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Why Corporate Tax Reform Can Happen

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Abstract

This brief essay explains what the stakes are for corporate tax reform and why such reform is more politically feasible than most observers believe. The largest conceptual impediments to corporate tax reform are international tax design and the fact that a large fraction of U.S. business income is earned by unincorporated businesses. In response, the essay demonstrates that a framework has emerged with respect to the former that can serve as the basis for constructive negotiations. The essay further lays out a novel strategy for dealing with unincorporated businesses in corporate tax reform, which is to construct a corporate tax rate schedule sufficiently inviting that pass-through businesses will be encouraged to incorporate. Finally, the paper argues that inevitable revenue shortfalls can be plugged by general limitations on the deductibility of business interest expense, which are conceptually desirable in any event.

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In this report, Kleinbard explains what the stakes are for corporate tax reform and why that reform is more politically feasible than most observers believe. The largest conceptual impediments to corporate tax reform are international tax design and the fact that a large fraction of U.S. business income is earned by unincorporated businesses. Kleinbard demonstrates that a framework has emerged for the former that can serve as the basis for constructive negotiations. He further lays out a novel strategy for dealing with unincorporated businesses in corporate tax reform, which is to construct a corporate tax rate schedule sufficiently inviting that passthrough businesses would be encouraged to incorporate. Finally, Kleinbard argues that inevitable revenue shortfalls can be plugged by general limitations on the deductibility of business interest expense, which are conceptually desirable in any event.

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I. The Mess We Are In

President Obama's FY2015 budget proposes sweeping changes to the taxation of U.S. corporations generally, and to the international income of U.S. multinationals in particular. To some business groups, these international tax proposals are anticompetitive and reflect poor economics, while to the political left, they are a giveaway to big business. In fact, neither claim is true, and the carefully calibrated responses of senior Republicans on Capitol Hill signal that a rough framework is emerging that could stun pundits by actually becoming the basis of corporate tax reform legislation. But before corporate tax reform legislation becomes reality, revenue considerations must be addressed and the riddle of what to do with passthrough businesses must be resolved.

This report briefly makes the case that corporate tax reform can happen, as early as this year. The two political parties are not terribly far apart regarding international tax design, which has been the most contentious issue over the last few years, and both revenue considerations and the passthrough business sector can be addressed in ways that do not do violence to either party's core values.

A. What Constitutes 'Corporate Tax Reform'?

Corporate tax reform is usually understood to comprise a lower statutory tax rate and a broader base, leading to a more consistent tax burden on different forms of business investment and modes of financing those investments. The February 2015 Council of Economic Advisers' report[1] ably lays out the case for corporate tax reform along these lines. Responsible economists of all political leanings should largely agree with its diagnosis of our current ills, if not the president's precise prescriptions for a cure.

It has been observed that the lower tax rate/broader base paradigm can actually raise the after-tax cost of business investment in greasy machinery and the like through slowing down depreciation deductions,[2] but the fact is that today the United States offers *negative* tax rates on debt-financed

[1]Council of Economic Advisers, "Economic Report of the President" (Feb. 1, 2015).

[2]Martin A. Sullivan, "The Critical Role of Depreciation in Dynamic Revenue Estimates," *Tax Notes*, Jan. 19, 2015, p. 287.

equipment purchases[3] — that is, corporations enjoy better than tax-exempt rates of return while we all collectively pay companies to make those investments. Conservative market-oriented observers should applaud the elimination of government waste and abuse inherent in the spectacle of taxpayers directly subsidizing ordinary corporate investments.

The argument that removing these subsidies will hurt economic growth is predicated on economic models that largely assume their conclusions.[4] The models rely on largely undisclosed premises that the government revenue shortfalls that result from these subsidies will be made up, behind the curtain, either by raising taxes on others or by slashing other government spending, which in turn is assumed to have zero growth consequences. Moreover, many critical economic activities, such as the services sector, are largely unaffected by depreciation schedules, as are ''supersized'' returns generally (economic rents). In the absence of any persuasive evidence of systemic market failure, it is difficult to see why government should put its thumb on the scale to subsidize one form of business activity at the expense of others through accelerated depreciation deductions.

Current tax law also subsidizes investments in intangibles in many instances, because the costs of developing those intangibles are immediately deductible. Here, at least, there is some evidence of systemic market failure that the tax system can address, because corporations in fact cannot capture for themselves 100 percent of the fruits of their research and development efforts. Nonetheless, current law applies too light a touch to the development and exploitation of intangibles, as, for example, in allowing a deduction for all advertising expenses and in its mistargeted R&D subsidies. The answer, however, is to address those excesses, not to use them as an excuse for continuing to offer negative tax rates on leveraged investments in tangible asset investments.[5]

In sum, the traditional rate lowering/base broadening conception of corporate tax reform continues to make sense, even if as a transition matter ''old'' capital enjoys the benefits of lower rates. As the CEA report states matters:

> Given the tension between reform that exclusively targets the effective marginal tax rate by accelerating depreciation and reform that lowers the statutory tax rate with an eye toward attracting mobile, high-return investment and reducing other distortions, the . . . [better approach is to target] the statutory rate. Such an approach encourages additional domestic investment . . . and also reduces disparities in tax rates across industry, asset, means of financing, and organizational form.[6]

The United States desperately needs corporate tax reform along those lines, for three reasons. First, the U.S. statutory rate (35 percent) is now much higher than world norms. This is a serious competitiveness issue that hurts U.S. domestic corporate business much more than it burdens our largest multinationals. Second, the effective (real-world) tax rate on corporate income is all over the map[7] as a result of tax expenditures[8] (essentially, government subsidy programs baked into the tax code[9]) and the law's systematic bias favoring debt financing.[10] Third, the tax rules applicable to the international operations of U.S. multinationals are universally reviled as just a half step short of utter madness.

