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WHY CORPORATE TAX REFORM CAN HAPPEN

Edward D. Kleinbard[1]

This brief essay explains in an informal way to nonspecialists what the stakes are for corporate tax reform and why such reform is more politically feasible than most observers believe. The essay emphasizes the central importance of international tax design as the largest conceptual impediment, but demonstrates that a framework has emerged that can serve as the basis for constructive negotiations. The essay further offers a novel strategy for dealing with the problem that a large fraction of U.S. business income is earned by unincorporated businesses.

I. The Mess We're In.

The President's Budget proposes the most sweeping changes in 50 years to the taxation of U.S. corporations generally, and to the international income of U.S. multinationals in particular. To groups like the Business Roundtable, these international tax proposals are "anticompetitive" and reflect poor economics, while to the Left, they are a giveaway to big business. In fact, neither claim is true, and the carefully calibrated responses of senior Republicans on the Hill signal that a rough framework is emerging that could stun pundits by actually becoming the basis of corporate tax reform legislation.

A. Revenues and Scope of Reform.

Two preliminary issues must be addressed before turning to the prospects for corporate tax reform. First is the question of tax revenues. Here the answer is simple. If the corporate tax rate is to come down to a figure in the middle of the pack of peer countries, there really isn't any room left to imagine corporate tax reform as a significant steady-state source of funds that can be deployed to reduce personal income tax rates. To phrase matters more colloquially, we should be so lucky as to get to genuine revenue-

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neutral corporate tax reform (that is, without counting one-time pickups like the tax on existing offshore retained earnings described below). The large tax reform package proposed by Dave Camp in 2014, when he was Chairman of the House Ways and Means Committee, apparently contemplated the corporate sector subsidizing individual rates, perhaps to the extent of roughly $250 billion over 10 years, but the numbers are difficult to parse because of how they were presented, and in any event included very large one-time corporate transition taxes.

The second preliminary matter is the problem of what to do about "pass-throughs" – businesses whose incomes are taxed only to owners. (Partnerships, S corporations and limited liability companies are all species of pass-throughs.) The technical question here is whether one can imagine "corporate only" tax reform, or whether instead pass-throughs must be included as well. The question is made difficult by the fact that most business tax reforms that broaden the tax base by eliminating tax expenditures (essentially, government subsidy programs baked into the tax code) would affect both the corporate and unincorporated business sectors; if the resulting revenue gains are used to buy down the corporate tax rate, pass-through business owners will argue that they are being asked to pay for lower tax rates that benefit only our largest business enterprises.

The United States and Germany are unusual in that a large portion of each country's business income is earned through pass-through vehicles. In the United States, pass-throughs are often represented as earning more than 50 percent of the country's total business income. This overstates matters, however, because much pass-through business income in fact is simply labor income that owners take in the form of business profits rather than explicit wages; in terms of relative capital intensiveness, corporations account for roughly twice as much as pass-throughs. Even so, pass-throughs earn a large fraction of business income, and of course are politically potent.

In political speech, pass-throughs are often equated with "small businesses," which in turn invariably are invoked as the engine of job creation. Both steps in the syllogism are false. Many pass-throughs are very large enterprises, and many small businesses (think about your hair salon, or accountant) are quite stable in their employment and already receive many subsidies. Today, pass-throughs enjoy lower

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effective (real life) tax rates than do corporates, particularly once the dividend tax cost of distributing profits to owners is considered. Further, a great many high-income wage earners hide behind the skirts of small business, using the political resonance of small business to apply leverage for lower tax rates on all personal incomes at the highest levels, however earned. But political nostrums still dominate policy, and so pass-throughs must be accommodated if corporate tax reform is to proceed.

