

Tax Reform

Advancing America in the Global Economy

OCTOBER 2015



Tax Reform Will Boost U.S. Growth, Jobs, Wages and Competitiveness

In *Tax Reform: Advancing America in the Global Economy*, Business Roundtable compared the U.S. corporate tax system to those of America's economic competitors.

U.S. Corporate Tax Policy Is Out of Step

- ▶ **14.4 percentage point higher tax rate:** At 39 percent, the U.S. statutory corporate tax rate is the highest among Organisation for Economic Co-operation and Development (OECD) nations and more than 14 percentage points higher than the OECD 24.6 percent average.
- ▶ **Higher than in 1988:** The United States is one of only two OECD countries with a higher statutory corporate tax rate than during the Reagan Administration.
- ▶ **Out of sync:** The United States is the only G7 country with a worldwide tax system on foreign earnings. All of the other G7 countries and 28 of 34 OECD nations use territorial tax systems.

It Is Anticompetitive, Stunts Growth and Hurts Workers

- ▶ **28 percent decline in top U.S.-headquartered companies:** In the face of strong competition from foreign-headquartered companies with more favorable rules, 28 percent fewer U.S.-headquartered companies were in the Global Fortune 500 in 2014 than in 2000.
- ▶ **Up to 2.6 percent reduction in gross domestic product (GDP):** The failure of the United States to keep the corporate tax rate competitive reduces GDP by 1.5 to 2.6 percent.
- ▶ **As much as 75 percent of corporate tax burden borne by workers:** Workers bear up to 75 percent of the corporate tax burden through lower wages — the indirect cost of the U.S. corporate tax system.

Tax Reform Would Boost U.S. GDP, Wages and Investment

In the long run, all Americans would benefit from reforms like those proposed in the 2014 Camp plan.

- ▶ **3.1 percent long-term GDP increase.**
- ▶ **6.1 percent after-tax wage boost** for American workers.
- ▶ **6.8 percent investment jump** from businesses.

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Global Economy

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Statement on Comprehensive Tax Reform

Business Roundtable supports comprehensive tax reform for individuals and all businesses to improve economic growth and provide for a simpler and more efficient tax system. Business Roundtable commends the ongoing efforts to advance tax reform by the House Ways and Means Committee, led by Chairman Paul Ryan (R-WI) and ranking member Sander Levin (D-MI); the Senate Finance Committee, led by Chairman Orrin Hatch (R-UT) and ranking member Ron Wyden (D-OR); and the Administration, led by President Barack Obama and Treasury Secretary Jacob Lew. Business Roundtable urges Congress and the Administration to make tax reform a top priority for legislative action.

Based on the knowledge and experience of most Business Roundtable CEOs, this primer on tax reform focuses on the corporate income tax system and the changes needed to update the corporate income tax to allow American companies and their workers to be competitive in markets both at home and abroad and improve U.S. economic growth, which will result in higher wages and increased job creation in the United States.

Business Roundtable supports modernization of the corporate tax system, including setting a corporate tax rate at a competitive 25 percent and adopting a modern international tax system, financed through broadening of the corporate income tax base and other corporate offsets. Given the need for the U.S. tax system to be competitive with the tax systems of our major competitors, all corporate revenues from base-broadening measures should be dedicated to establishing a modern, internationally competitive corporate tax code.

**A companion summary version of this Business Roundtable publication
is available at brt.org.**

Foreword by Business Roundtable President John Engler

There is broad bipartisan agreement on the need for tax reform. Our current tax system is outdated and anti-competitive. Modernization of our tax system will make our economy more competitive and more productive, resulting in immediate and visible benefits for American families in the form of higher wages and more and better paying American jobs.

There is an urgent need for tax reform. The U.S. corporate tax rate now is the highest among all industrialized countries. Our international tax system is still fundamentally based on rules first adopted in 1909 that tax the worldwide income of American corporations. Virtually all of the other advanced economies — including all other G7 countries and 28 of 34 Organisation for Economic Co-operation and Development countries — have adopted international tax rules that ensure that their own companies are as competitive as possible in the global marketplace. Together our high tax rate and antiquated international tax rules make the U.S. corporate tax system an outlier from the rest of the world, harming the ability of American companies and their workers to compete successfully.

Failure to modernize our nation's tax system has resulted and will continue to result in slower economic growth, with workers' wages growing more slowly and a sustained loss of U.S. competitiveness in the global economy.

The path to modernizing our corporate tax system is clear:

- ▶ Setting a competitive 25 percent corporate rate; and
- ▶ Adopting a modern international tax system that aligns the U.S. system with the tax systems of our major competitors.

These growth-promoting reforms can be adopted in a fiscally responsible manner through appropriate base-broadening measures that eliminate or restrict corporate tax preferences, tax credits and deductions. Base broadening can address existing distortions in the tax code and provide for a more level taxation of diverse economic activities, thereby allowing the nation's capital stock to be invested in a more productive manner and generating greater output. However, given the scale of changes needed for the U.S. tax system to be competitive with the tax systems of our major competitors, all corporate revenues from base-broadening measures will need to be applied toward corporate rate reduction and modernizing our international tax system.

This primer provides an overview of the important issues that tax reform must address and the clear benefits to the U.S. economy from undertaking reform. A modernized business tax system, with permanent and certain rules, will allow American companies to better compete at home and abroad. The net result will be a tax system that promotes economic growth through greater investment, higher wages and more jobs in the United States.

It is time for Congress and the Administration to act with urgency. Each year of delay has resulted in slower U.S. economic growth, stagnating wages and fewer job opportunities for American workers. At the same time, our anti-competitive system continues to give our trading partners an advantage in global markets.

But with determined effort, we can reform our tax system and be on a path to a healthier and more prosperous America. Business Roundtable urges Congress and the Administration to undertake and enact tax reform. Now!

Leaders of Both Parties Call for Tax Reform

“[T]oday our companies face the highest corporate tax rate in the world. ... It distorts our allocation of capital. It makes us less competitive relative to businesses that are headquartered overseas. We need to fix that.”

President Barack Obama

“We want tax reform. It’s critically important for our country. We’ve got a tax system that no one understands, not even the IRS understands. It hurts our economic growth. It hurts our economy. It hurts wages in America.”

House Speaker John Boehner (R-OH)

“If we make our tax code simpler ... we can create more jobs and more take-home pay. ... I believe we can work together to ... create a better system for American job creators—big and small—in the next year.”

*House Ways and Means Committee Chairman
Paul Ryan (R-WI)*

“Some people say that it’s impossible for tax reform to make the tax code simpler and fairer to everybody at the same time. But I don’t buy it. Simplification and fairness are cornerstones of any serious tax reform plan.”

Council of Economic Advisors Chairman Jason Furman

“As we look at our international tax system, our primary goals should be to make the U.S. a better place to do business and to allow American job creators to more effectively compete with their foreign counterparts in the world marketplace. ... Not only must our corporate tax rate come down across the board, we should also shift significantly in the direction of a territorial tax system.”

*Senate Finance Committee Chairman
Orrin Hatch (R-UT)*

“America’s tax code is an economic straitjacket. It’s a burden that businesses and families shouldn’t have to fight. ... What’s needed is a modern tax code that will help boost the nation’s economy, make the U.S. more competitive in the global marketplace, spark innovation and create jobs.”

*Senate Finance Committee Ranking Member
Ron Wyden (D-OR)*

“I continue to believe that the best way to achieve reform today is to start with pro-growth business tax reform that protects and strengthens the middle class, lowers rates, simplifies the system, levels the playing field, and eliminates unfair and inefficient loopholes.”

Treasury Secretary Jacob Lew

America needs tax reform.

Overview

Fast Facts

- ▶ The Organisation for Economic Co-operation and Development (OECD), a group of 34 advanced industrialized countries including the United States, calls the corporate income tax the most harmful type of tax for economic growth.
- ▶ Thirty-one of the 34 OECD countries have reduced their corporate tax rates since 2000; the United States is one of only two OECD countries with a higher statutory corporate tax rate today than in 1988.
- ▶ The United States now has the highest corporate tax rate among industrialized countries. Among all countries, only the United Arab Emirates and Chad have higher tax rates. Numerous studies also show that American companies on average have higher effective tax rates than their foreign competitors.
- ▶ The United States is the only G7 country to maintain a worldwide tax system on earnings from foreign markets; all other G7 countries and 28 of the 34 OECD countries use territorial tax systems.

Countries around the world have been focused on lowering their corporate tax rates and providing modern international tax rules to increase economic growth and job opportunities for their citizens. The United States stands as an exception to this worldwide trend at a time when U.S. businesses face unprecedented global competition.

Tax policy outside the United States reflects the growing recognition that a competitive corporate tax system plays an essential role in the dynamism of a nation's economy, its job growth and its workers' standard of living. Job creation depends on a vibrant private sector engaged in investing, hiring and innovating. The increased productivity resulting from private investment generates higher wages that allow each generation to achieve a higher standard of living.

Since the 2007–09 recession, the economy has grown slowly, with real growth of the economy averaging only a little more than 2 percent per year — nearly 1 percentage point lower than the prior 40 years. Median wages have been stagnant since 1980, growing an inflation-adjusted 0.3 percent per year. With years of below-average economic growth, policies that improve wage growth, create jobs and make the nation's economy more internationally competitive must be a top priority. Economic growth also plays a vital role in reducing the federal budget deficit and helping state and local governments. A sustained annual increase in U.S. economic growth of 1 percentage point is estimated to reduce the federal budget deficit by \$3.3 trillion over the next 10 years.¹

The United States is in urgent need of comprehensive tax reform to grow the U.S. economy and improve the well-being of all Americans.

Figure 1

OECD Combined National and Subnational Corporate Tax Rates, 2015

Combined national and subnational top corporate tax rate

Rank in 2015		Rate in 2015	Enacted or proposed changes
1	United States	39.0	
2	France	34.4	
3	Belgium	34.0	
4	Japan	32.1	31.3
5	Germany	30.2	
6	Australia	30.0	28.5
7	Mexico	30.0	
8	Portugal	29.5	27.5
9	Luxembourg	29.2	
10	New Zealand	28.0	
11	Spain	28.0	25.0
12	Italy	27.5	
13	Norway	27.0	
14	Israel	26.5	
15	Canada	26.3	
16	Greece	26.0	
17	Austria	25.0	
18	Netherlands	25.0	
19	South Korea	24.2	
20	Denmark	23.5	22.0
21	Chile	22.5	25–27*
22	Slovak Republic	22.0	
23	Sweden	22.0	
24	Switzerland	21.1	
25	Estonia	20.0	
26	Finland	20.0	
27	Iceland	20.0	
28	Turkey	20.0	
29	United Kingdom	20.0	18.0
30	Czech Republic	19.0	
31	Hungary	19.0	
32	Poland	19.0	
33	Slovenia	17.0	
34	Ireland	12.5	
OECD average, excluding United States		24.6	

Sources: OECD Tax Database (April 2015) and country updates.

*Beginning in tax year 2017, taxpayers in Chile may elect to be taxed under the "Attributed Income System" with a top tax rate of 25 percent or the "Partially Integrated System" with a top tax rate of 25.5 percent (27 percent in 2018).

Corporate Tax Rate

At 39 percent, the combined U.S. federal and state statutory corporate income tax rate is higher than the rate in any other country in the OECD. The U.S. rate is 14.4 percentage points higher than the 24.6 percent average rate of other OECD countries in 2015 (**Figure 1**).

The U.S. corporate tax rate is more than triple the tax rate of Ireland, nearly double that of the United Kingdom and 60 percent higher than the average of the other OECD countries. Globally, only the United Arab Emirates and Chad have higher corporate tax rates than the United States.²

In 1986, the last time there was a major overhaul of the U.S. tax system, the United States lowered the top federal corporate tax rate from 46 percent to 34 percent, bringing the United States from one of the higher taxed countries in the industrialized world to one of the lowest.

However, increased recognition of the importance of a pro-growth corporate tax system has led the rest of the world to reduce corporate tax rates since then, while the United States largely has stood still.

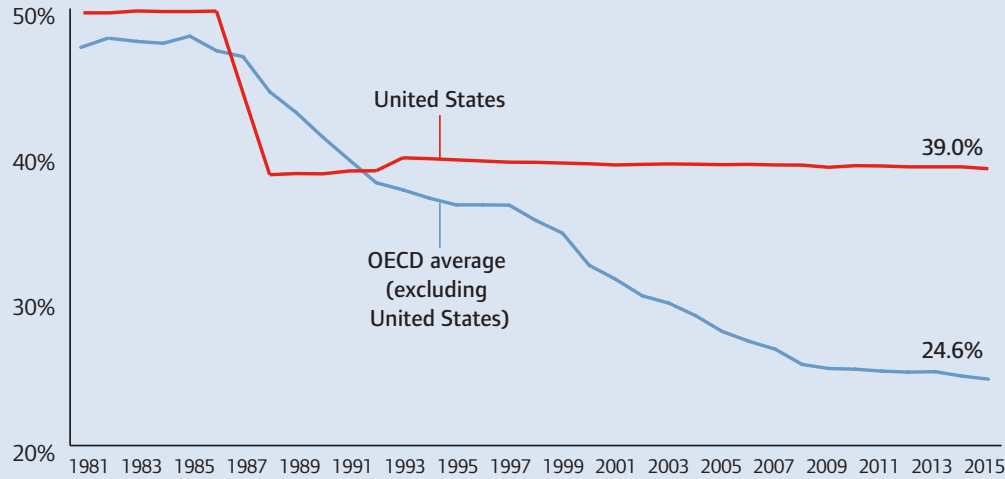
Since 1988, the average OECD corporate tax rate has dropped more than 19 percentage points, while the U.S. combined rate has increased, largely due to a 1 percentage point increase in the federal rate in 1993 (**Figure 2**).

Countries like Austria, Denmark, Finland, Germany, Norway and Sweden have cut their corporate tax rates by half since the late 1980s. After a series of rate cuts, Canada today has a federal corporate tax rate of 15 percent and, together with provincial taxes, has a combined average rate of approximately 26 percent. The United Kingdom has reduced its corporate rate from 30 percent in 2007 to 20 percent in 2015, with further scheduled reductions to 18 percent. Japan — which formerly had the highest corporate tax rate in the OECD — began a series of reductions starting in 2012 and has enacted further rate reduction to take effect in 2016.

Figure 2

U.S. and Average OECD Statutory Corporate Tax Rates, 1981–2015

Combined national and subnational top corporate tax rate



Since 1988, the average OECD statutory corporate tax rate (excluding the United States) has fallen by over 19 percentage points, while the U.S. combined corporate tax rate has increased.

Source: OECD Tax Database (April 2015).

The current U.S. rate is based on the 35 percent federal tax rate and average state tax rates of 6.15 percent. Because state taxes are deductible from federal taxes, the net combined tax rate is 39 percent.

International Taxation

Another significant trend since the 1990s has been the increasing use by other developed countries of international tax systems that are more supportive of selling and competing in the global marketplace. Today, the United States stands as an outlier in the manner in which it taxes cross-border corporate earnings. The United States is the only G7 country to use a worldwide tax system, which imposes tax on the active foreign earnings of its corporations when the earnings are remitted home as a dividend. The other G7 countries and 28 of the 34 OECD countries use territorial tax systems that generally exempt from domestic taxation active foreign earnings remitted home as a dividend (**Figure 3** on page 4). The number of OECD countries with territorial tax systems has tripled since 1990 and doubled since 2000.³

The U.S. worldwide tax rules date to the founding of the corporate income tax system in 1909. These rules were modified along the way, but they still are premised on the taxation of foreign earnings from active business operations when those earnings are brought home to the United States.

In the immediate post-World War II era, American companies were dominant players in global commerce, and unfavorable tax rules had less impact. But today American companies find themselves in steep competition as foreign-headquartered companies now undertake the majority of cross-border investment.

Cross-border trade and investment have given companies headquartered in any part of the globe the opportunity to expand into new consumer markets anywhere else in the world through both exports and local investment. This freedom of trade and investment has brought American products and services to billions of new consumers.

Figure 3

Taxation of Foreign-Source Dividends, OECD Countries, 2015

Combined national and subnational top corporate tax rate

Method of taxation	Countries	Dividend exemption percentage														
Territorial Tax Systems Exempt foreign-source dividends from domestic income taxation through territorial tax system*	Australia, Austria, Canada, Czech Republic, Denmark, Estonia, Finland, Greece, Hungary, Iceland, Luxembourg, Netherlands, New Zealand, Poland, Portugal, Slovak Republic, Spain, Sweden, Turkey, United Kingdom	100% exemption														
	Norway	97% exemption														
	Belgium, France, Germany, Italy, Japan, Slovenia, Switzerland	95% exemption														
Worldwide Tax Systems Worldwide system of income taxation with deferral and foreign tax credit	<table border="1"> <thead> <tr> <th>Country</th> <th>2015 Tax Rate**</th> </tr> </thead> <tbody> <tr> <td>Chile</td> <td>22.5%</td> </tr> <tr> <td>Ireland</td> <td>12.5%</td> </tr> <tr> <td>Israel</td> <td>26.5%</td> </tr> <tr> <td>Mexico</td> <td>30.0%</td> </tr> <tr> <td>South Korea</td> <td>24.2%</td> </tr> <tr> <td>United States</td> <td>39.0%</td> </tr> </tbody> </table>	Country	2015 Tax Rate**	Chile	22.5%	Ireland	12.5%	Israel	26.5%	Mexico	30.0%	South Korea	24.2%	United States	39.0%	0% exemption
	Country	2015 Tax Rate**														
	Chile	22.5%														
	Ireland	12.5%														
	Israel	26.5%														
	Mexico	30.0%														
	South Korea	24.2%														
United States	39.0%															

* Territorial tax treatment providing exemption of foreign-source dividends often depends on qualifying criteria (e.g., minimum ownership level, minimum holding period, the source country, income tax treaty status and/or the source country tax rate).

** Refers to generally applicable tax rate, including surcharges, of combined central and subcentral government taxes.

At the same time, these forces have increased business competition. American and foreign corporations now actively pursue the same markets, both within the United States and around the world.

Heightened global competition facing American companies

The increase in global competition facing American companies is reflected in a variety of statistics. To take just one measure, in 1960, American companies comprised 17 of the top 20 global companies ranked by sales. In 1985, the top 20 still included 13 American companies. In 2014, the latest data show just six American companies in the top 20.⁴

With the growth of strong competition around the world, American companies now find that their closest foreign competitors are based in countries with corporate tax rates that are lower than the U.S. rate and with international tax systems that are more favorable to their global operations than the U.S. rules. In fact, of the 14 non-U.S. companies on Fortune's 2014 global top 20 list, 10 were headquartered in countries that use territorial tax systems. Of the remaining four, three were state-owned companies headquartered in China, and the other was headquartered in South Korea, which has a 24.2 percent combined national and subnational tax rate. Within the OECD, 90 percent of the non-U.S. companies in the Global Fortune 500 in 2014 were headquartered in countries that use territorial tax systems (**Figure 4**).⁵ Reflecting the increasing use of territorial systems around the world, in 1995 only 27 percent of the non-U.S. OECD companies in the Global Fortune 500 were headquartered in territorial countries.⁶

Other countries have responded to the growing importance of cross-border investment by adopting territorial tax systems to strengthen, attract and retain the headquarters operations of multinational corporations. Under these territorial systems, companies can compete on a level playing field with other companies in foreign

markets and return these earnings home for reinvestment without incurring an additional layer of tax. Reforming the U.S. international tax system to provide similar rules for American companies would enhance the global competitiveness of American-headquartered companies and strengthen the U.S. economy by removing barriers to returning foreign earnings for investment in the United States.

The ability for globally engaged American companies to be successful in world markets contributes to success at home. U.S.-headquartered companies with international operations employed 23.1 million workers in the United States in 2012 and, including their supply networks and spending by their employees, supported nearly 72 million U.S. jobs.⁷ Domestic employment by U.S.-parented companies accounted for nearly two-thirds of their worldwide employment. The average annual compensation paid in 2012 by American parent companies to their American workers was \$76,538, 34 percent higher than for other U.S. businesses.⁸

The Case for Corporate Tax Reform

A robust U.S. economy depends on strong American companies growing at home and abroad, as well as foreign-headquartered companies entering the U.S. market through U.S. investments employing American workers.

In many ways, however, the U.S. corporate tax system today works against the U.S. economy. Our high corporate tax rate discourages investments by American and foreign-headquartered companies in the United States. Our outdated system of international taxation also raises the cost to American companies of competing globally and returning earnings for investment at home, causing American companies to be less competitive both in foreign markets and at home.

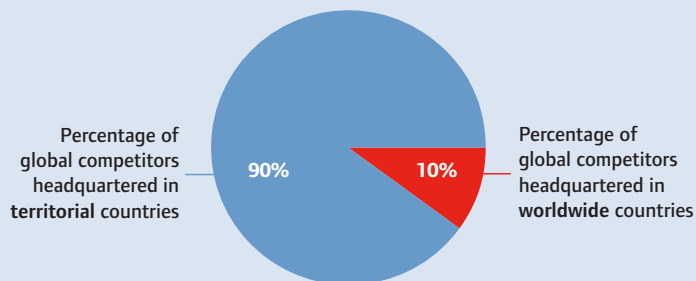
The combined effect of our high corporate tax rate and outdated international tax system is to slow the growth of the U.S. economy and create fewer and lower paying jobs for American workers.

Corporate tax reform to modernize our tax system will enhance U.S. economic growth, increase U.S. investment, and provide for better and higher paying jobs. A competitive corporate tax rate and a more modern and competitive international tax system will provide a level playing field for American-based businesses, increasing the growth of U.S. companies, attracting investment to the United States, and enhancing and sustaining U.S. economic growth and job creation.

