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# The Case for Corporate Tax Reform

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High rates, low revenues, cash kept overseas, and thousands of pages of complexities—nothing about our corporate tax system seems to be working. Our corporate tax code is a relic, last substantially reformed in 1986—before the Internet, before the Euro, and before capitalist China. Many of America's competitor nations have revamped their codes, but not the United States. Reform of our corporate code has been restrained in part by concerns that lowering rates would benefit only multinational corporations while doing little to create decent jobs or raise revenues. However, it is increasingly clear that modernizing our corporate code is a competitive necessity. Done right, corporate tax reform can help businesses create jobs and wealth here, and generate revenues to address the deficit and fund national priorities. In this paper, we lay out the seven reasons why America should embrace corporate tax reform that lowers rates, changes our taxation of international profits, and reduces complexity in the tax code.

## NUMBER ONE

### Our code reflects a bygone time when America was unquestionably the place to locate or expand a business.

In a world where goods, services, and capital move around the globe like never before, we have a tax code suited for a static world.

Globalization, advances in technology, expansion of the world's labor market, a rising international middle class, and unprecedented capital mobility have altered the way businesses operate and where they choose to locate. As other countries, like China, India, and Brazil, rise in economic stature and buying power, doing business in America has gone from being a matter of certainty to a matter of selection. America must compete for investment against hungry upstart nations who have recently entered the top global economic tier. The U.S. corporate tax code plays a major role in that contest.[1]

The current code is a competitive burden for American businesses. With a top bracket of 35%, the U.S. federal tax code has one of the highest corporate income tax rates in the world. State corporate taxes add roughly another four percentage points on average for a total combined statutory rate between 39% and 40%.[2] When Japan completes its proposed corporate rate reduction,[3] the United States will have the highest statutory rate among members of the Organisation for Economic Co-operation and Development (OECD), coming in almost ten percentage points above the weighted average of all of the other OECD corporate rates.[4] It is far in excess of the top rate of 25% that businesses face in China or Malaysia.[5]

The decline of American manufacturing in the last decade is telling. Even though a special tax incentive for domestic manufacturers took full effect in 2010, U.S. manufacturers still face a marginal federal tax rate of 31.85%.[6] From January 2001 to January 2011 the U.S. lost nearly 5.5 million jobs or 32% of its entire manufacturing workforce.[7] Productivity increases and labor cost differentials are a large part of the reason, but relatively high corporate tax rates contribute to the reasons why multi-national companies choose to manufacture less in America. As Jim Owens, chairman of Caterpillar put it, "If you tax me at a higher rate than other companies are taxed at, then I can't compete with them anymore. And you don't want that, because me being in those global markets allows me to export there, and that creates jobs here in the U.S."[8]

Around the world, countries are moving to lower their corporate rate in order to entice job-creating business investments. Between 2000 and 2010, nine OECD countries lowered their statutory rates by ten percentage points or more.[9] Canada is in the process of lowering its central government rate from over 22% in 2007 to 15% by 2012,[10] and the United Kingdom is lowering its rate from 26% to 23% by 2014.[11]

America's inherent economic strengths will always attract business activity. However, the higher the corporate tax "price" of doing business in America, the less likely a multinational corporation with the option to locate facilities elsewhere will invest in the U.S. The World Bank Group ranks the U.S. the 62nd out of 183 of the most business friendly economies in the "paying taxes" category—tied with Uganda.[12]

While the U.S. doesn't have to engage in a pure corporate tax rate race to the bottom, we do need reform to recalculate the "American premium" that businesses will pay to locate, hire and invest here, and make sure the tax costs do not exceed this.

## NUMBER TWO

### The current code encourages job creation—overseas.

While it is often argued that corporations take advantage of the tax code to ship jobs overseas, it's the code itself that rewards overseas investment and punishes U.S.-based activities. If corporations paid the full U.S. statutory tax rate, they would often be at a severe disadvantage versus international competitors operating under much lower tax rates. Because of the tax code's outdated structure and tax planning techniques, corporations can lower their rates through various international corporate structures and financial transactions. These actions are not only legal but, in some cases, were originally intended to allow U.S.-based corporations to better compete with others based in foreign countries with very different kinds of corporate tax systems.