It is well known that many peer countries have lowered their headline corporate tax rates significantly (often in conjunction with eliminating accelerated depreciation and other tax expenditures). In response, both the president and the Republican leadership believe that the U.S. statutory federal corporate income tax rate should be materially lower than the current rate of 35 percent. This intuition is sound, given the tightly integrated

[3]Congressional Budget Office, ''Taxing Capital Income: Effective Marginal Tax Rates Under 2014 Law and Selected Policy Options'' (Dec. 1, 2014).

[4]Edward D. Kleinbard, ''A Republican Ruse to Make Tax Cuts Look Good,'' *The New York Times*, Jan. 2, 2015.

[5]Former House Ways and Means Committee Chair Dave Camp's 2014 comprehensive tax reform proposal in fact contained several provisions designed to raise the effective tax rate on intangibles. For example, section 3108 of his draft would have required five-year amortization rather than current expensing for R&D outlays; section 3110 would have required that half of advertising expenses be capitalized and amortized over 10 years; and section 3119 of his draft would have increased the amortization period to 20 years (from 15) for goodwill and similar intangibles purchased in connection with the acquisition of a trade or business. The Joint Committee on Taxation estimated that these three provisions alone would raise $375 billion over 10 years.

[6]Council of Economic Advisers, *supra* note 1, at 224.

[7]CBO, ''Taxing Capital Income,'' *supra* note 3, at 9.

[8]JCT, ''Background Information on Tax Expenditure Analysis and Historical Survey of Tax Expenditure Estimates,'' JCX-18-15 (Feb. 6, 2015). The document was prepared by the JCT for the Senate Finance Committee's hearing titled, ''Getting to Yes on Tax Reform: What Lessons Can Congress Learn From the Tax Reform Act of 1986.''

[9]Kleinbard, ''The Congress Within the Congress: How Tax Expenditures Distort Our Budget and Our Political Processes,'' 36 *Ohio N. U. L. Rev.* 1 (2010).

[10]Ruud A. de Mooij, ''Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions,'' IMF (May 3, 2011).

global economy in which many large corporations operate, whether U.S. or foreign-based.

The great policy risk we run with a corporate tax rate that is an outlier relates not so much to the alleged uncompetitiveness of U.S.-based corporations regarding their international operations,[11] but rather to diminishing the attractiveness of the U.S. domestic economy as an environment for corporate investment, whether from U.S. or foreign corporations. Unfortunately, corporate tax reform discussions to date have generated a great deal of heat about the former, and not nearly enough attention to the latter. Observers interested in ''putting America first'' thus should be as enthusiastic as anyone else for a lower corporate tax rate. And as the next section reminds readers, there just are not enough tax revenues to go around to both lower the statutory rate and to continue stuffing money into the pockets of businesses to make the same investments they would have made in any case.

The last Republican comprehensive tax reform package and the president each envision the same rate on domestic manufacturing income (25 percent), and the ''bid-ask'' spread on other domestic income (25 percent versus 28 percent) is easily bridged. In turn, lower tax rates by themselves reduce the value of tax deductions, including interest deductions, thereby mitigating to some extent current-law differences in effective tax rates that result from different subsidies and forms of financing investments. And, of course, the dismantling of our current stockpile of targeted tax subsidies and preferences for different industries, made necessary to finance corporate rate reduction, directly moves tax rates across different types of business investment into closer alignment.

B. Corporate or Business Tax Reform?

Warts and all, the federal corporate income tax raises substantial tax revenues. The Congressional Budget Office projects that corporate tax receipts will reach $328 billion in fiscal 2015,[12] just about 10 percent of total federal tax revenues. A few hundred large corporations, many of which derive a substantial fraction of their total economic income from operations outside the United States, pay the vast bulk of federal corporate income taxes.

One cannot consider the prospects for corporate tax reform without first positing a view on the tax revenue goals for that legislation. On one hand, reducing the corporate tax rate is expensive; on the other, the CBO's current deficit projections demonstrate that we cannot afford significantly lower steady-state tax revenues.

If the corporate tax rate is to come down to a figure in the middle of the pack of peer countries, it will take a painful struggle to do so in a revenue-neutral manner, but that nonetheless should be the goal. Genuine revenue-neutral corporate tax reform means legislation that is revenue-neutral in a steady state, without counting one-time pickups like the tax on existing offshore retained earnings, described below.

The large tax reform package proposed by Dave Camp in 2014,[13] when he was chair of the House Ways and Means Committee, apparently contemplated the corporate sector subsidizing individual rates, perhaps to the extent of roughly $250 billion over 10 years, but the numbers are difficult to parse because of how they were presented, and in any event included very large one-time corporate transition taxes. Stripped of these transition revenues, it is not clear that the business tax component of the Camp bill would have been revenue neutral over time.

Reducing the corporate tax rate in a roughly revenue-neutral fashion in turn requires throwing a great many general business tax expenditures under the bus. This directly raises the problem of what to do about passthroughs — businesses whose incomes are taxed only to owners. (Partnerships, S corporations, and limited liability companies are all species of passthroughs.) The technical question here is whether one can imagine ''corporate only'' tax reform, or whether instead passthroughs must be included as well. The question is made difficult by the fact that most business tax reforms that broaden the tax base by eliminating business tax expenditures would affect both the corporate and unincorporated business sectors; if the resulting revenue gains are used to buy down the corporate tax rate, passthrough business owners will argue that they are being asked to pay for lower tax rates that benefit only our largest business enterprises.

