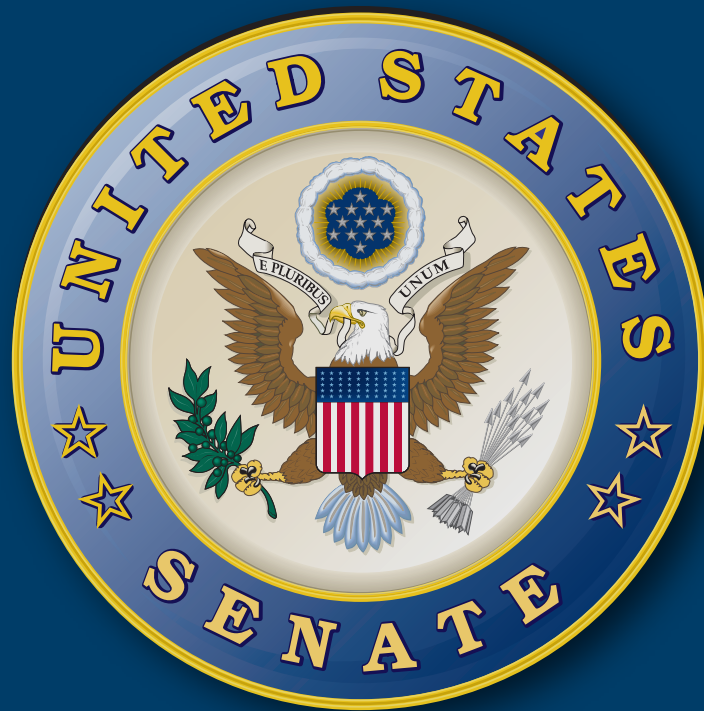


# Comprehensive Tax Reform for 2015 and Beyond



By  
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United States Senate

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Foreword (Senator Orrin G. Hatch)

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## Foreword

We live in very partisan times. Indeed, it's become almost cliché for politicians, like myself, to comment on the rank partisanship that pervades in Washington, D.C. and to lament the lack of progress or agreement on even the most simple and fundamental issues of the day. But, make no mistake, that's the world we're living in. However, despite partisan gridlock in Congress on many issues, there is bipartisan agreement on the need to fix our nation's broken tax code. Virtually everyone – in Washington and elsewhere – agrees that, when it comes to our tax system, the status quo is unacceptable. Everyone agrees that our economy has stagnated, and too many Americans are out of work or underemployed. And, our broken tax code is holding back economic progress and job creation. That is why I have made tax reform my highest priority, and I'm not alone.

Republicans and Democrats, representatives and senators have all expressed a desire to move this effort forward. In just the past few years, some, like Chairman Dave Camp of the House Ways and Means Committee and Chairman Ron Wyden of the Senate Finance Committee, have gone so far as to introduce tax reform legislation. Others, like former Finance Committee Chairman Max Baucus, have unveiled tax reform frameworks that specify the direction they believe this effort should take. There are ideas proposed by others as well. While I do not believe that any of those efforts have cracked the proverbial code when it comes to tax reform, I applaud them all.

Too often, when people talk about reforming our tax code, they reduce the entire endeavor to a set of talking points – “we just need to broaden the base and lower the rates” – as if it were a simple exercise. That may work in the context of a political campaign, but, as I'm sure my colleagues who have actually put forward specific proposals can attest, tax reform will be far more

difficult and complicated than anything that can be boiled down to a simple slogan. It will involve balancing countless interests and making difficult choices among numerous competing priorities. In fact, despite the number of specific proposals that are out there, I don't know that we've even scratched the surface on the degree of difficulty we face when it comes to tax reform. Part of the difficulty is natural, given that we live in a complex world with a complex economy. The key is to understand the complexities and wade through them to engineer a tax system that enhances efficiency, fairness, and simplicity. Living in a complex world does not mean that we should accept or promote additional complexities from the tax system.

Despite the difficulties, I believe that reform is vital and necessary to our nation's economic well-being. Our tax code is a huge obstacle standing between us and continued prosperity. The costs of compliance alone are staggering. And, those costs are nothing compared to the economic distortions created by a tax system that, far too often, picks winners and losers. I believe this is true of both the individual tax system as well as the business tax system. That is why I have repeatedly called for a comprehensive approach that fixes the tax code for individuals and families as well as corporations and small businesses.

Once again, I commend those who have introduced specific proposals for their contributions to the overall tax reform debate. To continue this conversation and, hopefully, set the stage for an even more robust discussion in the near future, I asked my Senate Finance Committee staff to compile this report, titled "Comprehensive Tax Reform for 2015 and Beyond." The report is intended to provide background on where we are and where we have been with regard to our tax system as well as some possible direction on where our reform efforts should go in the near future. I believe it will be helpful both to tax experts and academics, as well as those who do not spend all their days steeped in these issues.

I want to thank my staff for their efforts in putting this report together, particularly Chris Campbell, my Staff Director for his leadership and counsel; Mark Prater, my Chief Tax Counsel and Deputy Staff Director for his leadership and unparalleled expertise on these matters; and Christopher Hanna, my Senior Policy Advisor for Tax Reform, for taking the lead as principal drafter of the report. I also want to thank Tony Coughlan, Jim Lyons, Jeff Wrase, Preston Rutledge and Bryan Hickman for their substantial contributions. Additional assistance was provided by Shawn Novak, Peter Russo, Caleb Wiley, Nick Wyatt, Robert Chun and Abegail Cave.

In conclusion, I want to stress that, if we are ever going to make tax reform a reality, both parties will have to come together to get it done. That will mean Republicans and Democrats in both the Congress and the White House working together toward a common goal that will benefit the American people and help get our economy moving on a better course. To some, that may sound like a fairy tale. But, at this point, I do not believe we can consider tax reform to be an optional exercise – it is a matter of necessity. That is why I am optimistic that there is enough goodwill in Washington and throughout our country to make this effort successful. I won't speak for anyone else, but, I want to be clear: I am willing to work with anyone – Republican or Democrat – to fix our country's tax code. I hope others will view this report as an invitation to work together on these issues.

Senator Orrin G. Hatch  
Ranking Member  
U.S. Senate Committee on Finance

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## Chapter 1: Introduction to Tax Reform

The year 2013 marked a historic occasion – the United States’ individual income tax system was 100 years old. It has had an interesting history, and some may also say that it has served us well over the years. But one thing was pretty certain – the centennial received little fanfare. And for good reason -- the U.S. income tax system is outdated and in desperate need of reform. In that respect, it is similar to the United States’ corporate tax system, which achieved its centennial five years ago. But no one celebrated because our corporate tax system is also outdated and in dire need of reform.

The last time we had major tax reform in the United States was in 1986 – almost 30 years ago. Think of the domestic and global changes that have taken place since that time. In 1986, the size of the U.S. economy was about \$4.6 trillion (\$7.9 trillion in 2009 dollars)<sup>1</sup> with a population of 240 million people.<sup>2</sup> Last year, the size of the economy was \$16.8 trillion (\$15.7 trillion in 2009 dollars)<sup>3</sup> with a population of 316 million people.<sup>4</sup> In 1986, manufacturing was 17.4 percent of the U.S. economy.<sup>5</sup> Last year, manufacturing was 12.1 percent of the economy.<sup>6</sup> In 1986, exports were seven percent of the economy.<sup>7</sup> In 2014, exports are 13.6 percent of the economy.<sup>8</sup> In 1986,

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<sup>1</sup> U.S. DEPARTMENT OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS at <http://www.bea.gov/national/index.htm#gdp>

<sup>2</sup> UNITED STATES CENSUS BUREAU at <http://www.census.gov/popclock/>

<sup>3</sup> U.S. DEPARTMENT OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS at <http://www.bea.gov/national/index.htm#gdp>

<sup>4</sup> UNITED STATES CENSUS BUREAU at <http://www.census.gov/popclock/>

<sup>5</sup> U.S. DEPARTMENT OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS at [http://bea.gov/industry/gdpbyind\\_data.htm](http://bea.gov/industry/gdpbyind_data.htm)

<sup>6</sup> Id.

<sup>7</sup> FEDERAL RESERVE BANK OF ST. LOUIS, ECONOMIC RESEARCH at <http://research.stlouisfed.org/fred2/series/B020RE1Q156NBEA>

<sup>8</sup> Id. U.S. DEPARTMENT OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS, GDP AND THE ECONOMY: SECOND ESTIMATES FOR THE SECOND QUARTER OF 2014 (Sept. 2014), available at [http://bea.gov/scb/pdf/2014/09%20September/0914\\_gdp\\_and\\_the\\_economy.pdf](http://bea.gov/scb/pdf/2014/09%20September/0914_gdp_and_the_economy.pdf) (accessed Nov. 20, 2014).

components of our economy and the business world, such as the internet, derivatives, and cloud computing, were unknown to almost all Americans. In 2014, the internet and cloud computing are part of our daily lives and almost all large businesses utilize some type of derivative as part of their regular business practice. In 1986, C corporations earned 59 percent of the net income earned by all businesses.<sup>9</sup> By 2008, that percentage had decreased to 22 percent.<sup>10</sup> In the 1980s, foreign operations generated slightly less than 14 percent of the profits of U.S. multinationals.<sup>11</sup> In 2010, that percentage was closer to 24 percent.<sup>12</sup>

Yet, with all the changes that have taken place in the last 28 years, in 2014, we still have an income tax system designed during a different time and a different generation. A consensus has begun to emerge that tax reform, done properly, is imperative if we are to get America's fiscal house in order. In doing so, we should use the same three criteria established by many economists and adopted by former President Ronald Reagan when he put tax reform on the table in 1984: fairness, efficiency and simplicity.

Evidence that our income tax system is not achieving the first criterion of fairness can be seen by simply looking at how few Americans pay the Federal income tax. According to the nonpartisan U.S. Congressional Joint Committee on Taxation, in 2014, approximately 46 percent of American households (i.e., tax units) will not pay even one dollar of Federal income taxes (slightly down from 51 percent in 2009).<sup>13</sup> In other words, slightly less than one-half of all

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<sup>9</sup> INTERNAL REVENUE SERVICE, SOI TAX STATS – INTEGRATED BUSINESS DATA, available at <http://www.irs.gov/uac/SOI-Tax-Stats-Integrated-Business-Data> (accessed Nov. 13, 2014).

<sup>10</sup> *Id.*

<sup>11</sup> *See* J.P. MORGAN, NORTH AMERICA EQUITY RESEARCH (June 27, 2011), available at [http://www.politico.com/static/PPM191\\_110629jpmorgan.html](http://www.politico.com/static/PPM191_110629jpmorgan.html) (accessed Nov. 13, 2014).

<sup>12</sup> *Id.*

<sup>13</sup> Memorandum from Thomas A. Barthold (no date). This document is included in the Appendix – Exhibit 1. If 46 percent of our fellow Americans are not bearing any (direct) burden of government, then they may tend to support an ever more expansive, and expensive, government.

American households will pay nothing in Federal income taxes for 2014. A large percentage of American households pay no Federal income tax because their income is low. But a large percentage pays no Federal income tax because of various tax expenditures that create, in essence, winners and losers in our tax system.<sup>14</sup> In addition, a tax system in which the top one-tenth of one percent pays a lower average effective tax rate than the top one percent is not fair – the tax system should be progressive even at the highest end of the income spectrum.<sup>15</sup>

We must also reform our tax system so that it promotes efficiency and economic growth. Economic growth will be the key criterion for our nation’s future prosperity and fiscal health. And tax signals are powerful factors for determining where taxpayers are likely to engage or disengage their labor and capital. Clearly, these tax signals – marginal tax rates, for example – interfere with market forces by redirecting economic activity from where it would otherwise go. A more efficient tax system would promote economic growth and remove unnecessary or unintended distortions that serve to misallocate resources. The Joint Committee on Taxation’s recent macroeconomic analysis of House Ways and Means Committee Chairman Dave Camp’s comprehensive tax reform plan released on February 26, 2014, which broadens the income tax base and lowers tax rates, confirms the economic growth potential in reforming the tax code.<sup>16</sup> Alternatively, evidence suggests that a broad-based consumption tax system would lead to greater efficiency and economic growth.

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A broadly shared tax burden would cause a democratic check on creating more government spending programs.

<sup>14</sup> As an example: The Republican staff of the Senate Finance Committee is acquainted with an individual who in 2009 had an adjusted gross income exceeding \$126,000, but not only paid no Federal income taxes, but actually received a check for over \$2,000 from the Internal Revenue Service.

<sup>15</sup> See Chapter 4, Part B.

<sup>16</sup> See Chapter 4, Part D.

Finally, we must simplify our tax system. When Winston Churchill characterized Russia as “a riddle, wrapped in a mystery, inside an enigma,” he could just as well have been describing our overly-complex tax system. Former House Ways and Means Committee Chairman William Archer compared it to a weed and wanted to “rip the income tax system out by its roots.” We think of it as a garden choked with weeds. If we do not cut back the weeds, they will eventually take over and become more burdensome on every American. That must not happen.

The tax code has grown to almost four million words.<sup>17</sup> Approximately 56 percent of individual taxpayers use paid preparers to do their individual income taxes and 34 percent use tax software to assist them.<sup>18</sup> Absent an ability to understand the tangled web of confusing tax forms and instructions, Americans find themselves forced into outsourcing their tax preparation either to paid preparers or robotic software programs. Even so, taxpayers and businesses spend over six billion hours a year complying with tax-filing requirements, with compliance costs totaling over \$170 billion annually.<sup>19</sup> We need an income tax system that is simple to understand, simple to comply with, and simple to administer.<sup>20</sup>

Similar evidence of the need to reform is seen with our corporate tax system. The United States has the highest corporate tax rate in the developed world, yet the corporate tax raises little revenue for the Federal government (when compared, for example, to the individual income tax).

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<sup>17</sup> NATIONAL TAXPAYER ADVOCATE, 2013 ANNUAL REPORT TO CONGRESS, Vol. 1. at 97 (Dec. 31, 2013), available at <http://www.taxpayeradvocate.irs.gov/2013-Annual-Report/> (accessed Oct. 8, 2014).

<sup>18</sup> Written Testimony of John A. Koskinen, Commissioner of the Internal Revenue Service, Before the Senate Finance Committee on Regulation of Tax Return Preparers (April 8, 2014), available at <http://www.finance.senate.gov/imo/media/doc/Koskinen%20Testimony.pdf> (accessed Dec. 4, 2014).

<sup>19</sup> NATIONAL TAXPAYER ADVOCATE, 2012 ANNUAL REPORT TO CONGRESS, Vol. 1 at 5-6 (Dec. 31, 2012), available at <http://www.taxpayeradvocate.irs.gov/2012-Annual-Report/FY-2012-Annual-Report-To-Congress-Full-Report> (accessed Nov. 13, 2014).

<sup>20</sup> See Chapter 4, Part E.



A high corporate tax rate yielding a low amount of corporate taxes with high compliance costs is strong evidence of a very inefficient tax system. In addition, the combination of a high corporate tax rate, worldwide taxation (with deferral), and the temporary nature of some tax incentives make U.S. companies less competitive when compared to their foreign counterparts.

U.S. multinational companies are discouraged or penalized from repatriating foreign earnings because of the U.S. corporate tax that applies at the time of repatriation. Tax reform should significantly reduce the high U.S. corporate tax rate and also establish a territorial type of tax system, thereby placing U.S. multinational companies on an equal footing with their foreign competitors when conducting business in other countries. The result would be more multinationals establishing or retaining their corporate headquarters in the United States; more exports to global markets; decreased pressure on U.S. multinationals to invert; enhanced competitiveness of U.S. multinationals against foreign-based multinationals in acquiring foreign target corporations; and reinvestment of resources in the United States rather than abroad. All of these results will foster the creation of jobs in the United States and a strengthened U.S. economy.

It is time for a new, bold and innovative tax system – a tax system “that looks like someone designed it on purpose.”<sup>21</sup> We need a tax system that achieves the goals of fairness, efficiency and simplicity – not for an economy in 1913 or even 1986 – but rather for the global economy of 2015 and beyond. We need a tax system that encourages individual entrepreneurship, innovation and ambition; a tax system that recognizes that many small businesses are conducted, for example, as limited liability companies – entities that 100 years ago were completely unknown; a tax system that recognizes that only 22 percent of all net business income is earned by C corporations; a tax system that taxes business income only once; a tax system that significantly lowers both the

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<sup>21</sup> We have borrowed this phrase from former Secretary of the Treasury William Simon.

individual tax rate and the corporate tax rate allowing U.S. flow-through businesses and domestic C corporations to be more competitive; a tax system that does not distort incentives to work and invest; a tax system that does not unfairly favor one individual or business-type or industry over another that is similarly situated; and a tax system that does not encourage U.S. multinationals to earn income abroad and then discourages those same U.S. multinationals from bringing their cash earnings back home.

Reforming our tax system will not be easy. The Tax Reform Act of 1986 is considered by most to have been the last significant tax reform effort that involved broadening the tax base and lowering tax rates. But the United States is in a fundamentally different place today than in 1986, and the tax code has been altered year-by-year since 1986, so that gains that might have been claimed by the 1986 effort in terms of fairness, efficiency and simplicity have been eroded. The Tax Reform Act of 1986 was premised on an understanding that the legislation would be approximately revenue neutral and roughly distributionally neutral – that is, the legislation would raise roughly the same amount of revenue as the old tax laws and would not proportionately raise (or lower) tax burdens on one income class more than another. To achieve static revenue neutrality, the 1986 Act decreased taxes on individuals while at the same time increasing taxes on corporations by approximately the same amount.

Unlike in 1986, it would now be difficult to increase taxes on corporations. U.S. corporations are already facing the highest statutory corporate tax rate in the developed world, and the United States has an outdated method of taxing foreign income. Furthermore, any change to our corporate tax laws that would make it more costly or less advantageous for U.S. corporations to operate in the United States would be to our detriment. In 1986, there was little chance that U.S. corporations would shift capital abroad to avoid U.S. taxes because of barriers to international

investment along with U.S. corporate tax rates having been in line with, or even lower than, much of the developed world. Today, capital is much more mobile and much less tangible than in previous eras. And with countries like Canada and the United Kingdom substantially lowering their corporate tax rates, capital could easily leave the United States to countries with much lower corporate tax rates. In fact, we have seen that happen frequently over the last 10 to 20 years.

