THE FIRST 100 DAYS:
CED's Policy Recommendations

Committee for Economic Development

Corporate Income Tax Reform in 2017?

A Policy Brief by the Committee for Economic Development of The Conference Board

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Introduction

Although Washington's ability to drive the $18 trillion US economy is easy to exaggerate, a major change in the US income tax system may be the most economically consequential step that Washington can take—for good or ill. It is essential to get it right.

There are some complex and important aspects of recent individual income tax reform proposals. But today, the greatest interest and emphasis lie in the debate over the corporate income tax.

Companies are struggling to generate pennies of income and save pennies of expense to remain globally competitive, so corporate tax reform matters—for economic growth, budget sustainability, and perceptions of fairness.

CED's Recommendations: Summary

Corporate tax policy changes can affect the well-being of businesses, and the economy as a whole, for good or ill. Radical change—notably different systems that collect approximately the same amount of revenue but in a dramatically different way—can cause such severe dislocation and even failure for so many businesses that it would disrupt the entire economy. In addition, the nation's public debt has grown so large that major changes in tax policy must not worsen that critical problem. CED recommends steady, rather than radical, change that does not worsen the federal budget deficit. The principal components of our approach are:

1. Eliminate corporate tax preferences.
2. Eliminate the corporate alternative minimum tax (AMT).
3. Reduce the statutory corporate tax rate as much as possible, consistent with maintaining revenue.
4. Maintain the general current-law treatment of pass-through entities.
5. Maintain the current system of deferral of taxation of profits of US-based multinational corporations.

The US Corporate Income Tax: Today and Yesterday

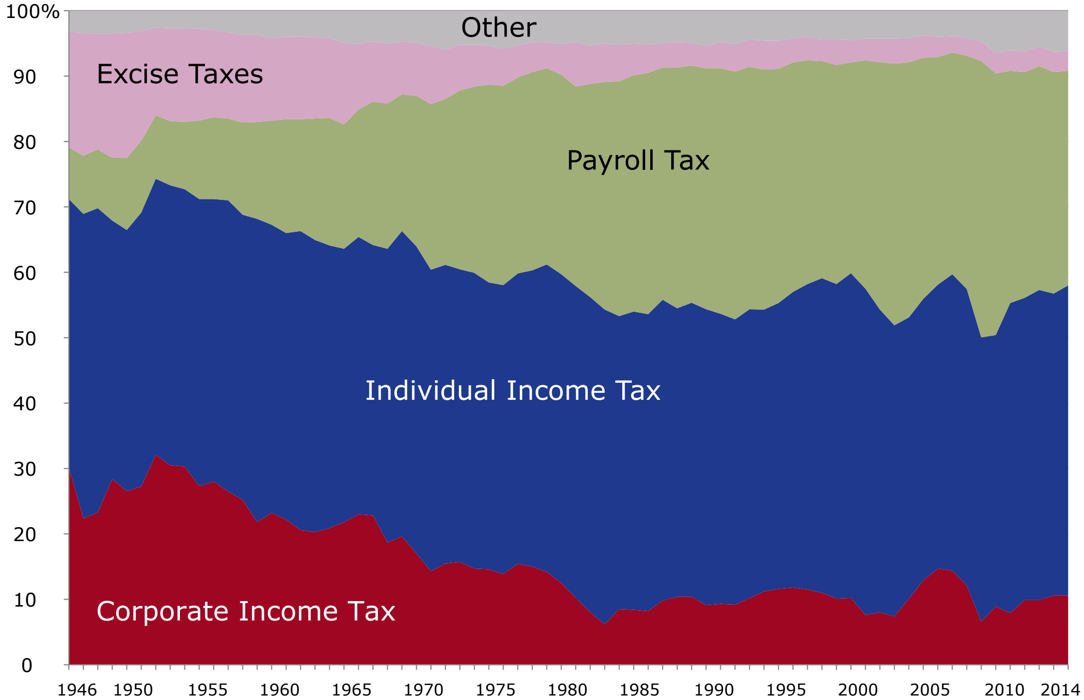
Over time, the vital signs of the US corporate income tax have fluctuated significantly. Any assessment of policy options today must be cognizant of the tax's performance in the past and its trajectory into the future.

Revenue yield

As one key indicator, corporate income tax revenue as a share of total federal revenue has generally declined from more than 30 percent in 1954 to barely 10 percent today (Chart 1).

Chart 1

Shares of Total Federal Tax Revenue



Source: Office of Management and Budget, *Budget of the United States Government, Historical Tables, Fiscal Year 2017*, Table 2.2.

Similarly, corporate income tax revenue as a share of gross domestic product (GDP) was almost 6 percent shortly after World War II and then fell as low as 1 percent in the early 1980s (Chart 2). Since then, revenue has been below 2 percent of GDP in most years.[1]

It is interesting and curious that this pattern in corporate tax revenue generally has not mirrored trends in corporate profits, or their share in the economy (Chart 3). Corporate profits as a share of gross domestic income[2] (GDI) did decline over the post-World War II years into the early 1980s, but they have since recovered almost to their original level.[3]

