Chapman Law Review

Volume 18 | Issue 1 Article 2

2014

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Recommended Citation

Jordan M. Barry, *The Emerging Consensus for Cutting the Corporate Income Tax Rate*, 18 Chap. L. Rev. 19 (2014).
Available at: http://digitalcommons.chapman.edu/chapman-law-review/vol18/iss1/2

The Emerging Consensus for Cutting the Corporate Income Tax Rate

*By Jordan M. Barry**

INTRODUCTION

Contemporary tax policy circles are characterized by healthy debates on a range of policy measures. However, a consensus has emerged among tax policy experts on one point: the United States should lower its statutory corporate income tax ("CIT") rate.[1] Doing so would produce a number of benefits, both internationally and domestically. This short Article summarizes some of the chief benefits that are driving the consensus for a reduced CIT rate. It also describes the surprising degree of political agreement that has quietly emerged on this point.

I. INTERNATIONAL TAX BENEFITS

Much of the consensus surrounding the value of cutting the U.S. CIT rate derives from concerns about U.S. competitiveness.

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1 *See, e.g.*, Karen C. Burke, *Is the Corporate Tax System "Broken"?*, 28 VA. TAX REV. 341, 363–66 (2008); Karen C. Burke, *Passthrough Entities: The Missing Element in Business Tax Reform*, 40 PEPP. L. REV. 1329, 1329 (2013); Peter R. Merrill, *Competitive Tax Rates for U.S. Companies: How Low to Go?*, 122 TAX NOTES 1009 (2009), *available at* taxprof.typepad.com/files/tn1009.pdf; David M. Schizer, *Fiscal Policy in an Era of Austerity*, 35 HARV. J.L. & PUB. POL'Y 453 (2012); Joseph J. Thorndike, *The Durability of a Dysfunctional Tax: Public Opinion and the Failure of Corporate Tax Reform*, 21 KAN. J.L. & PUB. POL'Y 347, 350 (2012); John Diamond & George Zodrow, *The Case for Corporate Income Tax Reform*, AM. ACTION F. (May 29, 2013), http://www.americanactionforum.org/research/the-case-for-corporate-income-tax-reform; Dan Maffei & Ryan McConaghy, *The Case for Corporate Tax Reform*, THIRD WAY 1 (Aug. 2011), http://content.thirdway.org/publications/434/Third_Way_Policy_Memo_-_The_Case_for_Corporate_Tax_Reform.pdf; *Tax: Fundamentals in Advance of Reform: Hearing Before the S. Comm. on Fin.*, 110th Cong. 20–21 (2008) (statement of Michael J. Graetz, Professor of Law, Yale Law School), *available at* http://www.finance.senate.gov/hearings/hearing/?id=dd061d06-e1ba-5190-a38 f-6fbf4c8dab2e; PETE DOMENICI & ALICE RIVLIN, BIPARTISAN POLICY CTR., RESTORING AMERICA'S FUTURE: REVIVING THE ECONOMY, CUTTING SPENDING AND DEBT, AND CREATING A SIMPLE, PRO-GROWTH TAX SYSTEM 17 (2010), *available at* http://www.bipartisanpolicy.org/projects/domenici-rivlin-debt-reduction-task-force; *see also* Dylan Matthews, *Everyone Wants to Lower Corporate Tax Rates. Here's How You Do It.*, WASH. POST (Sept. 26, 2012), http://www.washingtonpost.com/blogs/wonkblog/wp/2012/09/26/everyone-wants-to-lower-corporate-tax-rates-heres-how-you-do-it/ ("Everyone wants to cut the corporate income tax rate. That's one of the few areas of real common ground in American tax policy . . . . All three major bipartisan tax reform plans—Bowles-Simpson, Domenici-Rivlin and Wyden-Coats—include a corporate rate cut.").

Reducing the statutory CIT rate would make the United States a more attractive business environment by lowering the tax cost of doing business in the United States. At the margin, this would help encourage more businesses to open and operate in the United States.