Figure 4

Global Competitors of American Companies Predominantly Headquartered in Territorial Countries

Headquarters location of non-U.S. OECD companies in the Global Fortune 500, 2014



Source: Fortune (2014).

I. Higher Wages, Better Jobs and Increased Economic Growth Through Corporate Tax Reform

Fast Facts

- ▶ The corporate income tax is recognized by the Organisation for Economic Co-operation and Development (OECD) as the most harmful type of tax for economic growth.
- ▶ The burden of the corporate income tax falls on Americans in their roles as workers, consumers and savers — corporations merely serve as tax collectors.
- ▶ A growing body of evidence finds that workers bear 20 to 75 percent of the corporate tax burden through lower wages.
- ▶ Treasury Department analysis finds that lower- and median-income families face a greater burden from the corporate income tax than from the individual income tax.
- ▶ Corporate tax reform can increase economic growth and the living standards of Americans by increasing investment, raising wages and boosting job creation in the United States. The failure of the United States to keep our corporate rate competitive with other countries reduces wages by 1.0 to 1.2 percent and reduces gross domestic product (GDP) by 1.5 to 2.6 percent.

Economic growth is the means by which Americans achieve rising living standards. This growth depends on greater investment and technological innovation, which increase the productivity of American workers and lead to higher wages. A growing economy creates more and better paying employment opportunities for all Americans.

High Corporate Income Taxes Restrain Economic Growth

The corporate tax system primarily affects economic growth by reducing investment and entrepreneurial risk-taking in the economy. Business investment encompasses a range of forward-looking expenditures, including investments in tangible capital, such as machinery and equipment, as well as investments in intangible capital, such as research and development (R&D). These risk-taking investments require an upfront expenditure of funds today in expectation of future profits.

Corporate income taxes affect both the amount and the location of business investment. The corporate income tax drives a wedge between the *pretax* and *after-tax* profitability of a given investment. Since corporations will choose to invest in projects with the highest *after-tax* rates of return, differences in corporate income taxes across countries can play an important role in the amount of business investment undertaken in each country. While many factors affect the location of business investment, including proximity to consumers and costs of production, the evidence suggests that business location decisions have become more sensitive to differences in taxation.⁹

Growth in wages and the overall economy can be enhanced by reducing the level of taxation and establishing a tax system that provides for greater certainty and predictability. A tax system with stable and permanent rules reduces risks for businesses making long-term investments.

A vast analysis of the corporate income tax in countries around the world — both industrialized and developing countries — finds that the corporate income tax reduces economic growth, worker productivity, domestic investment by domestic and foreign companies, and entrepreneurship.¹⁰

These research findings have led the OECD to call the corporate income tax *the most harmful type of tax for economic growth*:

*Corporate income taxes are the most harmful for growth as they discourage the activities of firms that are most important for growth: investment in capital and productivity improvements.*¹¹

Countries around the world have been reducing their corporate tax rates and undertaking tax reform to provide for greater economic growth and increased national competitiveness. Tax systems that rely less on corporate income taxes can enhance economic growth, as can reforms that implement the corporate income tax more efficiently.

Recent studies show that growth-enhancing impacts from tax reform can provide significant economic benefits. One study finds that the failure of the United States to keep our corporate rate competitive with other countries reduces wages by 1.0 to 1.2 percent and reduces GDP by 1.5 to 2.6 percent.¹² Even larger economic benefits were estimated in an analysis of the rate-reduction and base-broadening tax reform legislation proposed by then-House Ways and Means Committee Chairman Dave Camp in 2014 (**Box 1** on page 9).

Corporate Income Taxes Reduce Labor Income

Because the corporate income tax is collected from corporations rather than from individuals, a common misperception is that the tax is borne by corporations. However, corporations are merely legal entities. The corporate tax is a hidden tax that falls on individuals in some manner in their roles as workers, consumers and savers. How exactly the burden is shared among individuals in these roles has been a matter of long-standing economic study.

As noted by Laura Tyson, the top economic adviser to former President Bill Clinton:

*For many years, the conventional wisdom was that the corporate income tax was principally borne by the owners of capital in the form of lower returns. Now, with more mobile capital, workers are bearing more of the burden in the form of lower wages and productivity as investments move around the world in search of better tax treatment and higher returns.*¹³

A number of recent studies find that workers bear between 20 and 75 percent of the burden of the corporate income tax (**Box 2** on page 10). The Joint Committee on Taxation (JCT), the Congressional Budget Office (CBO) and the Treasury Department each assess that a portion of the corporate income tax is borne by labor.¹⁴ Treasury Department analysis, while assuming that less of the corporate tax burden falls on workers than many academic studies, still finds that lower- and median-income families on average face a greater burden from the corporate income tax than from the individual income tax.¹⁵

Implications for tax reform

The findings of these studies suggest that reforms that reduce the burden of the corporate income tax would provide significant benefits to workers through higher wages. As Laura Tyson states, “A high corporate tax rate not only undermines the growth and competitiveness of American companies; it is also increasingly ineffective as a tool to achieve more progressive outcomes in the taxation of capital and labor income.”¹⁶ The nearly 50 percent of all American families who own corporate stock directly or through investments in mutual funds and tax-deferred retirement accounts, including employer-sponsored retirement plans such as 401(k) plans, would also benefit from corporate rate reduction.¹⁷ Approximately two-thirds of 401(k) plan balances are invested in equities.¹⁸ Additionally, state and local government defined benefit plans have 37 percent of their assets invested in corporate stocks.¹⁹

Corporate Tax Reform Promotes Economic Growth

With years of below-average economic growth, policies that improve wage growth, create jobs and make the nation’s economy more internationally competitive must be a top priority. A competitive tax environment for America’s job creators is essential to providing the conditions to foster job creation, investment and economic growth. In summary, corporate tax reform to increase investment and employment in the United States is a vital component of needed policy changes.

Economic Growth from Tax Reform

In 2014, then-Chairman of the House Ways and Means Committee Dave Camp introduced H.R. 1, the Tax Reform Act of 2014, a comprehensive reform of the corporate and individual income tax systems, which lowered tax rates for both businesses and individuals and broadened the tax base by reducing or eliminating a large number of tax preferences.

For corporations, the legislation reduced the top federal corporate rate to 25 percent, financing this rate reduction with the elimination of a wide range of business tax preferences. The legislation also modernized the U.S. international tax rules along the lines of the tax systems used by most other developed countries, while slightly increasing tax revenues.

For individuals, the legislation provided lower tax rates, with a new two-rate basic structure of 10 percent and 25 percent, supplemented by a 35 percent bracket on certain forms of income. To offset the cost of individual rate reduction, the legislation eliminated or reduced many individual tax preferences.

An analysis of the macroeconomic impacts of the legislation by the Joint Committee on Taxation estimated an increase in gross domestic product (GDP) of up to \$3.4 trillion over the 10-year budget period (1.6 percent of forecast GDP).

An independent macroeconomic study of the legislation was conducted for Business Roundtable by Rice University professors John Diamond and George Zodrow.²⁰ The Diamond-Zodrow analysis finds that the legislation would:

- ▶ Increase annual GDP by 0.9 percent two years after enactment, by 2.2 percent after 10 years and by 3.1 percent in the long run;
- ▶ Boost after-tax wages for American workers by 2.3 percent after two years, by 3.8 percent after 10 years and by 6.1 percent in the long run; and
- ▶ Increase business investment by 1.8 percent after two years, by 6.5 percent after 10 years and by 6.8 percent in the long run.

Higher wages would increase living standards for current and future generations, boosting consumption by 1.6 percent after two years and by 4 percent in the long run. Extra tax revenue resulting from economic growth would allow the corporate tax rate to be reduced to 20 percent with no loss in overall tax revenue.

Former Chairman Camp's proposal is just one example of the significant improvements in U.S. economic growth and American living standards that is achievable through tax reform.

How Much of the Corporate Income Tax Burden Falls on Workers?

Researchers examining the burden of the corporate income tax find across a wide range of settings that workers bear a substantial share of the corporate income tax burden, with several studies concluding that between half and three-quarters of the burden is borne by labor.

- ▶ An analysis of the U.S. corporate income tax by the Congressional Budget Office (CBO) finds that labor bears more than 70 percent of the burden of the corporate income tax, with the remaining 30 percent borne by domestic savers through a reduced return on their savings.²¹
- ▶ Based on a range of empirical and theoretical studies analyzing the incidence of the corporate income tax, a 2007 Treasury Department review concludes that labor “may bear a substantial portion of the burden from the corporate income tax.”²²
- ▶ A study by American academic economists of the wages paid by American multinational companies operating in more than 50 countries concludes that labor bears 57 percent of the burden of the U.S. corporate income tax, with estimates ranging between 45 and 75 percent.²³
- ▶ A study by European researchers of more than 55,000 companies in nine European countries concludes that workers bear approximately half of the burden of the corporate income tax in the long run.²⁴
- ▶ A study by researchers at the National Bureau of Economic Research of state corporate income tax rate differences in the United States finds that unionized workers bear 54 percent of the burden of higher state corporate income taxes.²⁵
- ▶ An academic study based on U.S. data estimates that labor bears 60 to 80 percent of the burden of the U.S. corporate income tax.²⁶
- ▶ Noted public finance economist Arnold Harberger estimates that with worldwide mobility of capital 96 to 130 percent of the U.S. corporate income tax burden falls on labor.²⁷
- ▶ A study by economists at the American Enterprise Institute concludes that each \$1 increase in U.S. corporate income tax collections leads to a \$2 decrease in wages in the short run and a \$4 decrease in aggregate wages in the long run. This study implies that workers bear more than 100 percent of the burden of the corporate income tax. The authors believe that the large decline in wages in the long term is due to reductions in investment that reduce worker productivity. These reductions are not observable in studies focusing on short-run changes in tax rates.²⁸

The CBO, the Joint Committee on Taxation and the Treasury Department each assume that a portion of the corporate income tax is borne by workers in the form of lower wages.

II. Competitiveness in the Global Economy

Fast Facts

- ▶ Global trade and cross-border investment represent an increasing share of worldwide economic activity, with trade rising by more than 50 percent and cross-border investment rising sevenfold relative to world output since 1980.
- ▶ The U.S. economy benefits from global engagement through increased exports of goods and services and earnings from foreign markets, with nearly 72 million U.S. jobs supported by globally engaged companies and their supply chains.
- ▶ However, the global market share of American-headquartered companies is declining in the face of strong competition from foreign-headquartered companies with more favorable tax rules. The number of U.S.-headquartered companies in the Global Fortune 500 declined 28 percent between 2000 and 2014.
- ▶ Of the non-U.S. OECD companies in the Global Fortune 500 in 2014, 90 percent are headquartered in countries that use more favorable territorial tax systems, and all have a lower home-country corporate tax rate.
- ▶ One study estimates that if the United States had provided a 25 percent U.S. federal corporate tax rate over the past 10 years, this reform would have increased U.S. acquisitions of foreign companies and reduced foreign acquisitions of U.S. companies by \$769 billion.

The U.S. economy still is the envy of the world. But the significant economic advantage the United States had in the last century — dubbed by some the American Century — has begun to wane. While once the United States could make policy decisions with little concern for global competitiveness, today we no longer have that luxury.

Advances in telecommunications, lower costs of transport, improvements in infrastructure, falling trade barriers and the adoption of market-based economies throughout the world have brought the world's populations closer together while heightening economic competition. These new markets bring enormous opportunities for America's economy, businesses and workers. At the same time, expanding production by foreign-based companies has resulted in enhanced competition at home and abroad.

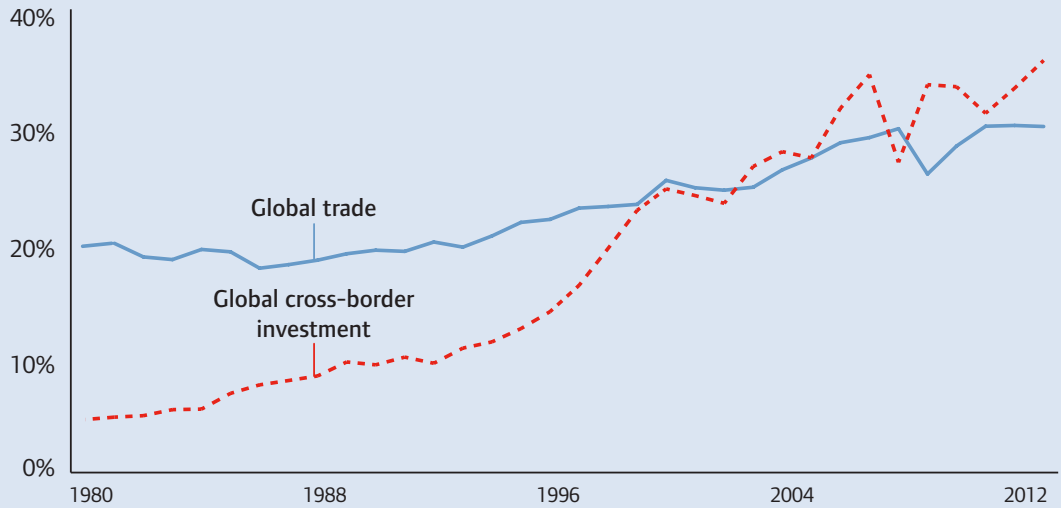
Global Trade and Investment Is Increasingly Important to World Economies

The growing global interconnections of the world's economies are evident in our daily life. Global trade has increased from 20 percent of world output in 1980 to 30 percent in 2013. Global cross-border investment has increased even more rapidly, rising from 5 percent of world output in 1980 to 36 percent in 2013 (**Figure 5** on page 12).

Figure 5

Increasing Importance of World Trade and Investment to Global Economies, 1980–2013

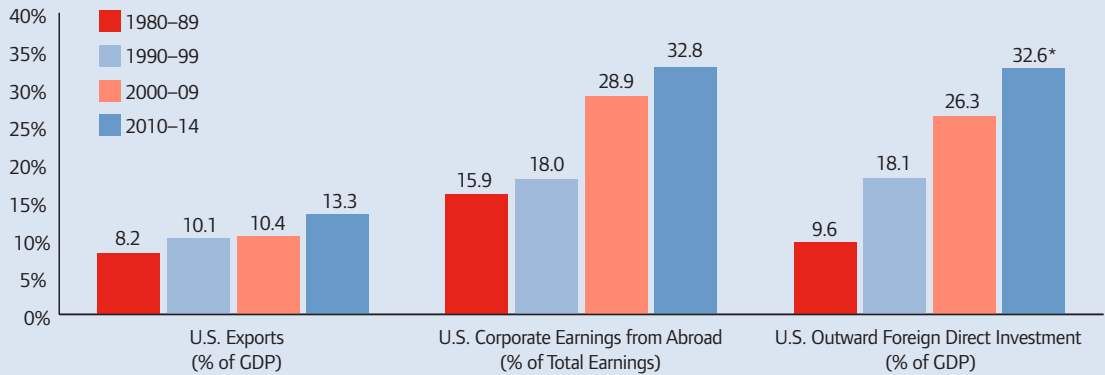
World trade and foreign direct investment as a percentage of world GDP



Sources: World Bank World Development Indicators for trade data and United Nations Conference on Trade and Development statistics database for foreign direct investment.

Figure 6

Global Markets Provide an Increasing Benefit to the U.S. Economy, 1980–2014



*2014 data for U.S. outward foreign direct investment are not yet available (2010–13 shown).

Sources: Bureau of Economic Analysis, National Income and Products Accounts Tables 1.1.5 and 6.16 for data on corporate profits and exports as a share of GDP; United Nations Conference on Trade and Development statistics database for foreign direct investment.

The United States also has increased participation in global markets over this period, expanding both trade and foreign direct investment relative to U.S. GDP (**Figure 6**):

- ▶ Exports of goods and services have increased to an average of 13.3 percent of GDP in 2010–14, up from an average of 8.2 percent of GDP in the 1980s.²⁹
- ▶ The share of total corporate earnings from abroad has increased to an average of 32.8 percent in 2010–14, up from an average of 15.9 percent in the 1980s.³⁰
- ▶ Foreign direct investment by American companies has increased to an average of 32.6 percent of GDP in 2010–13 (the most recent years for which data are available), up from an average of 9.6 percent of GDP in the 1980s.³¹

U.S. Share of World Exports and Foreign Investment Is in Decline

Despite the increased importance of foreign markets to the U.S. economy, American companies have not kept pace with expanding global markets.

In 2013, exports from the United States accounted for about 9.7 percent of world exports, down from 17 percent in 1960. U.S. outward investment as a share of worldwide cross-border investment has declined even more significantly. In 2013, outward foreign direct investment from the United States accounted for about 24 percent of global cross-border investment, down from 39 percent in 1980 (**Figure 7**). With American companies responsible for a smaller share of world exports and cross-border investment, the U.S. economy is losing its share of the global marketplace to foreign competitors.



American companies account for a declining share of the Global Fortune 500

The declining relative importance of American companies in the world economy also is reflected in the rankings of the largest companies in the world. In 1960, American companies comprised 17 of the top 20 global companies ranked by sales. In 2014, the latest data show just six American companies in the top 20.³²

Figure 8

Global Fortune 500 Winners and Losers, 2014 vs. 2000

Country	Number of companies on Global 500		Change (decline or gain)
	2014	2000	
LARGEST DECLINES			
United States	128	179	-51
Japan	57	107	-50
United Kingdom	27	38	-11
Germany	28	37	-9
France	31	37	-6
LARGEST GAINS			
China	95	10	85
India	8	1	7
Russia	8	2	6
South Korea	17	12	5
Brazil	7	3	4
Netherlands	12	8	4
Taiwan	5	1	4

Source: Fortune (2014 and 2000).

Among the companies listed in the Global Fortune 500, the number of U.S.-headquartered companies declined 28 percent between 2000 and 2014, from 179 to 128. The countries with the largest number of additions to the top 500 global companies over this period include the so-called BRICs: China added 85, India added seven, Russia added six and Brazil added four (**Figure 8**). In 2014, China was second to the United States in the number of companies in the top 500, up from 14th in 1995. Within the next 10 years, China is expected to be home to more companies with revenue of \$1 billion or more than either the United States or Europe.³³ Worldwide by 2025, nearly half of the world's companies with revenue of \$1 billion or more are expected to be headquartered in emerging markets.³⁴

While taxes are just one reason for the declining number of U.S.-headquartered companies, one study estimates that if the United States had provided a 25 percent U.S. federal corporate tax rate over the past 10 years, this reform would have increased U.S. acquisitions of foreign companies and reduced foreign acquisitions of U.S. companies by \$769 billion and resulted in the creation and retention of 1,300 U.S.-headquartered companies.³⁵

Emerging Markets Provide New Opportunities for American-Produced Goods and Services

Growth of the emerging market economies will increasingly offer new markets for American-produced goods and services — 95 percent of the world's population growth over the next decade is forecast to be in emerging markets, with increasing spending by their middle-class populations relative to developed countries.³⁶ Worldwide, each year for the next 10 years population growth and income growth will add an average of 120 million people to the world's consumer class — that is, consumers with sufficient income beyond that required for basic needs.³⁷

Annual consumption in emerging markets alone is expected to grow to \$30 trillion over the next 10 years, nearly three times annual consumption spending in the United States today (**Figure 9**).³⁸ By 2025, consumption spending in emerging markets will represent nearly half of worldwide spending.

American companies compete in these emerging markets with both locally headquartered companies and multinational companies headquartered in other developed countries. Within the OECD, 90 percent of the non-U.S. companies in the 2014 Global Fortune 500 are headquartered in countries that use more favorable territorial tax systems, and all have a lower home-country corporate tax rate.³⁹ In 1995, only 27 percent of the non-U.S. OECD companies in the Global Fortune 500 were headquartered in territorial countries, demonstrating the rapid global shift to territorial systems over the last 20 years.

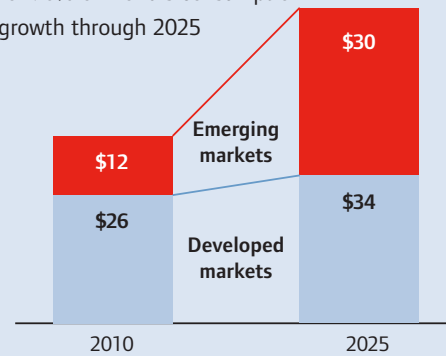
This heightened world competition makes U.S. corporate tax policy more important than ever. American companies require an internationally competitive tax system to compete on a level playing field with their fiercest global competitors in markets at home and abroad. Wherever American companies compete abroad, they are virtually certain to be facing off against foreign companies with more favorable tax rules. Corporate tax rules that hinder the competitiveness of American companies disadvantage American workers and undermine the strength of the U.S. economy.

Figure 9

Consumption Growth in Emerging Countries Dominates Growth of Developed Markets, 2010–25

(Trillions of dollars)

Emerging markets to account for 70% of world's consumption growth through 2025



Source: McKinsey & Company (2012).

III. The U.S. Corporate Tax System at a Glance

Fast Facts

- ▶ Business income of C corporations is subject to two layers of tax — first under the corporate income tax and a second time when earnings are paid out as a dividend to shareholders under the individual income tax.
- ▶ The top combined federal corporate and individual tax rate on corporate income paid as a dividend is 51.25 percent in 2015, with state and local corporate and individual income taxes paid on top of this.
- ▶ Business income earned by pass-through entities (such as partnerships and S corporations) is taxed directly to their owners under the individual income tax rather than the corporate income tax.
- ▶ Business income of pass-through entities now accounts for the majority of business income of U.S. enterprises, exceeding that earned by C corporations. An average of more than 60 percent of all business income was earned by pass-through entities over the past 15 years.
- ▶ The United States is unique in having such a large pass-through business sector relative to other countries. As a result of the significant amount of U.S. business activity conducted by pass-through businesses, the ratio of corporate income tax to GDP is a misleading indicator of differences in the effective tax rate on corporate income between the United States and other countries.
- ▶ American companies are subject to both a high U.S. statutory tax rate and a high effective tax rate on corporate income relative to companies headquartered in other countries.