Tax reform also needs to address the more than 90 percent of U.S. businesses organized as pass-through entities, such as partnerships, S corporations, limited liability companies and sole proprietorships. According to recent data, approximately 58 percent of all net business income in the United States is earned by pass-through entities.<sup>22</sup> If real estate investment trusts and mutual funds are included as pass-through entities, then the percentage rises to 78 percent.<sup>23</sup> Because of these numbers, it is important that we approach tax reform in a comprehensive manner, addressing both the individual and corporate tax systems. As the data show, both systems are intertwined and must be looked at in the whole.

During 2011 to 2014, the Senate Committee on Finance held a number of hearings on topics relating to tax reform, such as individual taxation, international taxation, corporate tax reform, and taxation of financial products. In addition, the Finance Committee held three joint hearings with the House Committee on Ways and Means – the first such joint hearings since 1940. In early 2013, the majority and minority staffs of the Finance Committee issued 10 option papers focusing on all areas of tax reform.<sup>24</sup> Throughout this process, we heard from leading tax law

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<sup>22</sup> INTERNAL REVENUE SERVICE, SOI TAX STATS – INTEGRATED BUSINESS DATA, available at <http://www.irs.gov/uac/SOI-Tax-Stats-Integrated-Business-Data> (accessed Nov. 14, 2014).

<sup>23</sup> *Id.*

<sup>24</sup> U.S. SENATE FINANCE COMMITTEE, TAX REFORM OPTION PAPERS, available at <http://www.finance.senate.gov/issue/?id=6c61b1e9-7203-4af0-b356-357388612063> (accessed Dec. 4, 2014).

academics, economists, practitioners, industry executives, government officials, and business owners. This book is intended to continue this conversation. Chapters 2 and 3 provide some detailed background on previous tax reform efforts in the United States and also where the U.S. economy and tax system are headed in the foreseeable future. The details of a number of various tax reform proposals are discussed in chapters 4, 5 and 6.

## Chapter 2: Where Have We Been?<sup>25</sup>

In the early years of our country, from 1789 until the Civil War, the United States relied almost exclusively upon custom receipts as a source of revenue.<sup>26</sup> Almost unnoticed during this period, in 1815, Secretary of the Treasury Alexander Dallas recommended the enactment of an income tax (and inheritance tax) to raise \$3 million to help fund the War of 1812. Dallas modeled the income tax after the British income tax that was enacted in 1799 to help finance the Napoleonic wars. However, the War of 1812 ended in early 1815, eliminating, at least temporarily, the perceived need for an income tax.<sup>27</sup>

The first U.S. income tax law was enacted by Congress as part of the Revenue Act of 1861 to help fund the Civil War.<sup>28</sup> It was a flat rate income tax imposing a three percent tax on incomes over \$800. With the enactment of the income tax, the United States became one of the first countries in the world to enact such a tax following the United Kingdom. Just one year after passage of the 1861 tax law, the United States replaced its flat rate income tax with a progressive rate income tax, with rates of three percent and five percent, as part of the Revenue Act of 1862.<sup>29</sup> The income tax remained in effect until expiring in 1872 during Reconstruction.<sup>30</sup>

In 1894, Congress again enacted an income tax as part of the Revenue Act of 1894 (Wilson-Gorman Tariff of 1894) following the financial panic and recession of 1893.<sup>31</sup> This income tax

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<sup>25</sup> Some of the early historical data in this chapter has been adopted from STANLEY S. SURREY, WILLIAM C. WARREN, PAUL R. MCDANIEL AND HUGH J. AULT, *FEDERAL INCOME TAXATION: CASES AND MATERIALS* (1972); ROY G. BLAKEY AND GLADYS C. BLAKEY, *THE FEDERAL INCOME TAX* (1940).

<sup>26</sup> BLAKEY AND BLAKEY, *supra* note 25, at 2-3.

<sup>27</sup> SURREY, *supra* note 25, at 3.

<sup>28</sup> BLAKEY AND BLAKEY, *supra* note 25, at 3.

<sup>29</sup> *Id.* at 4. The 1861 tax law imposed a three percent tax on income of U.S. residents. A five percent tax was imposed on income of U.S. citizens living abroad. *Id.*

<sup>30</sup> *Id.* at 7.

<sup>31</sup> *Id.* at 12-17.

was the first income tax enacted during peacetime in the United States. It was, however, short-lived. Just one year after enactment, the U.S. Supreme Court in *Pollock v. Farmers Loan & Trust Co.*,<sup>32</sup> struck down the 1894 income tax as unconstitutional. The Court held that income taxes on interest, dividends and rents were direct taxes and violated the requirement from Article I, sections 2 and 9 of the Constitution that such taxes be apportioned among the states.

On July 5, 1909, the U.S. Senate passed a proposed amendment to the Constitution.<sup>33</sup> One week later, the House of Representatives followed suit.<sup>34</sup> The proposed amendment provided that: “The Congress shall have the power to lay and collect taxes on income, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.” Alabama was the first state to ratify the amendment doing so in 1909.<sup>35</sup> On February 3, 1913, the states of Delaware, Wyoming and New Mexico approved the amendment thereby securing the necessary three-fourths votes of the states resulting in ratification of the amendment.<sup>36</sup> On February 25, 1913, Secretary of State Philander Knox certified that the amendment had become part of the U.S. Constitution as the Sixteenth Amendment. Less than three months later, on May 8, 1913, the House of Representatives passed the Revenue Act of 1913, which provided for the reinstatement of the income tax.<sup>37</sup> The 1913 Act was passed by the Senate

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<sup>32</sup> 157 U.S. 429, *aff’d on reh’g*, 158 U.S. 601 (1895).

<sup>33</sup> BLAKEY AND BLAKEY, *supra* note 25, at 61-62.

<sup>34</sup> *Id.* at 62.

<sup>35</sup> *Id.* at 68.

<sup>36</sup> *Id.* at 69. The Sixteenth Amendment was rejected by Rhode Island (Apr. 29, 1910), Utah (Mar. 9, 1911), Connecticut (June 28, 1911), and Florida (May 31, 1913, i.e., post-ratification). Virginia and Pennsylvania failed to complete action on the amendment. See AMENDMENTS TO THE CONSTITUTION: A BRIEF LEGISLATIVE HISTORY, SUBCOMMITTEE ON THE CONSTITUTION, COMMITTEE ON THE JUDICIARY, S. Prt. 99-87 (Oct. 1985). See also *Virginia House Opposes Federal Clause by 54 to 37*, WASH. POST. (Mar. 8, 1910).

<sup>37</sup> BLAKEY AND BLAKEY, *supra* note 25, at 82.

on September 9, 1913, and signed into law by President Woodrow Wilson on October 3, 1913, creating our modern income tax system.

The corporate income tax, which was enacted into law four years before the individual income tax, was part of President Howard Taft's effort to enact an income tax that would not be struck down as unconstitutional by the Supreme Court. On June 16, 1909, President Taft proposed a constitutional amendment allowing federal income taxes on individuals and also proposed an excise tax on corporations.<sup>38</sup> The term excise tax was used because of concerns that a direct income tax could be challenged on constitutional grounds.<sup>39</sup> The corporate excise tax was enacted into law on August 5, 1909, providing for a one percent tax on corporate income with the first \$5,000 of income exempt from the tax.<sup>40</sup> The Supreme Court upheld the tax in *Flint v. Stone Tracy Company*<sup>41</sup> on the grounds that it was not a direct tax but rather an excise tax on business done in corporate form. The Revenue Act of 1913 made this corporate excise tax part of the income tax system.<sup>42</sup>

The 1913 Act included a regular or normal tax of one percent on individual net incomes above \$3,000 with an additional \$1,000 exemption for a married person. There was a progressive surtax beginning at one percent on net income from \$20,000 to \$50,000 to six percent on net income above \$500,000.<sup>43</sup> Corporate net income was taxed at a flat one percent with no exemption amount.

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<sup>38</sup> SURREY, *supra* note 25, at 9.

<sup>39</sup> BLAKEY AND BLAKEY, *supra* note 25, at 52-53.

<sup>40</sup> SURREY, *supra* note 25, at 9.

<sup>41</sup> 220 U.S. 107 (1911).

<sup>42</sup> BLAKEY AND BLAKEY, *supra* note 25, at 97.

<sup>43</sup> Surrey, *supra* note 25, at 10.

Our income tax system underwent a number of changes during its early years. Although the rates were originally quite low, the need for revenue during World War I resulted in a substantial increase in individual tax rates. As part of the Revenue Act of 1918, a normal tax of six percent applied on the first \$4,000 of income with a 12 percent rate on income above that amount.<sup>44</sup> The exemptions were \$1,000 for a single person, \$2,000 for a married couple and \$200 per dependent.<sup>45</sup> In addition, a surtax of one to 65 percent applied to income in excess of \$5,000, with the top rate applying to income over \$1 million.<sup>46</sup> As a result, the combination of the normal tax rate of 12 percent with the surtax rate of 65 percent led to a marginal tax rate of 77 percent on incomes above \$1 million.<sup>47</sup> The corporate tax rate was 12 percent for 1918 and 10 percent for each year thereafter.<sup>48</sup> In addition, an excess profits tax, which applied to corporate net income, was enacted during this period.<sup>49</sup>

Although the income tax quickly became a leading source of revenue for the Federal government, only a small percentage of Americans paid Federal income taxes. In 1913, individual and corporate income taxes totaled about \$35 million with total Federal revenues of \$344 million. Almost 90 percent of Federal revenues were composed of excise taxes. By 1920, however, Federal tax revenues were \$5.4 billion with almost \$4 billion coming from individual and corporate income taxes. However, there were only about 5.5 million individual taxable income tax returns for 1920

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<sup>44</sup> SURREY, *supra* note 25, at 12.

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> *Id.* Students of Federal income tax may remember studying the famous case of *Old Colony Trust v. Commissioner*, 279 U.S. 716 (1929), in which Mr. William Wood, president of American Woolen Company, paid almost 70 percent of his salary income in Federal income taxes to the U.S. government for the years 1918 and 1919.

<sup>48</sup> BLAKEY AND BLAKEY, *supra* note 25, at 186.

<sup>49</sup> SURREY, *supra* note 25, at 12.



out of a population of roughly 106 million.<sup>50</sup> The individual income tax was a tax “on the well-to-do.”<sup>51</sup>

After a recession in 1920-21, the United States entered a period of prosperity. Secretary of the Treasury Andrew Mellon pushed for reductions in taxes resulting in a series of Revenue Acts decreasing the high taxes that were enacted during World War I.<sup>52</sup> By 1928, the normal tax rate was 1.5 percent on the first \$4,000 of income, three percent on the next \$4,000, and five percent on income over \$8,000.<sup>53</sup> The surtax ranged from one percent beginning with income over \$10,000 to 20 percent on income over \$100,000. The excess profits tax, which was enacted in 1917, was repealed at the end of 1921, and the corporate tax rate was decreased to 11 percent.<sup>54</sup> By 1929, individual tax receipts were almost \$1.1 billion -- about 37 percent of Federal revenues.

In late 1929, the country entered into the Great Depression. The United States began running deficits each year as revenues from the individual income tax and corporate tax significantly declined. Income tax rates were increased and exemption amounts decreased in a bid to raise additional revenue. Excise taxes again became a major source of revenue and would continue as a major source until World War II.<sup>55</sup> In 1932, the Acting Chairman of the Ways and Means Committee, Charles R. Crisp, introduced a 2.25 percent manufacturers’ sales tax.<sup>56</sup> Treasury Secretary Mellon opposed a sales tax stating: “We laid aside all thought of a general sales or turnover tax, not only because generally speaking it bears no relation to ability to pay and is regressive in character, but because of the great administrative difficulties involved and the

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<sup>50</sup> Id.

<sup>51</sup> Id.

<sup>52</sup> Id. at 13.

<sup>53</sup> Id.

<sup>54</sup> Id.

<sup>55</sup> Id.

<sup>56</sup> BLAKEY AND BLAKEY, *supra* note 25, at 311.

almost inevitable pyramiding of the tax in the course of successive sales.”<sup>57</sup> An amendment in the House to strike the sales tax was adopted.<sup>58</sup> In 1935, President Franklin D. Roosevelt signed the Social Security Act into law with the first taxes collected in January 1937. Payroll taxes would quickly become a significant source of Federal revenue.

By 1938, the normal tax rate for the individual income tax was four percent with a surtax of four percent starting at \$4,000 of income culminating in a 75 percent surtax at \$5 million of income.<sup>59</sup> The top corporate tax rate had increased to 19 percent.<sup>60</sup> The payment of the income tax was still limited to a small percentage of the U.S. population. In 1939, Congress consolidated and codified the internal revenue laws that were scattered through numerous volumes of the Statutes at Large. The consolidation and codification was referred to as the Internal Revenue Code of 1939. The 1939 Code remained in force each year (until 1954) except to the extent that Congress amended particular provisions.

In 1942, almost immediately after the U.S. had entered World War II, Congress changed the individual income tax from a tax on the privileged few to a tax on the masses.<sup>61</sup> The revenue needs were great to fund the war effort. The exemption amounts were decreased, and the surtax began at the first dollar of taxable income. The initial tax rate (including the surtax) was 23 percent and increased to a combined rate of 50 percent on taxable income over \$14,000.<sup>62</sup> The top corporate tax rate increased to 40 percent with an excess profits tax rate that reached as high as

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<sup>57</sup> Statements of Hon. Andrew W. Mellon, Secretary of the Treasury, and Hon. Ogden L. Mills, Undersecretary of the Treasury, Hearings Before the Committee on Ways and Means, House of Representatives, 72<sup>nd</sup> Cong., 1<sup>st</sup> Sess. 4 (Jan. 13, 1932).

<sup>58</sup> BLAKEY AND BLAKEY, *supra* note 25, at 317.

<sup>59</sup> SURREY, *supra* note 25, at 14.

<sup>60</sup> *Id.*

<sup>61</sup> *Id.* at 15.

<sup>62</sup> *Id.* at 16.

89.5 percent.<sup>63</sup> By 1945, about 43 million taxable individual income tax returns were filed for the year.

**Table 2.1**

**Internal Revenue Receipts by Principal Sources, 1913-1945<sup>64</sup>**

Fiscal Year	Individual Income Taxes	Corporate Income Taxes	Payroll Taxes	Estate and Gift Taxes	Other Taxes (Mainly Excise)	Total Internal Revenue Receipts
1913		\$35,006,300			\$309,410,666	\$344,416,966
1917	\$180,108,340	\$207,274,004		\$6,076,575	\$415,934,721	\$809,393,640
1920	\$3,956,936,004	Included in Individual Income Taxes		\$103,635,563	\$1,347,008,685	\$5,407,580,252
1925	\$845,426,352	\$916,232,697		\$108,939,896	\$713,541,323	\$2,584,140,268
1929	\$1,095,541,172	\$1,235,733,256		\$61,897,141	\$545,882,806	\$2,939,054,375
1932	\$427,190,582	\$629,566,115		\$47,422,313	\$453,550,033	\$1,557,729,043
1936	\$674,416,074	\$753,031,520	\$48,279	\$378,839,515	\$1,713,872,993	\$3,520,208,381
1939	\$1,028,833,796	\$1,156,280,509	\$740,428,865	\$360,715,210	\$1,895,315,573	\$5,181,573,953
1941	\$1,417,655,127	\$2,053,468,804	\$925,856,460	\$407,057,747	\$2,566,070,241	\$7,370,108,378
1942	\$3,262,800,390	\$4,744,083,154	\$1,185,361,844	\$432,540,288	\$3,423,082,842	\$13,047,868,518
1943	\$6,629,931,989	\$9,668,956,103	\$1,498,705,034	\$447,495,678	\$4,126,297,693	\$22,371,386,497
1945	\$19,034,313,374	\$16,027,212,826	\$1,779,177,412	\$643,055,077	\$6,316,628,887	\$43,800,387,576

**Table 2.2**

**Individual Income Tax Returns, 1913-1945<sup>65</sup>**

Year	Total	Taxable	Nontaxable	Adult Population (20 years of age and older)
1913	357,598			
1917	3,472,890	2,707,234	765,656	
1920	7,259,944	5,518,310	1,741,634	62,667,000
1929	4,044,327	2,458,049	1,586,278	
1930	3,707,509	2,037,645	1,669,864	75,166,000
1936	5,413,499	2,861,108	2,552,391	
1939	7,570,320	3,896,418	3,673,902	
1940	14,598,074	7,437,261	7,160,813	86,364,000
1941	25,770,089	17,502,587	8,267,502	
1942	36,456,110	27,637,051	8,819,059	
1943	43,506,553	40,222,699	3,283,854	

<sup>63</sup> Id.

<sup>64</sup> ANNUAL REPORT OF THE SECRETARY OF THE TREASURY ON THE STATE OF THE FINANCES FOR THE FISCAL YEAR ENDED JUNE 30, 1929 (1930) at 420-424; ANNUAL REPORT OF THE COMMISSIONER OF INTERNAL REVENUE FOR THE FISCAL YEAR ENDED JUNE 30, 1948 (1949) at 125.

<sup>65</sup> U.S. DEPARTMENT OF COMMERCE, HISTORICAL STATISTICS OF THE UNITED STATES --- COLONIAL TIMES TO 1970 (Part 2) (1975) at 1110; SURREY, *supra* note 25, at 31.

1945	49,932,783	42,650,502	7,282,281
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A number of significant changes were made to the tax laws during World War II. Congress required employers to withhold income taxes on the wages and salaries of employees, shifting the administrative burden from the government to the private sector and increasing compliance.<sup>66</sup> In addition, Congress required quarterly estimated tax payments for non-withheld income. As a result, taxes were collected under a pay-as-you-go plan. Also, employers began providing health insurance to their employees as a way of avoiding the wage and price controls that were in effect during World War II. An IRS ruling in 1943 provided that employer contributions to group health insurance would not be taxed to the employees. The ruling was later codified as part of the tax code. Congress also provided a standard deduction of 10 percent of gross income and an across-the-board \$500 exemption for the taxpayer, the taxpayer’s spouse and each dependent.<sup>67</sup>

At the end of World War II, beginning with the Revenue Act of 1945, Congress decreased taxes by reducing the surtax, providing an overall reduction of income tax, increasing the exemption amount, and repealing the excess profits tax.<sup>68</sup> The corporate tax rate was set at 38 percent. In 1948, Congress permitted married couples to compute their tax on a split-income joint return so that their tax liability would be exactly equal to twice the tax on one-half of their combined income.<sup>69</sup> Three years later, Congress enacted the head of household filing status.