The United States and Germany are unusual in that a large portion of each country's business income is earned through passthrough vehicles.[14] In the United States, passthroughs are often represented as earning more than 50 percent of the country's total business income. This overstates matters, however, because much passthrough business income in fact is simply labor income that

[11]Kleinbard, '''Competitiveness' Has Nothing to Do With It,'' *Tax Notes*, Sept. 1, 2014, p. 1055.

[12]CBO, ''The Budget and Economic Outlook: 2015 to 2025'' (Jan. 14, 2015).

[13]Camp, ''The Tax Reform Act of 2014'' (H.R. 1).

[14]Rosanne Altshuler, Stephen Shay, and Eric Toder, ''Lessons the United States Can Learn From Other Countries' Territorial Systems for Taxing Income of Multinational Corporations,'' Tax Policy Center (Jan. 21, 2015).

owners take in the form of business profits rather than explicit wages; in terms of relative capital intensiveness, corporations account for roughly twice as much as passthroughs. Even so, passthroughs earn a large fraction of business income, and, of course, are politically salient actors.

In political speech, passthroughs are often equated with "small businesses," which in turn invariably are invoked as the engine of job creation. Both steps in the syllogism are false. Many passthroughs are very large enterprises,[15] and many small businesses (think about your hair salon or accountant) are quite stable in their employment and already receive many subsidies.[16] Today passthroughs enjoy lower effective (real-life) tax rates than do corporations,[17] particularly once the dividend tax cost of distributing profits to owners is considered. Further, a great many high-income wage earners hide behind the skirts of small business, using the political resonance of small business to apply leverage for lower tax rates on all personal incomes at the highest levels, however earned. But political nostrums dominate policy, and so passthroughs must be accommodated if corporate tax reform is to proceed.

The administration's answer in the budget is to propose some special new tax deductions that would be available only for small businesses, not all passthroughs, such as increased expensing of capital investment. But there is in fact a better way to proceed.

The ultimate goal, for a host of policy and administrative reasons, should be to encourage (but not compel) all but microbusinesses to incorporate, so that all significant businesses face the same basic tax system. Incorporating, of course, is tax free under section 351. If in fact corporate tax rates drop to the mid-20s and dividend and capital gains tax rates stay where they are (20 percent[18]), the all-in tax burden on future corporate profits distributed to owners will not differ materially from what the owners of successful passthrough businesses face today. As a result, the large tax rate differential working in favor of the corporate form, even after taking dividend tax costs into account, might by itself precipitate a wave of incorporations.[19]

Herding more business income into the corporate tax system has important policy and political payoffs. Congress and the IRS today must maintain two very different and completely uncoordinated business tax systems, at great administrative and taxpayer cost. We should make one system work well rather than muddling along with two competing regimes, with all the attendant waste that implies. Moreover, taxpayers are very good at arbitraging the two sets of rules: We could reduce the wide disparity in effective tax burdens on business incomes as well as taxpayer gaming if we just picked one system as the norm for all but microbusinesses.

There is another important political economy payoff to bringing a large fraction of the passthrough business sector into the corporate fold. The unspoken great fear of U.S. multinationals in tax reform is that Congress will play them for fools: The multinationals will surrender their business tax subsidies and accept the new international tax order described below in return for lower corporate tax rates, and then in a few years Congress will hike the rates again. The best insurance against this is for the corporate tax rolls to swell with tens of thousands of successful small- and medium-size businesses, as found in every congressional district. They will serve as the practical bulwark protecting business tax reform's fundamental bargain.

But what should be done about genuinely small businesses? The corporate tax can accommodate them, too, by offering bona fide graduated tax rates on corporate incomes, just as we do for individuals. As an arbitrary example, we might offer preferential rates on the first $2 million of corporate income each year, designed roughly to offer small firms a better deal for corporate income than is obtained through the individual rate structure, after consideration of a hypothetical immediate dividend tax.

Section 11 nominally offers graduated rates today, but the reduced corporate tax rate brackets are set to absurdly low income levels; corporate income exceeding $75,000 is taxed at a 34 percent rate. (The last percentage point of tax kicks in at $10 million of corporate income.) And in a particularly cruel twist, the code almost immediately claws back the benefit of the lower tax brackets on the first $75,000 of corporate income through a surtax on corporate income exceeding $100,000. We can encourage the incorporation of domestic businesses by letting

[15]Treasury Office of Tax Analysis, "Methodology to Identify Small Businesses and Their Owners" (Aug. 2011).

[16]CBO, "Small Firms, Employment, and Federal Policy" (Mar. 1, 2012).

[17]CBO, "Taxing Capital Income," *supra* note 3, at 9.

[18]I ignore section 1411's 3.8 percent tax on the net investment income of high-income earners because it is mirrored by an equivalent tax on labor incomes (section 1401(b)(2) and section 3101(b)(2)). In the context of tax reform, the latter rules should be revised to impose a constant tax rate on labor income, regardless of whether that income is earned as salary or as the returns derived by an owner-entrepreneur of an S corporation or other passthrough vehicle. In the end, all labor and capital income above the threshold should be subject to the hospital tax under one regime or the other.

[19]Kleinbard, "Corporate Capital and Labor Stuffing in the New Tax Rate Environment" (Mar. 26, 2013).

companies keep the benefit of graduated corporate tax rates until their annual earnings reach much more substantial levels — perhaps $10 million.

The economic and political ecnonomy payoffs to offering bargain corporate tax rates to induce small- and medium-size companies to accept business tax reform would be very large. One comprehensive and sensible tax system for most businesses beyond the smallest should be the ultimate objective. The partnership form should be reserved for those businesses that really need the complex allocations that partnership tax law alone can handle.