Chart 2

Corporate Income Tax Receipts as a Percent of Gross Domestic Income

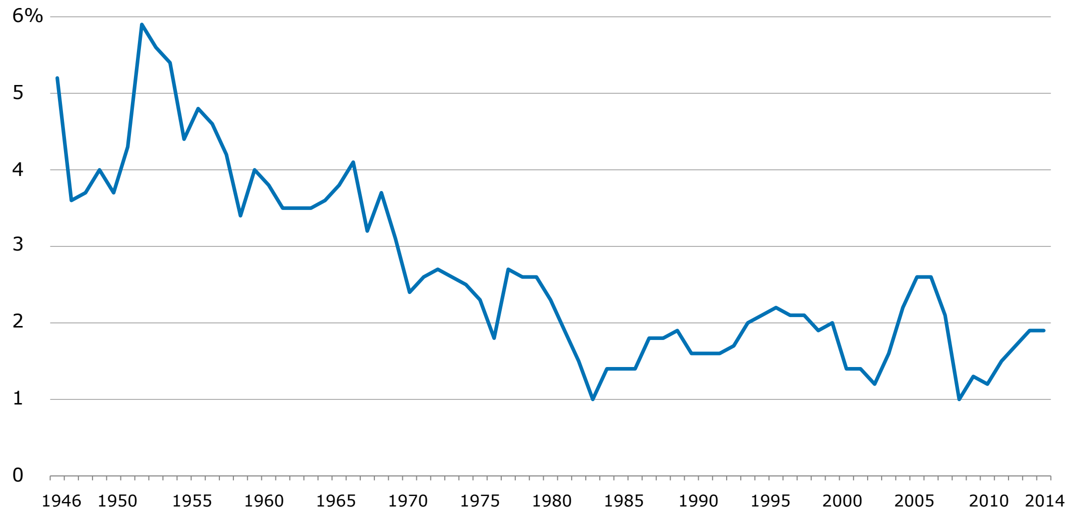
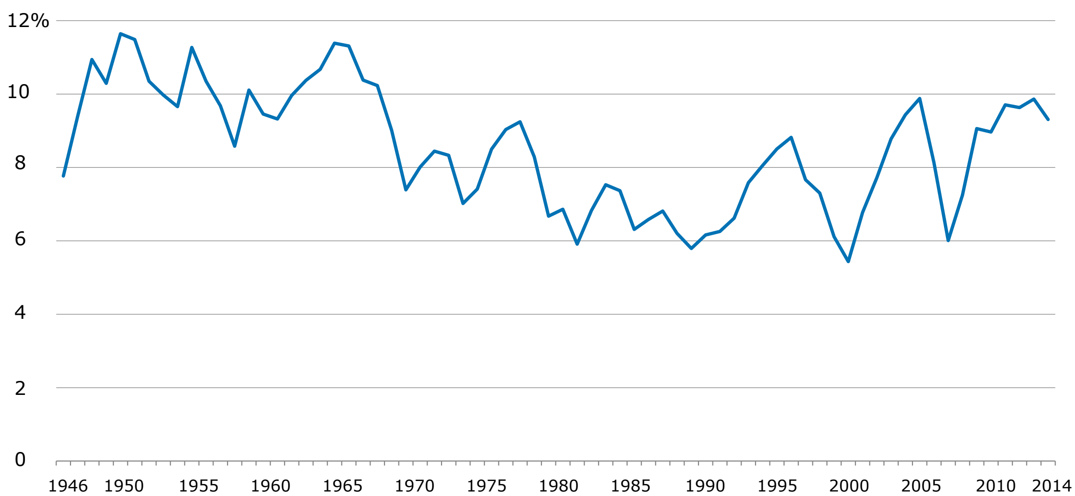


Chart 3

Corporate Profit Share of Gross Domestic Income



Source: U.S. Department of Commerce, Bureau of Economic Analysis, GDP and the National Income and Product Accounts (NIPA), Historical Tables, Table 1.10.

So why has corporate income tax revenue not recovered, too? Below are a few reasons.

Use of "pass-through entities"

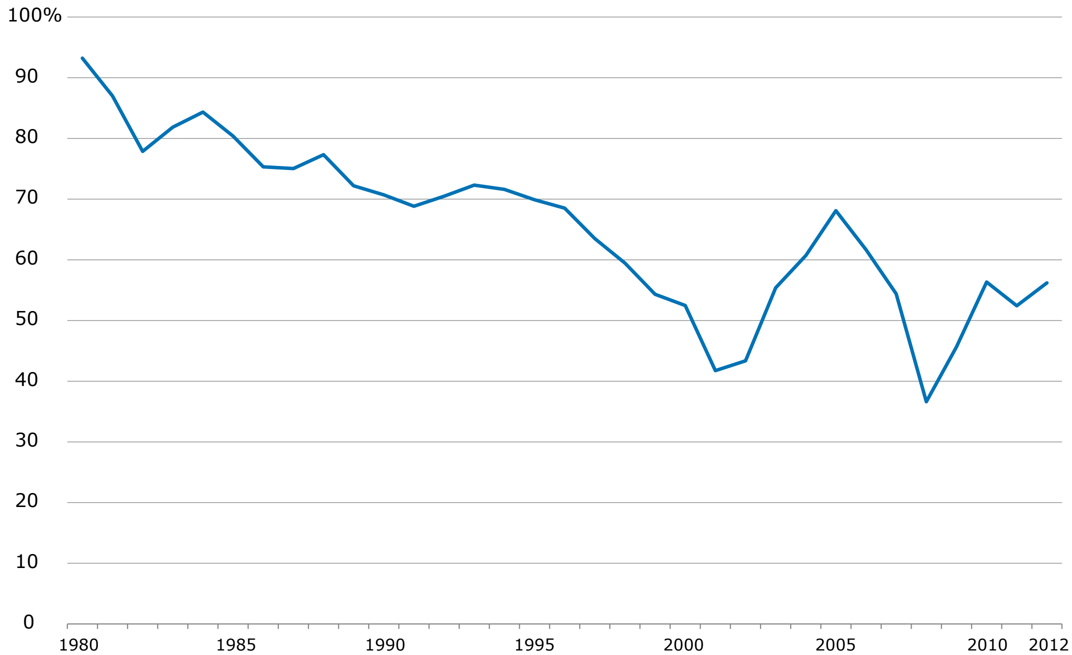
In 1980, Subchapter C corporations—corporations subject to the corporate income tax—accounted for more than 90 percent of the net income attributable to all corporations (Chart 4). The balance of income received by corporations was reported by various forms of "pass-through entities," which are taxed only under the individual income tax and offer limited personal liability and simplicity of organization.[4]

Following several changes to the tax law since 1980, the Subchapter C share of net income attributable to all corporations has generally declined. Since the late 1990s, Subchapter C corporations have generally accounted for just over half of all net corporate income in the United States. In 2008, during the worst of the financial crisis, the share dropped to less than 37 percent.

Thus, *corporate income tax revenue* has lagged relative to the overall economy, but *income tax revenue from corporations* most certainly has not. In effect, income that was once taxed as corporate income is still taxed, but as individual income. The difference lies in the growing use of pass-through entities to take advantage of limited personal liability and certain advantages of simplicity of creation and organization, but also in part to avoid paying the additional layer of corporate tax. Particularly following the Tax Reform Act of 1986, which reduced individual income tax rates and therefore made the pass-through form more attractive, there have been changes in law and regulations to simplify and permit expanded use of these pass-through entities. And their use has indeed expanded.[5]

Chart 4

Subchapter C Corporation Share of Total Corporate Income



Source: U.S. Department of the Treasury, Internal Revenue Service, "Statistics of Income Tax Stats – Integrated Business Data, Table 1, Number of Returns, Total Receipts, Business Receipts, Net Income (less deficit), Net Income, and Deficit by Form of Business, Tax Years 1980-2012."

