Evaluating the Case for 1986-Style Corporate Tax Reform

By Daniel N. Shaviro

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Shaviro explores the relationship between taxing corporate income at the entity level and the difficulties in evaluating whether a corporate rate cut would be desirable without significant structural changes.

A. Introduction

Does agreement in principle require agreeing about principles? Recent Washington tax policy debate concerning corporate tax reform would appear to suggest not. Leaders in both parties have expressed support for a common vision, in which the U.S. corporate tax rate is reduced significantly, with accompanying base broadening that offsets the stand-alone revenue cost. I call this "1986-style tax reform,"[1] as it describes the model that Congress followed (for both individuals and corporations) in enacting the landmark Tax Reform Act of 1986. This time around, however, it might only pertain to corporations. There is far less consensus regarding the continuing desirability of 1986-style reform of the individual income tax.[2]

Despite significant bipartisan support for stand-alone, 1986-style reform of the corporate income tax, there has never been much reason to believe that reform is imminent. As an initial matter, it might seem logical to attribute this lack of progress to the fact that the parties disagree so vehemently in general, and are so little engaged in cooperative efforts of any kind. Yet, while the state of legislative politics in Washington might alone have sufficed to prevent enactment of an ambitious corporate tax reform package, it is conceivable that a sunnier political climate would not have changed the (non-) result. This partly reflects the fact that making up the lost revenue — assuming this remained a precondition — would have been politically awkward. The losers from eliminating current law corporate tax benefits would have complained, and in doing so would undoubtedly have found friends.

Another option is to cut the corporate rate without making up the lost revenue through base broadening. This would eliminate direct political losers from the change. It also might seem less unthinkable than it did previously from a purely budgetary standpoint, given recent declines in the federal budget deficit.[3] However, the budgetary effect might be considered undesirable even if one thinks that our long-term budgetary path is not dangerously unsustainable. As Jason Furman, chair of the Council of Economic Advisers, recently noted, "many dynamic models show that the cost of higher deficits associated with unpaid for corporate tax reductions outweighs any potential efficiency benefits of the tax cuts themselves — leaving the level of output lower as a result."[4] Failing to finance the tax rate cuts might also assure a regressive distributional effect from enacting the reform. Whether or not the long-term incidence of the corporate tax falls primarily on owners of capital,

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[1]*See* Daniel N. Shaviro, "1986-Style Tax Reform: A Good Idea Whose Time Has Passed," *Tax Notes*, May 23, 2011, p. 817.

[2]*Id.*

[3]*See* Congressional Budget Office, "Monthly Budget Review for September 2014" (Oct. 8, 2014).

[4]Furman, "Business Tax Reform and Economic Growth," Address at NYU School of Law (Sept. 22, 2014), *available at* http://www.whitehouse.gov/sites/default/files/docs/business_tax_reform_and_economic_growth_jf.pdf.

rather than on other groups such as workers, current shareholders surely would gain, as a transitional matter, from corporate rate reductions that had not been fully anticipated.[5]

Despite all this, it is not just political considerations that impede lowering the corporate rate, either straight-out or in a 1986-style reform. Even among experts, there is a fundamental lack of consensus about how, realistically speaking, corporate income ought to be taxed if the broader income tax system does not change much. The lack of good choices can make the politics harder, by offering the critics of any proposed package a ready list of cogent complaints.

Why is it so hard to design a reasonable corporate tax reform package that would win widespread expert support? Obviously, the problem is not that current law is so good. Rather, it lies in the large set of underlying conceptual tangles that plague entity-level corporate income taxation. The character of these problems is such that, with dismaying frequency, easing some of them can lead to worsening others. The net effect can make offering a corporate tax reform proposal, especially if it has a limited character that leaves the system's main features in place, feel like wandering blindfolded in a maze that has multiple flag stations you would like to reach. Every step that you take toward one station may lead you further away from others.

The "original sin" underlying the conceptual muddle is taxing corporate income at the entity level. Once a corporate tax system has that feature, several of our current system's problems are unavoidable. Others, while in principle avoidable, evidently become intuitively appealing, and thus politically hard to resist. This is not to say that entity-level corporate income taxation should (or even reasonably could) be eliminated, barring broader changes, but it does indicate that the end product will be unsatisfying at best.

Winston Churchill famously called democracy the "worst form of government, except all those other forms that have been tried from time to time."[6] Support for taxing corporate income at the entity level, rather than just at the owner level, requires similar diffidence. On the plus side, entity-level taxation has substantial administrative advantages: It centralizes information collection and payment and obviates the need to allocate the income to particular owners. There might also be regulatory rationales for setting tax consequences at the entity level.[7] And when we have a realization-based income tax system, in which individuals are not taxed currently on the economic income that they earn as corporate shareholders, and indeed may never be taxed on that income given the tax-free step-up in asset basis at death,[8] an entity-level corporate income tax becomes almost indispensable.[9] Bad choices have bad consequences, however, even if all of the other choices are worse.

This article explores the relationship between the "original sin" of taxing corporate income at the entity level and the difficulty of evaluating whether, to what extent, and how a corporate rate cut would be desirable, without significant structural changes to the system. The article first reviews the main problems associated with entity-level corporate taxation and then draws on those considerations to evaluate the leading arguments for lowering the entity-level corporate rate.

B. Taxing Corporate Income at the Entity Level

Good chess players who are mired in bad positions can distinguish between forced moves and blunders. We can similarly analyze entity-level corporate income taxation, although perhaps there is more of a continuum. As we will see, one of the main problems is unavoidable once tax is imposed at the entity level. A second is seemingly gratuitous, although perhaps unsurprising as a matter of political optics. A third falls in the middle, being a natural byproduct of entity-level taxation, yet one that could be mitigated through better rule design. The following catalog of problems addresses their placement along this continuum, as well as how they muddy or complicate the normative assessment of whether to cut the U.S. corporate tax rate absent broader structural changes.

1. Lack of information about the personal or household characteristics of the individuals to whom corporate income accrues. Surely the most inevitable downside of taxing corporate income at

[5] *See* Shaviro, *When Rules Change: An Economic and Political Analysis of Transition Relief and Retroactivity* (2000).

[6] 444 Parl. Deb. H.C. (5th Ser.) (1947) 207 (U.K.).