In sum, corporate-only tax reform, properly constructed, is feasible. Doing so will require attention to appropriate graduated tax rates and a reasonable ''all-in'' burden after dividend or capital gains taxes are considered, but these are not insurmountable barriers (at least if the dividend/capital gain rate remains 20 percent).

C. The Puzzle of International Tax

International tax policy is difficult stuff.[20] Most countries tax their individual residents on their worldwide income, but corporations are artificial persons, and multinationals operate through many local subsidiaries. What is more, to encourage open global markets, some principle must be applied to prevent the double taxation of cross-border corporate income, once in the foreign country where earned (the source country), and once again in the country where the corporation (or its parent company) is domiciled (the residence country). For almost 100 years, the consensus has been that source countries should have first priority in taxing business income arising in their jurisdictions.

All the excitement in this area really boils down to one theoretical and one practical question. First, should a residence country impose a secondary residual tax, when its tax rates exceed those of the local source countries? (Such a regime is called a worldwide system; a regime that opts not to tax business profits attributable to foreign operations is a territorial system.) And second, how on earth do we figure out in practice what business income *really* arises in which source country? When an Amazon customer in Germany orders a book through a website residing on servers in Ireland, using a software platform originally developed in the United States and adapted in Luxembourg, and takes delivery through a German logistical subsidiary, which retrieves the book from a warehouse in France, how much profit resides where?

Most tax economists would agree that an ideal territorial tax system is superior to an ideal worldwide system, but the problem is that, as my Amazon hypothetical implies, real business operations just cannot be crammed into such tidy conceptual cubbyholes. We are not talking about rounding errors, as if we were carrying water with a slightly leaky bucket — the current international tax environment operates more like ferrying water a mile in a sieve. Corporations show an uncanny aptitude for applying rules and cutting special deals to divert profits to very low-taxed jurisdictions, in magnitudes completely unrelated to any rational theory of where value is being added.

For example, we know a good deal about where Amazon actually books its European business profits for tax purposes, thanks to a recent EU investigation.[21] The answer essentially is ''nowhere.'' Amazon situates its core European operations in Luxembourg, a small, low-tax country always willing to cut a special deal. Most profits from Amazon's European business flow to its Luxembourg operating company. That company in turn pays ''royalties'' equal to most of its pre-royalty income to an intangibles holding company, also in Luxembourg, thereby wiping out most of the operating company's tax bill. Then, in the sort of magic for which U.S. corporations are the leading prestidigitators, Luxembourg says that the intangibles holding company is located in the United States and therefore cannot be taxed by Luxembourg, while the United States believes that the company is in Luxembourg and thus is not subject to U.S. tax unless and until it pays dividends to its U.S. parent.

As another example, Microsoft's financial statements suggest that it pays an effective foreign income tax rate of around 4 percent. In what imaginary countries are its foreign employees and customers located to explain this?

The geographic source of income is too uncertain and too easily manipulated for any sensible country to afford a pure territorial system: Antiabuse or income apportionment rules are needed. From the other direction, a true worldwide tax system (in which a U.S. multinational would pay U.S. tax on the global net income of the entire group, less a credit for foreign taxes actually paid) would substantially eliminate the payoffs from the ''stateless income'' tax planning[22] that corporations use today to drive their foreign tax rates down to single digits (because U.S. tax would be due in any case), but it

[20]For a description of some principal economic efficiency issues and possible policy responses, see Kleinbard, ''The Lessons of Stateless Income,'' 65 *Tax L. Rev.* 99 (2011).

[21]European Commission, ''Luxembourg: Alleged Aid to Amazon by Way of a Tax Ruling'' (July 10, 2014).

[22]Kleinbard, ''Stateless Income,'' 11 *Fla. Tax Rev.* 699 (2011).

would encourage indifference to foreign tax bills[23] (thanks to the U.S. tax credit) and require a low tax rate for "competitiveness" reasons. In practice, every country is sufficiently concerned about competitiveness to stop short of adopting true worldwide taxation.

Most tax systems today therefore are a hodgepodge of different themes, bolting antiabuse rules on top of general rules, all in light of a particular country's economic circumstances.[24] The nominal starting point for most countries is a territorial system, and for the United States a worldwide system, but there are no pure territorial or worldwide tax systems in practice.

The United States perfectly illustrates this. Its tax system is described as "worldwide," but in fact it operates in practice as an ersatz territorial system,[25] without any of the safeguards appropriate to one, and with a bizarre and economically inefficient twist. That twist is deferral, under which a U.S. multinational can enjoy an anything-goes sort of territorial tax environment, but only as long as it leaves its low-taxed foreign profits in its foreign subsidiaries and does not repatriate the earnings to the U.S. parent or its shareholders. What is more, by declaring to their accountants that these offshore low-taxed profits are permanently reinvested outside the United States, corporations effectively operate on a territorial basis for financial statement purposes as well.[26]

The result is that today U.S. corporations have booked more than $2 trillion in cumulative offshore low-taxed profits, of which at least $1 trillion is in the form of cash (that is, bank deposits in U.S. banks, short-term Treasury notes, etc.).[27] As a result, most U.S. corporations are posturing when they claim that the current system is anti-competitive for them.[28]

Deferral is the exception that swallows up our "worldwide" tax rule, and it is also the source of all the instability in the current U.S. system. Shareholders are frustrated by large sums of cash on corporations' balance sheets, just out of reach (because the residual U.S. repatriation tax is prohibitive). Corporations waste resources planning around the edges of the rules, borrowing in the United States to fund dividends (so as not to trigger the repatriation tax) or making suboptimal foreign investments with their offshore cash in order to put the money to at least some use. And the United States collects very little by way of current repatriation taxes. Inversions and demands for repatriation holidays reflect the pent-up demand to use offshore earnings domestically, primarily to return those earnings to shareholders, not to invest in U.S. business. (We saw exactly this pattern when Congress in 2004 offered a "one-time" repatriation tax holiday, and more than $300 billion in cash was repatriated.[29])

