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IMPROVE THE U.S. CORPORATE TAX SYSTEM TO INCREASE TAX COMPETITIVENESS IN A GLOBAL ECONOMY

The existing U.S. corporate tax laws have grown into a patchwork of overly complex, inefficient and unfair provisions that impose large costs on corporate business. U.S. corporations seeking to minimize the costs imposed by the counterproductive provisions in the U.S. corporate tax system have adopted strategies to reduce overall tax exposure and increase profits. Such strategies include moving operations overseas, corporate inversions, transfer pricing, earnings stripping, and complex leasing arrangements, all to minimize taxation.

Debate surrounding the issue of corporate tax reform has lately focused on whether or not the U.S. corporate tax system contributes to a structural decline in manufacturing jobs and, more generally, to the weakening competitiveness of U.S. firms in a global economy. Many U.S. businesses are conducting costly and complex operations that have minimal economic content but rather seem designed solely to reduce tax exposure.

Unless broad and significant corporate tax reforms are enacted it is likely that U.S. tax competitiveness will continue to suffer. The results of inaction are undesirable: loss of American jobs, foreign outsourcing of economic content, sale of U.S. companies to foreign multinational firms, and general erosion of the corporate tax base.

The Advisory Panel on Tax Reform, created by President George W. Bush, is expected to submit a report to the United States Department of the Treasury by July 31, 2005. The report is expected to suggest broad reforms, many of which would impact corporate taxation.

This Joint Economic Committee (JEC) research report provides a brief overview of the important economic issues of the U.S. corporate income tax system and lists several reform options to supplement the reform options that might be included in the Advisory Panel's recommendations. Readers interesting in further information are encouraged to read the full JEC study on which this research report is based: *Reforming the U.S. Corporate Tax System to Increase Tax Competitiveness* (May 2005).

The corporate tax system in the United States has broad and important effects on the allocation of capital investment and is biased against saving and investment. First, the U.S. tax system favors non-corporate investment over corporate investment. For example, individual investment in real estate is favored over the purchase of corporate stock. Second, corporate debt is favored over corporate equity investment, since debt is not subject to the tax and interest paid is deductible from gross revenues. Third, due to the complex and unfair international provisions in the U.S. corporate tax system, many foreign-owned firms have a competitive tax advantage over domestic firms. All three effects have led to a decline in corporate income tax revenue, and have potentially resulted in the loss of American jobs and further impeded the productivity and growth of the U.S. economy.

There are two basic types of international tax systems: worldwide and territorial. Though a hybrid, the U.S. tax system is basically a worldwide system whereby companies registered as U.S. domestic companies are subject to taxation on all income regardless of where income is earned (i.e., domestically or internationally).

While profits generated by certain types of overseas activities are taxed in the year earned, profits from other activities are not taxed by the U.S. government until repatriated.

In contrast, many foreign corporations that trade with the United States are incorporated in countries that operate under a territorial tax system. Under a territorial system, income earned by foreign subsidiaries and branch operations (e.g., a foreign owned company with a subsidiary operating in the United States) is exempt from their country's domestic corporate income tax. Therefore, under a territorial system, profits are only taxed by the country where the income is earned. Hence, the U.S. international tax system can impose an uncompetitive cost burden on U.S. based corporations that have foreign operations.

<u>Possible Reform Options:</u>

Territorial System of Taxation

To make the U.S. corporate tax system more competitive, the playing field could be leveled with many U.S. trading partners by moving toward or adopting a territorial tax system. Such reforms would significantly reduce the inefficiencies, inequities and complexities of the current U.S. corporate tax system and produce substantial economic benefits. Potential reforms include exempting all foreign-source income, exempting only active foreign-source income, or exempting only certain kinds of foreign-sourced income. Further, adoption of a territorial tax system would remove a major incentive for U.S. multinational corporations to move headquarter operations overseas.

Consumption-Based Tax System

A general switch to a consumption-based tax system, as opposed to an income-based system, could improve efficiency and fairness and result in a simpler tax system. Under a consumption-based tax system, the corporate income tax would be replaced or eliminated. A consumption tax can be more efficient because it removes the extra tax imposed on saving. Consumption taxes can be fairer (more equitable) because consumption can be a better measure of ability to pay than income, especially if measured on a lifetime basis. The basic argument for simplicity is that taxing only consumption removes the complexity involved with measuring and taxing income, including the need to fill out many complex tax forms and the necessity of a revenue collection agency as large as the Internal Revenue Service.

