A Proposal to Reform the Taxation of Corporate Income

Eric Toder and Alan D. Viard
June 17, 2016
Problems with current system

- Longstanding distortions (organizational form, financing, payout policy)
- Reliance on source of income and corporate residence poses severe challenges in open economy – each concept is ill-defined and can be manipulated
- Tax penalties on investing in United States, booking profits in United States, and having U.S. charter
Limitations of commonly proposed reforms

• Base broadening and statutory rate reduction
  – Can’t reduce statutory rate very much
  – May increase effective tax rate on new investment
  – Doesn’t address flaws of source and corporate residence

• Commonly proposed international reforms
  – Rate reduction on overseas income better than deferral
  – But, does little to address flaws of source and corporate residence
Proposal

• Reduce corporate tax rate to 15 percent
• Tax at ordinary rates dividends and marked-to-market capital gains of taxable American shareholders of publicly traded companies
• Allow (only) those shareholders an imputation credit for corporate taxes – 17.5 percent of cash or stock dividends
• Provisions to address volatility, companies going public, tax-exempt shareholders, transition, etc.
Economic rationale

• Double taxation of corporate income eliminated for taxable American shareholders

• Much smaller role for income source and corporate residence – greater role for shareholder residence, which is harder to manipulate

• Corporate tax continues to collect revenue from foreigners investing in United States, but at lower levels, encouraging investment in U.S.
Selected provisions

• Tax other publicly traded assets, and their derivatives, on mark-to-market basis
• Tax unrealized capital gains on non-publicly-traded assets taxed at death (or when contributed to charity)
• Low-rate tax on previously accrued gains when closely held company goes public
Selected provisions (cont.)

- 15 percent tax on interest income of tax-exempt organizations and retirement plans
- Small asset-holder exemption – disregard gains and losses below a threshold amount
- Fallback provision in (unlikely) event that mark-to-market taxation is ruled to be unconstitutional
Transition policy

• Ten-year phase-in of corporate rate reduction, introduction of imputation credits, and rate increase on dividends and capital gains

• Immediate changeover to mark-to-market taxation – low-rate tax on previously accrued gains (above a threshold amount)

• Other transition rules
Addressing tax-base volatility

• High volatility of accrued gains/losses on corporate stock
• Tax-base volatility may force taxpayers to sell shares, make it harder for states to balance budgets, and impede public acceptance of mark-to-market
• Simple averaging has limited effectiveness, requires history of past gains to be tracked
• Geometric smoothing allows many years to be averaged, without tracking past history
Mark-to-market tax base is highly volatile
Geometric smoothing reduces volatility

Figure 4: Current Tax Base and Smoothed Mark-to-Market Tax Base
(Smoothing Parameter = 0.2)
Effects of Corporate Reform Proposal

- Federal Revenues
- Distribution of Tax Burdens by Income Group
- Long-Term Investment, Saving, and Output
- Economic Stabilization
- Fiscal Systems of State Governments
- Reactions of Foreign Governments
## Effects on Federal Tax Liability (2025, in billions of dollars)

<table>
<thead>
<tr>
<th>Components of Revenue Change</th>
<th>No Behavioral Response</th>
<th>Corporations Report Increased US Taxable Profits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduce Corporate Tax Rate to 15%</td>
<td>-234.4</td>
<td>-173.0</td>
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<tr>
<td>Reform taxation of capital gains and dividends</td>
<td>121.4</td>
<td>121.4</td>
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<tr>
<td>15% tax on interest from retirement accounts</td>
<td>59.5</td>
<td>59.5</td>
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<tr>
<td>15% tax on income of non-profits</td>
<td>14.5</td>
<td>14.5</td>
</tr>
<tr>
<td>Tax unrealized gains at death</td>
<td>28.1</td>
<td>28.1</td>
</tr>
<tr>
<td>TOTAL</td>
<td>-10.9</td>
<td>50.5</td>
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</table>
### Effects on Distribution of Tax Burdens, 2025

