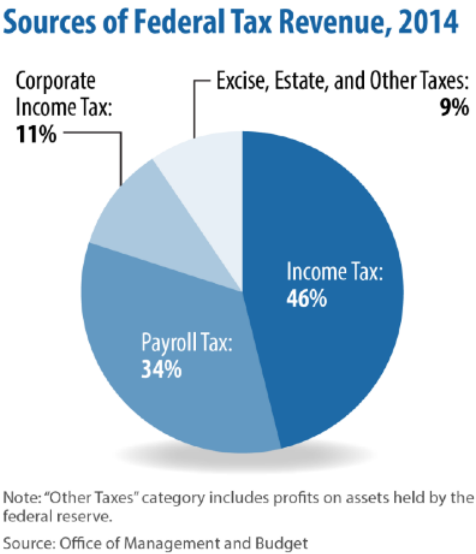
Corporate Taxation and Tax Avoidance

Jiaming Mao

Xiamen University

Contact: jmao@xmu.edu.cn

Course homepage: jiamingmao.github.io/principles-of-economics



Sources of U.S. Federal Tax Revenue

Personal Income Tax

Rate	Single Filers	Married Joint Filers
10%	$0 to $9,225	$0 to $18,450
15%	$9,225 to $37,450	$18,450 to $74,900
25%	$37,450 to $90,750	$74,900 to $151,200
28%	$90,750 to $189,300	$151,200 to $230,450
33%	$189,300 to $411,500	$230,450 to $411,500
35%	$411,500 to $413,200	$411,500 to $464,850
39.6%	$413,200+	$464,850+

U.S. Federal Personal Income Tax Rates (2015). The table reports marginal rates. For a history of U.S. federal personal income tax rates, see here.

Corporate Income Tax

Taxable Income	Tax Rate
$ 0– 50,000	15%
50,001– 75,000	25
75,001– 100,000	34
100,001– 335,000	39
335,001–10,000,000	34
10,000,001–15,000,000	35
15,000,001–18,333,333	38
18,333,334+	35

U.S. Federal Corporate Income Tax Rates. The table reports marginal rates. For a history of U.S. federal corporate income tax rates, see here.

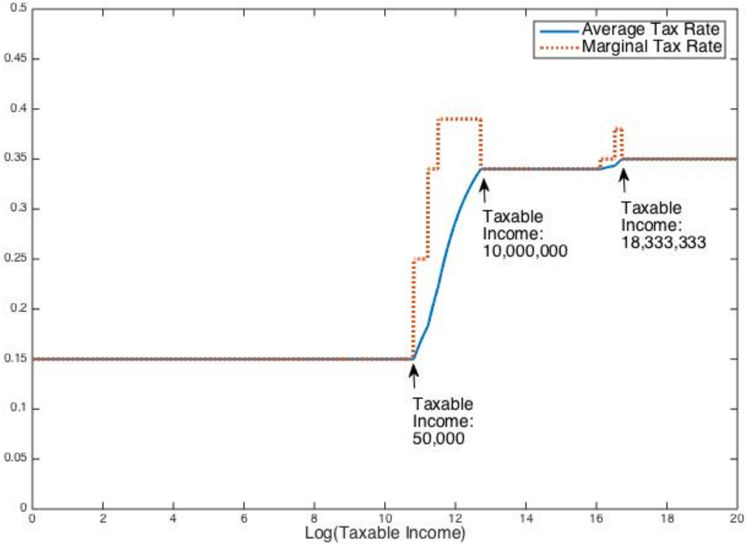
Corporate Income Tax

(1) Taxable Income	(2) Marginal Tax Rate	(3) Total Tax	(3)/(1) Average Tax Rate
$ 45,000	15%	$ 6,750	15.00%
70,000	25	12,500	17.86
95,000	34	20,550	21.63
250,000	39	80,750	32.30
1,000,000	34	340,000	34.00
17,500,000	38	6,100,000	34.86
50,000,000	35	17,500,000	35.00
100,000,000	35	35,000,000	35.00

Marginal and Average Tax Rate

For large U.S. corporations (taxable income $>$ 18.3mil), both the average and marginal tax rates are 35 percent.

Corporate Income Tax



Corporate Income Tax

- The corporate income tax is one of the primary ways of taxing capital.
- Without the corporate income tax, the personal income tax can be dodged or postponed by individuals incorporating themselves and keeping their income within firms.
- When corporate profits are paid out, they are typically taxed at a lower rate than earned income, as tax authorities recognize **double taxation**.
  - In the U.S., top federal income tax rate on capital gains and dividends paid by corporations is 20 percent, compared to 39.6 percent for ordinary income.