Although in popular terminology “business” and “corporation” are often used interchangeably, only certain businesses are subject to the corporate income tax. Most businesses in the United States are organized as pass-through entities, such as partnerships and S corporations. Income of pass-through entities is taxed to the owner of the business, typically under the individual income tax, rather than at the entity level as under the corporate income tax. Only a C corporation (named after Subchapter C of the tax code) is subject to the corporate income tax — a tax that is applied at the entity level separate from any tax levied on the owners of the corporation. Publicly traded corporations are all taxable under the corporate income tax.⁴⁰

Double Taxation of Corporate Income

Dividends paid by a C corporation to its shareholders are subject to a second level of tax at the shareholder — or owner — level. In contrast, income of pass-through entities is subject to only a single level of tax to the owner.

This double taxation of C corporation income increases the cost of capital for C corporations and reduces the ability of C corporations to raise capital and make investments relative to a tax system that applies only a single level of tax. Partial relief from double taxation through a reduction in the maximum individual tax rate on corporate dividends received by shareholders was enacted in 2003 as a temporary measure and was made permanent in 2013. Since 2013, the top statutory tax rate applying to dividend income under the individual income tax has been 20 percent, but combined with other federal income taxes it is as much as 25 percent.⁴¹ Between 2003 and 2012, the top tax rate on dividend income under the individual income tax was 15 percent.

The total tax on corporate income under the federal income tax system is the sum of taxes collected at the corporate level, individual income taxes paid on dividend income and capital gains taxes on corporate shareholdings.

In 2015, the combined tax burden on \$100 of corporate income, the net proceeds of which are distributed as dividends to a shareholder subject to the 20 percent dividend tax rate, is \$51.25 — that is, an effective tax rate of 51.25 percent on corporate distributions. This is the sum of \$35 in corporate income tax (35 percent corporate rate times \$100) plus \$13 in individual income tax collected on the dividend payment (20 percent individual tax rate times \$65 dividend) plus additional amounts collected from the phaseout of itemized deductions and the 3.8 percent Medicare tax on investment income (**Figure 10**).⁴² In addition, state income taxes may apply at both the corporate and individual levels.

Figure 10

Double Tax Collections on Corporate Dividend Payments, 2015

Federal income tax payments on \$100 of corporate taxable income

Item	
Corporate taxable income	\$100.00
Corporate income tax (35%)	\$35.00
After-tax corporate income	\$65.00
Dividend payment	\$65.00
<i>Individual income tax on dividend</i>	
Ordinary rate (20%)	\$13.00
Phaseout of itemized deduction (1.2%)	\$0.78
Medicare tax (3.8%)	\$2.47
Subtotal individual income tax (25%)	\$16.25
Total income tax	\$51.25

Note: Applicable state and local income taxes at the corporate and individual levels are in addition to the above.

The double tax on corporate income gives rise to several inefficiencies that reduce the overall productivity of the economy. First, the double tax creates a disincentive to make investments in corporate activities relative to business activities that can be undertaken in noncorporate form. The double tax thus tends to discriminate against funding large-scale activities that need to raise equity capital in public markets. Second, the double tax encourages the use of debt financing over equity financing since corporate investment financed by debt is effectively taxed once at the level of the lender, rather than twice as under equity finance. Third, the double tax discourages the payment of dividends in favor of retaining earnings for reinvestment by the corporation. By retaining earnings, shareholder-level tax is deferred until dividends are paid out or the shareholder sells shares and realizes capital gains on the appreciated value of the stock.

Efforts to reduce or eliminate the double taxation of corporate income require some form of integration of the corporate and individual tax systems. As described above, partial relief from the double tax under current law is achieved by taxing dividend distributions at reduced rates relative to the ordinary individual tax rate.

One form of integration would provide a deduction for dividends paid by a corporation in a manner similar to the deduction provided for interest payments.⁴³ An alternative approach would be to provide shareholders a credit for taxes paid by corporations on earnings distributed as a dividend.⁴⁴ Other forms of integration would “flow through” all corporate earnings to be taxed at the shareholder level, whether distributed or not, in a manner similar to the taxation of S corporations and partnerships.

Within the OECD, a variety of integration mechanisms are used: Two countries allow corporations to deduct a measure of the cost of equity finance from taxable income; two countries do not tax dividend income received by individuals; seven countries give shareholders full or partial credit for corporate income taxes paid on earnings distributed as a dividend; and a number of countries, including the United States, tax dividend income at a rate less than the ordinary income tax rate.⁴⁵

Corporate Income Tax Payments

Corporate income tax payments in FY 2014 were \$320.7 billion, the third highest level in history, and 10.6 percent of total federal tax receipts.

While the argument has been made that corporate income tax collections have been declining over time relative to the size of the economy, it is important to recognize that since corporate profits vary over the business cycle, corporate income tax payments are quite variable as well.

Corporate income tax payments as a share of GDP reached a low of 1.0 percent in 2009 — the lowest percentage of GDP since 1936. The low percentage in 2009 reflected low profitability from the recession, tax losses and temporary investment incentives providing enhanced accelerated depreciation (partial expensing). Just a few years earlier, in 2006 and 2007, corporate income tax payments as a share of GDP reached 30-year highs. In 2014, corporate income taxes were 1.9 percent of GDP, slightly above the 1.8 percent average of the past 40 years (**Figure 11**).

In addition, an increasing share of business activity is now conducted by pass-through businesses directly subject to tax under the individual income tax rather than under the corporate income tax. Over the past 15 years, net income of corporations averaged less than 40 percent of total business net income, while pass-through businesses accounted for an average of more than 60 percent of business net income.⁴⁶ In contrast, in the 10-year period of 1980–89, corporations earned an average of 70 percent of net business income while pass-through entities earned just 30 percent.

The United States is unique in having such a large pass-through business sector relative to other countries.⁴⁷ As a result of the significant amount of business activity conducted in the United States by pass-through businesses, the ratio of corporate income tax to GDP is a misleading indicator of differences in the effective tax rate on corporate income between the United States and other countries (**Box 3** on page 20).

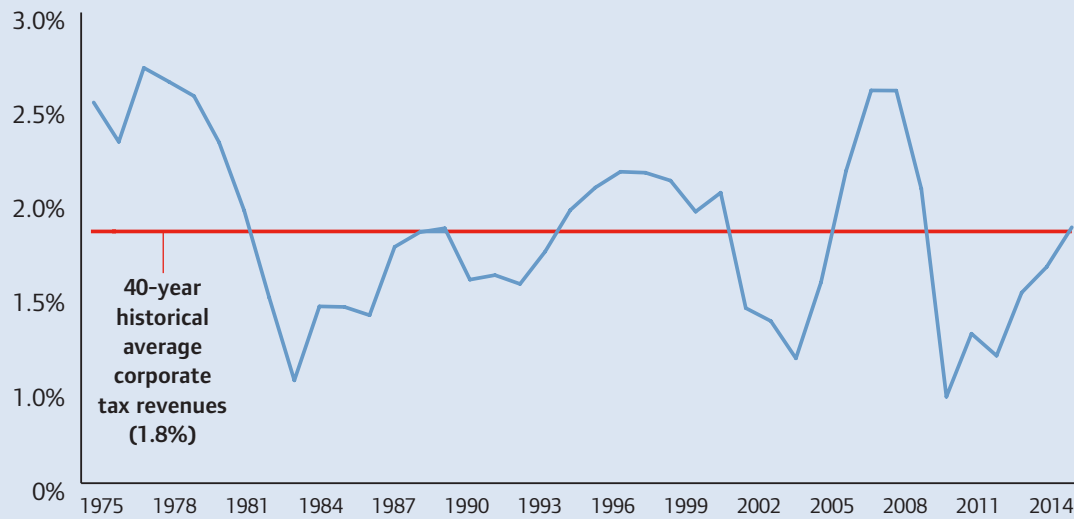
The vast majority of corporate income taxes are paid by America's largest corporations, which earn most of the reported corporate income. In 2012, the most recent year for which detailed data are available, 1.6 million C corporations filed tax returns. Among large corporations, those with assets of \$250 million or more, 7,998 companies filed returns — representing just 0.5 percent of all corporations. This group of one-half of 1 percent of all corporations accounted for 88 percent of the total corporate income tax in 2012 (**Figure 12**).⁴⁸

Among very large corporations, those with assets of \$2.5 billion or more, 1,652 companies filed returns, representing only 0.1 percent of all corporations. This group of one-tenth of 1 percent of all corporations accounted for 70.3 percent of the total corporate income tax in 2012.

This pattern of the vast majority of corporate income tax payments being attributed to the largest companies in America has been relatively constant over the past 10 years and is not due to the recent recession or recent changes in tax law.

Figure 11

Federal Corporate Income Taxes as a Percentage of GDP, 1975–2014



Source: Congressional Budget Office.

Figure 12

Large Companies Pay Nearly All of the Federal Corporate Income Tax

Corporate income tax returns and income tax payments, 2012

Item	All active corporations	Corporations with assets of \$250 million or more	Corporations with assets of \$2.5 billion or more
Number of returns	1,617,739	7,998	1,652
Number of returns as a percentage of all active corporations	100%	0.5%	0.1%
Total income tax after credits	\$267.8 billion	\$234.4 billion	\$188.3 billion
Total income tax after credits as a percentage of all active corporations	100%	87.5%	70.3%

Source: IRS, Statistics of Income Division, Corporation Source Book, 2012 and special tabulations.

Excludes Regulated Investment Companies (1120-RIC), Real Estate Investment Trusts (1120-REIT), and S corporations (1120-S).

It Is Not Just the Statutory Rate — Effective Corporate Tax Rates Also Are High

It is well known that the U.S. statutory tax rate is the highest in the Organisation for Economic Co-operation and Development (OECD), but it is sometimes questioned whether American companies also face a high effective tax.

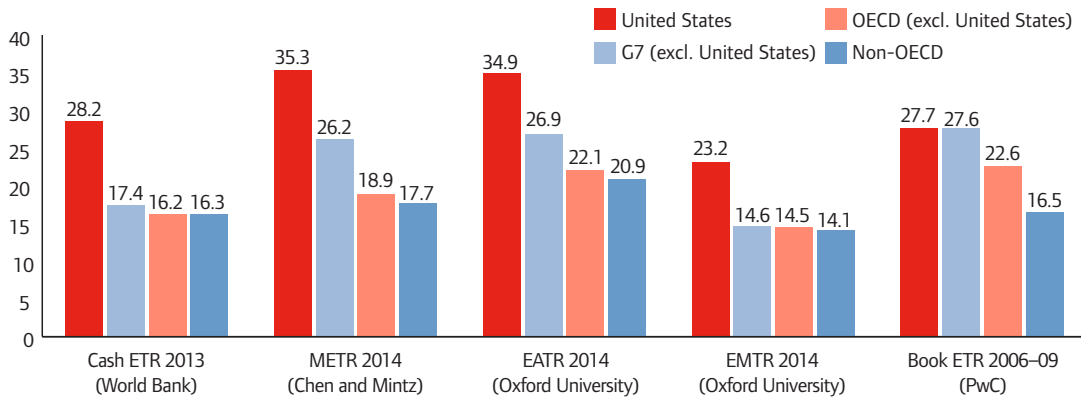
Some commentators have incorrectly claimed that U.S. effective tax rates on corporate income are below average since U.S. corporate income tax collections are a smaller share of GDP than the average of other OECD countries. However, this calculation ignores the larger pass-through sector in the United States relative to other advanced economies.

Studies examining effective tax rates on corporate income generally find that the U.S. effective tax rate is among the highest in the world. Four recent studies of corporate effective tax rates are described here.

- Cash Effective Tax Rates.** A World Bank study of corporate income taxes in 189 countries for 2013 finds that cash tax payments for companies operating in the United States are higher as a percentage of income than the average of other OECD and non-OECD countries.⁴⁹ The U.S. cash effective tax rate of 28.2 percent is **12 percentage points higher** than the average of other OECD countries and nearly **12 percentage points higher** than the average of non-OECD countries. The U.S. cash effective tax rate is the second highest in the G7 and the third highest in the OECD.
- Marginal Effective Tax Rates.** A study by Canadian academics Duanjie Chen and Jack Mintz of the tax rates on new corporate investments in 95 countries for 2014 finds that the U.S. marginal effective tax rate of 35.3 percent is more than **16 percentage points higher** than the average of

Figure 13

Corporate Effective Tax Rates



U.S. ranking of ETR (1 = highest)

	Cash ETR 2013 (World Bank)	METR 2014 (Chen and Mintz)	EATR 2014 (Oxford University)	EMTR 2014 (Oxford University)	Book ETR 2006-09 (PwC)
G7 rank	2	2	1	2	4
OECD rank	3	2	1	4	4

ETR: effective tax rate METR: marginal effective tax rate EATR: effective average tax rate EMTR: effective marginal tax rate

Sources: See discussion within this box for references.

other OECD countries and more than **17 percentage points higher** than the average of non-OECD countries. The marginal effective tax rate reflects all taxes on capital, including income, sales and excise taxes. The U.S. marginal effective tax rate is the second highest within the OECD.⁵⁰

▶ **Effective Average Tax Rates and Effective Marginal Tax Rates.** A study by researchers at Oxford University examines two measures of effective tax rates in 2014 for 46 countries, including all 34 OECD countries.⁵¹ One measure, the effective average tax rate, considers the tax burden on a highly profitable corporate investment. The second measure, the effective marginal tax rate, considers the tax burden on a marginal investment that just breaks even. The study finds that the U.S. effective average tax rate of 34.9 percent is more than **12 percentage points higher** than the average of other OECD countries. The U.S. effective marginal tax rate of 23.2 percent is nearly **9 percentage points higher** than the average of other OECD countries. The United States has the highest effective average tax rate and the fourth highest effective marginal tax rate within the OECD.

▶ **Financial Statement Effective Tax Rates.** Another study, conducted by PwC for Business Roundtable, considers effective tax rates reported for financial statement purposes (“book” effective tax rates) for the four-year period of 2006–09 for the 2,000 largest companies in the world, headquartered in

59 countries, as ranked by the 2010 Forbes Global 2000 list.⁵² The study includes both multinational companies and companies that are entirely domestic. The study finds that the book effective tax rate of U.S. companies of 27.7 percent is more than **5 percentage points higher** than the average of companies based in other OECD countries. The U.S. book effective tax rate is the fourth highest among the 28 OECD countries included in the study. It is worth noting that for U.S. companies (but not their foreign competitors) this high effective tax rate comes with an added economic cost of having their foreign earnings locked out of the United States.

Although not a cross-country comparison, a recent study by the Government Accountability Office (GAO) found surprisingly low effective tax rates for U.S. companies. Using alternative measures, the study found effective tax rates ranging from a low of 12.6 percent to a high of 22.7 percent in 2010.⁵³ An analysis using the same data found that the results for 2010 were not representative of the effective tax rates for a longer period of time, as they were affected by losses and write-downs incurred during the recession.⁵⁴ The analysis also noted methodological issues with GAO’s study, which understated effective tax rates by excluding state and local taxes and foreign income taxes. Using an extended time period and a variety of alternative measures, worldwide effective tax rates of U.S. companies were found to range from a low of 22.0 percent to a high of 37.3 percent.

Taxes on Corporate Income as a Percentage of Total Tax Revenues

The United States relies to a greater extent on both personal and corporate income taxes than do other OECD countries. Including federal, state and local tax collections, corporate income taxes represented 10.2 percent of total U.S. tax collections in 2012.⁵⁵ The average for all other OECD countries was 8.5 percent.

Because of the significant amount of business activity undertaken in pass-through form in the United States, this comparison understates reliance on business taxes in the United States relative to other OECD countries. Unfortunately, comparisons of total business tax collections within OECD countries are not readily available.

However, when all personal income tax collections (including income taxes on wages and other personal income) and corporate income tax collections are combined, they represented 47.9 percent of total tax collections in the United States in 2012. The average for all other OECD countries was 33.2 percent.⁵⁶

Despite the greater reliance on both personal and corporate income taxes in the United States, considering all taxes — including income, payroll, property and consumption taxes — the United States is a relatively low-taxed country. In 2012, total tax collections in the United States relative to GDP were 24.4 percent, placing the United States third lowest in terms of total tax collections as a share of GDP in the OECD.⁵⁷ The average for all other OECD countries of total tax collections relative to GDP was 34.0 percent.

A contributing factor to the greater reliance on income taxation in the United States is its relatively lesser reliance on consumption taxes than in other OECD countries. In the United States, taxes on consumption occur mainly through excise taxes and state and local sales and use taxes. The United States is the only OECD country without a general national-level consumption tax in the form of a goods and services tax or value added tax. In 2012, consumption taxes represented just 17.9 percent of total tax collections in the United States compared to 33.2 percent in other OECD countries.⁵⁸

Goods and services taxes and value added taxes in other countries are rebated to producers on exports and imposed on imports. As a result, unlike the corporate income tax, these taxes do not create a competitive imbalance between businesses that operate within the country and those located abroad. In some countries, tax reforms have reduced corporate income tax collections and simultaneously increased consumption-based taxes as a means of improving economic competitiveness.⁵⁹

IV. Tax Reform: A Competitive Corporate Tax Rate

Fast Facts

- ▶ Thirty-one of the 34 OECD countries have reduced their corporate tax rate since 2000; the United States is one of only two OECD countries with a higher statutory corporate tax rate today than in 1988.
- ▶ A lower corporate tax rate would make the U.S. economy more internationally competitive; increase U.S. jobs, wages and investment; and improve the efficiency of the tax system. According to one academic study, a 1 percentage point decrease in the average corporate tax rate would result in an increase in real U.S. GDP of between 0.4 and 0.6 percent within one year of the tax cut.
- ▶ Studies throughout the OECD, the United States and Canada suggest that corporate rate reduction can result in increases in corporate income and GDP sufficient to make such rate reductions largely self-financing for government revenue collections.

The high U.S. corporate tax rate is an outlier among the world's economies. The high rate deters investment in the United States, reduces economic growth and holds down wages for American workers. A competitive corporate rate is an important instrument for increasing U.S. economic growth and job creation.

President Obama, House Ways and Means Chairman Paul Ryan, Senate Finance Committee Chairman Orrin Hatch, and ranking members Representative Sander Levin and Senator Ron Wyden have all called for tax reform that lowers the corporate tax rate. Corporate rate reduction is included in the bipartisan recommendations of the Senate Finance Committee Tax Reform Working Group on Business Income.⁶⁰ Recent tax reform proposals that would reduce the corporate tax rate include:

- ▶ President Obama's *Fiscal Year 2016 Budget* (February 2015) and *Framework for Business Tax Reform* (February 2012);
- ▶ Former House Ways and Means Chairman Dave Camp's *Tax Reform Act of 2014* (February 2014);
- ▶ Then-House Budget Chairman Paul Ryan's *FY 2015 House Budget Resolution*; and
- ▶ Senator Ron Wyden's and Senator Dan Coats' *Bipartisan Tax Fairness and Simplification Act* (April 2011).⁶¹

Bipartisan commissions proposing tax reform to lower the corporate tax rate include:

- ▶ The recommendations of the co-chairs of President Obama's National Commission on Fiscal Responsibility and Reform, former Senator Alan Simpson and former White House Chief of Staff Erskine Bowles (December 2010);⁶² and
- ▶ The recommendations of the Bipartisan Policy Center task force co-chaired by former Senator Pete Domenici and Alice Rivlin (November 2010).⁶³

A lower corporate tax rate would make the U.S. economy more internationally competitive; increase U.S. jobs, wages and investment; and improve the efficiency of the tax system.

A Lower U.S. Corporate Tax Rate Would Make the U.S. Economy More Competitive

As shown in **Figure 1** on page 2, the combined federal and state corporate tax rate of 39 percent is more than 14 percentage points higher than the 24.6 percent average rate in the rest of the OECD — a difference of nearly 60 percent. Other OECD countries have recognized the adverse economic consequences of a high corporate tax rate and have significantly reduced their corporate tax rates over time, with 31 of the 34 OECD countries reducing their corporate rates since 2000. The United States is one of only two OECD countries with a higher corporate tax rate today than in 1988 (when the 1986 tax reform was fully phased in).⁶⁴

To provide the same combined statutory tax rate in the United States as the average of other OECD countries, the U.S. federal tax rate would need to be reduced below 20 percent, given average state income tax rates of 6.15 percent.⁶⁵ If the U.S. federal corporate tax rate were reduced to 25 percent, the combined U.S. corporate tax rate of 29.6 percent would place the U.S. rate 5 percentage points above the OECD average.

A Lower U.S. Corporate Tax Rate Would Increase Investment in the United States

The high corporate tax rate discourages investment in the United States by both American and foreign corporations.

“The headline rate of corporation tax remains the most visible sign of how competitive our country is.”

— U.K. Chancellor of the Exchequer George Osborne, March 21, 2012

While investment also is affected by other features of the corporate tax system, such as accelerated depreciation and tax credits, the corporate tax rate plays an especially significant role in influencing the location of some highly profitable investments.

