Corporate and International Tax Reform

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What is the U.S. corporate tax?

Good to know what it is & does, before we plan any reforms. But unfortunately, it's a compound & economically ill-defined system.

E.g., it includes (1) capital income of U.S. individuals, (2) labor income of U.S. individuals (owner-employees), and (3) capital income of foreign individuals who invest through U.S. companies.

No good rationale for taxing (3) the same as (1) & (2). Foreigners don't have to invest here, & may not bear the tax economically (at least for normal returns). Debatable whether we should tax (1) & (2) the same.

Yet the corporate rate applies to all 3. Note that the key rationale for lowering the U.S. corporate rate – global tax competition for capital & reported profits – applies to (3), not so much to (1), & not at all to (2).

What about the SH-level tax?

Should the corporate tax rate be lower due to the second level of tax? (Dividend & other distributions to SHs, SH-level CG from selling stock.)

10 years ago, corporate tax reform emphasized eliminating the SH-level tax, rather than lowering the tax rate at the entity level.

2003 dividend rate cut went part of the way there, but reform efforts have moved on – & not just due to “been there, done that.”

Entity-level taxation seems ever worse given corporate residence and source issues. Also, can’t exempt SH-level CG on corporate stock without creating tax planning issues for all asset sales.

So, even if concerned about double taxation, the entity level may be the better place to address it. But there’s a problem.

Unfathomability of the SH-level tax

How great is the burden of the SH-level tax? Depends on ease of avoiding pre-death SH-level gain realization, probably heterogeneous (by firm type and/or market sector).

This uncertainty & heterogeneity make it hard to say how corporate tax rates should relate to non-corporate business tax rates.

U.S. business sector is roughly half corporate, half non-corporate. So corporate rate cuts – especially if financed, 1986-style, by base-broadening for general business items – raise issues for non-corporate businesses.

Say we want a level playing field between the two business sectors. The issues raised by SH-level taxes make it hard to say what this requires in practice.

More corporate tax reform problems

The U.S. corporate tax also reaches both old & new investment.

Say you get accelerated depreciation in Year 1, earn income in Year 2. Then, to a degree, the Year 2 tax is on things that happened in the past.

Generally no good reason to incentivize / reward *past* decisions.

Say we cut the corporate rate, financed by scaling back depreciation. To some extent, what we've done is reward old investment at the expense of new investment.

Plus, have we increased or reduced overall tax neutrality between investment choices? Consider all those that are effectively expensed.

Bottom line: the existing U.S. corporate tax is such a conceptual & practical mess that reform is appealing – but just what to do is unclear. Lots of tradeoffs, no clean solutions.

International tax reform

Let's start with some obvious points:

(1) All else equal, it's probably best if U.S. companies don't have a U.S. tax incentive to shift investment or reported profits abroad.

(2) We can't tax foreign companies when they invest abroad. E.g., no possible U.S. tax on Siemens when it invests in Germany or France.

Point (1) above implies full worldwide taxation of U.S. companies – without even foreign tax credits (we don't get the $$ from foreign taxes).

Point (2) implies lower –perhaps much lower – U.S. taxes on companies' foreign source income (FSI) than on what they earn in the U.S. After all, what's the point of fuller WW taxation insofar as foreign assets/investment shift to non-U.S. companies. (New incorporations, M&A, asset swaps, who issues new equity)

If we're talking average / effective U.S. tax rates, *everyone* agrees that FSI should generally bear less U.S. tax than domestic source income. (Note pro-worldwide proponents' support for foreign tax credits.)

Two bad tools

Since the U.S. needs a jurisdictional hook to tax corporate income in a global economy, we have 2 possible tools: residence & source.

Both tools are terrible. Corporations don't "reside" anywhere in the same sense as individuals (hence, corporate residence electivity), problems with the source concept are, if anything, even worse.

All major countries with corporate income taxes use *both* tools (reflecting that each is by itself so inadequate).

Even "territorial" countries, such as the U.K. and Japan (and see also Chairman Camp's international tax reform discussion draft), tax certain FSI of resident companies, to protect the domestic tax base.

Two bad ways of lowering the average U.S. tax rate on FSI

Everyone (except me) seems to agree that the statutory U.S. tax rate for FSI must either be the full domestic rate or 0% – nothing in-between. (This is very odd – not how we normally think about marginal changes in tax rates or anything else.)

We use 2 tools to ensure a much lower average tax rate on FSI: foreign tax credits (FTCs) and deferral.

Both tools have bad incentive effects on U.S. companies. FTCs can eliminate cost-consciousness re. foreign taxes (and creditability is not reciprocal in today's exemption-dominated world); deferral leads to lock-out & costly / convoluted internal financing maneuvers.

Yet repealing either rule would not only raise the average U.S. tax rate on FSI (a conceptually distinct issue), but worsen the other rule's incentive effects. (All repatriations fully taxable if no FTCs, U.S. companies will usually be indifferent to foreign tax costs if no deferral.)

More bad thinking in U.S. international tax policy debate: conflating multiple margins

We always hear about the choice between WW & exemption systems. But these differ in *two* distinct dimensions, not just one.

(1) Tax burden on FSI: a WW system uses the full domestic rate (although FTCs ensure a lower average rate); exemption uses a zero rate.

(2) Marginal reimbursement rate (MRR) for foreign taxes.

WW systems with FTCs offer a 100% MRR (leaving aside FTC limits & the effect of deferral). (Hence a continual parade of new "abusive" transactions – splitters, etc. – reflecting the incentive effects that *all* immediately claimable FTCs have.)

By contrast, territorial systems feature implicit foreign tax deductibility. The MRR equals the marginal tax rate (MTR), hence resident companies will spend up to $1 to avoid $1 of foreign taxes.

The international tax reform problem

We are stuck in what I call an “iron box.”

Both deferral & FTCs are terrible rules, but scaling back either of them worsens distortions from the other. (An issue, e.g., for “minimum tax” proposals.)

Plus, neither has anything to do with how heavily or lightly one should want to tax U.S. companies’ FSI.

Then there’s the tax haven conundrum: no U.S. benefit if our firms pay higher rather than lower foreign taxes, but tax haven income may be a “tag” indicating profit-shifting at the expense of the domestic tax base.

Needed: some fresh thinking, but my time is up.