Corporate Income Tax Reform . . .

Dreaming On

BY ERIC TODER

President Obama and the House Republican leadership agree on little. But on one point, they do seem in accord: the corporate income tax needs to be fixed. Indeed, pretty much no one, inside the Beltway or out, is happy with the current state of affairs.

Chief executives and policy economists alike complain that the high corporate tax rate (35 percent) and the rules for taxing the foreign-source income of U.S. companies discourage investment in the United States and place U.S.-based multinationals at a disadvantage with competitors based overseas. On the other side of the coin, pundits and members of Congress are inclined to react with high dudgeon to the reality that some highly profitable U.S. corporations, including icons of the digital age like Apple and Google, use sophisticated planning techniques to shift reported profits to foreign tax havens.

Politicians of both parties favor closing loopholes – tellingly, with little detail on which ones – to offset the revenue losses from lowering the top corporate tax rate. The latest House Budget Resolution calls for a reduction in the top rate from 35 to 25 percent and changes that would exempt the foreign profits of U.S. corporations from federal tax. President Obama wants a slightly more modest reduction, to a 28 percent rate, and would set a minimum tax on repatriated foreign profits of U.S. multinationals.

But neither side has credibly specified how it would pay for these rate cuts. Obama would scale back some tax breaks – but wouldn't come close to paying for the proposed rate cut. The House Republicans, for their part, have not identified a single preference they would remove.

Tax reform is hardly ever a piece of cake. The big question here, though, is why reform of the corporate income levy seems to be an especially daunting project. In my view, the most likely way to break the logjam is to rethink the tax from the basics.

JUST THE FACTS

The corporate income tax is imposed on the profits of all corporations with permanent business establishments in the United States and on the worldwide profits of U.S.-resident corporations. Profits are defined as revenue less deductions for wages, payments for other inputs like raw materials, interest on debt and depreciation of capital assets. Corporations may not deduct dividends paid to shareholders from taxable income. Thus, since recipients pay income taxes on their dividends – albeit at preferred rates – the total tax burden on corporate profits includes more than just the corporate tax.

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Almost all profits are taxed at the top federal rate of 35 percent. States impose additional taxes averaging about 6.3 percent, though some are as high as 9 percent. Combining state and federal taxes, and accounting for deductibility of state taxes from federal income, the top average rate is 39.1 percent – the highest corporate tax rate among advanced industrial countries in the OECD.

"Your Honor, my client would like to be tried offshore."

DANA FRADON/THE NEW YORKER COLLECTION/WWW.CARTOONBANK.COM

The Congressional Budget Office projects that the federal corporate income tax will raise about $4.8 trillion over the next decade, which amounts to 12 percent of all federal receipts and slightly over 2 percent of GDP. That's a lot of money: the corporate income tax is the third-largest source of federal receipts. But the revenue is far less than the proceeds from the individual income tax and the payroll taxes that fund Social Security and Medicare.

Without the corporate tax, sheets of the corporations

Actually, corporate receipts used to constitute a much larger share of tax revenue. Between the 1950s and 1980s they plummeted from about 5 percent to less than 2 percent, mostly because of increases in legislated corporate tax preferences, increased debt financing by corporations (interest is deductible from taxable profits) and growth in foreign investments. The Tax Reform Act of 1986 reduced the top corporate rate from 46 to 34 percent (since raised to 35 percent), but increased revenues by curtailing the investment tax credit, lengthening depreciation periods and enacting various accounting changes that delayed deductions. Since the 1980s, receipts from the tax have varied with the business cycle, but have averaged about 2 percent of GDP.

Why tax corporations at all? Corporations, whatever the Supreme Court says, are not really people. They are enterprises that employ workers, raise funds from shareholders and creditors, and provide goods and services to consumers. All corporate taxes must ultimately be borne by these stakeholders, in the form of lower investment returns, lower wages or higher prices for goods and services. Why not tax these stakeholders directly?

That is not a purely hypothetical question. Enterprises that account for over half of business receipts and taxable profits in the United States are not taxed as corporations. Their profits are allocated directly to their owners, who include them in the income they report to the IRS on their personal income tax returns. While these business owners, like other individual taxpayers, benefit from a number of preferences in the law, they are taxed on their income in the same way individual workers and investors are.

