REFORMING THE U.S. CORPORATE TAX SYSTEM TO INCREASE TAX COMPETITIVENESS

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Executive Summary

The U.S. corporate tax system is a patchwork of overly complex, inefficient and unfair provisions that impose large costs on corporate business. U.S. corporations seeking to minimize the costs imposed by the detrimental provisions in the U.S. corporate tax system have adopted strategies to reduce overall tax exposure and increase profits. Such strategies include moving operations overseas, corporate inversions, transfer pricing, earnings stripping, and complex leasing arrangements, all to minimize taxation.

Debate surrounding the issue of corporate tax reform has lately focused on whether or not the U.S. corporate tax system contributes to structural declines in manufacturing jobs and, more generally, to the weakening competitiveness of U.S. firms in a global economy. Furthermore, 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.

Unless broad and significant corporate tax reforms are enacted, it is likely that U.S. tax competitiveness will continue to suffer. The results of inaction are undesirable: potential loss of American jobs, movement of production overseas, sale of U.S. companies to foreign multinational firms and general erosion of the corporate tax base. This Joint Economic Committee study provides a general overview and discussion of the important economic issues of the U.S. corporate income tax system and provides a primer on several reform options to enhance U.S. tax competitiveness.

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REFORMING THE U.S. CORPORATE TAX SYSTEM TO INCREASE TAX COMPETITIVENESS

I. INTRODUCTION

The existing U.S. corporate tax laws have grown into a patchwork of overly complex, inefficient and unfair provisions that impose large costs on corporate business. U.S. corporations seeking to minimize the costs imposed by the counterproductive provisions in the U.S. corporate tax system have adopted strategies to reduce overall tax exposure and increase profits. Such strategies include moving operations overseas, corporate inversions, transfer pricing, earnings stripping, and complex leasing arrangements, all to minimize taxation.[1]

Debate surrounding the issue of corporate tax reform has lately focused on whether or not the U.S. corporate tax system contributes to a structural decline in manufacturing jobs and, more generally, to the weakening competitiveness of U.S. firms in a global economy.[2] However, some have argued that the issue of international competitiveness is over-emphasized in the discussion of international corporate taxation.[3] Further, some economists argue that international competitiveness has no economic meaning, given the economic concept of comparative advantage and the role of exchange rates as an adjustment mechanism.[4] In any event, it is obvious that many U.S. businesses are conducting costly and complex operations that have minimal economic content[5] but rather seem designed solely to reduce tax exposure.[6]

Unless broad and significant corporate tax reforms are enacted it is likely that U.S. tax competitiveness will continue to suffer. The results of inaction are undesirable: potential loss of American jobs, foreign outsourcing of economic content, sale of U.S. companies to foreign multinational firms, and general erosion of the corporate tax base.

This Joint Economic Committee (JEC) study provides a general overview and discussion of the important economic issues of the U.S. corporate income tax system and provides a primer on several reform options to enhance U.S. tax competitiveness. This study addresses the fundamental ways in which the current U.S. corporate tax system is biased against saving and investment, overly complex, inefficient and unfair. The study also addresses how the current U.S. corporate tax system can impair the efficient allocation of U.S. corporation resources in a global economy. Several broad reforms to the U.S. corporate tax system are then discussed. Section II provides some background of the U.S. corporate tax system and how various

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[1] For a good general overview, see, for example, Martin A. Sullivan, "International Tax Planning: A Guide for Journalists," *Tax Notes*, October 4, 2004.
[2] David A. Hartman, "The Urgency of Border-Adjusted Federal Taxation," *Tax Notes*, September 6, 2004.
[3] See, for example, Jane G. Gravelle, "Issues in International Tax Policy," *National Tax Journal* LVII, no. 3. (September 2004).
[4] *Ibid*.
[5] Economic content generally consists of jobs, research, development, and production of goods and services.
[6] Martin A. Sullivan, "Data Show Dramatic Shift of Profits to Tax Havens," *Tax Notes*, September 13, 2004; and Martin A. Sullivan, "Shifting of Profits Offshore Costs U.S. Treasury $10 Billion or More," *Tax Notes*, September, 27, 2004, p. 1480.

components impede corporate tax competitiveness, including problems associated with worldwide taxation. Section III offers some specific economic considerations and Section IV discusses several policy reforms to alleviate the impairment to tax competitiveness caused by the U.S. corporate tax system.[7]

While this study provides a general overview and discussion of the important economic issues of the corporate income tax and discusses several general policy reforms, tax jargon and detailed descriptions of complex tax issues are kept to a minimum. Readers seeking more detailed information are encouraged to consult the resources listed in the references at the back of this study.

Lastly, an important principle of taxation that is often ignored in policy discussions is that only individual people can pay taxes. Corporations are not people. They are legal entities involving employees, shareholders, creditors, etc., each with their own individual wealth and income characteristics. As Larry Summers, former Secretary of the Treasury in the Clinton Administration, explained in a Brookings Institution paper, "Although unsophisticated observers focus on the distinction between tax relief for business and for individuals, all taxes are ultimately borne by individuals in their role as labor suppliers, consumers, or suppliers of capital."[8] Hence, it is difficult to apply the concept of tax fairness to corporations. Any tax imposed on corporations results in either a reduction to employee wages, an increase in costs passed on to consumers, a reduction in the return to capital received by shareholders, or a combination of all three.

Therefore, it is not helpful to compare the corporate tax burden with the burden of individuals, as some advocacy groups do.[9] No matter how appealing it might be to look at corporations as entities for a source of tax revenue, the fact of the matter is that corporations do not bear the burden of taxation – individual workers, consumers and investors do. Reports and rhetoric advocating increased corporate taxation miss the economic realities of taxation and are harmful to efforts to raise the level of public education necessary in order to have an informed debate on tax reform.