Corporate Income Tax

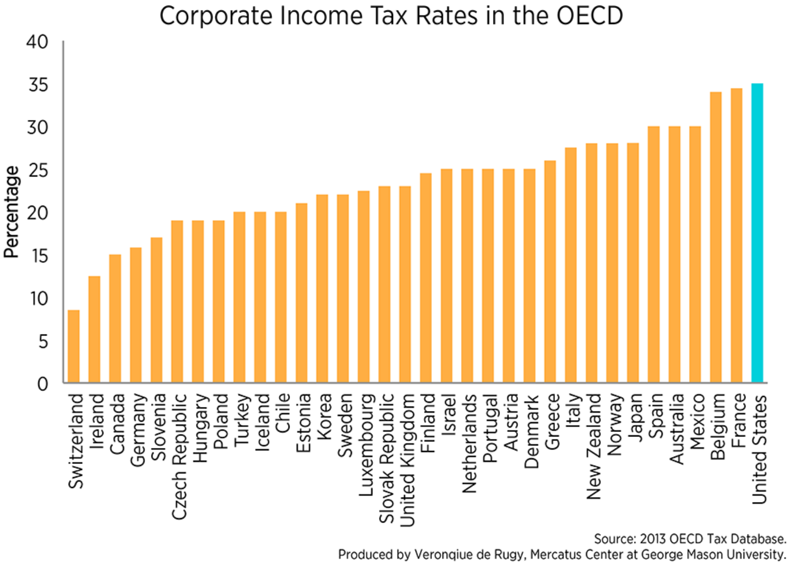
Corporate tax raison d'être:

- A prepayment for the personal income tax
- A way to tax rents (such as extractive industries) and business activities that generate negative externalities
  - Tax credits can then be used as subsidies for business activities that generate positive externalities.
- A tax on foreign shareholders who benefit from the public goods provided by the country

Corporate Income Tax

- The U.S. corporate income tax rate is the highest among OECD countries.
- In actuality, because of various tax deductions and loopholes, the effective tax rates paid by U.S. corporations are significantly lower than the statutory rates.

Corporate Income Tax

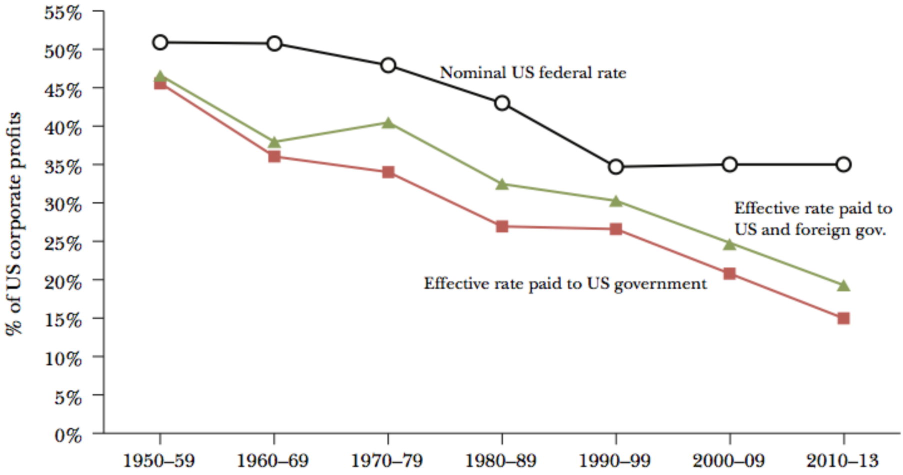


Corporate Income Tax

Industry	Number of Companies	Average Tax Rate
Electric utilities (Eastern U.S.)	24	33.8%
Trucking	33	32.7
Railroad	15	27.4
Securities brokerage	30	20.5
Banking	481	17.5
Medical supplies	264	11.2
Internet	239	5.9
Pharmaceutical	337	5.6
Biotechnology	121	4.5

Effective Rates Paid by U.S. Corporations by Industry (2011)

Nominal and Effective Corporate Tax Rates on US Corporate Profits



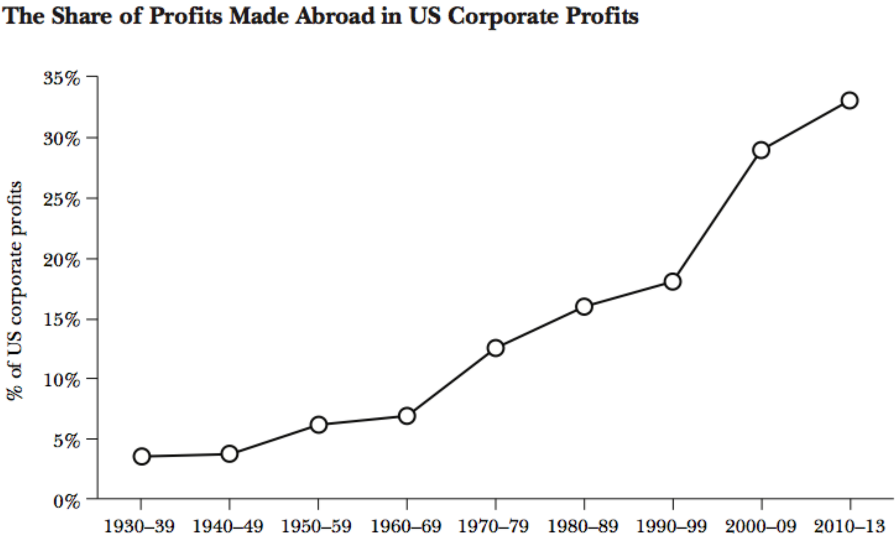
Source: Zucman (2014)

