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Corporate Tax Reform:
A Dutch Uncle Speaks

Edward D. Kleinbard
Johnson Professor of Law and Business
USC Gould School of Law
ekleinbard@law.usc.edu

Corporate Tax Reform Prospects

- The stars are aligning for corporate tax reform
  - Policy case for reform is clear
  - Differences between rational members of the two parties are quite small
  - Sooner or later lobbyists and Members will have to deliver *something*
  - So 2017 or bust!
- But what should directors bear in mind?
  - It's not just about the US
  - Be careful what you wish for

Don’t Just Focus on US Tax Reform!

- US statutory rates will fall in tax reform
- *But* for big international firms in particular, ETRs are heading **up**
  - BEPS + CBC reporting
  - EU State Aid inquiries
  - Large revenue shortfalls in many countries
  - General revulsion at stateless income gaming
  - US tax reform transition taxes (more later)
- *Directors who believe CFOs’ claims that the future will resemble the past are not asking tough questions*

US 2017: Playing Well Together

- No HRC tax reform position paper on website
- But HRC + Ryan (H. Speaker) + Wyden (D. SFC Chair) would work together professionally
  - Insufficient info to evaluate DT presidency
  - Treasury is just another constituent on Capitol Hill
- Great Deal of Work Already Done
  - *President's Framework for Business Tax Reform* (April 2016)
  - House: Camp Bill (2014), Brady working groups
  - Senate: Bipartisan working groups, Majority integration work

