VIEWS ON THE CORPORATE TAX*

Jane G. Gravelle, Congressional Research Service

In this panel discussion, the participants were asked to choose between the approaches to corporate tax revisions: eliminating the tax on new investment (via a consumption tax), integrating the tax, or reforming the essentially classical system (with a tax at both the corporate and the individual level). We were to consider these alternatives without regard to political constraints.

I would normally first reject the approach of moving to a consumption tax on political grounds. But even setting that aside, I don't think this is a wise course for reasons of revenue yield, transitional problems, and equity. Because of the macroeconomic transitions necessary to accommodate a value added tax (VAT), where the locus of tax is shifting from individuals, requiring either a significant price rise or downward pressure on wages, with the accompanying risk of recession, I think only a version of the Hall-Rabushka flat tax or Bradford X tax would be feasible. (A national retail sales tax has even more serious macroeconomic transition problems than a VAT and confronts serious questions of compliance as well). This latter tax, because it operates only on real transactions, concentrates the lump-sum wealth on equity capital, and can be confiscatory for those with leveraged assets. (These problems are spelled out in greater detail by Gravelle, 2008a).

Corporate tax integration is also fraught with many difficulties other than political. The most appropriate way to integrate is via a partnership treatment, which is virtually impossible given the mass ownership and exchange of shares. Rate alignment — eliminating the tax at the individual level and setting the corporate rate at the top individual rate — is an imperfect but relatively straightforward method that works well in a closed economy. We have already taken steps in that direction, by lowering tax rates on dividends and capital gains and exempting a significant amount of income that is held in pensions and other tax exempt forms. In an open economy, however, it attaches the tax to the firm level that does not address the reservations about corporate tax with respect to capital outflow and international tax avoidance. Moreover, it is very difficult to integrate without losing revenue.

I would, therefore, focus on tax reform within an existing classical system and in a revenue neutral fashion. Nevertheless, the corporate integration issue does inspire one obvious reform. If we are concerned about the firm level tax rate and its effect on discouraging capital investment in the United States and its effect on shifting of profits to low-tax jurisdictions, it would be better to increase tax rate at the individual level, particularly on dividends, and use those revenues to reduce the corporate rate. The concerns about actual capital outflows are, in my view, of less concern than profit shifting.

In addition to a focus on lowering the statutory rate, another principle is to discuss reforms that are, at least, revenue neutral.

What sorts of reforms could lead to a lower statutory tax rate? One obvious reform in line with the argument for shifting the burden to the individual level would be to roll back the lower tax rates on dividends and capital gains; that is, to increase the tax rate on dividends to the ordinary rates and increase the capital gains rate to 20 percent. Of course, whether this change would be revenue neutral depends on whether one takes the baseline of the current rates, or the baseline after rate reductions expire in 2008. In any case, Gravelle (2008b) estimates that the corporate tax rate could be reduced by 4 percentage points, from 35 percent to 31 percent if these individual level rates could be increased. If capital gains were to be taxed at ordinary rates, depending on the assumptions about realizations responses, the rate could be reduced another 1 to 3 percentage points; I would suggest something towards the latter, so that rates could fall to as little as 28 percent.

The rate could be reduced much further if corporate capital gains were taxed on an accrual basis, an approach that could achieve considerable rate reduction for the corporate tax. It is difficult to estimate the magnitude of this effect, because it would increase the gains taxed but would still

*The views in this paper do not reflect the views of the Congressional Research Service.

exclude income of nonprofits and would tax the inflationary portion of gains. Just to illustrate the general magnitude, consider that capital gains in a steady-state relationship is about $700 billion (Congressional Budget Office, 2008). Assume about 70 percent is due to corporate stock or about $500 billion. Current tax is 20 percent or $100 billion. With a tax rate of around 30 percent, the gain is $50 billion, which is worth about 5 percentage points of the corporate tax. Assuming that only half of the gain is realized, there would be another 10 percentage points, but if half were excluded to reflect inflation, we would be left at the same level. This would reduce the required corporate rate from 31 percent to 26 percent. One reason that the benefit is limited is that a lot of capital gains and dividends, about half, is estimated to be received by tax exempt entities such as pension funds and nonprofits. If the returns to these tax exemptions could be taxed at the benefit they received from the lower tax rate, the tax rate could be reduced to about 17 percent with an approximate 18 percent tax on the corporate income of nonprofits. Although this type of integration could achieve a very low statutory tax rate, an indexed realization basis taxation of corporate capital gains has both the problems of shareholders owing tax without the accompanying income and the complications of the correction capital gains for inflation.

