Center for American Progress

Priorities for Progressive, Pro-Growth Corporate Tax Reform

June 17, 2013

Since the last time the U.S. corporate tax was significantly reformed, with the Tax Reform Act of 1986, a number of important economic and policy changes have occurred that have broad policy ramifications.

- The economy is increasingly globalized, and capital has become more mobile. About half of U.S. corporate taxes are now paid by multinational corporations,[1] many of which are truly global in reach. To an increasing extent, the assets of these global businesses are intangible and can be located anywhere in the world with relative ease. These trends pose competitive challenges to the U.S. economy—affecting both U.S. companies and U.S. workers—and threaten to undermine our corporate tax revenue base.

- New business forms such as limited-liability companies and S corporations have exploded in scope.[2] These "pass-through" entities now benefit from nearly all the privileges of corporate status but are exempt from corporate tax. The prevalence of these entities has grown to the point where they account for nearly half of all business income, further eroding the corporate tax base.

- Excessive leverage in the financial sector contributed to the financial crisis of 2008, and the many economic dislocations caused by the last recession were worsened by leverage throughout the economy. While the tax code did not cause the financial crisis or the recession, its bias toward debt financing may have worsened them. At the same time, Wall Street has developed new financial products that blur the traditional lines between debt and equity, thereby complicating the application of a distinction that is important to the corporate tax system.

- Congress has created numerous new loopholes and subsidies in the corporate and individual tax codes, while preserving some that have become obsolete.

- The United States is confronting major long-term fiscal challenges, yet the corporate tax provides a smaller and declining share of revenue.

- Income and wealth inequality has greatly increased in the United States, while the overall tax system has become less progressive. In particular, corporate effective rates have declined and income from capital gains and corporate dividends are taxed at rates that are low by historical standards.

The failure of the U.S. corporate tax to respond to these challenges is an impediment to the nation's long-term economic prospects. Our corporate tax provides incentives for multinationals to invest overseas rather than in the United States. It continues to subsidize companies taking on high levels of debt. And it distorts corporate decision making in ways that are harmful to long-run economic growth. While some existing tax code incentives are helpful and important for the economy, as a group they need streamlining and improvement. In sum, a broad reform is needed to ensure that the corporate tax code enables, rather than impedes, our nation's economic success.

Given these challenges, a progressive vision for corporate tax reform would include the following priorities:

1. Reforming the international tax system to find a more appropriate balance between the important goals of leveling the playing field for domestic job creation, maintaining the competitiveness of U.S.-based companies, reversing the revenue drain from profit shifting, and exercising U.S. leadership to prevent a global "race to the bottom"

2. Reducing the subsidy for corporate debt

3. Leveling the playing field among competing businesses and ending outdated and ineffective subsidies

4. Maintaining and strengthening investments in innovation

5. Raising additional revenue

Reforming the international tax system

The international aspects of the corporate tax code greatly need reform. Our existing code encourages U.S. companies to invest overseas rather than in the United States, and it allows corporations to exploit offshore tax havens to avoid tens of billions of dollars in taxes every year. Many U.S. multinationals say that its method of taxing international income and its high statutory rate put U.S. companies at a competitive disadvantage and deter them from bringing substantial earnings back home.

How U.S. multinationals defer U.S. taxes on foreign profits

The U.S. tax system allows corporations to defer paying taxes on their foreign profits by generally treating overseas subsidiaries of U.S.-based corporations as separate entities for tax purposes. So, for example, if a U.S. corporation has a subsidiary based in a foreign country—let's call it "Zamunda"—and the Zamundan subsidiary turns a profit from its operations in a given year, no tax is owed to the U.S. government. However, if the Zamundan subsidiary distributes the profits it has earned to its American parent—as a dividend payment, for example—then the parent owes U.S. tax on the amount it has received. The parent company is allowed to claim a foreign tax credit for the Zamundan taxes its subsidiary already paid on the profits, and the credit is subtracted from the parent company's U.S. tax bill. Therefore, the amount of U.S. tax owed on the profits is the difference between the U.S. tax rate (35 percent) and the rate at which the profits were taxed in Zamunda.

This example assumes the subsidiary distributes its profits to its U.S. parent in the year it earned them. But that's not what usually happens. Instead, U.S. corporations often direct their foreign subsidiaries to store or reinvest their profits. By keeping the profits overseas in this manner instead of "repatriating" them, U.S. corporations essentially control when they pay U.S. taxes. As long as corporations are willing to allow their profits to accumulate on the books of their foreign subsidiaries, they can continue to defer U.S. taxes year after year with no limitation. In fact, under financial accounting rules, if U.S. corporations deem their foreign subsidiaries' profits to be "permanently" reinvested overseas, they do not even have to account for the U.S. tax liability that is theoretically owed at some point in the future.

Indefinite deferral is extremely valuable to U.S. corporations because of the time value of money: Overseas profits can compound year after year free of U.S. tax. The longer that taxes on foreign profits are deferred, the more the U.S. system starts to resemble a "territorial" system in which foreign profits are exempt from tax entirely.

Because of deferral, foreign profits give U.S. multinational corporations a tax advantage that they do not get from domestic profits. Ultimately, corporate decisions to locate operations overseas get rewarded. Deferral also provides powerful incentives for corporations to report their profits overseas even if they were actually earned in the United States, in a phenomenon known as "profit shifting," which is discussed below.