[7] *See, e.g.*, Reuven S. Avi-Yonah, "Corporations, Society, and the State: A Defense of the Corporate Tax," 90 *Va. L. Rev*. 1193 (2004) (offering regulatory rationales for the imposition of an entity-level corporate income tax).

[8] *See* section 1014.

[9] Entity-level corporate income taxation might be unnecessary if owners of corporate stock were taxed on a mark-to-market basis, rather than just upon realization. *See, e.g.*, Joseph Bankman, "A Market-Value Based Corporate Income Tax," *Tax Notes*, Sept. 11, 1995, p. 1347; Joseph M. Dodge, "A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal," 50 *Tax L. Rev*. 265 (1995); Michael S. Knoll, "An Accretion-Type Corporate Income Tax," 49 *Stanford L. Rev*. 1 (1996); Eric Toder and Alan D. Viard, "Major Surgery Needed: A Call for Structural Reform of the U.S. Corporate Income Tax" (2014).

the entity level is that it prevents the income tax system from conditioning tax liability on the personal or household characteristics of the individuals to whom the income ultimately belongs. This matters for three main reasons.

a. Rate graduation. First, recall the main reason for having an income tax, rather than a lump sum tax (such as a uniform head tax), despite the efficiency cost of taxing economic production. It is to tailor tax liability to individuals' varying personal circumstances. If achieving this objective happens to involve the application of graduated marginal tax rates to individuals' incomes, one may want to apply those rates to income earned through corporations, as well as income earned directly. This cannot be done insofar as corporate income is measured at the entity level. Corporate tax rates cannot realistically be based on shareholders' potentially varying rates. Even if this could be done, corporate capital structures generally would not apportion the tax liability based on different shareholders' applicable marginal rates.

As it happens, the U.S. corporate income tax system features graduated rates for small versus large corporations, as measured by annual income.[10] However, it is widely recognized that this makes little or no sense. It is hard to see, for example, why one would want a ''small'' C corporation that was jointly owned by Warren Buffett and Bill Gates[11] to pay tax at a lower rate than a ''large'' one that was owned by millions of small investors.

b. Loss nonrefundability. A second reason why it matters that we tax corporate income at the entity level relates to the application of net loss nonrefundability. In principle, taxing positive income at a positive tax rate might be thought to imply refunding net losses at a symmetric negative rate. This would increase the tax system's risk neutrality, although some risk discouragement might still result from positive rate graduation. It also would pay distributional heed to the fact that losing money is worse than breaking even, at least if one cannot escape bearing the loss via insolvency. But in a realization-based income tax system, loss refundability would potentially open the floodgates for using economically bogus tax shelter losses, not just to escape positive tax liability, but to siphon potentially unlimited amounts of cash out of the treasury.

Applying loss nonrefundability at the corporate rather than the individual level has the virtue of impeding high-income individuals' use of C corporations to generate usable tax shelter losses. (Thus, in the 1980s' tax shelter era, investors who valued limited liability relied heavily on exploiting the corporate resemblance regulations of the time to avoid C corporation status for limited partnerships that arguably were very corporate-like.)[12] At the corporate level, however, entity-level nonrefundability can create inefficient incentives for conglomeration, so that losses from any one activity will be usable against income from other activities. This would not be an issue if corporate income were taxed at the owner rather than the entity level.

c. Taxpayer residence. In today's globalized world of capital mobility and stateless income, surely the most important consequence of taxing corporate income at the entity level — and the one most relevant to the case for cutting the corporate tax rate — pertains to the definition of resident taxpayers. Countries can, if they like, tax what they classify as domestic-source income without regard to the taxpayer's residence. But once they accept that a given dollar of income is foreign-source income (FSI), they cannot tax it unless they define the taxpayer to whom they attribute it as a domestic resident. This has huge implications in a world of cross-border share ownership and investment.

To clarify this, suppose, as a thought experiment, that all corporate income could be and was assigned for income tax purposes to the ''correct'' individuals.[13] Under these circumstances, countries would have good reason to tax the FSI that resident individuals earned through corporations, along with all their other FSI, at the full domestic rate. After all, if one is measuring how well-off they are, in order to determine how much tax they should pay, there is no reason to ignore income earned abroad.[14] There also would be little reason to grant

[10]*See* section 11.

[11]If Buffett and Gates jointly owned all the stock of a small corporation, why would they do so under subchapter C, rather than electing subchapter S status? While this is just a simple hypothetical to illustrate a broader point, they might have good tax reasons for doing so if it lowers the applicable marginal tax rate from 39.6 percent (the top individual rate) to 35 percent (the top corporate rate), if they do not anticipate having to worry about shareholder-level dividend or capital gain realization.

[12]Treasury regulations loaded the dice against corporate status, apparently in response to efforts of the self-employed to get fringe benefits before these were extended. The rules' manipulability may have motivated Treasury's decision to replace the corporate resemblance test with the check-the-box regulations, reg. section 301.7701-2 and -3, in 1997.

[13]For Haig-Simons income that is earned through a corporation, attributing to particular individuals is clear-cut as a theoretical matter, although likely to be quite difficult in practice. It is less clear, however, on what theoretical basis one should flow through corporate taxable income when — due, for example, to income tax preferences or the realization requirement — it differs from economic income.

[14]Giving a tax break to resident individuals' FSI would also risk reducing domestic investment and tax revenues, relative to

(Footnote continued on next page.)

foreign tax credits on outbound investment, other than on a reciprocal basis that involved other countries' crediting one's own source-based taxes on inbound investment by their residents.[15]

That scenario shows why there might also be good arguments (whether or not they would be heeded) against taxing inbound investment by foreign individuals. Suppose that those individuals can earn just as much abroad as they can through inbound investment (that is, they have no special opportunities to earn economic rents here) and that one cannot affect, through one's tax system, the global pretax rate of return. Then all one would accomplish by taxing inbound investment would be to reduce the amount of it, without actually, as a matter of economic incidence, imposing tax burdens on foreigners.[16]

In the absence of cross-border shareholding, entity-level corporate taxation would not change this picture all by itself. However, the picture changes significantly once the need for entity-level taxpayer residence determinations leads to a situation in which resident individuals may invest through foreign corporations, while foreign individuals may invest through domestic corporations. The merits become messier for both source-based taxation of ''inbound'' investment (or that made domestically by a foreign corporation) and residence-based taxation of ''outbound'' investment (or that made abroad by resident corporations).[17]

As to ''inbound'' investment, any notion that it ought to be exempted because foreign individuals will not bear the tax incidence becomes harder to rely on if resident individuals can invest at home via foreign companies. Under that exemption rule, without safeguards, even a corner pizzeria might be incorporated in the Cayman Islands — or have its ''annual meeting'' there if that satisfied a headquarters rule — as a way of avoiding tax on the labor income of domestic individuals who were under-compensated owner-employees. While it might be easy to handle the corner pizzeria case through antiabuse rules, it could prove problematic for larger and more complex businesses.