The year 1954 saw a major revision of the tax laws with the Internal Revenue Code of 1954 replacing the Internal Revenue Code of 1939. One major tax policy change enacted as part of the 1954 Act recognized the importance of tax incentives for investment—for example, the

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<sup>66</sup> SURREY, *supra* note 25, at 16.

<sup>67</sup> *Id.*

<sup>68</sup> *Id.* at 17.

<sup>69</sup> *Id.*

introduction of accelerated depreciation and a deduction for research and experimental expenditures. Another major change was the reduction in tax for individuals over 65 years old.<sup>70</sup> The 1954 Act also made a number of significant technical changes to the tax laws, including a consolidation of the administrative provisions, changes in terminology such as replacing “net income” with “taxable income,” combining the individual normal tax and the surtax, complete revisions of the income tax treatment of partnerships, trusts and estates, and corporate distributions, and liberalization of the income tax accounting rules.<sup>71</sup> Four years later, as part of the Technical Amendments Act of 1958, Congress enacted a new subchapter S of the tax code permitting the income of a small business corporation to be taxed directly to the shareholders.

In the Revenue Act of 1962, Congress introduced a seven percent investment tax credit that was designed to encourage investment in equipment and machinery and foster economic growth.<sup>72</sup> As part of the same act, Congress enacted the controlled foreign corporation (CFC) rules. Under these rules, Congress sought to limit the deferral of U.S. taxation of certain income earned outside the United States by foreign corporations controlled by U.S. persons. Two years later, as part of the Revenue Act of 1964, which was intended to boost economic growth, Congress decreased the top tax rate for individuals from 91 percent to 70 percent and decreased the top corporate tax rate from 52 percent to 48 percent.<sup>73</sup>

At the end of 1969, Congress enacted the Tax Reform Act of 1969, which has been described as “the most comprehensive substantive reform of the Federal income tax law since its inception in 1913.”<sup>74</sup> As part of the act, Congress repealed the investment tax credit, placed a

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<sup>70</sup> Id. at 20.

<sup>71</sup> Id.

<sup>72</sup> Id. at 22.

<sup>73</sup> Id. at 23.

<sup>74</sup> Id. at 25.

maximum 50 percent marginal tax rate on earned income, increased the tax rate on capital gains (from 25 percent to 35 percent), substantially cut back accelerated depreciation for commercial real estate, reduced the percentage depletion allowance for most minerals (including oil and gas), and enacted a new minimum tax (not indexed to inflation) that imposed a 10 percent tax on the amount by which a taxpayer's tax preferences exceeded the regular tax (with an exemption amount of \$30,000).<sup>75</sup> In the Revenue Act of 1971, Congress reinstated the investment tax credit and introduced the domestic international sales corporation (DISC) regime, which generally allowed deferral of tax on all income from qualified exports until actual or deemed distributions were made to the shareholders.<sup>76</sup>

In the Tax Reform Act of 1976, Congress increased the investment tax credit, enacted provisions to shut down tax shelters being utilized by high net worth individuals, increased the minimum tax rate from 10 percent to 15 percent, increased the standard deduction to encourage individuals to switch from itemizing their deductions to utilizing the standard deduction, and substantially revised the estate and gift tax laws.<sup>77</sup> Two years later, as part of the Revenue Act of 1978, Congress increased the standard deduction and the personal exemption amounts, reduced the top corporate tax rate from 48 percent to 46 percent, and decreased the capital gains tax rate from 35 percent to 28 percent.<sup>78</sup>

In 1981, Congress enacted the Economic Recovery Tax Act of 1981 (ERTA), which included an across-the-board 23 percent decrease in tax rates over three years, bringing the top

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<sup>75</sup> *Id.*

<sup>76</sup> *See* JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE ACT OF 1971, JCS-30-72 (Dec. 15, 1972).

<sup>77</sup> *See* JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, JCS-33-76 (Dec. 29, 1976).

<sup>78</sup> *See* JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE ACT OF 1978, JCS-7-79 (Mar. 12, 1979).

individual rate down from 70 percent to 50 percent.<sup>79</sup> The capital gains tax rate was reduced from 28 percent to 20 percent, and the tax parameters were indexed for inflation. Congress also introduced the accelerated cost recovery system (ACRS) to replace the existing class life asset depreciation system. The next year, Congress, as part of the Tax Equity and Fiscal Responsibility Act of 1982, changed ACRS making it less generous to taxpayers, imposed additional restrictions and limitations on a number of tax expenditures, and introduced tougher compliance and enforcement rules.<sup>80</sup>

Two years later, Congress enacted significant tax legislation as part of the Tax Reform Act of 1984.<sup>81</sup> The main purposes of the 1984 tax act were to reduce the budget deficits and to prevent further erosion of the tax base as a result of tax shelters. The act achieved these dual purposes by postponing 10 tax reductions that were scheduled to take place in 1984; increasing the cost recovery period for real property from 15 years to 18 years; modifying the income averaging formula; broadening the definition of earnings and profits; increasing the reduction in certain corporate tax preferences from 15 percent to 20 percent; reducing the tax benefits of certain business property that was also used for personal purposes; enacting a number of provisions dealing with the time value of money; limiting the benefits of private purpose tax-exempt bonds; reforming the rule governing tax-free transfers of intangible property to foreign corporations; and creating a new system of taxing the export income of foreign sales corporations (FSCs). The Act

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<sup>79</sup> See JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE ECONOMIC RECOVERY ACT OF 1981, JCS-71-81 (Dec. 29, 1981).

<sup>80</sup> See JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, JCS-38-82 (Dec. 31, 1982).

<sup>81</sup> See JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, JCS-41-84 (Dec. 31, 1984).

also increased the earned income tax credit and eliminated the 30 percent withholding tax on portfolio interest received by foreign investors.

By the mid-1980s, individual income taxes made up approximately 53 percent of all internal revenue receipts. In contrast, in 1985, corporate income taxes were only about 10 percent of all internal revenue receipts, a significant decline from the late 1940s and 1950s when they were about 25 to 30 percent. By 1970, payroll taxes had surpassed corporate income taxes as the second largest source of internal revenue receipts, and by 1985, payroll taxes were about 30 percent of all internal revenue receipts.

**Table 2.3**

**Internal Revenue Receipts by Principal Sources, 1946-1985 (in Thousands)<sup>82</sup>**

Fiscal Year	Individual Income Taxes	Corporate Income Taxes	Payroll Taxes	Estate and Gift Taxes	Other Taxes (Mainly Excise)	Total Internal Revenue Receipts
1946	\$18,704,536	\$12,553,602	\$1,700,828	\$676,832	\$7,036,299	\$40,672,097
1948	\$20,997,781	\$10,174,410	\$2,381,342	\$899,345	\$7,411,664	\$41,864,542
1954	\$32,813,691	\$21,546,322	\$5,107,623	\$935,121	\$9,517,234	\$69,919,991
1960	\$44,945,711	\$22,179,414	\$11,158,589	\$1,626,348	\$11,864,741	\$91,774,803
1965	\$53,660,683	\$26,131,334	\$17,104,306	\$2,745,532	\$14,792,779	\$114,434,634
1970	\$103,651,585	\$35,036,983	\$37,449,188	\$3,680,076	\$15,904,264	\$195,722,096
1975	\$156,399,437	\$45,746,660	\$70,140,809	\$4,688,079	\$16,847,741	\$293,822,726
1980	\$287,547,782	\$72,379,610	\$128,330,480	\$6,498,381	\$24,619,020	\$519,375,273
1983	\$349,627,967	\$61,779,556	\$173,847,854	\$6,225,877	\$35,765,539	\$627,246,793
1985	\$396,659,558	\$77,412,769	\$225,214,568	\$6,579,703	\$37,004,943	\$742,871,541

The last major tax reform in the United States was the Tax Reform Act of 1986, which was signed into law by President Ronald Reagan on October 22, 1986. It was the culmination of over two and a half years of work by the Administration and the Congress. In January 1984, President Reagan as part of his State of the Union address directed the Treasury Department to

<sup>82</sup> INTERNAL REVENUE SERVICE, COMMISSIONER AND CHIEF COUNSEL, HIGHLIGHTS OF 1985, available at <http://www.irs.gov/pub/irs-soi/85dbfullar.pdf> (accessed Nov. 14, 2014).



embark on a major study of tax reform. Treasury issued its study in November 1984.<sup>83</sup> Now, roughly 30 years later, the Treasury study is still considered one of the most significant documents ever published in the area of tax law. In May 1985, President Reagan submitted the Administration's tax reform proposals to the Congress.<sup>84</sup> Both the House Ways and Means Committee and the Senate Finance Committee conducted almost a year-long review of tax reform proposals, both by the full committees and subcommittees, in public hearings and in markup consideration.

The Tax Reform Act of 1986 made sweeping changes to the tax laws. As described by the Joint Committee on Taxation:

First, Congress desired a fairer tax system. Congress questioned the fairness of a tax system that allowed some high-income individuals to pay far lower rates of tax than other, less affluent individuals. The Act provides new limitations on the use of losses from passive investments to shelter other types of income and expands the minimum tax to curtail these tax inequities in the future. The Act also completely removes six million low-income individuals from the income tax roll and provides significant reductions in the tax burden of other working low-income individuals.

Second, Congress desired a more efficient tax system. The prior-law tax system intruded at nearly every level of decision-making by businesses and consumers. The sharp reductions in individual and corporate tax rates provided by the Act and the elimination of many tax preferences will directly remove or lessen tax considerations in labor, investment and consumption decisions. The Act enables businesses to compete on a more equal basis, and business success will be determined more by serving the changing needs of a dynamic economy and less by relying on subsidies provided by the tax code.

Third, Congress desired a simpler tax system for individuals. Beginning in 1988, the Act establishes two individual income tax rates – 15 percent and 28 percent – to replace more than a dozen tax rates in each of the prior-law rate schedules, which extended up to 50 percent. Significant increases in the standard deduction and modifications to certain personal deductions provide further simplicity by greatly reducing the number of taxpayers who will itemize their deductions.<sup>85</sup>

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<sup>83</sup> U.S. DEPARTMENT OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH (Nov. 1984).

<sup>84</sup> THE WHITE HOUSE, THE PRESIDENT'S TAX REFORM PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH AND SIMPLICITY (May 1985).

<sup>85</sup> JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, JCS-10-87 (May 4, 1987) at 6.

The Tax Reform Act of 1986 was approximately revenue neutral and roughly distributionally neutral. Over a five-year budget period (1987-1991), it was projected to reduce individual income tax revenues by \$121.9 billion while increasing corporate tax revenues and excise taxes by \$120.3 billion and \$1.5 billion, respectively.<sup>86</sup> The Act reduced the top individual tax rate from 50 percent to 28 percent, decreased the top corporate tax rate from 46 percent to 34 percent, repealed the investment tax credit, made ACRS slightly less generous, and eliminated preferential tax treatment for capital gains. The Act also increased the standard deduction and personal exemption amounts, increased the earned income tax credit, repealed the two-earner deduction, repealed the state and local sales tax deduction, repealed the deduction for consumer interest, and enacted a limitation on deductibility of passive losses.

Some had hoped that the Tax Reform Act of 1986 meant an end to frequent tax legislation. Nevertheless, the Tax Reform Act of 1986 was followed over the next four years by four significant tax acts: The Revenue Act of 1987, the Technical and Miscellaneous Revenue Act of 1988, the Revenue Reconciliation Act of 1989, and the Revenue Reconciliation Act of 1990.

The Revenue Act of 1987 contained about 200 amendments to the Internal Revenue Code. Some of the major changes included changes in the accounting rules for long-term contracts; limitations on the use of the installment method; application of the corporate tax rules to publicly traded partnerships; repeal of the estate freeze technique; reduction in the dividends received deduction from 80 percent to 70 percent in many cases; restrictions on employer deductible contributions to defined benefit plans; and limitations on the home mortgage interest deduction to acquisition debt of \$1 million and home equity debt of \$100,000.

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<sup>86</sup> Id. at 1378.

The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) made a number of technical corrections to the Tax Reform Act of 1984, the Tax Reform Act of 1986 and the Revenue Act of 1987. TAMRA contained the Taxpayer Bill of Rights, limited the completed contract method of accounting, and extended a number of expiring provisions.

The Revenue Reconciliation Act of 1989 contained the repeal of section 89, a controversial provision involving nondiscrimination and qualification rules for employee benefit plans. It also contained a major restructuring of the penalty provisions of the tax code; an extension of the low-income housing credit; treatment of securities received in a tax-free incorporation as taxable boot; elimination or modification of certain advantages associated with employee stock ownership plans; modification of the corporate alternative minimum tax; repeal of the completed contract method of accounting; establishment of an excise tax on ozone-depleting chemicals; and extensions of certain expiring provisions.

The Revenue Reconciliation Act of 1990 added a new top tax rate of 31 percent, retained the capital gains tax rate at 28 percent, increased the individual alternative minimum tax rate from 21 percent to 24 percent, temporarily reduced or eliminated personal and dependency exemptions for upper-income taxpayers (the *Personal Exemption Phaseout* or “PEP”), and temporarily reduced itemized deductions for upper-income taxpayers (commonly known as the “Pease limitation,” named after Representative Donald Pease (D-OH)). Congress also enacted a new 10 percent luxury excise tax on automobiles, boats, aircraft, jewelry and furs, permanently extended the three percent excise tax on telephone service, and raised the cap on taxable wages for Medicare from \$53,400 to \$125,000.

Three years later, Congress enacted the Omnibus Budget Reconciliation Act of 1993 which, like the 1990 Act, increased taxes on upper-income taxpayers. Two new tax rates were

enacted: a 36 percent rate and a 39.6 percent rate (which began at taxable income of \$250,000). The alternative minimum tax rate for individuals was increased from 24 percent to a two-rate structure of 26 percent and 28 percent. The \$125,000 cap on Medicare tax was repealed, PEP and Pease were made a permanent part of the tax code, the taxable portion of Social Security benefits was increased from 50 percent to 85 percent, the earned income tax credit was extended to single workers with no children earning \$9,000 or less, and the deduction for business meals and entertainment was reduced from 80 percent to 50 percent. The top corporate tax rate was increased from 34 percent to 35 percent. Congress repealed the luxury taxes enacted three years earlier except on automobiles.

In 1996, Congress enacted the Health Insurance and Portability Act of 1996, the Small Business Job Protection Act of 1996, and the Taxpayer Bill of Rights 2.<sup>87</sup> Congress enacted medical savings accounts, increased the health expense deduction for the self-employed, increased small business expensing, simplified a number of pension provisions, and established a Taxpayer Advocate within the IRS. In addition, Congress expanded and strengthened the rules for taxing expatriates, enacted the work opportunity tax credit, terminated the Puerto Rico and possession tax credit, and simplified a number of S corporation rules.

The next year, Congress enacted the Taxpayer Relief Act of 1997,<sup>88</sup> which introduced a child tax credit of \$500 per child; introduced the Hope and Lifetime Learning credits for education; increased the estate tax unified credit from \$600,000 to \$1 million; reduced the capital gains tax

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<sup>87</sup> See JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 104<sup>TH</sup> CONGRESS, JCS-12-96 (Dec. 18, 1996).

<sup>88</sup> See JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, JCS-23-97 (Dec. 17, 1997).

rate from 28 percent to 20 percent; established Roth IRAs and education IRAs; increased the income limits for deductible IRAs; and conformed AMT depreciation lives to regular tax lives.

In 2001, Congress enacted the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) resulting in significant tax reductions for individuals.<sup>89</sup> As part of EGTRRA, Congress created a new 10 percent tax rate on the first \$12,000 of taxable income (\$6,000 for an individual). EGTRRA also phased in reduction of the 28 percent, 31 percent, 36 percent and 39.6 percent rates to 25 percent, 28 percent, 33 percent and 35 percent, respectively; phased in repeal of PEP and Pease; phased in doubling of the child tax credit to \$1,000 and made it refundable; phased in lowering of the marriage penalties; gradually reduced the estate and gift tax rate from 55 percent to 45 percent, with a gradual increase of the exemption amount from \$1 million to \$3.5 million; repealed the estate tax and generation-skipping transfer (GST) tax for 2010; phased in increases of annual contribution limits for IRAs and 401(k) plans; permitted designated Roth contributions to 401(k) plans; established a temporary credit for retirement savings; and expanded credits and deductions for education expenses.

Two years later, Congress enacted the Jobs and Growth Tax Relief and Reconciliation Act of 2003 (JGTRRA).<sup>90</sup> As part of the pro-growth JGTRRA, Congress lowered the capital gains tax rate from 20 percent to 15 percent and lowered the tax rate on dividends also to 15 percent, achieving partial integration of the corporate and individual income tax systems. Congress also temporarily permitted 50 percent expensing of certain business assets.

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<sup>89</sup> See JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 107<sup>TH</sup> CONGRESS, JCS-1-03 (Jan. 24, 2003).

<sup>90</sup> See JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108<sup>TH</sup> CONGRESS, JCS-5-05 (May 31, 2005).

The next year, Congress enacted the most sweeping business tax reform since the 1986 Act.<sup>91</sup> As part of the American Jobs Creation Act of 2004, Congress enacted a special deduction for U.S. manufacturers, which was loosely designed to replace the tax benefits of the foreign sales corporation/extraterritorial income (FSC/ETI) regime, which the World Trade Organization found to be a prohibited export subsidy. Some of the highlights of the 2004 Act include reform of S corporation taxation; simplification of international taxation, including reducing the number of foreign tax credit baskets from nine to two; clamping down on tax shelters and other tax avoidance schemes; accelerating depreciation for leasehold and restaurant improvements; and allowing deductions for state and local sales taxes in lieu of deductions for state and local income taxes.

Also, in 2004, Congress enacted the Working Families Tax Relief Act of 2004.<sup>92</sup> The Act generally extended a number of individual and business provisions that expired or were set to expire, such as the \$1,000 child tax credit, elimination of the marriage penalty, expansion of the 10 percent tax bracket, alternative minimum tax relief, and the research and development tax credit.