Another way to achieve a lower statutory rate would be to restrict the ability of firms to be taxed as partnerships while still obtaining limited liability. The U.S. Department of the Treasury (2007) revealed a shocking statistic: the share of business income in the noncorporate sector has climbed from 20 percent in 1980 to 50 percent today. This climb likely reflects the more generous limits to the number of partners in Subchapter S firms, and the increasing prevalence of limited liability companies not taxed as corporations. If this ratio could return to is 1980 share, the corporate tax could be reduced by about 3 percentage points, assuming the corporate tax is 39% (Gravelle 2006, advisory panel study), capital gains tax and the tax rate of the investors in partnerships averages around 30 percent to 32 percent. (The Treasury study indicates that 61 percent of income is in the top bracket and 11 percent in the next bracket, suggesting an average marginal tax rate of this general magnified.) One way to achieve this change is to require any firm with limited liability to be taxed as a corporation and to reduce the number of shareholders that can elect Subchapter S status. This expansion of the scope of the corporate tax should increase economic efficiency by broadening the base and lowering the rate, just as any other form of base broadening would (since it is high tax rates). Such a reform would also eliminate the check-the-box rules whose application to foreign-source income has increased the scope for international tax avoidance.

Thus, the consequence of rolling back changes that happened in 2003 affecting dividends and capital gains and rolling back the rules that have allowed noncorporate treatment of large limited-liability firms would permit a reduction in the corporate rate to about 28 percent, and a further increase in the capital gains tax could reduce that level by more.

Another way to broaden the base and reduce the rate is to disallow the portion of the interest deduction that represents inflation (and eliminate it at the individual level). This change would significantly reduce the very generous tax treatment of debt relative to equity capital, and would allow a tax change of about 2.5 percentage points (Gravelle and Hungerford, 2008). This reform has its drawbacks from an international perspective: the generous treatment of debt at the corporate level probably attracts capital into the United States, and indeed, if debt is more mobile than equity a change of this nature could actually reduce the U.S. capital inflow (which is another way of saying that higher corporate rates, which contribute to this benefit would cause capital inflows as well). Unfortunately, very little attention has been directed at the magnitude of this effect.

At the same time, restricting the benefits of deducting interest would reduce the desirability and ability to shift profits to low-tax jurisdictions via leveraging, and this effect might be the more important if capital of all types is relatively immobile but the ability to recharacterize income very mobile.

Adding an inflation adjustment for interest to the dividend and capital gains rollback would permit a tax rate of 28 to 29 percent, and including all three items (dividend and capital gains rollback, expanding the base to include more limited liability firms and disallowing the inflation deduction for interest) would result in a tax rate of 26 percent to 27 percent.

Another way of expanding the base, obtaining greater neutrality, and lowering the rate, would be to eliminate deferral of foreign-source income and tax all income currently. There is some disagreement about the amount of rate reduction that would be feasible. With corporate revenues about $350 billion, a percentage point requires a revenue gain of about $10 billion at 2008 levels. According to the Joint Committee on Taxation's estimates (U.S. Congress, 2008), eliminating deferral raises about that amount, suggesting a reduction of 1 percentage point. At the same time, Grubert and Altshuler (2008) estimated that worldwide taxation without deferral would permit a reduction to 28 percent in 2002, a 7 percentage point reduction. This discrepancy likely partially reflects a larger dollar estimate by Grubert and Altshuler (2008) and significantly lowers corporate tax revenues. The administration's estimates of tax expenditures (Office of Management and Budget, 2008) has somewhat higher estimates than the U.S. Joint Committee on Taxation (about $14 billion) but that would still justify only a small reduction of under 1.5 percentage points.

An end to deferral along with formula apportionment, where income is allocated based on the share of some factor (usually assets, labor, and sales) for purposes of the foreign tax credit could be an even larger revenue raiser, especially with the formula apportionment (where income allocation is applied on a per country basis). Avi-Yonah and Clausing (2007) have found very large potential revenue gains of $50 billion simply from applying a sales based formula without deferral, which would imply a potential rate reduction of 5 percentage points. The success of formula apportionment in raising revenue has, however, been questioned by Altshuler and Grubert (2008), although they do not apply it at the same time as deferrral.. A number of other researchers have found large effects from income shifting, that suggest additional revenue could be raised, as discussed in Gravelle (2009).

