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

Edward D. Kleinbard
Professor of Law
ekleinbard@law.usc.edu

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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.
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 $\frac{1}{2}$ 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 *residence* 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