In 2006, Congress enacted the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA).<sup>93</sup> The Act included a number of “tax extenders,” such as extending individual alternative minimum tax relief and favorable tax rates for capital gains and qualified dividend income, as well as adding a temporary provision providing an exception from subpart F for dividends, interest, rents and royalties received by one controlled foreign corporation from another controlled foreign corporation (generally referred to as the CFC look-through rule). The Act also added some new

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<sup>91</sup> *Id.*

<sup>92</sup> *Id.*

<sup>93</sup> *See* JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 109TH CONGRESS, JCS-1-07 (Jan. 17, 2007).

provisions, such as increasing the age at which the kiddie tax applies from 14 to 18 years of age and requiring information reporting for interest on tax-exempt bonds. Also, in the Pension Protection Act of 2006, Congress made permanent the retirement changes contained in EGTRRA.<sup>94</sup>

With the economy slumping in 2008, Congress enacted the Housing Assistance Tax Act of 2008 and the Emergency Economic Stabilization Act of 2008.<sup>95</sup> The former act provided tax incentives with respect to housing, and the latter act included AMT relief, extension of a number of individual and business deductions and credits, disaster relief for those affected by hurricanes and flooding, as well as a number of energy-related provisions.

Early in 2009, Congress enacted the American Recovery and Reinvestment Act of 2009, which was estimated at the time to have a \$787 billion federal budget cost.<sup>96</sup> The Act was a Keynesian-driven response to the so-called “great recession,” intended by its advocates to provide “stimulus” to the economy. The Act included a new refundable Making Work Pay tax credit; replacement of the Hope scholarship credit with a more generous American Opportunity Tax Credit; enhancements to the child tax credit and the refundable EITC; AMT relief; and energy incentives.<sup>97</sup>

The next year, Congress enacted the Hiring Incentives to Restore Employment Act, the Patient Protection and Affordable Care Act, and the Health Care and Education Reconciliation Act

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<sup>94</sup> *Id.*

<sup>95</sup> *See* JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 110TH CONGRESS, JCS-1-09 (Mar. 18, 2009).

<sup>96</sup> *See* JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 111TH CONGRESS, JCS-2-11 (Mar. 2011).

<sup>97</sup> Non-refundable tax credits reduce taxes owed on income, but not below zero. Refundable tax credits reduce taxes when positive taxes are owed and then, if any credit remains, the remainder is provided to the taxpayer (often times referred to as a refund).

of 2010.<sup>98</sup> The centerpiece of the acts was fundamental reform of the health care system. The acts also contained a number of tax provisions including a refundable health insurance premium assistance credit for those taxpayers with household income between 100 percent and 400 percent of the federal poverty level; an additional health insurance tax of 0.9 percent on individuals with wages or self-employment income in excess of \$200,000 (\$250,000 for married filing jointly); a 3.8 percent net investment income tax on individuals (and estates and trusts); a 40 percent excise tax on “Cadillac” health plans (effective in 2018); codification of the economic substance doctrine; and stringent reporting requirements on foreign financial institutions and non-financial foreign entities (Foreign Account Tax Compliance Act—or, FATCA).

In 2010, Congress extended the basic structure of EGTRRA and JGTRRA through 2012 as part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.<sup>99</sup> In early 2013, as part of the American Taxpayer Relief Act of 2012, Congress again extended the basic structure of EGTRRA and JGTRRA, but limited the benefits for upper-income taxpayers.

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<sup>98</sup> See JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 111<sup>TH</sup> CONGRESS, JCS-2-11 (Mar. 2011).

<sup>99</sup> Id.



The following table shows the internal revenue receipts for the years 1986 to 2013.

**Table 2.4**

**Internal Revenue Receipts by Principal Sources, 1986-2013 (in Thousands)<sup>100</sup>**

Year	Individual Income Taxes	Corporate Income Taxes <sup>101</sup>	Payroll Taxes	Estate and Gift Taxes	Other Taxes (Mainly Excise Taxes)	Total Internal Revenue Receipts
1986	416,964,771	80,441,620	243,978,380	7,194,955	33,672,086	782,251,812
1987	465,452,486	102,858,985	277,000,469	7,667,670	33,310,980	886,290,590
1990	540,228,408	110,016,539	367,219,321	11,761,938	27,139,445	1,056,365,652
1993	585,774,159	131,547,509	411,510,516	12,890,965	34,962,476	1,176,685,625
1995	675,779,337	174,422,173	465,405,305	15,144,394	44,980,627	1,375,731,835
1998	928,065,857	213,270,011	557,799,193	24,630,962	45,642,716	1,769,408,739
2000	1,137,077,702	235,654,894	639,651,814	29,721,620	54,810,895	2,096,916,925
2001	1,178,209,880	186,731,643	682,222,895	29,247,916	52,418,848	2,128,831,182
2003	987,208,878	194,146,298	695,975,801	22,826,908	52,771,160	1,952,929,045
2005	1,107,500,994	307,094,837	771,441,662	25,605,531	57,252,098	2,268,895,122
2008	1,400,405,178	354,315,825	883,197,626	29,823,935	51,707,840	2,746,035,410
2009	1,175,421,788	225,481,588	858,163,864	24,677,322	46,631,646	2,345,337,177
2010	1,163,687,589	277,937,220	824,188,337	19,750,836	47,190,057	2,345,055,978
2011	1,331,160,469	242,848,122	767,504,822	9,079,375	49,337,563	2,414,952,112
2012	1,371,402,290	281,461,580	784,396,853	14,450,249	56,174,937	2,524,320,134
2013	1,539,658,421	311,993,954	897,847,151	19,830,148	85,729,747	2,855,059,420

<sup>100</sup> INTERNAL REVENUE SERVICE, SOI TAX STATS – GROSS COLLECTIONS BY TYPE OF TAX – IRS DATA BOOK Table 6, available at <http://www.irs.gov/uac/SOI-Tax-Stats-Gross-Collections-by-Type-of-Tax-IRS-Data-Book-Table-6> (accessed Nov. 13, 2014).

<sup>101</sup> Includes taxes on corporate income and taxes on unrelated business income of tax-exempt organizations.

### Chapter 3: Where Are We and Where Are We Going?

Driven by increased revenues from a tepid economic recovery along with tax hikes, the deficit has improved over the last several years. However, the long-term overall budget outlook is not rosy. The Congressional Budget Office (CBO) has written that “. . . later in the coming decade, if current laws governing federal taxes and spending generally remain unchanged, revenues would grow only slightly faster than the economy and spending would increase more rapidly, according to the Congressional Budget Office’s projections. Consequently, relative to the size of the economy, deficits would grow and federal debt would climb.”<sup>102</sup> CBO predicts that the budget deficit will decrease to \$469 billion in 2015, but will then begin increasing again, reaching almost \$1 trillion in 2022.<sup>103</sup> The projected increase is due primarily to the aging population, rising per capita health care costs, expansion of federal subsidies for health insurance and rising interest payments on the debt.<sup>104</sup>

CBO estimates that budget deficits as a share of gross domestic product (GDP) will remain below 3.0 percent until 2019.<sup>105</sup> From 2019 until 2024, CBO predicts that budget deficits will range from 3.0 percent to 3.8 percent of GDP.<sup>106</sup> Debt held by the public, which was 72 percent of GDP at the end of 2013, will be 74.4 percent at the end of 2014, the highest ratio since 1950.<sup>107</sup> Over the last 40 years, debt held by the public has averaged 39 percent of GDP and was 35 percent of GDP as recently as 2007.<sup>108</sup>

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<sup>102</sup> CONGRESSIONAL BUDGET OFFICE, AN UPDATE TO THE BUDGET AND ECONOMIC OUTLOOK: 2014 TO 2024 (Aug. 2014) at 1.

<sup>103</sup> *Id.* at 2.

<sup>104</sup> *Id.* at 7.

<sup>105</sup> *Id.* at 2.

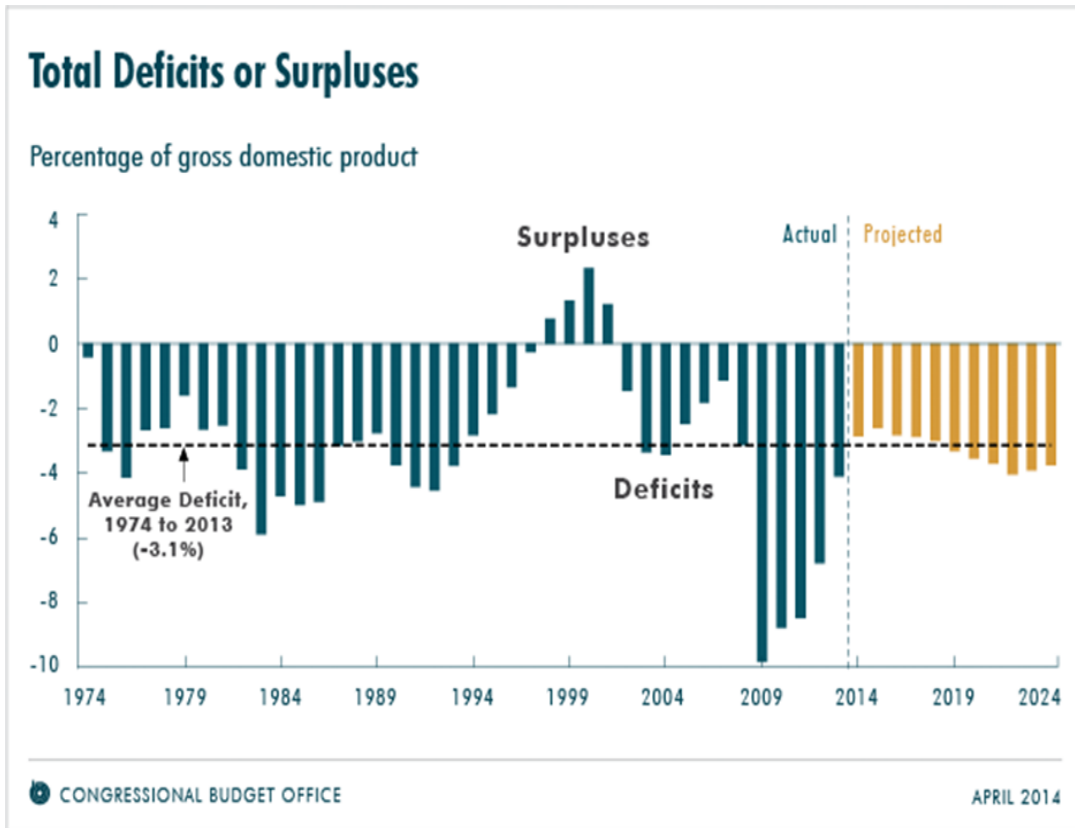
<sup>106</sup> *Id.*

<sup>107</sup> *Id.* at 7 and 9.

<sup>108</sup> *Id.* at 7.

Figure 3.1

Total Deficits or Surpluses, 1974-2024



CBO notes that revenues are increasing and will continue to do so as the economy recovers. For fiscal year 2014, CBO estimates that revenues will equal 17.5 percent of GDP, which is an increase from the previous year of 16.7 percent of GDP.<sup>109</sup> The percentage estimated for 2014 is slightly higher than the 40-year historical average of 17.4 percent.<sup>110</sup> CBO estimates that revenues will be 18.3 percent of GDP in 2015, and then remain in the 18.0 to 18.2 percent range through 2024.<sup>111</sup> Under current law, individual income tax receipts are projected by CBO to rise by nearly

<sup>109</sup> Id. at 9.

<sup>110</sup> Id. at 15.

<sup>111</sup> Id. at 9.

one percent of GDP between 2015 and 2012, to 9.4 percent, driven largely because a larger proportion of income will fall into higher income tax brackets which, in turn, arises because of tax brackets being indexed to inflation but not to real (inflation-adjusted) income growth—a phenomenon known as “real bracket creep.”<sup>112</sup> Over the same period, CBO projects that the increased personal income tax receipts will be offset by a decline in corporate income taxes, which are projected to fall to 1.8 percent of GDP in 2024, largely because of a projected drop in domestic profits relative to the size of GDP, and by smaller remittances to Treasury from the Federal Reserve.<sup>113</sup>

With respect to outlays, CBO estimates that spending will equal 20.4 percent of GDP in fiscal year 2014, a slight drop from 20.8 percent of GDP in 2013. The estimated percentage for 2014 is lower than it has been since 2008, before the large spending increase that began in 2009, and is almost identical to the 40-year historical average of 20.5 percent of GDP. After 2014, however, CBO estimates that outlays will begin growing again as a percentage of GDP reaching about 22 percent from 2022 through 2024.<sup>114</sup> According to CBO: “Between 2014 and 2024, annual outlays are projected to grow, on net, by \$2.3 trillion, reflecting an average annual increase of 5.2 percent. Boosted by the aging of the population, the expansion of federal subsidies for health insurance, rising health care costs per beneficiary, and mounting interest costs on federal debt, spending for the three fastest-growing components of the budget accounts for 85 percent of the total projected increase in outlays over the next 10 years...”<sup>115</sup> The three fastest-growing components of the budget CBO refers to are Social Security, the government’s major health care

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<sup>112</sup> *Id.* at 4.

<sup>113</sup> *Id.*

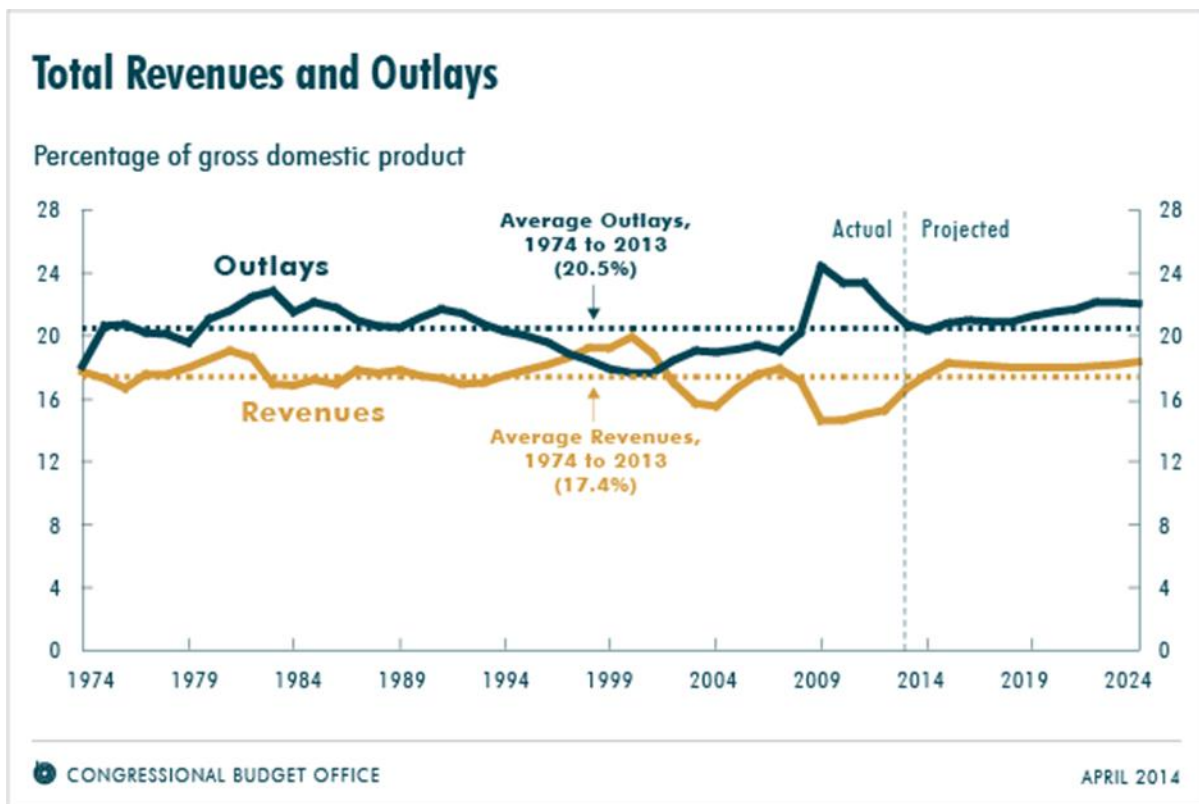
<sup>114</sup> *Id.* at 9.

<sup>115</sup> *Id.* at 3.

programs (Medicare, Medicaid, the Children’s Health Insurance Program, and health insurance subsidies purchased through exchanges), and net interest on the federal debt. Unsustainable entitlement spending, coupled with mounting interest costs, account for the bulk of projected federal spending increases and future federal debt accumulation.

**Figure 3.2**

**Total Revenues and Outlays, 1974-2024**



**Table 3.1**

**Deficits Projected in CBO’s Baseline Budget Projections (in Billions of Dollars)<sup>116</sup>**

	Actual 2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2015- 2019	2015- 2024
Revenues	2,775	3,006	3,281	3,423	3,605	3,748	3,908	4,083	4,257	4,446	4,644	4,850	17,965	40,243
Outlays	3,455	3,512	3,750	3,979	4,135	4,308	4,569	4,820	5,076	5,391	5,601	5,810	20,741	47,439
<b>Deficit</b>	-680	-506	-469	-556	-530	-560	-661	-737	-820	-946	-957	-960	-2,777	-7,196

**Table 3.2**

**Deficits Projected in CBO’s Baseline (as a Percentage of Gross Domestic Product)<sup>117</sup>**

	Actual 2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2015- 2019	2015- 2024
Revenues	16.7	17.5	18.3	18.1	18.1	18.0	18.0	18.1	18.1	18.1	18.2	18.2	18.1	18.1
Outlays	20.8	20.4	20.9	21.0	20.8	20.7	21.1	21.3	21.5	21.9	21.9	21.8	20.9	21.3
<b>Deficit</b>	-4.1	-2.9	-2.6	-2.9	-2.7	-2.7	-3.0	-3.3	-3.5	-3.8	-3.7	-3.6	-2.8	-3.2

The two leading sources of revenue are individual income taxes and social insurance taxes (i.e., payroll taxes). As a revenue source, the corporate income tax is a distant third. During the recent economic downturn, individual income tax revenues declined significantly so that in two years (2009 and 2010) revenues from social insurance taxes were almost equal to that of individual income taxes. However, revenues from corporate income taxes showed the most dramatic decline, raising only \$138 billion of revenue in 2009. As the economy has gradually recovered, revenues from corporate income taxes have climbed back to near pre-economic downturn levels.

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<sup>116</sup> Id. at 9.

<sup>117</sup> Id.