II. BACKGROUND

The base of the corporate income tax system is profits. Generally speaking, profits are defined as gross revenue minus deductions for allowable costs. Costs allowed to be deducted from gross revenue include wages, cost of materials, interest and depreciation of capital assets, such as

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[7] Defined by Robert Tannenwald in *The Encyclopedia of Taxation and Tax Policy* (J. Cordes, R. Ebel, and J. Gravelle, Eds.) "Tax Competition" is "The design of tax policy to attract and to retain geographically mobile capital, labor, and consumption."

[8] Lawrence H. Summers, Barry P. Bosworth, James Tobin, and Philip M. White, "Taxation and Corporate Investment: A q-Theory Approach," *Brookings Papers on Economic Activity*, Vol. 1981, No. 1, p. 105.

[9] See, for example, Robert S. McIntyre and T.D. Coo Nguyen, "Corporate Income Taxes in the Bush Years," Citizens for Tax Justice and Institute on Taxation and Economic Policy (September 2004).

machines, physical structures and other equipment. Profits are then subject to federal corporate income tax at graduated rates up to 35 percent.

Smaller firms often have smaller profits and are usually taxed at the lower marginal rates, 15 percent or 25 percent. By contrast, many large firms can generate larger profits and are subject to the higher marginal tax rates. The bulk of the corporate income tax is collected on large firms, many of which tend to be multinational firms with operations abroad as well as in the United States. For these firms, the international aspects of the U.S. corporate income tax system are extremely important.

The basic structure of the international component of the U.S. corporate income tax system dates to the early 1960s, when the U.S. economy accounted for over half of all multinational investment in the world.[10] According to a 2002 Treasury Department report:

> The global economy, and the U.S. place in it, has changed dramatically in the last 40 years. The globalization of the U.S. economy puts ever more pressure on our international tax rules. When the rules first were developed, they affected relatively few taxpayers and relatively few transactions. Today, there is hardly a U.S.-based company of any significant size that is not faced with applying the international tax rules to some aspect of its business.[11]

Problems Associated with Worldwide Taxation

There are two basic types of international tax systems: worldwide and territorial.[12] Though a hybrid of the two, the U.S. tax system is basically a worldwide system whereby companies registered as U.S. domestic companies are subject to taxation on all income regardless of where income is earned (i.e., domestically or internationally). While profits generated by certain types of overseas activities are taxed in the year earned, profits from other activities are not taxed by the U.S. government until repatriated. U.S. corporations are allowed a credit for taxes paid on foreign income to foreign tax authorities, up to the U.S. tax rate, so that corporations are not taxed twice on the same income (first by a foreign tax authority and then by the Internal Revenue Service). However, complex rules apply that limit the availability of U.S. corporations to take full credit for foreign taxes paid. If the foreign tax rate is less than 35 percent, U.S. firms have a tax incentive to keep their profits overseas. Other countries that generally adhere to a worldwide system of taxation include the United Kingdom and Japan.

In contrast, many foreign corporations that trade with the United States are incorporated in countries that operate under a territorial tax system. Countries that adhere to a territorial tax system include Canada, France, Germany and the Netherlands. Under a territorial system,

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[10] United States Department of the Treasury, *Corporate Inversion Transactions: Tax Policy Implications* (May 2002).
[11] *Ibid*.
[12] No country uses a tax system that is purely worldwide or territorial, but all tax systems have features that allow for them to be primarily characterized as either worldwide or territorial.

income earned by foreign subsidiaries and branch operations (e.g., a foreign owned company with a subsidiary operating in the United States) is exempt from their country's domestic corporate income tax. Therefore, under a territorial system, profits are only taxed by the country where the income is earned.

Hence, the U.S. international tax system can impose an uncompetitive cost burden on U.S. based corporations that have foreign operations. For example, a U.S. company that sells products in the United Kingdom has to pay income tax on those sales to both the U.S. International Revenue Service and to the U.K. Revenue & Customs (formerly called U.K. Inland Revenue). France, in contrast to the United States, has a territorial tax system. Therefore, a French-based company selling comparable products in the U.K. would only remit tax to the U.K. Revenue & Customs on its products sold in the U.K. As a result, the U.S. company's profit margins on its U.K. sales are reduced by the amount of the tax. The difference in tax treatment puts the U.S. company at a competitive tax disadvantage relative to its foreign competitor.

Finally, the tax treatment of corporate income from foreign-owned firms creates a tax disadvantage for domestic-owned firms. As the U.S. Treasury Department points out,

> No country has rules for the immediate taxation of foreign-source income that are comparable to the U.S. rules in terms of breadth and complexity. For example, the U.S. tax system imposes current tax on the income earned by a U.S.-owned foreign subsidiary from its shipping operations, while that company's foreign-owned competitors are not subject to tax on their shipping income. Consequently, the U.S.-based company's margin on such operations is reduced by the amount of the tax, putting it at a disadvantage relative to the foreign competitor that does not bear such a tax. The U.S.-based company has less income to reinvest in its business, which can mean less growth and reduced future opportunities for that company.[13]

III. ECONOMIC CONSIDERATIONS

The corporate tax system in the United States has broad and important effects on the allocation of capital investment and is biased against saving and investment. First, the U.S. tax system favors non-corporate investment over corporate investment. For example, individual investment in real estate is favored over the purchase of corporate stock. Second, corporate debt is favored over corporate equity investment, since debt is not subject to the tax and interest paid is deductible from gross revenues. Third, due to the complex and unfair international provisions in the U.S. corporate tax system, many foreign-owned firms have a competitive tax advantage over domestic firms. All three effects have led to a decline in corporate income tax revenue, potentially resulted in the loss of American jobs and further impeded the productivity and growth of the U.S. economy.

[13] United States Department of the Treasury, May 2002.