Globalization

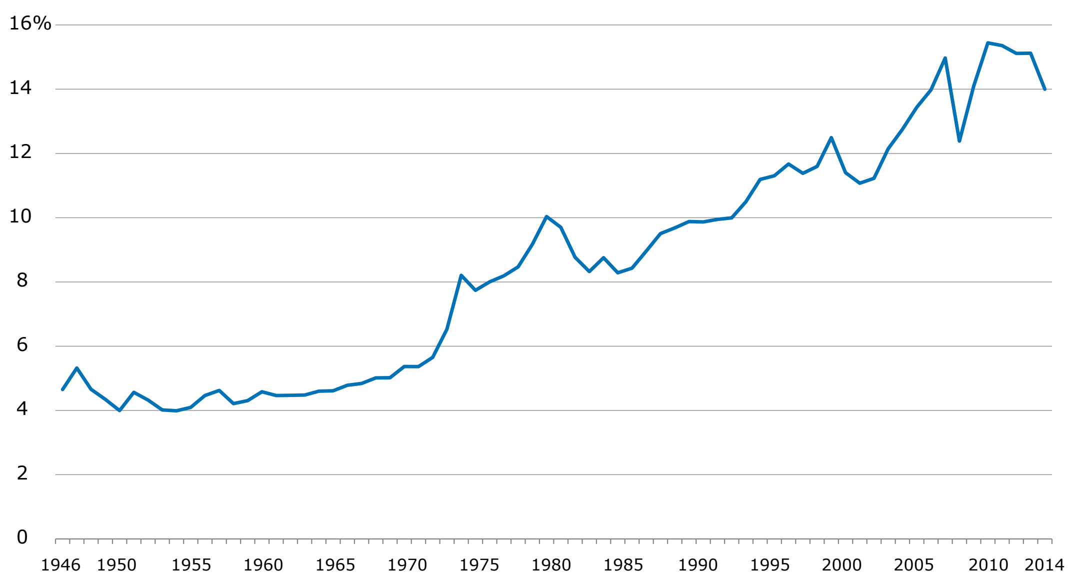
The development and growth of pass-through entities could have occurred even if the United States were a totally closed economy. But other causes of deterioration in corporate income tax revenues were driven in whole or in part by our economy's growing globalization.

For almost 30 years following World War II, the United States was one of the most closed, self-sufficient economies on the planet (Chart 5). Over the succeeding years, however, the OPEC oil cartel raised prices significantly—thus, because the United States was a large net oil importer, greatly expanding US imports measured in dollars. Other developed nations rebuilt after the war and made great strides toward increased productivity and export competitiveness. International organizations and trade agreements reduced tariffs and integrated markets. US and other firms grew across national borders to become truly multinational. Improvement in the human capital of other nations with far lower wages grew an entirely new labor force and encouraged simple low-value-added production, including manufacturing and assembly, overseas.

Meanwhile, US technological leadership led to high-value production in the United States for export. Both US imports and exports (including service exports, facilitated by instantaneous electronic communication) grew enormously as a result. Elaborate supply chains, in which complex components produced in the United States are cross-shipped to other countries for lower-value, simpler assembly, have pushed this globalization still further.[6] Measured relative to the low levels of post-World War II (pre-1970s) America, US trade as a share of our total economic activity has tripled, and a growing share of US corporate profit is earned overseas—which itself has reduced the share of profits of US multinational corporations that is immediately subject to tax.

Chart 5

Average of Imports and Exports as a Percentage of GDP



Source: U.S. Department of Commerce, Bureau of Economic Analysis, GDP and the National Income and Product Accounts (NIPA), Historical Tables, Table 1.1.5.

The direct and inevitable result of this growing globalization is that national economies and income tax systems interact much more today than they did several decades ago.

Tax preferences

Tax provisions providing selective relief for businesses—such as particular industries, lines of business, or business locations—drain tax bases and distort the allocation of scarce economic resources. Such legal or regulatory provisions are often referred to as "tax expenditures."[7] Such tax preferences are primarily responsible for the sometimes wide divergence of "effective tax rates" (the percentage of profit paid in tax) among corporations in different industries.

"… unjustified tax preferences are demoralizing to the body politic and can corrode our nation's public life."

Tax expenditures are taken by some as evidence of "crony capitalism." That is, preferential provisions for select firms are alleged to be favoritism—a diversion of funds from the federal Treasury into the coffers of the politically connected.[8] Such unjustified tax preferences are demoralizing to the body politic and can corrode our nation's public life. Other critics argue that, whatever merit they might have had previously, many (if not all) preferential provisions have become obsolete, and, though designed to incentivize, they have evolved into inefficient subsidies, providing additional and unnecessary profit ("rents") rather than a necessary inducement to invest.

US tax experts have concluded that total elimination of all US tax preferences for corporations would reduce the corporate income tax rate on a strictly revenue-neutral basis from its current 35 percent to about 28 percent—a substantial change in terms of the amount of tax on a marginal dollar of profit, but less of a reduction than some US policymakers now seek.[9] Deeper rate reduction would require greater deficit reduction from other sources, such as tax law or spending changes or economic growth, to avoid adding to the federal deficit, which is already excessive.[10]

Intangible assets

Another fundamental change in the economic environment that has significantly affected the performance of corporate income taxes both in the US and globally is intangible assets, which have become a better-identified and far more important component of the corporate balance sheet. Intangible assets include knowledge or intellectual property (e.g., patents, copyrights, or research and development), computerized information, and goodwill. Although the value in broad terms of intangible capital is undeniable, its precise monetary value and physical location are, to a considerable degree, unknowable or arbitrary. This creates challenges for the taxation of its return to the firm.[11]

International tax competition

Another issue in corporate taxation is the ongoing tax competition among developed nations. One view is that competition among nations as taxing jurisdictions spurs innovation and growth. But some policy observers believe that some nations attempt to achieve competitive advantage through clever legal language, not by creating a better, more productive environment for economic growth. Such language offers businesses tax savings by moving *income recognition* rather than the *production* that actually generates that income. This kind of maneuver, observers believe, unavoidably encourages a "race to the bottom" in which all nations lose some of their ability to raise revenue.[12]

The US Federal Budget Deficit

An issue lurking around this entire US corporate tax debate is the federal budget deficit. As CED has reminded many times since the 1980s, the federal budget has been on an unsustainable path. After a few brief months of respite in the middle of this decade, the federal debt is set to resume a growth rate significantly faster than that of the economy (out of which that debt must be serviced).

> "... the current federal debt requires that corporate tax reform must not leave the overall budget problem even worse than it is today."

In other words, the nation's debt-to-GDP ratio is rising, and that cannot go on without eventual severe adverse consequences. Although the corporate income tax is not a major contributor to federal revenue, the current federal debt requires that corporate tax reform must not leave the overall budget problem even worse than it is today.