The argument laid out above can be made for any country that imposes a CIT. However, there is a sense among many that the United States is in particular need of a CIT rate cut. The basic argument is as follows: Over the last twenty-five years, business has become increasingly mobile. This has fueled an increase in tax competition among jurisdictions, which have cut their statutory CIT rates to attract businesses.[2] The United States has not participated in this rate cutting and has kept its statutory CIT rate relatively steady at a little below 40%.[3] In 1990, a 40% CIT rate was slightly below the OECD average.[4] However, by 2010, the average CIT rate of non-U.S. OECD countries had fallen to approximately 25%.[5] Thus, the United States, by maintaining the same CIT rate, has found itself changed from a low-CIT-rate country to the nation with the highest statutory CIT rate in the OECD.[6]

Tax policy experts know that the story described above is accurate, but incomplete.[7] Focusing on the effective tax rates that U.S. companies actually pay paints a more complicated picture. U.S. CIT revenues, as a percentage of GDP, have been below the OECD average almost every year since 1981.[8] For example, in

2 *See, e.g.*, Bert Brys, Stephen Matthews & Jeffrey Owens, *Tax Reform Trends in OECD Countries* (OECD Ctr. for Tax Policy and Admin., Working Paper No. 1, 2011), *available at* http://www.dx.doi.org/10.1787/5kg3h0xxmz8t-en; Merrill, *supra* note 1, at 1009–10.

3 *See* Merrill, *supra* note 1, at 1010. This number includes both the federal corporate tax rate and state- and local-level corporate income taxes. *Id.*

4 At that time, the average CIT rate of non-U.S. OECD countries was a little over 41%. *See, e.g.*, *OECD Corporate Income Tax Rates, 1981-2013*, TAX FOUND. (Dec. 18, 2013), http://www.taxfoundation.org/article/oecd-corporate-income-tax-rates-1981-2013 (reporting statistics corresponding to a 41.2% average CIT rate across non-U.S. OECD member countries in 1990). The GDP-weighted average tax rate of non-U.S. OECD member countries was even higher. *Id.*

5 *See id.* (reporting statistics corresponding to a 25.2% average CIT rate across non-U.S. OECD member countries in 2010).

6 *See, e.g.*, Kyle Pomerleau & Andrew Lundeen, *The U.S. Has the Highest Corporate Income Tax Rate in the OECD*, TAX FOUND. (Jan. 27, 2014), http://www.taxfoundation.org/blog/us-has-highest-corporate-income-tax-rate-oecd (identifying the U.S. CIT rate, including both federal and state-level CITs, as 39.1%, and the next-highest CIT rate as Japan's 37.0%).

7 *See, e.g.*, Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 759 (2011) ("[T]he gap between U.S. and world corporate [statutory] tax rate[s] . . . is sometimes overstated.").

8 *Revenue Statistics - Comparative Tables*, OECD STATEXTRACTS, http://stats.oecd.org/Index.aspx?DataSetCode=REV (last visited July 11, 2014). In 1994 and 1995, the U.S. percentage was 0.1% above the OECD average, and in 1996 the U.S. percentage and

2009, U.S. CIT revenues constituted less than 2% of U.S. GDP, one of the smallest proportions in the OECD.[9] From this perspective, the United States could be seen as a low-CIT nation.

Nonetheless, the general sense that the United States is a high-tax environment for corporations seems to have set in, and the impression seems to be a powerful one. This may be because the statutory CIT rate is simply much more visible than most other information about the corporate tax system. To the extent that this perception drives investment behavior, this is a problem for U.S. competitiveness. If so, this suggests that there may be real benefits to reducing the corporate income tax rate—even if doing so did not have a large impact on effective tax rates.

II. DOMESTIC TAX BENEFITS

In addition to increasing U.S. competitiveness, lowering the statutory CIT rate would have a number of domestic benefits. Our corporate tax laws affect all manner of business decisions, including which legal entity to use, which types of business to pursue, and how to fund the business. Many of these effects are negative, and a lower CIT rate would help ameliorate them.

U.S. taxpayers can choose to operate their businesses through a number of legal entities, including many pass-through business entities that are not subject to entity-level tax. The menu of pass-through options includes S corporations, disregarded entities, and partnerships, as well as more specialized structures such as regulated investment companies ("RICs") and real estate investment trusts ("REITs").