The share of U.S. businesses that calculate their taxes as part of their owners' personal returns has increased dramatically in the past 30 years. The main factors driving this increase have been the cut in the top individual income tax rates (from 70 percent as recently as 1980 to less than 40 percent today) and tax law changes that enable businesses to benefit from the limited liability status that corporations have without paying corporate income tax.

The two main vehicles that businesses use to achieve this end are subchapter S corporations and limited liability companies. Limits on companies that qualify for S-corporation status have been relaxed over time. And since 1997 Treasury regulations (the so-called check-the-box rules) have made it easy for most companies to choose limited liability company status. Today, only publicly traded companies must still be organized as taxable corporations.

So again: why not tax all businesses this way? The key reason is a practical one. Taxing income from profits at the source eliminates the problem of how to allocate the tax liability for profits among thousands or millions of shareholders who trade stocks frequently within the year. Note, too, that without the corporate tax, shareholders would be able to defer taxable income indefinitely by keeping it on the balance sheets of the corporations – in effect, converting the entire corporate sector into a giant tax shelter.

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Nonetheless, there is widespread recognition that the tax is imperfect. It imposes higher overall tax burdens on businesses organized as taxable corporations than on flow-through companies, because corporate shareholders pay tax both at the corporate level and again at the individual level when dividends are paid or when retained earnings contribute to capital gains on sales of stock. The tax favors debt financing over equity because the latter bears both the corporate and individual levels of tax. And it encourages corporations to retain profits (instead of paying dividends) by allowing individuals to defer individual income taxes on the resulting gains until they sell their shares.

IT'S A BIG, BIG WORLD

Most of the revenue from the U.S. corporate income tax comes from large multinational corporations. Since the 1980s, the world economy has become increasingly globalized, dispersing the assets and employees of typical large multinationals over dozens of countries. Multinationals raise funds for their investments in global capital markets and provide goods and services to consumers throughout the world. And U.S.-based companies must compete with foreign-based ones in both American and foreign markets.

For purposes of taxation, corporate income can be classified by *source* (where the goods and services are produced) or by *residence* (where the corporation is based). The United States taxes the corporate income of all permanent establishments within its borders, whether controlled by U.S. or foreign-based corporations. (An example of the latter would be a Toyota plant in Tennessee.) The United States has no jurisdiction over the income of foreign-based corporations that comes from investments outside the United States.

	U.S.-SOURCE INCOME	FOREIGN-SOURCE INCOME
U.S.-RESIDENT MNCs	Taxable under U.S. corporate income tax	Taxable under U.S. corporate income tax when repatriated with credit for foreign income taxes
FOREIGN-RESIDENT MNCs	Taxable under U.S. corporate income tax	Not subject to U.S. corporate income tax

U.S. companies operating in other countries typically organize these entities as foreign subsidiaries – in tax jargon, controlled foreign corporations. If the local government where the investment is made and the home government where the corporate group is based both taxed the income of controlled foreign corporations, foreign investments would bear a heavier tax than domestic investments and international capital flows would be discouraged. To prevent that, countries (either unilaterally, or through bilateral agreements) use one of two methods to avoid double taxation. Under a *worldwide* system, a country taxes the foreign income of its multinational corporations annually at the home-country's corporate rate, but allows its multinationals to claim a credit for foreign income taxes paid. This subjects all corporate income to at least the home-country tax rate. Under a *territorial* system, a country exempts the foreign-source income of its multinational corporations. This subjects domestic-source income to the home country tax rate and foreign-source income to the tax rates in the jurisdiction in which they are generated.

The current U.S. system is a compromise between the pure worldwide and pure territorial methods. Active income accrued within foreign affiliates of a U.S. company benefits from a provision known as deferral. Under deferral, foreign-source income of U.S. multinational corporations is subject to local income taxes, but incurs no U.S. corporate income tax liability until the income is repatriated in the form of dividends to the U.S. parent company. Upon repatriation, the U.S. parent is taxed on the dividend plus the amount of the associated foreign income tax, but receives a credit for foreign income taxes paid. In general, this means that the income from foreign investments of U.S. corporations is subject to the U.S. tax rate when repatriated as a dividend to the U.S. parent, but, thanks to deferral, there is no current U.S. tax on the income that is retained in the controlled foreign corporation.

