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# Corporate Tax Reform, Business Tax Reform, or Capital Income Tax Reform?

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# What are We Reforming Here?

- "Business" tax reform talk is all around us
- But do we want to reform the income taxation of U.S. *corporations* (in practice, public companies), or all U.S. *businesses*, or of *capital income*?
- Capital income:
  - All returns to savings & investment
  - Not just "capital gains"
  - Includes *interest*, rents, dividends
  - Also includes net business profits, because labor inputs are deductible. This includes the corporate income tax.

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# And Why Do We Want To Reform Things?

- Because corporate headline rate is “uncompetitive”?
  - Certainly true that it is out of line with peer nations
- To pick up incremental economic efficiency gains?
  - Certainly true that current tax system imposes wildly different burdens on different capital investments, depending on type of investment, type of financing and type of business organization
- Distributional goals?
  - The rich turn out to have more capital income than do the poor
- Revenue needs?
  - Should corporates/businesses/capital pay more?

# Disentangling Our Reasons for Reform

- Is corporate rate really so uncompetitive in practice?
  - Not for most multinationals, but what about domestic ETRs?
- Efficiency is a complex goal
  - Requires thinking about capital income more comprehensively
  - Classic rate lowering + base broadening rewards “old” capital
- Distributional goals conflict with efficiency goals
  - Particularly acute in capital income taxation
- Revenue goals are particularly fraught
  - No political consensus of any kind on overall revenue goals

# Corporate or Business Income Reform?

- U.S. is virtually unique in having ½ its business income earned outside corporate form
  - Overstated to extent that much unincorporated net business income is simply labor income
  - Capital intensiveness more like 70 – 30
- Unincorporated sector today taxed more lightly than corporates on domestic income
- Closing "business tax expenditures" affects both
  - Different depreciation schedules etc. for different legal forms would make a bad situation worse
- Changing "personal" tax rates directly affects unincorporated businesses

# Capital Income Tax Reform Is Daunting

- Goal would be consistent tax burden on all capital income of a given type, regardless of:
  - Form of financial investment (e.g., equity or debt)
  - Form of "real" investment (depreciation)
  - Form of business organization
- Reason would be economic efficiency gains
- Requires fundamental reorientations:
  - Tax all business enterprises identically
  - Rethink debt vs equity to tax regardless of legal form
  - Tease apart labor and capital income in the closely held firm through a capital-labor income centrifuge

# Current Capital Income Inefficiencies

- Current law does OK taxing labor income, but does a terrible job of taxing capital income
- CBO 2005 study: enormous variations in tax burdens on returns to different investments, taking into account:
  - Legal form of business organization
  - Nature of “real” investment asset
  - Choice in financing the investment
- Effective tax rates on corporate investments varied from +36% to -6%, a 42 percentage point swing!
- Consequences?
  - Underinvestment where tax burden is high
  - Misdirected investment, compared to a world of constant–burden taxation

# One Capital Income Rate or Many?

- Economic components of capital income :
  - “Normal” returns (boring “returns to waiting”)
  - Risky returns
  - Supernormal returns (economic rents)
- Good arguments for taxing each differently
  - Normal returns probably should be taxed at zero, or a low rate
  - Risky returns require symmetry in profit/loss tax treatment
  - Supernormal returns (economic rents) can bear higher tax
- And no particular reason to believe that any logically should be taxed at the same rates as labor income

# Fundamental Capital Income Reform

- Fundamental capital income reform is technically possible but requires much more than base broadening
  - Treat all business enterprises alike
  - Treat all forms of financial investment alike
  - Address unavoidable imprecision of depreciation (key to taxing normal returns)
  - Separate labor from capital income when the two are mixed
  - Impose coherence on tax rates imposed on different categories
- Dual BEIT is the answer, but no one asks the question
  - Dual income tax to separate labor from capital and inspire rates
  - BEIT to deal with measurement issues