Multinationals, Profit-Shifting, and Tax Avoidance

- The practicality and enforceability of the corporate income tax is increasingly challenged by globalization today.
- Corporations can avoid paying corporate taxes by shifting their profits from high-tax jurisdictions to low-tax jurisdictions.
- The U.S. employs a worldwide tax system: U.S. corporations are in theory taxed on all income, whether derived in the U.S. or abroad.
- Profits made by foreign subsidiaries of U.S. corporations, however, are not taxed until they are repatriated to the U.S. in the form of dividends.

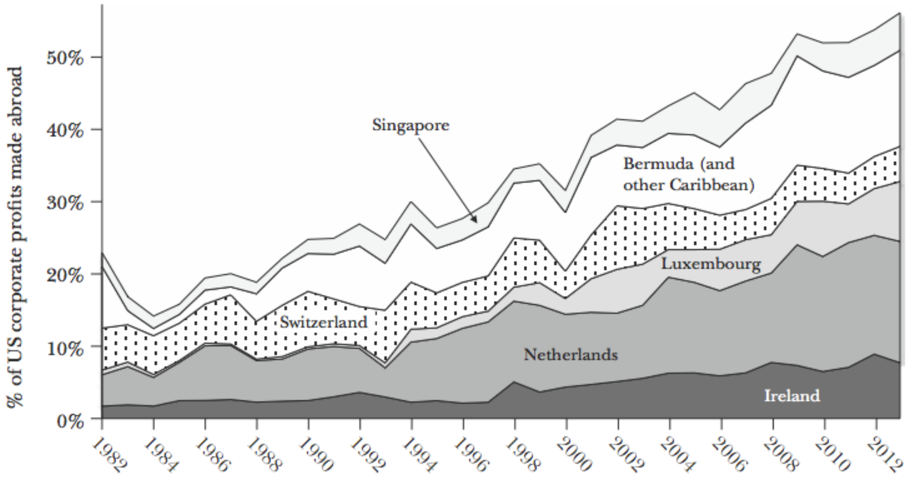
Multinationals, Profit-Shifting, and Tax Avoidance

- U.S. corporations can lower their tax burden by
  - Shifting their domestic profits to low-tax foreign jurisdictions.
  - Keeping the profits of their foreign subsidiaries offshore.
- About two-thirds of the decline in the U.S. effective corporate tax rates over the last 15 years could be attributed to increased profit-shifting to tax havens such as Bermuda, Luxembourg and the Cayman Islands (Zucman, 2014).
  - An estimated 20 percent of all U.S. corporate profits are now parked in these tax havens (Zucman, 2014).

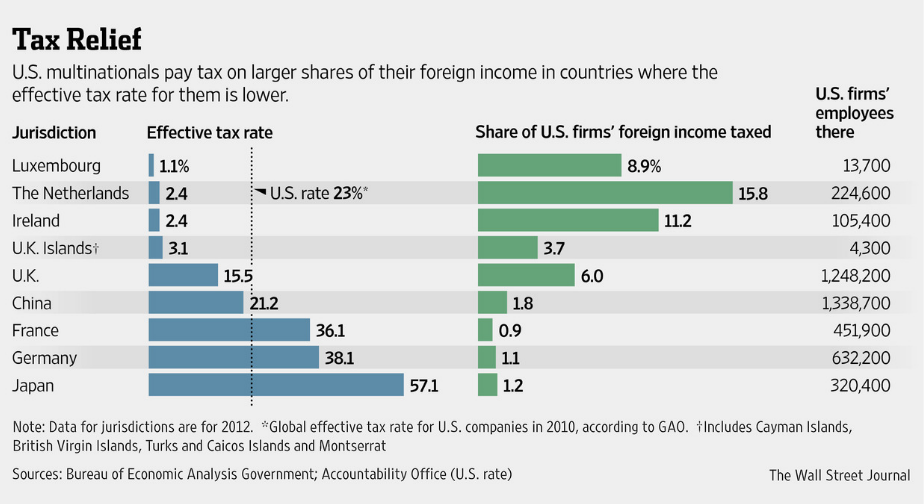


Source: Zucman (2014)