It isn't quite that simple. Foreign tax credits are limited in order to prevent U.S. companies from claiming credits in excess of the U.S. corporate tax rate. Other provisions limit erosion of the domestic tax base by taxing certain forms of passive and easily shiftable income of U.S.-controlled foreign corpora-

"When I think of the as yet undreamed-of loopholes that are going to be available to you guys!"

tions in the year they are accrued. That is, passive income such as interest earnings on bank deposits is not eligible for deferral. Other countries impose similar sorts of rules to prevent avoidance.

WHAT'S NOT TO LOVE?

The corporate income tax provides an important backstop for the individual income tax base. And it has the added virtue of being a progressive tax because much of the burden falls on income that is concentrated among the highest-income individuals. But the tax has numerous problems:

• It encourages corporations to use debt instead of equity financing, distorting the allocation of capital and increasing the risks of bankruptcy.

• It favors businesses taxed as flow-through enterprises over taxable corporations. The result is too little investment in the corporate sector relative to sectors like real estate, where flow-through enterprises dominate.

• It contains numerous targeted tax preferences. Some of them, like the research credit, may be justified as a way to encourage activities with broader social benefits. But in general, tax preferences lead to resource misallocation, undermining productivity.

• The high U.S. tax rate favors foreign investment over domestic, and encourages multinational corporations to shift profits to other jurisdictions. Although various tax preferences make the average effective rate on corporate investments lower than the statutory rate, the United States still has a high effective rate compared with the OECD average.

• The U.S. tax on repatriated income encourages U.S. multinationals to keep their funds overseas instead of paying dividends to U.S. shareholders – and, some argue, places U.S. multinationals at a disadvantage compared with foreign-based ones. In recent years, other countries, notably Britain and Japan, have shifted to territorial systems that exempt profits repatriated by their own multinational corporations.

• The combination of deferral and rules that determine how income and expenses are allocated among countries has enabled many profitable U.S. multinationals to avoid a lot of tax liability. These opportunities are especially large for U.S. companies with intangible income – royalties on patents, for example – that are able to shift reported income to low-tax countries like Ireland or to tax havens like the Cayman Islands or Bermuda. Over the past decade, the reported foreign profits of U.S. multinationals have grown much faster than other measures of their foreign activity (like employment and sales), suggesting that much of this growth comes from aggressive tax planning.

Thus, the tax distorts investment choices, discourages investment in the United States and damages the competitiveness of U.S. multinationals while at the same time allowing some large and profitable U.S. multinationals to pay very little tax on their worldwide income. No wonder most everyone favors reform, at least in the abstract.

BUT WHAT SORT?

One set of proposals would reduce the corporate rate and make up the revenue loss by reducing or eliminating tax preferences like favorable depreciation rules for equipment and for oil and gas drilling. A second set of proposals would switch to a territorial system by removing the tax on repatriated profits of controlled foreign corporations and accompany the tax break with provisions that would reduce tax avoidance through income-shifting to tax havens. In my view, while either approach could improve the efficiency and equity of the tax code, they would both fail to address problems that can only be fixed with more fundamental reforms.

Scrapping tax preferences would, indeed, address an old and familiar problem in tax policy: with time, tax systems become riddled with special tax breaks. This gradual erosion of the tax base is not hard to explain. Many of these tax breaks cost little, taken one by one, but are worth a lot to specific constituencies. Thus, the many who would gain a little bit each by removal of a preference can't overcome the focused interests of the few who would lose a lot if the tax break were eliminated.

By this logic, the only way to enact reform is to take on many special tax preferences at once in order to pay for a big enough cut in rates to garner broader support. That is what happened in 1986, when reform advocates were able to win over an influential group of corporations that found the prospect of a large rate cut more attractive than the loss they would suffer in terms of narrowly targeted benefits.