How should the tax rate for domestic-source corporate income compare with the rate for income earned directly by resident individuals? If the two rates were the same, that would prevent domestic individuals from either avoiding the tax, through the use of a corporate entity, or having reason to use an entity when that would reduce pretax profitability. However, the use of a lower rate may be motivated, not just by the case of foreign shareholders, but also by the possibility that actual or reported domestic-source income is more tax-elastic when earned through a company than directly by a resident individual.[18] This conceivably might support arguments for a lower corporate rate than, say, the tax rate on salary, even without considering shareholder-level tax.

Now consider ''outbound'' investment. The case for taxing residents' FSI at the full domestic rate is weakened if resident individuals can avoid this tax by investing abroad via foreign corporations. At the limit, if the factors that determine corporate residence were wholly irrelevant to them, U.S. taxation aside, it would be pointless to attempt taxing FSI that they earned through corporate entities. Where corporate residence tax-electivity is positive but not infinite, it is plausible that one would want to respond by taxing U.S. companies' FSI at a rate somewhere between zero and the full domestic rate.[19] That rate itself might optimally (all else equal) be different for corporations than for individuals — for example, due to the shareholder-level tax, or the view that actual and reported domestic-source income is more tax-elastic for companies than individuals.

Another complication involves foreign individuals who might choose to earn FSI by investing through resident companies, for example, foreign individuals who own stock in U.S. multinationals. If those individuals sufficiently value the use of a U.S. company to be willing to pay extra for it in this way, the United States could benefit from exacting some sort of a tax price, for example by taxing the companies' FSI at a positive rate. However, there is no reason to assume that the tax rate should be the same as in the case in which one was thinking specifically about resident individuals' FSI. But the

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the case where those individuals were taxable on their worldwide income, by giving them a domestic tax incentive to invest abroad rather than at home. However, the overall effect on domestic investment and tax revenues would depend on the extent to which, dollar by dollar, inbound investment by foreign individuals replaced outbound investment by domestic individuals.

[15] *See* Shaviro, *Fixing U.S. International Taxation* (2014).

[16] In this scenario, foreign individuals might pay domestic taxes without bearing them economically. Thus, consider the case in which they can earn a 6 percent return abroad, face a 25 percent domestic income tax rate on inbound investment, and this leads the pretax rate of return on inbound investments they make to be bid up to 8 percent.

[17] I use scare quotes around the terms ''inbound'' as ''outbound'' because the description may not be accurate at the investor level, once there is cross-border shareholding.

[18] As I discuss in Section B.3 below, another possible reason for setting the corporate rate lower than the individual rate pertains to shareholder-level taxes on corporate income.

[19] *See* Shaviro, ''The Rising Tax-Electivity of U.S. Corporate Residence,'' 64 *Tax L. Rev*. 377 (2011); *see supra* note 15.

fact that residence is being determined, and tax imposed, at the entity level means that one cannot generally tailor the relevant tax rate to the residence of particular shareholders.

2. Relationship between taxation at the entity level and the owner level. A second core problem that is posed in practice by entity-level corporate taxation is considerably more avoidable. It concerns the relationship between the entity-level tax and the overall tax burden that investors face when they use a C corporation to invest. Under a classical system of corporate income taxation, like that employed in the United States (and widely throughout the world), both the entity and its shareholders are taxed on a C corporation's income. While the shareholders are not immediately taxed given the realization requirement, they may face dividend and capital gains taxes upon the receipt of corporate distributions or upon transferring corporate shares.

As a lengthy literature has noted, the resulting (or at least potential) double taxation of corporate income creates undesirable economic distortions that are not inevitable byproducts of income taxation. In particular, a classical corporate tax system distorts choices between (1) corporate and noncorporate entities, (2) debt and equity financing of corporate entities, (3) distributing and retaining corporate earnings, and (4) dividend and nondividend corporate distributions.[20]

In general, these distortions can lie in either direction, depending on the details about the applicable rules and the taxpayer's circumstances.[21] For example, so long as the top individual rate exceeds the top corporate rate (as it has in the United States since 2013, and previously did for most of the history of the U.S. income tax), some taxpayers may actually reduce their expected tax burdens by using C corporations and equity financing. All this requires is that one be in the top individual bracket and anticipate little or no difficulty in permanently avoiding shareholder-level taxation (ultimately through the tax-free basis step-up at death). Nonetheless, it appears that, in the predominant set of cases, the tax system disfavors the use of C corporations and equity financing.[22]

An earlier U.S. corporate tax reform era had focused on addressing the four distortions through corporate integration, which could have taken several different forms.[23] In 2003 that movement culminated in the adoption of the 15 percent (now 20 percent) dividend tax rate. However, even though the 2003 change offered only limited progress toward eliminating the four distortions, reformers' predominant attention has shifted to lowering the corporate rate. This shift reflects rising concerns about the ongoing feasibility of entity-level taxation that underlie the widespread calls for lowering the corporate rate. Many, although not all, of the leading approaches to corporate integration would have focused on the entity level to ensure that corporate income was generally taxed just once.