The difference between the U.S. combined tax rate of 39 percent and the average OECD rate of 24.6 percent means that, after paying taxes on an equal amount of taxable income, a foreign corporation can reinvest an average of 24 percent more than an American company.⁶⁶ For investments with high returns, differences in depreciation allowances between the United States and other countries are unlikely to offset this significant disadvantage.⁶⁷

High-return investments are frequently based on research-intensive and innovative technologies. High-return investments are also likely to be more internationally mobile and especially sensitive to tax rate differences. Reductions in the statutory tax rate can therefore be an important and effective policy tool for attracting these highly desirable investments.⁶⁸ By attracting such investments, corporate tax rate reduction can lead to particularly large productivity gains, as suggested by OECD studies.⁶⁹ These investments benefit the economy by leading to higher worker productivity, higher wages, higher incomes and a rising standard of living over time.

A more competitive corporate tax rate would also increase inward investment into the United States by foreign companies. In 2012, U.S. affiliates of foreign companies employed 5.8 million workers in the United States and accounted for 6 percent of private-sector U.S. GDP.⁷⁰ The U.S. share of the accumulated global value of inward investment has declined from 37 percent in 2000 to 19 percent in 2013.⁷¹

A Lower U.S. Corporate Tax Rate Would Reduce Other Inefficiencies in the Corporate Tax System

If the corporate income tax is the most harmful tax for economic growth, as many believe, the corporate tax rate may be the most harmful element of this most harmful tax.⁷² Reductions in the corporate tax rate can generate a number of efficiency gains, including reducing the bias against the use of equity finance and a more efficient allocation of corporate capital across diverse assets.

Reduced bias against the use of equity finance

Because interest payments are deductible in calculating corporate taxable income, but payments of dividends are not, there is a tax bias in favor of debt finance and against the use of equity to fund corporate investments.

Excessive reliance by companies on debt finance increases the risk of bankruptcy during periods of low profitability. Bankruptcy may impose a range of private and social costs, especially when restructuring leads to layoffs, reorganization costs and loss of firm-specific know-how.

Total elimination of the bias against equity finance requires either providing a comparable deduction for the cost of equity finance or completely denying the deduction for interest expense — a policy that no country has adopted.⁷³

A reduction in the corporate tax rate, however, can help reduce the bias against equity finance. Because interest is deducted at the statutory corporate tax rate, a reduction in the tax rate decreases the value of the interest deduction and thus increases the after-tax cost of debt finance. This tends to drive down the use of debt finance and increase the use of equity finance.⁷⁴ One study estimates that a 10 percentage point reduction in the corporate tax rate would reduce the proportion of a company's assets financed with debt by about 2 to 3 percentage points.⁷⁵ For example, for a company with an initial debt-to-asset ratio of 30 percent, a 10 percentage point reduction in the corporate tax rate would reduce the debt-to-asset ratio to about 27 percent — representing a 10 percent reduction in its debt ratio.

More efficient allocation of corporate capital

Businesses undertake a wide range of capital investments in their productive activities, including investments in plant and equipment, office buildings, inventories, and land. Under an ideal tax system, a company would allocate its capital among these alternative investments in the same manner as in the absence of any taxes.

In real-world tax systems, however, the allocation of capital among competing investments is likely to be influenced by the different cost recovery rules for each type of investment. Assets whose costs are recovered more slowly for tax purposes than their true decline in value are disfavored relative to assets whose cost recovery is more closely aligned with their true economic depreciation.

As a result, in practice, taxes cause businesses to allocate their capital among diverse assets in a different and less efficient manner than they would in the absence of these tax distortions.⁷⁶

A reduction in the corporate tax rate diminishes the distorting effects of the corporate income tax system on the allocation of capital across all corporate investments. This is because at a lower tax rate, the after-tax value of any deduction — and the difference between the after-tax value of one deduction and another deduction

— is reduced. By reducing these distortions, corporations allocate capital among alternative investments more efficiently. For any given amount of total investment, a more efficient allocation of capital results in greater output. A greater amount of output for the same total investment makes our economy more productive.

A Lower Corporate Tax Rate Would Result in Higher Tax Revenues Through Greater Economic Activity

A broad body of research suggests that stand-alone corporate rate reduction need not lead to a loss in corporate tax revenues and can actually increase overall tax revenues through the resulting increase in economic activity and economic growth.

- ▶ **Joint Committee on Taxation (JCT).** By convention, estimates by the JCT staff do not account for any changes in economic growth resulting from tax changes. Under this macrostatic assumption, the JCT estimates that each percentage point reduction in the corporate income tax would reduce government revenue collections by approximately \$10 billion annually.⁷⁷

In contrast to the conventional macrostatic assumption, a 2005 JCT study designed to evaluate the macroeconomic impacts of tax changes found that a reduction in the corporate tax rate was more growth enhancing than individual tax reductions, including individual rate reduction.⁷⁸ As a result of the additional economic growth resulting from corporate rate reduction, additional tax revenues are collected through so-called feedback effects. The JCT estimated that these feedback effects reduce the cost of corporate rate reduction by between 10 and 20 percent of conventional revenue estimates.⁷⁹

- ▶ **Academic research.** A number of research studies suggest that the growth-enhancing effects of corporate rate reduction are significantly greater than estimated by the JCT. A recent empirical study by researchers at Cornell University and the University of London of past corporate tax changes in the United States concludes that a reduction in corporate income taxes in the United States would be “approximately self-financing” due to significant increases in corporate income and GDP in response to these cuts.⁸⁰ The study finds that a 1 percentage point decrease in the average corporate tax rate would result in an increase in real U.S. GDP of between 0.4 and 0.6 percent within one year of the tax cut.

Research by economists at the American Enterprise Institute concludes that corporate tax rates above 26 percent result in a loss of corporate tax revenues for OECD countries.⁸¹ Applied to the United States, this result suggests that corporate tax revenue would *increase* if the federal statutory corporate tax rate were lowered from 35 percent to 26 percent — and that a rate as low as 18 percent would generate the same corporate tax revenues as the current 35 percent tax rate without requiring any offsetting base broadening.⁸²

The analysis by Rice University professors Diamond and Zodrow (described in **Box 1** on page 9) finds that the macroeconomic effects of the tax reform legislation introduced by former House Ways and Means Committee Chairman Dave Camp would permit a further reduction in the corporate tax rate from 25 percent to 20 percent with no loss in revenue.⁸³

One U.K. academic study also finds that some OECD corporate tax rates are above the revenue-maximizing tax rate.⁸⁴ The study finds that at low corporate tax rates, increases in the tax rate may increase corporate revenues but that this effect disappears above moderate rates, whereby “further increases in the tax rate may actually reduce revenues.” Corporate tax revenues may be sensitive to the corporate tax rate by affecting overall investment levels, changing the location of economic activity between countries, and shifting activity between the corporate and noncorporate business sectors.

- ▶ **Government estimates from the United Kingdom.** An analysis of the macroeconomic impacts of the reduction in the corporate tax rate in the United Kingdom was conducted by the U.K. treasury department.⁸⁵ The government, using a model that was peer reviewed by leading academics, examined the reduction in the corporate tax rate from 28 percent (the rate in 2010) to 20 percent (the rate applying from 2015 on). The government estimated that the rate reduction would increase investment by between 2.5 and 4.5 percent in the long run. Long-run annual GDP was estimated to increase by between 0.6 and 0.8 percent. The government estimated that the increase in profits, wages and consumption would be sufficient to increase taxable income enough to offset between 45 and 60 percent of the conventional cost of the corporate rate reduction.

Canada's experience with corporate rate reduction

Canada has lowered its combined federal and provincial corporate rate from 42.4 percent to 26.3 percent since 2000, with the federal rate now at 15 percent.⁸⁶

Analysis of the recent Canadian experience provides strong evidence that a reduction in corporate tax rates can lead to offsetting increases in corporate tax revenues. Canada reduced its combined statutory corporate tax rate by 16 percentage points between 2000 and 2011. Despite this significant reduction — and a recession in 2009 — corporate tax revenues as a percentage of GDP remained virtually constant over this period, as an increase in corporate taxable income compensated for the rate reduction.⁸⁷ Corporate income tax revenue in Canada as a share of GDP is approximately 50 percent greater than in the United States, despite Canada's lower tax rate.⁸⁸

Canada's experience is consistent with an earlier study by Canadian researchers that concluded that Canadian rate reduction would increase corporate tax revenues.⁸⁹ In addition to increased corporate tax revenue, increases in employment and wages would result in additional individual income tax revenue, payroll tax revenue and sales tax revenue.

“Creating jobs and growth in our economy is our top priority. ... We are creating the conditions for businesses to successfully compete in the global economy. ... Through our Government's low-tax plan for jobs and growth, we are continuing to send the message that Canada is open for business and the best place to invest.”

**— Then Canadian Finance Minister
Jim Flaherty, December 29, 2011**

V. Tax Reform: A Competitive International Tax System

Fast Facts

- ▶ Emerging markets will be responsible for 95 percent of the world's population growth over the next decade and, within 10 years, will account for annual consumption nearly three times greater than in the United States today. These markets present enormous opportunities for American workers and American businesses.
- ▶ While expanding export opportunities of American businesses is critical, American businesses also need to operate abroad to serve foreign customers. Approximately 90 percent of the sales by foreign subsidiaries of American companies are to foreign customers.
- ▶ Growing foreign operations of U.S. companies leads to more U.S. jobs. One study finds that for every 100 jobs added in a company's foreign operations, an average of 124 U.S. jobs are created at home.
- ▶ Proposals for a move to a modern international tax system in the United States have been made by five separate commissions established by President Obama, including Simpson-Bowles, and were part of the tax reform legislation proposed by then-House Ways and Means Committee Chairman Dave Camp in 2014.
- ▶ A modern international tax system, in line with other advanced economies, would enhance U.S. competitiveness in foreign markets, reduce the number of foreign takeovers of American companies and increase the reinvestment of foreign earnings in the U.S. economy.

Large and growing world markets present enormous opportunities for American workers and American businesses. With 95 percent of the world's population and more than 80 percent of the world's purchasing power located in markets outside the United States — and with economic and population growth rates in emerging economies expected to outpace developed country rates — growth at home requires successful engagement in world markets.⁹⁰ Annual consumption in emerging markets alone is expected to grow to \$30 trillion over the next 10 years, nearly three times annual consumption spending in the United States today.⁹¹ Emerging markets are estimated to represent nearly half of global consumer spending by 2025.⁹²

For American companies to succeed in these markets and the American economy to benefit from expanding overseas opportunities, American companies must not be placed at a competitive disadvantage by U.S. tax rules. Today, U.S. tax rules on international income are an outlier among developed countries. They prevent American companies from entering foreign markets on competitive terms and discourage the return of those profits for investment in the U.S. economy. The unlevel playing field for American companies in turn slows the growth of the U.S. economy and disadvantages American workers.

American Companies Compete in the Global Marketplace with Operations at Home and Abroad

Be there to sell there

American companies compete in foreign markets through U.S. exports of goods and services and foreign investment — whether through joint ventures, foreign acquisitions or the establishment of new facilities.

American companies operate abroad first and foremost to serve foreign customers. Approximately 90 percent of the sales by foreign subsidiaries of American companies are to foreign customers rather than to the U.S. market.⁹³ Localized foreign operations allow American companies to tailor their products to local needs and tastes and overcome transportation cost and trade barriers that otherwise would make their products noncompetitive. A range of services provided by American companies can be performed only locally, including construction, utilities, retail trade and financial services.

Gaining access to natural resources

Natural resource industries, including mining, oil and natural gas, must locate operations where the resources can be obtained. The United States benefits when American companies develop these resource deposits.

Benefits to the U.S. economy from the foreign operations of American companies

Foreign operations can increase the demand for U.S. exports of other goods and services that are complementary to the local foreign operations. Increased global operations also create additional U.S. headquarters jobs to manage, support and coordinate the international activity of globally engaged U.S. companies. As a result, growing foreign operations support the growth of U.S. operations and U.S. jobs.

One academic study focusing on U.S. manufacturers found that this complementary nature between expanded economic activities of companies abroad and their growth at home occurs across a broad range of activities.⁹⁴ For example, the study found that:

- ▶ An increase in sales by an American company's foreign subsidiaries of 10 percent results, on average, in an increase in exports of goods from the United States by the American company of 6.5 percent.
- ▶ An increase in local foreign employment by an American company's foreign subsidiaries of 10 percent results, on average, in an increase in the number of the company's American workers of 6.5 percent. Given that U.S. employment of American multinationals is 90 percent higher than their foreign employment, this translates into an average increase of 124 U.S. jobs for every 100 jobs added abroad.⁹⁵

A study by economists in the U.S. International Trade Commission finds similar complementary relationships for service industry companies between growth in their foreign affiliate activities and increases in their U.S. employment. This study further estimates that the export of services by U.S. companies to their foreign affiliates supports 700,000 U.S. jobs. Additional U.S. employment is generated through the domestic supply chains of the U.S. parent companies.⁹⁶

While U.S. manufacturing jobs have been declining over time, the evidence points to productivity gains driven by technological change as the prime factor, not globalization. In fact, globally engaged U.S. manufacturers have had significantly smaller declines in their employment than U.S. manufacturers without foreign affiliates.⁹⁷ These

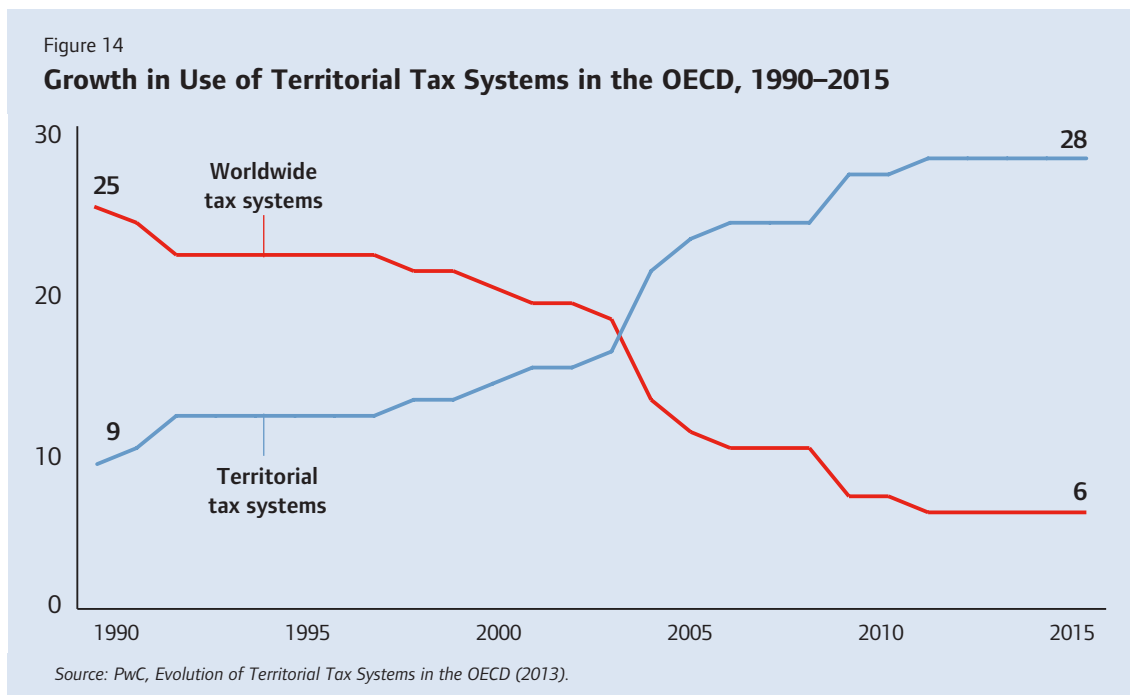
data further support the conclusion that the ability to grow in foreign markets has a positive effect on U.S. jobs. In short, successful foreign operations of American companies benefit the U.S. economy and add jobs at home.

The U.S. Economy Is Hamstrung by Outdated International Tax Rules

Unlike most OECD countries, the United States taxes American companies on their business income earned in foreign countries. Under the U.S. worldwide system, U.S. tax is assessed on active business earnings when they are remitted to the United States, with a tax credit allowed for foreign income taxes paid in the country where the income was earned. The U.S. system thus imposes a second round of tax on foreign earnings, equal to the difference between the U.S. rate and the foreign rate on the remitted earnings. As a result, American companies pay tax on their international income twice — once in the foreign country where the earnings arise and then again when the earnings are remitted to the United States.

In contrast, 28 of the 34 OECD countries (and all other G7 countries) use territorial tax systems under which active business earnings remitted home as dividends are subject to little or no additional home-country tax. As shown in **Figure 3** on page 4, 20 of these 28 countries exempt 100 percent of qualifying dividends, while eight countries exempt between 95 and 97 percent of the qualifying dividends from domestic taxation. The 95 to 97 percent exemption typically results in a home-country tax rate of about 1 percent on the foreign dividend for multinational companies headquartered in these countries. The use of less than a 100 percent exemption by these eight OECD countries is sometimes justified as a substitute for any disallowance of domestic expenses that indirectly relate to the foreign earnings of a corporation.⁹⁸

The move to territorial tax systems throughout the OECD is a relatively recent trend, with 20 of the 28 countries adopting territorial rules since the United States last undertook major tax reform in 1986 and 15 of the 28 countries adopting territorial tax systems since 2000 (**Figure 14**).⁹⁹ The United Kingdom and Japan were among the most recent major countries to adopt territorial tax systems, switching from their worldwide tax systems in 2009.



A detailed proposal for modernizing U.S. international tax rules, including a territorial tax system, was included in the 2014 tax reform legislation introduced by then-Chairman of the House Ways and Means Committee Dave Camp.

Five separate commissions established by President Obama and his Administration also have supported a movement to a territorial tax system:

- ▶ The 2010 report by the co-chairs of President Obama’s National Commission on Fiscal Responsibility and Reform (Simpson-Bowles) noted that a territorial system would “put the U.S. system in line with other countries, leveling the playing field” and would make “us more globally competitive.”¹⁰⁰
- ▶ President Obama’s Export Council in 2010 stated that “expansion abroad by U.S. companies is vital for establishing export-platforms for U.S.-produced goods” and recommended that “a competitive territorial tax system for the United States should broadly follow the practice of our trading partners.”¹⁰¹
- ▶ President Obama’s Council on Jobs and Competitiveness in 2012 wrote: “Many Council members agree that the U.S. should shift to a territorial system of taxation in order to make America more competitive in global markets. ... Adopting a territorial tax system would bring us in line with our trading partners and would eliminate the so-called ‘lockout’ effect in the current worldwide system of taxation that discourages repatriation and investment of the foreign earnings of American companies in the U.S.”¹⁰²
- ▶ The Advanced Manufacturing Partnership Steering Committee of President Obama’s Council of Advisors on Science and Technology in 2012 recommended reforms to “create an internationally competitive tax system.” These reforms “must consider the tax treatment of overseas earnings of U.S. based corporations, including the consideration of a competitive partial exemption system similar to the type adopted recently by the UK. ... Ultimately, comprehensive tax reform must ensure that U.S. companies are competitive when operating abroad and in the United States.”¹⁰³
- ▶ The Secretary of Commerce’s Manufacturing Council in 2011 recommended to “move the United States from a worldwide to a territorial tax system to reduce the double tax burden imposed by the United States to allow manufacturers to make greater investments in expansion, innovation, and job creation.”¹⁰⁴

The Worldwide Tax System Disadvantages the U.S. Economy

There are many good reasons why the United States should adopt a territorial tax system.¹⁰⁵ Special attention should be paid to two of the ways in which the current worldwide tax system damages the U.S. economy — first by reducing the competitiveness of U.S. companies in foreign markets and second by discouraging companies from bringing foreign earnings back for use in the United States.

“Globalisation has meant that the world’s markets have become more open and competitive. As a result companies increasingly operate across national borders and the ownership of UK businesses has become more internationally diverse. A competitive tax system should recognize this. In particular, the Government needs to ensure that the way the tax system operates for UK headquartered multinationals does not inhibit commercial business practices or make them unattractive to international investment.”

**— U.K. Exchequer Secretary to the Treasury
David Gauke, November 29, 2010**

Reduced foreign competitiveness

First, American companies that do bring their foreign earnings home face an additional tax burden not faced by their foreign competitors. This extra tax can place American companies at a significant disadvantage relative to their foreign competitors — American companies must either generate a higher pretax return through other cost savings to earn the same after-tax return on their investments, or they must accept a lower after-tax return. Neither result may be sustainable.

As shown in **Box 4**, a Canadian multinational company with operations in the United Kingdom can earn an after-tax rate of return that is 31 percent higher than an American company with a comparable U.K. investment. Even when the American company is the most efficient producer, the difference in tax treatment faced by the American company may make it noncompetitive.¹⁰⁶

The disadvantageous tax rules applying to the foreign operations of American companies make it more likely that when an American company merges with a foreign company, the foreign company will acquire the American company rather than the American company being the acquirer. Current U.S. tax rules encourage foreign ownership of U.S. operations since an acquiring foreign corporation can expand outside the United States without being subject to the worldwide tax rules that would apply if the American company were the acquirer.

The disadvantages of the U.S. tax system are also a force behind the redomiciliations that occur in cross-border transactions in which shareholders of the U.S. company continue to have majority control of the combined entity. While these cross-border combinations are sometimes referred to as “inversions,” in truth they are substantive business transactions.

One study finds that if the United States adopted a territorial system, American companies would be 17 percent more likely to be the acquirers in a cross-border transaction.¹⁰⁷ The disadvantage of the worldwide tax system for American companies in cross-border mergers and acquisitions is exacerbated by the high U.S. corporate tax rate, which results in an increased U.S. tax burden on foreign income upon remittance.¹⁰⁸

While tax rules are just one of various factors affecting mergers and acquisitions, cross-border mergers in which American companies were the target of a foreign acquisition were 43 percent greater in value than those in which American companies were the acquirers of a foreign target between 2000 and 2013.¹⁰⁹ Over this period, \$500 billion of U.S. assets on net were transferred to foreign ownership.