The U.S. tax code subsidizes foreign investment

Profits are generally taxed in the year they are earned. But the existing tax code, by allowing U.S. companies to defer paying taxes on their foreign profits until those profits are returned to the United States (see box), contains a perverse incentive for U.S. companies to locate investment, and ultimately jobs, overseas. The Congressional Budget Office explains how this differential treatment of foreign and domestic profits affects incentives:

> *The current tax system provides incentives for U.S. firms to locate their production facilities in countries with low taxes as a way to reduce their tax liability at home. Those responses to the tax system reduce economic efficiency because the firms are not allocating resources to their most productive use. Those responses also reduce the income of shareholders and employees in the United States and they lead to a loss of federal tax revenue. In addition, those investment decisions may initially result in more unemployment in this country. Over time, however, as the economy adjusts, other jobs are created and total employment would not be significantly affected. But as a result of such decisions, in the*

long run, total compensation for U.S. workers is lower, and employment may be concentrated in different industries and regions.[3]

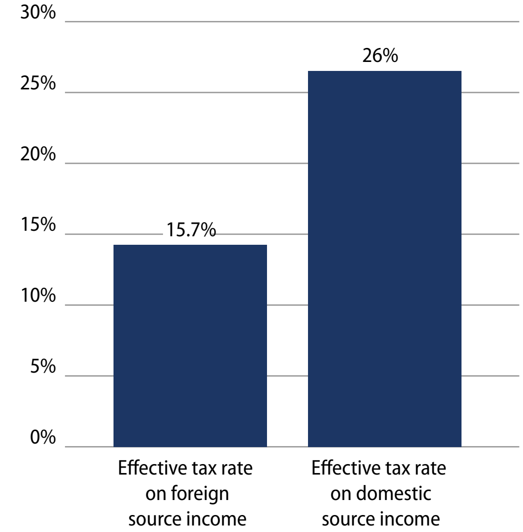
Because deferral often allows U.S. multinationals to avoid taxes on foreign profits for extended periods or indefinitely, the *effective* tax rate that U.S. corporations pay on their foreign profits is by one measure about a third lower than the tax rate on their domestic profits. (see figure)[4]

The differential treatment of domestic and foreign profits "encourage[s] firms to locate physical assets, production, and jobs in [low-tax foreign] countries," according to the nonpartisan Tax Policy Center.[5] Our existing system even encourages companies to invest in high-tax foreign countries instead of the United States: Once they have established operations in a foreign country, U.S. corporations can arbitrage international tax rules to shift profits on paper from that country to other countries, including tax havens.[6] In sum, the U.S. tax code subsidizes overseas investment—a policy that violates economic neutrality and does not serve our national interest.

FIGURE 1

U.S. tax code favors overseas investment

Effective tax rates on foreign-source and domestic-source income of large U.S. corporations, 2007



Source: Melissa Costa and Jennifer G. Gravelle, "Taxing Multinational Corporations: Average Tax Rates," Tax Law Review 65 (2012): 391–414. These rates refer to corporations with assets of more than $10 million.

The U.S. tax code results in billions of dollars being lost to tax havens

The existing international tax system fails to protect the corporate tax base. Enticed by the ability to defer taxes and enabled by porous tax rules and ineffective enforcement, multinational companies have developed elaborate techniques to shift their profits from the United States to low-tax countries around the globe. U.S. multinationals consistently report their largest profits in a handful of relatively small countries that impose little or no corporate tax. American companies reported 43 percent of their overseas profits in Bermuda, Ireland, Luxembourg, the Netherlands, and Switzerland in 2008, even though only 4 percent of these companies' foreign workforces were employed there and only 7 percent of their foreign investments were made there.[7]

Techniques to shift profits include aggressive "transfer pricing," accounting for internal transactions within a multinational-corporate group in ways that, on paper, maximize the profits of affiliates in low-tax countries—such as Ireland or Bermuda—and minimize them in higher-tax countries. The techniques include the increasingly common practice of transferring valuable intangible property such as patents or brand names—things that exist only on paper but can be worth billions—to affiliates in tax-haven countries and then having the affiliates in high-tax countries pay tax-deductible royalties for their use. Profit-shifting techniques also include the strategic use of debt to maximize interest deductions in the United States.

The evidence of rampant profit shifting is overwhelming.[8] By one estimate, the U.S. government lost about $90 billion in revenue in 2008 from corporate income shifting, up from $60 billion in 2004.[9] To put that figure in perspective, the corporate income tax raised an average of $300 billion per year during the 2004–2008 period. Some companies are able to virtually wipe out their federal tax obligations.[10] Clearly, the current tax code is failing on this score.

Some U.S. firms face a heavier tax rate than foreign rivals but there is little evidence that the U.S. tax system puts U.S. multinationals at a competitive disadvantage in the aggregate

The United States has one of the highest statutory corporate tax rates in the world—a federal rate of 35 percent—and, unlike most other countries, has a form of worldwide tax system that stakes a tax claim on all global profits of domestically based multinationals. As a result, some U.S. firms face a heavier tax burden on profits earned in foreign countries than do their foreign rivals.