The fact that the U.S. tax system continues to bias choices between C corporations and other entities, and between debt and equity financing of C corporations — despite integration approaches that could have been used to address these problems — suggests that here we have an unforced error, rather than a problem that entity-level taxation makes inevitable. Yet the persistence of these problems also is not entirely unrelated to the ''original sin'' of taxing corporate income at the entity level. As a matter of political optics, at least for large, publicly traded companies, entity-level taxation might even be viewed as making shareholder-level taxes close to inevitable. For example, if ''I receive a dividend from a big company like General Electric in which I own a few shares, it could not possibly look more like income than it does. A large and remote organization that I do not control or even influence has sent me a check that I deposit in my bank account, apparently enriching me.''[24] Likewise, debt bias has an optical explanation that supports viewing its persistence as more than accidental, even if less than inevitable. ''Debt . . . is conceptualized as creating an arm's-length relationship between the corporation

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[20]*See* Shaviro, *Decoding the U.S. Corporate Tax* 25-41 (2009), for a general overview of these issues.

[21]Thus, consider the shareholder-level tax on dividend distributions. Under ''new view'' assumptions, which include the inevitable application at some point of a perpetual, fixed-rate dividend tax, this has no effect on incentives to retain rather than distribute corporate earnings. *Id*. at 73-77. However, the prospect of eliminating the deferred tax burden at death, by reason of section 1014, can yield tax discouragement of dividend distributions. On the other hand, a temporary low dividend tax rate can lead to tax encouragement of distributing corporate earnings sooner rather than later.

[22]*See, e.g.*, Ruud de Mooij, ''Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions,'' IMF Staff Discussion Note 11/11, at 4-7 (2011) (finding that tax systems are predominantly biased towards debt).

[23]The possible methods include, for example, dividend exemption, dividend deductibility, the provision of a shareholder imputation credit, and various methods for concentrating the taxation of all or particular components of corporate income (whether debt-financed or equity-financed) at either the entity level or the owner level. *See supra* note 20, at 151-165.

[24]*Id*. at 15. Arguably, however, this optical factor would not entirely prevent adoption of a system of imputation credits, under which a suitable share of previously entity-level taxes would in effect be treated as a tax prepayment on behalf of the shareholder.

and a third-party provider of capital . . . [whereas] equity . . . is conceptualized as giving the holder an inside or ownership interest in the corporation,''[25] thus making it seem logical that interest payments, but not dividends, should be deductible.

From the standpoint of lowering the U.S. corporate rate, the persistence of shareholder-level taxation of corporate income creates a design and evaluation problem. In principle, if one wants to move toward tax neutrality between different types of entities and debt-versus-equity financing, the entity-level corporate rate should be lower than the individual rate, under a classical system. After all, one presumably should want to equalize expected upfront tax burdens, taking into account both entity-level and shareholder-level taxes.

Yet the expected burden of the shareholder-level tax, which determines how much lower the corporate rate should be on this ground, is hard to evaluate. It depends, not just on how Congress might change relevant tax rules in the future, but also on the ease with which shareholders in C corporations can anticipate avoiding pre-death shareholder-level gain realization. This may well be heterogeneous, varying not just with the identity of the shareholder but also, perhaps, by firm type or market sector. Thus, the question of what rate differential between entity-level corporate taxes and those levied directly on individuals would best promote a level playing field has no clear or uniform answer.

The unusual structure of the U.S. business sector helps to make this problem more consequential than it might otherwise be. In many countries, the corporate tax generally applies to business activity, at least leaving aside small household-level firms. U.S. business taxation, by contrast, features a substantial overlap between C corporations and flow-throughs, the income from which is instead taxed directly to owners. Businesses that generally are taxed on a flow-through basis include S corporations, partnerships, limited liability companies, and sole proprietorships.[26] A recent study found that in 2008, flow-throughs accounted for almost 95 percent of all business entities, employed 54 percent of the private sector workforce, and reported 36 percent of all business receipts.[27] For 2004 through 2008, flow-throughs' individual owners reported 54 percent of all business net income and paid 44 percent of all federal business income taxes.[28] The fact that a 1986-style corporate tax reform would raise flow-through owners' taxes, if they faced the base broadening without getting anything comparable to the rate cut, may complicate not just the politics but also the policy merits of that reform.

3. Difficulty in distinguishing between capital income and labor income. A final issue posed by entity-level corporate income taxation fits under the rubric of lost opportunities. As I discuss in Section C, one may want to tax capital income at a lower rate than labor income. In the abstract, it might seem that corporations will just earn capital income. After all, if all workers are paid arm's-length wages that reflect the market value of their work to the entity, presumably all that remains are the profits associated with owning its capital. Thus, entity-level corporate taxation might seem to facilitate confidently identifying, if not all capital income, at least a significant swath of it.

In practice, however, this neat identity fails due to owner-employees, who can undercompensate themselves without economic loss because this merely involves, in effect, the right hand taking advantage of the left hand. Accordingly, if one wants to set the corporate rate in light of policy preferences that relate to capital income, one needs what Edward D. Kleinbard calls a ''labor-capital income centrifuge,'' permitting one to distinguish between entity-level capital and labor income without needing to rely on the observed wages that owner-employees happen to pay themselves.[29]

As Kleinbard notes, guidance on how this might be done can be derived from ''dual income tax'' rules that the four Nordic countries — Denmark, Finland, Norway, and Sweden — pioneered beginning in the late 1980s.[30] In brief, what a dual income tax system can do is impute a normal return to corporate capital, while treating the residual as wages.[31] The low (and relatively flat) tax rates that

[25]*Id.* at 5.

[26]Under some circumstances, partnerships and LLCs are taxed as C corporations. *See* section 7704 (providing that some publicly traded partnerships are taxed as C corporations); reg. section 301.7701-3 (providing that some types of noncorporate entities, under relevant U.S. state or foreign law, may elect to be taxed as C corporations).

[27]Robert Carroll and Gerald Prante, ''The Flow-Through Business Sector and Tax Reform,'' prepared for the S Corporation Association and published by EY in April 2011, *available at* http://www.s-corp.org/wp-content/uploads/2011/04/Flow-Through-Report-Final-2011-04-08.pdf.

[28]*Id.*

[29]Kleinbard, ''An American Dual Income Tax: Nordic Precedents,'' 5 *Northw. J. Law & Social Policy* 1, 41 (2010).

[30]*Id.* at 57-61.