As a result, multinational companies can lower their taxes through various technical and legal rules that reduce taxes paid by American companies to foreign countries in which they operate. Some multinational companies can also lower their tax bill through transfers of intellectual property and other assets to overseas subsidiaries. Meanwhile, the high U.S. tax rate inhibits new, potentially job-creating direct investment in the U.S. by foreign-based multinationals because those corporations have incentives to locate their facilities in countries where their overall tax rate will be much lower.

The higher a country's rates and the easier it is to avoid them by investing elsewhere, the less investment that country will see. A National Bureau of Economic Research analysis of 85 countries showed, "a consistent and large adverse effect of corporate taxes on both investment and entrepreneurship." The study found that a 10 percentage point increase in the effective corporate tax rate reduces the investment to GDP ratio by about 2 percentage points.[13]

In America, corporations have fewer options to lower their rates (from the high statutory corporate tax rates) where physical operations are concerned. As former Intel CEO Craig Barrett points out, "the corporate income tax rate in the U.S. is a real disincentive [to manufacturing]. We have essentially the highest corporate tax rate in the world. And in a big capital intensive facility you would like to have incentives to build it, not disincentives."[14] While manufacturing companies can benefit from certain tax incentives like the Section 199 deduction for domestic production activities, other domestic enterprises such as retailers have even fewer tools at their disposal.

Responsible corporate tax reform will help to lower the barrier to business activity in America and eliminate incentives to transfer assets overseas in order to ensure that we attract growth and job-creating business investment.

## NUMBER THREE

### America punishes companies for bringing foreign earnings back home.

America's international tax system is an outlier. We are one of the few large industrialized countries employing a "worldwide" system of taxation which means American corporations pay the U.S. tax rate whether profits are earned here or abroad. But the only way those taxes are actually collected is when the company decides to bring the money home. As a result, money that is earned overseas often stays overseas. It is estimated that the code has locked nearly $1.2 trillion in capital out of the U.S. market.[15]

As MIT Professor Kristin Forbes points out, "The extra tax that U.S. multinationals must pay when they bring foreign profits back home provides an incentive for those companies to leave those profits there [overseas]. They then might choose to spend that money to expand foreign operations instead of bringing the funds back to the U.S. to invest in new plants and equipment here."[16] Economists George Schink and Laura Tyson concur on this point, stating that, "An unfortunate consequence of the interaction of current U.S. tax policy and foreign tax and subsidy policy is that U.S. multinationals are discouraged from bringing the earnings from their foreign operations home and are encouraged to expand their foreign operations in lieu of their domestic operations. To the extent that these foreign earnings are never brought into the U.S., they are used to support operations and investment abroad rather than at home."[17]

All of the other G-8 nations, most other OECD members, and many of our up-and-coming competitors do it differently.[18] They use a "territorial" system, where income is taxed only in the country where it is made. The result is that the flow of capital to the home country, where it can be reinvested, is not inhibited by tax policy. In a world where capital will flow to where it can be most efficiently moved and invested, America's system forces it to compete on a different, disadvantageous level.

The interaction of America's predominantly worldwide system with other countries' predominantly territorial systems creates significant complications for American businesses, competitive drawbacks, and incentives to invest abroad.

Because companies have so much flexibility to move resources around, they often can postpone bringing these overseas earnings into the U.S. The mechanism in the tax code by which this takes place is known as "deferral." Under deferral, an American company with a profitable foreign subsidiary is incentivized NOT to bring back and invest in the U.S. money earned overseas because it would be then taxed by the U.S. at its high rate, while it can avoid the U.S. tax indefinitely if it keeps the money abroad.