A tax system based on consumption, would remove many of the economic inefficiencies that result from the current income-based tax system. A consumption-based tax system differs from one based on income by excluding savings and investment from the tax base. For example, a cash flow consumption-based tax system subtracts savings and gifts from the tax base. Withdrawals from savings, and gifts and bequests received from others are included in the tax base.[14] Alternatively, amounts saved and invested can be included in the tax base, but their returns excluded from taxation.

Various forms of consumption based tax systems would eliminate the multitude of problems associated with measurement of the tax base under an income based tax system. For example, complex depreciation rules, inflation adjustments and the allocation of undistributed corporate income would disappear since all forms of saving are removed from the tax base under a consumption based income tax system. The double-taxation of corporate profits would also be removed.

However, currently, corporate profits are generally subject to "double-taxation," whereby firm profits are taxed first at the corporate level and then again at the individual level. For example, consider a firm in the 35 percent federal corporate income tax bracket. For each $100 profit subject to the 35 percent rate, the firm pays $35 in federal corporate income tax, leaving $65 of after-tax profit to re-invest or distribute. If the firm decides to distribute the remaining $65 to shareholders in the form of a dividend, the shareholders are then taxed at the individual level. Hence, this is the second time that the same profit is being taxed: first at the corporate level and second at the individual level.

Individuals exposed to the maximum 15 percent tax rate on dividends or capital gains will owe $9.75 in federal individual income taxes on the $65 dividend. Combined, the original corporate profit distributed as dividends is actually taxed at a rate of 44.75 percent ($35 + $9.75 / $100).[15] This example does not account for any additional state tax levied at the corporate and individual levels. Since most other capital gains are taxed only once and at a maximum rate of 15 percent, the current corporate tax system favors non-corporate investment (such as owner-occupied housing) over corporate investment.

With respect to the financing of capital, debt financing is preferred at the corporate level because interest payments are deductible under the corporate income tax. However, in recent years this has been partially offset because equity financing is preferred at the individual level since capital gains (and now dividend payments) are taxed at lower tax rates. Additionally, equity is also

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[14] For a good discussion of a consumption based tax system, see: David F. Bradford, *Blueprints for Basic Tax Reform - 2nd Edition* (Arlington, VA: Tax Analysts, 1984).

[15] Dividends used to be taxed at the individual's marginal tax rate, up to 39.6 percent. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) bill reduced the maximum capital gains rate to 15 percent and equalized the individual tax treatment of dividends and capital gains. For those individuals whose dividends were subject to the then maximum tax rate of 39.6 percent the total combined marginal federal income tax rate on corporate profits would have been 60.74 percent.

preferable to debt financing at the individual level since taxes can effectively be deferred until an individual sells their shares of stock to create a taxable capital gain.[16]

The negative effects that the U.S. corporate income tax system has on revenues are evident. First, tax receipts from the corporate income tax system have been trending downward in recent decades. In fiscal year 2004, the individual income tax accounted for 44.5 percent of total federal receipts, the social security tax for 39.0 percent and the corporate income tax 10.1 percent.[17] As a percentage of Gross Domestic Product (GDP), the corporate income tax totaled 1.6 percent of GDP in FY2004, down from 4.2 percent in 1960. As a comparison, the individual income tax now totals 7.0 percent of GDP in FY2004, from 7.9 percent in FY1960 (See Table 1 and Chart 1).[18]

Table 1. Major Sources of Federal Tax Receipts

Federal Government Receipts as a Percent of GDP				Major Sources of Tax Receipts as a % of Total Receipts				
Fiscal Year	Total Receipts	Individual Income Taxes	Corporate Income Taxes	Individual Income Taxes	Corporate Income Taxes	Social Security Taxes	Excise Taxes	Other Taxes
1960	17.8%	7.9%	4.2%	44.0%	23.2%	15.9%	12.6%	4.2%
1965	17.0%	7.1%	3.7%	41.8%	21.8%	19.0%	12.5%	4.9%
1970	19.0%	8.9%	3.2%	46.9%	17.0%	23.0%	8.1%	4.9%
1975	17.9%	7.8%	2.6%	43.9%	14.6%	30.3%	5.9%	5.4%
1980	19.0%	9.0%	2.4%	47.2%	12.5%	30.5%	4.7%	5.1%
1985	17.7%	8.1%	1.5%	45.6%	8.4%	36.1%	4.9%	5.1%
1990	18.0%	8.1%	1.6%	45.2%	9.1%	36.8%	3.4%	5.4%
1995	18.5%	8.1%	2.1%	43.7%	11.6%	35.8%	4.3%	4.6%
2000	20.9%	10.3%	2.1%	49.6%	10.2%	32.2%	3.4%	4.5%
2001	19.8%	9.9%	1.5%	49.9%	7.6%	34.9%	3.3%	4.3%
2002	17.8%	8.3%	1.4%	46.3%	8.0%	37.8%	3.6%	4.3%
2003	16.4%	7.3%	1.2%	44.5%	7.4%	40.0%	3.8%	4.3%
2004	16.3%	7.0%	1.6%	43.0%	10.1%	39.0%	3.7%	4.2%