**Table 3.3**  
**Actual Revenues for 2007 to 2013 (Billions of Dollars)<sup>118</sup>**

Revenues	2007	2008	2009	2010	2011	2012	2013
Individual income taxes	1,163.5	1,145.7	915.3	898.5	1,091.5	1,132.2	1,316.4
Social insurance taxes	869.6	900.2	890.9	864.8	818.8	845.3	947.8
Corporate income taxes	370.2	304.3	138.2	191.4	181.1	242.3	273.5
Other	164.6	173.7	160.6	207.9	211.1	229	236.3
<b>TOTAL</b>	<b>2,568.0</b>	<b>2,524.0</b>	<b>2,105.0</b>	<b>2,162.7</b>	<b>2,303.5</b>	<b>2,450.2</b>	<b>2,774.0</b>

CBO estimates that revenues from individual income taxes will substantially increase over the next decade.<sup>119</sup> This is due, in large part, to real bracket creep.<sup>120</sup> In addition, CBO estimates that increases in withdrawals from tax-deferred retirement accounts as baby boomers retire, changes in tax provisions, and other factors will lead to an increase in revenues from individual income taxes.<sup>121</sup>

**Table 3.4**  
**Projected Revenues for 2014 to 2024 (Billions of Dollars)<sup>122</sup>**

Revenues	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Individual income taxes	1,390	1,526	1,623	1,735	1,835	1,931	2,035	2,142	2,254	2,371	2,493
Social insurance taxes	1,024	1,065	1,102	1,146	1,193	1,249	1,309	1,359	1,416	1,473	1,531
Corporate income taxes	315	389	413	452	469	465	463	464	469	478	490
Other	278	302	285	272	251	263	276	292	307	323	336
<b>TOTAL</b>	<b>3,006</b>	<b>3,281</b>	<b>3,423</b>	<b>3,605</b>	<b>3,748</b>	<b>3,908</b>	<b>4,083</b>	<b>4,257</b>	<b>4,446</b>	<b>4,644</b>	<b>4,850</b>

<sup>118</sup> CONGRESSIONAL BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: 2014 TO 2024 (Feb. 2014) at 158.

<sup>119</sup> CONGRESSIONAL BUDGET OFFICE, AN UPDATE TO THE BUDGET AND ECONOMIC OUTLOOK: 2014 TO 2024 (Aug. 2014) at 21.

<sup>120</sup> *Id.*

<sup>121</sup> *Id.* at 22.

<sup>122</sup> *Id.* at 9.

**Table 3.5**

**Projected Revenues for 2014 to 2024 (as a Percentage of Gross Domestic Product)<sup>123</sup>**

Revenues	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Individual income taxes	8.1	8.5	8.6	8.7	8.8	8.9	9.0	9.1	9.2	9.3	9.4
Social insurance taxes	6.0	5.9	5.8	5.8	5.7	5.8	5.8	5.8	5.8	5.8	5.7
Corporate income taxes	1.8	2.2	2.2	2.3	2.3	2.1	2.0	2.0	1.9	1.9	1.8
Other	1.6	1.7	1.5	1.4	1.2	1.2	1.2	1.2	1.2	1.3	1.3
TOTAL	17.5	18.3	18.1	18.1	18.0	18.0	18.1	18.1	18.1	18.2	18.2

If comprehensive tax reform is done properly, it will lead to increases in revenue through economic growth.<sup>124</sup> More growth generates more revenue. Less growth, on the other hand, provides less revenue.

Shifting away from looking at the budget numbers to the actual provisions in our tax laws, we see that our tax system is a disaster. Utilizing the three factors that President Reagan adopted as part of his tax reform effort in the mid-1980s, which are, once again, fairness, efficiency, and simplicity, our current tax system fails miserably in all three aspects.

Over the last 28 years, we have moved further and further away from the reforms enacted as part of the Tax Reform Act of 1986. In fact, our current tax code bears little resemblance to the one created by the 1986 tax law. We have added tremendous complexity to the tax code with provisions that distort investment and business decisions leading to tremendous inefficiency. In addition, and probably most importantly, the lack of fairness in our current tax code is a huge concern.

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<sup>123</sup> Id.

<sup>124</sup> See Chapter 4, part D.



On April 1, 2012, the United States achieved the dubious distinction of having the highest corporate tax rate in the developed world, taking the title away from Japan.<sup>125</sup> We want America to be number one in many areas, but having the highest corporate tax rate in the developed world is not one of them. The growing number of temporary tax provisions is another serious problem. In 1998, there were 42 temporary tax provisions. Today there are nearly 100 such provisions.<sup>126</sup>

Moving forward, tax reform should adhere to seven guiding principles. The first three principles are adopted from President Reagan's tax reform in the mid-1980s, with four additional principles that are critical in today's world: (1) efficiency and economic growth, (2) fairness, (3) simplicity, (4) revenue neutrality, (5) permanence, (6) competitiveness, and (7) incentives for savings and investment.<sup>127</sup>

With regard to the first principle of efficiency, tax reform, if done properly, would significantly reduce many of the economic distortions that are present under the current income tax system. It would eliminate the anticompetitive nature of the current tax system, such as the United States having the highest corporate tax rate in the industrialized world which distorts, among other things, international capital flows and location of intellectual property. The anticompetitive nature of the tax system stifles job growth and hinders the creation of a strong economy.

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<sup>125</sup> See Scott A. Hodge, *The Countdown is Over. We're #1* (April 1, 2012), available at <http://taxfoundation.org/article/countdown-over-were-1> (accessed Nov. 14, 2014); *Hatch on U.S. Corporate Tax Rate Becoming Highest in World* (Mar. 30, 2012), available at <http://www.finance.senate.gov/newsroom/ranking/release/?id=64ed582d-c3de-498f-bfe0-9b8f155b8329> (accessed Nov. 14, 2014).

<sup>126</sup> See JOINT COMMITTEE ON TAXATION, LIST OF EXPIRING TAX PROVISIONS 2013-2024, JCX-1-14 (Jan. 10, 2014).

<sup>127</sup> These seven principles were the foundation for the recommendations of the Republican members of the Finance Committee to the Joint Select Committee on Deficit Reduction on October 14, 2011. U.S. SENATE COMMITTEE ON FINANCE, REPUBLICAN CONSENSUS RECOMMENDATIONS TO THE JOINT SELECT COMMITTEE ON DEFICIT REDUCTION (Oct. 2011).

To promote fairness, we need to broaden the tax base and lower the rates. The income tax base, which has become riddled with exclusions, exemptions, deductions and credits, should be as broad as possible. So-called “tax expenditures” in the individual income tax system currently total over \$1 trillion per year.<sup>128</sup> The Tax Foundation has estimated that eliminating the 11 largest individual tax expenditures could permit tax rates to be reduced by 36.5 percent.<sup>129</sup> Tax reform should eliminate or reduce a number of tax expenditures, thereby broadening the tax base while simultaneously lowering tax rates.

The lack of simplicity in our current tax code is obvious. The tax code has grown to almost four million words.<sup>130</sup> Approximately 56 percent of individual taxpayers use paid preparers for their tax returns and another 34 percent use tax software to assist them.<sup>131</sup> Taxpayers and businesses spend 6.1 billion hours a year complying with tax-filing requirements and compliance costs total \$170 billion annually.<sup>132</sup> The annual monetary compliance burden of the median individual taxpayer was \$258 in 2007.<sup>133</sup> Tax reform should greatly simplify the tax code by eliminating or reducing many tax expenditures and eliminating the alternative minimum tax

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<sup>128</sup> See JOINT COMMITTEE ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2014-2018, JCX-97-14 (Aug. 5, 2014).

<sup>129</sup> See Michael Schuyler, *The Effects of Terminating Tax Expenditures and Cutting Individual Income Tax Rates*, Tax Foundation, No. 396 (Sept. 30, 2013), available at <http://taxfoundation.org/sites/taxfoundation.org/files/docs/ff396.pdf> (accessed Dec. 4, 2014).

<sup>130</sup> NATIONAL TAXPAYER ADVOCATE, 2013 ANNUAL REPORT TO CONGRESS, Vol. 1 at 97 (Dec. 31, 2013), available at <http://www.taxpayeradvocate.irs.gov/userfiles/file/2013FullReport/Volume-1.pdf> (accessed Oct. 8, 2014).

<sup>131</sup> Written Testimony of John A. Koskinen, Commissioner of the Internal Revenue Service, Before the Senate Finance Committee on Regulation of Tax Return Preparers (Apr. 8, 2014), available at <http://www.finance.senate.gov/imo/media/doc/Koskinen%20Testimony.pdf> (accessed Dec. 4, 2014).

<sup>132</sup> NATIONAL TAXPAYER ADVOCATE, 2012 ANNUAL REPORT TO CONGRESS, Vol. 1 at 6 (Dec. 31, 2012), available at <http://www.taxpayeradvocate.irs.gov/userfiles/file/Full-Report/Volume-1.pdf> (accessed Nov. 13, 2014).

<sup>133</sup> *Id.*

(AMT). Simplifying the tax code would result in greater, and less costly, compliance by American taxpayers.

Tax reform should not be an occasion to raise taxes on Americans or U.S. businesses. Over the last four decades, federal revenues as a percentage of GDP have averaged 17.4 percent per year.<sup>134</sup> As previously stated, CBO has projected that federal revenues will be 17.5 percent of GDP in 2014, which is slightly higher than the historical average.<sup>135</sup> In addition, CBO has projected that federal revenues will be between 18.0 percent and 18.3 percent from 2015 through 2024.<sup>136</sup> Therefore, revenues are already heading higher than their historical average. We do not need to use tax reform as another excuse to raise taxes on the American people.

The tax code needs permanence and certainty. The Joint Committee on Taxation lists almost 100 provisions expiring from 2013-2024.<sup>137</sup> Individuals and businesses need to be able to rely on provisions in the tax law for personal and business planning. The research and development tax credit, for example, expires every couple of years, and businesses are always unsure if Congress will resurrect it, and if so, whether it will be done retroactively or only prospectively. The research and development tax credit is a very worthy provision, and it should be enhanced and made permanent, as Senator Hatch proposed in a bill that was introduced in September 2011.<sup>138</sup> The lack of certainty in our tax laws hinders job creation at a time when the

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<sup>134</sup> CONGRESSIONAL BUDGET OFFICE, AN UPDATE TO THE BUDGET AND ECONOMIC OUTLOOK: 2014 TO 2024 (Aug. 2014) at 10.

<sup>135</sup> *Id.* at 9.

<sup>136</sup> *Id.*

<sup>137</sup> *See* JOINT COMMITTEE ON TAXATION, LIST OF EXPIRING FEDERAL TAX PROVISIONS 2013-2024, JCX-1-14 (Jan. 10, 2014).

<sup>138</sup> Greater Research Opportunities with Tax Help Act (“GROWTH Act”), S.1577, 112<sup>th</sup> Cong., 1<sup>st</sup> Sess. (Sept. 19, 2011).

unemployment rate is about six percent<sup>139</sup> and the labor force participation rate is less than 63 percent, which is the lowest rate since 1978.<sup>140</sup>

We also need a more competitive tax code. Once again, the United States has the highest statutory corporate tax rate (35 percent) in the developed world. In contrast, the United Kingdom, for example, has a 21 percent corporate tax rate (scheduled to decrease to 20 percent in 2015). In addition, the United States is one of only six OECD countries that has a worldwide tax system – the other 28 OECD countries have a territorial type of tax system. The combination of a high corporate tax rate, worldwide taxation, and the temporary nature of some tax incentives make U.S. companies less competitive when compared to their foreign counterparts. U.S. multinationals are also discouraged or penalized from repatriating foreign earnings because of the U.S. corporate tax that applies at the time of repatriation. As a result, a number of U.S. multinationals have changed or are in the process of changing their legal domicile from the United States to countries that have a more competitive tax system, as illustrated by U.S.-based Medtronic’s \$43 billion acquisition of Irish-based Covidien that will result in an Irish company subject to a 12.5 percent corporate tax rate and a de facto territorial tax system.

Tax reform should reduce the high U.S. corporate tax rate and also achieve neutrality through a territorial type of tax system, thereby placing American companies on an equal footing with their foreign competitors when conducting business in other countries. The result would be more companies establishing or retaining their corporate headquarters in the United States, the creation of more exports to global markets, and reinvestment of money in the United States rather

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<sup>139</sup> See UNITED STATES DEPARTMENT OF LABOR, BUREAU OF LABOR STATISTICS, available at <http://data.bls.gov/timeseries/LNS14000000> (accessed Oct. 8, 2014).

<sup>140</sup> See UNITED STATES DEPARTMENT OF LABOR, BUREAU OF LABOR STATISTICS, available at <http://data.bls.gov/timeseries/LNS11300000> (accessed Oct. 8, 2014).

than abroad, all resulting in the creation of jobs in the United States and a stronger U.S. economy. Substantially lowering both the top individual tax rate and the top corporate tax rate will allow U.S. pass-through businesses and domestic C corporations to be more competitive.

Finally, many aspects of the U.S. income tax system discourage savings and investment by individuals, thereby hindering long-term growth. In fact, an income tax system by its very nature discourages savings and investment. Tax reform should result in a tax system that is more favorable to savings and investment. This could be achieved by enhancing the consumption tax aspects of our current tax system (i.e., retirement plan savings) or transitioning to a more consumption-based tax system.<sup>141</sup>

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<sup>141</sup> If the United States were to transition to a consumption-based tax system, procedural safeguards, which could include a Constitutional amendment, should be enacted to ensure that the consumption-based tax system would not be simply an add-on tax and that the consumption-based tax was not increased over time.

## Chapter 4: Individual Tax Reform

One of the most difficult areas we will have to deal with as we undertake comprehensive tax reform will be the taxation of individuals. The individual tax system includes not only income earned directly by individuals, such as wages, salaries, interest, capital gains and dividends, but also income earned through business entities such as sole proprietorships, partnerships, limited liability companies and S corporations. Such business entities are generally referred to as “pass-through entities,” meaning that the income of such businesses is passed through and taxed to the owners of the business. What makes individual tax reform so difficult is deciding the base on which individuals should be taxed as well as how much of the total tax burden should each individual income group bear. Currently, the tax base is a hybrid of income, consumption and wage tax bases.

### A. Base of Taxation

With regard to individual taxation, there are generally three bases on which to tax: income, consumption or wages. A generally accepted idea is that income can be thought of as consumption plus any increase in wealth.<sup>142</sup> An income tax base is thought to achieve fairness based on the concept of ability to pay. This was a concept developed by Adam Smith in the *Wealth of Nations* published over two hundred years ago.<sup>143</sup> This approach requires that tax burdens be assigned so that taxpayers with a greater ability to contribute pay more in taxes. A person with greater income

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<sup>142</sup> See HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938) (Simons put forward a conceptualized vision of income, writing that “Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.”).

<sup>143</sup> ADAM SMITH, WEALTH OF NATIONS (1776). Smith also noted that fairness requires that the benefits received by the taxpayer be roughly commensurate with the tax paid (“The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.”).

has a greater ability to pay than one with a lesser amount of income. The concept of ability to pay is generally associated with an income tax base but is not limited to such a base. It could apply to any base of tax that relates to the taxpaying capacity of individuals.<sup>144</sup>

On the other hand, fairness may require that the benefits received by the taxpayer from the government be equal, or at least roughly equal, with the taxes the taxpayer pays.<sup>145</sup> The “ability to pay” principle of taxation is in tension with the “benefits received” principle of taxation. That is, for example, low-income persons might pay little or no income tax (because of their low ability to pay tax), but receive significant benefits from the government in the form of public goods (roads, schools, defense, etc.) and in the form of welfare benefits.

One of the main arguments against an income tax base is that it is inefficient because it encourages consumption and discourages savings. This was an observation made by John Stuart Mill over 160 years ago.<sup>146</sup> Roughly speaking, in an income tax system an individual is taxed on his wages. When the individual invests money, the individual is taxed on any return earned on the investment. There is, in a sense, a double tax – once when the saved funds are earned and a second time when the investment return is realized on the saved funds. This double tax discriminates against savings and is therefore thought to be inefficient.

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<sup>144</sup> See BORIS I. BITTKER AND LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 3.7 (3<sup>rd</sup> ed. 1999) (“That is, ability to pay taxes might better be gauged by taxpayers’ command over economic resources (as measured by income) than their uses of those resources (as measured by consumption).”).

<sup>145</sup> See Saul Levmore, *Just Compensation and Just Politics*, 22 CONN. L. REV. 285, 292 (1990) (suggests that expenditures from tax revenues must provide a roughly commensurate reciprocal benefit to avoid a Fifth Amendment takings claim.) See also *Allegheny County v. Monzo*, 500 A.2d 1096 (Pa. 1985) (“Where the benefit received [from the government] and the burden imposed [by a tax] is palpably disproportionate, a tax is ... a taking without due process under the Fourteenth Amendment to the United States Constitution ...”).

<sup>146</sup> JOHN STUART MILL, *PRINCIPLES OF POLITICAL ECONOMY* (1848).

For example, assume an individual earns \$100, which can be either spent or saved. If the individual saves the \$100 at an annual yield of 10 percent, he will have \$110 at the end of one year. The individual has 10 percent more available for consumption by saving for one year. He can either spend at that time or continue to save. If a 40 percent income tax is introduced, then the individual has \$60 to initially spend or save. If the individual saves it for one year with an annual yield of 10 percent, the individual will have \$63.60 (\$60 plus \$6 of interest less tax of \$2.40) at the end of that time. The individual has only six percent rather than 10 percent more available for consumption by saving for one year. In this way, the income tax discriminates against savings. At a time when Americans are saving only about 5.5 percent of their disposable personal income (versus a long-run—1959-2014—average of 6.8 percent),<sup>147</sup> some question whether we should have a system that effectively discourages savings.<sup>148</sup>

A consumption tax base in which consumption and not income is taxed dates back many centuries. In 1651, Thomas Hobbes argued that consumption and not wages should be taxed by government because the state provides protection for the enjoyment of life and taxes are a price for that protection:

Which considered, the equality of imposition consisteth rather in the equality of that which is consumed, than of the riches of the persons than consume the same. For what reason is there that he which laboureth much and sparing the fruits of his labour, consumeth little should be more charged than he that, living idly, getteth little and spendeth all he gets;

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<sup>147</sup> See U.S. DEPARTMENT OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS, PERSONAL INCOME AND OUTLAYS (Aug. 2014), available at <http://www.bea.gov/newsreleases/national/pi/pinewsrelease.htm> (accessed Oct. 8, 2014). Disposable personal income is personal income less personal current taxes.