The problem with repeating the 1986 experience today is that there simply is not enough revenue to be gained by attacking vulnerable tax breaks to pay for the rate cuts that both the House Budget Committee and President Obama are promising. Most of the real money is in two provisions – deferral of active income of controlled foreign corporations and accelerated depreciation of machinery and equipment. But repealing these provisions would raise major substantive and political issues.

Note that the revenue gained by repealing deferral would be much less than the current tax expenditure if the corporate rate were lowered in the bargain. That's because the cost of deferral depends on the difference between the U.S. and foreign rates, not the U.S. rate alone. So if, for example, the United States dropped its rate from 35 to 25 percent, repealing deferral would raise no revenue from taxation of foreign income already subject to a 25 percent (or higher) foreign income tax.

Moreover, repealing deferral would make the United States the only country that taxed its multinationals on a current basis on their worldwide income, placing U.S.-based firms at a major competitive disadvantage with firms based in other countries. For this reason, it is a political nonstarter, with the discussion today focusing on moving in the opposite direction by exempting taxation of foreign-source income.

Repealing accelerated depreciation would raise effective tax rates on new investments in manufacturing equipment in the United States. That would likely generate substantial political resistance. It is counter to the policy of the Obama administration, which has used accelerated deductions as an antirecession policy. And while it would reduce a current bias that favors investment in equipment over structures, it would increase the bias favoring the development of intangible property (deducted immediately), over investment in machinery.

Another concern with the traditional tax reform approach of trading off a lower corporate rate for base-broadening is that it would raise effective tax rates for flow-through enterprises unless also accompanied by a cut in individual income tax rates. And lowering the corporate rate below the individual rate could generate opportunities for high-income individual investors to use corporations as tax shelters. This point highlights the difficulties of reforming the corporate income tax alone without addressing interactions with the individual income tax system.

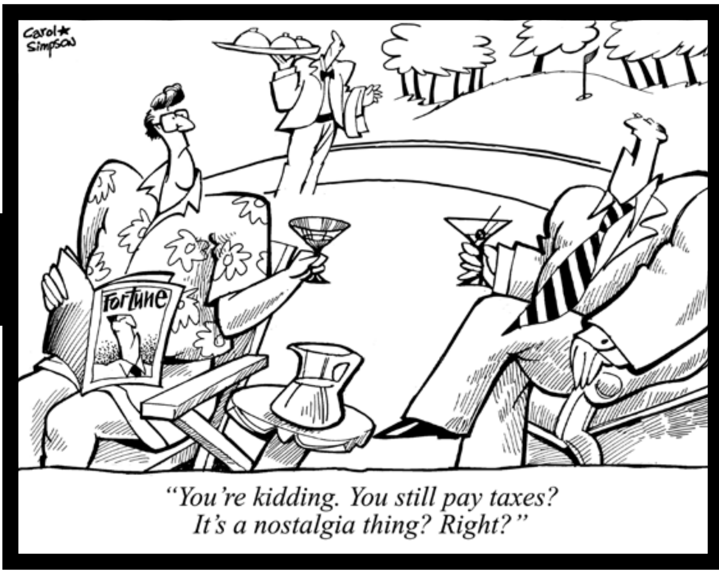
So, yes, eliminating some tax breaks and using the revenue to pay for reducing the corporate tax rate would be good policy. But it wouldn't pay for the types of rate cuts that politicians are promising.

The other approach would follow the examples of our major trade partners, adopting what is called a territorial tax system, by exempting dividends paid to U.S. corporations by their foreign affiliates. Germany and

"A word to the wise. When the gods speak, they'd better say 'across-the-board tax cut.'"

LEE LORENZ/THE NEW YORKER COLLECTION/WWW.CARTOONBANK.COM

France have had dividend-exemption systems for years. Canada exempts dividends from foreign affiliates based in countries with which they have a tax treaty, and have effectively moved towards universal exemption as their network of treaty partners has expanded. Britain and Japan have also recently enacted dividend-exemption systems, leaving the United State as one of the few holdouts.



"You're kidding. You still pay taxes? It's a nostalgia thing? Right?"