Integration of Individual and Corporate Income Taxes

Under the current corporate income tax system, the United States taxes corporate profits first at the corporate level and then again at the individual level. This "double taxation" leads to economic distortions that favor non-corporate investment (e.g., real estate over corporate stock) at the individual level and debt financing over equity investment at the corporate level.

Further, the double taxation of corporate profits provides incentives for corporations to retain earnings or to structure distributions of profits in ways to avoid the double taxation. The end result is reduced efficiency and reduced economic return to corporate investments. A solution is to integrate the individual and corporate income tax systems.

Expensing

Expensing allows a corporation to deduct the full costs of acquiring depreciable capital assets immediately, instead of having to take partial deductions over numerous years (defined by the "useful life" of the asset). Businesses are able to fully deduct the costs associated with labor and materials, as these inputs are used up immediately in the production of goods and services. The current rationale for depreciating assets is that capital assets can be used over and over through their useful life. Hence, only a portion of the cost of acquiring capital assets is allowed to be deducted in a given year.

The problem with depreciation is that a dollar of deduction today is worth more than a dollar of deduction in the future. The current depreciation schedules in the corporate income tax code bias against investment in capital assets with long useful lives. As a result, the U.S. economy ends up with less investment in plant and equipment. Expensing would eliminate the bias against investing in long-lived capital assets and increase business investment.

Reduction in Corporate Income Tax Rate

The United State has one of the highest corporate tax rates relative to its trading partners. Further, many trading partners have passed legislation to lower corporate tax rates. The higher U.S. corporate tax rates impose an economic drag on the ability of U.S. corporations to compete. First, higher tax rates reduce after-tax cash flow, which can be used to invest in domestic jobs and economic growth. Second, higher rates discourage the establishment of business activity in the United States.

A reduction of the corporate income tax rate would benefit a wide range of corporations and is simple to implement. Any rate reduction should apply equally to all corporations, regardless of goods manufactured or services provided.

Eliminate or Reform the Corporate Alternative Minimum Tax (CAMT)

The CAMT, like the individual AMT, adds an unnecessary level of complexity and burden to the federal income tax system. Additionally, like any tax on corporate profits, the CAMT increases the cost of capital. A repeal of the CAMT would have the likely effect of increasing cash flow for those corporations impacted by the CAMT. Increased cash flow could be immediately used for domestic job creation and business investment. The benefits of repealing the CAMT would be greatly enhanced if corporations were allowed a rebate of their unused CAMT credits.

Elimination of Corporate Income Tax

A CRS report asks: "Why tax corporate profits at all? Corporate equity profits are taxed twice, once at the corporate level and once under the individual income tax when they are received by stockholders as dividends or capital gains. As a consequence, taxes tend to steer investment away from the corporate sector." (RL32808, March 10, 2005, p. 7.)

An important principle of taxation that is often ignored in policy discussions is that only individual people can pay taxes. Corporations are not people. They are legal entities involving employees, shareholders, creditors, etc., each with their own individual wealth and income characteristics. Hence, it is difficult to apply the concept of tax fairness to corporations. Any tax imposed on corporations results in either reduction to employee wages, an increase in costs passed on to consumers, or a reduction in the return to capital received by shareholders, or a combination of all three.

Therefore, it is not helpful to compare the corporate tax burden with the burden of individuals. No matter how appealing it might be to look at corporations as entities for a source of tax revenue, the fact of the matter is that corporations do not bear the burden of taxation – individual workers, consumers and investors do. Reports advocating increased corporate taxation miss the economic realities of taxation and are harmful to efforts to raise the level of public education necessary in order to have an informed debate on tax reform.

For further information please see the following Joint Economic Committee studies by visiting the JEC website www.house.gov/jec, or contacting the JEC at (202) 226-3234.

- *Reforming the U.S. Corporate Tax System to Increase Tax Competitiveness* (May 2005)
- *How Competitive is the U.S. Tax System?* (April 2004)