<sup>148</sup> But see William G. Gale, *Building a Better Tax System: Can a Consumption Tax Deliver the Goods*, 69 TAX NOTES 781 (Nov. 6, 1995) (arguing that a transition from the current U.S. income tax system to a pure consumption tax may not be efficient and may not lead to increased savings); Eric M. Engen and William G. Gale, *The Effects of Fundamental Tax Reform on Saving*, in ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM 83, 84 (Henry J. Aaron and William G. Gale, eds., 1996) (replacing the current tax system with a consumption tax is not likely to raise the saving rate by very much, and the change in saving could be negligible).



seeing the one hath no more protection from the Commonwealth than the other? But when the impositions are laid upon those things which men consume, every man payeth equally for what he useth; nor is the Commonwealth defrauded by the luxurious waste of private men.<sup>149</sup>

A consumption tax base is thought to achieve efficiency because it is more neutral than an income tax between present consumption and future consumption (savings). Under such a base, an individual is taxed on what she consumes. Any amount that is saved is not taxed. Although some see a consumption tax as encouraging savings, it actually takes tax out of the decision whether to save or consume. This can be demonstrated by returning to our simple example of an individual that earns wages of \$100. If the individual saves the \$100 at an annual yield of 10 percent, she will have \$110 at the end of one year. The individual has 10 percent more available for consumption by saving for one year. If a 40 percent tax is introduced on consumption, then the individual has \$60 to spend or can save the entire \$100. If the individual saves the \$100 for one year with an annual yield of 10 percent, the individual will have \$110 at the end of that time. If the individual decides to consume it at the end of one year, the individual will have \$66 (\$110 less tax of \$44) available to consume. The individual has 10 percent more available for consumption by saving for one year. As a result, a consumption tax base does not discriminate between present consumption and future consumption (savings).

A wage tax base, like a consumption tax base, is thought to achieve efficiency because it also equalizes the decision whether to consume or save.<sup>150</sup> Under such a base, an individual is taxed on his wages, salaries and any other income from services. Income from capital, such as

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<sup>149</sup> THOMAS HOBBS, *LEVIATHAN* (1651).

<sup>150</sup> A wage tax is sometimes referred to as a prepaid consumption tax reflecting the notion that the funds used to generate income from capital are taxed on the front end, i.e., when the wages and salaries are earned. In contrast, a consumption tax is sometimes referred to as a postpaid consumption tax reflecting the notion that the funds used to generate income from capital are not taxed until the funds are used for consumption.

dividends, interest, rent, royalties, capital gains, is not taxed. For example, assume an individual earns wages of \$100. At a 40 percent tax rate, he would owe \$40 in taxes leaving the individual with \$60 to save or consume. The individual decides to save the \$60 for one year at an annual yield of 10 percent. The \$6 return on the savings is not taxed under a wage tax base. At the end of one year, the individual will have \$66 that he can save or consume. The individual has 10 percent more available for consumption by saving for one year. As a result, a wage tax base does not discriminate between consumption and savings.

Our current income tax system is actually a hybrid of income, consumption and wage tax principles. To illustrate, if an individual receives wages, interest, rents, or royalties -- all of those items are included in the individual's income thereby illustrating an income tax system. If the individual contributes funds to a 401(k) plan or an individual retirement account (IRA), the tax on those funds is deferred either by exclusion from the individual's income (in the case of a 401(k) plan) or through receipt of a deduction by the individual for contributing those funds to the retirement plan (in the case of an IRA). When the funds are removed from the retirement plan (for example, when the individual retires) the tax deferral ends and the individual is taxed at that time because the funds are used for consumption and no longer for savings. As a result, 401(k) plans and IRAs are examples of a consumption tax system. Total U.S. retirement assets, which were \$24.0 trillion as of June 30, 2014, accounted for 36 percent of all household financial assets in the United States at the end of the second quarter of 2014.<sup>151</sup> Consequently, the current income tax system is, in large part, a consumption tax system (and wage tax system).

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<sup>151</sup> See INVESTMENT COMPANY INSTITUTE, RESEARCH AND STATISTICS, available at [http://www.ici.org/research/stats/retirement/ret\\_14\\_q2](http://www.ici.org/research/stats/retirement/ret_14_q2) (accessed Nov. 15, 2014).

Our current income tax system also has wage tax principles. For example, long-term capital gains and dividend income, which are two types of income from capital, are taxed at rates lower than other types of income, i.e., “preferential” rates.<sup>152</sup> A pure wage tax system would exempt from tax all income from capital. By taxing capital gains and dividends at rates lower than the taxation of wages and salaries, the tax system is a partial wage tax system. In addition, individuals may contribute funds to a designated Roth account in a 401(k) plan or a Roth IRA. Any amounts contributed to these types of retirement accounts are included in the individual’s income at the time of contribution (by denying an exclusion or deduction for these contributions). The earnings on these amounts are not taxed, and the amounts are not taxed when removed from the retirement accounts for consumption. As a result, the earnings on amounts contributed to a Roth account in a 401(k) plan or Roth IRA are completely exempt from tax, once again illustrating a wage tax system.<sup>153</sup>

Some tax proposals would move the individual income tax system to a consumption tax system. This could be done in one of two ways: through a transactional (or indirect) consumption tax or an individual consumption tax. A transactional consumption tax would be achieved through a national sales tax or a value-added tax (VAT). A sales tax is a tax levied on the sale of goods or services to its final end user. A VAT is a tax levied on the value added to a product, material or service as part of the manufacturing or distribution process. A sales tax and a VAT are similar in that ultimately only the end consumer is taxed. A VAT is used by over 150 countries around the

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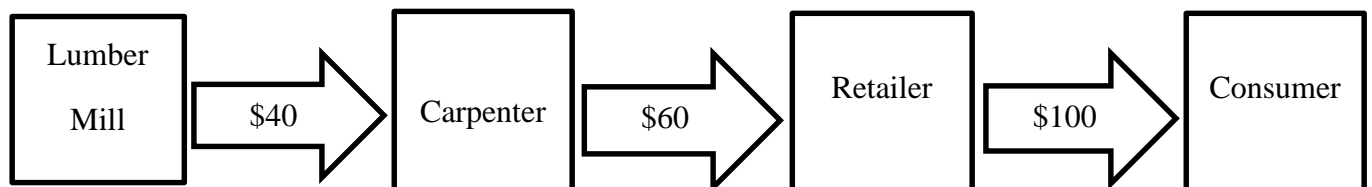
<sup>152</sup> IRC sec. 1(h)(1)(B), (C), (D) (zero percent rate on adjusted net capital gain, which includes qualified dividend income, that would otherwise be taxed at 10 percent or 15 percent; 15 percent rate on adjusted net capital gain that would otherwise be taxed at 25 to 35 percent; 20 percent rate on adjusted net capital gain that would otherwise be taxed at 39.6 percent). In addition, a 3.8 percent net investment income tax can apply to capital gains and dividend income. IRC sec. 1411.

<sup>153</sup> Designated Roth accounts also are permitted in 403(b) plans, governmental 457 plans and the Federal Thrift Savings Plan.

world and 33 of the 34 OECD countries, with the United States being the lone exception.<sup>154</sup> However, 45 of the 50 states and the District of Columbia utilize a retail sales tax, which is similar to a VAT.<sup>155</sup>

There are generally two methods of implementing a VAT. The first method is the credit-invoice method, which is used by almost all countries that have adopted a VAT. Under this method, the tax rate is applied to a business' gross receipts from all sales with no deductions but a credit is allowed for the taxes paid by the business' vendors. The credit is reflected on invoices supplied by the vendors to the business. To illustrate, assume a lumber mill sells wood to a carpenter, who utilizes the wood to make furniture and sells the furniture to a retailer who then sells to consumers. In the absence of tax, the price of wood is \$40, the price of furniture from carpenter to retailer is \$60, and the price of furniture to the consumer is \$100.

#### Sales Price



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<sup>154</sup> See ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, CONSUMPTION TAX TRENDS 2012: VAT/GST AND EXCISE RATES, TRENDS AND ADMINISTRATION ISSUES, available at [http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/consumption-tax-trends-2012\\_ctt-2012-en#page1](http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/consumption-tax-trends-2012_ctt-2012-en#page1) (accessed Dec. 4, 2014).

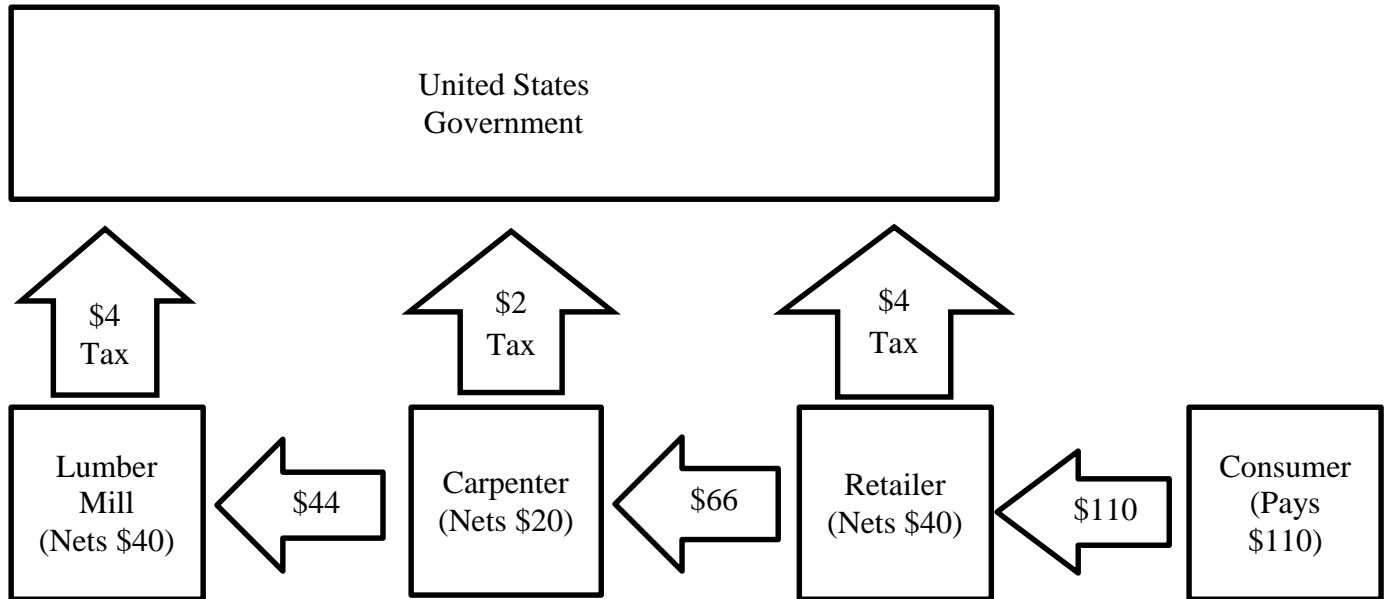
<sup>155</sup> Five states do not have a statewide sales tax: Alaska, Delaware, Montana, New Hampshire, and Oregon. Of these, Alaska and Montana allow localities to charge local sales taxes. See Scott Drenkard, Liz Emanuel and Jordan Yahiro, *State and Local Sales Tax Rates Midyear 2014*, Tax Foundation, Fiscal Fact No. 438 (Sept. 2014), available at <http://taxfoundation.org/article/state-and-local-sales-taxes-midyear-2014> (accessed Nov. 15, 2014).

With a 10 percent VAT, the lumber mill charges the carpenter \$44 (\$40 for the wood plus \$4 in tax) and remits \$4 in tax to the government. The lumber mill issues an invoice to the carpenter entitling the carpenter to credit the \$4 in tax. The carpenter charges the retailer \$66 (\$60 for the furniture plus \$6 in tax). Although the carpenter collects \$6 in tax on the sale to the retailer, he will only remit \$2 in tax to the government as the carpenter credits the \$4 in tax paid by the lumber mill. The carpenter issues an invoice to the retailer entitling the retailer to credit the \$6 in tax (\$4 paid by the lumber mill and \$2 paid by the carpenter). The retailer charges the consumer \$110 (\$100 for the furniture and \$10 in tax). Although the retailer collects \$10 in tax on the sale to the consumer, she will only remit \$4 in tax to the government as the retailer credits the \$6 in tax paid by the lumber mill and carpenter. In total, the government collects \$10 in tax (\$4 from the lumber mill, \$2 from the carpenter and \$4 from the retailer), and the consumer pays the \$10 in tax.<sup>156</sup>

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<sup>156</sup> VATs are typically applied on destination basis as opposed to an origin basis. This means that when goods and services pass from one country to another country, no VAT is imposed by the exporting country but VAT is imposed by the importing country. A VAT can be applied on an origin basis although such a basis would appear to be inconsistent with the view that a VAT is a consumption tax. Whether a VAT is imposed on a destination basis or origin basis may not be significant as many economists claim that currency exchange rates adjust so as to eliminate the distinction. In actual practice, however, the currency exchange rates may take some time to adjust and may not exactly offset the VAT.

## Cash Flow



A second method for implementing a VAT is the subtraction method. Under this method, the tax base for each business is gross receipts from sales less all costs incurred in purchases of goods and services from other businesses that are subject to the VAT. Wages paid to employees are not deductible because employees are not subject to the VAT. A subtraction method VAT is a cash-flow type of tax except that wages are not deductible. Under a subtraction-method VAT, the tax can be imposed on a tax-exclusive basis or a tax-inclusive basis. To illustrate, utilizing the same numbers from the furniture example with a 10 percent tax-exclusive VAT, the lumber mill's tax base would be \$40 (\$40 gross receipts less zero costs). The tax would be \$4 with the carpenter paying the lumber mill \$44. The carpenter's tax base would be \$20 (\$60 gross receipts less \$40 costs paid to the lumber mill). The tax would be \$2 with the retailer paying the carpenter \$66. The retailer's tax base would be \$40 (\$100 gross receipts less \$60 costs paid to the carpenter). The tax would be \$4 with the customer paying the retailer \$110.

To illustrate utilizing a tax-inclusive rate of 9.09 percent, the lumber mill's tax base would be \$44 (\$44 gross receipts less zero cost) resulting in a tax liability of \$4 (\$44 times 9.09 percent). The carpenter's tax base would be \$22 (\$66 gross receipts less \$44 costs paid to the lumber mill) resulting in a tax liability of \$2 (\$22 times 9.09 percent). The retailer's tax base would be \$44 (\$110 gross receipts less \$66 costs paid to the carpenter) resulting in a tax liability of \$4 (\$44 times 9.09 percent).

One concern with any possible transition from our current tax system to a sales tax or a VAT is the impact it could have on those who saved under our current system and would then be subject to tax under a transactional consumption tax.<sup>157</sup> Assume an elderly couple has diligently saved during their working years and are now living off their savings. They have already paid tax on their savings if the savings are held in a bank account, mutual fund, Roth 401(k) account or Roth IRA.<sup>158</sup> To subject this elderly couple to either a national sales tax or VAT would simply be unfair. Some mechanism would need to be enacted to allow certain pre-existing savings to be exempt from a national sales tax or VAT. However, exempting pre-existing savings may reduce much of the efficiency gains from enactment of a consumption tax.<sup>159</sup>

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<sup>157</sup> See Lee A. Sheppard, *Consumption Tax Debunking at Tax Foundation Conference*, 69 TAX NOTES 1071 (Nov. 27, 1995) ("A person who paid income taxes all his working life and who retires, becoming a consumer, just as a consumption tax is introduced, 'isn't going to get the joke,' according to [Ken] Kies.").

<sup>158</sup> Savings held in a 401(k) plan or IRA are part of a consumption tax system. As a result, the elderly couple may be indifferent as to savings held in a 401(k) plan or IRA if a transactional consumption tax were adopted.

<sup>159</sup> See BITTKER AND LOKKEN, *supra* note 144, at ¶ 3.7; Ronald A. Pearlman, *Transition Issues in Moving to a Consumption Tax*, in A COMPREHENSIVE ANALYSIS OF CURRENT CONSUMPTION TAX PROPOSALS, A REPORT OF THE ABA SECTION OF TAXATION TAX SYSTEMS TASK FORCE (1997); Alan J. Auerbach, *Tax Reform, Capital Allocation, Efficiency, and Growth*, in ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM 29, 60-61 (Henry J. Aaron and William G. Gale, eds., 1996); Eric M. Engen and William G. Gale, *The Effects of Fundamental Tax Reform on Saving*, in ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM 110 (Henry J. Aaron and William G. Gale, eds., 1996). See also David Altig, Alan J. Auerbach, Lawrence Kotlikoff, Kent A. Smetters and Jan Walliser,

A retail sales tax or VAT is also regressive. In other words, it imposes a greater tax burden, as a percentage of income, on lower-income taxpayers who devote larger income shares to consumption than on upper-income taxpayers. As a result, some mechanism would be needed to alleviate, if not eliminate, the regressive nature of the tax. For example, certain items such as food, clothing or medical supplies could be exempt from tax. Alternatively, a certain dollar amount of purchases by lower-income taxpayers could be exempt (or the tax rebated) in an attempt to eliminate the regressivity of a retail sales tax or VAT. While it is certainly possible to eliminate the regressive nature of a retail sales tax or VAT, a mechanism to do so would add substantial complexity to the tax, create inefficiencies, as well as shrink the base of such a tax.

A retail sales tax or VAT would have to be coordinated with state and local sales taxes that are imposed by over 9,600 localities in the United States.<sup>160</sup> Such coordination is possible as witnessed by Canada's coordination of its Goods and Services Tax (GST) with the regional Provincial Sales Tax (PST) resulting in the Harmonized Sales Tax (HST).<sup>161</sup> However, Canada has just ten provinces and only five have participated in the harmonization.<sup>162</sup> Harmonization in the United States would almost certainly be significantly more difficult. It would also require the Internal Revenue Service to administer a new tax system.

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*Simulating Fundamental Tax Reform in the United States*, 91 AMER. ECON. REV. 574 (June 2001) (discussing importance of transition rules in choosing any new tax system).

<sup>160</sup> See Scott Drenkard, Alex Raut and Kevin Duncan, *Sales Tax Rates in Major U.S. Cities*, Tax Foundation, Fiscal Fact No. 296 (Apr. 11, 2012), available at <http://taxfoundation.org/sites/default/files/docs/ff296.pdf> (accessed Dec. 4, 2014).

<sup>161</sup> See CANADA REVENUE AGENCY, *GST/HST RATES*, available at <http://www.cra-arc.gc.ca/tx/bsnss/tpcs/gst-tps/rts-eng.html> (accessed Oct. 8, 2014).

<sup>162</sup> *Id.*



Finally, a retail sales tax or VAT may simply be used as a money machine for additional government spending. Countries that have adopted VATs generally impose the tax at a high rate. The following table shows the VAT rate in the 34 OECD countries.

