Building on Wyden-Coats: Making International Tax Reform Possible

By Michael C. Durst

Michael C. Durst is a tax lawyer in Washington and a columnist for Tax Notes.

In this column, Durst praises the recently introduced Wyden-Coats reform proposal, but he suggests ways it might be enhanced to increase the likelihood of enactment, particularly regarding its international provisions. In particular, Durst recommends further reducing the plan’s proposed 24 percent corporate rate to 20 percent to ensure the elimination of corporate income shifting to tax havens. Durst suggests recovering the revenue cost of the reduced corporate rate through additional measures that will further increase the progressivity of the individual income tax but will not require an increase to the 35 percent maximum individual rate.

A Promising Model

As someone who has worked closely with the U.S. tax system for the past 30 years and considers its current waste and appearance of unfairness to be nothing short of disgraceful, I am encouraged by the recent introduction by Senate Finance Committee member Ron Wyden, D-Ore., and Sen. Daniel Coats, R-Ind., of the Bipartisan Tax Fairness & Simplification Act of 2011 — an update of the reform plan offered last year by Wyden and Judd Gregg, former Senate Budget Committee ranking minority member. Politically, the Wyden-Coats plan seems resolutely centrist; its orientation appears pragmatic rather than ideological. It would eliminate the most wasteful and socially corrosive element of the current international tax rules: the highly visible shifting of massive amounts of corporate income to shell companies in overseas tax havens. In return, the proposal would use the revenue available from the elimination of income shifting and from other structural reforms of the corporate tax to reduce the corporate tax rate and promote economic growth and U.S. competitiveness. The proposal would raise additional revenue by making several changes to the individual income tax that would make it more progressive. The Wyden-Coats plan would not, however, attempt the politically quixotic task of raising the maximum individual rate above its current 35 percent.

Despite the plan’s many merits, I believe that changes to it would significantly increase its likelihood of political success, especially in its attempt to eliminate opportunities for income shifting to tax havens. In particular, the discussion below is based on a concern that even a 24 percent corporate rate would be too high to ensure the political support needed to repeal deferral. This article therefore addresses the feasibility of incorporating into the Wyden-Coats plan an even lower corporate rate of 20 percent. That rate might be too low for some — including, frankly, this author — to accept without political discomfort. I believe, however, that the lower corporate rate is not only feasible from a revenue standpoint but also may be necessary to eliminate opportunities for income shifting and to realize the other important benefits of the Wyden-Coats approach.

Political Feasibility

Several recent tax reform plans have suggested either limiting or eliminating international income-shifting opportunities, along with other corporate tax reforms, in return for a lower corporate rate. Despite the conceptual appeal of that two-pronged approach, however, none of the proposals has attracted substantial political support. The reason for the political barrier is simple: The revenue gains from curtailing income-shifting opportunities and eliminating various special deductions and credits would be sufficient only for a relatively modest reduction in the statutory rate from its current 35 percent to somewhere in the mid-20s.

Praise for the Wyden-Coats plan is not intended to signal my agreement with every provision of the proposed legislation. Indeed, I expect that many aspects of the plan, particularly as they affect the individual tax, will need to be revised if the plan is to be enacted. I do believe, however, that the plan provides a framework on which a workable, desirable tax reform ultimately can be constructed.

1For a summary of the Wyden-Coats legislation, see Doc 2011-7198 or 2011 TNT 66-39. For the proposed legislation (S. 727) as introduced, see Doc 2011-7271 or 2011 TNT 66-29.

The Wyden-Coats plan offers, to my knowledge, the lowest corporate rate of all mainstream reform plans. Even that rate, however, has not been sufficient to attract serious support from multinational companies and their supporters. Many companies, through international income shifting and other forms of tax planning, have global effective tax rates significantly below 20 percent, and those companies would experience substantial net tax increases under a plan that reduces the corporate rate to the mid-20s. Those companies wield enormous political power; as a result, corporate reform that would broaden the base and lower the rate to the levels envisioned in Wyden-Coats is probably a non-starter.