The Administration's answer in the Budget is to propose some special new tax deductions that would be available only for small businesses, not all pass-throughs. But there is in fact a better way to proceed. The ultimate goal, for a host of policy and administrative reasons, should be to encourage (but not require) all but micro-businesses to incorporate, so that all significant businesses face the same basic tax system. Incorporating is tax-free, and if in fact corporate tax rates drop to the mid-20's, the large tax rate differential in favor of the corporate form, even after taking dividend tax costs into account, might by itself precipitate a wave of incorporations.

The final piece would be to provide a more congenial environment for authentic small business, once inside the corporate fold, than does the Budget, by offering genuine progressive tax rate brackets. For example, the first $2 million of corporate income (to choose an arbitrary stalking horse) would be taxed at lower rates than the top new corporate rate. In turn, the benefit of the lower rates could be clawed back through a corporate surtax applicable to corporate incomes above a much higher level, such as $10 million, until the benefit of the low rate tax brackets is recaptured. Current law nominally does all this, but the claw back operates at such a low level that it makes the existing low corporate rates meaningless.

In short, and contrary to many claims, corporate-only tax reform, properly constructed, is feasible. Doing so will require attention to appropriate graduated tax rates and a reasonable "all-in" burden after dividend or capital gains taxes are considered, but these are not insurmountable barriers.

B. Why Corporate Tax Reform is Urgently Required.

The United States desperately needs corporate tax reform, for three reasons. First, the U.S. statutory rate (35 percent) is much higher than world norms. This is a serious competitiveness issue that hurts U.S. domestic corporate business much more than it burdens our largest multinationals. Second, the effective (real world) tax rate on corporate income is all over the map, as a result of tax subsidies and the law's systematic bias in favor of debt financing. Third, the tax rules applicable to the international operations of U.S. multinationals are universally reviled as just a half step short of utter madness.

The last Republican comprehensive tax reform package and the President envision the same rate on domestic manufacturing income (25 percent), and the "bid-ask" spread on other domestic income (25 vs. 28 percent) is easily bridged. The second point is more complex, but the reforms necessary to pay for the lower rate will bring effective rates across different investments into closer alignment. This leaves reaching an agreement on international taxation as the major impediment to corporate tax reform.

C. The Puzzle of International Tax.

International tax policy is difficult stuff. Most countries tax their residents on their worldwide income, but corporations are artificial persons, and multinationals operate through many local subsidiaries. What's more, to encourage open global markets, some principle must be applied to prevent the double taxation of cross-border corporate income, once in the foreign country where earned (the "source" country), and once again in the country where the corporation (or its parent company) is domiciled (the "residence" country). For almost 100 years, the consensus has been that source countries should have first priority in taxing business income arising in their jurisdictions.

All the excitement really boils down to one theoretical and one practical question. First, should a residence country impose a secondary residual tax, when its tax rates exceed those of the local source countries? (Such a regime is called a "worldwide" system; a regime that opts not to tax business profits attributable to foreign operations is a "territorial" system.) And second, how on earth do we figure out in practice what business income "really" arises in which source country? When an Amazon customer in Germany orders a book through a website residing on servers in Ireland, using a software platform originally developed in the United States and adapted in Luxembourg, and takes delivery through a German logistical subsidiary, which retrieves the book from a warehouse in France, how much profit resides where?

Most tax economists would agree that an ideal territorial tax system is superior to an ideal worldwide system, but the problem is that, as my Amazon hypothetical implies, real business operations just cannot be crammed into such tidy conceptual cubbyholes. We're not talking about rounding errors, as if we were carrying water with a slightly leaky bucket – the current international tax environment operates more like ferrying water a mile in a sieve. Firms show an uncanny aptitude for applying rules and cutting special deals to divert profits to very low taxed jurisdictions, in magnitudes completely unrelated to any rational theory of where value is being added.