Limited reinvestment of foreign earnings in the U.S. economy

Second, in addition to reducing the competitiveness of U.S. companies abroad, the worldwide system of taxation also encourages companies to reinvest foreign earnings outside the United States rather than bring them back as dividends for use at home. Earnings may be retained abroad for reinvestment and expansion in physical facilities or retained in cash if companies foresee an eventual, if not immediate, use of the funds in their foreign operations. Publicly traded U.S. companies reported \$2.3 trillion in accumulated foreign earnings, representing both physical assets and cash, which were held by their foreign subsidiaries as indefinitely reinvested abroad at the end of 2014.¹¹⁰

U.S. Worldwide Tax System Uncompetitive with Territorial Systems

Consider an American and a Canadian company, each with active business operations in the United Kingdom. The U.K. statutory corporate tax rate is 20 percent in 2015, and for simplicity, the example assumes that the U.K. tax system results in a 20 percent effective tax rate on corporate income. (Including tax incentives, the U.K. effective rate of tax is likely below 20 percent.)

Under the **Canadian international tax rules** — like those of most Organisation for Economic Co-operation and Development countries — the Canadian company will pay the U.K. tax on its foreign earnings and will not owe any additional home-country tax when it remits its earnings home.

Under the **U.S. international tax rules**, if the American company remits its foreign earnings home, it will pay an additional 15 percent in U.S. federal tax (35 percent less a foreign tax credit of 20 percent), plus additional state taxes (an average of 4 percent, after deduction against federal taxes). The combined U.S. and U.K. tax rate of 39 percent imposed on the American company is 19 percentage points higher than the rate of tax paid by its Canadian competitor.

The tax differential allows the Canadian company to earn \$80 after tax on its investment compared to the \$61 earned by the American company, a 31 percent higher after-tax return (\$80/\$61).

Figure 15

After-Tax Net Income on Remitted Foreign Income for American and Canadian Companies Competing in the United Kingdom

American-owned foreign subsidiary		Canadian-owned foreign subsidiary	
Income	\$100.00	Income	\$100.00
Local U.K. tax	-\$20.00	Local U.K. tax	-\$20.00
U.S. federal and state tax	-\$19.00	Canadian tax	-\$0.00
Net income	\$61.00	Net income	\$80.00

This incentive to maintain funds abroad under the U.S. worldwide tax system is referred to as the “lockout” effect, as the high U.S. tax rate that would be imposed on foreign earnings brought back to the United States effectively locks these funds out. Multinationals headquartered in territorial countries do not face such a disincentive to the remittance of foreign earnings and can use these funds to expand operations at home, undertake research, make additional contributions to their pension plans, pay dividends to shareholders, pay down debt and make other uses of the funds in their domestic economies. The ability to access foreign funds for use at home results in an additional competitive advantage in the form of a lower cost of capital for foreign-headquartered multinationals relative to American companies.

A study by Laura Tyson, former economic adviser to President Bill Clinton, estimates that if the United States were to adopt a territorial system like other OECD countries, it would lead to the repatriation of an additional \$100 billion each year to the United States from future foreign earnings.¹¹¹ These additional earnings are estimated to add about 150,000 U.S. jobs a year on a sustained basis. Further, the repatriation of a portion of the previously accumulated foreign earnings permitted under a transition to a new international tax system, such as in former House Ways and Means Committee Chairman Dave Camp’s 2014 proposal, is estimated to increase U.S. GDP by \$200 billion and support about 1.5 million U.S. jobs in the first few years following enactment.

Some have proposed a one-time repatriation of foreign earnings at a reduced tax rate without a permanent reform of our international tax system. A temporary change in tax law enacted in 2004 provided a reduced tax rate of 5.25 percent for qualifying repatriations. An estimated \$362 billion was repatriated by corporations under this temporary provision.¹¹² One study estimates that the companies repatriating the most funds under this temporary provision spent 72 percent of their repatriated cash on acquisitions to expand operations, R&D, and capital expenditures.¹¹³ However, a temporary repatriation measure does not solve the ongoing competitive disadvantage faced by American companies in foreign markets, as future earnings would still be subject to additional U.S. tax upon repatriation. Only a permanent modernization of U.S. international tax rules can address the competitive disadvantage faced by American companies and permanently eliminate the lockout effect.

Modern Territorial Tax Systems Increase Competitiveness and Protect the Tax Base

Concerns have been expressed that the adoption of a territorial tax system could provide American companies an incentive to shift U.S. activities offshore or would lead to a loss of the U.S. tax base. In considering the possible impact of a territorial system on domestic activities, it is instructive to look at the experience of other developed countries. Twenty-eight of the 34 OECD countries employ territorial tax systems, with half of these countries having adopted territorial tax systems since 2000. It would be surprising if territorial systems led to a loss of domestic employment as these countries gave careful consideration to their international tax rules and then adopted territorial tax systems as a means to improve the competitiveness of their domestic economies.¹¹⁴ Further, only two OECD countries — Finland and New Zealand — have ever switched from a territorial tax system to a worldwide tax system. Both countries found the experiment to be a failure and subsequently switched back to territorial tax systems.¹¹⁵

Territorial tax systems, by increasing the ability to compete in foreign markets, may increase employment in foreign subsidiaries. However, greater employment by foreign subsidiaries of American companies generally is *not* associated with reduced U.S. employment. Directly countering the argument that job gains abroad are at the expense of jobs at home, studies show that increases in foreign employment are associated with increases in U.S. employment of the same company.¹¹⁶ Many countries desire to be attractive headquarters locations for globally engaged companies precisely to achieve employment gains associated with the global activities of these companies.

A related concern is that adoption of a “pure” territorial tax system would provide firms an incentive to use “accounting mechanisms to shift profits out of the United States.”¹¹⁷ Compared to the current U.S. tax system, however, corporate tax reform that reduced the U.S. statutory corporate tax rate in combination with the adoption of a territorial tax system could actually reduce such incentives relative to current law. A reduced U.S. corporate statutory tax rate is an important base protection measure.

Of course, all countries with territorial or worldwide tax systems guard against artificial transactions to reduce taxable income by enforcing transfer pricing rules that require related-party transactions be conducted using the same prices that would apply to third-party “arm’s-length transactions.” If the United States adopted a territorial tax system, it would continue to enforce transfer pricing rules to ensure that the arm’s-length standard is maintained just as other countries do.

The United States and many other countries, including those with territorial tax systems, also use controlled foreign corporation (CFC) rules to buttress the transfer pricing system by taxing immediately certain foreign income that is passive or that can easily be moved out of the home country to low-tax countries. Proposals for a

Expiring Tax Provisions Supporting U.S. International Competitiveness

Two longstanding international tax provisions to improve the competitiveness of American companies operating in foreign markets have been enacted and temporarily renewed repeatedly. The policy goals of these two provisions should be made permanent under a reformed tax system.

Active Financing Income. A basic principle of the U.S. tax system is that the active foreign business earnings of subsidiaries of American companies are not taxed in the United States until remitted back to the U.S. parent. This basic principle of deferral was also the law for active financial services income for nearly the entire history of the tax code, until it was changed in 1986. Since 1997, the principle of deferral for active financial services income has been a temporary provision of the tax code and has been extended numerous times. The current temporary provision expired at the end of 2014.

U.S. financial service companies — including banking, securities and insurance companies — compete in foreign markets around the world with other financial institutions to provide financial services locally to foreign customers. Commercial clients of these financial service companies look to a financial institution that can meet their needs worldwide — not just in the United States. The ability of U.S. financial service companies to be competitive in foreign markets increases domestic employment in the United States. In addition, U.S. companies providing their financial services to foreign customers can help boost exports of U.S. goods by assisting in financing the sale of these goods to foreign customers.

Without the ability to defer tax on active financial services income, U.S. financial service companies would face a significant tax disadvantage relative to their foreign-headquartered competitors. Failure to make this provision permanent under a reformed system would harm the competitiveness of American companies and reduce U.S. jobs.

The President's *Fiscal Year 2016 Budget* proposes to permanently extend this provision.

Look-Through Rule. Another temporary provision allows American companies to redeploy income between a foreign subsidiary earning active business income and a related foreign subsidiary in another country through the payment of dividends, interest, rents or royalties without subjecting the payment to current U.S. taxation. The look-through rule "looks through" to the underlying source of income to determine whether such income is active foreign business income eligible for deferral or passive income that would be subject to current U.S. taxation. The look-through rule was first effective in 2006 and expired at the end of 2014.

The look-through rule permits income to be redeployed efficiently among related foreign subsidiaries. Because the cost of financing through internal funds is generally lower than use of external funds, a firm will generally first choose to use internal funds before tapping more expensive external sources of finance. The look-through rule allows U.S. companies to redeploy internal funds between foreign subsidiaries without creating a tax barrier to such transfers.

The look-through rule helps maintain the competitiveness of American companies operating in foreign markets. Without the look-through rule, foreign operations might require greater use of external funds or greater reliance on funds drawn directly from the U.S. parent. This rule should be made permanent under a reformed system to facilitate the redeployment of foreign earnings and enhance the competitiveness of American companies competing abroad.

The President's *Fiscal Year 2016 Budget* proposes to permanently extend this provision.

territorial tax system in the United States would generally retain CFC rules for other than active business income. To the extent necessary, the adoption of a territorial system could be accompanied by a review of transfer pricing and CFC rules to further safeguard against any incremental shifting of income from the United States to low-tax countries that might occur as a result of the territorial system. However, it would be important to ensure that any such safeguards are specifically targeted and designed to minimize both the adverse impact on the competitiveness of U.S. companies and any increases in compliance and administrative burden.

It is also common for countries to adopt “thin cap” rules that limit net interest expense to a percentage of earnings. Thin cap rules currently apply to foreign companies that operate in the United States and could be expanded to apply to U.S. companies with foreign operations.

In considering whether additional rules or safeguards are needed to protect the U.S. tax base, it is important that policymakers distinguish between practices of American companies (as well as their foreign competitors) that reduce *foreign tax burdens on foreign income* from those that result in a reduction of *U.S. tax on U.S. income*. The former — a reduction in foreign tax burdens — does not reduce U.S. tax revenues and enhances the competitiveness of American companies in foreign markets. Enacting unilateral policies that would require American companies to pay more foreign taxes fails to advance any U.S. interest and is likely to undermine the economic welfare of U.S. workers and their families.

In this regard, overly broad proposals to limit the ability of American companies to earn low-tax foreign income undermine the competitiveness of U.S.-headquartered companies relative to their foreign-headquartered counterparts who face no such limitation. The “minimum tax” proposed in the President’s *Fiscal Year 2016 Budget* is an example of such an anti-competitive measure. The proposed tax would apply broadly to foreign income, without any test of whether such income is related to U.S. activities. Such a tax is effectively a U.S. headquarters tax as it applies only to U.S.-headquartered companies and exempts all others (**Box 6**).

Figure 16

EU Countries with Enacted or Proposed Intellectual Property Box Systems

Country	Fully phased-in tax rate
Belgium	6.8%
Cyprus	2.5%
France	15.0%
Hungary	9.5%
Ireland (proposed)	5.0% to 6.25%
Italy	13.75%
Luxembourg	5.84%
Malta	0.0%
Netherlands	5.0%
Portugal	14.75%
Spain	10.0%
United Kingdom	10.0%

Anti-competitive impacts from adoption of overly broad base protection measures can be as significant as the underlying choice of whether to adopt a territorial or worldwide tax system. A recent example of overly broad CFC rules in the United Kingdom illustrates the potential adverse effects from their imposition and the benefits from their replacement with more targeted rules protecting the tax base (**Box 7** on page 38).

Rather than penalizing foreign operations, countries are increasingly using their tax systems to incentivize globally engaged companies to locate their headquarters and high-value activities within their borders. An example of these incentives is the increasing use of “patent boxes” or innovation boxes to encourage the development and exploitation of patents and certain other intellectual property within their countries. Currently 12 European Union (EU) countries, accounting for nearly 60 percent of EU GDP, have implemented or are planning to introduce these incentives, typically applying a tax rate of 10 percent or less to such income (**Figure 16**). Under a recent agreement between the United Kingdom and Germany, these incentives are recognized as an appropriate mechanism for countries to grow their economies — increasing job growth and wages — provided they are associated with substantive economic activities within

the country.¹¹⁸ A bipartisan proposal for a U.S. patent box was introduced in Congress in 2012 by Representatives Allyson Schwartz and Charles Boustany; a modification of this legislation, proposing a U.S. innovation box, was recently released as a discussion draft by Representatives Boustany and Richard Neal.¹¹⁹

It is understandable that policymakers want assurances that tax changes adopted as part of tax reform do not provide incentives that would reduce U.S. employment or lead to a loss of the U.S. tax base. At the same time, it should be noted that a failure to adopt competitive international tax rules for American companies will result in a more slowly growing U.S. economy as American companies are less able to sell American goods and services in foreign markets. In addition, a gradual loss of American-headquartered companies through cross-border mergers is likely to continue, if not accelerate, as their foreign operations are more profitably held by foreign-headquartered companies. This migration of U.S. assets results in a loss of jobs associated with headquarters support activities, both directly within these companies and through their supply chains. As a result, maintaining the current U.S. worldwide tax system likely will result in a loss of the U.S. tax base over time and is the wrong policy for maximizing U.S. jobs and U.S. economic growth.

Box 6

President Obama’s Foreign Minimum Tax Imposes Anti-Competitive Burden on U.S.-Headquartered Companies

President Obama’s *Fiscal Year 2016 Budget* proposes a burdensome minimum tax on the foreign earnings of American companies. Because the proposed tax would have broad application to the foreign earnings of American companies, it would impose a new anti-competitive burden only on U.S.-headquartered companies; foreign-headquartered companies would be exempt from this new tax. No other country in the world imposes tax penalties of this kind on their own companies.

The tax would apply to foreign earnings of American companies in any country with a foreign effective rate of tax of less than 22.4 percent. (Although the proposal is worded as applying a 19 percent minimum tax rate, because it gives credit only for 85 percent of the foreign tax rate, the tax actually applies to earnings taxed at a foreign rate up to 22.4 percent.) More than half of all EU countries have a statutory tax rate of less than 22.4 percent. Because effective tax rates are lower than statutory tax rates due to incentives built into each

country’s tax laws, the proposed tax would have even broader application.

As proposed, this tax could apply to a majority of the foreign earnings of American companies. Applying immediate U.S. tax to these foreign earnings would impose new tax burdens even more onerous than under the present worldwide tax system of the United States.

The tax places foreign operations of American companies at a competitive disadvantage to those owned by foreign companies. Further, the tax would encourage foreign governments to collect more tax from American companies — benefiting foreign treasuries rather than the U.S. Treasury. Less competitive foreign operations and increased tax payments by American companies to foreign treasuries would harm U.S. workers and the U.S. economy.

Less competitive foreign operations could result in these operations being acquired by foreign companies and the loss of U.S.-headquartered companies.

Case Study: Anti-Competitive Impacts from Overly Broad Base Protection Measures in the United Kingdom

Prior to the United Kingdom's adoption of a territorial tax system in 2009 and reforms to its controlled foreign corporation (CFC) rules, a number of major U.K.-headquartered companies left to establish their headquarters elsewhere, and more were considering leaving.¹²⁰ This flight was largely due to concerns that stringent CFC rules would apply broadly to foreign income taxed at a rate less than 75 percent of the U.K. rate. The CFC rules would have subjected such income to current U.K. tax. A U.K. government survey in 2009 indicated that nearly 20 percent of large U.K. businesses had considered relocating abroad for tax reasons in the prior 12 months.¹²¹

In addition to its adoption of a territorial tax system, the United Kingdom responded by reforming its CFC rules. In a 2010 road map outlining changes to its CFC rules, the U.K. government acknowledged that "too many businesses have left the UK amid concerns over tax competitiveness."¹²² It further stated that "[t]o be more competitive, the UK's corporate tax system should focus more on profits from UK activity in determining the tax base rather than attributing the worldwide income of a group to the UK. Moving towards a more territorial system in this way will better reflect the global reality of modern business and will allow businesses based here to be more competitive on the world stage supporting

UK investment and jobs." The government recognized that the former CFC rules "can be seen as going further than what is needed to protect the UK tax base; new rules must instead minimise the impact on commercial decisions and not interfere with the efficient management of overseas operations."

The revised U.K. CFC rules are intended to apply only to profits that have been artificially diverted from the United Kingdom, rather than low-taxed foreign income generally or foreign income earned by U.K. foreign subsidiaries in a manner that minimized foreign income taxes.¹²³ (Note: These CFC rules are different from controversial new "diverted profits tax" legislation enacted in 2015, which has been viewed as targeted at foreign multinational companies and has been criticized for jumping ahead of coordinated action under the Organisation for Economic Co-operation and Development base erosion and profit shifting project.)

The changes to the U.K. CFC rules, adoption of a territorial tax system and reductions in its corporate tax rate were part of the U.K. government's commitment "to creating the most competitive tax regime in the G20" and reforming "the corporate tax system to make it more attractive to international businesses."¹²⁴ After adoption of these reforms, a number of companies that had moved their headquarters from the United Kingdom returned.¹²⁵

OECD Base Erosion and Profit Shifting Project

The Organisation for Economic Co-operation and Development initiated a project in 2013 to address global tax issues raised by so-called base erosion and profit shifting (BEPS).

In view of the importance of global trade and investment to the growth of the economies of the United States and the world, and the impediment that taxes can be, Business Roundtable supports efforts to provide clear and consistent rules for the taxation of cross-border business activities that reflect longstanding international agreements. The end result of such rules should be to promote cross-border trade and investment, not to erect new barriers that lead to a reduction in these growth-enhancing activities.

Business Roundtable believes the following principles should guide these efforts:

- ▶ Changes to the international tax regime should advance the interests of the U.S. economy, business and workers.
- ▶ The United States should reject any changes to the existing international order that would compromise U.S. interests or limit the ability of Congress to write its own tax laws.
- ▶ The international tax rules should enhance the competitiveness of American business in the global marketplace and attract investment to the United States.
- ▶ The international tax rules should ensure a level playing field for U.S. business and workers in the global economy.
- ▶ International tax rules for the allocation of cross-border income must be designed in a clear, consistent and predictable manner and with processes established to:
 - Avoid making the same income subject to tax in more than one jurisdiction;
 - Avoid disputes between taxing jurisdictions; and
 - Provide for fast and fair resolutions of disputes when they do arise.
- ▶ Tax rules must respect arm's-length relationships and treat related-party transactions no less favorably than if conducted between unrelated parties.
- ▶ Cost-benefit analysis should apply to the development of new reporting and administrative requirements imposed on taxpayers to ensure that the benefits of new measures outweigh the costs to comply and administer them.
- ▶ Information collected by tax authorities should be protected to prevent the disclosure of taxpayers' confidential and proprietary information and should be used only for tax administration purposes. Information should not be shared between governments when these conditions cannot be guaranteed.
- ▶ A process should be designed to provide for the ongoing monitoring of adherence to the principles regarding avoidance of double taxation, provision of fast and fair dispute resolution, respect for arm's-length pricing, minimization of administrative burdens, and protection of confidential taxpayer information by all governments, and violations should be reported publicly and require a program of remediation be established.

VI. Fiscally Responsible Corporate Tax Reform

Fast Fact

- ▶ A uniformly applied corporate tax system — with a broader base, a competitive corporate tax rate and modernized international tax rules and without temporary and uncertain provisions — would result in greater economic growth and job creation for the United States, with no loss in tax revenue.

Corporate tax reform can promote the competitiveness of the United States by allowing businesses to compete on a level playing field with each other and by providing a tax structure that is competitive with other advanced economies. To ensure that corporate tax reform benefits the economy and is fiscally responsible, Business Roundtable supports appropriate base-broadening measures as part of reform providing a competitive corporate tax rate and competitive international tax rules like those of other OECD countries. In addition, such reform should not impose burdens on small business to pay for corporate reforms.

The experience of other countries that have reduced their corporate tax rates, as well as analysis of the potential benefits of corporate tax reduction in the United States reviewed in Section IV, indicates that corporate rate reduction need not result in a loss of corporate tax revenue, as the lower corporate rates themselves stimulate the economy, leading to greater economic growth, an increase in corporate income and additional tax revenue.¹²⁶ As noted in Section I, the OECD has identified the corporate income tax as the most harmful tax for economic growth, so reductions in this tax can have greater effects on growth than similar reductions in other taxes.¹²⁷ One study concludes that the failure of the United States to keep our corporate rate competitive with other countries has reduced wages by 1.0 to 1.2 percent and reduced GDP by 1.5 to 2.6 percent.¹²⁸ In determining the overall effects on tax revenue from corporate rate reduction, it is important to account for these dynamic effects of corporate tax reform on economic growth.

The Rationale for Replacing Targeted Incentives with Overall Rate Reduction

Partly to incentivize certain activities as well as to alleviate the adverse impacts of the high U.S. corporate tax rate, policymakers have introduced a wide range of provisions, typically in the form of enhanced deductions or tax credits, which reduce the effective rate of tax on specified business activities. While such provisions lessen the tax burden on qualifying activities, they are viewed by many as less efficient from an economywide perspective than a broadly applicable across-the-board incentive or an overall rate reduction. This is because narrowly applicable incentives divert resources away from other valuable business activities that may generate higher pretax returns and greater value for consumers.