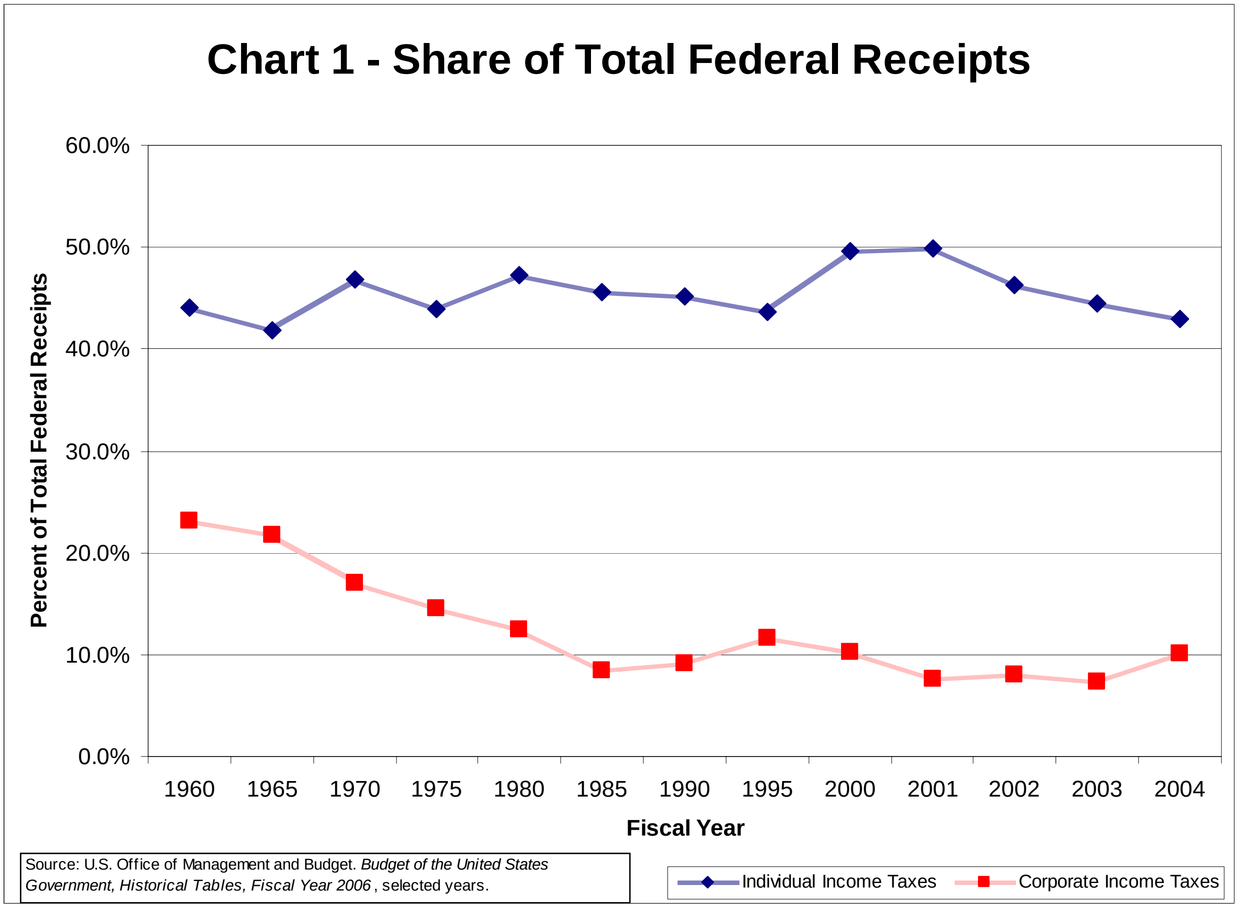
Source: U.S. Office of Management and Budget. *Budget of the U.S. Government, Fiscal Year 2006 Historical Tables*. 2005. Selected Years.

Second, the increasing competitiveness of global markets has forced U.S. corporations to seek cost reductions wherever possible. One such avenue is to pursue strategies that reduce tax liabilities. If capital can move freely across borders, all else being held equal, then capital will tend to leave countries that have high tax rates for countries with lower tax rates. An analysis in *Tax Notes* provides some evidence that profits of U.S. multinational corporations are "shifting" out of the United States.[19]

As shown in Table 2, countries that are considered to be "tax havens," such as Bermuda, have seen a rise in the profits attributable to U.S. multinational corporations. Countries that have recently lowered their corporate income tax rates to spur investment, such as Ireland, have also seen an increase in the amount of profits attributable to U.S. multinationals. The shifting of

[16] For a more detailed discussion of the distortion caused by the different tax treatment of debt versus equity, see, Jane G. Gravelle, *Capital Income Tax Revisions and Effective Tax Rates* (CRS Report for Congress, RL32099, October 2, 2003).
[17] U.S. Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2005 Historical Tables* (Washington, DC: 2004), 31-32 and 288-289.
[18] *Ibid*.
[19] Sullivan, September 13, 2004; and Martin A. Sullivan, "Latest IRS Data Show Jump in Tax Haven Profits," *Tax Notes*, October 11, 2004.

profits out of the United States has been estimated to total about $75 billion a year and to cost the U.S. Treasury $10 billion or more per year.[20]



In October 2004, the Statistics of Income division of the Internal Revenue Service released data covering the 7,500 largest controlled foreign corporations during 2000. The data indicate that multinationals are increasingly moving profits to low-tax countries (Table 2).[21] The data show "that from 1998 to 2000 before-tax earnings of subsidiaries of U.S. corporations grew from $143.8 billion to $207.6 billion [– an increase of 44 percent]. That large an increase would be noteworthy for any two-year period."[22] From an equity standpoint, any erosion of the U.S. tax base from firms shifting profits oversees would need to be made up by the taxes paid from other companies or other sources of revenue, such as the individual income tax, assuming revenue neutrality.