But there is little empirical evidence that on the whole the U.S. tax system impedes the competitiveness of U.S. firms. Of course, U.S. companies still drive global commerce and are by far the most successful in global markets. And studies of the tax burden on U.S.-based companies relative to their foreign rivals have not found that the U.S. companies face any tax disadvantage in the aggregate.[11] The ability to defer taxes on foreign earnings, coupled with the United States' relatively weak anti-profit-shifting rules[12] and other features of the U.S. system, mean that many U.S. companies have avenues available to reduce their tax costs and offset any disadvantages of the tax system. For some companies, the current tax rules are even more favorable than a pure "exemption" or territorial system, which is discussed in the next section.[13]

This isn't to say that the current system doesn't create challenges for U.S. companies. One consequence of corporations taking advantage of the deferral of tax until repatriation and the opportunities to avoid foreign tax has been the massive buildup of earnings in foreign subsidiaries.[14] The "stranding" of these earnings is not, however, the barrier to U.S. parent corporations that it might appear to be. In the event of cash needs—for investment, operational expenses, dividend payments, or share buy-backs—a parent corporation is in a strong balance-sheet position to borrow at very low interest rates in order to finance such outlays. And it is worth noting that the foreign profits of U.S. multinationals are allowed to be held in U.S. banks under an exception to the rules requiring tax upon repatriation; and a large share are in fact held in the United States.[15]

Nevertheless, the existing U.S. tax system undoubtedly distorts corporate capital structures. The complexity of the tax and accounting structures needed to make deferral work also impose additional costs on firms that would be better invested in their actual businesses. The billions of dollars spent establishing byzantine corporate structures and determining how to meet financing needs without triggering repatriation tax is a deadweight loss for society. In addition, notwithstanding the lack of evidence of an overall negative impact on the competitiveness of U.S. corporations, some companies do appear to be disadvantaged in their competitive dealings and are paying relatively high taxes on their foreign subsidiaries earnings.[16]

Proposals for reform

The impact of our international tax system on competitiveness is multifaceted and nuanced.[17] Taxes affect the relative attractiveness of the United States as a location for investments—such as factories and research labs, among others—and therefore the competitiveness of U.S. workers. Taxes can also affect the cost of capital for U.S.-based firms as they compete in global markets against foreign rivals. Tax considerations may also influence the choice of where new companies choose to incorporate or where the global headquarters of multinationals are situated.[18] And the U.S. tax system's ability to raise adequate revenue advances U.S. competitiveness by allowing investments in the economy through infrastructure, education, and innovation. All of these aspects of competitiveness are important, and progressive international tax reform will seek to balance all of them.

Next we will consider some major proposals and how they balance the critical policy goals of international tax reform.

The United States should not adopt a 'territorial' tax system

The policy debate over U.S. international taxation is often dominated by buzzwords that obscure rather than illuminate the most important issues at stake. It is often said, for example, that the United States is one of few remaining countries with a "worldwide" tax system—in which the profits of U.S.-based companies are subject to U.S. tax wherever in the world they are earned—and that, to maintain our competitiveness, we need to move to a "territorial" system, in which we tax profits earned on U.S. soil, not outside our borders.

In reality, our system is a hybrid. It is "worldwide" in that the profits of U.S.-based companies are subject to U.S. tax wherever they are earned. The U.S. system, however, gives a credit for foreign taxes paid, and, as described above, it allows multinationals to defer U.S. tax on their foreign profits. Since taxes are deferred for long periods and even indefinitely, the U.S. system operates in practice somewhat like a "territorial" system, which in a pure theoretical form exempts foreign profits from tax.

At the same time, many of our trading partners' systems of taxing global income are said to be "territorial," while in fact they too are territorial/worldwide hybrids. For example, many of these countries tax the profits attributable to subsidiaries in tax-haven countries. These "controlled foreign corporation" rules often go further than U.S. rules in ensuring that corporate profits are not shifted on paper to tax havens.

Many multinational corporations and some policymakers support moving the United States toward a territorial system, also called an exemption system because it would amount to an exemption from U.S. tax for U.S. corporations' overseas profits.

Adopting a territorial system carries substantial risks for the United States because it could exacerbate the worst features of our existing tax system. Allowing U.S. corporations not only to defer taxes on foreign profits but avoid them forever without any consequences would further widen the gap in treatment between foreign and domestic profits. That larger foreign bias could cause U.S. corporations to shift investment overseas; one study estimated that as many as 800,000 jobs would be created elsewhere, potentially at the expense of U.S. jobs.[19]

Moving to a territorial system could also worsen the problem of profit shifting by enhancing its rewards. Currently, the tax upon repatriation provides something of a backstop against profit shifting abroad: Tax is ultimately owed even if that tax can be delayed and there are costs for companies to leaving income in foreign subsidiaries. A complete exemption for foreign profits would remove that backstop, enhancing the rewards for the kinds of accounting tricks that make domestic income appear as foreign income. Countries that have moved to territorial systems are finding that profit shifting is undermining their domestic tax base.[20] Adoption of a territorial system, without adequate safeguards, would "eviscerate the U.S. corporate tax base by eliminating any constraints to shifting income abroad," in the words of one tax economist.[21]

In fact, the concept of a territorial tax system is increasingly difficult to apply in today's economy, where global commerce is driven by multinational corporations that are integrated across borders and whose assets are largely intangible (brand names, goodwill, patents, and knowhow). Given the global nature of commerce, the lines between "domestic" and "foreign" profits are difficult to draw. Without safeguards ensuring that corporate profits are taxed somewhere, a shift to "territorial" could simply mean that an increasing share of corporate profits would be taxed nowhere, as they end up reported in tax-haven jurisdictions.

A territorial system makes U.S. firms more "competitive" in the sense that it lowers the tax rate they would face on foreign profits, specifically by removing the cost of repatriating those profits. But a shift to a territorial system would make U.S. workers less competitive by driving capital away, and could further harm U.S. competitiveness by undermining the tax base needed for public investments and sustainable budgets.