In drawing up initial plans for legislation that became the Tax Reform Act of 1986, the Treasury Department explained the rationale for replacing targeted incentives with overall rate reduction:

One of the primary advantages of a free market economy is its tendency to allocate economic resources to their most productive uses. For example, market forces lead business firms to produce what consumers want in ways that are relatively efficient and economical. Any tax inevitably discourages the type of activity that is taxed. An ideal tax system would, however, interfere with private decisions as little as possible. ... Any deviation from this principle represents implicit endorsement of government intervention in the economy — an insidious form of industrial policy based on the belief

*that those responsible for tax policy can judge better than the marketplace what consumers want, how goods and services should be produced, and how business should be organized and financed.*¹²⁹

Tax-induced distortions adversely affect economic growth. As the Treasury Department further explained:

*Preferential tax treatment of certain industries — industrial policy implemented through tax policy — causes too much labor and capital to flow into the favored industries, and too little into other sectors. ... The result of all this tax-induced interference with market forces is lost opportunities for productive investment and needless sacrifice of national output. Economic growth, a primary goal of the study of fundamental tax reform, depends on a neutral tax system — one that would not hinder the potential for growth inherent in a free market economy.*¹³⁰

Narrowly designed incentives can be complicated to administer and can create uncertainty for taxpayers as to whether they will qualify for the incentive. Some activities very similar in nature to the qualifying activity may not be eligible for the incentive even though they yield greater economic benefits. To avoid distortions that would divert resources from higher value activities, tax incentives need to consider the full range of value-creating economic activities. Designing a single incentive to encourage all of these activities as efficiently as a reduction in the corporate tax rate is difficult, if not impossible.

Tax incentives frequently are enacted as temporary provisions. A business may be uncertain whether an activity initiated in response to a temporary tax incentive will be completed before the expiration of the incentive. When the incentive expires, the business may not know whether the government will restore the incentive to cover periods since its expiration. The uncertainty of temporary provisions reduces their efficacy. Greater economic growth can be achieved through permanent provisions covering the broadest range of activity, such as that attainable through corporate rate reduction.

Tax Expenditures

Many view base-broadening reforms as those that would reduce or eliminate tax expenditures. The staffs of the JCT and the Treasury Department prepare lists of “tax expenditures” annually.¹³¹ The JCT and the Treasury Department identify any tax provision in the form of a credit, deduction or exclusion as a tax expenditure when it is being used as an alternative to other policy instruments, such as spending programs. Tax expenditures are identified for provisions affecting both corporations and individuals. Some analysts take issue with the terminology of “tax expenditures” as they believe such provisions often make the tax system fairer or more efficient. Some also point out that the definition of tax expenditures does not rely on a well-defined baseline of a neutral tax system against which exceptions should be measured.¹³²

To the government, the cost of providing corporate tax incentives comes in the form of reduced corporate income tax collections. The JCT estimates that in 2014 more than 70 separate tax expenditures each accounted for more than \$50 million in reduced corporate income tax revenue.¹³³

These provisions cover a range of activities and are intended for a variety of reasons. While a history and rationale for the specific provisions is beyond the scope of this study, a reduction or elimination of these provisions without a substitution of alternative policy instruments would in some cases reduce the level of the targeted activities undertaken.¹³⁴ In some cases, a reduction in the activity could be viewed as economically undesirable. For example, tax subsidies for undertaking R&D are intended to increase the amount of R&D undertaken in the

Figure 17

Revenue from Repeal of Major Domestic Corporate Tax Expenditures

Provisions with tax revenue exceeding \$10 billion, FY 2012–21

Provision	10-year revenue, FY 2012–21 (\$ billions)
Accelerated depreciation of equipment (in excess of alternative system)	\$506.8
Expensing of research and experimental expenditures	\$152.2
Domestic production activities deduction	\$127.0
Last-in, first-out inventory accounting method	\$62.7
Credit for low-income housing	\$33.0
Deferral of gain on like-kind exchanges	\$16.0
Completed contract rules accounting method	\$13.9

Source: Joint Committee on Taxation (October 27, 2011).

economy. R&D, and the know-how it generates, creates spillover benefits to society for which the company undertaking the R&D cannot be fully compensated. As a result, in the absence of research subsidies, too little R&D may be undertaken.¹³⁵ For this reason, repeal of these or any other specific provisions as base broadeners must be weighed carefully relative to the economic benefits achieved through the other components of tax reform.

In 2011, the JCT provided preliminary estimates of the tax revenue that could be raised through the elimination of 21 corporate tax expenditures on domestic commerce as part of tax reform that provided a lower statutory corporate tax rate.¹³⁶ The JCT estimates that repeal of these provisions would provide sufficient revenue to reduce the corporate tax rate to 28 percent in a revenue-neutral manner. The seven largest corporate tax expenditures (those with 10-year revenue exceeding \$10 billion) are shown in **Figure 17**. These seven provisions account for 95 percent of the revenue raised in the JCT estimates.

Incentives for New Investment Versus Across-the-Board Corporate Rate Reduction

Some argue that a tax incentive, such as a tax credit or deduction available for only new investment, could more directly stimulate economic activity relative to a reduction in corporate tax rates because the tax incentive could be claimed only if the new investment is undertaken whereas the rate reduction is not guaranteed to result in new economic activity.¹³⁷

Some evidence, however, suggests that corporate rate reduction could be more effective in attracting highly profitable investments to the United States than an incentive in the form of a tax deduction or credit. For a highly profitable investment, the tax savings from accelerating the deduction for depreciation allowances, for example, are small relative to a reduction in the rate of tax on the income from the investment. A company choosing where to locate its most profitable investments is likely to be more influenced by a lower tax rate on the investment than an enhanced initial deduction (**Box 9** on page 44).

A 2007 study by the Treasury Department notes that the trend in OECD countries over the past two decades has been to reduce corporate tax rates but to at least partially offset these reductions through less accelerated depreciation allowances.¹³⁸

As noted in Section IV, rate reduction also can improve the efficiency of the tax system by reducing the bias in favor of debt finance and result in a more efficient allocation of corporate capital across diverse assets.

President Obama’s Council of Economic Advisers explains in its 2015 *Economic Report of the President* that reductions in disparities in the rate of tax across investments and industries achieved through base broadening that fund statutory corporate rate reduction can improve the quality of investment and thereby boost overall

productivity of the economy. At the same time, it argues that the reductions in the statutory corporate tax rate achieved by such reforms “are essential to encourage additional internationally mobile, high-return investments in the United States.”¹³⁹

Base-Broadening Tax Reform

Economic growth and job creation would be enhanced through corporate tax reform providing a reduced statutory tax rate and a competitive territorial tax system. The experiences of other countries suggest that the cost of these reforms is at least in part self-financing, as the added economic growth increases tax revenues. To the extent required, appropriate base-broadening reforms that limit tax expenditures and similar provisions can ensure that corporate tax reform does not result in a reduction in tax revenues. The use of any specific provision as a revenue offset in tax reform must carefully weigh the economic benefits achieved through the other components of tax reform. Implementation of comprehensive reform should include transition rules to minimize taxpayer uncertainty while legislation is being formulated and to avoid retroactive taxation. Further, because increases in the corporate income tax adversely affect economic growth, any base-broadening provisions should be kept to the minimum necessary to provide for corporate rate reduction and improving the competitiveness of the U.S. international tax system.

Corporate Rate Reduction as an Investment Incentive

Conventional economic models have emphasized incentives such as accelerated depreciation over rate reduction to encourage business investment.¹⁴⁰ As noted by others, however, when businesses earn positive profits on their investments and have a choice about where to locate their profit-making investments, corporate rate reduction can be a more effective way to increase investment and economic growth.¹⁴¹

President Obama's *Framework for Business Tax Reform* notes that "in an increasingly global economy, accelerated depreciation may be a less effective way to increase investment and job creation than reinvesting the savings from moving towards economic depreciation into reducing tax rates."¹⁴²

Martin Sullivan, chief economist for *Tax Notes*, describes in 2006 testimony to the Senate Finance Committee the reasons why corporate rate reduction may be more effective than incentives like accelerated depreciation:

In this new era of corporate taxation, it is not accelerated depreciation and tax credits that are the big draw for corporate investment. It's the reduction of corporate tax rates.

Why the change? There are several reasons.

First, as economies move away from manufacturing—as intangible assets become more important than plant and equipment, as the rate of profitability per dollar of physical capital increases—it is a straightforward matter of arithmetic that rates play a larger role than conventional incentives in determining the after-tax profit of investment decisions.

Second, as transportation and communications costs have dropped, and trade barriers and currency controls have also declined, there is more cross-border investment than ever. In the old days—say, before 1995—economists were thinking about how to use taxes to get a domestic firm to boost its domestic investment on the margin, for example, by 3 or 4 percent. In that case—that is, in the case of investment of borderline profitability—traditional incentives can mean a lot. And because this was the type of investment governments were trying to encourage, using tax credits and depreciation was a revenue-efficient way for governments to provide investment incentives.

But with increased capital mobility, economists have changed their thinking about how taxes motivate investment. Under the new paradigm, governments are trying to influence location decisions of multinationals. Because these decisions involve large chunks of investment—not just those marginally profitable—tax rates matter more than tax credits.

Finally, as mobile as capital may be, profits are more mobile. In deciding where to channel profits, tax rate differentials are all important, and conventional incentives don't matter at all.

What does all this mean? It means that without increasing the deficit and without changing the overall tax burden on the corporate sector, a government can protect its revenue base, increase investment, and increase competitiveness.¹⁴³

VII. Conclusion

Corporate tax reform can grow the economy by increasing domestic investment and increasing the competitiveness of American companies in global markets. A faster growing U.S. economy will produce more and better paying jobs both now and for future generations of Americans.

The problems with our current corporate tax system are well known, and the reforms that are needed are clear. The U.S. corporate tax system has failed to keep pace with the changing global economy, with the last comprehensive restructuring of the tax system occurring in 1986. Today the U.S. corporate tax system is an outlier at a time when capital is more mobile and the world's economies are more interconnected than at any time in history.

Our current tax system discourages capital investment in the United States, impairs the ability of American companies to compete abroad, and thereby harms U.S. workers and their families. The United States has the highest corporate tax rate among advanced economies and is one of the few remaining advanced economies to maintain a worldwide tax system. The U.S. corporate tax system is the least competitive among advanced economies — when we should be striving to make it the most competitive. The end result of this tax system is a more slowly growing economy, resulting in fewer jobs and lower wages for American workers.

Tax reform to improve economic growth and job creation in the United States should at a minimum result in a tax system that is as competitive as the tax systems of our trading partners. A competitive corporate tax rate and modern international tax rules like those of other OECD countries will promote investment in the United States and provide a level playing field for American-based businesses to compete globally. Together these reforms will provide for enhanced U.S. economic growth, with higher wages and greater employment opportunities for American workers.

Now is the time for Congress and the Administration to act.

Appendix A. Summary of Major Corporate Tax Reform Plans

This appendix and the accompanying table (**Figure 18** on page 50) summarize several recent corporate income tax reform proposals: President Obama’s *Framework for Business Tax Reform* and additional detail provided in his *Fiscal Year 2016 Budget* proposal; then-House Ways and Means Chairman Dave Camp’s comprehensive tax reform legislation introduced as the Tax Reform Act of 2014 in the 113th Congress; the recommendations of former Senator Alan Simpson and Erskine Bowles, co-chairs of President Obama’s National Commission on Fiscal Responsibility and Reform; and Senator Ron Wyden’s and Senator Dan Coats’ Bipartisan Tax Fairness and Simplification Act in the 112th Congress. In addition, the text describes the business tax reform components of two recently proposed reforms of the tax system that would incorporate elements of consumption taxation: Senator Ben Cardin’s Progressive Consumption Tax Act and Representative Devin Nunes’ American Business Competitiveness Act.

President’s Framework for Business Tax Reform (February 2012); President’s Fiscal Year 2016 Budget proposal

President Obama’s *Framework* would reduce the corporate tax rate to 28 percent, with further reductions for manufacturers, and eliminate a number of tax expenditures.¹⁴⁴ The plan would establish a minimum tax on the foreign earnings of U.S. companies. The plan would make the research credit permanent and increase the credit rate for the alternative simplified credit. The plan recommends reforms that would treat large pass-through entities on a basis more comparable to large corporations. The President’s *Fiscal Year 2016 Budget* proposal provides more details on aspects of the plan.

Figure 18 on page 50 provides a summary of other provisions in the proposals.

Former House Ways and Means Chairman Dave Camp’s Tax Reform Act of 2014 (February 2014)

Then-House Ways and Means Chairman Dave Camp (D-MI) released a discussion draft in February 2014 for comprehensive tax reform of both the individual and business tax systems. The legislation was subsequently introduced as the Tax Reform Act of 2014, H.R. 1. For corporations the bill phased in a 25 percent corporate tax rate over five years, provided a 95 percent exemption system (territorial) for active foreign business income, and provided for a broad repeal or reduction of most tax expenditures. The legislation, encompassing both individual and business reforms, was estimated by the JCT to be revenue neutral over the 10-year budget period under conventional scoring. A macroeconomic analysis of the legislation estimated a net revenue gain between \$50 billion and \$700 billion under alternative modeling assumptions.

The new foreign system includes base-protection measures that would tax currently certain foreign income, defined as “foreign base company intangible income,” and provides a reduced 15 percent tax rate on intangible income from foreign related sales of domestic corporations. Additionally, interest deductions would be limited under a “thin capitalization” rule if (i) interest expense exceeds 40 percent of adjusted taxable income and (ii) domestic leverage exceeds 110 percent of the worldwide consolidated leverage of the group.

The alternative simplified research credit rate would be increased to 15 percent and made permanent. Domestic base-broadening provisions include slowing depreciation deductions, amortizing research and advertising expenditures, and repealing the deduction for domestic production activities.

Bipartisan Tax Fairness and Simplification Act (Wyden-Coats, April 2011)

Senator Ron Wyden (D-OR) and Senator Dan Coats (R-IN) introduced the Bipartisan Tax Fairness and Simplification Act (S. 727, 112th Cong.) in April 2011. The legislation, similar to legislation previously co-sponsored by Senator Wyden and former Senator Judd Gregg (R-NH), would reduce the corporate tax rate to 24 percent. The legislation would repeal a number of tax expenditures.

The legislation would subject all foreign earnings of U.S. companies to immediate taxation, without deferral, and would restrict the use of foreign tax credits by imposing a per-country foreign tax credit limitation. The legislation would provide a temporary one-year period during which foreign earnings could be repatriated at a maximum tax rate of 5.25 percent.

The legislation would deny a deduction for a portion of gross interest expense. Interest income of recipients would be fully included in taxable income.

President's National Commission on Fiscal Responsibility and Reform (Simpson-Bowles, December 2010)

President Obama's National Commission on Fiscal Responsibility and Reform, co-chaired by former Senator Alan Simpson (R-WY) and former White House Chief of Staff Erskine Bowles, recommended reducing the corporate tax rate to a range between 23 and 29 percent and providing a territorial tax system.¹⁴⁵ The cost of these reforms would be offset by the elimination of all business tax expenditures.

Representative Devin Nunes' American Business Competitiveness Act of 2015 (January 2015)

Representative Devin Nunes (R-CA) has proposed (but not formally introduced in Congress) the American Business Competitiveness Act. The legislation would, after a phase-in period, tax net business income at a 25 percent rate, whether earned by individuals, pass-throughs or corporations. Net business income would be computed on the basis of cash-flow accounting with full expensing of capital investments but with no deduction for interest expense. Business tax credits would be repealed. Foreign earnings would be exempt from taxation. Pre-enactment accumulated unremitted foreign earnings would be subject to a 5 percent tax. Interest, dividends and capital gains income would be taxable to individuals, with interest taxed at the current law reduced rates applying to dividend income and long-term capital gains. No other changes would be made to the taxation of nonbusiness income.

Business taxation under the plan is similar to a subtraction method value added tax with a deduction for wages (after a phase-in period), a tax base also known as the "X-Tax."

Senator Ben Cardin's Progressive Consumption Tax Act (December 2014)

Senator Ben Cardin (D-MD) introduced the Progressive Consumption Tax Act (S. 3005, 113th Cong.) in December 2014. The legislation provides for a new consumption tax, in the form of a goods and services or value added tax used by other countries, with the revenues from this new tax used to reduce tax collections under both the corporate and individual income tax.

The consumption tax would be calculated by businesses under the credit-invoice system so that businesses would receive full credit for tax previously paid on business inputs. The consumption tax would be rebated on exports from the United States and fully imposed on imports to the United States.

The bill would reduce the corporate income tax rate to 17 percent and repeal the alternative minimum tax. It would not otherwise change other business deductions or credits, and it would continue the current worldwide system of taxation.

Figure 18

Summary of Recent Corporate Tax Reform Proposals

Item	Current law	President's Framework for Business Tax Reform (2012) and modifications included in the President's Fiscal Year 2016 Budget proposal
Top Statutory Corporate Tax Rate	35%	28%
Taxation of Active Foreign-Source Income	Taxed when repatriated (deferral) with credit for foreign income taxes.	Impose a minimum tax on foreign earnings. As specified in the President's <i>Fiscal Year 2016 Budget</i> , the foreign minimum tax would apply when the effective tax rate on a company's earnings in any foreign country was less than 22.4%. Such income, less an allowance for a risk-free return, would be taxed currently at a 19% rate. A per-country foreign tax credit for 85% of foreign taxes would be permitted against the tax. A 14% tax would apply to previously untaxed foreign earnings, payable over five years.
Corporate Alternative Minimum Tax	Corporations pay the greater of 20% of alternative minimum taxable income or regular corporate tax.	Not specified.
Domestic Production Deduction	Up to 9% deduction of qualified production activities income.	Target and increase deduction to 10.7% (results in a 25% tax rate on qualifying manufacturing income).
Research & Development (R&D) and Research & Experimentation (R&E)	R&D costs may be deducted as incurred ("expensed"). A credit is allowed for qualified R&E costs, determined under one of three methods, through 2014.	Make R&E credit permanent and increase the credit rate for the alternative simplified credit.
Capital Cost Recovery	Modified accelerated cost recovery system; temporary 50% bonus depreciation through 2014; \$500,000 of investment may be 100% expensed in 2014 subject to phaseout.	As part of a menu of options, proposes less accelerated depreciation allowances. Allows small businesses to expense up to \$1 million in investment.
Inventory Methods	Businesses may account for inventories under the last-in, first-out (LIFO) method of accounting and the lower of cost or market (LCM), in addition to other methods.	LIFO inventory method is disallowed. President's <i>Fiscal Year 2016 Budget</i> would also disallow LCM method. It would allow cash accounting for businesses with up to \$25 million in gross receipts.
Deduction of Interest Expense	Limited to bona fide debt (sec. 385). Earnings stripping rules apply to interest paid to or guaranteed by related nontaxable person (sec. 163(j)).	Consider reduced deductibility of interest expense as part of a menu of options. President's <i>Fiscal Year 2016 Budget</i> provides that interest expense allocated and apportioned to foreign earnings would be deductible at the residual minimum tax rate and not deductible if not subject to U.S. tax.
Other General Business Credits	More than 30 tax credits.	Make tax credit for production of renewable electricity permanent and refundable.
Other Tax Expenditures	More than 70 tax expenditures.	Eliminate tax expenditures for specific industries, including oil and gas tax preferences, and reform treatment of insurance industry and products.
Pass-Through Businesses	Income of pass-through businesses is not subject to an entity-level tax; business owners are subject to income tax on their share of pass-through business income.	Consider modifications to establish greater parity between large corporations and large noncorporate businesses. Small businesses would not be affected.

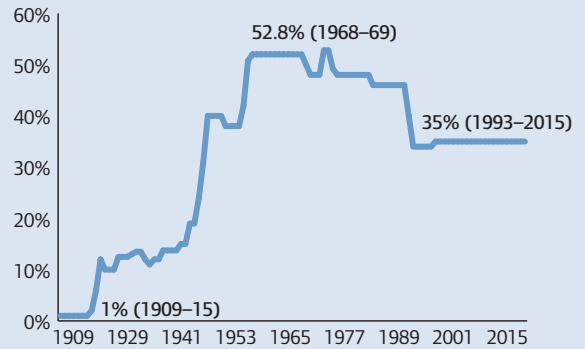
Former House Ways & Means Chairman Camp, Tax Reform Act of 2014 (H.R. 1), 2014	Simpson-Bowles (President's National Commission on Fiscal Responsibility and Reform), 2010	Wyden-Coats (S. 727), 2011
25% (phased in over five years)	23%–29% (“illustrative plan” provides 28% rate)	24%
Adopt a territorial system that exempts 95% of active foreign earnings. “Intangible income” from foreign markets taxed currently at a reduced 15% rate once fully phased in. Foreign “intangible income” from sales to U.S. market taxed currently at a 25% rate. U.S. “intangible income” for exports also eligible for reduced 15% rate. Require an 8.75% tax on pre-existing unremitted foreign earnings held as cash and cash equivalents and a 3.5% tax on other pre-existing unremitted foreign earnings (with a foreign tax credit), payable over eight years.	Adopt a territorial system.	Repeal deferral and impose a per-country foreign tax credit limitation. Repeal inventory property sales source rule. Provide a one-year temporary dividends received deduction for foreign earnings.
Repealed.	Repealed.	Repealed.
Phased out and repealed over three years.	Repealed.	Repealed.
Make the alternative simplified credit permanent and increase the credit rate to 15%. Excludes software development costs and supplies from eligible expenditures for the credit. R&D costs would be amortized over five years.	No R&E credit. R&D costs would be amortized over five years.	No R&E credit. Present-law expensing of R&D costs.
Repeal accelerated depreciation. Replace with modified alternative depreciation system (ADS) of present law. Modification would permit a form of inflation indexing to deductions. Allow small businesses to expense up to \$250,000 in investment.	Repeal accelerated depreciation. Replace with ADS of present law.	Repeal accelerated depreciation. Replace with ADS. Allow expensing for businesses with up to \$1 million of gross receipts.
LIFO and LCM methods disallowed. Cash accounting allowed for businesses with up to \$10 million in gross receipts.	LIFO inventory method is disallowed with appropriate transition.	Disallow LCM valuation method. Inventory accounting not required for business with less than \$1 million of gross receipts.
A “thin capitalization rule” would disallow a portion of net interest expense of U.S. multinational companies to the extent they have excessive domestic interest expense relative to worldwide leverage and it exceeds 40% of adjusted taxable income.	Present law.	Inflation component of gross interest expense is not deductible (all interest income remains taxable).
Repeal most business credits.	Repealed.	Credit for enhanced oil recovery repealed.
Eliminate or reduce most tax expenditures. Additionally limit net operating loss deduction to 90% of taxable income; require 50% of advertising expense to be amortized over five years; and extend amortization of acquired intangibles from 15 to 20 years.	Repealed.	Repeal selected tax expenditures, including percentage depletion for oil and gas.
In general, changes to business deductions and tax credits would also apply to pass-throughs. Publicly traded partnerships, other than those with qualifying income from mining and natural resource activities, would become taxable as corporations after a transition period.	Present law.	Present law.

