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United States Has Highest Corporate Tax Rates

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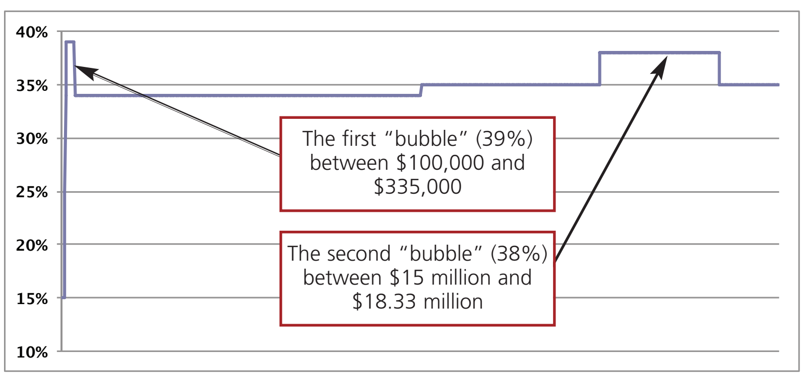
The high corporate tax rates in the United States may be driving businesses and jobs abroad or leading to transfer pricing maneuvers. This ultimately leads to a negative impact on the economy and a reduction in tax revenue for the federal government.

The U.S. corporate tax rate has been fairly constant since 1988, while non-OECD (Organisation for Economic Co-operation and Development) member countries have seen their corporate tax rate drop below that of the United States continuously since 1992. In fact, the U.S. was second only to Japan for having the highest corporate tax rate. Then, at midnight on April 1, 2012, Japan lowered its corporate tax rate from 39.5% to 36.8%, leaving the U.S.—and its 38% and 39% "bubble" rates—as the country with the highest corporate tax rate in the industrialized world. The "bubble" rates (see Figure 1) apply for specific taxable income ranges and are intended to neutralize the lower tax rates for smaller corporations, such as the 15% and 25% tax brackets.

The subject of corporate tax rates was a significant campaign issue leading up to the presidential election in November. President Obama indicated a willingness to reduce the corporate tax rate to 28%, while Republicans proposed a reduction to 25%. At the 28% rate, the U.S. would have the third-highest tax rate, trailing Japan (36.8%) and Germany (29%). At 25%, the U.S. would be tied with Sweden for 10th. Both proposed reductions in U.S. corporate tax rates represent a significant reduction. Regardless of the final outcome, the real challenge will be finding the funds necessary to offset the lost revenue from any reduction.

The discussion around lowering the corporate tax rate raises several questions that should be addressed. The most prominent question is: Are these reductions in the U.S. corporate tax rate desirable or necessary? At a time when many Americans feel that corporations aren't paying their "fair share" of taxes, a reduction of corporate tax rates might seem inequitable. Of course, most Americans fail to recognize that corporations don't pay taxes; rather, investors and consumers pay them—the price of every product that a consumer purchases is set to include a profit after taxes, and increased taxes will likely lead to increased prices. But the average American typically doesn't appreciate why or how a reduction in U.S. corporate tax rates may be needed to remain internationally competitive. Businesses will establish new operations and shift existing operations to countries where tax rates are lower, enabling the business to keep prices at a more competitive level.

Figure 1: U.S. Corporate Income Tax Rates



Worldwide Corporate Tax Rates

The average corporate tax rates in countries around the world have declined steadily since 1985, but the rate in the U.S. has remained fairly constant. In fact, the average corporate tax rates in the rest of the world have declined to an average of approximately 25%. The corporate tax rate in South Korea is 24%, Germany's is 29%, and the Russian Federation has maintained an established maximum corporate tax rate of 20% since 2009. In the People's Republic of China, where there is no local or provincial income tax, the established maximum corporate tax rate has been 25% since 2008. The lowest rates can be found in the Cayman Islands (16%) and Bermuda (17%).

Perhaps a reduction in corporate tax rates in the U.S. would attract businesses, create jobs, and lead to an economic boost. If lower labor costs are seen as a driver in the outsourcing of high-paying U.S. jobs to Asia over the past few decades, it might be time to consider the possibility that lower U.S. corporate tax rates could reverse this trend and benefit Americans.

A similar parallel can be seen in Japan, where the government lowered tax rates to boost the economy. After maintaining a 0% short-term interest rate for several deflationary years, the Bank of Japan raised the benchmark short-term interest rate to 0.25% in 2006. Japan's economy was just emerging from what many refer to as the "Great Recession" when it was suddenly confronted with the aftermath of the 2011 earthquake and tsunami in the northeastern part of the island of Honshu. In response, then Prime Minister Naoto Kan reduced corporate taxes to stimulate investment in Japan and to encourage businesses to create more jobs. Now, with a need for greater revenue to finance reconstruction following the earthquake and tsunami, Japan currently is considering an increase in its consumption tax from 5% to as much as 8%.

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Transfer Pricing

Transfer pricing (IRC §482) continues to provide an economic incentive for companies to shift corporate formation, businesses, jobs, and taxable profits to countries with lower corporate tax rates. Multinational corporations use transfer pricing arrangements to shift taxable income to related entities in countries with a lower tax rate while retaining higher expenses in the domestic country. The net result is the overall reduction in taxes when considering the related entities as a whole.

There aren't any statistics or estimates about tax revenues lost from transfer pricing maneuvers and arrangements, but the case of GlaxoSmithKline (GSK) illustrates the potential tax revenue being lost. In 2006, the pharmaceutical giant agreed to pay the IRS approximately $3.4 billion in tax and interest relating to transfer pricing issues. To settle this issue, GSK agreed with the IRS audit determination that intercompany adjustments between GSK and its parent company in the United Kingdom reduced profits in the U.S. and shifted the point of taxation to the U.K., benefiting from the U.K.'s lower tax rate. And that's only one corporation. Considering the number of U.S. multinational corporations, there's an opportunity for the U.S. to gain substantial tax revenues through increased enforcement.

To better address the issue of transfer pricing compliance and other international issues, the IRS reorganized its Large & Mid-Size Business Division (LMSB). In 2010, the LMSB was changed to the Large Business & International Division (LB&I). As part of the reorganization, the Service added an executive-level position solely to oversee transfer pricing compliance efforts. In addition, the IRS increased its enforcement efforts by hiring accountants with experience in international taxation to serve as revenue agents. Reducing the corporate tax rates might alleviate some of these transfer pricing issues and keep some revenue in the U.S. that might otherwise be transferred to other countries.

The U.S. isn't the only country looking into the transfer pricing policies of multinationals. In Canada, for example, the Supreme Court for the first time has granted a hearing on a transfer pricing issue between GSK and the Canadian Revenue Agency. Although the Canadian Supreme Court is hearing the case now, transfer pricing has been going on for more than 20 years. In other words, it isn't a new technique, and it's gaining momentum around the world.

The Perception of Equity

When people look at the role that corporations have played in the U.S. economy recently, they see things such as the Enron and WorldCom scandals, Lehman's involvement in the bursting of the housing bubble, government bailouts, and oil companies enjoying record profits while the cost for gasoline continues to rise for the average American. While many of these same people have deferred compensation plans and own mutual funds that contain shares of corporate stocks, they may not perceive the component of this wealth that "trickles down" to them as proportionate. But, then, most don't truly realize the complexity of the issue of corporate taxes, transfer pricing, and global tax rates.

Ultimately, the question is simple: Are the political parties in Congress and the President willing to consider—and act on—a reduction in U.S. corporate tax rates in order to regain some global competitiveness? **SF**

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