[20] Sullivan, September 27, 2004.
[21] Sullivan, October 11, 2004.
[22] *Ibid.*

Table 2. Before-Tax Profits and Foreign Effective Tax Rates (E.T.R.) of Subsidiaries of U.S. Multinational Corporations in 1998 and 2000. (dollar amounts in billions)

	1998		2000		Profit Growth From 1998 to 2000		
	Profits	E.T.R.	Profits	E.T.R.	Amount	% of Total	% Change
All Countries	$143.8	24.2%	$207.6	20.8%	$63.74	100.0%	44%
Low-Tax Countries	$51.1	13.8%	$84.1	13.2%	$33.00	51.3%	64%
Other Countries	$92.7	29.9%	$123.5	26.6%	$30.74	48.7%	33%
Selected Individual Countries Ranked by 2000 Profits							
United Kingdom	$22.4	24.0%	$29.7	23.3%	$7.30	11.5%	33%
Netherlands *	$20.5	15.5%	$26.9	16.3%	$6.46	10.1%	32%
Canada	$12.7	33.7%	$24.8	23.8%	$12.02	18.9%	94%
Ireland *	$8.5	8.7%	$11.8	9.4%	$3.29	5.2%	39%
Switzerland *	$5.5	11.0%	$11.0	8.6%	$5.47	8.6%	99%
Japan	$5.3	58.1%	$10.2	42.5%	$4.99	7.8%	95%
Cayman Islands *	$3.7	8.4%	$8.9	9.0%	$5.21	8.2%	143%
Germany	$10.9	34.8%	$8.8	25.7%	-$2.06	-3.2%	-19%
Bermuda *	$3.6	12.4%	$8.7	13.0%	$5.10	8.0%	143%
Mexico	$4.4	19.7%	$6.1	25.4%	$1.66	2.6%	37%
France	$6.1	28.8%	$5.4	30.8%	-$0.70	-1.1%	-11%
Singapore *	$2.9	13.1%	$5.3	8.4%	$2.41	3.8%	84%
Hong Kong *	$2.5	16.1%	$3.8	12.1%	$1.24	1.9%	49%
Spain	$2.7	22.2%	$3.7	35.2%	$0.95	1.5%	34%
Brazil	$3.9	27.4%	$3.4	25.7%	-$0.50	-0.8%	-13%
Norway	$0.3	53.1%	$3.1	61.5%	$2.83	4.4%	915%
Luxembourg *	$1.7	33.8%	$3.1	11.0%	$1.36	2.1%	80%
Italy	$4.5	46.2%	$3.0	38.6%	-$1.51	-2.4%	-33%
Australia	$2.7	29.8%	$2.8	31.4%	$0.00	0.0%	0%
Belgium	$3.7	16.2%	$2.2	20.5%	-$1.41	-2.2%	-39%
Venezuela	$1.5	13.6%	$2.1	15.4%	$0.58	0.9%	39%
Sweden	$1.6	23.2%	$1.7	13.3%	$0.18	0.3%	12%
South Korea	$0.1	75.4%	$1.5	22.9%	$1.40	2.2%	1070%
China	$0.6	16.1%	$1.4	9.0%	$0.71	1.1%	111%
Israel	$0.9	19.6%	$1.3	13.7%	$0.41	0.6%	46%
Taiwan *	$0.7	16.2%	$1.2	15.4%	$0.47	0.7%	64%
Malaysia *	$1.1	9.0%	$1.2	11.6%	$0.06	0.1%	6%
Bahamas *	$0.3	46.8%	$1.1	22.0%	$0.83	1.3%	316%
Denmark *	$0.2	38.3%	$1.0	13.4%	$0.79	1.2%	359%
Austria	$0.6	23.4%	$1.0	18.9%	$0.38	0.6%	63%

Note: (*) Indicates country is considered a "low-tax" country for analysis purposes in this table.
Detail may not add due to rounding.
Not all countries included in totals for "All Countries" are listed under "Selected Individual Countries."
Source: Martin A. Sullivan. "Latest IRS Data Show Jump in Tax Haven Profits." *Tax Notes*. October 11, 2004.

Third, manufacturers contend that they are more adversely affected by the cost burdens imposed by the U.S. corporate tax system than other firms, as discussed throughout a January 2004 report issued by the U.S. Department of Commerce titled, "Manufacturing in America: A Comprehensive Strategy to Address the Challenges to U.S. Manufacturers." The Commerce Department report states "there is a broad recognition of the advantage conferred on foreign manufacturers by the interrelationship between the current U.S. tax system and international trade rules."[23] The report further states:

> American manufacturers are well aware that most of their competitors are located in countries that rely more heavily on consumption, rather than income, as the basis for taxation. In practical terms, foreign governments apply taxes solely to

[23] U.S. Department of Commerce, *Manufacturing in America: A Comprehensive Strategy to Address the Challenges to U.S. Manufacturers* (January 2004), 46.

> income earned on sales in their jurisdictions and will rebate any taxes that apply to exports.
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> By relying more heavily on income as the basis for taxation, and in taxing U.S. manufacturers on their worldwide income, the U.S. system contains no simple means of ensuring that U.S. exporters receive comparable treatment.[24]

A 2003 white paper prepared for The Manufacturing Institute of the National Association of Manufacturers also discusses some of the negative effects experienced by U.S. manufacturers.[25] This white paper provides a useful summary of the important economic issues facing U.S. manufacturers. The report lists five primary structural costs that are harming U.S. manufacturers: (1) excessive corporate taxation; (2) escalating costs of health and pension benefits; (3) increasing tort litigation costs; (4) compliance costs for regulatory mandates; and (5) rising energy costs.[26]

Among the five structural costs listed, the report calculates that the cost burden of the corporate income tax is the most severe on U.S. manufacturers, and calls for a reduction in the corporate tax burden and a reform to the treatment of foreign-source income.[27] It is important to keep in mind that although the corporate tax is a true burden on corporate activity, the economic incidence of the tax falls on individuals in the form of reduced wages, a lower return to investment, or in the form of higher prices for goods and services.

The current U.S. system for taxing corporate income results in an overly complex set of rules that is inefficient, imposes excessive deadweight costs given the amount of revenue collected, and can violate the tax principle of equity. Though the issue of corporate tax reform can be complicated and debates over specific reforms often get bogged down in minutiae, there are several areas of U.S. corporate tax reform that can be adopted to address the inefficiencies, complexities and lack of fairness in the corporate tax system. A general discussion of these reforms follows in the next section.