Current law thus leads to perverse corporate behaviors, but not to a loss of corporate competitiveness or significant tax collections. The system is imploding because corporations are drowning in the sheer volume of their offshore cash — a sure signal that corporations' stateless income tax planning has outrun good ideas for what to do with those profits. Corporations understandably do not want to pay 35 percent tax on their global profits, and rightly point out that our statutory corporate tax rate has become an outlier by world norms. But from the other direction, U.S. multinationals implicitly did agree to residual U.S. tax as the price of deferral, and much of their foreign income has been taxed essentially nowhere. Corporations thus find themselves hoist by their own petard.

D. The Missing Revenue Piece

In the end, not every tax subsidy that should be repealed will be. As a result, it will prove difficult in practice to find enough tax revenue to fund revenue-neutral corporate tax reform while offering the carrots of a 25 percent tax rate for large companies and graduated rates for smaller ones.[30] The solution, motivated by a commitment to economic

[23]Daniel N. Shaviro, *Fixing U.S. International Taxation* (2014).

[24]*See* Altshuler, Shay, and Toder, *supra* note 14, at 20-32.

[25]Kleinbard, "Stateless Income," *supra* note 22, at 718-723.

[26]Kleinbard, "'Competitiveness' Has Nothing to Do With It," *supra* note 11.

[27]Richard Rubin, "U.S. Companies Are Stashing $2.1 Trillion Overseas to Avoid Taxes," Bloomberg Business News, Mar. 4, 2015 (cumulative profits). This article also lists the cash hoards of 299 leading companies.

One very recent analyst's report has pegged corporations' total offshore cash at $2.1 trillion, but this number includes financial as well as nonfinancial companies and does not reflect only low-taxed offshore retained earnings. The same report finds that U.S. nonfinancial companies hold $1.8 trillion in cash worldwide. Citi Research, *Washington Watch*, Feb. 3, 2015. An article by Richard Clough, "Corporations From GE to Apple Putting $2 Trillion to Work," Bloomberg Business News, Apr. 24, 2014, cites a Moody's Investors Service report to the effect that foreign cash represents about 58 percent of U.S. corporations' total cash holdings.

[28]Kleinbard, "'Competitiveness' Has Nothing to Do With It," *supra* note 11, at 1061.

[29]Dhammika Dharmapala, C. Fritz Foley, and Kristin J. Forbes, "Watch What I Do, Not What I Say: The Unintended Consequences of the Homeland Investment Act," 66 *J. Fin.* 753 (2011).

[30]Jane G. Gravelle, "Corporate Tax Reform: Issues for Congress," Congressional Research Service, report RL34229 (Jan. 6, 2014).

neutrality as much as the search for revenues, lies in curbing the large swath of business income that today enjoys zero or negative tax rates: debt-financed investments.[31] The problem, of course, is that under current U.S. tax law, interest expense is deductible without meaningful limits, but interest income often is not includable on any person's tax return, because much corporate debt is held by tax-exempt institutions or foreign investors.[32] Debt financing thus streams a fraction of business income away from tax at the entity level and delivers that stream direct to those investors unburdened by tax at any level. Moreover, as noted earlier, when combined with accelerated depreciation or expensing of the asset so financed, this income is better than tax exempt, because it generates direct cash payments for businesses, analogous to refundable tax credits at the individual level.

At every turn, you can see the evidence of the distortions that follow from our tax system's bias in favor of debt financing. In the domestic arena, debt financing reduces the effective tax rates imposed on successful and stable businesses that can raise external debt financing cheaply, particularly when the proceeds are used to fund investments eligible for expensing or accelerated depreciation. In the case of outbound foreign direct investment, unrestricted debt financing leads to the wholesale evisceration of the domestic tax base through arbitrage: U.S. corporations fund their foreign subsidiaries with equity, park their foreign profits in low-tax foreign jurisdictions, incur most of their worldwide borrowings through the U.S. parent, and use the resulting interest expense, which really supports global operations, to offset their domestic tax base.[33] And in the converse case of inbound investment into the United States, foreign parent companies rely on our generous rules (even after application of the earnings stripping limitations of section 163(j)) again to minimize the U.S. domestic tax base without ruffling the feathers of their third-party investors, through intragroup leverage that is invisible to the outside world. Inversions are just a special case of self-help rate reduction through intragroup interest payments.

When you take a step back, it is something of a miracle that we collect any corporate income tax at all.

I have proposed a radical solution — the business enterprise income tax — that among other virtues does away with the debt-equity distinction entirely and neutralizes the effects of any depreciation method (so that expensing and capitalization of that expense lead to the same present value tax liability).[34] I believe that this approach is the optimal direction in which business tax reform should proceed, but I also recognize that it is much too novel to be considered in the time available for corporate tax reform before the next presidential election.

The immediate answer, and one roughly consistent with policies adopted by some peer countries, is to introduce comprehensive "thin capitalization" or "interest barrier" legislation, to accomplish three related purposes.[35] First, the legislation would tighten the standards of section 163(j) regarding earnings stripping of the U.S. tax base to foreign parent companies. Second, it would constrain arbitrage of the U.S. corporate tax base by U.S. corporations that earn low-taxed foreign earnings while undertaking substantially all their worldwide debt-financing needs at the level of the U.S. parent company. Third, and most radically, it would impose a general cap on the deductibility of interest expense — third-party as well as related-party — incurred to finance business operations in the United States, in order to protect the U.S. tax base from current law's systemic bias favoring debt financing.