A corporate minimum tax would forestall the race to tax havens

In his 2012 State of the Union address, President Barack Obama proposed a "corporate minimum tax" on overseas earnings, which would be similar in purpose and effect as provisions of the corporate tax systems of our trading partners. Under the proposal, if a U.S. corporation is paying taxes in a foreign jurisdiction at a rate lower than the minimum rate (which was not specified), it would have to pay a current tax on the difference. For example, if a subsidiary of a U.S. multinational is reporting profits in Bermuda on which it pays zero (or negligible) corporate tax, it would be required to pay the U.S. minimum tax on a current basis, with the remainder of the regular U.S. tax imposed when those profits were returned home—for example, as dividends to the U.S. corporate parent. As under current rules, companies would still be entitled to a foreign tax credit for any foreign taxes paid.

A corporate minimum tax would help level the playing field between foreign and domestic investment by providing a backstop ensuring that all corporate profits, wherever they are reported, are subject to at least a minimum level of tax in the year they are earned. In so doing, the minimum tax helps narrow the differential between tax rates on foreign investment and on domestic investment. The minimum tax also deters the shifting of profits into tax havens, thus protecting the U.S. revenue base. With a robust minimum tax, there is no reason to set up a tax-haven subsidiary and stuff profits into it. Corporate resources would be freed for more productive uses than finding and exploiting tax havens.

Also, a minimum tax would exert U.S. influence to prevent an international "race to the bottom" on corporate tax rates. Foreign countries—below a point—would not be able to underbid each other to attract U.S. corporations to locate their paper profits there.

A corporate minimum tax is unlikely to put many U.S. firms at a competitive disadvantage. In fact, it would bring the United States' corporate tax antiabuse rules closer in line with those of our major trading partners. Many European countries and Japan have somewhat similar anti-profit-shifting rules that take into account the tax rate paid in the foreign jurisdiction in determining whether to tax a corporation's income on a current basis.[22] For example, under Japan's rule, if a corporate subsidiary in another country is paying an effective tax rate of less than 20 percent, that subsidiary's income is essentially treated as Japanese income and taxed currently at Japanese rates.

The drain of revenue to tax havens creates an urgent need for a U.S. corporate minimum tax.[23] And there is no policy reason why such a critical antiabuse mechanism should only be considered in an overarching corporate tax reform. It would vastly improve the international tax system on its own, while raising needed revenues.

Political reality, however, may mean that a minimum tax will only be considered in the context of a broader tax reform. It has been noted that a corporate minimum tax is not incompatible with a limited exemption for foreign profits.[24] If the minimum tax, coupled with other antiabuse rules, is robust enough to stop tax-haven abuse and limit the rewards for shifting investments overseas, then a shift toward a limited exemption for overseas profits would not run the same risks as a shift toward a pure territorial system that exempted foreign profits with no safeguards.

Measures needed to complement a minimum tax

A minimum tax mechanism is not the only necessary safeguard to protect the domestic tax base. Others include:

- **Thin capitalization/interest allocation rules:** Other countries in the Organisation for Economic Co-operation and Development, or OECD, have adopted rules to prevent the income-stripping strategy of directing the members of a global corporate group in high-tax countries to take on disproportionate leverage, and therefore take advantage of tax deductions for interest expenses in high-tax countries.

- **Greater use of formulary methods:** Transfer pricing, as discussed above, is generally governed by the "arm's length" method. Under the arm's length method, multinational corporate groups are required to set hypothetical "prices" for intragroup transactions as if each of their affiliates were independent entities dealing at arm's length with each other. That standard makes sense in a world of trading in common tangible goods, where it is possible to determine the correct arm's-length price by looking at comparable transactions among third parties. But today, many of the most important intercompany transactions aren't done between unrelated parties in widely traded goods, so comparable transactions provide a reliable reference point less and less often (for example, a software company licensing its brand name and core technology to its own foreign affiliate; a pharmaceutical company and its own, controlled, overseas affiliate entering a "cost-sharing" agreement to develop a potentially lucrative drug).[25] Sometimes the assets themselves are so unique (brand names, know-how, formulas, business opportunities, etc.) that it is all but impossible to put a price on them.

  U.S. tax treaties and the network of international tax treaties generally require the arm's-length standard. But even if arm's length remains the basic standard, tax authorities can and should resort to using "formulary" methods where there exist no good comparable transactions to provide a reliable benchmark.[26] Under such a system, instead of apportioning profits among countries based on a hypothetical arm's-length price, profits are apportioned by a formula of business measures—typically some combination of revenues, payroll, and fixed business assets.

- **Country-by-country reporting:** The magnitude of the overall corporate income-shifting problem is clear from Bureau of Economic Analysis data. Yet investors and government authorities do not have sufficient country-by-country information about public companies' offshore activities. As Sen. Carl Levin (D-MI) has found through several investigations of offshore tax abuses, the lack of country-specific information "impedes efficient tax administration, leaving tax authorities unable to effectively analyze transfer pricing arrangements, foreign tax credits, business arrangements that attempt to play one country off another to avoid taxation, and illicit tactics to move profits to tax havens."[27] Sen. Levin's Stop Tax Haven Abuse Act would require all multinational corporations that file financial reports with the Securities and Exchange Commission to report employees, sales, financing, tax obligations, and tax payments on a country-by-country basis. This provision will aid tax enforcement and also give policymakers critically needed information about how the tax system is functioning.

Multilateral solutions to global tax problems

Because the United States' international corporate tax system is so ineffective in protecting our national interests, Congress should act to reform it. But many of the pressures bearing on the U.S. corporate tax system are global in nature and demand global coordination and cooperation.