Three Broad Policy Alternatives

The enduring objectives of tax policy—which CED shares—are economic efficiency, fairness, simplicity, and revenue sufficiency. For corporations, economic efficiency means an allocation of capital and other economic resources according to value in the marketplace, not political influence or other criteria. Fairness in the corporate-tax context flows from economic efficiency, which is to say that investors who follow true economic value should be rewarded. Simplicity requires not only ease of compliance, but also ease of choosing business strategy; a tax code that interferes with market forces will impose additional and unproductive criteria onto business strategy making. Revenue sufficiency has been a much-ignored criterion of tax policy over the last several decades, but CED has formulated all of its policy recommendations with fiscal sustainability in mind.

From that perspective, we consider several of the big-picture choices that the nation must make to achieve meaningful tax reform.

1. The "worldwide" versus the "territorial" corporate tax model

The United States persists with a corporate tax model that the rest of the world has abandoned: a so-called worldwide or "residence-based" tax. Under this model, US multinational firms pay income tax in the countries in which they operate, but also pay tax domestically, having received a credit for the foreign taxes that they paid. Thus, US firms wind up paying no more than the US rate, which they would have paid if they kept operations within the United States. So our corporate tax offers US firms the option to operate in the United States or overseas and face the same tax rate either way. The US corporate tax on foreign earnings is not due until that income is repatriated—that is, until it is brought back to the United States. This allows a benefit of tax deferral, during which period the profits can earn the time value of money.[13] The deferral period can be quite long if the firm invests those profits in continued and expanded operations overseas.

However, other developed nations use a "territorial" tax model, under which their firms pay tax only where income is earned. So, for example, a German firm operating in France would pay French tax, not German tax, on the portion of its income earned in France.

US multinational corporations have complained about our nation's worldwide tax approach, and their behavior has made that complaint tangible. Because the US statutory corporate income tax rate is the highest in the developed world, US corporations invariably face an income tax liability if or when they repatriate their foreign earnings, even with the benefit of the foreign tax credit. Responding to that prospective tax bill, many US firms have held or invested their foreign profits overseas. The total of those overseas balances has been estimated at $2.5 trillion as of 2016.[14]

Firms complain that they have been deterred from repatriating and reinvesting overseas balances in the United States by the tax liability that would be due upon repatriation. These firms and some economists have expressed concern that holding these profits overseas reduces investment and job creation in the United States. Therefore, they argue for a permanent (or at least temporary) preferential rate on repatriated earnings. Their preferred outcome probably would be to eliminate the US tax on foreign earnings of multinationals permanently—that is, adopting a territorial tax system that is used by all other developed countries.

That general approach has strong support, but it is not universally accepted. There are different degrees of movement toward a territorial system that raise somewhat different potential benefits—and concerns.

One approach, a **temporary and voluntary repatriation "holiday"** at a preferential rate, would encourage the return of overseas holdings of corporate earnings. This would make funds flow to their preferred uses, gradually making their way through demand, consumption, and financial markets into a more robust economic expansion. It is on that basis that a repatriation holiday should compete with alternative public policy steps.

Some argue that such a holiday would result in a leap of domestic corporate investment—in physical plant, equipment, and intellectual capital. But the proceeds likely would be used for paying dividends or buying back outstanding corporate stock, not for investment. Analyses of past repatriation holidays have indicated that, despite supposed requirements that overseas funds repatriated at preferential rates be reinvested, the fungibility of money has won out and the additional after-tax cash flow was ultimately directed to dividend payments and stock buybacks. Some would contend that these are attractive uses of the funds.

Others argue that no one-time holiday would likely motivate any long-term program of investment—for the simple reason that it does not provide ongoing financing. The temporary nature of the holiday would, by definition, inhibit change in long-term investment behavior because it would produce no change in the cost of capital.[15] So no one-time repatriation holiday is likely to provide an immediate, direct, or long-lived bonus of investment and economic growth.

Some corporate tax proposals have followed a different tack and contemplated **mandatory repatriation** on all current overseas balances, sometimes as part of a transition to a fundamentally different system, and generally at a reduced (but non-zero) tax rate. Such a proposal is not unthinkable because the current US policy of tax deferral on foreign earnings is considered by some to be preferential treatment that could be repealed. However, some firms surely would protest. Chief among them likely would be US corporations that reinvested their earnings overseas so that they could better service foreign markets. (In other instances, surely, US firms have engaged in "offshoring" to re-import their foreign production.) These firms may have expected to use those earnings overseas over long periods of time to become more competitive globally.[16] A mandatory repatriation would violate the expectations of such US-based corporations that they could continue to invest their overseas earnings to improve their overseas operations. They will argue that this unexpected tax will make them less globally competitive and that the surprise element of the tax will aggravate the impact. It also could encourage preemptive inversions or sales to foreign companies.

There is the further and much more structural option of **changing the US worldwide system into a territorial system permanently**, thereby allowing foreign earnings to be permanently tax free.

To some firms, this option would be extremely attractive. But the applications of territorial systems by other countries are far from uniform. Other nations, for example, do not passively cede to their competitor nations the power to tax whatever share of the income that corporations deem "foreign." There are "controlled foreign corporation" rules, "transfer pricing" rules, rules related to intra-corporation financial transactions aimed at the deductibility of interest ("thin capitalization" rules), and other rules to prevent domestic income from fleeing to foreign tax systems with lower tax rates.

A pure US territorial system, however, relative to the current worldwide system and so long as the United States continues to have the highest statutory corporate tax rate, could make it cheaper to repatriate *past* foreign profits to the United States. (It is to recapture some of these tax savings for multinational firms that many such proposals would impose a mandatory repatriation, albeit at a reduced rate.) At the same time, however, a territorial system could encourage US firms to make future investments in, and move their intangible capital and their income to, other nations with lower statutory tax rates.[17]

2. A Destination-Based Cash-Flow Tax

Yet another option, much more recently developed, is most often called a destination-based cash-flow tax (DBCFT). It would be a replacement for the entire current corporate income tax.[18] The DBCFT would be a single-rate tax on cash receipts, less current costs of labor, materials, etc., and the total cost of all investment ("expensing"—no delay for depreciation deductions), but, unlike the current income tax, with no deduction for interest paid. And very much unlike the current income tax, the tax attributable to exports would be rebated at the border, and a corresponding tax calculated for imports would be imposed when they cross the border. (This would be done by deducting receipts from exports and by disallowing deductions for the costs of foreign purchases.) This clever structure is aimed squarely at current concerns about the implications of our corporate income tax for international competitiveness and trade. By taxing imports and exempting exports, the DBCFT is thought by some to be—potentially—an effective weapon to increase the competitiveness of US products on world markets and domestically, as well.