Germany, for example, has a thin capitalization rule (although the preferred term there is now "interest barrier rules") under which a corporation's net interest expense (interest expense reduced by interest income) cannot exceed 30 percent of pretax earnings before interest and depreciation — what financial accountants call EBITDA.[36] Germany, unfortunately, is not a perfect model for U.S.

[31] De Mooij, *supra* note 10.

[32] Even nominally taxable institutional investors like life insurance companies are effectively tax exempt on their investments in portfolio debt because the income from those assets is largely offset by deductions for increases in their insurance reserves.

[33] Kleinbard, "Stateless Income," *supra* note 22.

[34] Kleinbard, "Designing an Income Tax on Capital," in Henry J. Aaron et al., *Taxing Capital Income* (2007); Kleinbard, *We Are Better Than This: How Government Should Spend Our Money*, at ch. 13 (2014). Looking only at the corporate level, the business enterprise income tax can be thought of as a superior implementation of an allowance for corporate equity. *Cf*. de Mooij, *supra* note 10.

[35] For recent overviews of thin capitalization type statutes, see Yifan Yuan, "Stopping Base Erosion: A Look at Interest Deductibility," *Tax Notes Int'l*, Jan. 19, 2015, p. 255; and Stuart Webber, "Thin Capitalization and Interest Deduction Rules: A Worldwide Survey," *Tax Notes Int'l*, Nov. 29, 2010, p. 683. An important earlier article making the conceptual case for a worldwide interest allocation system is Michael J. Graetz, "A Multilateral Solution for the Income Tax Treatment of Interest Expense," 62 *IBFD Bull. Int'l Tax'n* 486 (2008). Graetz rejects as improbable legislation to constrain interest expense generally. *Id*. at 491.

[36] Germany's rule properly applies to net rather than gross interest expense in fairness to the special circumstances of

(Footnote continued on next page.)

corporate tax reform legislation because the German rule does not apply to wholly domestic corporations, and because Germany has an escape clause under which German interest expense is deductible without regard to the fraction of German EBITDA that the expense represents, as long as a group's intra-Germany assets-to-equity ratio is within 2 percentage points of its worldwide ratio.[37]

The German rule thus functions as a bilateral international earnings stripping rule: It disallows excessive leveraging of a German subsidiary by a non-German multinational group, and also the excessive leveraging of the German parent of a German-based multinational enterprise. But there is no reason in principle to use this sort of mechanism solely in this manner, given that a large fraction of interest paid by corporate issuers is taxed nowhere and that many debt-financed assets are eligible for expensing or accelerated depreciation.

A general cap on nonfinancial business interest expense as a percentage of EBITDA, without any escape clause and fully applicable to wholly domestic enterprises, can raise enormous sums of money while at the same time rendering the tax system more neutral in the burdens imposed on different business activities. For example, one relatively recent study found that the revenues raised by disallowing 35 percent of the interest expense that nonfinancial companies otherwise could deduct could pay for reducing the corporate tax rate to 25 percent (at least on a static revenue estimation basis).[38]

The evidence suggests that the German interest ''barrier'' of 30 percent of EBITDA is much too generous; a sliding scale, with higher limits for small corporations and a 10 percent of EBITDA cap for large ones, is a plausible point from which to start negotiating. This rule would apply first, and any interest expense allowable under it would then be tested again under a worldwide pro rata rule of the sort envisioned by the president's budget (described below), to ensure that the otherwise allowable interest-expense-to-earnings ratio of a U.S. corporation is not disproportionate to a multinational group's worldwide interest-to-earnings ratio.

In early March, Sens. Marco Rubio, R-Fla., and Mike Lee, R-Utah, proposed their own comprehensive tax reform legislation that would disallow all interest expense.[39] The conceptual reason for doing so is that these policymakers have proposed replacing the corporate income tax with a cash flow consumption tax that ignores financial flows generally — an ''R'' based cash flow tax. Their proposal has its own issues, including reliance on highly optimistic growth forecasts as a plug for missing tax revenue projections, and while it does contemplate the elimination of all business interest deductions, it does so to implement properly the conceptually different tax system they are proposing. As such, it cannot fairly be cited as on point for a proposal to cap business interest expense within the income tax. The policy reasons for suggesting a cap on overall business interest deductions within the existing corporate income tax are to mitigate the effects of accelerated depreciation and expensing of debt-financed assets, and the large presence of formally or functionally tax-exempt investors in the marketplace for corporate debt instruments.

II. The Budget's Response to the Current Mess

This brings us at last to the president's budget. It contains four important proposals that are particularly relevant here.[40] First, as indicated earlier, the budget contemplates a lower domestic corporate tax rate in line with world norms and Republican aspirations. Second, it adopts a new territorial tax as the basic structure of our international corporate tax rules, again consistent with Republican views. Third, the budget proposes a one-time transition tax to wipe the slate clean regarding past stockpiles of low-taxed offshore earnings: In lieu of a highly contingent 35 percent tax liability on ultimate repatriations, corporations would be required to pay a 14 percent tax today on all their offshore earnings accumulated to the date of the switch to the new system. (The tax bill could be paid in installments over several years.) And finally, the United States would adopt a novel 19 percent minimum tax, under which the government would impose an immediate tax (on a country-by-country basis) if U.S. corporations drive their foreign effective tax rates below the floor set by the minimum tax.

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financial services companies, which earn large amounts of interest income from debt-financed third-party assets in the ordinary course of their business.