# International Tax Reform Today?

- Taxation of international operations is critical (and screwed up)
  - Entirely a corporate tax issue
  - “Competitiveness” complaints largely fact-free
  - Behavioral distortions rampant in current law
  - *Domestic* revenue base is at risk
- Only three obstacles to doing better
  - Definition of corporate “residence” is difficult
  - Identifying the “source” of income is even tougher
  - Politics made still more difficult by “tax mercantilism” of many countries

# U.S. FDI Tax System Today

- Ersatz territorial tax system
  - As a “cash” tax matter
  - And (probably more important) also as a GAAP matter
- Exception I:
  - Extraordinary dividends are taxed
- Exception II:
  - Royalties and interest from foreign subs are tax-preferred, compared with a territorial system
- Two exceptions point in opposite directions
- Exception III:
  - The lock-out phenomenon

# Stateless Income

- Income of an MNE
  - Derived from factors of production in foreign country (relative to home country of group's parent)
  - Taxed in foreign country other than country where factors of production are located or home country of group
- Invariably low-taxed income
  - Idea is migration of high tax foreign income to low tax jurisdictions
  - Software sales in Germany where profits end up in Ireland
- Parallel but not identical to avoidance of home country tax
  - Transfer pricing abuses, etc. relevant to both
  - Policy recommendations relevant to both

# Consequences of Stateless Income

- Firms are hoist by their own petard!
  - Hugely successful in generating stateless income
  - Wallowing in $2 trillion in permanently reinvested earnings
  - GE worldwide ETR for 2013 (on $13B earnings) = 4.2%
  - Numerous examples of single digit effective foreign tax rates
- No observable current competitiveness costs
  - Except costs of maintaining the tax machinery
  - No current tax or GAAP drag
  - Frustration of course that offshore cash cannot be used to support stock price
  - Must find uses for all those earnings
  - But money is somewhere in the U.S. economy

# Efficiency Consequences of Stateless Income for U.S.

- Distorts US firms' investment/ownership preferences
  - Undercuts capital ownership neutrality story by creating "tax rents"
- Requires resources to make the tax magic happen
- Requires earnings to stay formally in foreign subs
  - "Lock-out"
  - Can lead to suboptimal foreign investments
  - Lock-out becomes lock-in: investors cannot optimize their portfolios
- Exposes US tax base to erosion through arbitrage

# So Where Is Business Tax Reform Today?

- President:
  - Lower corporate rate perhaps to 28%, somehow
  - Tax existing PRE stockpile to raise $150B for infrastructure
  - Another $250B (mostly international) to pay for rate reduction
- Dave Camp
  - Detailed and comprehensive tax bill with many useful ideas
  - “Revenue neutral” reform with lower personal tax revenues
  - Corporate rate to 25%; individuals to 35% (except manufacturing), but on broader tax base
  - Territorial system, $170B transition tax on PRE stockpile
  - $590B apparently shifted from business to pay for lower personal taxes

# Can We Get to a Deal?

- There are some points in common
  - Surprising consensus on corporate tax rates in particular
  - And agreement that international system is unstable and must be fixed in ways that eliminate lock-out
  - Weaker consensus that business tax reform cannot be a substantial revenue generator
  - But zero chance of consensus around overall revenue targets
- Can business tax reform move separately?
  - Technical issues of distinguishing labor from capital income
  - Substantial differences in approaches to international income
  - Political goals

# Disentangling Camp Personal vs. Business

- Personal taxes go down $590B over 10 years, while business taxes go up by about same amount
  - JCT (JCX-20-14): [Business tax reform – corp. AMT repeal + international + excise taxes]
  - While corporate rate goes down to 25%
- But this overlooks netting within unincorporated sector
  - Broader base from business changes, but lower rate on net business income on individual return
  - Net change in unincorporated business income burden unclear, but certainly much smaller than implied
  - Corporates do seem to be subsidizing personal rates over first 10 years, despite lower rate – perhaps to tune of $250B
- JCT presentation is quite unhelpful here