A further potential advantage of the DBCFT is that the border rebate would be available only to domestic production. Therefore, the tax on US-produced goods bound for other markets would be nullified by the border adjustment, and there would be no ostensible incentive to seek out a foreign tax haven for production destined for third markets.

However, there are several complications with a DBCFT. One is that the mere imposition of a border-adjustable tax does not necessarily make a nation more competitive in trade. Economists expect that, starting from the equilibrium conditions of the market at the time of the tax's inception, such a tax would cause the value of the tax-imposing nation's currency to appreciate to restore the previous equilibrium terms of trade. In the case of the United States, a higher value of the dollar would make US exports more expensive again, while returning the prices of imports into the United States to their previous lower level. To be sure, there are financial market influences, as well as trade (goods/services market) influences on the exchange value of the dollar. But there is no denying that some of the first-round benefits of the DBCFT would be lost to the foreign exchange markets.

Some US manufacturers use foreign goods as inputs to their products and have expressed concern that taxing imports would reduce their competitiveness.

Retailers of foreign products have voiced the same concern. In response, some DBCFT advocates have tried to reassure these businesses that the value of the dollar will rise and restore their purchasing power with respect to imports, thereby holding them harmless. But if the dollar rises for the imports these manufacturers buy, it necessarily rises for all other US purchasers of imports, who were supposed to be deterred from buying imports because of that same border adjustment. And the dollar necessarily would rise as well for all foreign purchasers of our exports, who were supposed to be enticed to buy US goods because of the border adjustment. So this reassurance would seem to undercut the entire trade-competitiveness rationale of the proposal.

Another selling point for the DBCFT to businesses and some policymakers is that it will allow "expensing" (immediate full deduction) for all investment costs (which others have proposed as a separate step under our current income tax). The current income tax allows only depreciation of investment expenses—that is, deduction in annual installments based approximately upon the investment's anticipated useful life. To many businesses and some policymakers, this is an extremely attractive feature. However, expensing can only be justified by eliminating the deduction for interest expense.[19] Of course, many US businesses, particularly smaller businesses that cannot readily sell stock to finance investments or purchases of inventory, rely heavily on borrowed money and, therefore, on the deductibility of interest expense. Eliminating deductibility could very well render many such businesses non-viable.

Yet another question mark hanging over the DBCFT is in regards to international trade law.[20] International trade agreements allow border adjustments for consumption taxes.[21] The DBCFT will likely be represented to the international trade authorities and to our trading partners as a consumption tax so that it can be border adjusted. But for domestic political purposes, it is being marketed as a (corporate) income tax, which to be politically acceptable must allow firms to deduct wages paid.[22] However, almost by definition, a consumption tax does *not* allow a deduction for wages paid. This puts the DBCFT on the horns of a dilemma: If it is put forward with a deduction for wages, it very likely will be ruled ineligible for the border adjustment that is essential to make it effective and attractive.[23] Should it be ruled to be legally border-adjustable, however, then we can expect other nations to replace their corporate income taxes with DBCFTs in the very near future. Although some advocate adopting the DBCFT as a trade advantage, it is not certain whether the United States will gain or lose competiveness under that scenario; it will depend upon the terms of the DBCFTs that other nations adopt, including their tax rates.

A critical assessment of the DBCFT might be that its motivation is either random or opportunistic. There is no obvious economic reason why the US should choose a quantum tax-system change that bears much more heavily on US production that involves foreign value added (which includes sectors that are high-wage, high-value, and high-tech) and favors purely US production (which tends to be low value-added).[24] There are perhaps two systematic reasons: One, the US happens to currently run a large trade deficit and therefore can collect substantial additional revenue (an estimated $1 trillion over 10 years) by taxing imports more than exports. Two, there is a strong popular sentiment against trade—as has been common in our modern history whenever the US economy has been perceived to perform poorly. Neither of these motivations would seem a sound basis for quantum choices about permanent US tax policy.

To export successfully, a nation must import. That is especially true in today's world of complex (but economically efficient) supply chains that can cross multiple borders, even several times each, before goods ultimately reach the consumer (and, notably, US consumers).[25] A DBCFT could well leave both US producers less competitive and US consumers worse off after all effects are fully felt. Still, the debate over the DBCFT reflects a concern that US business is playing on a tilted field and that, under the current system, US corporations are incented to invest elsewhere, engage in "inversions" and other transfers of ownership, and otherwise find ways to compete more successfully in the global marketplace. Proposals to shift to a territorial corporate tax system or to a DBCFT are two attempts to "normalize" policy to encourage firms to invest and produce in the United States.

3. A 1986-style tax reform

Another broad general path toward better corporate tax policy is change along the lines of the Tax Reform Act of 1986. This Act eliminated a number of significant corporate tax preferences and used the proceeds to reduce the statutory corporate tax rate. After its enactment, the United States had one of the lowest statutory corporate tax rates in the developed world. Since that time, the United States essentially has stood still, while other nations have outdone us in statutory rate reduction, leaving us with the highest statutory rate in the OECD.

An aggressive repeat of the 1986 tax reform could achieve substantial rate reduction (from the current 35 percent to perhaps 28 percent) without losing revenue. However, at this time, there are not enough remaining corporate tax preferences to repeal that could achieve a statutory corporate tax rate below that of our international competitors without losing revenue. Thus, given the United States' dire need to achieve fiscal sustainability (which is high among CED's policy objectives), the nation would need to find additional budget savings if policymakers were to insist on a corporate tax rate below approximately 28 percent.

"… the corporate tax rate is only one factor in business location decisions, and the United States will be a highly attractive location if we have a competitive—even if not the lowest—tax rate."

However, policymakers should keep in mind that, while tax rates matter, not all business activity has moved to the developed nation with the lowest corporate tax rate. There are sound business reasons to locate production close to a business's target market. Proximity reduces transportation costs. If such a location gives proximity to talented labor and natural resources, including low energy costs and efficient regulation, so much the better. And nearness to the sales market always allows a better understanding of and quicker and more accurate response to the wishes of the customer. Thus, the corporate tax rate is only one factor in business location decisions, and the United States will be a highly attractive location if we have a competitive—even if not the lowest—tax rate.

If policymakers insist on reducing our statutory tax rate below approximately 28 percent, our current budget problem would require additional deficit reduction. One possible source would be increased revenues from other taxes. The debate over the DBCFT has highlighted that the United States does not impose a border-adjustable consumption tax. Many other countries rely on a value-added tax (VAT), which is unquestionably border-adjustable. Apart from some aspects of design that may not stand up in actual application, a DBCFT is very much like a VAT. It may be worth considering a DBCFT that is designed to be border-adjustable (which would be much more like the legally border-adjustable VAT that many of our trading partners use) and would make up only part, rather than all, of the revenues of the corporate income tax.