The interplay between America's worldwide system and the territorial system used by most other nations forces the U.S. to employ a contorted system of credits to prevent double taxation. American companies receive a foreign tax credit to compensate for tax payments they make to foreign governments where they do business. If companies repatriate the income, they receive a credit for taxes paid in other jurisdictions. While the rationale for these measures is clear, these mechanisms to prevent double-taxation have some dubious side-effects. As James Kvaal wrote, "In some cases, multinationals can deduct the costs of foreign investments without paying taxes on the resulting income. Foreign Tax Credits can spill over to shield U.S. business activity from U.S. taxation."[19]

The high rate combined with the structure of the current tax code both incentivizes investment overseas and reduces the competiveness of U.S.-based multi-national corporations. By changing these effects and making it easier to bring profits back home, corporate tax reform would pave the way for greater job growth.

### The Deferral Dilemma

*Those concerned about abuse or inequity in the code have highlighted "deferral" as an example of corporate welfare and called for its repeal. While that may seem like a simple solution, outside of the context of broad reform it would seriously harm our economy by undermining the ability of U.S. businesses to compete in foreign markets.*

*Consider the tax plight of two hypothetical multinationals—U.S.-headquartered Acme and the German Deutschecorp. Imagine that they were both operating in a third country and their subsidiaries were paying taxes to that country's government at 20% rate.*

*Under the worldwide system Acme's subsidiary's earnings would also be subject to U.S. tax. However, Acme is not expected to pay the full U.S. 35% rate plus the 20% foreign payment. Instead, it gets U.S. foreign tax credits to offset payments to that country. When Acme's subsidiary distributes its income to Acme in the U.S., it will have to pay a net 15% more in taxes. (35% U.S. rate minus foreign tax credits worth 20% of earnings.)*

*On the other hand, Deutschecorp will only have to pay the foreign 20% rate. If Acme were not allowed to use the deferral provision to defray some of its tax cost, its effective tax rate would be much higher than Deutschecorp on the exact same business activities in the exact same country. It's even possible Acme might just move its headquarters to another country where it can compete on a level playing field with Deutschecorp.*

*By addressing such problems, changing incentives, and bringing statutory rates in line, corporate tax reform can make U.S. multinationals more competitive versus their foreign-based competitors and remove the incentives to invest and hire overseas.*

## NUMBER FOUR

### Corporate tax reform could direct billions from tax reducing efforts into job-creating economic activity.

For businesses, navigating the corporate tax code is like running an accounting slalom course rife with zigzagging specialized deductions, credits, and compliance rules. Companies, in a desire to lower their tax burden and compete with businesses from lower tax jurisdictions, have to run this course looking for provisions that can lower their effective rate to well below the statutory rates—and many are successful. In fact, the broad average effective tax rate for corporations generally—the tax they all collectively pay divided by their total pre-tax income—is 27.7% for the 2006-2009 period according to one study.[20] This tells us that many corporations avoid paying the full statutory rate of 35%, and the result is a broad average tax rate that is closer to the average effective rate for other OECD countries.

Unlike in other countries, the rate a corporation pays is largely based on how well it maneuvers the tax code obstacle course rather than economic factors. With large investments in tax accounting and lobbying, a corporation can pay much less than the statutory rate, or even the average effective rate.

Currently, companies spend vast amounts of time and money in efforts to lower their tax bill. As the Congressional Joint Economic Committee found, "it is obvious that many U.S. businesses are conducting costly and complex operations that have minimal economic content but rather seem designed solely to reduce tax exposure."[21] Corporations freed from this obstacle course of corporate tax hoops and hurdles would become more efficient.

The result of the complexity and unfairness in the corporate tax code is that economic distortions impede growth. American businesses have their hands full figuring out how to stay ahead of foreign competitors, but under the current system they have to figure out how to navigate their own tax code first. As a result of the search for tax relief provisions and efforts to stay within the rules, overall compliance costs for the corporate tax amount to over $40 billion per year,[22] draining precious financial resources away from more productive endeavors.

Corporate tax reform that clears out expenditures to allow corporations to spend time and money looking for will make the code more simple and free up capital for more productive investments.

## NUMBER FIVE

### The current code picks arbitrary winners and losers.

The actual tax rate that corporations pay varies widely and for seemingly immaterial reasons. The labyrinth of rules and exemptions favors businesses that have the most resources to devote to lowering their tax bill as opposed to those with the best product or business model.