In the interest of exploring whether effective reform is politically feasible, I believe it is worth considering whether a 20 percent corporate rate could fit within the Wyden-Coats plan or a similar proposal without sacrificing the proposal’s revenue neutrality. Although substantial, additional analysis, particularly in the area of revenue estimation, will need to be conducted to confirm the feasibility of this approach, I think it likely that such an effort might succeed and that an important political barrier to comprehensive tax reform could thereby be removed.

First, I believe that the revenue estimates for the reduction of income-shifting from the United States that have been used in constructing the Wyden-Coats plan may be too low. The plan’s preliminary revenue estimates consider the combined effects of eliminating deferral together with another important international reform — the move from an overall to a per-country foreign tax credit limit. Although substantial, additional analysis, particularly in the area of revenue estimation, will need to be conducted to confirm the feasibility of this approach, I think it likely that such an effort might succeed and that an important political barrier to comprehensive tax reform could thereby be removed.

I believe this in part because, historically, revenue-estimating techniques on Capitol Hill seem to result in unrealistically low estimates on the repeal of deferral. The most recent authoritative, stand-alone estimate for the repeal of deferral of which I am aware — from a 2011 Congressional Budget Office study — indicates that repeal of deferral would raise about $11 billion annually. That seems very low in light of available estimates of the degree of income shifting, and to the extent that a similar method was used in connection with the Wyden-Coats plan, the proposal may rest on too low an assessment of the revenue available from eliminating deferral.

Also, the Wyden-Coats plan would reduce income shifting not only by repealing deferral but also by dramatically reducing the U.S. corporate tax rate, thus reducing incentives for foreign-based multinationals to shift income away from the United States. This effect should lead to U.S. revenue increases in addition to those resulting from the elimination of deferral. The elimination of opportunities for deferral on the part of U.S. multinationals also should permit the IRS to devote greater transfer pricing enforcement efforts to foreign-based multinationals, a move that could raise further revenue.

These observations cannot in themselves produce a comprehensive estimate of the revenue that might be raised by reducing opportunities to shift income away from the United States. Detailed calculations, with access to extensive data, will be required to produce a satisfactory estimate. Nevertheless, I believe the above factors suggest that significant additional revenues from the reduction of income shifting are not unlikely. Because the availability of those revenues could prove decisive in making comprehensive tax reform politically feasible, serious efforts to develop a satisfactory revenue estimate seem warranted.

Additional revenue might be found using various “backstop” reform measures that would be designed to prevent a significantly reduced corporate tax rate from facilitating avoidance of the individual income tax. Those measures would be highly desirable under the Wyden-Coats plan even with a 24 percent rate, or under any other reform plan that would reduce the corporate rate to a level significantly below the maximum individual rate. In particular, to prevent the use of corporations as incorporated pocketbooks, interest and portfolio income of corporations (including dividends on portfolio stock) should be taxed at a rate similar to

---

1Very preliminary revenue estimates of the Wyden-Gregg plan, the predecessor of the Wyden-Coats proposal, are available at http://wyden.senate.gov/imo/media/doc/Score.pdf. For preliminary estimates from the Tax Policy Center, see Doc 2010-11534 or 2010 TNT 100-28.

that of the highest individual marginal tax rate, with exceptions provided for regulatory reserves of banks and insurance companies. Also, to prevent the shifting of income to personal service corporations, income derived from the personal services of a shareholder or a related party should be taxed at the maximum individual rate. These measures would not be designed primarily to raise revenue, but it nevertheless seems likely that they would generate revenue, and in amounts that might prove significant.

Further, a substantial reduction in the corporate tax rate would remove some of the conceptual support for reduced rates of tax on qualified dividends and on long-term capital gains. The Wyden-Coats plan envisions raising the rates on both items from 15 percent to about 22.75 percent. If, however, the rate on qualified dividends were raised to 35 percent and on long-term capital gains to 28 percent only for taxpayers with adjusted gross income of $250,000 or higher, IRS Statistics of Income data suggest that revenues of $18 billion to $20 billion could be raised annually, above what would be generated under the Wyden-Coats plan. Again, comprehensive, formal revenue estimates would be needed, but it seems likely that substantial revenues would be available. Moreover, the suggested changes might significantly increase progressivity.

