By Martin A. Sullivan — martysullivan@comcast.net

Thanks to President Obama, corporate tax reform has gone prime time. Major news outlets are reporting on closed-door discussions involving Treasury officials, congressional staff, and industry representatives and on any utterance from members of Congress on the topic. But progress is slow, and most veterans of prior reform efforts are pessimistic.

The main problem is that the president has so limited the scope of the debate that most meaningful options are off the table. He has called for revenue-neutral corporate tax reform — widely interpreted to mean that reform would not change overall corporate revenues. More specifically, revenues lost from a cut in the statutory corporate tax rate must be offset by cutting corporate tax breaks.

At first glance, there is a lot to be said for Obama’s approach. Hard-wired into the brains of all economists — no matter their politics — is that classic tax reform with rate cuts and base broadening is good tonic for an economy that needs to improve its competitiveness. We should be mindful of the political advantages for the president as well. By working with business groups on their long-sought goal of corporate rate reduction, his administration is building relationships rather than burning bridges.

The Limits of Revenue-Neutral Reform

But for all the big talk, the action taken so far is small. There are no concrete proposals from political principals. The whole effort has a hollow ring to it. It is easy to be for competitiveness, lower rates, jobs, etc., but who is willing to make real, live enemies by finding money to pay for those goodies? Corporate tax reform, already sickly, is soon likely to die a quiet death. There are several reasons:

- **It is unlikely that any revenue-neutral rate reduction would leave the United States with a rate below that of most of its competitors.** On average, our competitors have a rate of about 25 percent. (See testimony of Kevin Hassett, director of economic policy studies at the American Enterprise Institute, Doc 2011-1280 or 2011 TNT 14-43.) That figure is what members of Capitol Hill have in mind when they think about reform, as evidenced by recent statements from House Majority Leader Eric Cantor, R-Va., and House Ways and Means Committee Chair Dave Camp, R-Mich. But for both policy and political reasons, they will be lucky to get to 30 percent.

- **Revenue-neutral corporate reform will create large winners and losers that will undo the corporate coalition currently supporting reform.** The three largest corporate tax expenditures are accelerated depreciation for equipment, the section 199 deduction for domestic manufacturing, and the research credit. The beneficiaries of those provisions are mainly in the manufacturing sector. Therefore, the main thrust of any revenue-neutral corporate reform effort would be a tax increase on the manufacturing sector offset by a tax cut for other sectors like retail and finance. (For more on the size of a rate cut and the burden of revenue-neutral reform, see “Winners and Losers in Corporate Tax Reform,” Tax Notes, Feb. 14, 2011, p. 731, Doc 2011-2847, or 2011 TNT 30-2.)

- **Requiring corporate tax reform to be revenue neutral makes international corporate reform unattractive to multinational businesses.** Big business has been clamoring for reform of U.S. international tax rules for decades, and now that the United Kingdom and Japan have adopted territorial systems, the calls for change are louder than ever. But most territorial plans put on the table so far — like those proposed by President Bush’s 2005 advisory panel and by the Joint Committee on Taxation — would raise revenue because they generally would treat business more harshly than under current law. The main difference between those proposals and other territorial systems around the world is their disallowance of deductions for interest and headquarters expenses related to exempt foreign dividends. As long as we are in a revenue-neutral framework, the type of territorial system sought by multinationals would make it even more difficult to reduce the corporate statutory rate to levels comparable to those of our competitors.

- **Revenue-neutral reform leaves many fundamental problems of the corporate tax unaddressed.** The current corporate tax encourages corporations to finance with debt instead of equity. There is no reason to favor debt over equity. If anything, the bias should be the opposite. The corporate tax provides unfair advantages to businesses that can structure themselves as partnerships and S corporations. That might be considered a subsidy for small business. But is such a subsidy justified? And even if it is, the current dividing line only very crudely divides “small” from “large” businesses.
As previously stated, revenue-neutral corporate tax reform may be a laudable goal, but its benefits are limited and its political difficulties enormous. The U.S. rate would still be comparatively high. The manufacturing sector would experience a tax increase. And revenue-neutral reform would still leave us with a fundamentally flawed system of taxing business.