[37]Altshuler, Shay, and Toder, *supra* note 14. The German ''escape clause'' is not available if *any* member of the group makes interest payments greater than 10 percent of its net interest expense to a related affiliate that is not part of the worldwide consolidated financial reporting group, or to an unrelated lender with recourse to that related party. *Id.*; Lee A. Sheppard, ''BEPS Interest Deduction Guidance Coming,'' *Tax Notes*, Mar. 9, 2015, p. 1176.

[38]Robert C. Pozen and Lucas W. Goodman, ''Capping the Deductibility of Corporate Interest Expense,'' *Tax Notes*, Dec. 10, 2012, p. 1207.

[39]Luca Gattoni-Celli, ''Rubio and Lee Prioritize Growth Over Revenue in Tax Reform Plan,'' *Tax Notes*, Mar. 9, 2015, p. 1192.

[40]Treasury, ''General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals'' (Feb. 2015).

The budget does not, of course, follow the direction suggested earlier in this report regarding integrating small business into the corporate income tax. Instead, the budget proposes extending and expanding current section 179's rules permitting the expensing of investments by small businesses. The new rules would permit $1 million of business investments to be written off and would claw back the benefits of expensing dollar-for-dollar to the extent a taxpayer's investments exceeded $2 million. This does nothing for service-oriented small business and simply perpetuates all the distortions attendant on current law, including the rush to buy company cars and the like with any spare cash at year-end. (Admittedly, SUV dealers will be saddened that the vehicles on their lots would be capped at a $25,000 immediate write-off.)

Camp's 2014 comprehensive legislative package also would have expanded section 179, although not as generously as the budget proposes. But the Camp draft contemplated lowering the maximum individual income tax rate to 35 percent, which would be relevant to many business owners, as well as to highly compensated employees.

The budget follows exemplars like Germany in their approach to tightening current section 163(j), dealing with outbound earnings stripping, and in imposing a mirror-image interest disallowance rule that would limit a U.S. parent company's interest expense if it is overleveraged relative to the entirety of its worldwide group. Ignoring all the details, section 163(j) would be replaced by a bilateral rule applicable to any U.S. corporation (parent or subsidiary) that is part of a larger group filing consolidated financial statements; if the U.S. corporation is overleveraged relative to the worldwide group (using financial accounting income and expense as the determinants), U.S. interest expense would be disallowed to that extent.[41]

U.S. interest expense of a U.S. group that owns foreign subsidiaries and that survives the first hurdle would be subject to a second level of disallowance to the extent it was allocable to foreign investments not subject to U.S. tax under the territorial system described below. Basically, interest expense allocated and apportioned to foreign earnings would be deductible at the same rate as any minimum tax payable on those earnings (as described below); if no minimum tax was due, the allocable interest would not be deductible. Wholly domestic interest expense would remain fully deductible.

In these respects, the budget again is roughly similar to Camp's 2014 comprehensive tax reform package. Thus, if the Camp package is taken as a starting point for conversation from the Republican point of view (admittedly, a contentious assumption), the two sides are not that far apart on small business expensing and interest expense limitations.

Of course, expanding small business expensing is a poorly targeted tax lollipop for small businesses. Both sides would do better to consider genuinely graduated corporate tax rates, and to constrain the deductibility of domestic business interest expense to some extent.

It is necessary to consider in a bit more detail the main elements of the budget's international tax proposals. As mentioned earlier, our tax rules for outbound foreign direct investment really are collapsing under their own weight, and this fact by itself is probably a leading driver of corporate tax reform. The most important question for corporate tax reform, beyond what will be offered to the passthrough sector by way of compensation, therefore boils down to what sort of international tax regime the president contemplates and how different it might be from ideas mooted by senior Republican policymakers.

The president's proposals here need to be understood against the background of worldwide tax developments. In a nutshell, there is lots of evidence that foreign countries have lost their patience with the stateless income tactics of multinationals generally and U.S. corporations in particular: The OECD is pushing forward on its base erosion and profit-shifting initiative,[42] designed to reset the international consensus on taxing cross-border profits; the EU has moved aggressively against secret tax deals between countries like Luxembourg and multinational corporations; and some countries, like the United Kingdom, have jumped the queue by adopting their own measures to preserve their tax bases from the depredations of cross-border tax planning. So, while U.S. multinational CEOs may not have fully internalized that fact, U.S. multinationals will in the near future pay higher taxes on their foreign income. The only interesting question is how much will be collected by source countries, and how much by the United States.

[41]Technically, the U.S. members of the group would be treated in effect as a single company, and the test would be measured by comparing the ratio of U.S. interest expense to U.S. earnings against the ratio of worldwide interest expense to worldwide earnings.

[42]OECD, "First Steps Towards Implementation of OECD/G20 Efforts Against Tax Avoidance by Multinationals" (Feb. 6, 2015).

The administration's transition tax and the minimum tax actually have their roots in the comprehensive tax reform first mooted by Camp in 2011[43] and revised in 2014. His thoughtful proposal for a new territorial tax system went nowhere but did represent a real conceptual breakthrough. For the first time, a senior Republican tax policymaker acknowledged that moving to a toothless territorial tax system was a terrible idea, because doing so would only lead to U.S. corporations doubling down on the same aggressive tax strategies they employ today. As a result, Camp proposed several possible antiabuse rules, including the germ of a minimum tax to backstop the new system.

Under the president's proposal, the new U.S. territorial tax system would impose no tax on post-enactment repatriation dividends. The Camp bill, by contrast, retained a 1.25 percent repatriation dividend tax going forward.