There are other alternatives to ending deferral; Chairman of the Ways and Means Committee Rangel has proposed to raise similar amounts of revenue through disallowing the share of parent company interest and overhead associated with deferred income in H.R. 3970, the Tax Reduction and Reform Act of 2007.

The final set of base broadeners are associated with particular provisions. In the U.S. Department of the Treasury (2007) study, the corporate tax rate could have been reduced to a 28 percent rate (7 percentage points) with a series of revenue raisers. Three of these percentage points arise from accelerated depreciation, but it is not clear whether it is desirable to replace accelerated depreciation with a rate reduction. Other corporate tax subsidies may have merit (the R&D tax credit) or substitute for spending programs that may be desirable (Low Income Housing Credit). Here I list some of the more clearly questionable tax preferences and the potential rate reductions: (1) the production activities deduction 1 to 2 percentage points, (2) the inventory property sales rule, slightly over 0.5 percentage points, (3) graduated corporate rates, 0.3 percentage points, and (4) exemption of credit unions, 0.2 percentage points. There are a few smaller provisions, such as those for insurance companies and energy production that might add up to another percentage point or even more. Thus base broadening could permit a rate reduction of around 3 percentage points without repealing any of the provisions that might have some merit.

The potential reform outlined in this paper, therefore, starting from current law as the base, would reduce the rate by 4 percentage points from rolling back the 2003 dividend and capital gains change, 3 percentage points from applying the corporate tax to large partnerships, 2 to 3 percentage points from disallowing the inflation portion of interest deductions, 1 to 5 points from international reforms, and 3 points from domestic base broadening. These reforms suggest a 13 to 18 point reduction (a 22 percent to 17 percent rate) using the current law as a revenue neutral base line, and a 9 to 14 percentage point reduction using post-2010 law as a base line, with rates of 26 percent to 21 percent. It seems clear, therefore, that a significant reduction in the corporate tax rate to the neighborhood of 25 percent is quite feasible.

References

Altshuler, Rosanne and Harry Grubert. Formula Apportionment: Is It Better Than the Current System and Are There Better Alternatives? Paper presented at the Mobility and Tax Policy Conference, University of Tennessee, Knoxville, TN, 2008. http://cber.bus.utk.edu/confpapers/Alt_Grubrv7.pdf

Avi-Yonah, Reuven S. and Kimberly A. Clausing. Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment. Washington, D.C.: Brookings Institution, 2007. The Hamilton Project, Discussion Paper 2007-2008.

Gravelle, Jane G.

The Advisory Panel's Tax Reform Proposals. Washington, D.C.: U.S. Library of Congress, 2006. Congressional Research Service Report RL33545.

The Flat Tax, Value-Added Tax, and National Retail Sales Tax: Overview of the Issues. Washington, D.C.: U.S. Library of Congress, 2008a. Congressional Research Service Report RL32603.

Reform of U.S. International Taxation: Alternatives. Washington, D.C.: U.S. Library of Congress, 2008b. Congressional Research Service Report RL34115.

International Corporate Tax Reform: Issues and Proposals. *Florida Tax Review* 9 (2009): 469-496.

Gravelle, Jane G. and Thomas L. Hungerford. Corporate Tax Reform: Should We Really Believe the Research? *Tax Notes* 121 (October 2008): 419-438.

Grubert, Harry and Rosanne Altshuler. Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income. In John W. Diamond and George R. Zodrow, eds. *Fundamental Tax Reform: Issues, Choices, and Implications*. Cambridge: MIT Press, 2008, pp. 319-354.

Office of Management and Budget. Budget of the United States Government, Analytical Perspectives, Fiscal Year 2009. Washington, D.C., 2008.

U.S. Congress. Joint Committee on Taxation. Estimates of Federal Tax Expenditures for Fiscal Years 2008-201. Washington, D.C., 2008.

U.S. Congressional Budget Office. Budget and Economic Outlook, Fiscal Years 2008-2018. Washington, D.C., 2008.

U.S. Department of the Treasury. Conference on Business Taxation and Global Competitiveness. Background Paper. Washington, D.C., 2007.