The loss of corporate tax revenues to profit-shifting strategies is hardly unique to the United States. Many of our trading partners experience the same drain of corporate revenues as foreign multinationals shift profits from home countries to tax havens. And often, differences in countries' tax rules can result in corporate income falling between the cracks and being taxed nowhere. As the OECD explains:

> *Most tax rules are still grounded in an economic environment characterized by fixed assets, plant and machinery and a lower degree of economic integration across borders, rather than today's environment where much of the profit lies in risk taking and intangibles. Some rules and their underlying policies were built on the assumption that one country would cede taxation as the other would then be able to exercise it. With movements to global supply chains, and aggressive corporate tax structures, that assumption may often not be accurate and profits may often end up in a third, low or no tax, country.*[28]
>
> *[T]he strategies used to shift profits and erode the taxable base put increased pressure on the rules and on the governments that designed them. [Tax avoidance] strategies take advantage of a combination of features of tax systems which have been put in place by home and host countries. Accordingly, it may be impossible for any single country, acting alone, to fully address the issue.*[29]

In February, as part of a new focus on corporate tax base erosion issues, the OECD delivered a report to the G-20 on corporate tax base erosion, calling it a "serious risk to tax revenues, tax sovereignty, and tax fairness for OECD member countries and non-members alike."[30] The OECD report was an urgent call for multilateral action. The finance ministers of Britain, Germany, and France have issued a joint statement calling for greater international coordination and backing the OECD's Base Erosion and Profit Shifting, or BEPS, efforts. The United States should support and indeed lead these efforts to ensure that they bear fruit. It should also exercise leadership within the OECD to ensure that the OECD's influential guidelines on transfer pricing adapt to current economic realities and address the shared problem of income shifting.[31] Specifically, we should use our influence to push the OECD to reduce reliance on the increasingly obsolete arm's-length standard, and embrace formulary apportionment in the transfer pricing guidelines and model tax treaty.

The European Commission has already proposed a Common Consolidated Corporate Tax Base, or CCCTB, for the European Union. If adopted, the CCCTB would introduce a common European tax base to allow firms to calculate their aggregate EU-wide profits.[32] Profits would then be apportioned among member states according to a formula, with tax rates determined by each country according to its policies. The CCCTB's formula would be based on three equally weighted factors: (1) payroll and number of employees in each country; (2) sales in each country; and (3) the value of fixed tangible assets in each country. The CCCTB is a pioneering cross-border approach, but it has strong precedents: The United States and Canada apportion income in a similar fashion among states and provinces.[33] The European CCCTB would be adopted on a voluntary basis, at least at first. But it illustrates the European Union's recognition that territorial tax systems are vulnerable to income shifting from transfer pricing; that the most effective approach to the challenge of defining the corporate tax base is multilateral; and that, given the complexity of cross-border transactions, the arm's-length method is increasingly unreliable, while formulary apportionment is a viable alternative.

Eliminating the bias toward debt

One of the other serious flaws of the corporate tax code is that it encourages companies to incur debt, and this practice can lead to higher and sometimes unhealthy levels of leverage. The bias toward debt results from the fact that corporations can deduct interest payments to creditors but not dividends to shareholders.

This differential treatment is rooted in the outdated economic notion that creditors are third-party outsiders lending funds to the corporation while shareholders are insiders playing an active role in managing the corporation.[34] In today's business world, however, it is difficult to draw such a clear line. Rank-and-file shareholders exercise little control over the corporations they invest in, while creditors might closely monitor and influence their borrowers. And new financial instruments have arisen, blurring the traditional lines between debt and equity, and making the stark differential in tax treatment increasingly arbitrary.[35]

This differential treatment results in an enormous gap between the effective tax rates on investments financed with debt and those financed with equity. The Treasury's Office of Tax Analysis found that debt-financed corporate investment faces an effective marginal tax rate[36] of negative 2.2 percent, while equity-financed corporate investment faces a rate more than 40 percentage points higher, including both corporate- and shareholder-level taxes. Many countries' corporate tax systems are biased toward debt in a similar manner, but the disparity between debt and equity in the United States is the highest among OECD nations.[37] In short, our tax code subsidizes corporate debt.

Unfortunately, the tax code's bias in favor of debt financing has far-reaching consequences. The code encourages firms to have more debt in their capital structure than they otherwise would, increasing their vulnerability to business downturns.[38] And when firms fail, it results in disruptions and bankruptcies that impose social costs on employees, vendors, and the wider economy.[39] According to a recent report by the International Monetary Fund, "The general view of experts has been that the bias was not a major cause of the financial crisis. … Yet by contributing to the excessive leverage of firms, it might well have deepened the crisis."[40] The debt bias also creates competitive distortions: It favors corporations that have access to debt financing over those that do not, and it subsidizes firms that purchase companies using debt, as through leveraged buyouts.[41]

The deductibility of interest also enables corporations to shift their taxable profits outside of the United States to minimize their tax bills here, and this shift diminishes the U.S. tax base.[42] Without limits on interest deductions, U.S. corporations can borrow funds in the United States, deduct the interest payments against their U.S. tax bills, and then use the proceeds to make investments overseas, where the resulting profits will be tax deferred.

Corporate tax reform can address the bias toward debt by limiting corporate interest deductions. Using some of the resulting revenue to pay for a reduction in corporate rates would further reduce the debt bias. Both President Obama and House Ways and Means Committee Chairman Rep. Dave Camp (R-MI) have identified interest deductions as a potential area for reform.[43]

There are several ways to limit interest deductions that warrant deeper consideration by policymakers:

- The president's Economic Recovery Advisory Board's August 2010 report on tax reform options offered an illustrative proposal to limit the deductibility of net interest expense to 90 percent of expense in excess of $5 million per year. So, for example, if a corporation has $15 million of net interest expense, it could deduct all of the first $5 million and then $9 million of the next $10 million. The Treasury Department estimated roughly that the revenue effect of the proposal would allow for a 0.7 percent reduction in the corporate rate. Other analysts have estimated that a stricter limit on interest expense would allow for an even greater reduction in the corporate rate.[44]

- Germany recently enacted an innovative limit on corporate interest deductions, with the resulting revenue helping to offset a reduction in the corporate rate.[45] Under Germany's rule, interest is deductible only up to 30 percent of annual earnings before interest, taxes, depreciation, and amortization, or EBITDA.[46] The rule applies only when net interest (interest expense minus interest income) is higher than €3 million (about $4 million), thereby exempting smaller businesses.