However, there is the clear concern that adopting a VAT could reduce the pressure on policymakers to reduce spending and eliminate income tax preferences, which could have compounding repercussions in the future.

Some leading policymakers have put their ideas on the table (see box below):

House Speaker Paul Ryan has put forward a comprehensive tax reform proposal. Its corporate tax component is based on a DBCFT, with expensing of corporate investment, eliminating the deductibility of interest, and eliminating the foreign tax credit, consistent with the description of the DBCFT above. It would entail a mandatory repatriation of current untaxed foreign earnings and repeal of the corporate

PROMINENT PROPOSAL PACKAGES

	Trump	Ryan	CED
Tax rate, C corporation	15	20	27
Tax rate, pass-through	≤15	≤25	27
Interest deductibility	"A reasonable cap"[i]	Repealed	Retained
Investment expensing	Yes[ii]	Yes	No
Tax treatment of foreign earnings of multinationals	Foreign profits taxed currently; no deferral	Destination-based cash-flow tax	Deferral
Foreign tax credit	Yes	No	Yes
Mandatory repatriation of past foreign earnings	Yes	Yes	No
Tax preferences	Some repealed or reduced	Some repealed or reduced	Some repealed or reduced
Corporate alternative minimum tax	Repealed	Repealed	Repealed
Ten-year revenue loss, static scoring, trillions[iii]	\$4.4–5.9 (TF)[iv] \$6.1 (TPC)[v]	\$2.4 (TF) \$3.1 (TPC)	-\$2.3 (TPC)[vi]
Ten-year revenue loss, dynamic scoring, trillions[vii]	\$2.6–3.9 (TF) \$6.0 (TPC)	\$0.2 (TF) \$2.5–3.0 (TPC)	N.A.

i Interest deductibility may be eliminated only for manufacturing firms that elect to expense their investment.

ii May apply to manufacturers only, may apply to all corporations, may be available to pass-through entities.

iii Includes effects of policy proposals affecting all tax revenues, not only corporate income tax.

iv Source: Tax Foundation.

v Source: Tax Policy Center.

vi Designates revenue gain, estimated as of 2010 assuming enactment in 2011, measured over fiscal years 2012-2020.

vii Includes effects of policy proposals affecting all tax revenues, not only corporate income tax.

alternative minimum tax (AMT). One concern is that the Ryan plan could entail a significant revenue loss, which would make it more difficult to attain fiscal sustainability in the foreseeable future, although the most optimistic revenue estimate published would have the plan as revenue neutral.

President Trump suggested a somewhat unorthodox proposal during his campaign, moving in the opposite direction of Speaker Ryan's plan. It would tax foreign profits currently (thereby eliminating deferral), although it would cut the US statutory corporate tax rate substantially. It would have a mandatory repatriation of current untaxed foreign profits. The plan would allow expensing corporate investment, but still allow some deduction of interest expense subject to an unspecified cap—thus, possibly allowing tax shelter opportunities. Perhaps most unusual, it would create a separate rate for pass-through entities—equal to the corporate rate, but lower than the top bracket individual rate. This feature has caused serious concern among tax policy and tax administration professionals because it appears to invite upper-income individuals to create their own personal service corporations (for labor income) and investment corporations (for investment income) so as to migrate their income from the statutory top individual tax bracket into the preferential lower rate for pass-through entities. Such tax sheltering would reduce both the federal government's total revenues and the tax burden exclusively on those individuals with the highest amounts of income. Given the potentially large tax savings for individuals who would benefit from this provision, it is likely that considerable legal expense would be invested in attempts to circumvent any preventive regulations.

CED Recommendations

There is no silver bullet by which corporate tax reform can simultaneously maximize all of the stated objectives; trade-offs are unavoidable. History is replete with proposals of radical new tax ideas that have been argued to have enormous advantages. But there is an inherent limitation to all such alleged great leaps forward. Except for highly unusual circumstances of fiscal plenty, any replacement tax must generally collect as much revenue as the tax it replaces. Collecting the same amount of tax in a radically different way is likely to create many happy winners and just as many unhappy losers. But perhaps even more important, in a truly radical tax change, the economic enterprises that are the worst losers may not be able to survive, which would have broader economic consequences. Policymakers should consider the potential fallout of such dislocation carefully, along with the important role in economic growth of simple deficit reduction.

CED has recommended incremental, but significant, reform:[26]

1. **Eliminate corporate tax preferences.** This would level the playing field across different types of firms, allocate capital more efficiently, and facilitate economic growth.
2. **Eliminate the corporate alternative minimum tax (AMT).** The corporate AMT was designed to prevent profitable corporations from paying zero or near-zero income taxes *in any single year*. The number and importance of true tax preferences that are potentially washed out by the corporate AMT is very small. Rather, the corporate AMT has become more of a timing device.

"… there is an inherent limitation to all such alleged great leaps forward.… Collecting the same amount of tax in a radically different way is likely to create many happy winners and just as many unhappy losers."

A firm that undertakes a large investment in a particular year may have substantial depreciation deductions in that and a few succeeding years. In our view, forcing that firm to pay more in corporate income taxes in those few years, and then giving the suspended depreciation deductions back in later years, serves no enduring purpose. The same can be said of suspending operating losses if a profitable firm happens to have a few bad years. The incentives for firms to manipulate the timing of their investments to avoid falling prey to the AMT likewise serve no economic and social purpose. We believe that any genuine tax preferences that are appropriately included in the AMT would better be eliminated outright for purposes of the ordinary corporate income tax, with the revenue gained applied to general corporate tax rate reduction.

3. **Reduce the statutory corporate tax rate as much as possible.** The lower the statutory corporate income tax rate, the greater the attractiveness of earning profits in the United States. The lower the statutory tax rate, the less the economic distortion caused by any remaining tax preferences and the less the difference between the tax charged on any ordinary income and that on any preferred uses.

4. **Maintain the general current-law treatment of pass-through entities.** With lower and equal statutory corporate and top-bracket individual tax rates (given that much of the income from pass-through entities is taxed at the highest individual rate), the potential for manipulation of either form could be minimized with sound regulation and administration.