[31]An alternative approach involves imputing ''normal'' wages and treating the residual as capital income. This, however, is likely to be considerably less reliable, as it ''requires the authorities to create a schedule of minimum wages for different tax categories of business owner and adjust them annually to

(Footnote continued on next page.)

those systems seek to apply to capital income can then be limited to the normal return. Another advantage of this approach is that it permits applying the higher rate for labor income to economic rents, which can efficiently be taxed at a higher rate than normal returns even if one views them as falling within the rubric of capital income.[32]

The U.S. corporate tax system does not, however, contain any such rules. While several code provisions are conceptually similar in that they purport to distinguish between earned and unearned income, or else to delimit ''reasonable compensation''[33] that C corporations can properly deduct rather than treating as dividend payments, Kleinbard notes that they are ''dispiritingly badly engineered,''[34] because they require fact-intensive, case-by-case determinations and are ''almost always . . . invoked as a ceiling, but not a floor, on an owner-manager's labor income.''[35]

4. Summing up. With corporate income being taxed at the entity level, while also facing the variably relevant shareholder-level tax and in the absence of an effective labor-capital income centrifuge, there is a basic problem in assessing how high the corporate rate ought to be. The entity-level income tax base contains multiple categories of income that we might want to tax at the entity level at very different rates if we could tell them apart. Indeed, these rates might range all the way from zero to the top U.S. individual rate. For example, zero is likely to be the optimal U.S. tax rate for truly inbound investment earning a merely normal rate of return which the investors could and would match elsewhere, assuming a lack of full residence country foreign tax credits for source-based U.S. liabilities. On the other hand, when high-income owner-employees are compensated by stock appreciation in lieu of express salary payments, and when they expect never to pay shareholder-level tax given their companies' dividend policies along with their anticipating stock retention until death (when the basis step-up will apply), the corporate taxable income that results from the underpayment probably should face the top individual rate. And even in these two seemingly polar cases, weakening the stated assumptions might support wanting to apply an intermediate rate.

If a single corporate rate (or set of rates) will apply to a tax base that is a composite of those heterogeneous items, presumably one must think in terms of a compromise solution, for example, some kind of weighted average. At best, this is likely to complicate the process of deciding what the corporate rate ought to be. Accordingly, the nature of the problems in the area makes it surprising that there should be so much apparent consensus in favor of reducing the corporate rate, either as a stand-alone or accompanied just by general tax base broadening that fails to reach key structural issues. In Section C, I look more closely at the main arguments that appear to underlie the consensus in favor of cutting the corporate rate even in the absence of broader structural changes. I find some of these arguments to be stronger than others.

C. Arguments for a 1986-Style Corporate Reform

1. The undesirability of being 'out of step.' Perhaps the most intuitively compelling, as well as widely heard, argument for lowering the U.S. corporate tax rate is that we are out of step with peer countries. According to a recent OECD table, the U.S. corporate rate of 39.1 percent — computed by considering not just the federal rate, but also the average state and local corporate taxes (and their federal deductibility), is the highest in the world.[36] The average national plus subnational corporate tax rate for OECD countries, weighted by national GDP, is only 32.5 percent.[37] What is more, the recent downward trend in other countries, if ongoing, could cause the rate disparity to grow ever larger over time. Reducing the U.S. federal corporate tax rate would bring us closer to the global norm.

Why might being out of step matter? There are two distinct lines of argument here. The first focuses on the wisdom of crowds (that is, the theory that collective opinions often outperform the isolated judgments even of experts[38]). This line of argument is well illustrated by the old joke about a proud mother watching soldiers on parade, who comments that ''they're all out of step but my Johnny.'' The United States certainly has no monopoly on wisdom, nor does our political system appear to be unusually healthy and well functioning. Thus, the fact that we have an unusually high

account for inflation, productivity changes, and other market factors affecting compensation.'' Thornton Matheson and Pall Kollbeins, ''Allocating Business Income Between Capital and Labor Under a Dual Income Tax: The Case of Iceland,'' IMF Working Paper 12/263 (Nov. 2012).

[32]*See supra* note 29.

[33]Section 162(a)(1).

[34]*See supra* note 29, at 50.

[35]*Id*.

[36]*See* OECD, ''Corporate and Capital Income Taxes,'' OECD Tax Database.

[37]The simple average corporate tax rate for OECD countries, without GDP weighting, is just 25.5 percent. *See* OECD, ''OECD Corporate Income Tax Rates, 1981-2013'' (Dec. 18, 2013), *available at* http://taxfoundation.org/article/oecd-corporate-income-tax-rates-1981-2013.

[38]*See, e.g.*, James Surowiecki, *The Wisdom of Crowds: Why the Many Are Smarter Than the Few and How Collective Wisdom Shapes Business, Economies, Societies and Nations* (2005).

corporate tax rate should at least prompt reflection about whether we could learn something from the rest of the world.

But there are two problems with relying too readily on the wisdom-of-crowds argument. First, our circumstances might be relevantly different. In particular, as a large country with some degree of global market power, we might be able to benefit from imposing corporate tax at rates higher than other countries find suitable. Second, our higher corporate rate is best viewed as a mere symptom of a broader U.S. tax distinctiveness: We rely more on income taxes and less on consumption taxes than any peer country. The United States is unique among economically advanced countries in not levying a national VAT or goods and services tax. While we also have payroll taxes to help fund entitlements, the lack of any national consumption tax, and the fact that state and local governments' retail sales taxes are much less fiscally significant than other countries' national VATs/GSTs, leaves us more reliant on income taxation than is the norm.

On this broader issue, I agree that the wisdom of crowds weighs against the U.S. approach, although it is merely one input to the broader assessment. However, once we have a system that is weighted towards greater reliance on income taxation, lowering just the corporate rate would fall well short of bringing us into genuine alignment, and would raise the question of whether it bettered or worsened the balance between income taxation of the corporate and noncorporate sectors.[39]

A second line of argument against being out of step pertains to tax competition. All else equal, a country with an unusually high corporate tax rate may tend to lose both actual investment and reported taxable income to countries with lower rates. However, for many decisions that companies make, the marginal tax rate on the last dollar of reported income is less important than the average tax rate that is anticipated on earnings over a much broader range. Thus, suppose a company is choosing between placing a factory in a country with a high tax rate but rapid cost recovery, and one with a low tax rate but slow cost recovery. The relevant tax implications of the choice depend on the overall picture, not just the marginal rates.