- Another approach is to deny deductions for the portion of interest expense attributable to inflation. Such a proposal is included in the bipartisan tax reform legislation submitted by Sens. Ron Wyden (D-OR) and Dan Coats (R-IN), and is estimated to raise $163 billion in revenue over 10 years.

All of these approaches would improve our tax system by reducing the debt bias. Of the three, the percentage limit suggested by the president's Economic Recovery Advisory Board might be the most workable, although a more aggressive version might be even better. It would apply fairly consistently across larger firms rather than affecting only firms that have high-interest expenses in certain years, as with the German approach. It is also a more direct method to limiting interest deductions than the Wyden-Coats approach.

Broadening the tax base and leveling the playing field to reduce distortions and enhance growth

Tax expenditures—subsidies delivered through the tax code in the form of tax deductions, deferrals, and credits—reduce corporate tax revenues by more than $100 billion per year. While some of these provisions are incentives backed by solid economic rationales, many are simply preferences for politically favored industries or relics of the tax code that have existed for decades with little scrutiny. There are also unjustified loopholes that are not technically counted as tax expenditures in the official accounting, but should be. Reforming tax expenditures and closing loopholes could help boost federal revenues and pay for a lower corporate rate. Perhaps as importantly, reducing the number of unjustified subsidies in the tax code reduces harmful economic distortions and thereby improves the prospects for growth. Here is a partial list of tax breaks that should be addressed:

- **Oil and gas:** The tax code provides more than $4 billion per year in tax subsidies for fossil fuels. Big Oil companies, among the most profitable companies in the world, are among the primary beneficiaries. Several of these subsidies are relics of the tax code, originated nearly 100 years ago and continued because of concerted lobbying efforts. Taxpayer subsidies are simply not needed for a mature and profitable industry, especially at a time of high gas prices. Eliminating them is a long-overdue priority.

- **Timber and agriculture:** Timber companies and agribusinesses benefit from a number of special tax preferences, including special expensing provisions and capital gains treatment of certain items. Eliminating these provisions would save about $1 billion per year.[47]

- **LIFO/LCM:** Special tax provisions allow companies to choose the most favorable methods for valuing their inventory and cost of goods sold. The "last-in-first-out," or LIFO, and the lower-cost-or-market, or LCM, methods amount to subsidies for holding inefficient amounts of inventory.[48] The Treasury Department estimates that eliminating these tax subsidies would gain $88 billion in revenue over 10 years, allowing for a 10-year phase-out period.[49] The revenue gain from disallowing LIFO, however, would be less over the long term.

- **Offshore reinsurance loophole:** The tax code includes provisions intended to prevent "interest stripping" by foreign-owned corporations operating in the United States. But similar rules do not exist for foreign-owned insurance companies that deduct reinsurance premiums paid to affiliates in Bermuda and Switzerland to reduce their U.S. taxable income. This loophole, which costs $1.7 billion per year, puts domestic reinsurers at a competitive disadvantage. Legislation introduced by Rep. Richard Neal (D-MA) and a similar Obama administration proposal would close this loophole.[50]

- **Like-kind exchanges:** Originally intended to help farmers exchange land, livestock, or farm equipment, a special rule in the tax code allows corporations and real-estate investors to defer paying taxes on realized gains. As The New York Times recently reported, some major corporations "have routinely pushed the boundaries [of the like-kind exchange rules] while claiming lucrative tax savings."[51] In all, like-kind exchanges cost the Treasury $3 billion per year. Congress should consider eliminating like-kind exchanges or strongly limiting their use.

- **Tax-exempt organizations providing commercial services:** Certain organizations, including fraternal-benefit societies and credit unions, are exempt from corporate income taxes even though many are large institutions that compete with taxable rivals to provide financial services. Congress should examine whether the largest of these organizations should receive a special subsidy if the scale of their operations rivals for-profit competitors.

- **Business meals and entertainment:** Food and entertainment are personal expenses. If people take their families out to dinner, they cannot deduct the cost of that meal from their taxable income. If, however, they take someone out to lunch and claim it is for a business purpose, then they can deduct half of the cost of the meal. This special exception, which costs the Treasury up to $14 billion per year,[52] acts as an unnecessary subsidy for people benefiting from expense accounts as well as their guests.[53] Allowing deductions for business meals and entertainment also results in an unknown quantity of abuse and fraud, with personal expenses classified as "business" expenses and the IRS ill-equipped to police the legitimacy of the deductions.[54]

- **Advertising deductions:** Businesses can generally deduct their advertising costs in the year they are incurred. But advertising can have long-lasting rewards for a business, increasing its income over many years. Therefore, policymakers should consider requiring businesses to "capitalize" a portion of their advertising costs under a wider range of circumstances than currently required, which would mean that they would take deductions over a period of time rather than all at once.