Finally, the Wyden-Coats plan does not reach one item that a recent Joint Committee on Taxation report indicated could raise substantial annual revenues: the inclusion of unrealized capital gains on a taxpayer’s death. Such a change would be politically sensitive; it probably could apply only to taxpayers with very large amounts of gain, and gain on some assets, such as closely held businesses, almost certainly would need to be exempted largely or in full. Nevertheless, the potential revenue gains seem sufficiently large that even a very scaled-down proposal might be capable of raising annual revenues in the range of $5 billion to $10 billion. Implementation of such a proposal would probably also enhance progressivity.

The possibility of increased estimated revenue from the curtailment of income shifting, as well as the revenue that might be raised from the additional reform measures just mentioned, should be compared with the likely revenue cost of reducing the corporate rate under the Wyden-Coats plan from 24 to 20 percent. Although an adequate estimate of that cost, like the other revenue figures used above, will require an analysis far more extensive than can be conducted here, “back of the envelope” calculations suggest that under the Wyden-Coats plan, each percentage point reduction in the corporate rate should cost approximately $10 billion in annual revenue. Therefore, reducing the corporate rate from 24 to 20 percent should cost approximately $40 billion per year. I believe that the discussion above suggests a high probability that the $40 billion could be recovered through a combination of revised revenue estimates relating to the curtailment of international income shifting, and additional reforms that would enhance the overall progressivity of the tax system without requiring an increase in the 35 percent individual rate.

The discussion above also suggests that even if a reform plan as comprehensive as the Wyden-Coats proposal proves infeasible, it should be possible to fashion a revenue-neutral, stand-alone plan that includes the corporate and international reforms of the Wyden-Coats proposal, a corporate rate of 20 percent, and targeted individual tax changes that would not require a maximum rate more than 35 percent. I believe that kind of stand-alone plan would offer substantial public benefits and should be considered if more extensive reform proves out of reach for the time being.

**Next Steps**

Those supporting the Wyden-Coats initiative should consider carefully whether it may be feasible to reduce the plan’s proposed corporate rate from 24 to 20 percent using measures such as those outlined above. If comprehensive reform such as the Wyden-Coats plan cannot be enacted in the short term, I believe that a less extensive reform centering on a 20 percent corporate rate should be considered seriously.

I do not make this recommendation lightly; as a liberal Democrat since birth, I find it odd to promote a reduction in corporate tax rates to a level lower than that sought by some conservative Republicans. The pros and cons of corporate taxation raise many important questions, but for present purposes I can provide a short explanation of why I believe the reduction to 20 percent is desirable.

First, I believe — largely based on my own observations in legal practice — that corporate decision-making is particularly sensitive to the tax rate that will apply to income from a prospective investment. Therefore, although I realize that others
may disagree and that careful analysis of the question is always warranted, I think that reduction of the corporate tax rate is likely to stimulate investment in the United States more than would most other kinds of tax reductions.

Second, whereas I believe that only very ambiguous evidence is available to support the proposition that corporate taxation adds progressivity to the tax system, I believe the revenue-raising measures suggested above would be more unambiguously progressive. Therefore, I believe that my suggested approach will enhance the progressivity of the tax system overall, despite the reduction in the corporate rate.

Third, I believe that only a reduction in the corporate rate to a historically very low level, such as 20 percent, will make it politically possible for Congress to eliminate today’s rampant shifting of corporate income to tax havens. This activity, which occurs with the obvious acquiescence of Congress, represents an insult to all compliant individual taxpayers. Large-scale income shifting erodes public confidence in governmental and private sector institutions, and it must be stopped promptly and decisively. Sens. Wyden and Coats plainly desire to effectuate the reforms needed to end the practice of corporate income shifting; I believe that a lower corporate tax rate will make it substantially more likely that their plan will succeed. Even if enactment of their full plan proves out of reach politically, I believe that elements of it can help point the way toward badly needed reforms in international and corporate taxation.