In general, U.S. companies' average or effective tax rates are far below the 39.1 percent marginal rate. For example, a recent report by the Government Accountability Office found that, in 2010, profitable U.S. public companies paid U.S. federal income taxes amounting to only 12.6 percent of the worldwide income that they reported on their financial statements.[40] This figure rose to 16.9 percent when the GAO also included foreign countries' income taxes, and to 22.7 percent when it also included companies that lost money,[41] but this still left it well below the federal statutory rate of 35 percent.

While data limitations impede making meaningful comparisons[42] on the relative tax burdens faced by U.S. and foreign companies, at present there is "no evidence" to support assertions that U.S. companies generally face higher effective tax rates, whether by reason of the higher statutory rate or having a nominally worldwide system for taxing foreign source income.[43] Indeed, one recent study found that rates were 4 percent lower for U.S. companies than for those headquartered in the EU.[44] Kleinbard, for one, would attribute this to

[39]What is more, the issue of U.S. uniqueness in tax and fiscal policy is arguably broader still than our distinctive balance between tax instruments. The U.S. tax system might be less progressive if it used income taxes with graduated rates less, and consumption taxes that are collected at the business level — such as VATs and GSTs — more, while everything else remained the same. However, the overall U.S. fiscal system could be more progressive if the United States used revenues from a VAT/GST to fund broad-based benefits, such as healthcare, at higher levels, thus bringing our fiscal system into even greater harmony with those of peer countries in the OECD. *See, e.g.*, Kleinbard, *We Are Better Than This: How Government Should Spend Our Money* (2014).

[40]*See* GAO, "Corporate Income Tax: Effective Rates Can Differ Significantly From the Statutory Rate," GAO-13-520, at 14 (May 30, 2013). Noting these latter figures, as well as the relevance of the Great Recession to 2010 results, Martin A. Sullivan views the GAO findings as compatible with "the consensus view that average worldwide effective corporate tax rates are somewhere in the mid- or upper 20s when we are not in the throes of a recession." Sullivan, "Behind the GAO's 12.6 Percent Effective Corporate Tax Rate," *Tax Notes*, July 15, 2013, p. 197, at 199.

[41]GAO, *supra* note 40, at 2, 14.

[42]*See* Leslie Robinson, Testimony Before the Finance Committee on Hearing on International Corporate Taxation, at 2-3 (July 22, 2014) (stating that "researchers cannot make comparisons by jurisdiction that would seem necessary to resolve the competitiveness issue").

[43]*Id*. at 1, 2. The studies that Robinson cites in relation to this conclusion include Kevin Markle and Douglas A. Shackelford, "Cross-Country Comparisons of Corporate Income Taxes," National Bureau of Economic Research, Working Paper No. 16839 (2011); Avi-Yonah and Yaron Lahav, "The Effective Tax Rate of the Largest US and EU Multinationals," University of Michigan Public Law Working Paper 255 (2011); and Giorgia Maffini, "Territoriality, Worldwide Principle, and Competitiveness of Multinationals: A Firm-Level Analysis of Tax Burdens," Centre for Business Taxation, Working Paper 12/10 (2012). *See also* Sullivan, *supra* note 40, stating in relation to the GAO study that "it seems reasonable not to revise the consensus view that average worldwide effective corporate tax rates are somewhere in the mid- or upper 20s when we are not in the throes of a recession."

[44]*See* Avi-Yonah and Lahav, *supra* note 43.

U.S. firms effectively operating in an ''ersatz territorial tax environment, without any of the anti-abuse rules that a thoughtful territorial tax system would impose,''[45] and to the fact that those firms ''have established themselves as world leaders in global tax avoidance strategies.''[46]

Even if one nonetheless believes that the high U.S. corporate tax rate leads to competitive disadvantage, either for U.S. companies or for the United States as a source country that is competing for inbound (and stay-at-home) investment, it is odd to see revenue-neutral, 1986-style tax reform being touted as a response. After all, the whole point of that reform is to reduce marginal tax rates while keeping tax burdens about the same. Such reform could, it is true, achieve revenue neutrality by combining tax cuts for corporations with tax increases for noncorporate business. This conceivably might aid the United States in global tax competition if corporate investment is generally far more mobile in response to tax rate differences than noncorporate investment (and if their respective capital markets operate sufficiently separately). But surely the main argument for 1986-style corporate tax reform would have to rest on the general tax policy merits of cutting the rate while broadening the base. I therefore turn next to that set of issues.

2. General merits of revenue-neutral base broadening. ''Lower the rates, broaden the base.'' Since the run-up to the 1986 act, this little mantra has been endlessly seductive to tax reform proponents, and generally with good reason. Why wouldn't one want to reduce both inter-asset distortions and the marginal rate on earning one's next dollar of gross income? At least, if this can be done in a revenue-neutral fashion and, better still — again like the 1986 act, at least according to official estimates — without changing overall progressivity, the case may seem clear. But in fact, at least as applied to 1986-style corporate tax reform, the underlying merits of following the mantra may be more complicated than they initially seem. Here are three points that may help to show this.

a. Why this policy experiment, instead of a different one? The mantra's appeal reflects the often well-founded belief that repealing the tax benefits to make up for revenue that would be lost through stand-alone rate cuts is generally not a good policy. For example, they may inefficiently favor some assets and activities relative to others that already are fully included in the tax base. Suppose, therefore, that they ought to be repealed — no less than any government spending programs that are both costly and inefficient without having offsetting distributional benefits. What is the particular reason for combining them with tax rate cuts, rather than with any other ''good'' use of the budgetary gain from their repeal?

In a 2011 *Tax Notes* piece assessing 1986-style reform of the income tax for individuals, I noted the ''critique that we should not use up low-hanging fruit (in the sense of clearly bad existing rules) without improving our long-term fiscal situation.''[47] Why are lower tax rates necessarily the best way to use the budgetary improvement that results from base broadening? Even taking as granted rate reduction's desirability on general efficiency grounds, there are always plenty of other possible claimants when the repeal of bad rules creates long-term budgetary improvement.