The abundance of pass-through options is one of the reasons why the United States has the highest statutory CIT rate in the OECD, yet its CIT collects a smaller percentage of GDP than other countries do. Consider a 2007 OECD study that looked at the number of incorporated and unincorporated businesses with varying characteristics in OECD member nations. It found that, among U.S. businesses with annual income of $500,000 or more, there were more than twice as many unincorporated businesses as incorporated businesses.[10] In every other country, this ratio

the OECD average were equal. On average, from 1982 through 2012 (the most recent year for which data was available), the United States' figure was 79% of the OECD average; looking at medians gives a similar picture. *Id.*

9 *See id.* (indicating that, in 2009, U.S. taxes on corporate profits raised revenue equal to 1.7% of U.S. GDP, tied with Austria for the third lowest among OECD countries; the OECD average was 2.8%).

10 *See* ALFONS J. WEICHENRIEDER, OECD, SURVEY ON THE TAXATION OF SMALL AND MEDIUM-SIZED ENTERPRISES: DRAFT REPORT ON RESPONSES TO THE QUESTIONNAIRE 7–8 tbl.1 (2007), *available at* http://www.oecd.org/tax/tax-policy/39597756.pdf (reporting a

was reversed—there were at least two incorporated businesses for every unincorporated business at this income level.[11]

The U.S. pass-through sector has seen pronounced growth since the 1980s. This growth seems tied to the tax reform bills of the era, which reduced statutory tax rates for individuals[12] and raised the tax burden on corporate income, making it more tax efficient to operate a business via a pass-through entity than through the corporate form.[13] The subsequent changes in business entity choices, presumably due at least in part to these changes in tax incentives, have been dramatic.

For example, in 1980, C corporations filed slightly more federal tax returns than pass-through entities did, but the figures were comparable.[14] By 2008, pass-through entities filed more than four times as many returns as C corporations did.[15] In 1985, C corporations filed more than three times as many returns as S corporations;[16] by 2008, that ratio had almost reversed itself.[17] Looking at income earned, instead of at returns filed, tells a similar story: in 1980, C corporations earned over four times as much income as pass-through entities;[18] by 2008, pass-through entities earned significantly more income than C corporations.[19]

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total of 81,000 such unincorporated entities and 29,000 incorporated entities).

11 *See id.* The country with the next closest ratio is the United Kingdom, which had 2.1 incorporated businesses for every unincorporated business in this income range. *Id.*

12 The Tax Reform Act of 1986 reduced the marginal tax rate on the highest earners from 50% to 28%. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 104(b)(8), 100 Stat. 2085, 2105.

13 In particular, the Tax Reform Act of 1986 repealed the *General Utilities* doctrine, which enabled corporations to distribute appreciated property to shareholders without triggering entity-level tax. This essentially enabled many corporations to avoid the corporate income tax. When this doctrine was repealed, more corporate income was subject to two levels of tax, once at the corporate level and once at the shareholder level, significantly raising the effective tax rate on corporate income. *Id.*

14 That year, there were 2,163,458 C corporation returns filed, and a combined total of 1,926,734 returns filed by S Corporations, RICs, REITs, and partnerships. These figures do not include the 8,931,712 returns filed by non-farm sole proprietorships. *See SOI Tax Stats – Integrated Business Data*, INTERNAL REVENUE SERV. tbl.1, http://www.irs.gov/uac/SOI-Tax-Stats-Integrated-Business-Data (last visited Sept. 24, 2014).

15 *Id.* (reporting the filing of 1,782,478 returns by C corporations and a combined total of 7,210,749 returns by S Corporations, RICs, REITs, and partnerships, not including the 22,614,483 returns filed by non-farm sole proprietorships).

16 *Id.* (reporting that C corporations and S corporations filed 2,549,091 and 724,749 returns, respectively; a ratio of 3.52:1).

17 *Id.* (reporting that C corporations and S corporations filed 1,782,478 and 4,049,944 returns, respectively; a ratio of 1:2.27).

18 *Id.* (reporting C corporation net income of $288,701,762,000 and combined S corporation, RIC, REIT, and partnership net income of $67,857,464,000; a ratio of 4.25:1).