There have been widely-reported examples of large and apparently profitable multinational corporations paying very little U.S. tax while other corporations pay much higher tax rates. According to a study by The New York Times and Capital IQ, 115 companies in the S&P 500 paid less than 20% in taxes over the last five years.[23] Many of the biggest companies utilize vast tax departments to minimize their U.S. tax burden.

Medium-sized corporations, which usually do not have vast resources to dedicate to navigating the tax code, have fewer options when it comes to reducing their rates. The inequity created by the tax code's complexity and structure is widely recognized. In CFO magazine's recent survey of 200 financial officers, 67% indicated that there is an imbalance in the effective rates paid by large companies versus small ones.[24]

One of the biggest factors is the extent to which a company can take advantage of the deferral provisions, the foreign tax credit and other tax rules by involving international transactions among its subsidiaries. Professor James Hines and former Treasury Secretary Lawrence Summers point out that within the law, "(m)ultinational firms can structure a variety of transactions—intrafirm debt, royalty payments, dividend repatriations, and intrafirm trade—in a manner that is conducive to tax avoidance."[25]

To make matters worse, the complexity of the tax code generates wildly uneven effects among and even within different industries. Companies in some industries can take cumulative advantages from a broad array of options allowed by the corporate tax code and reduce their effective U.S. rates to the single digits (or even negative). Companies in other sectors have fewer options. For example, the average effective rate for construction companies is 33.8% and it is 32.9% for electric utilities. Banks pay much less—on average 17.5%. Internet companies on average pay just a 5.9% corporate tax.[26] Very diversified corporations like General Electric or Honeywell with a wide array of international holdings and domestic and foreign manufacturing have the most options for lowering their U.S. corporate tax burdens.

However, large company size does not guarantee a lower effective rate. Companies that do not have overseas subsidiaries and those companies whose main business involves activities that cannot be so easily shifted around have fewer options to lower their effective tax rate. Hence, large retailers such as Walmart, Target and Home Depot had effective tax rates in the thirties - close to the full statutory rate. Similarly, an entertainment and theme park company, Disney, has a rate of 36.5%.[27]

Even within industries the impact of the code is far from fair. A major study found that, within a single industry, the degree to which individual companies use avoidance strategies to lower their tax bills can vary widely.[28]

Responsible corporate tax reform would create a simpler tax structure by reducing narrowly targeted tax breaks and lowering statutory rates. Under such a code, the advantages of size, industry, and political influence will be replaced by a more level playing field where companies make decisions for good business reasons rather than tax burden reduction.

## NUMBER SIX

### The corporate tax code is failing at its fundamental purpose—raising revenue.

Despite our high statutory rate, corporate taxes make up less than half as much of federal revenue as they did 50 years ago. The corporate income tax accounted for only an average of 10.3% of the annual federal tax receipts for the period FY2001-FY2010, and the percentage of total federal revenues provided by the corporate tax has greatly declined since the 1940s (average of 29.7% each year FY41-FY50) and 1950s (average of 27.2% each year FY51-FY60). In comparison, the percentage of total federal revenues provided by individual taxes since the 1950s has remained between 40% and 50%.[29]

The amount of revenue from the corporate tax as a share of GDP was 1.3% in the U.S. in 2010, and has been near historical lows.[30] According to a 2007 U.S. Treasury background paper, as reported by Tax Analysts, notwithstanding the fact that the U.S. corporate income tax rate exceeds the OECD average rate, "U.S. corporate income tax revenue (federal and state) as a percentage of GDP paradoxically is much lower than the OECD average—2.2 percent in the United States versus an OECD average of 3.4 percent—over the 2000-2005 period."[31]

Part of this difference often has been attributed to growth in the number of business entities organized as "pass-throughs," under which profits are taxed directly to the owners as opposed to the corporate level. Most of the growth in the number of "pass-throughs" over the last few decades has been in S corporations and limited liability companies (LLCs) as owners have sought to limit their legal liability while reducing regulatory and tax burdens.[32] However, a portion of the growth in LLCs is actually caused by joint ventures between corporations, which would still result in a corporate-level tax,[33] and it is likely that a good deal of this growth is attributable to legislative actions that have allowed pass-through owners to qualify for favorable pensions previously available only to owners of corporations, flipping of corporate and individual top marginal rates, and requiring a two-level tax on liquidation of corporations.