Alternatives to Revenue-Neutral Reform

A. Deficit Financing

The easy way to solve the difficulties of corporate rate reform would be to pay for it simply by adding to the deficit. That is how Congress funded the $1.2 trillion cost (over 10 years) of the Medicare prescription drug benefit enacted in 2003. You may be thinking that such extravagance would be impossible now. But let’s not forget that deficit financing is how Congress funded the two-year extension of the Bush tax cuts at the end of last year.

B. Increase Taxes on Capital Gains and Dividends

One novel approach to paying for a reduction in the corporate tax rate would be to increase the tax rate on capital gains and dividends, currently at 15 percent. Economists have long favored eliminating double taxation of corporate income, which can be done by eliminating tax at either the corporate or shareholder level.

In the past, the approach generally favored by Treasury to alleviate double taxation has been to reduce shareholder taxes. In his March 8 testimony before the Senate Finance Committee, Prof. Michael Graetz of Columbia Law School, a former Treasury official, said the Treasury approach has not withstood the test of time. Graetz has suggested a cut in the corporate rate and a tax increase on individuals in the form of a withholding tax on corporate shareholders and bondholders. (For Graetz’s testimony, see Doc 2011-4868 or 2011 TNT 46-37.)

In a 2010 paper, economists Rosanne Altshuler, Benjamin Harris, and Eric Toder explored the possibility of returning the top dividend and capital gains rates to their pre-1997 level of 28 percent (“Capital Income Taxation and Progressivity in a Global Economy,” Tax Policy Center (May 12, 2010), Doc 2010-11525, 2010 TNT 100-29). They made a number of interesting observations. First, most OECD countries have moved in the opposite direction of the United States and have raised shareholder tax rates while lowering corporate rates. Second, because the cross-border mobility of individuals is less than that of corporations, such a change would reduce tax distortions in economic decision-making. Third, because the burden of corporate taxation is believed to increasingly fall on labor, a shift in tax from corporations to shareholders would increase the progressivity of the tax system. Lastly, the authors made a rough estimate and predicted that increasing the tax rate on dividends and capital gains to 28 percent could pay for a corporate rate reduction from 35 percent to 26 percent.

Obviously, the suggestions of Graetz and Altshuler, Harris, and Toder are fraught with new political difficulties, but with the lack of other easy options it is an approach we are likely to hear more about in the coming years.

C. VAT to Cut the Deficit

Now let’s discuss the magnitude of our deficit problems. In an article on corporate tax reform, this may seem like a digression, and in normal times it would be. But the growing federal debt will so change future tax and fiscal policy that not giving it our full attention would be like ignoring a tsunami warning before going to the beach.

Sizing up our future deficit problems critically depends on how successful Republicans are in their efforts to cut discretionary spending. Because there is so much uncertainty, Table 1 presents four alternative scenarios (and Figure 1 compares those scenarios with historical experience).

| Table 1. Deficits as Percent of GDP Under Different Assumptions About Discretionary Spending |
|---|---|---|---|---|
| | Discretionary Spending | Deficit |
| | 2016 | 2021 | 2016 | 2021 |
| Concord Coalition | 7.8% | 7.7% | 6.7% | 8.0% |
| Congressional Budget Office | 7.4% | 6.7% | 5.5% | 6.2% |
| Republican Study Committee | 5.7% | 5.0% | 3.4% | 3.8% |
| RSC, adjusted for historical lows | 6.2% | 6.2% | 3.9% | 5.2% |

The baseline most often cited is that of the Congressional Budget Office (“The Budget and Economic Outlook: Fiscal Years 2011 to 2021” (Jan. 2011), Doc 2011-1753, 2011 TNT 18-16). In its headline presentations, the CBO is required to assume that discretionary spending grows at the rate of inflation, which would shrink discretionary spending to 6.7 percent of GDP in 2021. Under that scenario, the budget deficit would be 6.2 percent of GDP in 2021. Stabilizing the federal debt (that is, to keep it from growing as a percentage of GDP) requires deficits equal to approximately 3 percent of GDP.