Suppose that changes to our healthcare system made it possible to reap federal budgetary savings of $100 billion per year while also improving healthcare outcomes. Would that similarly call for using the budgetary improvement on tax rate cuts in particular? Now, it is true that, say, tax rate cuts may indeed be a natural partner for slowing down cost recovery rules, insofar as both affect the cost of capital for new investment and this is a margin that one cares about in aggregate. But the optical appeal of 1986-style reform applies more broadly than this, to offsets that need not be similarly directed to the same margins, reflecting the idea that ''tax revenues'' ought to stay in aggregate the same.

That idea, while it may be politically convenient if (as in 1986) it promotes deal-making between actors with different ideological commitments, can reflect underlying conceptual confusion. As the literature concerning tax expenditure analysis convincingly shows, it often is not intellectually coherent to distinguish tax rules from spending rules based purely on whether they happen to be administered through the Internal Revenue Code, as distinct from, say, using direct outlays.[48] Insofar as base broadening involved the repeal of spending-like allocative rules that had been arbitrarily lodged in the income tax, there would be no particular reason to think of it as substantively raising taxes as distinct from cutting spending, leaving aside the political optics.

b. Transition effects of base broadening plus lower rates. A lot of the corporate base broadening that presumably would be used to pay for lower

[45]Kleinbard, '''Competitiveness' Has Nothing to Do With It,'' *Tax Notes*, Sept. 1, 2014, p. 1055, at 1056.

[46]*Id*. at 1057.

[47]*See supra* note 1, at 818.

[48]*See* Shaviro, ''Rethinking Tax Expenditures and Fiscal Language,'' 57 *Tax L. Rev*. 187 (2004).

corporate rates, in a 1986-style reform, would involve the timing of cost recovery. Perhaps the most frequently discussed change is adopting slower depreciation rules for tangible assets, with the aim of more closely approximating economic depreciation. However, a 2013 Senate Finance Committee staff discussion draft, prepared during the chairmanship of former Sen. Max Baucus, identified several other possible shifts towards slower cost recovery that might combine being economically more accurate with "rais[ing] enough revenue from corporations in the long-term to finance a significant reduction in the corporate tax rate."[49] The items mentioned here as possible targets for repeal included, for example, last-in, first-out inventory accounting, cash accounting for any business above a minimum size (as measured by gross receipts), the expensing of advertising costs, uniform capitalization rules that may permit expensing for some items that create lasting value, and 15-year amortization for some intangibles that are likely to retain value over a longer period.[50]

There are two distinct reasons why one might favor those changes. The first is to measure economic income more accurately, while the second is to offer more neutral treatment of alternative capital outlays. To help show why the distinction matters, suppose one instead enacted a cash flow consumption tax, under which all capital outlays were expensed. This would defeat the first objective — presumably on purpose — but it would accomplish the second objective. Indeed, it would do so better than any politically or administratively realistic shift towards "correct" income tax accounting, given the difficulty of defining economically accurate cost recovery. Base broadening (from an income tax standpoint) to help finance corporate tax rate cuts inevitably will fall short, in practice, of achieving full neutrality. While it very well might increase neutrality in treatment of alternative capital outlays — compared with today's broad hodgepodge of cost recovery approaches — even this is hard to know for certain.

Suppose one definitely prefers the steady state that would result from slowing down cost recovery for various capital outlays — whether primarily on neutrality grounds or because one wants to measure economic income more accurately. Adopting it as part of a 1986-style reform package still has transitional disadvantages that are relevant to the overall assessment. Using slower cost recovery to finance lower rates provides a windfall gain to old investment, which got faster cost recovery at the high marginal rate and now gets to include deferred income at the newly enacted low marginal rate. The extra tax revenues to provide overall budget neutrality presumably come at the expense of new investment. This may be especially regrettable in an era where the U.S. economy remains well short of full employment and, as a political matter, adequate stimulus to address the shortfall appears unlikely to be forthcoming.

c. Neutrality in the corporate versus noncorporate business setting. The difficulty of devising and enacting accurate, comprehensive income tax cost recovery rules is only one reason for concern about the overall neutrality effects of 1986-style corporate tax reform. Again, recall that corporate businesses would generally face lower tax rates than noncorporate businesses, and that shareholder-level taxes on the former, while potentially tending towards equalizing the two, pose unclear levels of burden that may vary as between firms.

3. The case for imposing a lower tax rate on capital income than labor income. As Alan Auerbach recently noted, whereas at one time "the standard objective of tax policy design . . . was the achievement of a broad-based income tax . . . the literature of recent decades has moved us quite far from thinking it natural that capital and labor income should be taxed according to the same schedule. . . . We have come to understand . . . that capital income is 'different.'"[51] Reasons for this conclusion include concern both about the intertemporal distortion that an income tax imposes, which can become pronounced over a long period,[52] and about the generally greater cross-border mobility of capital income as compared with labor income.

Insofar as corporate income generally is capital income rather than labor income, a reduction in the corporate rate, so that it was lower than high-end individual rates, might be viewed as a step in the direction of achieving the suggested differentiation between the two types of rates. To be sure, it would be both underinclusive, given the continued existence of noncorporate capital income, and overinclusive, given the problem of owner-employees who undercompensate themselves (especially if a

[49]Baucus, "Cost Recovery and Accounting Tax Reform Discussion Draft" (Nov. 21, 2013). For a fuller discussion of the proposals, see Baucus, "Summary of Staff Discussion Draft: Cost Recovery and Accounting" (Nov. 21, 2013).

[50]*See* Baucus, "Summary of Staff Discussion Draft," *supra* note 49.

[51]Auerbach, *Capital Income Taxation, Corporate Taxation, Wealth Transfer Taxes, and Consumption Tax Reforms* 1, 16 (2013).

[52]*Id*. at 4; Kenneth L. Judd, "Redistributive Taxation in a Simple Perfect Foresight Model," 28 *J. Pub. Econ*. 59 (1985); Christophe Chamley, "Optimal Taxation of Capital Income in General Equilibrium With Infinite Lives," 54 *Econometrica* 607 (1986).

better labor-capital income centrifuge was not simultaneously adopted). However, while this alone would not rule out its representing net progress in the indicated direction, it is unclear that the overall tax burden on capital income would actually decline, in a 1986-style framework in which revenues remained the same because slower cost recovery (or other income tax base broadening) was accompanying the rate cuts.

