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Corporate Tax is Broken and Needs Major Surgery

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Abstract

In a contribution to the *Wall Street Journal's MarketWatch*, Eric Toder and Alan Viard argue that recent highly publicized tax avoidance transactions by U.S. corporations reflect basic flaws in how we tax the income of multinational corporations, and that proposed reforms that maintain current definitions of corporate residence and source won't fix the underlying problems. They propose two fundamental structural reforms - seeking international agreement on rules for allocating the income of multinational corporations among countries, or scrapping the U.S. corporate income tax entirely and replacing it with taxation at ordinary income rates of dividends and accrued gains of U.S. resident shareholders.

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Corporate Tax is Broken and Needs Major Surgery
by Eric Toder and Alan D. Viard

Recent efforts by major corporations such as Medtronic (MDT), Mylan (MYL), AbbVie (AABV), and Walgreen's (WAG) to merge with smaller foreign firms and move their corporate residence overseas to reduce their U.S. tax liability have sparked outrage and prompted proposals to curb such transactions.

Tax avoidance by U.S. corporations, however, is not limited to those who migrate overseas. Congressional hearings earlier this year highlighted efforts by major U.S. firms, such as Caterpillar (CAT), Apple (AAPL), and Microsoft (MSFT) to avoid taxes by shifting their reported profits to affiliates in low-tax countries.

Policy makers and experts widely agree that current proposals to limit corporate expatriations are only a stopgap and that broader reforms are needed. President Barack Obama and Rep. David Camp, the Republican chairman of the House Ways & Means Committee, among others, have proposed cutting the corporate tax rate and eliminating tax breaks that help many firms avoid tax.

In a recent report funded by the Peter G. Peterson Foundation, we argue that even these broader tax-reform plans, however good they may be, don't go far enough. The United States should either reach agreement with its trading partners on a common way to allocate profits of multinational corporations or should scrap the corporate tax and directly tax shareholders instead.

At roughly 39% (including state taxes), the U.S. corporate tax rate is the highest among developed countries. Also, the United States is one of the few countries still taxing the active foreign-source income of its corporations.

These features of the corporate tax discourage investment in the United States, encourage U.S. multinationals to retain profits overseas, and may place U.S. companies at a disadvantage compared with their foreign competitors, giving our companies an incentive to change their corporate residence.

At the same time, the United States raises less revenue from the corporate income tax than other advanced countries, only about 2% of gross domestic product.

It's tempting to blame these problems on tax loopholes, greedy corporations, and populist opposition to corporate rate cuts. But we believe that the shortcomings of the corporate income tax are more fundamental.

The current method of taxing the profits of large, publicly traded corporations was designed for an economy in which international investment was relatively unimportant and most corporate profits were produced by tangible assets, such as machinery and buildings. It doesn't work well in today's economy, which features increasing globalization and a rising share of profits produced by patents, brand reputation, and other intangible property.

The United States and our major trading partners base a corporation's tax partly on the corporation's legal residence and partly on the source of its income. These residence and source concepts make little economic sense and are easily manipulated.

Both U.S.- and foreign-resident multinationals have investors, employees, and shareholders throughout the world, and intangible property contributes to a firm’s output throughout the world. As we have seen, corporations can avoid residence-based taxation by incorporating elsewhere and can avoid source-based taxation by shifting reported income overseas, often into tax havens.

The reform plans that have been put forward don’t solve these problems because they continue to rely on the flawed residence and source concepts.

Two structural reform options can get at the root of the problem.

The first option would seek international cooperation on defining the source of corporate income, building on the Organisation of Economic Co-operation and Development's ongoing Base Erosion and Profit Shifting Project. Agreement on common rules for allocating income would stop the shifting of profits to tax havens, without putting U.S. multinationals at a competitive disadvantage. Although consensus would be very hard to reach, all our leading trading partners have a common interest in protecting the corporate tax base.

A second, even more far-reaching reform option would scrap the U.S. corporate income tax entirely.

American shareholders in all publicly traded companies, domestic and foreign, would be fully taxed, at ordinary-income rates, on their dividends and the annual increases in the value of their shares, whether or not they’ve sold the shares. They would be allowed to claim a full deduction for any annual declines in share values. U.S. tax liability would depend only on the individual shareholder’s residence, not on the corporation’s legal residence or the source of its income.

The tax system would no longer discourage domestic investment, reward U.S. companies for shifting income elsewhere, or favor foreign over U.S.-resident companies. It would ensure, however, that American investors pay tax every year on all the income they receive from corporate share ownership.

Both these options would confront difficult design choices and significant political obstacles. We do not pretend that either is likely to be enacted soon. At some point, though, the United States has to move beyond tinkering with the current system and fundamentally reform the way we tax corporate income.

Read more about Toder and Viard’s ideas in this report.

Other Publications by the Authors

- Eric Toder
- Alan Viard