For example, we know a good deal about where Amazon actually books its European business profits for tax purposes, thanks to a very recent EU investigation. The answer essentially is, "nowhere." Amazon bases its European operations in Luxembourg, a small, low-tax country always willing to cut a special deal. Most profits from Amazon's European business flow to its Luxembourg operating company. That company in turn pays "royalties" equal to most of its pre-royalty income to an intangibles holding company, also in Luxembourg, thereby wiping out most of the operating company's tax bill. Then, in the sort of magic for which U.S. firms are the leading prestidigitators, Luxembourg says that the intangibles holding company is located in the United States, and therefore cannot be taxed by Luxembourg, while the United States believes that the company is in Luxembourg, and thus is not subject to U.S. tax unless and until it pays dividends to its U.S. parent.

As another example, Microsoft's financial statements suggest that it pays an effective foreign income tax rate of around 4 percent. In what imaginary countries are its foreign employees and customers located to explain this?

The geographic source of income is too uncertain, and too easily manipulated, for any sensible country to afford a pure territorial system: anti-abuse or income apportionment rules are needed. A true worldwide tax system (where a U.S. multinational would pay U.S. tax on the global net income of the entire group, less a credit for foreign taxes actually paid) would substantially eliminate the payoffs from the "stateless income" tax planning that firms use today to drive their foreign tax rates down to single digits (because U.S. tax would be due in any case), but would encourage indifference to foreign tax bills (thanks to the U.S. tax credit), and would require a low tax rate for "competitiveness" reasons. In practice, every country is sufficiently concerned about "competitiveness" to stop short of adopting true worldwide taxation.

Most tax systems today therefore are a hodgepodge of different themes, bolting anti-abuse rules on top of general rules, all in light of a particular country's economic circumstances. The nominal starting point for most countries is a territorial system, and for the United States a worldwide system, but there are no pure territorial or worldwide tax systems in practice.

The United States perfectly illustrates this. Its tax system is described as "worldwide," but in fact it operates in practice as an ersatz territorial system, without any of the safeguards appropriate to one, and with a bizarre and economically inefficient twist. That twist is "deferral," under which a U.S. multinational can enjoy an anything-goes sort of territorial tax environment, but only so long as it leaves its low-taxed foreign profits in its foreign subsidiaries, and does not "repatriate" the earnings to the U.S. parent or its shareholders. What's more, by declaring to their accountants that these offshore low-taxed profits are "permanently reinvested" outside the United States, firms effectively operate on a territorial basis for financial statement purposes as well.

The result is that today U.S. firms have booked over $2 trillion in cumulative offshore low-taxed profits, of which roughly $1 trillion is in the form of cash (i.e. bank deposits in U.S. banks, short-term Treasury notes, etc.) As a result, most U.S. firms are posturing when they claim that the current system is anticompetitive for them.

Deferral is the exception that swallows up our "worldwide" tax rule, and it is also the source of all the instability in the current U.S. system. Shareholders are frustrated by large sums of cash on firms' balance sheets, just out of reach (because the residual U.S. repatriation tax is prohibitive). Firms waste resources planning around the edges of the rules, borrowing in the United States to fund dividends (so as not to trigger the repatriation tax), or making suboptimal foreign investments with their offshore cash in order to put the money to at least some use. And the United States collects very little by way of current repatriation taxes. Inversions and demands for "repatriation holidays" reflect the pent up demand to use offshore earnings domestically, primarily to return those earnings to shareholders, not to invest in U.S. business. (We saw exactly this pattern when Congress in 2004 offered a "one-time" repatriation tax holiday, and over $300 billion in cash was repatriated.)

Current law thus leads to perverse corporate behaviors, but not to a loss of firm competitiveness, or significant tax collections. The system is imploding because firms are drowning in the sheer volume of their offshore cash – a sure signal that firms' stateless income tax planning has outrun good ideas for what to do with those profits. Firms understandably do not want to pay 35 percent tax on their global profits, and rightly point out that our statutory corporate tax rate has become an outlier by world norms. But from the other direction, U.S. multinationals implicitly did agree to residual U.S. tax as the price of deferral, and much of their foreign income has been taxed essentially nowhere. Firms thus find themselves hoist by their own petard.