<table>
<thead>
<tr>
<th>Income Group</th>
<th>Average Federal Tax Change ($)</th>
<th>Tax Change as Percentage of Income (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bottom quintile</td>
<td>-49</td>
<td>-0.26</td>
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<tr>
<td>Second quintile</td>
<td>-127</td>
<td>-0.27</td>
</tr>
<tr>
<td>Middle quintile</td>
<td>-248</td>
<td>-0.29</td>
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<tr>
<td>Fourth quintile</td>
<td>-449</td>
<td>-0.31</td>
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<tr>
<td>80-90&lt;sup&gt;th&lt;/sup&gt; percentiles</td>
<td>-717</td>
<td>-0.32</td>
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<tr>
<td>90-95&lt;sup&gt;th&lt;/sup&gt; percentiles</td>
<td>-959</td>
<td>-0.31</td>
</tr>
<tr>
<td>95-99&lt;sup&gt;th&lt;/sup&gt; percentiles</td>
<td>-1,367</td>
<td>-0.25</td>
</tr>
<tr>
<td>Top 1 percent</td>
<td>37,804</td>
<td>1.08</td>
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<tr>
<td><strong>All</strong></td>
<td><strong>-49</strong></td>
<td><strong>-0.04</strong></td>
</tr>
</tbody>
</table>
Long-Term Economic Effects

- Inflow of Foreign Capital
  - Domestic Corporate Capital Up
  - Pre-tax return (cost of corporate capital) down
  - More capital in other sectors
  - Wages up (more capital per worker)

- Domestic Saving May Fall
  - Lower pre-tax returns due to capital inflow

- GDP up, GNP effects less certain

- Economic efficiency gains on many dimensions
Proposal would enhance automatic fiscal stabilizers

Key measure is covariance of tax base with following year business cycle (% excess of actual over potential GDP)

- +0.022 for current tax base (sum of corporate taxable income, dividends and realized gains)
- +0.138 for mark to market tax base (dividends plus accrued capital gains)
- +0.044 for smoothed mark to market tax base
Effects on State Governments

- Effects on corporate tax receipts minor
  - Average 5% of state receipts but highly variable across states
  - Lower federal rate raises net burden
  - Reduced income shifting expands tax bases
  - 1986 experience suggests not much change

- Volatility of capital gains revenues could rise
  - Capital gains less than 4% of state revenue except in New York and California
  - Average tax base up if states conformed
Responses of Foreign Governments

- Possible Reactions
  - US “blacklisted” as tax haven (very unlikely)
  - Reduce their corporate rates (likely, but US competitive position would still improve)
  - Copy reform (unlikely, but would welcome)

- Other considerations
  - Undermining BEPS – not a big concern
  - Destabilizing current system – good or bad?
  - No problem for double tax agreements

- Bottom line – no show-stopper here
Conclusions

- Proposal would
  - Reduce corporate rate to 15%
  - Tax shareholders at ordinary rates on mark to market income
  - Allow imputation credits
  - Tax interest of non-profits and retirement plans

- Benefits
  - Reduce disincentives for firms to invest and establish corporate residence in US
  - Maintain revenues and increase progressivity

- Identifies Practical Solutions to Technical Problems
Tower of Babel or Smorgasbord?: Comments on Toder-Viard 2016

Daniel Shaviro, NYU Law School
American Enterprise Institute, June 17, 2016
So many plans, so little consensus

Individual tax reform: general expert consensus, albeit subject to debating rates, income tax vs. consumption tax.

But in corporate tax reform, it seems everyone has his/her own plan.

E.g., in addition to Toder-Viard: ALI Andrews, ALI Warren, CBIT, Kleinbard, Auerbach, Graetz, Grubert-Altshuler ...

I’d get in the game too, but policymakers have not as yet met my terms.
Why the Tower of Babel?

Even if all experts agreed, Congress still probably wouldn’t listen.

Cf. U.S. vs. New Zealand (1991 GST) or vs. various parliamentary countries with just 1 or 2 “leading experts.”

But why such a Tower of Babel on corporate tax reform?

Because there’s no really good answer! So it’s a game of pick your poison.
The unattainable ideal

Lewis Carroll’s Red Queen boasted that she could believe 6 impossible things before breakfast.

For corporate tax reform to have a slam-dunk, no-brainer solution, we only need to believe 2 impossible things:

(1) that perfect flow-through of corporate income to the owners is feasible, and

(2) that taxing owners indirectly at the entity level, rather than directly, makes no political economy or administrative difference.
Why ain’t it so?

Perfect flow-through: unless can use MTM, impeded by non-pro rata deals & the fact that taxable income ≠ economic income.

For tax-exempts or foreigners, in practice [entity-level taxation] may > [owner-level taxation] despite economic equivalence.

This may offer 2 reasons for favoring some entity-level taxation.

But the price is pain if [entity residence ≠ owner residence] &/or [entity tax rate ≠ owner tax rate].

Plus, one then must inter-relate the 2 levels of tax.
How *should* we tax corporate income earned by foreigners?