IV. BROAD REFORMS

Tax policies are often evaluated based on three criteria: efficiency, equity and simplicity. An efficient tax policy is one that raises a given amount of revenue while causing the least distortion in behavior. Equity implies that a tax policy should tax those with similar incomes and circumstances the same. Tax simplicity suggests that tax policy be simple to understand and comply with, or that changes reduce the complexity of an existing tax policy. All of the following optional reforms to the U.S. corporate tax system in some way improve either

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[24] *Ibid*.
[25] Jeremy A. Leonard, "How Structural Costs Imposed on U.S. Manufacturers Harm Workers and Threaten Competitiveness," White Paper prepared for The Manufacturing Institute of the National Association of Manufacturers, December 9, 2003.
[26] *Ibid*., 1.
[27] *Ibid*., 3.

efficiency, equity, simplicity, or all three. The reforms are not necessarily mutually exclusive or offered in any order of significance.

Tax reforms are generally desirable because they can have positive economic effects, regardless of any temporary or permanent reduction in revenue. Further, tax reforms can be structured to be revenue neutral, if desired. Lastly, while some reforms might result in a loss of corporate tax revenue, enhanced economic growth as a result of tax reform could increase overall tax receipts. Readers interested in a more detailed discussion of the following reform options are encouraged to consult the resources listed in the References.

Territorial System of Taxation

Recall that the U.S. tax system is basically a worldwide system whereby companies registered as U.S. domestic companies are subject to taxation on all income regardless of where it is earned (domestically or internationally). In contrast, many foreign corporations that trade with the United States are incorporated in countries that operate under a territorial tax system. Under a territorial system, income earned by foreign subsidiaries and branch operations (e.g., a foreign-owned company with a subsidiary operating in the United States) is exempt from their country's domestic corporate income tax. Therefore, under a territorial system, profits are only taxed by the country where the income is earned. Hence, the U.S. international tax system can impose an uncompetitive cost burden on U.S.-based corporations that have foreign operations.

According to a report issued by the Joint Committee on Taxation of the U.S. Congress:

> A territorial system arguably promotes economic efficiency better than a worldwide tax system, because a territorial system treats all investment within a particular source country the same, regardless of the residency of the investor. This efficiency norm is referred to as capital import neutrality (or, in the business community, as "competitiveness").[28, 29]

A recent paper published in the *National Tax Journal* concluded: "Improving the taxation of foreign investment income requires abandoning the notion of international tax provision as appendages to a domestic corporate tax."[30] The paper further concludes that "U.S. taxation of foreign income impairs the productivity of American firms in the global marketplace and, interestingly, impairs the productivity of investments located in the United States, since it distorts ownership patterns by foreign investors as well as Americans."[31]

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[28] United States Congress, Joint Committee on Taxation, *The U.S. International Tax Rules: Background and Selected Issues Relating to the Competitiveness of U.S. Business Abroad* (JCX-68-03, July 14, 2003), 4.

[29] Capital export neutrality refers to a system where an investor (individual or corporation) residing in a particular country is taxed at one rate regardless of where in the world investment is located. Capital import neutrality refers to a system where income from investment located in each country is taxed at the same rate regardless of the residency of the investor.

[30] Mihir A. Desai and James R. Hines Jr., "Old Rules and New Realities: Corporate Tax Policy in a Global Setting," *National Tax Journal* LVII, no. 4. (December 2004).

[31] *Ibid*.

To make the U.S. corporate tax system more competitive, the playing field could be leveled with many U.S. trading partners by moving toward or adopting a territorial tax system. Such reforms would significantly reduce the inefficiencies, inequities and complexities of the current U.S. corporate tax system and produce substantial economic benefits. Potential reforms include exempting all foreign-source income, exempting only active foreign-source income, or exempting only certain kinds of foreign-sourced income. Further, adoption of a territorial tax system would remove a major incentive for U.S. multinational corporations to move headquarter operations overseas.[32]

Suggested policy reforms that only tinker with the treatment of foreign income under the U.S. corporate tax code such as ending the ability of U.S. corporations to defer foreign-source income from U.S. tax or closing so-called "tax loopholes" might only enhance the tax incentives for U.S. companies to either reincorporate overseas, be sold to foreign firms, or to force newly-created firms to incorporate outside the United States in the first place. Efforts to remove the incentives for U.S. companies to move economic content, profits and jobs overseas must begin with a focuses on the fundamental issues that drive firms to these actions in the first place.

Consumption-Based Tax System

A general switch to a consumption-based tax system, as opposed to an income-based system, could improve efficiency and fairness and result in a simpler tax system.[33] Under a consumption-based tax system, the corporate income tax would be replaced or eliminated. A consumption tax could be more efficient because it removes the extra tax imposed on saving. Consumption taxes can be fairer (more equitable) because consumption can be a better measure of ability to pay than income, especially if measured on a lifetime basis.[34] The basic argument for simplicity is that taxing only consumption removes the complexity involved with measuring and taxing income, including the need to fill out many complex tax forms and the necessity of a revenue collection agency as large as the Internal Revenue Service.

It is important to note that many tax reform ideas are forms of a consumption tax. Consumption taxes can be designed to be progressive as well. For example, the Hall and Rabushka Flat Tax is a progressive consumption tax.[35] A more recent proposal, such as David Bradford's "X Tax," is

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[32] For many multinational firms, overseas economic activity is a sound business practice. U.S. multinational firms locating manufacturing and services abroad to serve international markets can reduce costs and increase profits. The problem with the U.S. tax system is that higher tax rates can bias foreign investment to be preferred over U.S. investment where the before-tax rate of return is higher in the U.S. but results in a lower after-tax return solely due to the higher U.S. corporate tax rates.