- **Distinctions between corporate and noncorporate businesses:** Another area where base broadening is needed to ensure a level playing field among businesses involves the increased use of pass-through businesses that avoid corporate-level taxes. C corporations pay corporate taxes, and their owners (i.e., shareholders) pay taxes on dividends distributed out of post-tax profits. But pass-through entities do not pay entity-level tax; rather, profits are attributed and taxed directly to owners. The use of pass-through business forms has been rising, both because states have created more noncorporate business forms that confer limited liability and other corporate attributes, and because of the relaxation of federal rules regarding "subchapter S" corporations. Currently, whether or not a business is subject to the corporate tax often depends on whether it is publicly traded. But some extremely large businesses that are not publicly traded compete with those that are without paying corporate-level tax. For example, the engineering firm Bechtel, with $33 billion in revenues in 2012, is structured as an S corporation and is thus exempt from corporate taxes.

  Redrawing the line between corporate and noncorporate businesses, and adding business size as a criteria, would be a good step in broadening the corporate tax base while ensuring that at least large businesses compete on a level playing field within the same tax framework.[55] Congress should also reconsider the special exceptions from the general rule that publicly traded entities must pay corporate tax, including those for investment partnerships and "master limited partnerships" in the oil and gas field.

- **Accelerated depreciation and the domestic production deduction:** These tax expenditures, the two largest, will reduce revenues by a combined $900 billion over the next 10 years.[56]

  Corporate tax reform is an opportunity to review how current depreciation schedules produce uneven tax rates, potentially slowing growth by distorting investments. One recent study found that effective tax rates vary widely by investment type. For example, mining structures and oil and gas structures are taxed at a mere 7 percent rate, while other structures can face a 35 percent to 40 percent effective tax rate. Similarly, the effective tax rate on investments in ships and boats was found to be about half that for autos.[57]

The domestic production deduction (section 199) should also be reviewed. It is clearly overbroad: Intended as an incentive for U.S. manufacturing, it applies to oil extraction and software development, among myriad other areas. Congress should reform the deduction to better target it toward its core purpose of encouraging domestic manufacturing.

Yet while reforms to these two incentives should be on the table in corporate tax reform, Congress should balance several concerns in wringing budget savings from them to pay for a lower rate.

Reducing accelerated depreciation to pay for a lower corporate rate runs the risk of providing a tax windfall for past corporate investments while removing an incentive for future ones. That is because a significant share of the benefits from a lower corporate rate flow to "old capital"—in other words, investments made before the change in tax policies—whereas accelerated depreciation exclusively encourages future investment. Economists at the Joint Committee on Taxation have found that trading reductions in accelerated depreciation for a lower corporate rate "results in a macroeconomic outlook that is worse by several measures than the current law baseline, with potentially lower consumption, employment, real GDP, and capital stock [particularly in the medium term]."[58]

Accelerated depreciation and the domestic production deduction also serve to mitigate the bias against domestic investment created by the tax deferral of foreign profits. They also act as a balance to incentives that other countries offer in their tax codes or in other forms of support and subsidies.

Corporate tax reform should contribute to increased federal revenue

Corporate tax reform will not happen in a vacuum. Policymakers must consider the overall economic challenges facing the country, including the problem of unsustainable deficits over the long term and shortfalls in needed public investments.

The corporate sector in the United States has a strong stake in our country's fiscal sustainability and growth. As they invest, innovate, hire, and earn returns for shareholders, U.S. corporations benefit greatly from government services, from law enforcement to product safety, patent protection, education, and workforce development. Given the need to address vital national priorities at a time of unsustainable budget deficits, the corporate sector cannot be exempted from contributing to the solution.

The corporate income tax is a significant revenue source, but it contributes a smaller share of federal revenues than it used to and a smaller share of revenues than corporate taxes in most other advanced economies. In 1953 corporate tax revenues were 5.6 percent of GDP and 30 percent of federal tax revenues. Over the past decade, corporate tax revenues averaged 1.8 percent of GDP and 10.3 percent of federal revenues, notwithstanding the fact that corporate profits constitute a growing share of the economy.[59] Corporate tax revenues in the United States are about 25 percent lower than the OECD average.[60] The diminishing corporate tax has worsened budget deficits and has caused the United States to rely more on other taxes, especially payroll and individual income taxes.

The decline of corporate tax revenue has been principally driven by two trends. First, corporations are paying lower taxes on their profits. The U.S. statutory corporate tax rate, at 35 percent, has remained nearly constant since the 1986 tax reform, and is the highest among OECD countries. Yet the effective rate paid by corporations—what they actually pay as a percentage of their profits—has declined. According to the Congressional Research Service, "Despite concerns expressed about the size of the corporate tax rate, current corporate taxes are extremely low by historical standards, whether measured as a share of output or based on the effective tax rate on income."[61]

And though the U.S. tax rate stands at 35 percent, effective tax rates put U.S. companies squarely in line with companies in other major economies:

- A survey of 280 Fortune 500 companies, each of which was profitable in all years from 2008 through 2010, found that they paid 18.5 percent of their profits in U.S. federal corporate income tax—slightly more than half of the statutory rate.

- The Congressional Research Service found that corporate effective rates are lower than average for OECD countries (weighted by the size of their economies).[62]

- A comprehensive study of the 100 largest U.S. multinationals and the 100 largest EU multinationals found that the U.S. companies paid lower effective rates, in the aggregate, over a 10-year period.[63]

The reason that the United States collects relatively little in corporate tax revenue despite having the highest statutory rate in the world is the narrowness of its corporate tax base. As a 2007 Treasury report concluded, "The contrast between [the United States'] high statutory corporate income tax rate and low average corporate tax rate implies a relatively narrow corporate tax base, due to accelerated depreciation allowances, corporate tax preferences, and tax-planning incentives created by [the] high statutory rate."[64]

The tattered state of the U.S. corporate tax base means that U.S. corporations can, on the whole, contribute a greater share of revenues without jeopardizing their competitiveness or the overall competitiveness of our economy. Given the huge potential savings from broadening the corporate tax base, it is possible to achieve deficit reduction from the corporate tax while also lowering the statutory rate. A lower corporate rate would reduce economic distortions caused by the corporate tax, including the disparities in tax rates among industries and the bias toward debt. Both goals—deficit reduction and a lower corporate rate—are desirable, and whether they are achievable depends on Congress's willingness to broaden and repair the corporate tax base.