If we’re self-interested & define them as not among “us,” may want to revenue-maximize ...

But: (a) in terms of economic, not nominal, incidence,

(b) taking account of DWL & externalities as to “us,” and

(c) subject to comity/ feasibility (e.g., reasonable claim of residence or source, despite the “Monty Python tax plan”).

Not a formula for clear or simple answers!
Corporate income of tax-exempts

Tax-exempt owners add a further layer of complication.

Charities: not clear how large the tax subsidy should be, how it should relate to charities’ intertemporal choices, etc.

Retirement saving vehicles: might want savers to be able to exempt the normal risk-free rate of return (even in an income tax).

Not just path-dependent to say we might want to preserve (at least) current revenues.
Prior corporate integration efforts

Various 2\textsuperscript{nd}-best methods have been around for decades – e.g., imputation, dividend exemption or deduction, CBIT.

Each inevitably has problems. See, e.g., Schler 1992.

Plus, no observable floodtide for any of them, encouraging a search for new approaches.

A smorgasbord, rather than a Tower of Babel?
The latest twist

Much recent talk of dividend deduction + withholding tax. This can = imputation (e.g., with nonrefundability for both).

Note companies still “shouldn’t” repatriate foreign earnings, for the same reasons as under present law.

But the theory is that the change would induce repatriation due to agency costs (if they DO care about reported earnings, DON’T care about SH welfare).

Lots more questions need to be asked about this gambit before endorsing it.
Toder-Viard 2014 vs. 2016

2014 was true integration, with tax only at the SH level – both in principle good features.

But problems included (a) publicly-traded vs. the rest, (b) revenue loss, (c) big gains to foreigners & tax-exempts.

Hence the big changes in 2016 (e.g., 15% corporate tax, 15% withholding tax for interest paid to tax-exempts).

These retreats from 2014’s purity were (in my view) needed, but they suggest reclassifying the plan.
“Grouping” Toder-Viard 2016

While aims & effects may overlap, I’d distinguish between corporate (a) integration & (b) rate reduction proposals.

I’d group Toder-Viard 2016 with (b).

Those in (b) can seek offsetting revenue from either *inside* or *outside* existing corporate (or business) taxation.

**Inside funding:** Toder-Viard 2016, Grubert-Altshuler; 1986-style base-broadening.

**Outside funding:** new revenues from VAT, carbon tax, etc.
Narrowing the field

1986-style reform is not the answer here.

Not enough there, new vs. old investment, non-corporate businesses, owner-employees (dual income tax?).

I’m also skeptical about outside funding (VAT, carbon tax).

Other claimants for those revenues! And the shift in tax burdens would raise big issues.

So, 2 in-category finalists: Toder-Viard, Grubert-Altshuler.
Adjudicating the choice

There’s a lot to like in Toder-Viard 2016.

E.g., collect tax annually based on FMV, debt-equity balance re. tax-exempts, going-public transition.

But I still worry about the publicly traded/closely held divide.

Compliance / tax planning issues under the withholding tax?

Realization at death would be great (under both proposals, or as a standalone) – but it, too, has been on the table for years.
The opposition (Grubert-Altshuler)

Here I worry about the deferred tax.

Interest charge helps a lot, & pure Auerbach-Bradford (perfecting Vickrey) isn’t happening, but:

(a) Still major lock-in for mega-gains (e.g., Zuckerberg/Facebook),

(b) For large & long-deferred gains, the sticker shock & political economy problems may be prohibitive.
A bunt instead of a grand slam?

Beach Boys’ *Smile* -> *Smiley Smile*: “bunt instead of grand slam.”

The Beach Boys blew it – but corporate tax reform is different!

What are the worst problems, how address them narrowly?

My “big 3” relate to (a) debt, (b) disguised labor income if we lower the corporate rate, & (c) international.

So how about (a) stronger thin cap, (b) normal vs. extra-normal returns, (c) international changes that I’ve discussed elsewhere.
A NEW CORPORATE TAX REFORM PROPOSAL
FROM
ERIC TODER AND ALAN VIARD

Comments by Joann M. Weiner,
Director of the MA in Applied Economics
The George Washington University
AEI - June 17, 2016
GOING THROUGH THE PROPOSAL: SELECTED ISSUES

- Who are the winners and losers?
- What are the general reactions to the proposal?
- How are Americans living abroad affected?
- How much money does the proposal raise?
- What happens to the states?
C corporations taxed at 39 percent (combined federal and state) and equity income is double taxed

In 2012, 95% of businesses organized as “flow-through” entities with 64% of net business income

Difficult to define source of profits

Hybrid international tax system with $2.4 trillion of un-repatriated profits

PROBLEMS WITH CURRENT SYSTEM
THE U.S. RATE (38.9%) IS 26.4 PCT PTS HIGHER THAN THE RATE IN IRELAND (12.5%)
PROPOSED SOLUTIONS – WHAT HAPPENS NEXT?