However, even when pass-throughs are taken into account, the U.S. corporate tax still brings in a relatively small amount of revenue (as a percent of GDP) compared to the average of other developed countries and compared to other times in U.S. history. This is an issue that must be addressed in the context of reform.

While reform should seek to raise more revenue, the approach must be thoughtful and acknowledge global economic realities. There are some who would simply call for an elimination of tax expenditures with no rate reforms, or for an increase in the statutory rate. However, with rates that are already higher than our competitors, it does not seem to make sense to raise them in today's increasingly globalized marketplace.

## NUMBER SEVEN

### "Revenue-neutral" simplification could pave the way for higher receipts in the future.

By weeding out the special tax breaks that favor some corporations over others or that may be obsolete, the tax base could be broadened enough to offset a substantial cut in the statutory rate without reducing revenue under congressional scoring rules.

In all likelihood, corporate tax reform that lowers rates and eliminates expenditures would also improve the economy once corporations are freed from making decisions based on their tax consequences and are better able to compete with foreign-based competitors. Accordingly, there's a good chance better operating and more profitable businesses would produce more revenue under the same tax rate as less profitable businesses would produce. In this way, any economic improvement caused by a better corporate tax code (even if the average effective tax rate was the same) would potentially increase revenue over a long time horizon.

Skeptics tend to be dismissive of such claims, in part because it is so difficult to predict how much additional revenue would result from the positive changes in corporate behavior and performance. As tax economist Len Burman, then at the Urban Institute, testified in 2006, "(m)ost economists would agree that a major tax reform in which loopholes were eliminated and tax rates lowered, holding overall revenues constant, would increase economic growth, although there would be a wide range of estimates of how much."[34] Given the unpredictability of the degree and timing of these effects, the Joint Committee on Taxation (JCT) does not take into account any potential positive effects on economic growth in its official ten-year estimates of the revenue effects of proposed tax law changes.[35]

But just because we can't "score" it within a ten-year window doesn't necessarily mean it won't happen. With many of our budgetary challenges extending to the future, it would make sense not to limit consideration of potentially positive revenue effects from broad-based corporate tax reform to the traditional scoring window.

There are several reasons to believe that reform may generate positive revenue effects beyond initial estimates. Provided the statutory rate is low enough, corporations would also have far less incentive to keep profits overseas or engage in other practices for tax savings purposes. As such, there would be more capital available to invest in the U.S. instead of in foreign accounts. That could help to spur growth and create resulting additional federal tax revenue over the long-haul while maintaining the average effective rate.

Furthermore, under lower statutory rates the U.S. would be a more attractive investment destination for U.S.-based and foreign multinationals alike. As a result, more investment in the U.S. would mean more a combination of more growth and more taxable business activity at home, leading to higher relative revenues.

While these effects are plausible and even likely, the inability to predict their scope would argue against pursuing revenue-negative reform and simply assuming growth effects will make up the budgetary difference. However, the reduced compliance burden and the positive impact on international business decisions resulting from corporate tax reform (even if scored as revenue neutral over the next ten years) are likely to have a positive effect on revenue in the long run. If someone cares about the corporate code pulling its fiscal weight in a time of budgetary constraint, this is a significant advantage.

## CONCLUSION

### A Code that Wins the Future

If you were starting a business or expanding one, would you choose the United States as the place to build a plant? Twenty-five years ago, when the code was last revamped, no one would even think of China, India, Russia, Brazil, Poland, Hungary, or Vietnam as an option. Our tax code is from a different time, but there is likely no scenario in which the United States "wins the future," as President Obama urged, without major revisions.

By ensuring that our tax code is modernized to reflect current global competition for business, corporate tax reform can help to ensure that America maintains its competitive edge. The benefits of a modernized tax code—economic growth, job creation, a level business playing field, and increased federal revenue over the long-term—can have a real and lasting impact on the lives of middle class Americans and on our ability to maintain global economic leadership.

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