# Camp Business Revenue Numbers

- Corporate rate reduction is expensive!
  - JCT: -$680B over 10yrs, with phasing in rate to 2019, but not counting repeal of corp. AMT (-$110B) or § 199 (+116)
- A lot of frontloading and backloading going on
  - Phase in of corporate rate backloads cost
  - Slower depreciation/amortization front loads savings
  - International "raises" $68B only because of *one-time* $170B transition tax
- Some reforms seem unrealistic even to this Democrat
  - Amortization of R&D and advertising ($360B over 10yrs)
- Many affluent individuals will have higher tax rates

# The Growth Fairy Will Not Plug the Gap

- Camp bill is *not* revenue neutral in steady state
  - Assuming that to be the goal!
- JCT macro analysis does not portend an easy solution
  - Macro analyses do not predict perpetual compounding gains
  - Revenue neutral bill should imply only modest macro gains
  - New capital EMTR may well go up – investment goes down
  - 8 different results from different models because macro analyses are so uncertain
  - Largest gains come from least realistic models of behavior and budget policy
- JCT conclusions widely misunderstood

# JCT Macroeconomic Conclusions

- JCT best case in their macro study was 1.6% greater real GDP in total over 10 years
- *Not* a prediction of a 1.6 percent greater growth *rate*
  - Predicted growth rate (CBO) = 2.5% for next 10 years
  - Imagine $100 GDP growing @ 2.5% for next 10 years
  - Total GDP over 10 years would = **$1120**
  - JCT best case here = total GDP of **$1138** over 10 years
  - Assuming constant growth rate, this implies growth @ 2.84%
  - A nice pickup, but of course other estimates were lower
- JCT presentation here could have been clearer

# Filling the Revenue Hole

- Camp bill is revenue-challenged even on its own terms
- What is the case for personal tax reduction and lower investment in the future (JCT macro analysis)?
  - Consumption does not fuel growth in perpetuity
  - What is EMTR on new capital investment in the USA under Camp? In hard capital? In intangibles?
- What is the case for $100 billion lower taxes on international corporate income?
  - This is going in the wrong direction!
  - Not required by “competitiveness”

# *Really* Filling the Revenue Hole

- Revenue-neutral tax law underfunds government
- Fiscal cliff tax deal (2013) is the reason
  - 2012 official CBO "baseline" showed deficits largely disappearing over 10 years ($2.3 trillion total/10 years)
  - Deal added $4.6 trillion to 10-year deficit;
    - CBO Feb 2014 now projects $8 trillion deficit 2015 - 2024
    - *And that forecast is optimistic relative to probable outcomes*
- "Slashing spending" is an exercise in magical thinking
- Stay tuned for: *We Are Better Than This: How Government Should Spend Our Money* (Oct. 2014)

# Rethinking Camp Bill Tradeoffs

- The bill  plainly is too soft on international
  - Stronger anti-abuse rules?
  - E.G. country by country minimum tax?
- The bill perhaps is too hard on capital investment?
  - *Domestic* thin cap would be consistent with larger capital income tax neutrality principles
- The bill is too soft on labor income
  - Lower burden on personal income, with slightly higher rate on capital gains/dividend income at the very top, implies significantly lower taxes than 2013 schedules on labor income generally
  - But EITC scaleback moves in the wrong direction

# International Options

- Territorial systems rely on economic *nexus* of income
  - But geographic nexus is nearly impossible to pin down
  - Only positive nexus story is section 954(h), and no one is volunteering for more of that
  - OECD holding back the sea with a broom
- Minimum tax and Baucus Option Z both point in the opposite direction, by addressing stateless income through *residenc*e taxation of corporation
  - Easier to police corporate residence than nexus of income
  - But is it economically rational, or just a pragmatic answer?
  - Corporate tax justifiable as a withholding tax on shareholders
  - U.S. (unlike others) still can treat a US corporation as a good proxy for US people