The Concord Coalition monitors budget issues and considers it more likely that after returning to
pre-recession levels, discretionary spending will grow at roughly the same rate as GDP (Doc 2011-1804, 2011 TNT 18-38). That would put discretionary spending at 7.7 percent of GDP in 2021. Under that scenario, the budget deficit would be 8 percent of GDP in 2021.

Moving in the opposite direction is the House Republican Study Committee (RSC). The committee has proposed the Spending Reduction Act of 2011, which would freeze non-defense domestic discretionary spending in dollar terms at its 2006 level. (For a summary, see http://rsc.jordan.house.gov/Solutions/SRA.htm.) The RSC proposal would reduce discretionary spending to 5 percent of GDP in 2021. Under that scenario, the budget deficit would be 3.8 percent of GDP in 2021.

As shown in Figure 1, that would be extremely low by historical standards. For that reason, a fourth alternative is presented (labeled “RSC, adjusted for historical experience”) in which the level of discretionary spending is not allowed to fall below the 20-year low of 6.2 percent of GDP in 1999. Under that scenario, the budget deficit would be 5.2 percent of GDP in 2021.

Without going into a prolonged discussion about what level of discretionary spending is appropriate (mostly a matter of personal opinion) or what amount of discretionary spending cuts is politically feasible, for the remainder of this discussion we will assume that over the next decade Congress will end up somewhere between the CBO baseline scenario (deficit 6.2 percent of GDP in 2021) and the adjusted RSC scenario (deficit 5.2 percent of GDP in 2021). That would be a major change from current trends, but it would fall considerably short of the goals of the most radical plans for budget cuts from the Republicans. Under either scenario, major deficit reduction would still be required.

Table 2 provides examples of policy changes that would be necessary to stabilize the debt. Under the adjusted RSC scenario, a broad-based VAT of 8 percent would be required. A VAT with exemptions for food and other necessities would need a rate of 14 percent to stabilize the debt.

In the current political environment, a double-digit VAT is unthinkable. Except when you consider the alternatives.

Instead of a 14 percent VAT to put America’s finances on a sustainable path, Congress could cut spending on entitlements by 16 percent, cut defense spending by 61 percent, raise individual income
taxes (incorporating the Bush tax cuts) by 25 percent, or some combination of those proposals.

While a VAT is now widely considered a political non-starter, it will undoubtedly receive more attention because other options for deficit reduction are similarly unattractive.

D. VAT to Pay for Corporate Cuts

Revenues from a VAT could be used to reduce the corporate rate. Table 3 shows the VAT rates required for different levels of rate reduction. A reduction in the corporate rate from 35 percent to 20 percent could be financed with a VAT with a rate between 2.6 and 4.5 percent, depending on how much special relief is provided.

Table 3. VAT Rates Needed to Pay for Corporate Rate Reductions

<table>
<thead>
<tr>
<th>Corporate Rate Reduced From 35 Percent to . . .</th>
<th>Broad-based VAT</th>
<th>Narrow-based VAT</th>
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<tbody>
<tr>
<td>15%</td>
<td>3.5%</td>
<td>6.1%</td>
</tr>
<tr>
<td>20%</td>
<td>2.6%</td>
<td>4.5%</td>
</tr>
<tr>
<td>25%</td>
<td>1.7%</td>
<td>3.0%</td>
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Reducing or even eliminating the corporate tax and replacing the lost revenues with a VAT has always been a good idea for competitiveness reasons. The United States would be substituting revenues from its least economically efficient tax with a highly efficient consumption tax. As part of his plan for tax reform, Graetz has proposed reducing the corporate tax rate to 15 or 20 percent and replacing the lost revenue with revenue from a credit invoice VAT. (See Graetz, “VAT as the Key to Real Tax Reform,” in the Tax Analysts VAT Reader, available at http://www.taxanalysts.com/www/freefiles.nsf/Files/GRAETZ-9.pdf/$file/GRAETZ-9.pdf.) In 2007 Treasury published a report including an option to replace the corporate tax with a business activity tax, a subtraction method VAT. In the United Kingdom, the Conservative-Liberal government has increased its VAT rate from 17.5 percent to 20 percent while gradually reducing its corporate rate from 28 percent to 24 percent (in 2015). In Japan, business and government leaders are seeking to pay for further reductions in the corporate tax rate (scheduled to drop to 35 percent in April) with increases in the 5 percent VAT rate.