Still, no system is purely territorial in the sense of exempting all foreign-source income from tax. Most countries have rules similar to the U.S. provisions, taxing some forms of passive income of controlled foreign corporations on a current basis. Others have rules to limit income-shifting through restrictions on the use of debt finance (so-called thin-capitalization rules) and rules for allocating fixed costs. Still others impose minimum taxes on income from tax havens.

The tax-writing committees under Representative Dave Camp (R-Mich.) and Senator Max Baucus (D-Mont.) are well aware of these concerns. Any proposal for a territorial system would have to include tighter rules to prevent income-shifting to low-tax countries. It would also have to address the question of how to tax the $2 trillion in profits that are currently parked overseas. Given the widely differing positions of multinational corporations, it would be difficult to develop a consensus in the corporate community, let alone the backing of interest groups that don't want to see corporate tax liability reduced.

It's worth keeping an eye on the prize, though. There would be substantial net economic benefits from a reform that kept the overall tax burden on corporate foreign-source income unchanged while taxing more income on an accrual basis and less when repatriated. The repatriation tax is a very inefficient way of raising money, because it generates little revenue for Washington relative to the costs it imposes on multinational corporations. But the reform would still leave open the question of the ideal effective tax rate to impose on foreign-source income of U.S. multinationals.

BACK TO BASICS

None of these proposals address the fundamental conundrum of the modern corporate tax in a globally integrated economy: without international cooperation, the competition between countries to attract corporate investment, capture a larger share of the reported corporate income and assist their home-based multinational corporations could lead to a race to the bottom and an erosion of corporate taxes worldwide.

Residence-based taxation would prevent U.S. multinationals from shifting profits to low-tax jurisdictions, because their income would be taxable at the same rate wherever it comes from. But it would place U.S. multinationals at a competitive disadvantage relative to corporations resident in countries that do not tax current foreign-source income. Source-based taxation would equalize the treatment under the U.S. income tax, but would increase the incentives for U.S. multinationals to invest overseas and to report more of their income in low-tax jurisdictions.

Beyond this trade-off, neither the source nor residence definitions have much real economic meaning today. Because of this, where multinational corporations report the source of profits and where they choose to reside is increasingly responsive to tax differentials.

On the sources side, the problem is the increasing share of profits that represent returns on intangible assets, like patents, software and technological skill, as opposed to physical assets, like plants and machinery. Unlike physical capital, which can only be in one place at a time, intangible capital can be deployed in any location without subtracting from its use elsewhere. So if Apple licenses a Chinese company to use its technology to make iPads, that same technology remains available to produce iPads in the United States or anywhere else. And since manufacturing is highly competitive, the lion's share of the profits earned on iPads consists of the return on the intellectual property. But it is unclear just where those profits are earned for purposes of taxation.

Where income is derived from depends on a number of factors, including how a multinational allocates fixed costs like research, general management and interest expenses, where it locates the ownership of intangible assets and what prices it sets for sales of goods and services and licensing of royalty rights within the corporate group. Multinationals can reduce their tax liability without affecting their overall profitability by paying high prices for goods and services they purchase from subsidiaries in low-tax jurisdictions and charging low prices for sales to these subsidiaries.

Under tax laws in place throughout the OECD, prices of sales within multinational corporations, called transfer prices, are supposed to reflect the prices of comparable arms-length transactions between independent companies – that is, the market price that would prevail if a market existed for the good or service performed. But when a multinational corporation is licensing a unique intangible to its subsidiary, there is often no comparable price, leaving considerable wiggle room in setting the transfer price. Indeed, multinationals have been able to use transfer pricing, debt-equity swaps and other methods to shift increasing amounts of reported income to low-tax jurisdictions.

On the residence side, the problem is that corporate residence has decreasing relevance in today's globalized economy. The largest multinational corporations have production facilities, employees and sales throughout the world and raise funds in capital markets anywhere from New York to London to Hong Kong. Even headquarters functions like central management, finance and R&D are increasingly decentralized. Multinationals may have national identities, but they have truly become citizens of the world.