**Table 4.1**  
**VAT Rates in 2014 in OECD Countries<sup>163</sup>**

Country	VAT Rate
Australia	10%
Austria	20%
Belgium	21%
Canada	5%
Chile	19%
Czech Republic	21%
Denmark	25%
Estonia	20%
Finland	24%
France	20%
Germany	19%
Greece	23%
Hungary	27%
Iceland	25.5%
Ireland	23%
Israel	18%
Italy	22%
Japan	5%
Korea	10%
Luxembourg	15%
Mexico	16%
Netherlands	21%
New Zealand	15%

<sup>163</sup> ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, OECD TAX DATABASE, available at <http://www.oecd.org/tax/tax-policy/tax-database.htm#vat> (accessed Nov. 13, 2014).

Norway	25%
Poland	23%
Portugal	23%
Slovak Republic	20%
Slovenia	22%
Spain	21%
Sweden	25%
Switzerland	8%
Turkey	18%
United Kingdom	20%

As the table shows, the VAT rate ranges from a low of five percent (Japan and Canada)<sup>164</sup> to a high of 27 percent (Hungary). In most of the countries, the rate is about 20 percent. In addition, in many of the OECD countries, the VAT rate has increased over time as the countries have generated greater needs for revenue. For example, in 1976, the VAT rate in the United Kingdom was eight percent. Today, it is 20 percent. In Germany, the VAT rate was 11 percent in 1976. Today, it is 19 percent. In fact, the unweighted average rate for the OECD countries was 15.4 percent in 1976. In 2014, the unweighted average for OECD countries was 19.1 percent.

In some countries, the increase in the VAT rate has been offset by a decrease in the corporate tax rate. For example, as the United Kingdom began reducing its corporate tax rate in 2008 from 30 percent to the current 21 percent (with a scheduled decrease to 20 percent in 2015), it also increased its VAT rate beginning in 2011 from 17.5 percent to 20 percent. Similarly, Japan decreased its corporate tax rate in 2012 from 30 percent to 25.5 percent but increased its VAT rate from five percent to eight percent in 2014 (with a scheduled increase to 10 percent in 2015).

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<sup>164</sup> Japan increased its VAT rate to eight percent effective April 1, 2014.

Although the United States is an outlier with respect to a VAT, adoption of a VAT is a bad idea. The Senate accurately captured this in 2010 when it voted 85 to 13 expressing its sense “that the Value Added Tax is a massive tax increase that will cripple families on fixed income and only further push back America's economic recovery.”<sup>165</sup> A VAT would increase federal revenues. It would also effectively be a tax hike on every American, including those who currently pay no income tax. If a VAT were imposed on top of our existing income tax system, it could cripple our economy by imposing new costs on virtually every purchase of goods and services in the United States. It could hamper manufacturing and damage entire retail sectors. Worst of all, it would be the most regressive tax ever imposed on the American people, disproportionately impacting families with lower incomes who spend a higher percentage of their wages on necessities.

An individual consumption tax (as contrasted to a transactional consumption tax), sometimes referred to as a cash-flow consumption tax, has some appeal and has been advanced by a number of tax scholars.<sup>166</sup> It would tax an individual’s consumption and not the individual’s income, thereby achieving neutrality between consumption and savings. It could be enacted utilizing our current income tax system.

A number of years ago, two economists posited that income is equal to consumption plus the net increase in savings.<sup>167</sup> If that concept is expressed in terms of a very stylized, simple formula:  $\text{Income (I)} = \text{Consumption (C)} + \text{Net Change in Savings } (\Delta S)$ . If we isolate C, then we

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<sup>165</sup> Sense of the Senate Regarding a Value Added Tax, S.Amdt. 3724, 111<sup>th</sup> Cong., 2d Sess. (2010).

<sup>166</sup> See, e.g., William D. Andrews, *A Consumption-Type or Cash-Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974); Joseph Bankman and David A. Weisbach, *The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax*, 58 STAN. L. REV. 1413 (2006); Mitchell L. Engler and Michael S. Knoll, *Simplifying the Transition to a (Progressive) Consumption Tax*, 56 SMU L. REV. 53 (2003).

<sup>167</sup> See Robert M. Haig, *The Concept of Income – Economic and Legal Aspects*, in THE FEDERAL INCOME TAX (1921); HENRY C. SIMONS, PERSONAL INCOME TAXATION (1938).

get:  $C = I - \Delta S$ . In other words, consumption equals income minus the net increase in savings.<sup>168</sup> So, for example, assume an individual has \$40,000 of income for the year and saves \$10,000. The individual's consumption is \$30,000 (\$40,000 income minus \$10,000 net increase in savings) for the year.

A consumption tax base is by definition smaller than an income tax base.<sup>169</sup> As a result, tax rates may need to be higher under an individual consumption tax than under an income tax to raise an equivalent amount of revenue. A progressive tax rate and exemptions could be applied to an individual consumption tax to retain the progressive nature of our current tax system. However, under an individual consumption tax, borrowed funds would need to be taxed upon receipt with a deduction upon repayment. Otherwise, borrowings could be used to fund savings decreasing an individual's tax liability.

In addition, and most importantly, the fairness of an individual consumption tax has always been a concern.<sup>170</sup> For example, assume an individual with \$100,000 of income saves \$70,000 and consumes \$30,000. Another individual has \$50,000 of income, saves \$20,000 and consumes \$30,000. For the year in question, both individuals would pay the same amount of tax under an individual consumption tax because both have consumption of \$30,000 although the first

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<sup>168</sup> Although income is equal to consumption plus the net increase in savings, there are difficult line-drawing problems in determining whether a particular item is consumption or savings. For example, how would "consumer durables" be classified? The very name "consumer" suggests the purchase of a consumer durable is consumption. On the other hand, the name "durable" suggests multiple years of duration, years of benefit, thus in turn suggesting investment/savings. Is the distinction between consumption and savings that the benefit of consumption is in the current period, but the benefit of savings is in a future period? Is savings merely delayed consumption? See Andrews, *supra* note 166, at 1155.

<sup>169</sup> It is possible to have net negative savings, i.e., an excess of consumption over income. In such case, a consumption tax base would be greater than an income tax base.

<sup>170</sup> See, e.g., Alvin C. Warren, Jr., *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931 (1975); Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?* 89 YALE L.J. 1081(1980).

individual had twice as much income as the second individual. As a result, some express a concern that a consumption tax trades fairness for efficiency. Of course, such a concern is only valid to the extent one believes taxes should be based on income, not on consumption.

A wage tax would tax an individual's wages and not an individual's capital income, thereby achieving neutrality between consumption and savings.<sup>171</sup> It could be enacted utilizing our current income tax system. Borrowings would have to be addressed as the interest deduction on personal debt should be denied to individuals. Under our current tax system, personal interest is generally not deductible and investment interest is only deductible to the extent of net investment income.<sup>172</sup> So mechanisms are already in place in the tax code to deal with borrowings.

One of the main differences between a wage tax system and an individual consumption tax is the treatment of so-called "supernormal" returns. Some analysts propose that a capital investment will generate a return that can be categorized into three elements: a risk-free rate of return, a risk premium and, in certain cases, a supernormal return.<sup>173</sup> According to that concept, the first element, the risk-free rate of return, is the return that represents compensation for deferring consumption. It is sometimes referred to as the "return to waiting." The second element, the risk premium, is the risk associated with a particular investment with uncertain returns. It is the return to risk taking. The third element, supernormal return, is the return due to a unique idea,

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<sup>171</sup> A wage tax base involves difficult line-drawing problems in determining whether an individual's income is from labor or from capital. For example, business income may be due to a combination of labor inputs and capital inputs. Moreover, definitions of "labor" and "capital" are often tenuous in practice, as labor income—wages—are returns on human capital. See Edward D. Kleinbard, *An American Dual Income Tax: Nordic Precedents*, 5 NW. J. LAW & SOC. POL'Y 41 (2010).

<sup>172</sup> IRC sec. 163(h) and (d).

<sup>173</sup> A fourth element, which is usually assumed away in discussion of the elements of the return on capital, is the inflation component. See Daniel Halperin and Eugene Steuerle, *Indexing the Tax System for Inflation*, in *UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX* 347 (Henry J. Aaron et al., eds. 1988).

entrepreneurial skill, or simply luck. Of course, this stylized way of thinking about returns leads to many serious measurement problems, as market returns are complicated conglomerations of many premiums. In terms of measurement and administration of a tax system, isolation of the notions of the “risk-free” and “supernormal” returns presents many difficulties.

Under a wage tax, the return to capital is not taxed so that the risk-free rate of return, the risk premium and the supernormal return would not be taxed. In a consumption tax, neither the risk-free rate of return nor the risk premium is taxed from an income perspective. Scholars have debated as to whether the supernormal return is taxed from an income perspective under a consumption tax.<sup>174</sup>

Similar to the concerns regarding a consumption tax, some have questioned the fairness of a wage tax. For example, if one individual has salary of \$20,000 and another individual has salary of \$20,000 but also has a \$60,000 capital gain, under a wage tax, both individuals would pay the same amount of taxes although the second individual had four times as much income as the first individual. As a result, there has been a concern that a wage tax trades off fairness for efficiency.

A number of tax reform proposals adopt one (or more) of the three different tax bases. For example, the Fair Tax is a tax reform plan first proposed in 1999 by Representative John Linder (R-GA).<sup>175</sup> It would replace all Federal taxes with a 23 percent national retail sales tax on new goods and services. It is a tax on a consumption tax base or more specifically a transactional consumption tax. The USA (Unlimited Savings Allowance) Tax, proposed in 1995 by Senators

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<sup>174</sup> See, e.g., Alvin C. Warren, Jr., *How Much Capital Income Taxed Under an Income Tax is Exempt Under a Cash Flow Tax?* 52 TAX L. REV. 1 (1996); Noel B. Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 TAX L. REV. 17 (1996). From a consumption perspective, all consumption is taxed whether as a result of a supernormal return or any other type of return. As a result, supernormal returns are not taxed under a wage tax but are taxed under a consumption tax, which is generally thought to be a weakness of a wage tax.

<sup>175</sup> Fair Tax Act of 1999, H.R. 2525, 106<sup>th</sup> Cong., 1<sup>st</sup> Sess. (1999).

Sam Nunn (D-GA) and Pete Domenici (R-NM), would replace the Federal income tax with a VAT at the business level and a consumption tax at the individual level.<sup>176</sup> The consumption tax is accomplished at the individual level by utilizing the equation that (C) Consumption equals (I) Income minus ( $\Delta S$ ) net change in Savings. The USA Tax would require than an individual determine his or her income for the year and then subtract any contributions to an unlimited IRA account. The resulting taxable income would equal the individual's consumption for the year.

Similar to the USA Tax is the Flat Tax, proposed by American economists Robert Hall and Alvin Rabushka.<sup>177</sup> The Flat Tax would impose a cash-flow tax<sup>178</sup> at the business level and a wage tax at the individual level. It utilizes a wage tax base for individuals in contrast to the USA Tax, which utilizes a consumption tax base for individuals.

Some other tax reform proposals would utilize a combination of tax bases. For example, the Growth and Investment Tax (GIT) Plan, proposed in 2005 by the President's Advisory Panel on Tax Reform, would replace the Federal income tax with a cash-flow tax at the business level coupled with a tax on wage income and a modest tax on capital income at the individual level.<sup>179</sup> The tax at the individual level on a wage tax base with a modest tax on capital income results in a hybrid tax base at the individual level of wage and income. The Competitive Tax Plan advanced by Professor Michael Graetz would impose a transactional consumption tax (i.e., a VAT) on all taxpayers with an income tax imposed only on upper-income taxpayers in an effort to retain

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<sup>176</sup> USA Tax Act of 1995, S.722, 104<sup>th</sup> Cong., 1<sup>st</sup> Sess. (1995).

<sup>177</sup> ROBERT HALL AND ALVIN RABUSHKA, *THE FLAT TAX* (2007).

<sup>178</sup> A cash flow tax is a tax on net cash flow -- meaning gross receipts minus all expenditures (including expenditures for purchases of equipment).

<sup>179</sup> REPORT OF THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM (Nov. 1, 2005), available at <http://govinfo.library.unt.edu/taxreformpanel/final-report/> (accessed Dec. 4, 2014).

progressivity in the tax system.<sup>180</sup> Such a tax system would be similar to the system in effect from 1913 until the beginning of World War II when only upper-income taxpayers were subject to the income tax. Many of the proposals above combine elements of consumption, wage, or income taxes in order to address issues of tax-burden distribution across the taxpaying population.

#### B. Distribution of the Tax Burden

One reason that reform of individual taxation is so difficult is that we have to take into account the distribution of the Federal income tax burden. More specifically, we need to determine how much of the Federal income tax burden should be borne by lower-income taxpayers, how much by middle-income taxpayers, and how much by upper-income taxpayers. This is all further complicated by the fact that there is no agreed upon definition of what it means to be lower-income, middle-income and upper-income or what is “fair” in terms of burden distribution. The following table shows the distribution of the individual Federal income tax for the year 2011 based on adjusted gross income (AGI).

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<sup>180</sup> MICHAEL J. GRAETZ, 100 MILLION UNNECESSARY RETURNS: A SIMPLE, FAIR AND COMPETITIVE TAX PLAN FOR THE UNITED STATES (2007).



**Table 4.2****Summary of Federal Income Tax Data, 2011<sup>181</sup>**

	Number of Returns with Positive AGI	AGI (\$ in millions)	Income Taxes Paid (\$ in millions)	Group's Share of Total AGI (%)	Group's Share of Income Taxes (%)	Income Split Point (\$)	Average Tax Rate (%)
All taxpayers	136,585,712	8,317,188	1,042,571	100.0	100.0		12.5
Top 1%	1,365,857	1,555,701	365,518	18.7	35.1	>388,905	23.5
1-5%	5,463,429	1,263,178	223,449	15.2	21.4		17.7
Top 5%	6,829,286	2,818,879	588,967	33.9	56.5	>167,728	20.9
5-10%	6,829,285	956,099	122,696	11.5	11.8		12.8
Top 10%	13,658,571	3,774,978	711,663	45.4	68.3	>120,136	18.9
10-25%	20,487,857	1,865,607	180,953	22.4	17.4		9.7
Top 25%	34,146,428	5,640,585	892,616	67.8	85.6	>70,492	15.8
25-50%	34,146,428	1,716,042	119,844	20.6	11.5		7.0
Top 50%	68,292,856	7,356,627	1,012,460	88.5	97.1	>34,823	13.8
Bottom 50%	68,292,856	960,561	30,109	11.5	2.9	<34,823	3.1

As the table demonstrates, the top one percent of American taxpayers have almost a 19 percent share of the total AGI but pay more than 35 percent of all Federal income taxes. The top one-half of all American taxpayers have an 88.5 percent share of the total AGI but pay more than 97 percent of all Federal income taxes.

The table clearly demonstrates that the United States has a progressive Federal income tax system. In fact, the United States has the most progressive Federal tax system out of all of the

<sup>181</sup> TAX FOUNDATION, SUMMARY OF LATEST FEDERAL INCOME TAX DATA (Dec. 18, 2013), available at <http://taxfoundation.org/article/summary-latest-federal-income-tax-data> (accessed Nov. 13, 2014).

OECD countries; in other words, the most progressive in the developed world.<sup>182</sup> We can certainly debate how progressive our Federal income tax system should be, but there is no denying that upper-income taxpayers are paying the lion's share of the Federal income tax but receiving a substantially smaller percentage of the total AGI.<sup>183</sup> The bottom 50 percent of all American taxpayers have 11.55 percent of the total AGI but pay less than three percent of all Federal income taxes.

The following table shows the percentage of Federal income tax paid by income group since 1980.

**Table 4.3**

**Total Income Tax Shares, 1980-2011 (Percent of Federal Income Tax Paid by Each Group)<sup>184</sup>**

Year	Total	Top 0.1%	Top 1%	Top 5%	Between 5% & 10%	Top 10%	Between 10% & 25%	Top 25%	Between 25% & 50%	Top 50%	Bottom 50%
1980	100%		19.05	36.84	12.44	49.28	23.74	73.02	19.93	92.95	7.05
1984	100%		21.12	37.98	12.58	50.56	22.92	73.49	19.16	92.65	7.35
1986	100%		25.75	42.57	12.12	54.69	21.33	76.02	17.52	93.54	6.46
1987	100%		24.81	43.26	12.35	55.61	21.31	76.92	17.02	93.93	6.07
1990	100%		25.13	43.64	11.73	55.36	21.66	77.02	17.16	94.19	5.81
1993	100%		29.01	47.36	11.88	59.24	20.03	79.27	15.92	95.19	4.81
1996	100%		32.31	50.97	11.54	62.51	18.80	81.32	14.36	95.68	4.32
2000	100%		37.42	56.47	10.86	67.33	16.68	84.01	12.08	96.09	3.91
2001	100%	15.68	33.22	52.24	11.44	63.68	17.88	81.56	13.54	95.10	4.90

<sup>182</sup> See ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, *GROWING UNEQUAL? INCOME DISTRIBUTION AND POVERTY IN OECD COUNTRIES* (2008) at 104, 106, available at [http://www.keepeek.com/Digital-Asset-Management/oecd/social-issues-migration-health/growing-unequal\\_9789264044197-en#page1](http://www.keepeek.com/Digital-Asset-Management/oecd/social-issues-migration-health/growing-unequal_9789264044197-en#page1) (accessed Dec. 4, 2014).

<sup>183</sup> Adjusted gross income (AGI) is only one measure of income. It does not include such items as tax-exempt interest and employer-provided health insurance. Utilizing a different measure of income may yield different results.

<sup>184</sup> TAX FOUNDATION, *SUMMARY OF LATEST FEDERAL INCOME TAX DATA* (Dec. 18, 2013), available at <http://taxfoundation.org/article/summary-latest-federal-income-tax-data> (accessed Nov. 13, 2014). The Tax Reform Act of 1986 changed the definition of AGI so that data before and after 1987 are not strictly comparable. The IRS changed its methodology so that the data before and after 2000 are not strictly comparable.