4. Addressing debt bias. As noted earlier, in theory a classical corporate income tax system can either favor or disfavor debt financing, relative to equity financing. Debt's tax advantage is that interest payments, unlike dividends, are deductible at the entity level, thus ensuring that there will be one level of tax. Equity's tax advantage, apart from the reduced 20 percent tax rate on dividends (which could outweigh entity-level nondeductibility if the company is in a loss position), is that one may never need to incur the second level of tax, potentially creating an overall tax advantage if the investor's marginal tax rate is above that of the entity.

Despite the theoretical indeterminacy of which way the greater bias lies, the empirical literature ''offers ample support for [predominant] debt bias.''[53] What is more, there is evidence that the welfare costs of debt bias are significant and have been rising over time by reason of rising elasticities regarding financial instrument choice.[54] Tax-induced excess corporate leverage is also suspected of having contributed to the 2008 financial crisis,[55] and could potentially help bring on or worsen similar crises.

The most direct responses to tax-induced excessive corporate leverage would involve either restricting interest deductibility or providing an interest deduction-like allowance for corporate equity.[56] However, lowering the corporate rate would potentially be a push in the right direction, by lowering both the tax rate on equity-financed investment and the marginal value of interest deductions.

What happens to this logic when one embeds the corporate rate cut in a 1986-style reform package in which overall business or corporate tax burdens remain about the same? If the expected tax burden on equity financing remains the same due to base broadening, the first of the above two effects is eliminated. A 1986-style reform might, however, reduce the expected tax burden on corporate equity to some extent, if overall revenue neutrality was achieved via an increase in noncorporate business taxes from the base broadening.

Even if overall corporate tax burdens remained the same, the rate cut might reduce debt bias by making corporate interest deductions less valuable. That marginal effect does not depend on the overall tax burden on equity-financed corporate income. Thus, while 1986-style corporate tax reform does not aim very directly at the problem of debt bias, it might have sufficiently positive effects in this regard to offer a significant argument in its favor. Yet one should keep in mind that this is just one of many relevant dimensions in assessing the merits of enactment.

5. First step towards improving international tax rules. One advantage that might be attributed to lowering the tax rate on domestic-source corporate income is that this would increase the policy merits of applying the domestic rate to U.S. companies' FSI. At present, of course, the same tax rate does indeed formally apply to both domestic-source income and FSI. In practice, however, FSI benefits not just from foreign tax credits, but also generally from deferral, when earned through a foreign subsidiary rather than a branch of the domestic company.

Harry Grubert and Rosanne Altshuler have argued that reducing the U.S. corporate tax rate — say, to 28 percent — would significantly improve the merits of repealing deferral, by addressing the concern that its stand-alone repeal would unduly raise the tax burden on resident companies' outbound investment.[57] Indeed, they conclude that what they call ''burden-neutral worldwide taxation'' — enactment of that type of rate cut plus the repeal of deferral, in which the burden effects are roughly offsetting — is preferable to other widely discussed international tax reform packages, such as the enactment of a territorial system accompanied by substantial tightening of the source rules.

In the case of a 1986-style corporate tax reform that passed in a relatively uncontroversial bipartisan consensus package, it seems unlikely that repealing deferral would be a part. That would be a controversial move and seems especially unlikely to attract Republican support (as Republicans tend to be more on the side of exempting FSI). Nonetheless, if one agrees with Grubert and Altshuler about the desirability of moving in this direction, the shift to a 28 percent corporate rate (offset by domestic base broadening) might be viewed as making it easier, in

[53]*See supra* note 22, at 8.
[54]*Id.*
[55]Shackelford et al., ''Taxation and the Financial Sector,'' 63 *Nat'l Tax J.* 781, 783 (2010).
[56]*See supra* note 22, at 14-19.

[57]Grubert and Altshuler, ''Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income,'' in *Fundamental Tax Reform: Issues, Choices, and Implications* (John Diamond and George R. Zodrow, eds., 2008).

policy terms even if not politically, to contemplate repealing deferral in the future.

My own views about international tax reform, which I have spelled out in some detail elsewhere,[58] suggest a couple of reasons for skepticism about this approach. First, I argue that it makes sense for the effective U.S. tax rate on domestic-source corporate income to exceed that for the FSI of U.S. companies, reflecting likely differences in the relevant tax elasticities. Second, I argue that, while it is generally unwise to rely on foreign tax credits — with their 100 percent marginal reimbursement rate (MRR) — to reduce the effective U.S. tax rate on U.S. companies' FSI, at least the presence of deferral tends to mitigate substantially the dampening of U.S. companies' incentives to minimize their foreign tax liabilities. Without deferral, the MRR for U.S. companies' foreign taxes truly would be 100 percent in all cases, other than those in which foreign tax credit limits applied. This would be unfortunate, from a U.S. standpoint, if we prefer that companies pay U.S. taxes, rather than foreign taxes, given that only in the former case are we the ones who get the money. (And while reciprocal foreign tax creditability might ease these concerns, most countries now employ territorial systems.) I therefore find the Grubert-Altshuler ''burden-neutral worldwide taxation'' approach problematic, although it is true that existing U.S. international tax law is as bad as to set the bar for policy improvements quite low.

[58]*See supra* note 15.

D. Conclusion

There is widespread support among academics and policymakers for a 1986-style corporate tax reform package, in which a reduction in the corporate rate would be accompanied by base broadening, much of it via the enactment of more economically accurate (from an income tax standpoint) cost recovery rules, with the aim of achieving overall budget neutrality. Part of the rationale for doing this, even though it fails to address broader problems with the U.S. income tax system, is that the enactment of more ambitious and far-reaching tax reform packages would be politically impractical, or at least more difficult and requiring longer development.

Even granting that rationale, I am more skeptical than many others about the degree of policy improvement, and the certainty of achieving overall improvement, that would result from enacting 1986-style corporate tax reform. My skepticism would decline somewhat if the enactment of significantly lower corporate rates were accompanied by the enactment of a more effective labor-capital income centrifuge in the corporate tax. And it would decline further if accompanied by significant improvements to the U.S. tax rules for FSI, although this article only very briefly addresses how those improvements might be defined.