Conclusion

For decades, the conventional political wisdom has been that a VAT will never be enacted in the United States because liberals view it as a tax targeting the poor and conservatives view it as a money machine. And in response, pundits would quip that a VAT will be enacted when liberals view it as a money machine and conservatives view it as a tax on the poor.

It’s time to jettison that type of talk. What passed for healthy skepticism in the 1990s is no longer useful or particularly relevant. Unlike in previous episodes when the federal deficit was front-page news — as in 1982-1984 (debt-to-GDP ratio at about 25 percent) or 1990-1993 (debt-to-GDP ratio at about 45 percent) — now we truly are playing with the possibility of the collapse of federal finances (debt-to-GDP ratio surpassing 80 percent in 2015, and growing). Until somebody can guarantee that our fiscal problems are under control, either because spending cuts are politically feasible or because concerns about the economic fallout from rising debt are overblown, it is prudent to give a VAT a prominent role in the debate about deficit reduction.

Moreover, as globalization increases demand for a more competitive tax system, the United States must consider shifting from a system that relies primarily on income taxation to one that relies primarily on consumption taxation. Most other major economies around the world depend more heavily on consumption taxation than does the United States. And by all indications, reliance on consumption taxes is increasing.

Finally, the traditional liberal and conservative arguments against consumption taxation are hardly insurmountable. True, VATs are generally more regressive than income taxes, but the differences are usually overstated (because government analyses equate well-being with annual income as opposed to lifetime income, a superior measure). But more importantly, however one evaluates fairness, any regressive effects of a VAT can be offset by changes
Consistency Is Focus of Voluntary Disclosure, IRS Official Says

By Marie Sapisir — msapisir@tax.org

The objective of the offshore voluntary disclosure initiative (OVDI) is to get taxpayers to "come in through the front door," John McDougal, special trial attorney and division counsel in the IRS Small Business and Self-Employed Division, said March 16. Many taxpayers have done just that, but many others are still standing outside, balking at the one-size-fits-all approach of the OVDI.

Reasonable Cause

Taxpayers who don’t meet the threshold for the application of the 5 percent or 12.5 percent penalties, and who are hoping for relief, should opt out of the OVDI and submit to an audit, McDougal said during a teleconference sponsored by the American Bar Association. Whether taxpayers can successfully assert reasonable cause as a ground for a reduction in penalties has been a source of frustration for those in the 2009 offshore voluntary disclosure program (OVDP). (For prior coverage of the OVDI, see Tax Notes, Feb. 14, 2011, p. 735, Doc 2011-2714, or 2011 TNT 27-1.)

McDougal explained that FAQ 35 of the 2009 OVDP, which says that participants would not be required to pay a penalty greater than what they would otherwise be liable for under existing statutes, was drafted loosely enough that many people interpreted it to mean the agents could make factual determinations. "That’s not what the commissioner intended,” he said.

"[The commissioner] has made it really clear for 2011 that any such factual determinations on willfulness or reasonable cause need to be made in examination, where the Service develops all the facts and we have a better chance of achieving consistency,” McDougal said. For cases that are still being worked, the commissioner wants agents to “go back to the initial view that he had of the way this was supposed to work,” McDougal said, adding that the IRS will not go back and reopen cases that have been resolved.

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Taxpayers do not like how the government defines reasonable cause. "The difference between reasonable cause and no reasonable cause has always been whether the taxpayer was aware of the facts that gave rise to the filing obligation," McDougal said. "If they were not aware of the facts, that’s reasonable cause. If they were aware of the facts, but just didn’t bother to check it out or ask the question whether they had a filing obligation, the case is pretty clear that’s not reasonable cause.” He said their representatives need to think about how