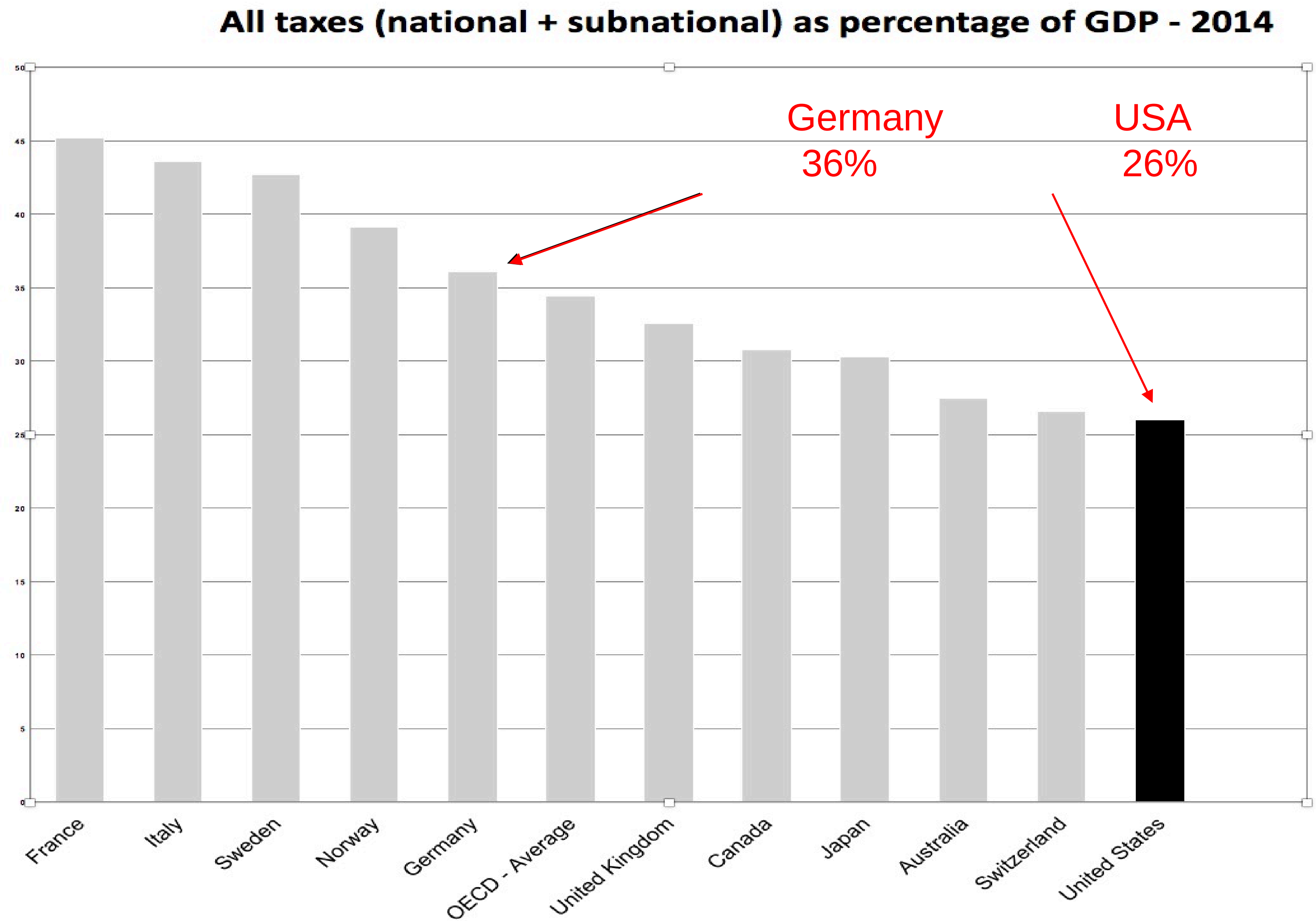
Corporate Tax Background Facts

- ~ $350 billion/year (~10% of total federal revenues)
- Corps earn ~ 50% of domestic net business income
  - Passthroughs the remainder – on personal tax returns
  - Many more passthroughs by number; corp. tax concentrated
  - Capital intensiveness more like 70 – 30 (corp/passthroughs)
  - International income almost entirely a corporate issue
- 1% reduction in corp rate costs ~ $100 billion/10 years
- Regardless of tax incidence theory, corp tax is very top-weighted in income distribution
- Passthroughs today taxed more lightly than corporates on domestic income

Nominal vs. Effective Tax Rates

- Yes statutory corporate tax rate is the highest
- But ETRs much lower than statutory rate
  - Corp ETR 23%, fully distributed 30%, but all over map
  - Passthrough ETRs lower still
- Economists often focus on EMTR
- CBO 2014 study (ignoring temp. bonus depreciation):
  - Corporate *domestic* EMTR on tangible property investment with blended financing = 31% (*including* investor-level taxes)
  - Pass-through domestic EMTR with typical financing = 27%
  - EMTRs fantastically sensitive to how investment is financed
    - *Debt-financed corporate investment =* ***- 6% EMTR***

A Nation of Tax Whiners



4 Crucial Decisions

- Corporate reform or business tax reform?
- Revenue neutral or revenue losing?
- Distributional consequences
- Corporate Details
  - International Design (Territorial / Minimum Tax?)
  - Patent Box
  - Corporate Integration
  - Interest expense disallowance

1. Corporate or Business Income Reform?

- Do we want to rewrite income taxation of U.S. *corporations* (public companies), or all U.S. *businesses*?
- Closing "business tax expenditures" affects both entities
  - Different depreciation schedules etc. for different legal forms would make a bad situation worse
- Apparent 11th Commandment of Tax Policy:
  - *Passthroughs must always have better deal than corporates*
  - But why? For decades not true, and passthroughs not all "small"
  - If post-reform corporate tax is great, people can incorporate
  - But this means no paying for corp tax reform with general business tax expenditures

2. Revenue Neutral or Revenue Losing?

- Using most biz TEs gets corp tax rate only to 26- 28%
- How to pay for it?
  - Transition taxes are not steady state pickups
    - Byrd rule (if Reconciliation); Sen. Rule 310(b)(1) [FY 2016 Budget Resolution]
  - A new tax?
  - International side?
  - Interest expense limitations?
- Both President (2016) and Camp (2014) would tax existing PRE ($150 billion+)

2.The Growth Fairy Will Not Plug the Gap

- Consider JCT analysis of Camp (2014)
  - Camp was *not* revenue neutral in steady state
- JCT macro analysis does not portend an easy solution
  - Macro analyses do not predict perpetual compounding gains
  - Revenue neutral bill should imply only modest macro gains
  - New capital EMTR may well go up – investment goes down
  - 8 different results from different models because macro analyses are so uncertain
- Largest gains came from least realistic models of behavior and budget policy
  - Best case was 1.6% greater real GDP *in total* over 10 years