19 *Id.* (reporting C corporation net income of $1,078,770,113,000 and combined S corporation, RIC, REIT, and partnership net income of $1,728,971,856,000; a ratio of 1:1.603).

If our tax laws are pushing U.S. businesses out of the corporate form and into pass-through entities, that is not a good thing. Essentially, this would mean that, when individuals are choosing how to structure their businesses, tax law is putting a thumb on the scale in favor of passthroughs and against C corporations. That means that some businesses that would be better managed as C corporations will not be conducted that way. By pushing these businesses out of the CIT base, we both reduce government revenue and reduce economic activity overall due to the less efficient management structure.

Similarly, there are several other features of pass-through entities that may also have negative economic impacts. For example, S corporations have significant limits on their capital structures, both in terms of the kinds of ownership interests that they can issue[20] and the shareholders that they are allowed to have.[21] Partnerships generally have more complicated returns than corporations, increasing compliance costs. Incurring these costs to reduce one's tax bill may make perfect sense from an individual businessperson's perspective, but little sense from an overall policy perspective. Lowering the corporate tax rate would help to reduce the tax system's influence on entity choice decisions, reducing all of these costs.

In addition, U.S. tax laws provide many deductions and credits that reduce the size of the CIT base.[22] From a policy perspective, this combination of a smaller base with a higher tax rate leaves much to be desired. These deductions and credits also tend to be fairly complicated, and are often industry-specific.[23] This makes it more difficult to understand the tax system, rendering the tax law more opaque. Such opacity makes it harder for constituents to understand and evaluate what their representatives have done, reducing political accountability and the force of popular opinion on policymaking.

An increase in the use of business tax expenditures also means that politically favored companies and industries are able to get tax breaks that others are not.[24] This disparate treatment

20 *See* I.R.C. § 1361(b)(1)(D) (2012).

21 *See* I.R.C. § 1361(b)(1)(A)–(C).

22 This is a second reason why U.S. CIT revenues are much lower than the statutory rate.

23 *See, e.g.*, I.R.C. § 179C (allowing the expensing of certain capital purchases for refineries); I.R.C. § 179E (allowing the expensing of certain capital purchases for mine safety equipment); I.R.C. § 181 (allowing the expensing of certain costs for qualified film and television productions).

24 *See, e.g.*, Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227 (2010) (discussing same); *see also* Jordan Barry, Response, *On Regulatory Arbitrage*, 89 TEX. L. REV. SEE ALSO 69 (2011).

is unfair, as it treats similarly situated taxpayers differently.[25] Moreover, the tax system is once again putting its thumb on the scale in favor of certain businesses relative to others, producing a different outcome than market competition would otherwise produce. More colloquially, the tax system is picking winners and losers. This is likely to produce inefficient outcomes.

The combined effects of these deductions and credits have been quite significant. For example, in 2009, publicly traded biotechnology firms had an average effective CIT rate of 4.5%.[26] In contrast, publicly traded trucking firms had an average effective CIT rate of 30.9%.[27]

Reducing the statutory CIT rate reduces the value of tax breaks. This both decreases the unfairness in treatment between favored and disfavored industries and the extent to which the tax system encourages certain types of economic activity over others.

Higher CIT rates also encourage capital structures with a higher percentage of debt relative to equity.[28] Because interest payments are deductible, money paid out to creditors is only subject to tax once, at the creditor level. In contrast, dividends paid to stockholders are subject to tax twice: First, the corporation pays tax when it earns the income. Second, the shareholder pays tax when she receives the dividend. The increased use of debt financing makes companies more brittle; in a downturn, a company funded with equity can reduce its dividend or suspend paying a dividend altogether. On the other hand, a company that cannot make interest payments on its debt faces the prospect of bankruptcy. This can potentially exacerbate business cycles, making recessions and depressions more severe and longer lasting.[29]

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25 Another way to describe this phenomenon is that it constitutes a violation of the principle of horizontal equity.

26 *See* Binyamin Appelbaum, *Corporate Tax Code Proves Hard to Change*, N.Y. TIMES (Jan. 27, 2011), http://www.nytimes.com/2011/01/28/us/politics/28tax.html; *see also* Mike Bostock et al., *Across U.S. Companies, Tax Rates Vary Greatly*, N.Y. TIMES (May 25, 2013), http://www.nytimes.com/interactive/2013/05/25/sunday-review/corporate-taxes.html (reporting effective CIT rates among S&P 500 companies by sector; the range was significant; utilities paid an average effective CIT rate of 12%, while retailers paid 34%).