The Share of Tax Havens in US Corporate Profits Made Abroad



Source: Zucman (2014)


Tax Relief
U.S. multinationals pay tax on larger shares of their foreign income in countries where the effective tax rate for them is lower.
Jurisdiction
Effective tax rate
Share of U.S. firms' foreign income taxed
U.S. firms' employees there
Luxembourg 1.1% 8.9% 13,700
The Netherlands 2.4 15.8 224,600
U.S. rate 23%*
Ireland 2.4 11.2 105,400
U.K. Islands† 3.1 3.7 4,300
U.K. 15.5 6.0 1,248,200
China 21.2 1.8 1,338,700
France 36.1 0.9 451,900
Germany 38.1 1.1 632,200
Japan 57.1 1.2 320,400
Note: Data for jurisdictions are for 2012. *Global effective tax rate for U.S. companies in 2010, according to GAO. †Includes Cayman Islands, British Virgin Islands, Turks and Caicos Islands and Montserrat
Sources: Bureau of Economic Analysis Government; Accountability Office (U.S. rate)
The Wall Street Journal

Caribbean/West Indies	Anguilla, Antigua and Barbuda, Aruba, Bahamas, Barbados,[d,e] British Virgin Islands, Cayman Islands, Dominica, Grenada, Montserrat,[a] Netherlands Antilles, St. Kitts and Nevis, St. Lucia, St. Vincent and Grenadines, Turks and Caicos, U.S. Virgin Islands[a,e]
Central America	Belize, Costa Rica,[b,c] Panama
Coast of East Asia	Hong Kong,[b,e] Macau,[a,b,e] Singapore[b]
Europe/Mediterranean	Andorra,[a] Channel Islands (Guernsey and Jersey),[e] Cyprus,[e] Gibralter, Isle of Man,[e] Ireland,[a,b,e] Liechtenstein, Luxembourg,[a,b,e] Malta,[e] Monaco,[a] San Marino,[a,e] Switzerland[a,b]
Indian Ocean	Maldives,[a,d] Mauritius,[a,c,e] Seychelles[a,e]
Middle East	Bahrain, Jordan,[a,b] Lebanon[a,b]
North Atlantic	Bermuda[e]
Pacific, South Pacific	Cook Islands, Marshall Islands,[a] Samoa, Nauru,[c] Niue,[a,c] Tonga,[a,c,d] Vanuatu
West Africa	Liberia

Countries Listed on Various Tax Haven Lists. Source: Gravelle (2015)

Multinationals, Profit-Shifting, and Tax Avoidance

- A popular method of profit-shifting is through the manipulation of **transfer pricing**, the setting of prices at which companies exchange goods and services internally.
  - Consider a corporation, USCo, that grows coffee beans in Brazil at a cost of \$1/lb and sells them for \$12/lb in the U.S. The company has a subsidiary, BrazilCo, in Brazil.
  - To avoid paying taxes in either the U.S. or Brazil, USCo could set up another subsidiary, BermudaCo, in Bermuda and have BrazilCo sell beans to BermudaCo for \$1/lb, who would in turn sell them to USCo for \$12/lb.
  - Both USCo and BrazilCo would record zero profits, while BermudaCo earns \$11/lb in profits but is subject to zero corporate income tax.

Multinationals, Profit-Shifting, and Tax Avoidance

- In practice, to prevent profit-shifting, transfer pricing is required to obey the **arm's length principle**: prices of goods and services traded by related companies must be based on market prices.
- **Intangibles**, such as patents and licenses, however, are hard to value as relevant market prices may not exist.
  - USCo could transfer its patent on coffee growing technology to BermudaCo and have BrazilCo pay royalties to BermudaCo for its usage.

Multinationals, Profit-Shifting, and Tax Avoidance

- Profit-shifting could also be achieved via **debt reallocation**, through which a corporation would hold the majority of its debt in high-tax jurisdictions to lower its taxable income in those jurisdictions through deductible interest expenses.
- Another popular method of profit-shifting is through intragroup loans, whereby subsidiaries in low-tax jurisdictions grant loans to subsidiaries in high-tax jurisdictions, a practice known as **earnings stripping**.
- The existence of thousands of bilateral tax treaties between countries has also created a web of inconsistent rules that corporations can exploit by choosing the location of their affiliates, a practice known as **treaty shopping**.

Reference

Gravelle, J. G. 2015. "Tax Havens: International Tax Avoidance and Evasion," Congressional Research Service report, R40623.

Zucman, G. 2014. "Taxing across Borders: Tracking Personal Wealth and Corporate Profits," *Journal of Economic Perspectives*, 28(4).