5. **Maintain the current deferral of taxation of profits of US-based multinational corporations, and the foreign tax credit when those profits are repatriated.** Conversion to a territorial system has strong support. However, the revenue loss that would accompany a true territorial system is problematic. The nation's deficit must be controlled or a debt problem or crisis at some future date (though not necessarily an imminent date) is inevitable. Therefore, we recommend continuation of the deferral system as an appropriate compensation for US-based firms that compete with other firms operating under territorial systems. We note especially that, with substantial reduction of the US statutory corporate tax rate (for example, the Bipartisan Policy Center's Debt Reduction Task Force recommended a reduction to 27 or 28 percent),[27] the difference from the statutory tax rates of our major trading partners will be much reduced and the significance of the entire issue of taxation of foreign profits will be commensurately smaller. If policymakers choose a territorial tax system as a high priority, then some additional sources of budget savings will be essential. The deficit problem looms so large that good options already may be scarce. Policymakers would need to consider new revenue sources and spending cuts to make room for a territorial system in our nation's fiscal future.

"One of the nation's most pressing issues, deficit reduction, requires some measure of give on the part of individuals and businesses alike."

Conclusion

This policy brief has focused on the policy considerations surrounding the corporate income tax. For reasons noted above, we believe that true reform of the corporate income tax cannot be achieved in total isolation from the status of the individual income tax. We hope to explain to our fellow citizens that there is no meaningful difference between taxation of corporate income under the corporate income tax, on the one hand, and taxation of that same corporate income through the individual income tax on the firm's owners, on the other. A reformed individual income tax should make it possible to reduce the corporate income tax burden and, therefore, to increase the competitiveness of US producers and job creators.

CED urges all business leaders to engage in an open and respectful dialog about corporate tax reform. That dialog should include expressions of concern about adverse consequences of a loss of competitiveness of US-based firms. One of the nation's most pressing issues, deficit reduction, requires some measure of give on the part of individuals and businesses alike. But businesses must thrive if they are to play their part throughout a long and prosperous future for all Americans.

Endnotes

1 US corporate tax revenue is below the average, as a percentage of GDP, among the Organisation for Economic Cooperation and Development member nations (which include most developed countries around the world) (https://data.oecd.org/tax/tax-on-corporate-profits.htm). However, the US statutory tax rate—the rate imposed by law on taxable profits—is the highest (OECD Tax Database, Table II.1 – *Corporate income tax rates: basic/ non-targeted*, May 2016, http://www.oecd.org/tax/tax-policy/tax-database.htm). This is one important indicator that the US corporate tax is in need of reform.

2 Or GDI, the income-side equivalent of the spending-side gross domestic product, or GDP.

3 See also the related discussion of globalization, below.

4 There are essentially four types of pass-through entities that report their earnings directly on individual income tax returns. A sole proprietorship, or one-owner business, is taxable to the owner. A partnership (either a "general" partnership or a "limited" partnership), with multiple owners (which can be individuals or other businesses), divides its results among the owners on their individual income tax returns. A limited liability company (LLC) can have single or multiple owners and enjoy the limited liability of the corporate form, even though it pays only the individual income tax and not the corporate income tax. A subchapter S corporation or "small business corporation" may be owned by up to 100 individual US citizens, not by foreign citizens or other businesses. All of these entities must pay tax on all of their earnings each year, even if those earnings have not been distributed to the owners. In contrast, a Subchapter C corporation can retain earnings that will not be subject to individual income tax until distributed (or realized as capital gain). Kyle Pomerleau, *An Overview of Pass-through Businesses in the United States,* Tax Foundation Special Report No. 227, January 2015 (http://taxfoundation.org/sites/taxfoundation.org/files/docs/TaxFoundation_SR227.pdf).

5 George A. Plesko and Eric J. Toder, "Changes in the Organization of Business Activity and Implications for Tax Reform." *National Tax Journal* 66(4): 855–70, 2013; American Bar Association, "LLCs: Is the Future Here? A History and Prognosis," *Law Trends & News*, October 2004, Vol. 1, No. 1 (http://www.americanbar.org/newsletter/publications/law_trends_news_practice_area_e_newsletter_home/llc.html).

6 As one example, Dudley Althaus and Christina Rogers, "Donald Trump's NAFTA Plan Would Confront Globalized Auto Industry," *Wall Street Journal*, November 10, 2016 (http://www.wsj.com/articles/donald-trumps-nafta-plan-would-confront-globalized-auto-industry-1478800848); Neil Irwin, "Donald Trump Trashes NAFTA. But Unwinding It Would Come at a Huge Cost." *New York Times*, October 3, 2016 (http://www.nytimes.com/2016/10/04/upshot/donald-trump-trashes-nafta-but-unwinding-it-would-come-at-a-huge-cost.html?_r=0http://www.nytimes.com/2016/10/04/upshot/donald-trump-trashes-nafta-but-unwinding-it-would-come-at-a-huge-cost.html?_r=0); Nick Miroff and Joshua Partlow, "Trump's Fight against Made-in-Mexico Could Carry Price on Both Sides of Border," *Washington Post*, December 1, 2016 (https://www.washingtonpost.com/world/the_americas/mexicans-believe-a-trump-trade-war-will-backfire--and-they-can-show-why/2016/11/30/103bb28c-a6c8-11e6-ba46-53db57f0e351_story.html?utm_term=.027f67e72c5f).

7 The US originator of the tax expenditure concept, elucidated the term with the explanation, "spending through the tax code." Stanley S. Surrey, *Pathways to Tax Reform* (Cambridge, MA: Harvard University Press, 1973). The primary source of data on preferential tax provisions is the "tax expenditures" list. Both the Office of Management and Budget (OMB, in the *Budget*) and the Joint Committee on Taxation of the Congress (the JCT, in its own separate publication) present annual lists, based on slightly different assumptions and methodology. Several of the largest tax expenditures (for example, the home mortgage interest deduction) are available only to individuals. The Treasury produces a table that reports only those tax expenditures available to corporations. The most recent such table is available at *Analytical Perspectives*, *Budget of the United States Government, Fiscal Year 2017,* Chapter 14, "Tax Expenditures," Table 14-2a, pp. 233–237 (https://obamawhitehouse.archives.gov/sites/default/files/omb/budget/fy2017/assets/ap_14_expenditures.pdf).

8 Some other tax expenditures were created by legislators to incent particular forms of behavior that were considered beneficial.

9 Howard Gleckman, "Mission Impossible: Cutting the Corporate Tax Rate to 25 Percent," Tax Policy Center (http://www.taxpolicycenter.org/taxvox/mission-impossible-cutting-corporate-tax-rate-25-percent).