27 Bostock et al., *supra* note 26.

28 *See, e.g.*, Ruud A. de Mooij, *The Tax Elasticity of Corporate Debt: A Synthesis of Size and Variations* (Int'l Monetary Fund, Working Paper No. 11/95, 2011), *available at* https://www.imf.org/external/pubs/ft/wp/2011/wp1195.pdf (collecting and reviewing studies of the effect of the CIT on the use of debt financing). Tax rates can also affect corporate capital structures in more subtle ways. *See, e.g.*, Jordan M. Barry & John William Hatfield, *Pills and Partisans: Understanding Takeover Defenses*, 160 U. PA. L. REV. 633, 658–59 (2012) (discussing how tax considerations can influence the structure of corporate mergers and acquisitions).

29 *See, e.g.*, Hilary J. Allen, *Let's Talk About Tax: Fixing Bank Incentives to Sabotage Stability*, 18 FORDHAM J. CORP. & FIN. L. 821, 839–44 (2013) (discussing the effect of the

III. POLITICAL AGREEMENT

The consensus for cutting the CIT rate also extends to the political arena. For example, during the 2012 presidential election, both Barack Obama and Mitt Romney advocated for a CIT rate cut.[30] More surprisingly, both advocated for nearly the same cut: Mitt Romney proposed a 25% federal CIT rate.[31] Barack Obama proposed a 28% federal CIT rate, along with a deduction for manufacturers that would ultimately give them a 25% federal CIT rate.[32] Considering the degree of polarization in contemporary politics and the 35% federal CIT rate currently in effect,[33] the size of the gap between these two policy positions seems quite small.

In addition, cutting the CIT rate could help reduce disagreement surrounding one of the tax policy questions on which Democrats and Republicans are most strongly divided: How should the United States tax income earned by U.S. corporations and their subsidiaries in non-U.S. jurisdictions?

Currently, U.S. corporations with foreign subsidiaries generally do not owe U.S. tax on income that those subsidiaries earn overseas until they repatriate those earnings.[34] This system has several negative effects: Most other companies' corporations are not subject to domestic tax on income that they earn in other countries. Because U.S. corporations investing abroad can face an additional level of tax, this can place them at a competitive disadvantage. Further, because income earned in foreign jurisdictions is not subject to U.S. tax until repatriated, it encourages U.S. businesses to move profits to lower-tax countries. Finally, because profits earned abroad are not subject

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CIT deduction for debt on banks, and suggesting that the effect is much larger than the "too big to fail" subsidy enjoyed by the largest institutions).

30 *See* THE WHITE HOUSE & THE DEP'T OF THE TREASURY, THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM 1 (2012) [hereinafter OBAMA PLAN], *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf; BELIEVE IN AMERICA: MITT ROMNEY'S PLAN FOR JOBS AND ECONOMIC GROWTH 6 (2011) [hereinafter ROMNEY PLAN], *available at* http://www.thepoliticalguide.com/Items/MittRomney/BelieveInAmerica-PlanForJobsAndEconomicGrowth-Full.pdf.

31 *See* ROMNEY PLAN, *supra* note 30, at 6, 43–45. This proposal did not end with the Romney campaign, and remains favored in Republican circles. In February 2014, House Ways and Means Committee Chairman Dave Camp put forward a tax reform proposal that also includes a 25% CIT rate. *See* HOUSE COMM. ON WAYS & MEANS, 113TH CONG., THE TAX REFORM ACT OF 2014: FIXING OUR BROKEN TAX CODE SO THAT IT WORKS FOR AMERICAN FAMILIES AND JOB CREATORS 19 (2014), *available at* http://www.waysandmeans.house.gov/uploadedfiles/tax_reform_executive_summary.pdf.

32 *See* OBAMA PLAN, *supra* note 30, at 1, 9, 12.