Major U.S. corporations are not about to shift their legal residences overseas. The United States enacted laws to deter so-called corporate inversions some years ago, after a highly publicized case in which a manufacturer (Helen of Troy cosmetics) changed its residence to Bermuda. U.S. multinationals that change their residence face a steep tax on their unrealized income. But there are other means to achieve the same end. New companies can choose to be chartered overseas instead of in the United States. U.S. companies can contract out production to foreign-based companies, shifting some of the income to nonresident companies. Mergers and acquisitions can reduce the share of corporate assets that are resident in the United States. And, of course, higher residence-based taxes on U.S.-resident multinational corporations will shift the composition of world output to foreign-based multinationals. While in the short run, major U.S. multinational are not likely to change their corporate residence in response to increased taxes on foreign-source income, in the long run taxes based on corporate residence, like taxes based on corporate source, are not really viable in competitive global markets.

The current system is broken, and simple patches will not go very far to improve efficiency, reduce inequities or even yield a political consensus.

We thus need to consider more radical alternatives. I offer two, with the caveats that neither is fully fleshed out and neither is ready for political prime time.

The first is a move toward global cooperation in taxing income of multinational corporations. This is not an idea as far outside the box as it might seem. Starting with the League of Nations in the 1920s and continuing through the OECD, the international community has developed some general principles for corporate taxation that are widely observed. They include the principles that the home country gets the first bite at taxing cross-border corporate income, that double taxation should be avoided either through a credit or exemption system, and that relief from double taxation should be negotiated through bilateral double-taxation agreements, of which both the United Nations and the OECD have provided templates. They also include the generally accepted principle that arms-length comparable transactions be used to set transfer prices within multinational corporations. The European Union has gone even further in establishing common practices in taxing corporations in member countries.

But the system for allocating income among countries and for preventing income-shifting to tax havens is not working well. The OECD and G20 countries have established the Base Erosion and Profit Shifting Project, and the OECD has issued a preliminary report with some recommendations. Going further, many academic experts have long argued for using some type of formulary apportionment system to allocate income among countries.

Such rules are already used to allocate profits among U.S. states, although not in an entirely consistent fashion. A more recent idea would supplement transfer-pricing rules with ones that allocate income from intangible assets in proportion to the owner's sales among jurisdictions – a so-called destination-based corporate tax. The rationale for this reform is that allocating profit according to sales is less easy to manipulate than current methods of setting the location of corporate profits. The thrust of all these proposals would be to retain the right of separate countries to set their own corporate tax rates, but to reduce the amount of discretion that multinational corporations have to determine the reported source of their income.

A second, more radical approach would scrap the U.S. corporate income tax entirely and replace it with a tax on the accrued income of U.S. shareholders of publicly traded corporations. Under this method, shareholders would be taxed annually on the sum of their dividends and the net change in the value of their shares. The current tax rules for flow-through enterprises would be retained.

JOEL PETT/NEW YORK TIMES SYNDICATE

Note the advantages: the U.S. tax system would no longer influence either the residence of corporations or the location of investment by U.S. and foreign-owned multinational corporations. But it would fully tax the income that shareholders accrue within corporations.

The accrued-income approach is, to say the least, a difficult sell. One reason is that a lot of influential people would consider it unfair to pay tax on gains on shares they have not sold. What's more, the public might perceive it as an unjustified break to big corporations, even though their U.S. shareholders would pay tax on their income with no preferential treatment for dividends and capital gains.

There are more issues to consider. The tax would affect incentives for companies to go public. There would also be thorny questions about how to treat foreign shareholders, tax-exempt institutions and qualified retirement plans like 401(k)s. Though mostly exempt from the U.S. individual income tax, foreign investors do currently pay corporate income taxes. Congress would thus need to decide whether some tax should be put in place to recapture the lost revenue.

Plainly, neither of these radical reforms amounts to a magic bullet. Like all tax proposals that do not sharply reduce expected revenues, they would create losers as well as winners, and the losers would be bound to resist the change. But the current system is broken, and simple patches will not go very far to improve efficiency, reduce inequities or even yield a political consensus. That's why it's time to think about big solutions to a big problem that is growing ever-harder to ignore. M