II. How The Budget Responds to the Current Mess.

This brings us at last to the President's Budget. It contains four important proposals relevant here. First, as indicated earlier the Budget contemplates a lower domestic corporate tax rate in line with world norms and Republican aspirations. Second, it adopts a new territorial tax as the basic structure of our international corporate tax rules, again consistent with Republican views. Third, the Budget proposes a one-time transition tax to wipe the slate clean with respect to past stockpiles of low-taxed offshore earnings: in lieu of a highly contingent 35 percent tax liability on ultimate repatriations, firms would be required to pay a 14 percent tax today on all their offshore earnings. (The tax bill could be paid in installments over several years.) And finally, the United States would adopt a novel 19 percent minimum tax, under which the United States would impose an immediate tax (on a country-by-country basis) if U.S. firms drive their foreign effective tax rates below the floor set by the minimum tax.

The President's proposals need to be understood against the background of worldwide tax developments. In a nutshell, there is lots of evidence that foreign countries have lost their patience with the stateless income tactics of multinationals generally, and U.S. firms in particular. The OECD is pushing forward on its "Base Erosion and Profit Shifting" initiative, designed to reset the international consensus on taxing cross border profits; the EU has moved aggressively against secret tax deals between countries like Luxembourg and multinational firms; and some countries, like the U.K., have jumped the queue by adopting their own measures to preserve their tax bases from the depredations of cross-border tax planning. So, while U.S. multinational CEOs may not fully have internalized the fact, U.S. multinationals will in the near future pay higher taxes on their foreign income: the only interesting question is, how much will be collected by foreign source countries, and how much by the United States?

The Administration's transition tax and the minimum tax actually have their roots in the comprehensive tax reform first mooted by Republican Dave Camp in 2011, and revised in 2014, when he was chairman of the House Ways and Means Committee. His thoughtful proposal for a new territorial tax system went nowhere, but did represent a real conceptual breakthrough: for the first time, a senior Republican tax policymaker acknowledged that moving to a toothless territorial tax system was a terrible idea, because doing so would only lead to U.S. firms doubling down on the same aggressive tax strategies that they employ today. As a result, Camp proposed a number of possible anti-abuse rules, including the germ of a minimum tax to backstop the new system.

Under the President's proposal, the new U.S. territorial tax system would impose no tax on post-enactment repatriation dividends. The Camp bill, by contrast, retained a 1.25 percent repatriation dividend tax going forward.

The President's proposed 14 percent transition tax on existing offshore retained earnings would be offset by a partial tax credit for foreign taxes actually paid on those earnings. To the extent that firms have been particularly adroit in driving down their foreign tax bills, the time therefore would come to pay the piper his full 14 percent.

The transition tax is projected to raise $268 billion in revenues. Business has reacted angrily to the tax, even though they will emerge with the territorial tax system for which they have clamored. The reason is simple: firms have no tax reserves against those offshore earnings, and the resulting tax therefore will be a dramatic hit to financial earnings as well as to cash. At the same time, progressives have criticized the rate as too generous, because it excuses firms from their contingent 35 percent tax liability on ultimate repatriations under current law.

Firms point to the 2004 "one-time" repatriation holiday tax rate of 5.25 percent, as if it were a ceiling on conscionable rates. But that repatriation holiday, like the one currently proposed by Senators Boxer and Paul, was fundamentally different in operation from the superficially similar transition tax. The repatriation holiday was a voluntary sort of amnesty program, and therefore to be effective, the rate had to be artificially low. What's more, the amnesty did not change the background tax law: firms could if they chose continue to hold their offshore earnings free of U.S. tax through the mechanism of deferral. Now, by contrast, all firms will move to a genuine territorial tax system, under which there is no incremental tax hit for repatriating foreign profits. It is necessary to do something to wipe the slate clean – no supercomputer yet exists that could enable a firm to keep track of both current and future international tax rules simultaneously.