33 This is a slight oversimplification. *See* I.R.C. § 11(b) (2012).

34 This is an oversimplification. Special rules apply to certain types of income, sometimes referred to as Subpart F income. *See* I.R.C. §§ 951–965.

to U.S. tax until they are returned to the United States, companies have an incentive to keep those profits overseas instead of bringing them back to the United States.

Democrats and Republicans have weighed these varying concerns differently. Democrats have tended to focus on reducing the incentive for U.S. businesses to move profits overseas. For example, President Barack Obama has proposed a minimum tax on foreign income at the time it is earned.[35] This would help reduce the relative benefits of earning income offshore instead of in the United States, but would make U.S. businesses competing abroad less competitive.[36] Republicans, in contrast, have focused more on the issue of U.S. competitiveness. Mitt Romney advocated switching to a territorial tax system, which would mean no U.S. tax on income earned abroad.[37] This would improve the competitive position of U.S. businesses operating abroad; however, it would also increase U.S. businesses' incentives to move profits overseas.[38]

Regardless, cutting the CIT rate helps with all three of these concerns: It reduces the competitive disadvantage to U.S. corporations from being subject to the U.S. CIT. It narrows the tax differential between earning profits in the United States and earning them in low-tax jurisdictions, reducing the incentive to shift profits out of the country. It reduces the tax cost of repatriating foreign earnings, which will encourage more repatriation at the margin. Thus, cutting the U.S. CIT rate is both a point of agreement across both parties, as well as a policy measure that will help reduce the magnitude of existing political disagreements.

CONCLUSION

This Article recaps some of the chief factors that have fueled the emerging consensus in favor of a cut in the statutory CIT rate. That said, it bears emphasis that tax policy experts generally envision such a cut as part of a larger tax reform package—and there is considerable disagreement on what the rest of that package should look like.

35 *See* OBAMA PLAN, *supra* note 30, at 14.

36 Currently, the advantage of foreign profits is that U.S. tax on such profits is deferred until they are repatriated. *See id.* at 13. Under such a change, more tax would be due at the time the income is earned, reducing the amount of tax deferred. *Id.* at 14. Such a change would also help reduce taxpayers' incentives to leave foreign profits in foreign subsidiaries. *Id.*

37 *See* ROMNEY PLAN, *supra* note 30, at 45–46.

38 Currently, the advantage of foreign profits is that U.S. tax on such profits is deferred until they are repatriated. *See id.* at 46. Under this change, such profits would be exempt from U.S. taxation—a significantly larger advantage.

Many call for a CIT rate cut to be paired with base-broadening provisions that eliminate or pare down existing deductions and credits.[39] Commentators disagree on which deductions and credits to target, and to what extent. Some, concerned about budget deficits, believe that a CIT rate cut can only be enacted if accompanied by spending cuts, new revenue raised from individuals, or a combination of both. Other commentators worry that a CIT rate cut could reduce the progressivity of our tax system, exacerbating economic inequality,[40] and must be enacted along with other tax provisions designed to counteract this effect. On a more nuts-and-bolts level, a reduced corporate tax rate, coupled with capital gains treatment for dividends, could render income earned through the corporate form subject to less tax than income earned by individuals.[41] This could open up an opportunity for tax avoidance and reduce the effectiveness of the individual income tax.

All of these are significant concerns for policymakers, and assembling a package that addresses them all will not be easy. Nor does it seem probable that such a package will emerge in the near future. But, given the broad support among commentators and policymakers for cutting the statutory CIT rate, such a cut does seem very likely to happen—eventually.

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39 *See, e.g.*, OBAMA PLAN, *supra* note 30, at 9–10.

40 The short version of this argument is as follows: The burden of the CIT is primarily borne by a combination of shareholders and executives. Both tend to be wealthier than the average American. Accordingly, reducing the corporate tax will reduce the tax burden on those with more income, rendering the tax system less progressive.

41 For example, a 20% CIT rate, coupled with a 20% capital gains rate on dividends would mean that shareholders keep 80% of 80% (=64%) of distributed corporate profits—in other words, the net tax rate on such income is 36%. This is less than the current top individual rate. Moreover, if profits grow as money is reinvested, deferring the payment of dividends and reinvesting at the corporate level subject to a lower tax rate can significantly magnify this advantage.