The president's proposed 14 percent transition tax on existing offshore retained earnings would be offset by a partial tax credit for foreign taxes actually paid on those earnings. To the extent that companies have been particularly adroit in driving down their foreign tax bills, the time therefore would come to pay the piper his full 14 percent.

The transition tax is projected to raise $268 billion in revenues. Businesses have reacted angrily to the tax even though they will emerge with the territorial tax system for which they have clamored. The reason is simple: Corporations have no tax reserves against those offshore earnings for financial accounting purposes, and the resulting tax therefore will be a dramatic hit to financial earnings as well as to cash. At the same time, progressives have criticized the rate as too generous because it excuses corporations from their contingent 35 percent tax liability on ultimate repatriations under current law.

Corporations point to the 2004 one-time repatriation holiday tax rate of 5.25 percent as if it were a ceiling on conscionable rates. But that repatriation holiday, like the one currently proposed by Sens. Barbara Boxer, D-Calif., and Rand Paul, R-Ky., was fundamentally different in operation from the superficially similar transition tax. The repatriation holiday was a voluntary sort of amnesty program, and therefore, to be effective, the rate had to be artificially low. What is more, the amnesty did not change the background tax law: Corporations could, if they chose, continue to hold their offshore earnings free of U.S. tax through the mechanism of deferral. Now, by contrast, all corporations will move to a genuine territorial tax system, under which there is no incremental tax hit for repatriating foreign profits. In doing so it is necessary to do something to wipe the slate clean — no supercomputer yet exists that could enable a corporation to keep track of both current and future international tax rules simultaneously.

A transition tax that applies only to past activities has a unique standing in tax economics. Such a tax is said to be ''efficient'' because, unlike taxes on current or future profits, there is no antiavoidance behavior possible, because the tax base is entirely backwards-looking. Corporations thus should not look to economic theory to justify an abnormally low tax rate. And from the other direction, the budget commits the $268 billion raised by the transition tax to infrastructure investment[44] through financing a reinvigorated Highway Trust Fund; this investment arguably makes sense on its own, and tying the two together no doubt is intended to mollify those on the left who think the proposal is too easy on multinationals.

Camp also proposed a mandatory transition tax, ranging up to 8.75 percent in his 2014 version. That bill would have raised $170 billion in revenues — less than the administration's proposal but close enough to spark a productive conversation. One attractive feature of the 2014 Camp proposal was its split tax rate, with a higher tax rate on offshore cash and a lower rate on offshore earnings invested in real business assets. The key point is that the basic framework is in place for constructive negotiations: a low corporate tax rate, a territorial international tax system, and a mandatory transition tax from the old system at some discounted rate.

Finally, the budget contemplates a new 19 percent minimum tax to backstop the territorial tax system, estimated to raise $206 billion in tax revenues over 10 years. The details of the minimum tax are complex, but the way to understand things is that the minimum tax functions as a relatively low-rate worldwide tax safety net underneath all the territorial tax acrobatics. Taxpayers doing business in most major trading partners of the United States and actually paying tax in those countries generally would owe little or no minimum tax, although the actual tax calculations would depend on several factors, making generalizations very difficult.

A revenue estimate of roughly $20 billion per year suggests that this minimum tax will bite hard, but it also signals just how successful U.S. corporations have been at lowering their effective foreign tax rates below the statutory rates applicable in most countries where they actually do business.

[43]Camp, *supra* note 13.

[44]White House, ''Investing in America's Future,'' *available at* http://www.whitehouse.gov/sites/default/files/omb/budget/fy2016/assets/investing.pdf.

Camp's 2014 tax bill contained a somewhat analogous antiabuse rule, estimated to pick up $116 billion over 10 years, so again the administration's proposal is substantially more aggressive than, but within shouting distance of, the most important Republican effort in this field.

The idea of the minimum tax safety net is to discourage corporations from turning the new territorial tax regime into a license to turbocharge their stateless income tax planning, stripping income both from the United States and from high-tax foreign countries. The United States can rationally care about protecting the tax base of, say, Germany, because a world in which U.S. corporations can easily strip German earnings to tax havens while still qualifying for the benefit of territorial taxation would encourage U.S. corporations to disproportionately invest in those high-tax foreign countries to provide the raw feedstock for their ultimate low-taxed stateless income distillate.

The administration has done a poor job explaining the operation of the minimum tax. On its face, a 19 percent tax rate sounds very high, but the budget contemplates that corporations would obtain a new deduction — an allowance for corporate equity (ACE) — that would reduce foreign income subject to the tax. The idea of the ACE is to exclude from the reach of the minimum tax a basic "normal" rate of return on equity, so that the tax would fall only on supersized returns, which generous returns, it might be argued, are at least partially explained as the fruits of tax hanky-panky. Camp's 2014 antiabuse rule (called foreign base company intangibles income) was equally complex and relied on similar insights by again targeting for current U.S. taxation abnormally high rates of return on investment.

The president's proposals have led to a predicable cacophony of squealing by businesses, on one hand, and by the political left, on the other. All this noise has largely drowned out the only really important reaction, which is that Ways and Means Committee Chair Paul Ryan, R-Wis., and other senior Republican tax policymakers have not wholly rejected the package. In fact, its basic terms — low domestic corporate rate, territorial taxation, one-time transition tax, and a targeted international minimum tax or other antiabuse rule — are consonant with earlier Republican work products. If the numbers are on the high side, well, that is what negotiations are for. The takeaway should be that a common conceptual framework from which reasonable people can negotiate to a deal is now in place. The two sides are surprisingly close on corporate rates and international tax design. Small business can be welcomed into the corporate tent with graduated rates. And both revenue needs and policy objectives can be satisfied through capping domestic interest expense deductibility.