3. Distributional Considerations

- Individuals ultimately bear the burden of any tax
- Different theories of corporate tax "incidence"
- JCT/CBO/Treasury leave most incidence on owners of capital
  - And it turns out that the rich have more capital than do the poor
  - Come to think of it, they have more income too
- So if HRC president corp tax reform will be coupled with some compensation to lower income households

4. Corp Tax Design Details

- Basic design is clear
  - Statutory rate to 25%, repeal sec. 199 and AMT
  - Territorial tax for outbound FDI
  - Mandatory repatriation tax on PRE
  - Depreciation reform etc (but what to give passthroughs)?
    - Camp: Deprec + R&D and Ad Capitalization = $630B/10
    - Sec. 199 + LIFO repeal = $200B/10
- International ETRs will go **up** not down
  - How could they go lower?
  - CbC minimum tax the cleanest, will get biggest score
  - PRE tax is *efficient*, rate driven by revenue constraints

International Tax Reform Design Issues

- Yes current FDI tax is screwed up
  - “Competitiveness” complaints largely fact-free
  - For “lock-out” read “hoist by own petard”
  - Behavioral distortions rampant
  - *Domestic* revenue base is at risk
- Only three obstacles to doing better
  - Definition of corporate “residence” is difficult
  - Identifying the “source” of income is even tougher
  - Politics made difficult by “tax mercantilism” of many countries
- Territorial tax requires anti-abuse rule
  - Minimum tax is ugly but effective responsive to base erosion

Interest Deductibility Holds the Key

- Interest deductibility + accelerated depreciation = Negative EMTRs!
  - Systematic tax preference for debt financing costs revenue and distorts both corporate capital structures and investment decisions
  - And intercompany leverage is key tool of stateless income planning
  - Capital markets are efficient: “taxable” interest income held in large measure by tax-exempt investors
- Excess leverage makes firms more fragile in downturns
- *Business tax reform requires curbing interest expense*
  - Both for revenue and for economic efficiency reasons
  - “Thin capitalization” statutes already adopted by some peers
  - Dual Business Enterprise Income Tax (Dual BEIT)

New Bad Idea I: Patent Box

- Patent boxes are all the rage
  - UK deal with EU and OECD terrible for tax policy and BEPS
  - Just leads to more income shifting
  - New race for putatively super productive employees
- Patent boxes not supported by economic theory
  - Subsidy should focus on gross investment in R&D, not preferential rates for payoffs from successful R&D
  - "Gross profit" patent boxes (deduct at regular rates, include at preferential rates) are better targeted but super expensive
  - Neither well targeted to startups
  - New CRS report R44522 (Jun. 13, 2016)
- "Competitiveness" justifies everything + anything

New Bad Idea II: Corporate Integration

- Sudden resurgence of interest in "corporate integration"
  - "Double taxation" of dividends, but mitigated today by 20% rate
  - Only 24% of US equities held in individual taxable accounts
  - Huge and well-known technical problems to dividend integration
- SFC: Dividends-Paid Deduction + Withholding tax
  - Keep statutory corporate rate 35%, repeal pref rate for holders
  - But give corporate deduction for dividends paid
  - And require corp to withhold @35% on all dividends
    - Not refundable to tax-exempts or foreigners
  - Maybe DRIP for retained earnings
  - "Ideally" withholding tax on interest too

The Trojan Horse of Corporate Integration

- What's Really Going On?
  - Withholding tax means no change for tax-exempts or foreigners
  - Top bracket individual tax rate goes up not down
  - Passthroughs completely unaffected, so politically expedient
  - *But corporation's GAAP ETR goes down as dividends paid*
  - *AND corps can repatriate PRE and redistribute to shareholders*
- Are markets really that stupid?
  - Corp cash flow *unchanged*: Corp tax + withholding tax = 35%
  - If a DRIP, then GAAP corporate ETR = 0? Really?
- No one will notice tax-free leakage of PRE at forgone revenue cost of $250 billion or so?