Appendix B. Federal Statutory Corporate Tax Rates, 1909–2015

- ▶ The initial corporate income tax in 1909 (enacted as an excise tax on corporate income) imposed a 1 percent tax on corporate income in excess of \$5,000.
- ▶ The top tax rate ranged from 10 percent to 19 percent between 1918 and 1939.
- ▶ The top corporate rate increased to 40 percent during World War II.
- ▶ The maximum tax rate reached 52.8 percent in 1968 and 1969, comprised of a 48 percent regular tax and a 10 percent surtax.
- ▶ The top corporate tax rate was reduced by the 1986 tax reform act, with the top rate reduced over two years from 46 percent to 34 percent.
- ▶ In 1993, the corporate tax rate was increased to 35 percent, where it remains.

Figure 19

Top Federal Statutory Corporate Tax Rate, 1909–2015



Source: IRS Statistics of Income Division.

Appendix C. Major Corporate Tax Developments, 1909–2015

Congress Taxes Corporate Income

- ▶ 1909: Federal excise tax imposed on corporations based on income; tax imposed on worldwide income with a deduction for foreign taxes
- ▶ 1913: Federal income tax enacted after ratification of the 16th Amendment; new law incorporates existing corporate tax, with top rate of 1 percent

Tax Rate Gradually Rises to 52 Percent

- ▶ 1918: Top rate of 12 percent; allows foreign tax credit (FTC) in place of a deduction for foreign taxes
- ▶ 1919: Top rate reduced to 10 percent
- ▶ 1922: Top rate of 12.5 percent
- ▶ 1936: Top rate of 15 percent
- ▶ 1938: Top rate of 19 percent
- ▶ 1939: Enactment of Internal Revenue Code of 1939 — restates and revises existing tax law
- ▶ 1940: Top rate of 24 percent
- ▶ 1941: Top rate of 31 percent
- ▶ 1942: Top rate of 40 percent
- ▶ 1946: Top rate of 38 percent
- ▶ 1950: Top rate of 42 percent
- ▶ 1952: Top rate of 52 percent

Developments from 1954 Code until Tax Reform Act of 1986

- ▶ 1954: Enactment of Internal Revenue Code of 1954 — restates and revises existing tax law; enacts current deductibility of research and experimental expenditures
- ▶ 1962: Revenue Act of 1962 — enacts subpart F limits on deferral, investment tax credit (ITC)
- ▶ 1964: Revenue Act of 1964 — top rate of 50 percent
- ▶ 1965: Top rate of 48 percent (surcharges applied in 1968–70)
- ▶ 1969: Tax Reform Act of 1969 — repeals ITC
- ▶ 1971: ITC restored; domestic international sales corporation (DISC) provisions enacted
- ▶ 1976: Tax Reform Act of 1976 — extends ITC; expands net operating loss carryover; modifies FTC, DISC, other international tax rules

- ▶ 1979: Top rate of 46 percent (under Revenue Act of 1978); ITC permanently extended
- ▶ 1981: Economic Recovery Tax Act of 1981 — adopts new accelerated cost recovery system; enacts research tax credit
- ▶ 1982: Tax Equity and Fiscal Responsibility Act of 1982 — limits certain corporate tax incentives
- ▶ 1984: Deficit Reduction Act of 1984 — enacts foreign sales corporation (FSC) provisions; postpones certain tax reductions to reduce deficit

Tax Reform Act of 1986 Reduces Corporate Rate

- ▶ 1986: Tax Reform Act of 1986 — revises and restates existing tax law as the Internal Revenue Code of 1986; enacts modified accelerated cost recovery system; repeals ITC; enacts phased reduction in corporate tax rate for 1987–88; enacts corporate alternative minimum tax; makes extensive changes to international tax rules
- ▶ 1987: Top rate of 40 percent
- ▶ 1988: Top rate of 34 percent

Rate Increase, Other Foreign and Domestic Developments

- ▶ 1993: Top rate of 35 percent; section 197 amortization of goodwill and section 162(m) compensation deduction limitation enacted
- ▶ 1997: Active finance provision enacted as a temporary provision, restoring deferral for active foreign income of financial services companies
- ▶ 2000: FSC regime repealed; extraterritorial income (ETI) regime enacted
- ▶ 2002: Partial expensing (“bonus” depreciation) first enacted as a temporary provision, retroactive to September 11, 2001
- ▶ 2003: Reduced individual tax rates for qualified dividends paid by corporations
- ▶ 2004: ETI regime repealed; section 199 domestic production activities deduction and section 965 temporary foreign earnings repatriation enacted
- ▶ 2006: Look-through rule for controlled foreign corporations enacted as a temporary provision, permitting the payment of dividends, interest, rents or royalties between related foreign subsidiaries without being subject to current U.S. taxation
- ▶ 2014: Most recent one-year temporary extension of a broad group of individual and business tax provisions, retroactive to January 1, 2014, and expiring after December 31, 2014

Appendix D. U.S. Employment by Corporations and Other Businesses

Business activity is conducted through different legal forms of organization, including corporations, partnerships and sole proprietorships, for various business and tax reasons.

For tax purposes, only business income of so-called C corporations (named after Subchapter C of the tax code) is subject to the corporate income tax. For the most part, businesses seeking to raise capital in publicly traded markets are required to be taxed under the corporate income tax as C corporations. Dividend distributions of corporate earnings from C corporations to individual shareholders are subject to a second level of tax under the individual income tax system when received by the shareholder.

In contrast, business income of S corporations (named after Subchapter S of the tax code), partnerships, limited liability corporations and sole proprietorships is attributed directly to their owners and is taxed under the individual income tax system rather than at the entity level.

In 2011, private-sector businesses employed 96.5 million full-time and part-time employees and had total payrolls of \$4.5 trillion.¹⁴⁶ C corporations employed 52.9 million workers and had payrolls of \$2.8 trillion, accounting for 55 percent of business employment and 63 percent of business payrolls (**Figure 20**).

Figure 20

Employment by Business Legal Form, 2011

Business	Employees (millions)	Percentage of total	Payroll (\$ billions)	Percentage of total
C corporations	52.9	55%	2,827.4	63%
S corporations	28.0	29%	1,052.8	23%
Partnerships	11.9	12%	505.9	11%
Sole proprietorships	3.8	4%	98.5	2%
TOTAL	96.5	100%	4,484.5	100%

Notes: Employee counts and payroll are of paid employees; proprietors and partners are excluded. Business employment excludes nonprofit and government-sector employment. Details may not add to totals due to rounding.

Sources: U.S. Census Bureau, U.S. Department of Commerce, Statistics of U.S. Businesses.

Large and Small Businesses

Large firms, defined as those with 500 or more employees, employed 51 percent of all workers in businesses and accounted for 56 percent of business payrolls in 2011.¹⁴⁷ Among C corporations, large firms employed 38.5 million workers and had payrolls of \$2.1 trillion in 2011.

Both large and small business enterprises play an important role in the economy. One survey of large American companies with international operations found that nearly one-quarter of all of their domestic business purchases are from U.S. small businesses, accounting for \$1.52 trillion in sales by U.S. small businesses in 2010.¹⁴⁸

Recent research has identified new businesses, which typically start as small businesses, as playing a disproportionate role in contributing to job growth.¹⁴⁹ New businesses may be created to develop new ideas and technologies, and their success leads to rapid growth. However, when one examines businesses of the same age, this research finds no evidence that small firms create jobs at a faster rate than large firms. Instead, it finds that net job creation is roughly in proportion to the amount of employment in each size class of firms.

Appendix E. Profile of American Companies with International Operations

American parent companies with international operations employed 23.1 million workers in the United States in 2012, the latest year for which preliminary data are available.¹⁵⁰ U.S. employment by these companies accounted for more than two-thirds of the worldwide employment of their combined U.S. and majority-owned foreign operations.

The average annual compensation paid in 2012 by American parent companies to their American workers was \$76,538 — 34 percent higher when compared with \$57,291 for other U.S. businesses.¹⁵¹

Of the 2,347 U.S. multinational parent companies in 2009, approximately one-quarter had less than 500 employees and were classified by the U.S. government as small or medium-sized businesses; 62 percent of U.S. parent companies had more than 1,000 employees. Large firms with more than 1,000 employees employed 97 percent of all Americans working for U.S. multinational corporations.¹⁵²

As with their significant employment base in the United States, American companies with international operations conduct most of their activity in the United States. More than 75 percent of the compensation paid by these companies to employees is in the United States, and 70 percent of the value added from the worldwide activities of these companies arises in the United States.¹⁵³ American parent companies undertook \$584 billion of capital expenditures in plant and equipment in the United States in 2012, representing more than 70 percent of their worldwide capital investment.¹⁵⁴

U.S. parent companies with foreign affiliates directly accounted for 45 percent of all U.S. exports in 2012.¹⁵⁵

Research has shown that increased sales by foreign affiliates of U.S. parent companies are typically associated with greater U.S. employment, greater U.S. investment, and increased exports of goods and services from the United States by the U.S. parent company.¹⁵⁶ Findings of one study suggest that an average of 124 U.S. jobs are created in the parent company's U.S. operations for every 100 jobs added abroad in its foreign affiliates.¹⁵⁷

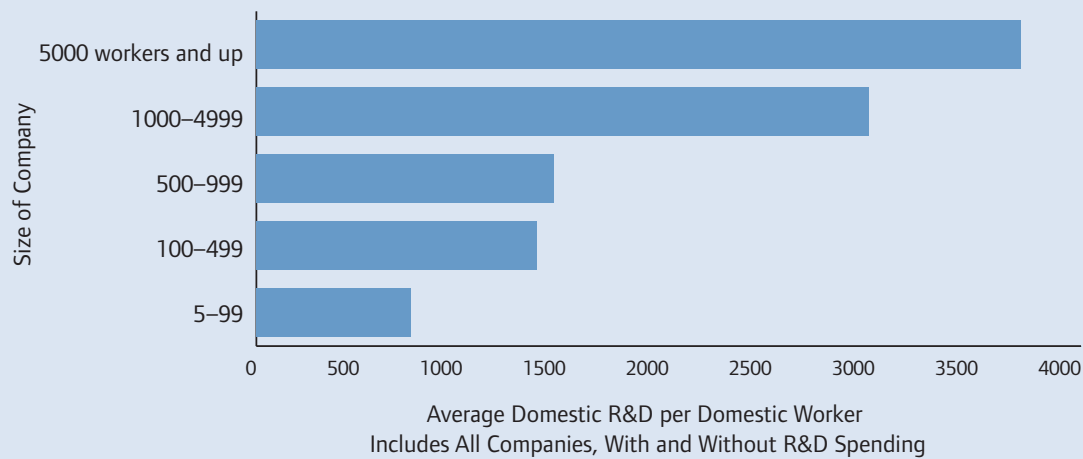
Research and Development (R&D) and Productivity of American Parent Companies

R&D expenditures by American parent companies in the United States were \$230 billion in 2012 and represented 84 percent of their worldwide R&D expenditures.¹⁵⁸ In 2012, R&D by American parent companies accounted for 76 percent of all research undertaken by American companies in the United States.¹⁵⁹ Sales to foreign markets help support domestic R&D by providing a larger base of sales over which to spread the costs of developing new products and processes.

A study by Michael Mandel of the Progressive Policy Institute, based on National Science Foundation data, finds that large firms on average undertake significantly more R&D per employee than small firms.¹⁶⁰ In addition, the study finds that companies spending more on research achieve significantly more innovations. More recent data support the conclusion that larger firms undertake more R&D per employee. Companies employing more than 5,000 workers had research expenses averaging \$3,709 per worker in 2011. Per-worker R&D expense declined for all smaller sized firms. On average, the largest sized firms spent five times more per employee on R&D than the smallest sized companies (those employing from five to 99 workers) **(Figure 21)**.

Figure 21

Average R&D Spending per Employee Increases with Company Size



Source: Calculations based on data from the National Science Foundation and the U.S. Census Bureau.

A study by Federal Reserve Board economists finds that companies with international operations are responsible for significant increases in U.S. labor productivity. The study finds that these companies were responsible for more than three-fourths of the increase in labor productivity in the U.S. corporate sector between 1977 and 2000 and all of the labor productivity growth in the U.S. corporate sector in the late 1990s.¹⁶¹

Research by the Bureau of Economic Analysis finds that American manufacturing companies with foreign operations were 16 percent more productive than companies that operated only in the United States.¹⁶² Further, this productivity advantage increases with the global scope of a company's operations. In 2008, American companies operating in 10 or more countries had 54 percent greater value added per employee than those companies operating in just one foreign country and 21 percent greater value added per employee than companies that operated in two to nine foreign countries.¹⁶³ Higher worker productivity in turn is the key determinant of higher wages and a higher standard of living for American workers.

Given the importance of R&D activities in fostering technological advancements and productivity gains, it is important that tax policy not diminish the ability of large companies to compete successfully globally. Worldwide operations of these companies provide the scale that allows these companies to invest in risky R&D activities.

Appendix F. Glossary of Tax Terms

The language of tax experts can be confusing, even to experienced audiences. To help decisionmakers understand the complex issues of taxation, Business Roundtable has compiled this glossary that defines some of the most frequently used tax terms.

- ▶ **Accelerated Depreciation:** Depreciation method under which tax deductions for depreciation are taken more rapidly than the decline in economic value of an asset. (Also see *Depreciation*, *Bonus Depreciation* and *Expensing*.)
- ▶ **Accrual Accounting:** A method of accounting for income under which revenue and expenses are recognized at the time the transactions occur, which may differ from the time cash payments are received or made. (See *Cash Basis Accounting* for an alternative accounting method.)
- ▶ **Active Financing Income Rule:** U.S. tax rules generally defer taxation of income from an active foreign business until that income is remitted to the U.S. parent. Under subpart F rules, interest and related income of a foreign subsidiary generally are subject to current taxation without benefit of deferral. These rules historically have aimed at requiring current taxation of income that is *passive* or easily moveable, although some forms of *active* income also are subject to these rules. The active financing income rule in present law is a temporary measure to permit deferral of certain types of income derived from the *active* conduct of a banking, finance or insurance business. This provision, most recently extended in December 2014, expires for taxable years beginning after December 31, 2014.
- ▶ **Active Income:** Income earned by a corporation through the active conduct of a trade or business, in contrast to income earned from a passive investment activity.
- ▶ **Advance Pricing Agreement (APA):** A binding agreement between a taxpayer and a taxing authority (unilateral) or two taxing authorities (bilateral) on the taxpayer's transfer pricing method for specific transactions.
- ▶ **Affiliates:** Entities that are related through a common ownership interest. This relationship can occur between a parent corporation and a subsidiary or through common ownership, such as brother-sister corporations.
- ▶ **Allocation:** The process of assigning income or expenses to a specific jurisdiction or categories of income and/or expenses based on their association with that jurisdiction or category. Allocation differs from apportionment as the former generally involves identifying how specific items of income or expense should be assigned to a jurisdiction or category.
- ▶ **Alternative Minimum Tax, Corporate:** Federal tax rules require companies to compute tax liability under the regular rules of the income tax system and then a second time under an alternative calculation that disallows many deductions, exemptions and business tax credits but applies a lower statutory rate of tax (20 percent). Corporations are required to pay the larger of their regular tax liability or the alternative tax amount. (See *Minimum Tax* in the context of the taxation of foreign income.)
- ▶ **Amortization:** The systematic, straight-line reduction of the basis of an intangible asset, in the form of a deduction, over the useful life of the asset. As in the case of depreciating tangible assets, U.S. tax law provides guidance for the length of the useful life for different types of intangible assets.

- ▶ **Apportionment:** The process of assigning income or expenses among jurisdictions or categories, usually through use of a formula.
- ▶ **Arm’s-Length Standard:** Under current law, transactions between a U.S. parent company and its foreign subsidiaries are required to use the same prices that the parent company and its foreign subsidiaries would use with unrelated companies. This principle of determining internal transfer prices using the same terms as would apply with unrelated companies is also known as the arm’s-length standard. It allows for agreement by countries with potentially conflicting interests to use a well-accepted principle for determining the source of income in cross-border transactions between related parties.
- ▶ **Average Tax Rate:** The percentage of a taxpayer’s income used to pay tax. The rate is determined by dividing the tax liability of the taxpayer by its taxable income.
- ▶ **Base Broadening:** Changes to tax rules that expand the tax base. When discussed in the context of income tax reform, such proposed changes typically increase the measure of taxable income by repealing or limiting deductions or exclusions from income or by repealing or limiting tax credits that reduce income tax liability.
- ▶ **Base Erosion and Profit Shifting (BEPS):** A project launched by OECD in 2013 to consider changes to international rules for the taxation of cross-border transactions. The project has been motivated by concerns of some host countries that they are not receiving their “fair share” of tax revenue from the activities or sales of multinational companies. These governments are concerned that tax planning by multinational companies can take advantage of cross-border differences in taxation to reduce or avoid tax on certain income in a manner not intended by the governments. Business concerns with the project are that any rewriting of accepted international tax rules can result in double taxation of income. Increased uncertainty about how business investment will be taxed is likely to result in reduced cross-border investment, with the risk of slower worldwide economic growth.
- ▶ **Baseball Arbitration:** The final-offer approach to dispute resolution in which the competent authorities present their respective proposed resolutions to an arbitration panel, which adopts one of the proposed resolutions.
- ▶ **Bonus Depreciation:** A temporary provision providing partial or full expensing of an asset in the year the asset is placed in service. In years the provision has been in effect, the amount of expensing permitted in the first year has been 30, 50 or 100 percent, depending on the asset’s placed-in-service date. The basis of each qualifying asset is adjusted by the amount of bonus depreciation taken before applying standard depreciation rules. Bonus depreciation of 50 percent, most recently extended in December 2014, expires for taxable years beginning after December 31, 2014.
- ▶ **C Corporation:** A corporation that is subject to tax at the entity level under Subchapter C of the Internal Revenue Code.
- ▶ **Cash Basis Accounting:** A method of accounting for income under which revenue is recognized when cash is received and expenses are recognized when cash payments are made. (See *Accrual Accounting* for an alternative accounting method.)

- ▶ **CFC Look-Through Rule:** In May 2006, Congress enacted a temporary “look-through” exception for subpart F with respect to payments of dividends, interest, rents and royalties between related controlled foreign corporations (CFCs). The rule provides that such payments will not give rise to subpart F income (thereby permitting deferral) to the extent the payments come from active, nonsubpart F earnings of the payer CFC. In effect, the provision “looks through” the form of payment to the underlying source of income. The provision was adopted to permit foreign subsidiaries of U.S. companies to redeploy active foreign earnings in a manner similar to that permitted by most U.S. trading partners. This exception from subpart F, extended in December 2014, expires for taxable years beginning after December 31, 2014.
- ▶ **“Check-the-Box” Election:** An election that allows an American company (or individual) to choose how an entity it owns, either domestic or foreign, will be treated for U.S. tax purposes. Before the check-the-box election was created, entities were determined to be corporations or pass-through entities based on detailed review of their characteristics.
- ▶ **Combined Corporate Tax Rate:** The tax rate of a corporation that includes the federal income tax rate as well as any state and local income tax rates, reduced by the benefit of any deduction allowable at the federal level for the state and local taxes. The average combined corporate tax rate for U.S. corporations in 2015 is 39 percent: 35 percent federal rate plus an average state and local rate of 4 percent net of deductibility at the federal level (6.15 percent before deductibility at the federal level).
- ▶ **Competent Authority:** The term used in income tax treaties to identify the designee or representative in each of the jurisdictions who will be responsible for implementing the treaty and its provisions. In the text of the treaty, the role of the competent authority is defined and generally includes serving as the primary point of contact for both taxpayers and the other jurisdiction’s competent authority. Depending on the treaty, there may be a single competent authority or different individuals designated as the competent authority for different activities.
- ▶ **Consumption Tax:** A tax levied on the value of a good or service to the ultimate consumer. Types of consumption taxes include sales tax, use tax, value added tax (VAT), and goods and services tax (GST). Sales and use taxes are assessed on the sale or use of a good or service, whereas a VAT or GST is levied at each stage of the supply chain with the total cost being borne by the ultimate consumer.
- ▶ **Controlled Foreign Corporation (CFC):** A foreign corporation in which more than 50 percent of the voting power or value of the stock is held by U.S. shareholders. Only a U.S. shareholder that owns 10 percent or more of the stock of the foreign corporation is included in this determination. Subpart F rules apply to foreign subsidiaries that are CFCs.
- ▶ **Deferral:** The United States defers collecting taxes on earnings of the foreign subsidiaries of U.S.-based corporations until those earnings actually are paid to the U.S. parent, with some exceptions (see *Subpart F*). Most frequently, repatriated foreign earnings are paid as a cash dividend to the U.S. parent company. This method of taxation mirrors the tax treatment of individual shareholders in a domestic corporation, who are not taxed on the earnings of the corporation until they receive a distribution from the corporation. All OECD member countries and other developed nations that tax the worldwide earnings of their globally operating corporations permit some form of deferral or otherwise exempt such earnings from domestic taxation.
- ▶ **Depreciation:** The systematic reduction of the basis of fixed assets, in the form of a deduction, for the basic wear and tear and loss of value over the useful life of the assets. U.S. tax rules provide specifications for the useful life of many types of assets.

