U.S. levied corporate taxes in excess of the Organization for Economic Cooperation and Development (OECD) average. By 1988, when the 1986 reform was fully implemented, the combined U.S. statutory rate had fallen below the OECD average. It has since become an international anomaly.

While statutory tax rates are critical to firm investment decisions, other measures of corporate taxation also warrant consideration.[2] A firm's *effective* tax rate includes other facets of the corporate tax code, such as credits and deductions, which figure in the determination of a firm's tax burden. While less stark than top statutory rates, an international comparison of effective corporate rates still paints the U.S. in an unfavorable light. According to a study by PricewaterhouseCoopers, "companies headquartered in the United States faced an average effective tax rate of 27.7 percent compared to a rate of 19.5 percent for their foreign-headquartered counterparts. By country, U.S.-headquartered companies faced a higher worldwide effective tax rate than their counterparts headquartered in 53 of the 58 foreign countries."[3]

The United States fails another competitiveness test in the design of its international tax system. The U.S. corporation income tax applies to the worldwide earnings of U.S. headquartered firms. U.S. companies pay U.S. income taxes on income earned both domestically and abroad, although the U.S. allows a foreign tax credit up to the U.S. tax liability for taxes paid to foreign governments. Active income earned in foreign countries is generally only subject to U.S. income tax once it is repatriated, giving an incentive for companies to reinvest earnings anywhere but the U.S., owing to its high corporate tax rate.

This system distorts the international behavior of U.S. firms and essentially traps foreign earnings – such as the $30 billion in cash that Pfizer has kept abroad – that might otherwise be repatriated back to the U.S.

While the U.S. has maintained an international tax system that disadvantages U.S. firms competing abroad, many U.S. trading partners have shifted toward a territorial system; that system exempts entirely, or to a large degree, foreign source income. Of the 34 economies in the OECD for example, 26 have adopted such systems, including recent adoption by Japan and the United Kingdom.[4]

Taxes and Inversions

Maintaining the U.S. worldwide system in compounds the incentive for firms to keep earnings offshore in the face of high domestic rates. The combination of high rates and an increasingly outmoded worldwide tax system disadvantages U.S. firms abroad, where market opportunities are growing. In addition, as shown by Pfizer and AstraZeneca, these features of the U.S. tax code incentivize the reincorporation of a company abroad for the purposes of tax minimization. Inversions are part of a merger or acquisition. Under current law, a company can reincorporate abroad if foreign stockholders own 20 percent of the new corporate entity. According to news reports, the latest offer from Pfizer is worth $119 billion and is split 45/55 percent between cash and stock.[5]

Tax considerations were explicitly mentioned as a key rationale for Pfizer's attempt to reincorporate overseas through its acquisition of AstraZeneca. It is only the most visible and recent drug makers to begin to move overseas.[6] Given the failure to enact comprehensive tax reform, the tax incentive to move overseas persists, particularly industries with more fluid capital.

A review of the top U.S. companies (including Pfizer) reveals the magnitude of equity that could follow in Pfizer's wake – over $6.7 trillion.

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One recent estimate on the macro-economic effects of fundamental tax reform, authored by John Diamond and George Zodrow, examined how Chairman Camp's draft bill would affect capital flows compared to current law.[7] In the long-run, the authors estimated that a Camp-style reform that lowered corporate rates and moved to an internationally competitive divided-exemption system would *increase* U.S. holdings of firm-specific capital by 23.5 percent, while the net change in domestic ordinary capital would be a 5 percent increase. It is important to note that these are relative measurements – they are relative to current law. Current law is inducing capital flight (see Pfizer). Moreover, to the extent that the rest of the world has reduced its corporate rates and moved to a territorial system, a Camp-style reform may merely move the U.S. to the middle of the pack in terms of its tax climate. Accordingly, the 23.5 percent and 5 percent *increases* in firm-specific and ordinary stock, respectively, may be interpreted in part as the effect of precluding future tax inversions.

Placing a value of this potential equity flight is uncertain, but based on these estimates, roughly 15 percent, or $988 billion in U.S. based capital is at risk of moving overseas.

[1] http://www.oecd.org/document/60/0,3746,en_2649_34533_1942460_1_1_1_1,00.html#C_CorporateCaptial