10 This discussion has implications for the legislative process. One of the most important objectives of trimming corporate tax preferences is to allow reductions in the corporate tax rate. However, many tax preferences that are used by Subchapter C corporations also are available to pass-through entities that pay under the individual income tax. When corporate tax reform cuts or eliminate preferences, those Subchapter C corporations are compensated by reduction of their statutory tax rates. However, pass-through firms paying under the individual income tax receive no such compensation—unless there is simultaneous fundamental reform of the individual income tax as well. Although certain focused changes of the corporate income tax may be possible in isolation, the broader the corporate reform that is attempted, the more that the individual income tax must be changed in parallel.

11 For example, a patent is, by definition, unique and is rarely sold, which means that there is almost by definition no market price to provide a fair arm's-length valuation. Intangible assets are much easier to move between countries than, say, a manufacturing plant. And certain nations—"tax havens"—have proven themselves willing to host the intangible capital of major corporations by offering very low corporate income tax rates on the return to intangibles (in some instances, by explicitly taxing the return to intellectual capital at lower rates than income from physical production through what are commonly known as "patent boxes"). Such nations typically have very low costs of government and very limited reasonably defined economic activity, so the essentially selective terms offered to major overseas (including US) corporations amount to trolling for extra revenue for the tax havens' budgets. These opportunities pose a challenge for all of the major nations and their corporate income taxes, but are particularly difficult for the United States. Countries frequently cited as "tax havens" include Luxembourg, the Cayman Islands, the Isle of Man, Jersey, Ireland, Mauritius, Bermuda, Monaco, Switzerland, and the Bahamas (http://www.fool.com/investing/general/2016/01/03/10-best-tax-havens-in-the-world.aspx). Prominent among the nations that have created explicit patent boxes are France, Hungary, the Netherlands, Belgium, Spain, Luxembourg, Malta, the United Kingdom, and Ireland (http://www.jec.senate.gov/public/_cache/files/02a2a18a-1e08-42ce-8c14-72b6138b54dd/031016-patent-boxes.pdf). The ease or cost-effectiveness of moving intellectual property across borders is a matter of some dispute in the business community.

12 This is in addition to the technological changes discussed in the section on intangible assets, which arguably drive an inexorable erosion of the viability of the corporate income tax.

13 In other words, the firm can use the cash in any way that enhances value, including (but not limited to) lending it to earn interest, or using it instead of borrowing to finance investment.

14 Jeff Cox, "US Companies are hoarding $2.5 trillion in cash overseas," CNBC, September 20, 2016 (http://www.cnbc.com/2016/09/20/us-companies-are-hoarding-2-and-a-half-trillion-dollars-in-cash-overseas.html).

15 Given that many firms have had the opportunity to invest by borrowing at very low interest rates at any time over the last several years and generally declined to do so, it is less than obvious that they would choose to invest any preferentially repatriated earnings at this time.

16 Producing close to your market for sales reduces transportation costs, but also gives a better sense of the sales market and allows quicker and more accurate responses to changes in it.

17 To see why this is so, compare the current US worldwide tax regime with an alternative simple territorial system, assuming for purposes of example that a US firm has the opportunity to invest in a foreign country with a 20 percent corporate tax rate and that the foreign earnings are repatriated rather than invested permanently overseas (see table below). The only change between the US current worldwide tax system and a hypothetical territorial tax system would be a reduction of the tax due on a foreign investment. For this reason, economists expect that a change to a US worldwide tax system would lead to the location of more investment by US firms overseas.

	Current Worldwide System		Alternative Territorial System	
	US investment	Foreign investment	US investment	Foreign investment
US tax rate	35	35	35	0
Foreign tax rate	N.A.	20	N.A.	20
US foreign tax credit	N.A.	-20	N.A.	0
Total tax rate	35	35	35	20

However, this abstracts from any protections against transfers of US firms' income overseas, which might lead to a disadvantage for particular US firms. Every national tax system is unique, falling on the continuum between "worldwide" and "territorial" systems; each is a hybrid in some respects. A US territorial system would fall into that irregular pattern, influenced by many unique cultural attributes of the US economy and US business. Once the fine print was written, a shift to a territorial tax, or any fundamentally different US corporate tax system, would have both winners and losers. This would be true especially given that a pure territorial system, all else equal, could lose revenue—requiring that other tax law provisions be changed to get the lost revenue back. The losers could be expected to object and to argue for concessions. And to the extent that any tax revision has a preponderance of winners, it will lose substantial amounts of revenue—and given the state of the federal budget, that lost revenue will be felt somewhere else in the economy, whether in higher interest rates, higher taxes, or reduced spending that will impinge on incomes and demand.

18 The DBCFT, as currently discussed, would apply only to Subchapter C corporations, not to pass-through entities.

19 A combination of expensing of capital investment and the deductibility of interest costs would result in a negative effective tax rate on debt-financed investment. That would allow the design of tax shelters using non-economic investments, which could result in potentially limitless revenue losses to the Treasury while wasting scarce investment resources in the private sector.

20 Trade law is enforced by the World Trade Organization (WTO).

21 The most commonly used consumption tax elsewhere around the world, a value-added tax (VAT), is typically border adjusted.

22 Employee compensation is typically the largest deduction on US corporate income tax returns.

23 This highly technical point might fairly be communicated as a trade-law principle that a nation's border-rebated tax must treat their exports and imports the same—"like for like." However, a border-rebated DBCFT would tax *all* of the value of imports, but (unlike the VAT that is routinely border-rebated around the world) would amount to a tax only on US profit (because it would allow a deduction for US wages paid). William R. Cline, "The Ryan-Brady Cash Flow Tax: Disguised Protection, Exaggerated Revenue, and Increased Inequality," Peterson Institute for International Economics Policy Brief PF 17-4 (https://piie.com/system/files/documents/pb17-4.pdf).

24 Adam S. Posen, Peterson Institute for International Economics, "The Proposed Border Tax's Costs Outstrip Its Benefits," (https://piie.com/newsroom/short-videos/proposed-border-taxs-costs-outstrip-its-benefits); and "Border Tax Adjustment and Corporate Tax Reforms," (https://www.youtube.com/watch?v=u-P4HpIffHo&feature=youtu.be&t=48m9s).

25 See references in endnote 6 above.

26 Committee for Economic Development, *The Federal Budget Deficit and the Public Debt: Dealing with a Lurking Problem*, (https://www.ced.org/reports/single/the-federal-budget-deficit-and-the-public-debt-dealing-with-a-lurking-probl), December 12, 2016.

27 Bipartisan Policy Center, *Restoring America's Future*, November 17, 2010 (http://bipartisanpolicy.org/library/restoring-americas-future/); and "Domenici-Rivlin 2.0" (http://bipartisanpolicy.org/wp-content/uploads/sites/default/files/D-R%20Plan%202.0%20FINAL.pdf).

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