Rehabilitating the corporate tax base is also important for ensuring a progressive overall tax system. By preventing tax sheltering by high-income individuals, the corporate tax provides a needed backstop to the individual income tax, and it is itself a strongly progressive tax.[65]

Conclusion

Corporate tax reform is complicated and involves many moving and interacting parts. Special preferences and loopholes in the code have created an extremely narrow tax base. Clearly, obsolete preferences and those that divert economic activity into less-productive pursuits should be eliminated. On the other hand, though not otherwise discussed here, measures such as the Research Credit can, if appropriately designed, encourage innovations that are beneficial to long-term economic health. Meanwhile, the deduction for interest payments on debt encourages companies to take on excessive leverage to minimize tax payments. Eliminating inefficient corporate tax expenditures and limiting deductions for interest payments on debt could raise significant revenue for investments in our future, and potentially allow for some rate reduction, which would, in turn, alleviate some of the concerns expressed by corporations about the current tax system.

With respect to the treatment of international income, reform efforts must deal with the rampant tax avoidance that the current system allows, encourage job creation in the United States, and address the legitimate concerns of multinational corporations. Moving to a pure territorial system would exacerbate many of the current problems with the tax system, and, while eliminating deferral is attractive, in the long run it could have adverse, unintended consequences and is unrealistic. A more likely and helpful approach would be to put in place a new hybrid model that includes a robust minimum tax that would immediately apply to all income (i.e., no deferral), thereby diminishing the incentive to shift income to low-tax countries or move jobs overseas. Most countries that ostensibly have territorial systems actually follow this kind of model, but the revised U.S. system should be more aggressive and include the full range of anti-tax-avoidance measures. Concerns expressed by multinational corporations could be addressed by adjusting the corporate tax rate overall or with a modestly differentiated rate for repatriated earnings—consistent with an overall increase in revenues.

Finally, the United States should work with its trading partners to address these issues. International cooperation is necessary for meeting all of the challenges in fair ways that benefit both U.S. and global economic growth.

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59 Jane G. Gravelle and Thomas L. Hungerford, "Corporate Tax Reform: Issues for Congress" (Washington: Congressional Research Service, 2011), available at http://taxprof.typepad.com/files/crs-rl34229.pdf; Congressional Budget Office, "Budget and Economic Outlook: Fiscal Years 2011 to 2021" (2011), available at http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/120xx/doc12039/01-26_fy2011outlook.pdf; Chris Isadore, "Corporate Profits Hit Record as Wages Get Squeezed," CNN Money, December 4, 2012, available at http://money.cnn.com/2012/12/03/news/economy/record-corporate-profits/. The measure of corporate profits conducted by the Bureau of Economic Analysis's National Income and Product Accounts includes entities not subject to the corporate income tax, including S corporations. As discussed below, one of the primary reasons for the decline of corporate tax revenue is the rise of S corporations and other business forms that are not subject to corporate taxes.

60 From 2001 through 2010, U.S. corporate taxes averaged 2.4 percent of GDP compared to 3.3 percent of GDP for the OECD as a whole. Organisation for Economic Co-operation and Development, "Revenue Statistics—Comparative tables," available at http://stats.oecd.org/Index.aspx?QueryId=21699 (last accessed June 2013).

61 Gravelle and Hungerford, "Corporate Tax Reform."

62 Jane G. Gravelle, "International Corporate Tax Rate Comparisons and Policy Implications" (Washington: Congressional Research Service, 2012), available at http://www.fas.org/sgp/crs/misc/R41743.pdf. The Congressional Research Service found that marginal effective rates—the expected tax rate on new investments—were only slightly higher in the United States compared to the weighted OECD average. The Treasury Office of Tax Analysis found the United States' marginal effective rates to be slightly lower than average among the other G-7 nations. The White House and the U.S. Department of the Treasury, "The President's Framework for Business Tax Reform."

63 Avi-Yonah and Lahav, "The Effective Tax Rate of the Largest U.S. and EU Multinationals." Avi-Yonah and Lahav note that "Japanese multinationals are known to be subject to higher statutory and effective tax rates than U.S. ones, and therefore, they are less relevant to this debate."

64 U.S. Department of the Treasury, "Treasury Conference on Business Taxation and Global Competitiveness" (2007), available at http://www.treasury.gov/press-center/press-releases/Documents/07230%20r.pdf.

65 The corporate tax is of course ultimately borne by individuals. There are unresolved questions about what percentage of the corporate tax is borne by owners of capital and what percentage is borne by workers. Nevertheless, the corporate tax is generally progressive even when the general belief that it is borne mostly by owners of capital is adjusted to assume that much of its incidence is borne by labor. Benjamin H. Harris, "Corporate Tax Incidence and Its Implications for Progressivity" (Washington: Tax Policy Center, 2009), available at http://www.urban.org/uploadedpdf/1001349_corporate_tax_incidence.pdf. And to the degree that the corporate income tax prevents wealthy individuals from sheltering income, it furthers the progressivity of the individual income tax.