A transition tax that applies only to past activities has a unique standing in tax economics. Such a tax is said to be "efficient," because unlike taxes on current or future profits, there is no anti-avoidance behavior possible, since the tax base is entirely backwards-looking. Firms thus should not look to economic theory to justify an abnormally low tax rate. And from the other direction, the Budget commits the $268 billion raised by the transition tax to infrastructure investment, through financing a reinvigorated Highway Trust Fund; this investment arguably makes sense on its own, and tying the two together no doubt is intended to mollify those on the Left who think the proposal is too easy on multinationals.

Chairman Camp also proposed a mandatory transition tax, ranging up to 8.75 percent in his 2014 version. That bill would have raised $170 billion in revenues – less than the Administration's proposal, but close enough to spark a productive conversation. One attractive feature of the 2014 Camp proposal was its split tax rate, with a higher rate on offshore cash, and a lower rate on offshore earnings invested in real business assets. The key point is that the basic framework is in place for constructive negotiations: a low corporate tax rate, a territorial international tax system, and a mandatory transition tax from the old system at some discounted rate.

Finally, the Budget contemplates a new 19 percent minimum tax to backstop the territorial tax system, estimated to raise $206 billion in tax revenues over 10 years. The details of the minimum tax are complex, but the way to understand things is that the minimum tax functions as a relatively low rate worldwide tax safety net underneath all the territorial tax acrobatics. Taxpayers doing business in most major trading partners of the United States and actually paying tax in those countries generally would owe little or no minimum tax, although the actual tax calculations would depend on a number of factors, making generalizations very difficult.

A revenue estimate of roughly $20 billion per year suggests that this minimum tax will bite hard, but it also signals just how successful U.S. firms have been at lowering their effective foreign tax rates below the statutory rates applicable in most countries where they do business. Dave Camp's 2014 tax bill contained a somewhat analogous anti-abuse rule, estimated to pick up $116 billion over 10 years, so again the Administration's proposal is substantially more aggressive than, but within shouting distance of, the most important Republican effort in this field.

The idea of the minimum tax safety net is to discourage firms from turning the new territorial tax regime into a license to turbocharge their stateless income tax planning, stripping income both from the United States and from high-tax foreign countries. The United States can rationally care about protecting the tax base of, say, Germany, because a world in which U.S. firms can easily strip German earnings to tax havens, while still qualifying for the benefit of territorial taxation, would encourage U.S. firms to disproportionately invest in such high tax foreign countries, to provide the raw feedstock for their ultimate low-taxed stateless income distillate.

The Administration has been its own worst enemy in this regard, because it has done a very poor job explaining the operation of the minimum tax. On its face a 19 percent tax rate sounds very high, but the Budget contemplates that firms would obtain a new deduction – an Allowance for Corporate Equity (ACE) – that would reduce foreign income subject to the tax. The idea of the ACE is to exclude from the reach of the minimum tax a basic “normal” rate of return on equity, so that the tax would fall only on supersized returns, which generous returns, it might be argued, are at least partially explained as the fruits of tax hanky-panky. Dave Camp’s 2014 anti-abuse rule was equally complex and relied on similar insights, by again targeting for current U.S. taxation abnormally high rates of return on investment. (Camp’s version was called “Foreign Base Company Intangibles Income.”)

The President’s proposals have led to a predicable cacophony of squealing by businesses, on the one hand, and the Left, on the other. All this noise has largely drowned out the only really important reaction, which is that Chairman Paul Ryan and other senior Republican tax policymakers have not wholly rejected the package. In fact, its basic terms – low domestic corporate rate, territorial taxation, one-time transition tax, and a targeted minimum tax or other antiabuse rule – are consonant with earlier Republican workproducts. If the numbers are on the high side, well that is what negotiations are for. The takeaway should be that a common conceptual framework from which reasonable people can negotiate to a deal is now in place.