- ▶ **Dispute Resolution:** The process of proactively addressing post-audit tax disputes by analyzing litigation hazards, developing defense strategies and exploring alternative dispute resolution opportunities. In the international tax context, dispute resolution is intended to provide multinational taxpayers with certainty and protection from double taxation and does so through procedures that are designed to ensure that their rights under tax treaties are enforced.
- ▶ **Disregarded Entity:** An entity that is 100 percent owned by one owner and is not considered separate from its owner for tax purposes. The owner may make a check-the-box election to treat a wholly owned entity as disregarded. All assets, liabilities, income, deductions, etc. of the disregarded subsidiary are included with those of the owner.
- ▶ **Dividend:** A taxable distribution, for which a corporation has enough earnings and profits to cover the payment, to the shareholders of the corporation. Although dividends are taxable income to the receiving shareholders, they are considered reductions in retained earnings of the distributing company and therefore are not deductible by the payer.
- ▶ **Dividends Received Deduction (DRD):** A deduction a corporation may take on a percentage of certain dividends received from another corporation. Dividends that qualify generally must come from a domestic corporation. The percentage of the DRD generally is 70 percent of the dividend received. However, the DRD is 100 percent for dividends received from another member of the same affiliated group of corporations. A temporary provision enacted in 2004 provided for an 85 percent DRD for dividends received from a controlled foreign corporation (see *Homeland Investment Act*). Some proposed dividend exemption systems for foreign earnings are implemented as a DRD (e.g., a 95 percent DRD for former House Ways and Means Committee Chairman Dave Camp’s 2014 territorial reform proposal).
- ▶ **Domestic Production Activities Deduction:** A deduction of 9 percent of U.S. taxable income or qualified production activities income, whichever is less, for domestic producers of goods. The deduction is 6 percent for oil-related qualified production activities income. The deduction is limited to 50 percent of the wages the taxpayer paid to employees, as reported on W-2s for the year. The deduction relates to taxable income earned for goods produced in the United States. This deduction is often referred to as the “Section 199 deduction” for the Internal Revenue Code section that provides the deduction.

The domestic production activities deduction defines several terms in its computation:

- o *Domestic production gross receipts (DPGR)* are the gross receipts associated with the sale, exchange, lease, rental or license of qualifying production property that has been manufactured, produced, grown or extracted completely or significantly within the United States by the taxpayer; gross receipts from the taxpayer’s domestic production of qualified films, electricity, natural gas or potable water; and gross receipts from construction of real property in the United States and related engineering or architectural services on such property performed in the United States.
- o *Qualified production activities income* is the measure of income for purposes of the domestic production activities deduction, equal to the amount of DPGR that are greater than the cost of goods sold and other deductions properly allocated to such receipts.
- o *Qualified production property* is property that is considered tangible personal property, computer software or a sound recording.

- ▶ **Double Taxation:** The taxing of income at two levels. Domestically, double taxation occurs when a corporation is taxed on its earnings and the earnings are subject to tax again (as a dividend) when they are distributed to the corporation's shareholders. Internationally, double taxation occurs when any item of income is taxed in the foreign country where it was earned and then taxed again by the taxpayer's home country due to a limitation or denial of credits for the taxes previously paid to the foreign country for that income. Jurisdictional double taxation refers to the system of taxation under which foreign income is subject to tax once in the source country where the income was earned and to a second level of additional tax in the home country of the taxpayer, even after receiving a credit for foreign taxes paid. Jurisdictional double taxation arises under worldwide systems of taxation, such as in the United States.
- ▶ **Earnings and Profits (E&P):** A tax accounting term describing a measure of income or surplus used to determine if a corporation has enough economic means to cover distributions. E&P is calculated through adjustments to taxable income. Current E&P is the E&P from the current tax year and is accounted for as of the end of the year, before consideration of any distributions made during the year. Accumulated E&P is the amount of E&P from prior years that has not been reduced previously through distributions. Ordering rules require distributions to first reduce current E&P and then accumulated E&P. If more is distributed in a year than the total E&P of the corporation, shareholders receive a return of capital up to their basis. Any remaining distribution is treated as a capital gain or loss.
- ▶ **Earnings Stripping Rules:** Current U.S. tax rules defer deductions for interest expense associated with related-party debt if incurred by a thinly capitalized U.S. subsidiary of a foreign corporation. For purposes of these rules, debt of such a U.S. corporation guaranteed by its foreign owner is considered related-party debt.
- ▶ **Effective Average Tax Rate:** Sometimes used as a synonym for effective tax rate but used by economists to evaluate the rate of tax paid on a highly profitable investment. It provides a measure of the disincentive effects of a tax system for undertaking such investments. (Contrast with *Average Tax Rate*, *Effective Tax Rate* and *Marginal Effective Tax Rate*.)
- ▶ **Effective Marginal Tax Rate:** See *Marginal Effective Tax Rate*.
- ▶ **Effective Tax Rate:** Effective tax rates typically measure the average rate of tax relative to a measure of income (sometimes other than taxable income). For example, "book" effective tax rates measure tax payments relative to financial statement income. (Somewhat different concepts are *Effective Average Tax Rate* and *Marginal Effective Tax Rate*.)
- ▶ **European Union (EU):** An economic and political partnership of 28 European countries: Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovak Republic, Slovenia, Spain, Sweden and the United Kingdom.
- ▶ **Exemption System:** See *Territorial Tax System*.
- ▶ **Expensing:** A term used to describe when a taxpayer deducts the full cost of property in the year it is placed in service, rather than capitalizing the asset and deducting its value over time, as with depreciation. The rules under Section 179 of the Internal Revenue Code allow expensing of qualified property. Bonus depreciation rules for assets placed in service for certain years are eligible for partial of full expensing of qualifying property.

- ▶ **Extraterritorial Income (ETI):** Gross income earned by the taxpayer from foreign trading gross receipts on U.S. exports. Under prior law, ETI could be excluded from gross receipts when determining taxable income of a U.S. taxpayer. ETI was enacted to replace the foreign sales corporation regime. The World Trade Organization deemed the ETI rules to be an export subsidy, which is illegal under international trade laws. ETI rules were repealed in the American Jobs Creation Act of 2004 and replaced with the domestic production activities deduction.
- ▶ **First-In, First-Out (FIFO):** A method used to value inventory on hand at the end of a tax year. Under FIFO, items are sold in the same order they were purchased or manufactured. As a result, stock on hand at the end of the year consists of the latest goods purchased or produced. FIFO matches current sales with the cost of the earliest acquired or manufactured inventory.
- ▶ **Foreign Base Company Income (FBCI):** A type of foreign income that is subject to current U.S. taxation under subpart F rules whether or not distributed to U.S. shareholders. The four categories of FBCI are:
 - *Foreign personal holding company income*, which consists of dividends, interest, royalties, rents and other kinds of investment income;
 - *Foreign base company sales income*, which is derived from the purchase and sale of property involving a related party where the property originates outside the country in which the controlled foreign corporation (CFC) is organized and is sold for use outside such foreign country;
 - *Foreign base company services income*, which arises on behalf of a related person outside the country in which the CFC is organized; and
 - *Foreign base company oil-related income*, which is income arising from the sale of oil and gas products except where the income is earned in the country in which it is extracted.
- ▶ **Foreign Sales Corporation (FSC):** A corporation formed under the laws of a foreign country or U.S. possession (other than Puerto Rico), meeting certain requirements, that exports U.S. goods. Under prior law, an FSC could treat a portion of its foreign trade income as tax exempt, and the remaining income was eligible for a generous dividends received deduction. The World Trade Organization declared the FSC system to be illegal, and U.S. tax laws permitting the entities were repealed in 2000, with the exception of transition rules.
- ▶ **Foreign Tax Credit (FTC):** To avoid double taxation of foreign income, the United States provides a credit against U.S. income tax for income tax paid to the host country. Without this credit, significant double taxation would make foreign investments noncompetitive for U.S.-based international companies. The FTC is subject to various limitations to ensure that a U.S. company pays at least as much tax on its worldwide income as it would pay on the same income earned at home.
- ▶ **G7:** The Group of 7 consists of seven major developed countries: Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.
- ▶ **G20:** A forum for international economic cooperation comprised of 19 countries and the European Union. The 19 countries are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom and the United States.
- ▶ **Goods and Services Tax:** See *Value Added Tax*.

- ▶ **Homeland Investment Act:** Part of the American Jobs Creation Act of 2004 that provided for a one-time 85 percent dividends received deduction (DRD) on distributions remitted to U.S. corporations from controlled foreign corporations. The dividend eligible for the DRD was limited to an amount that was in excess of average repatriated earnings from prior tax years. Calendar year taxpayers had to receive the eligible dividend by December 31, 2005, to benefit from the DRD.
- ▶ **Incidence of Tax:** The economic burden of a tax. The person bearing the incidence of the tax can be different from the person legally responsible for the tax payment.
- ▶ **Innovation Box:** See *Patent Box*.
- ▶ **Intangible Property:** Property that cannot be touched, such as a patent, copyright, noncompete agreement or goodwill. Intangible property with a limited life may be amortized, rather than depreciated, over time.
- ▶ **Integration:** Proposals to eliminate the double taxation of corporate income under which corporate income is first taxed at the entity level under the corporate income tax and a second time when earnings are distributed to shareholders under the individual income tax. Integration proposals typically give shareholders credit for taxes paid at the corporate level or eliminate or reduce the corporate tax paid at the entity level for earnings paid to shareholders.
- ▶ **Intellectual Property:** Property that is generally intangible in nature that is protected by copyrights, patents, trademarks, trade names, etc.
- ▶ **Inversion:** Typically a business transaction in which a company acquires an independent foreign company and the resulting new entity is incorporated in a country different from that of the acquiring company. The Internal Revenue Code and regulations provide rules governing the circumstances under which a transaction involving a U.S. acquirer will be recognized to result in a change in tax domicile.
- ▶ **Investment Tax Credit:** A credit for investment in certain business or income-producing depreciable property for rehabilitation, energy or therapeutic discovery purposes that is part of the general business credit. Prior to 1986, a comprehensive investment tax credit was available for general tangible personal property, subject to limitations, placed in service during the tax year.
- ▶ **IP Box:** See *Patent Box*.
- ▶ **Last-In, First-Out (LIFO):** Method used to value inventory on hand at the end of the year that treats the items most recently produced or purchased by a taxpayer as sold first. Any goods purchased or produced during a year that remain on hand at the end of that year create a "layer." A layer is depleted only when all goods from the current year are considered sold and any layers that had since been created have already been depleted. The objective of LIFO is to match current sales with current replacement costs. To use LIFO for tax purposes, taxpayers must also use LIFO for financial statement purposes. This stipulation is known as the LIFO conformity requirement.
- ▶ **Limited Liability Company (LLC):** An entity in which the liability of its members (owners) is limited to their investment in the entity. The default tax treatment of a multiple-member LLC is as a partnership. Single- and multiple-member LLCs may elect to be taxed as a corporation. A single-member LLC that does not elect to be treated as a corporation is disregarded for tax purposes.

- ▶ **“Lockout” Effect (Repatriation):** The disincentive for a U.S. company to remit earnings from a foreign subsidiary for reinvestment in the United States due to the additional layer of tax that would be required under the U.S. worldwide tax system, compared to the ability to repatriate funds with little or no additional tax under the territorial tax systems of most other OECD countries.
- ▶ **Marginal Effective Tax Rate:** Used by economists to evaluate the rate of tax paid on an investment on which the after-tax profits are just sufficient to cover the investor’s opportunity cost of capital. Also referred to as the “effective marginal tax rate.” The marginal effective tax rate provides a measure of the disincentive to undertake additional new investment. (Contrast with *Effective Average Tax Rate*.)
- ▶ **Marginal Tax Rate:** The tax rate at which a taxpayer’s last dollar of income is taxed.
- ▶ **Minimum Tax:** In the context of the taxation of foreign earnings, proposals that subject foreign earnings to current domestic tax if the foreign rate of tax does not exceed a prescribed percentage. President Obama proposed a minimum tax in his 2012 *Framework for Business Tax Reform*. Details of the proposal are provided in the President’s *Fiscal Year 2016 Budget* proposal. (In the context of domestic taxes, see *Alternative Minimum Tax, Corporate*.)
- ▶ **Mutual Agreement Procedures (MAP):** Assistance provided by the Office of the Competent Authority under the applicable tax treaties to both individual and corporate taxpayers seeking relief in situations in which the actions of one or both of the treaty participants result in taxation in contravention of treaty provisions.
- ▶ **Organisation for Economic Co-operation and Development (OECD):** An international organization to promote trade and economic development. The 34 member countries are Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, South Korea, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.
- ▶ **Partnership:** An association of two or more persons (or entities) engaged in a business for profit. Under U.S. law, partnerships are not taxable at the entity level; instead, items of income, deduction, gain and loss flow through to the tax returns of the ultimate owners.
 - *General partnership* is a partnership in which all partners have joint and several liability for debts.
 - *Limited partnership* is a partnership with general and limited partners. General partners manage the business and share full responsibility for debts of the company. Limited partners do not participate in managing the business, and their liability is limited to their investment in the company.
- ▶ **Passive Income:** Income earned in the form of interest, dividends and similar investment income through investment activities of the taxpayer (as opposed to income earned from the taxpayer’s active conduct of a trade or business).
- ▶ **Pass-Through Entity:** An entity that is not itself taxed but instead allocates its items of income, deduction, gain and loss to its owners, who will include such items with their income to be taxed. Partnerships, limited liability companies and S corporations are all generally considered pass-through entities.

- ▶ **Patent Box (Innovation Box or IP Box):** A tax regime adopted by a number of countries over the past decade that applies a reduced rate of corporate tax to income resulting from qualifying intellectual property (IP). Currently, 11 European Union countries — Belgium, Cyprus, France, Hungary, Italy, Luxembourg, Malta, Netherlands, Portugal, Spain and the United Kingdom — have adopted patent boxes that tax qualifying IP income at a reduced rate, typically at less than 10 percent. Ireland has proposed a patent box to be implemented with a tax rate between 5 and 6.25 percent.
- ▶ **Repatriated Earnings:** Income earned by a foreign subsidiary that has been brought back to a taxpayer's home country, generally in the form of a dividend. U.S. tax is usually assessed when foreign income is repatriated.
- ▶ **Revenue Neutral:** Changes to the tax system that result in no change in total revenue collections by the government. Revenue-reducing changes are exactly offset by other changes that increase tax revenue.
- ▶ **S Corporation:** A domestic small business corporation that for U.S. tax purposes has elected to have items of income, deduction, gain and loss flow through to shareholders. These items are apportioned on a per-share, per-day basis. To be an S corporation, businesses must meet and maintain certain requirements, including: (1) there are no more than 100 shareholders (attribution rules apply to determine one shareholder), (2) shareholders may only be individuals (and certain estates or trusts thereof), (3) shareholders may not be non-U.S. persons and (4) the company may only have one class of stock.
- ▶ **Single-Member LLC:** A limited liability company owned 100 percent by one member. Under U.S. tax law, the default treatment of a single-member LLC is as a disregarded entity, or not separate from its owner. A single-member LLC may elect to be taxed as a corporation separate from its owner.
- ▶ **Sole Proprietorship:** An unincorporated business owned by one individual, who is liable for all debts of the company. For U.S. tax purposes, all taxable profits and losses are not considered separate of the owner, who is liable for self-employment tax on income earned through the sole proprietorship.
- ▶ **Source Rules:** Rules used to allocate worldwide income, expenses and taxes into U.S. amounts and foreign amounts. In general, income is sourced to the place where the activity occurred that gave rise to the income, netted against directly related expenses.
- ▶ **Statutory Tax Rate:** The rate, as provided by law, that a taxpayer applies to net taxable income to determine tax liability. The top U.S. federal statutory corporate income tax rate is 35 percent.
- ▶ **Subpart F:** U.S. shareholders owning 10 percent of a controlled foreign corporation (CFC) are subject to U.S. tax currently on certain income earned by the CFC whether or not such income is actually distributed to the U.S. parent (i.e., without the advantage of deferral). These rules historically have aimed at requiring current taxation of income that is *passive* or easily moveable, although some forms of *active* income are also subject to these rules. Income subject to tax under subpart F includes certain insurance income and foreign base company income (defined previously).
- ▶ **Tax Expenditure:** Provisions in the Internal Revenue Code that provide taxpayers with favorable treatment relative to an assumed baseline tax system, generally through a deduction, credit, exclusion, exemption or lower rate.

- ▶ **Tax Information Exchange Agreement (TIEA):** A treaty between two governments to share tax-related information to reduce tax evasion.
- ▶ **Tax Treaty:** A formally signed, executed and ratified agreement between two governments negotiated to promote international trade and investment by reducing (or eliminating) the double taxation of income. U.S. tax treaties are negotiated by the Treasury Department subject to approval by the Senate.
- ▶ **Territorial Tax System:** Under a territorial or “exemption” system, the active foreign earnings of a foreign subsidiary are not subject to tax by the home country when paid as a cash dividend to the parent corporation. In 2015, 28 of the 34 OECD countries, including all G7 countries other than the United States, followed a territorial or exemption approach, with the remainder following a worldwide approach.
- ▶ **Thin Capitalization Rule:** Taxpayers with foreign related-party debt that have a high debt-to-equity ratio (i.e., are thinly capitalized) may be disallowed deductions of interest payments related to the excess debt.
- ▶ **Transfer Pricing:** U.S. tax law requires that taxpayers report income earned on cross-border transactions with related parties by setting appropriate internal prices for these transactions. Transfer pricing is the methodology by which these internal prices are determined. The transfer pricing system is enforced by the Internal Revenue Service through audits, advance pricing agreements and the rule-making process. Foreign governments also enforce and monitor transfer pricing to ensure that the foreign government taxes its proper portion of profits sourced to it.
- ▶ **Value Added Tax (VAT):** The VAT is the most common form of consumption tax in the world. Like a sales tax, a VAT is imposed on the final consumption of goods and services. Unlike a sales tax, which is collected once on the sale to the end user, a VAT is imposed on the value added at every stage of the supply chain. To avoid a cascading of the tax, each buyer in the supply chain, except the ultimate consumer, recovers the VAT paid through either the credit method or subtraction method. Under the credit method, VAT is collected on sales to other businesses or the ultimate consumer with an offsetting credit for VAT paid on purchases from other businesses. Under the subtraction method, the value added is determined by subtracting deductible pretax purchases from other businesses from pretax gross receipts from sales to other businesses or the ultimate consumer.
- ▶ **Withholding Tax:** A tax that is collected and paid to a taxing authority by the taxpayer that is the source of the income, rather than the taxpayer that has earned the income. For example, employers generally are required to withhold income tax from compensation paid to their employees. In international taxation, withholding taxes are often imposed on passive income, such as royalties, dividends and interest.
- ▶ **Worldwide Interest Allocation:** The American Jobs Creation Act of 2004 modified the interest expense allocation rules by providing a one-time election to allocate and apportion third-party interest expense of U.S. members of a worldwide affiliated group to foreign-source income for foreign tax credit limitation purposes in an amount equal to the excess, if any, of (1) the worldwide affiliated group’s interest expense multiplied by the ratio of total foreign assets of the group over worldwide assets over (2) third-party interest expense incurred by foreign members of the group that otherwise would be allocated to foreign sources. This worldwide fungibility approach is considered a benefit for U.S. taxpayers with foreign affiliates that incur significant interest expense. This provision was originally effective for tax years beginning after December 31, 2008. The effective date has since been delayed several times; as of 2015, the effective date is for tax years beginning after December 31, 2020.

- ▶ **Worldwide Tax System:** Under a worldwide system of taxation, all foreign earnings of a domestic corporation are subject to tax in the home country. In practice, countries following a worldwide approach, including the United States, permit deferral on most forms of active foreign earnings until such income is paid to the domestic corporation. Within the 34 countries of the OECD, six countries follow a worldwide approach, with the other 28 countries following a territorial or exemption approach. Worldwide countries in the OECD are Chile, Ireland, Israel, Mexico, South Korea and the United States.

Endnotes

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41. The phaseout of itemized deductions adds 1.2 percent, and the net investment income tax, sometimes referred to as the Medicare contribution tax, adds an additional 3.8 percent tax.
42. For comparison, the maximum individual federal tax rate on self-employment income earned from a pass-through was 44.6 percent in 2015 (comprised of 39.6 percent top individual statutory rate, 1.2 percent phaseout of itemized deduction and 3.8 percent Medicare tax), up from 37.9 percent in 2012 (35 percent top individual statutory rate and 2.9 percent self-employment Medicare tax). Certain pass-through business income is not subject to the Medicare tax.
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