[33] For a good overall discussion of a consumption based tax system and how a consumption based income tax system could improve efficiency, be equitable, and reduce complexity, see: David F. Bradford, *Blueprints for Basic Tax Reform (2nd)* (Arlington, VA: Tax Analysts, 1984); and Council of Economic Advisers, Executive Office of the President, *The Annual Report of the Council of Economic Advisers*, together with the *Economic Report of the President.* (Washington, DC: GPO, February 2005), Chapter 3.

[34] Don Fullerton and Diane Lim Rogers, "Distributional Effects on a Lifetime Basis," *NBER Working Paper No. 4862*, National Bureau of Economic Research, Cambridge, MA: September 1994.

[35] Robert E. Hall and Alvin Rabushka, *The Flat Tax* - 2nd Edition (Stanford, CA: Hoover Institution Press, 1995).

also a progressive consumption tax.[36] Additionally, a National Retail Sales Tax is a form of consumption tax.

The economic benefits of moving to a consumption-based system of taxation could be substantial. Removing the bias against saving and investment alone would provide a long-lasting increase to economic growth and domestic job creation. Though there are difficulties with transitioning to consumption-based taxation that need to be addressed, including fairness issues,[37] the benefits of taxing consumption over income should not be ignored.

Integration of Individual and Corporate Income Taxes

Under the current corporate income tax system, the United States taxes corporate profits first at the corporate level and then again at the individual level. This "double taxation" leads to economic distortions that favor non-corporate investment (e.g., real estate over corporate stock) at the individual level and debt financing over equity investment at the corporate level. Further, the double taxation of corporate profits provides incentives for corporations to retain earnings or to structure distributions of profits in ways to avoid the double taxation. The end result is reduced efficiency and reduced economic return to corporate investments.

A solution is to integrate the individual and corporate income tax systems. "The basic argument for integration is economic. The classical corporate tax increases the cost of capital for U.S. companies, discourages new equity investments in corporate enterprise, and encourages the issuance of corporate debt."[38] Many U.S. trading partners have some type of integrated individual and corporate income tax system. There are several specific procedures that could be adopted to integrate the individual and corporate income tax systems in order to eliminate or reduce the double taxation of corporate profits. For example, an individual exclusion could be allowed for corporate dividends or, more comprehensively, a Comprehensive Business Income Tax (CBIT) could be adopted.[39]

Regardless of the method chosen, integration of the individual and corporate tax systems would result in taxing corporate profit once and only once. The reduction in the economic distortions caused by the double taxation of corporate profits would increase economic efficiency, make the tax system more equitable and reduce complexity in the tax system. The overall economic gains could be substantial.

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[36] David F. Bradford, *The X Tax in the World Economy: Going Global with a Simple, Progressive Tax*, (Washington, DC: The AEI Press, 2004).

[37] William Gentry and R. Glenn Hubbard (1996) conduct distributional analyses to demonstrate that a consumption tax is more progressive than would be estimated under convention distributional assumptions.

[38] Michael J. Graetz and Alvin C. Warren Jr. "Integration of Corporate and Individual Income Taxes: An Introduction." *Tax Notes*. September 27, 1999.

[39] For more information, see, United States Department of the Treasury, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (January 1992) and R. Glenn Hubbard, "Corporate Tax Integration: A View From the Treasury Department," *The Journal of Economic Perspectives* Vol. 7, No. 1. (Winter 1993).

Expensing

Expensing allows a corporation to deduct the full costs of acquiring depreciable capital assets immediately, instead of having to take partial deductions over numerous years (defined by the "useful life" of the asset). The current method of requiring depreciable assets to be deducted over the economic life of an asset is consistent with the objective of taxing income. However, taxing consumption is more economically efficient, and expensing is consistent with a consumption-based tax objective.

Businesses are able to fully deduct the costs associated with labor and materials, as these inputs are used up immediately in the production of goods and services. The current rationale for depreciating assets is that capital assets can be used over and over through their useful life. Hence, only a portion of the cost of acquiring capital assets is allowed to be deducted in a given year.

The problem with depreciation is that a dollar of deduction today is worth more than a dollar of deduction in the future. The current depreciation schedules in the corporate income tax code bias against investment in capital assets with long useful lives. As a result, the U.S. economy ends up with less investment in plant and equipment. Expensing would eliminate the bias against investing in long-lived capital assets and increase business investment.[40]

Although changes in the deductibility of corporate interest payments would be necessary, allowing full expensing of depreciable capital assets would increase corporate cash flow and would most likely result in increased new investment in what are now depreciable assets, such as plants and equipment. A result of increased investment would likely be new domestic jobs and increased economic growth.

Reduction in Corporate Income Tax Rate

The United State has one of the highest corporate tax rates relative to its trading partners. Further, many trading partners have passed legislation to lower corporate tax rates. Higher U.S. corporate tax rates impose a drag on the economy. First, higher tax rates reduce after-tax cash flow, which could be used to invest in domestic jobs and economic growth. Second, higher rates discourage the establishment of business activity in the United States. With respect to manufacturing, a higher tax rate "discourages the establishment of foreign manufacturing facilities in the United States, and encourages the migration of U.S. manufacturing facilities to lower-tax jurisdictions."[41]

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[40] For more information, see, Darrel S. Cohen, Dorthe-Pernille Hansen, and Kevin A. Hassett, "The Effects of Temporary Partial Expensing on Investment Incentives in the United States," *National Tax Journal* Vol. LV, No. 3, (September 2002); and Alan J. Auerbach and Kevin Hassett, "Tax Policy and Business Fixed Investment in the United States," *Journal of Public Economics* Vol. 47, (March 1992).

[41] Jeremy A. Leonard, "How Structural Costs Imposed on U.S. Manufacturers Harm Workers and Threaten Competitiveness," White Paper prepared for The Manufacturing Institute of the National Association of Manufacturers, December 9, 2003, p. 10.