- Cut corporate income tax rate to a flat 15 percent
- Keep most tax preferences and the current international rules
- Tax capital gains and dividends of American shareholders at ordinary income tax rates with an imputation credit for share of corporate income taxes paid at business level
- Move to mark-to-market taxation for income American shareholders receive from investments in publicly traded U.S.-resident and foreign-resident corporations
IF THE U.S. REDUCES ITS CORPORATE TAX RATE FROM 35% TO 15%, THE FOREIGN TAX RATE ADVANTAGE FALLS SHARPLY, DISAPPEARS, OR FLIPS IN FAVOR OF THE UNITED STATES
Winners

- Domestic investors
- Foreign owners of closely held business with p.e.’s in U.S.
- Corps with deferred tax liabilities (from accelerated depreciation)
- IRS – easier to combat income shifting

Losers

- Foreign countries rate above U.S. rate
- Publicly-traded businesses with lots of tax deductions
- Corps with deferred tax assets (from NOLs but not from credits)
- Corps with too many biz tax credits
- Shareholders with imputation tax credits
- REITs now s.t. corporate tax

WHO DO TODER AND VIARD IDENTIFY AS SOME OF THE WINNERS AND LOSERS?
WHO WINS OR LOSES DEPENDS ON WHY THEY WIN OR LOSE

DTAs generally created when a company reports expenses or losses in financial statements before they’re deductible in tax returns or generates tax credits that it has to carryforward.

DTLs generally created when a company deducts items for tax purposes before they are expensed for financial statement purposes.

Tax carryforwards are important in the financial sector.
Deferred compensation and capital expenditures are important in the non-financial sector.

WHO ARE WINNERS AND LOSERS IN TOP 50 US PUBLIC COMPANIES?
SEE NEUBIG, ABELL, AND COX (TAX NOTES, 2011)

Winners: DTL>0
► In 2010, 31 of top 50 public U.S. companies were in a net DTL position
► DTLs of $465 billion due mostly to accelerated depreciation and intangible investments
► Benefit b/c both financial statement ETR and net DTL fall

Losers: DTA>0
► In 2010, 19 of top 50 public companies were in a net DTA position
► Net DTAs of $396 billion due mostly to tax loss/credit carryforwards and deferred compensation
► Lose b/c financial statement ETR rises and net DTA fall
Winners
- Berkshire Hathaway
- Exxon Mobil
- AT&T
- Pfizer
- Target
- Verizon
- Wells Fargo

Losers
- Citigroup
- JP Morgan Chase
- Bank of America
- Hewlett-Packard
- IBM
- Lockheed Martin
- Boeing

WHO ARE THESE FORTUNE 50 COMPANIES?
SEE RAEDY, SEIDMAN AND SHACKELFORD (TAX NOTES, 2011)
Winners by industry

- Railroads
- Drilling
- Gas transmission/distribution
- Utilities
- Telecomms/media services
- Pharmaceutical/biotech

Losers by industry

- Machinery
- Chemicals/metals
- Information technology services
- High-tech/life science
- Financial companies

WINNERS AND LOSERS AMONG S&P 500 COMPANIES (EXC. REITS) AFTER RECESSION
SEE CALEGARI (TAX NOTES, 2013)
WHO ARE THESE COMPANIES?

SEE CALEGARI (TAX NOTES, 2013)

Winners
- Union Pacific
- Occidental Petroleum
- Exelon
- Duke Energy
- AES Corp
- AT&T
- Disney
- News Corp

Losers
- Dow Chemical
- Monsanto
- Johnson Controls
- Ingersoll Rand
- Expedia
- Amazon.com
- Google
- Applied Materials
- Cisco Systems
ADDITIONAL REACTIONS TO PROPOSAL
* GENERAL COMMENTS
* FATCA
* REVENUE
* STATE TAXATION
I very much enjoy this proposal. While at first it sounds almost radical, it really just seems logical at this point.

Seems unfair that foreigners could avoid taxes while Americans could not; allowing American shareholders to claim share of corporate tax payment as a credit means that only foreign investors are paying the corporate tax.

