An increasing number of American companies are making plans to shift their headquarters to Europe. These so-called “inversions” would reduce these companies’ total tax bill by allowing them to escape from the United States’ uniquely unfavorable corporate tax rules. So what should US policymakers do?

President Barack Obama’s administration is seeking to block corporate inversion through administrative measures that may not hold up in US courts. It would be far better to develop a bipartisan legislative plan aimed at removing the temptation to shift corporate headquarters in the first place. Such a plan, if attractive to US multinational corporations, could result in a shift in employment and production to the US and higher tax revenue.

Under current law, US corporate profits are taxed at a rate of 35% – the highest rate among OECD countries, where the average is 25%. That tax is paid on profits earned in the US and on repatriated profits earned by US companies’ foreign subsidiaries.

For example, the subsidiary of a US firm that operates in Ireland pays the Irish corporate tax of 12.5% on the profits earned in that country. If it repatriates the after-tax profits, it pays a 22.5% tax (the difference between the 35% US rate and the 12.5% tax that it already paid to the Irish government). But if it reinvests the profits in Ireland – or in any other country – no further tax must be paid.

Not surprisingly, American firms prefer to leave those profits abroad, either in financial instruments or by

investing in new or existing subsidiaries. As a result, American companies now hold abroad roughly $2 trillion in profits that have never been subject to US tax.

All other OECD countries treat the profits of their companies' foreign subsidiaries very differently, relying on the so-called "territorial" method of taxing foreign earnings. For example, a French firm that invests in Ireland pays the 12.5% Irish corporate tax but is then free to repatriate the after-tax profits with a tax of less than 5%.

America's current tax system adversely affects the US economy in several ways. The extra tax that US firms pay if they repatriate profits raises their cost of capital, thus reducing their ability to compete in international markets. Foreign firms can also outbid their US counterparts in acquiring new high-tech firms in other countries. And when a foreign firm acquires a US company, it pays US tax on the profits earned in the US but not on the profits earned by that firm's other foreign subsidiaries, thus lowering its total tax bill.

A shift to a territorial system of taxation would remove the disadvantages faced by American multinational corporations and encourage them to reinvest their overseas profits at home, increasing US employment and profits. Because only a small share of overseas profits is now repatriated, the US government would lose very little tax revenue by shifting to a territorial system. A few years ago, the US Treasury Department estimated that shifting to a territorial system would reduce corporate tax revenue by only $130 billion over ten years.

It would also be desirable to reduce the US corporate tax rate gradually, bringing it closer to the 25% OECD average. That, too, would encourage more repatriation of overseas earnings.

Given that American companies have large amounts of profits abroad that have never been subject to US tax, the transition could even be carried out in a way that raises net revenue. In exchange for shifting to a territorial system and reducing the tax rate, the federal government could tax all of these untaxed past earnings at a low rate to be paid over a ten-year period. Companies would then be free to repatriate their pre-existing earnings without paying any additional tax, while future foreign earnings could, as in other countries, be repatriated by paying a low 5% tax.

A 10% tax on those existing accumulated foreign earnings would raise about $200 billion over the ten years. A 15% tax would raise $300 billion. The choice of tax rate would be part of the negotiation over how far to reduce the overall US corporate tax rate.

For example, with a 10% tax, a company with $500 million of accumulated overseas earnings would incur a tax liability of $50 million, to be paid over ten years. It could repatriate $500 million at any time with no additional tax liability. Repatriation of any earnings in excess of $500 million would be subject to a 5% tax.

The shift to a territorial system and a lower corporate tax rate would appeal to American multinational corporations even if they had to pay a 10-15% tax on accumulated past earnings. If Obama is looking for an

opportunity to negotiate a bipartisan deal that would strengthen the US economy and increase employment, he should seriously consider such a package of reforms.