As data presented in this study suggest (see Table 2), corporate investment and profits are flowing to countries with lower corporate tax rates than the United States more than ever. Therefore, in order to remain tax competitive, the corporate tax rate should be lowered. Some have suggested that reducing the corporate tax rate to 20 percent is an appropriate step.[42] A reduction of the corporate income tax rate would benefit a wide range of corporations and is simple to implement. Any rate reduction should apply equally to all corporations, regardless of goods manufactured or services provided.

Eliminate or Reform the Corporate Alternative Minimum Tax (CAMT)

Similar to the individual Alternative Minimum Tax (AMT), the CAMT is designed to prevent corporations that report large profits from paying little or no federal income tax. Under the CAMT, corporations are required to compute their tax liability under the normal corporate income tax and then again under the CAMT and pay the higher amount. The CAMT applies a lower tax rate to a broader definition of income with less generous allowances for deductions. As with the individual AMT, corporations are allowed a credit for the difference paid between the CAMT amount and their tax liability under the normal corporate income tax that can be applied to future years.

The CAMT, also like the individual AMT, adds an unnecessary level of complexity and burden to the federal income tax system. Additionally, like any tax on corporate profits, the CAMT increases the cost of capital. According to a report issued by the Congressional Research Service, "by lowering the federal tax burden on corporate capital and lessening the uncertainty faced by firms that move on and off the tax, the repeal of the CAMT could lead to increased business investment and a more efficient use of resources in the long run. It would also significantly lower the cost of complexity of administering the federal tax code."[43]

A repeal of the CAMT would have the likely effect of increasing cash flow for those corporations impacted by the CAMT. Increased cash flow could be immediately used for domestic job creation and business investment. The benefits of repealing the CAMT would be greatly enhanced if corporations were allowed a rebate of their unused CAMT credits.

Elimination of Corporate Income Tax

Criticism of the corporate income tax has been around since its enactment in 1909.[44] Congressional economist Jane Gravelle notes, "many economists have been critical of the corporate tax, citing uncertainty as to the burden of the tax and its creation of a variety of distortions."[45] As further stated by Gravelle, "the corporate tax causes resources to be

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[42] Chris Edwards, "Corporate Tax Reform: Kerry, Bush, Congress Fall Short," *Tax & Budget Bulletin*, Cato Institute (September 2004); and in *Tax Notes*, October 11, 2004.

[43] Gary Guenther, *Business Investment and a Repeal of the Corporate Alternative Minimum Tax* (CRS Report for Congress, RL31318, March 5, 2002).

[44] The individual income tax was enacted in 1913.

[45] Jane G. Gravelle, "Income tax, corporate, federal," in J. Cordes, R. Ebel, and J. Gravelle, (Eds.) *The Encyclopedia of Taxation and Tax Policy* (Washington, DC: Urban Institute Press, 1999).

misallocated in the economy: too much capital relative to labor is used in the noncorporate sector and too little is used in the corporate sector, causing inefficient production. In addition, prices are distorted, causing too little corporate production."[46]

A Congressional Research Service report asks: "Why tax corporate profits at all? Corporate equity profits are taxed twice, once at the corporate level and once under the individual income tax when they are received by stockholders as dividends or capital gains. As a consequence, taxes tend to steer investment away from the corporate sector."[47] While many liberal economists favor maintaining the corporate income tax as both a backstop against the individual income tax and as a means of raising revenue, there is little economic theory to justify a corporate income tax.[48]

As stated in the introduction, an important principle of taxation that is often ignored in policy discussions is that only individual people can pay taxes. Corporations are not people. They are legal entities involving employees, shareholders, creditors, etc., each with their own individual wealth and income characteristics. Hence, it is difficult to apply the concept of tax fairness to corporations. Any tax imposed on corporations results in either reduction to employee wages, an increase in costs passed on to consumers, or a reduction in the return to capital received by shareholders, or a combination of all three.

Therefore, it is not helpful to compare the corporate tax burden with the burden of individuals. No matter how appealing it might be to look at corporations as entities for a source of tax revenue, the fact of the matter is that corporations do not bear the burden of taxation – individual workers, consumers and investors do. Reports advocating increased corporate taxation miss the economic realities of taxation and are harmful to efforts to raise the level of public education necessary in order to have an informed debate on tax reform.

Eliminating the corporate income tax would encourage domestic entrepreneurship, job creation and economic growth. Further, instead of providing a tax incentive for U.S. corporations to move operations and job creation overseas, eliminating the corporate income tax would not only eliminate the tax incentives for U.S. firms to move operations overseas but also provide more incentives for foreign firms to invest in the United States.

V. CONCLUSION

This Joint Economic Committee study provides a general overview and discussion of the important economic issues of the U.S. corporate income tax system and provides a primer on several reform options to enhance U.S. tax competitiveness.

[46] *Ibid*.
[47] David L. Brumbaugh, Gregg A. Esenwein, and Jane G. Gravelle, *Overview of the Federal Tax System* (CRS Report for Congress, RL32808, March 10, 2005), p. 7.
[48] For a good overview of the policy option to eliminate the corporate income tax, see, Chris Edwards. "Replacing the Scandal-Plagued Corporate Income Tax with a Cash-Flow Tax," Policy Analysis No. 484, The Cato Institute (August 14, 2003).

This study has discussed how the current U.S. corporate tax system is biased against saving and investment, inefficient, unfair and overly complex. The U.S. system for taxing corporations is not tax competitive with many other nations. As a result, the U.S. has seen a decline in receipts from the corporate income tax as a share of total federal receipts. Further, some domestic companies are relocating economic content overseas and foreign multinational firms are buying domestic companies.

Unless broad and significant corporate tax reforms are enacted it is likely that U.S. tax competitiveness of will continue to suffer. The results of inaction are undesirable: potential loss of American jobs, foreign outsourcing of economic content, sale of U.S. companies to foreign multinational companies, general erosion of the corporate tax base and continuation of harmful tax policies that are biased against saving, investment and economic growth.

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