Revenue issues are important (original proposal lost $170 b).

How to sell the proposal to Americans who fundamentally lack an understanding of how globalization affects their daily life?

A tax on shareholders represents the types of taxes that low income voters resent.

Concerned that taxing on accrued capital gains instead of when sell isn’t the best option. People would be taxed on income that “didn’t exist.”
Proposal increases the incentive to evade individual taxes by holding and concealing foreign assets

FATCA: Foreign banks must report information to the IRS for customers who are U.S. persons

These rules make it difficult for Americans living abroad to obtain banking services

In Belgium, learned that many wonder whether U.S. citizenship is worth it

FATCA AND THE INCREASED INDIVIDUAL TAX RATES ON DIVIDENDS AND CAPITAL GAINS
HOW DOES THE PROPOSAL AFFECT FEDERAL REVENUE?
SEE ELASTICITIES FROM DOWD, ET AL (2016)

- Reduced tax rate encourages US corporations to shift reported profits from formerly lower tax jurisdictions to the US (see earlier chart)
- Federal govt collects about $330 b in corporate income tax
  - **Proposal with feedback would cut corporate tax revenue in half**
- If increased taxable income reflects shift from high-tax countries to the US, after-tax profits increase
- If corporations were shifting income from countries with rates below US rate, after-tax profits fall
  - In this case, corporate taxes paid to all govts increase and after-tax profits fall
- Assume after-tax profits don’t change, so proposal slightly raises revenue
FOREIGN DIFFERENCE WITH NEW U.S. RATE

5 countries with a tax rate advantage
- Ireland – 8 pctg pts
- Slovenia – 3 pp
- Czech Rep, Hungary, Poland – 1 pp

5 essentially the same

23 with a disadvantage
France, Belgium -14 pp
Germany, Australia, Mexico, Japan – 10 pp
POSSIBLE THAT US MNCS WILL SHIFT INCOME TO THE US WHEN FOREIGN RATE ADVANTAGE FALLS
Corporate income taxes account for 5% of state revenue

Eliminating federal corporate income tax would make it hard for states to apply formulary apportionment with federal tax base

States adapt to federal tax changes not only by changing their rates but also by changing their bases

Effective tax rate on capital is much lower than a decade ago

Average state rate would be 40% of federal rate instead of just 17% when federal rate is 35%
DUE TO FORMULARY APPORTIONMENT, EFFECTIVE TAX RATES ON CAPITAL (PROPERTY) DEPEND ON THE TAX RATE AND THE WEIGHT ON CAPITAL (PROPERTY) SEE MARTENS-WEINER (2006)

<table>
<thead>
<tr>
<th>State</th>
<th>Max Tax Rate</th>
<th>Wt on property</th>
<th>ETR on property</th>
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<tbody>
<tr>
<td>California 2005</td>
<td>8.84</td>
<td>0.25</td>
<td>2.21</td>
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<tr>
<td>2016</td>
<td>8.84</td>
<td>0</td>
<td>0</td>
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<tr>
<td>Colorado 2005</td>
<td>4.63</td>
<td>0.33</td>
<td>1.54</td>
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<tr>
<td>2016</td>
<td>4.63</td>
<td>0</td>
<td>0</td>
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<tr>
<td>Indiana 2005</td>
<td>8.5</td>
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<td>2016</td>
<td>6.5</td>
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<td>0</td>
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<td>Mass. 2005</td>
<td>9.5</td>
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<tr>
<td>2016</td>
<td>8.0</td>
<td>0.25</td>
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<tr>
<td>US avg. 2005</td>
<td>7.54</td>
<td>0.241</td>
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<tr>
<td>2016</td>
<td>6.19</td>
<td>0.135</td>
<td>0.861</td>
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HOW DOES THE REDUCED FEDERAL TAX RATE AFFECT THE STATES?

Winners

- States with low tax rates:
  - Kansas, Mississippi, North Carolina, North Dakota, South Carolina, Utah

- States with no corporate income tax:
  - Nevada, South Dakota, Texas, Washington, Wyoming

- States with high concentration of firms that benefit from tax cut

Losers

- States with high tax rates:
  - Connecticut, Delaware, Iowa, Maryland, Massachusetts, Minnesota, Nebraska, New Hampshire, Vermont, Wisconsin

- States with high concentration of firms that lose from tax cut

- All states b/c state rate now much more important relative to federal rate
THANK YOU

Joann M. Weiner
The George Washington University