2002	100%	15.09	33.09	52.86	11.77	64.63	18.04	82.67	13.12	95.79	4.21
2003	100%	15.37	33.69	53.54	11.35	64.89	17.87	82.76	13.17	95.93	4.07
2004	100%	17.12	36.28	56.35	10.96	67.30	16.52	83.82	12.31	96.13	3.87
2005	100%	18.91	38.78	58.93	10.52	69.46	15.61	85.07	11.35	96.41	3.59
2006	100%	19.24	39.36	59.49	10.59	70.08	15.41	85.49	11.10	96.59	3.41
2007	100%	19.84	39.81	59.90	10.51	70.41	15.30	85.71	10.93	96.64	3.36
2008	100%	18.20	37.51	58.06	11.14	69.20	16.37	85.57	11.33	96.90	3.10
2009	100%	16.91	36.34	58.17	11.72	69.89	16.85	86.74	10.80	97.54	2.46
2010	100%	17.88	37.38	59.07	11.55	70.62	16.49	87.11	10.53	97.64	2.36
2011	100%	16.14	35.06	56.49	11.77	68.26	17.36	85.62	11.50	97.11	2.89

In 1980, the top one percent paid about 19 percent of all Federal income tax. By 1990, the percentage had increased to 25 percent and by 2000, the percentage had increased to 37 percent, which is about where it has remained. The top 10 percent paid about half of all Federal income tax in 1980. By 2005, that percentage had increased to 70 percent, which is about where it remains today. Finally, the top 50 percent paid about 93 percent of all Federal income tax in 1980. By 2011, that percentage had increased to about 97 percent. As a result, it is clear that middle-income and upper-income taxpayers are paying a greater percentage of the Federal income tax today than they were 20 or 30 years ago.

The following table shows the average tax rate paid by income group for 1980-2011.

**Table 4.4**

**Average Tax Rate, 1980-2011 (Percent of AGI Paid in Federal Income Taxes)<sup>185</sup>**

Year	Total	Top 0.1%	Top 1%	Top 5%	Between 5% & 10%	Top 10%	Between 10% & 25%	Top 25%	Between 25% & 50%	Top 50%	Bottom 50%
1980	15.31%		34.47	26.85	17.13	23.49	14.80	19.72	11.91	17.29	6.10
1984	13.68%		29.92	23.42	15.57	20.81	12.90	17.47	10.48	15.35	5.77
1986	14.54%		33.13	25.68	15.99	22.64	12.97	18.72	10.48	16.32	5.63
1987	13.12%		26.41	22.10	14.43	19.77	11.71	16.61	9.45	14.60	5.09
1990	12.95%		23.25	20.46	13.63	18.50	12.01	16.06	9.73	14.36	5.01

<sup>185</sup> Id.

1993	13.32%		28.01	22.71	14.01	20.20	11.40	16.90	9.37	14.90	4.29
1996	14.34%		28.87	24.07	14.74	21.55	11.86	18.12	9.53	15.96	4.40
2000	15.26%		27.45	24.42	15.48	22.34	12.04	19.09	9.28	16.86	4.60
2001	14.47%	28.17	27.60	23.91	15.20	21.68	11.87	18.35	9.20	16.08	4.92
2002	13.28%	28.48	27.37	23.17	14.15	20.76	10.70	17.23	8.00	14.87	3.86
2003	12.11%	24.60	24.38	20.92	12.46	18.70	9.69	15.57	7.41	13.53	3.49
2004	12.31%	23.06	23.52	20.83	12.53	18.80	9.41	15.71	7.27	13.68	3.53
2005	12.65%	22.48	23.15	20.93	12.61	19.03	9.45	16.04	7.18	14.01	3.51
2006	12.80%	21.94	22.80	20.80	12.84	19.02	9.52	16.12	7.22	14.12	3.51
2007	12.90%	21.42	22.46	20.66	12.92	18.96	9.61	16.16	7.27	14.19	3.56
2008	12.54%	22.67	23.29	20.83	12.66	18.87	9.45	15.85	6.97	13.79	3.26
2009	11.39%	24.28	24.05	20.59	11.53	18.19	8.36	14.81	5.76	12.61	2.35
2010	11.81%	22.84	23.39	20.64	11.98	18.46	8.70	15.22	6.01	13.06	2.37
2011	12.54%	22.82	23.50	20.89	12.83	18.85	9.70	15.82	6.98	13.76	3.13

As the chart demonstrates, the average tax rate paid by all income groups has declined over the last 20 to 30 years. In some cases, the decline has been slight while in others more dramatic. For example, in 1980, the top 10 percent faced an average tax rate of about 23.5 percent. In 1987, it had decreased to about 20 percent. In 2011, it was slightly less than 19 percent. In contrast, the 25 to 50 percent income group faced an average tax rate of almost 12 percent in 1980. In 1987, it had decreased to about nine and a half percent and by 2011, the average tax rate was only seven percent.

The chart also demonstrates that upper-income taxpayers pay a higher average tax rate than middle-income taxpayers, who in turn pay a higher average tax rate than lower-income taxpayers. Some have questioned the progressivity of the Federal income tax system at the extreme upper income levels. It is true that the increasing levels of progressivity taper off at the extreme upper income levels, which is a concern with respect to the fairness of the tax system. For example, in 2011, the top one-tenth of one percent (AGI of \$1,717,675 and higher) faced an average effective tax rate of 22.82 percent, which was slightly lower than the 23.50 percent average effective tax

rate faced by the top one percent (AGI of \$388,905 and higher). This is due, in large part, to the tax treatment of capital gains and dividends.<sup>186</sup>

A disturbing trend in recent years is the distribution of the Federal income tax burden where the percentage of taxpayers with zero or negative tax liability has grown significantly. The following table shows the number and percentage of tax returns with zero or negative tax liability.

**Table 4.5**  
**Federal Individual Income Tax Returns with Zero or Negative Tax Liability<sup>187</sup>**

Year	Number of Returns Filed	Returns with Zero or Negative Tax Liability	Percentage of Returns with Zero or Negative Tax Liability
1950	53,060,098	14,873,416	28.0
1955	58,250,188	13,561,123	23.3
1960	61,027,931	12,966,946	21.2
1965	67,596,300	13,895,506	20.6
1969	75,834,388	12,112,994	16.0
1970	74,279,831	14,962,460	20.1
1975	82,229,332	20,738,595	25.2
1980	93,902,469	19,996,225	21.3
1985	101,660,287	18,813,867	18.5
1990	113,717,138	23,854,704	21.0
1995	118,218,327	28,965,338	24.5
2000	129,373,500	32,555,897	25.2
2001	130,255,237	35,491,707	27.2
2002	130,076,443	39,112,547	30.1
2003	130,423,626	41,501,722	31.8
2004	132,226,042	43,124,108	32.6
2005	134,372,678	43,802,114	32.6
2006	138,394,754	45,681,047	33.0
2007	143,030,461	46,655,760	32.6
2008	142,450,569	51,790,465	36.4

<sup>186</sup> Note that if certain major categories of income currently excluded from AGI (such as employer-provided health care and certain retirement savings income) were included in Table 4.4, this would likely make average tax rates for middle-income taxpayers go down significantly. It would also likely make the middle-income taxpayers' share of total income go up. A similar point could be made with respect to including tax-exempt interest in AGI and its impact on upper-income taxpayers.

<sup>187</sup> TAX FOUNDATION, FEDERAL INDIVIDUAL INCOME TAX RETURNS WITH ZERO OR NEGATIVE TAX LIABILITY, 1916-2010 (Oct. 18, 2011), available at <http://www.taxfoundation.org/taxdata/show/25587.html> (accessed Nov. 2, 2014).

2009	140,494,127	58,603,938	41.7
2010	142,892,051	58,416,118	40.9

As the chart demonstrates, the percentage of tax returns with zero or negative tax liability has increased dramatically over the last 10 years. From 1950 until 2000, the percentage was typically around 20 to 25 percent. In 2010, the percentage was almost 41 percent. The chart, however, only includes filed tax returns. If non-filers are included, then the percentage becomes closer to 50 percent.

The nonpartisan Joint Committee on Taxation issued a memorandum dated April 29, 2011, in which it estimated 164.4 million tax filing units for the year 2009.<sup>188</sup> Those units were estimated to be composed of 81.1 million single returns, 58.9 million joint returns, 21.7 million head of household returns and 2.5 million married filing separately returns. The Joint Committee estimated that for 2009, approximately 22 percent of all tax units, including filers and non-filers, would have zero income tax liability. Approximately 30 percent of all tax units would receive a refundable credit, and approximately 49 percent would have a positive income tax liability. As a result, approximately 51 percent of tax filing units had either a zero income tax liability or received a refundable credit. In other words, a majority of tax filing units had no stake in funding the government through the Federal income tax and either no “skin-in-the-game” concerning proposals to raise Federal income taxes even higher or distorted incentives in favor of higher taxes on others.

Some argue that the 51 percent of tax filing units that have had either a zero Federal income tax liability or receive a refundable credit do pay payroll taxes to the Federal government. While

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<sup>188</sup> Memorandum from Thomas A. Barthold (Apr. 29, 2011), available at <http://www.finance.senate.gov/newsroom/ranking/release/?id=e7723a9e-ed4a-4e10-af90-a56dfb0ccec5> (accessed Nov. 2, 2014). The document is included in the Appendix – Exhibit 2.

that is true, it does not change the fact that over half of the tax filing units pay no Federal income tax. Furthermore, payroll taxes are directly tied to benefits received on the basis of those taxes, with Social Security benefits being the predominant benefits. Social Security taxes support a very progressive benefit structure and, with payroll taxes and the benefits they generate, Social Security is on net very progressive. Identifying that payroll taxes are paid and they are regressive in and of themselves, without acknowledging corresponding benefits, is highly misleading, at best.

The Joint Committee on Taxation issued a memorandum dated May 28, 2010, estimating the number of taxpayers who receive refundable tax credits in excess of their payroll taxes paid to the Federal government.<sup>189</sup> The memorandum identifies that there are tens of millions of taxpayers paying no Federal income tax *and* (in substance) no employment taxes. The following table shows the number of returns with refundable tax credits in excess of payroll taxes (which includes the employee’s share of FICA and Medicare taxes plus self-employment taxes). The table reflects the statutory incidence of payroll taxes on wage earners and the self-employed.

**Table 4.6**

**Number of Returns with Refundable Tax Credits in Excess of Payroll Taxes**

Year	Number of Returns (in Millions)
2000	11.8
2001	12.6
2002	14.0
2003	14.6
2004	15.3
2005	15.8
2006	16.1
2007	N/A
2008	N/A
2009	23.0 (estimate)
2010	23.1 (estimate)

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<sup>189</sup> Memorandum from Bernard A. Schmitt (May 28, 2010).

Most economists believe that employees bear the economic burden of both the employee’s and the employer’s share of FICA and Medicare taxes. The following table shows the number of returns with refundable tax credits in excess of payroll taxes (which includes both the employer’s share and the employee’s share of FICA and Medicare taxes plus self-employment taxes). The table reflects the economic incidence of payroll taxes on wage earners and the self-employed.

**Table 4.7**

**Number of Returns with Refundable Tax Credits in Excess of Payroll Taxes**

Year	Number of Returns (in Millions)
2000	8.7
2001	9.4
2002	10.6
2003	10.8
2004	11.4
2005	11.6
2006	11.9
2007	N/A
2008	N/A
2009	15.5 (estimate)
2010	15.5 (estimate)

More recently, JCT has estimated that there will be 175.9 million tax filing units for the year 2014.<sup>190</sup> These units are estimated to be composed of 91.9 million single returns, 57.9 million joint returns, 23.1 million head of household returns and 2.9 million married filing separately returns. The Joint Committee estimated that for 2014, approximately 25 percent of all tax units, including filers and non-filers, will have zero income tax liability. Approximately 21 percent of all tax units will receive a refundable credit, and approximately 54 percent will have a positive income tax liability. As a result, approximately 46 percent of tax filing units will have either a zero income tax liability or receive a refundable credit.

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<sup>190</sup> Memorandum from Thomas A. Barthold (no date). This document is included in the Appendix – Exhibit 1.



The Tax Policy Center estimated that for 2011 about 46 percent of tax filing units will pay no Federal income tax or will receive a net refund.<sup>191</sup> Of these non-paying tax units, the Tax Policy Center estimated that about half are due to the standard deduction and personal exemptions for taxpayers and dependents. The standard deduction and personal exemptions for taxpayers are intended to exempt subsistence levels of income from tax. The exemption for dependents is designed to address the ability to pay based on family size. The remaining half of the non-paying tax units are due to tax expenditures. The following table shows Tax Policy Center estimates of tax units by income level that are subject to Federal income tax and those that are not.

**Table 4.8**

**Tax Units With and Without Income Tax Liability in 2011<sup>192</sup>**

Cash Income Level	All Tax Units (in thousands)	Tax Units With Income Tax Liability – Number (in thousands)	Tax Units With Income Tax Liability – Percent of All Tax Units	Tax Units Without Income Tax Liability – Number (in thousands)	Tax Units Without Income Tax Liability – Percent of All Tax Units
Less than \$10,000	24,457	157	0.6	24,300	99.4
\$10,000 to \$20,000	28,266	5,432	19.2	22,834	80.8
\$20,000 to \$30,000	20,763	8,111	39.1	12,652	60.9
\$30,000 to \$40,000	17,188	10,083	58.7	7,106	41.3
\$40,000 to \$50,000	13,691	9,505	69.4	4,186	30.6
\$50,000 to \$75,000	19,752	16,901	85.6	2,852	14.4
\$75,000 to \$100,000	13,684	12,963	94.7	720	5.3
\$100,000 to \$200,000	18,322	17,961	98.0	361	2.0
\$200,000 to \$500,000	5,366	5,312	99.0	54	1.0
\$500,000 to \$1 million	907	894	98.5	14	1.5

<sup>191</sup> See Rachel Johnson, James Nunns, Jeffrey Rohaly, Eric Toder and Robertson Williams, *Why Some Tax Units Pay No Income Tax*, The Tax Policy Center (July 2011), available at <http://www.taxpolicycenter.org/UploadedPDF/1001547-Why-No-Income-Tax.pdf> (accessed Dec. 4, 2014).

<sup>192</sup> Id. at 6.

More than \$1 million	433	429	99.0	4	1.0
All	163,869	87,762	53.6	76,107	46.4

According to Tax Policy Center estimates, approximately 93 percent of the tax units with no Federal income tax liability are those with incomes below \$50,000 and almost 80 percent of the tax units with incomes below \$30,000 have no Federal income tax liability.

The following table shows the Tax Policy Center estimates of tax units that do not pay Federal income tax due to standard income tax provisions, such as the standard deduction and personal exemption, and the tax units that do not pay Federal income tax due to tax expenditures.

**Table 4.9**  
**Tax Units Without Income Tax<sup>193</sup>**

Cash Income Level	All Units Without Income Tax	Units Without Income Tax Due to Standard Income Tax Provisions – Number (in thousands)	Units Without Income Tax Due to Standard Income Tax Provisions – Percent	Units Without Income Tax Due to Addition of Tax Expenditure Provisions – Number (in thousands)	Units Without Income Tax Due to Addition of Tax Expenditure Provisions – Percent
Less than \$10,000	24,300	24,247	99.8	53	0.2
\$10,000 to \$20,000	22,834	9,989	43.7	12,845	56.3
\$20,000 to \$30,000	12,652	2,428	19.2	10,223	80.8
\$30,000 to \$40,000	7,106	387	5.4	6,719	94.6
\$40,000 to \$50,000	4,186	91	2.2	4,095	97.8
\$50,000 to \$75,000	2,852	37	1.3	2,814	98.7
\$75,000 to \$100,000	720	10	1.4	710	98.6
\$100,000 to \$200,000	361	16	4.5	345	95.5
\$200,000 to \$500,000	54	5	8.8	49	91.2
\$500,000 to \$1 million	14	1	5.8	13	94.2
More than \$1 million	4	1	23.5	3	76.5
All	76,107	38,237	50.2	37,870	49.8

<sup>193</sup> Id.

As the table shows, approximately half of the tax units that pay no Federal income tax do so because of the standard income tax provisions. These provisions include the standard deduction, personal exemptions for taxpayers and dependents, the non-taxation of the portion of retirement income that represent the return of previously taxed contributions, and the deductibility of costs of earning income. The other half of the tax units that do not pay Federal income tax do so because of tax expenditures, such as tax benefits for the elderly (extra standard deduction for the elderly, the exclusion of a portion of social security benefits, the credit for the elderly) and tax credits for children and the working poor (the child tax credit, the child and dependent care tax credit and the earned income tax credit).

### C. Tax Expenditures

Every year, the Joint Committee on Taxation and the Treasury Department publish a list of “tax expenditures” along with the foregone revenue associated with each tax expenditure as required by the Congressional Budget and Impoundment Control Act of 1974 (the Budget Act).<sup>194</sup> The Budget Act defines tax expenditures as “those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.”<sup>195</sup> Of course, “special” is a term that must be thought of in reference to some “normal” system that does not treat the exclusion, exemption, deduction, or rate in the same fashion, and there is debate over what is that normal system.<sup>196</sup>

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<sup>194</sup> See JOINT COMMITTEE ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2014-2018, JCX-97-14 (Aug. 5, 2014); OFFICE OF MANAGEMENT AND BUDGET, FISCAL YEAR 2015 ANALYTICAL PERSPECTIVES BUDGET OF THE U.S. GOVERNMENT (2014).

<sup>195</sup> Congressional Budget and Impoundment Act Control Act of 1974, sec. 3(a)(3).

<sup>196</sup> Of course, the definition of “normal income tax” is by no means settled. Furthermore, to the extent the concept of tax expenditure refers to deviations from an ideal tax base, we do not

The concept of a tax expenditure derives largely from the late Harvard law professor Stanley Surrey, former Assistant Secretary of the Treasury (Tax Policy):

The tax expenditure concept posits that an income tax is composed of two distinct elements. The first element consists of structural provisions necessary to implement a normal income tax, such as the definition of net income, the specification of accounting rules, the determination of the entities subject to tax, the determination of the rate schedule and exemption levels, and the application of the tax to international transactions. These provisions compose the revenue-raising aspects of the tax. The second element consists of the special preferences found in every income tax. These provisions, often called tax incentives or tax subsidies, are departures from the normal tax structure and are designed to favor a particular industry, activity, or class of persons. They take many forms, such as permanent exclusions from income, deductions, deferrals of tax liabilities, credits against tax, or special rates. Whatever their form, these departures from the normative tax structure represent government spending for favored activities or groups, effected through the tax system rather than through direct grants, loans or other forms of government assistance.<sup>197</sup>

Unfortunately, Surrey's ideas lack precision and leave a lot to interpretation. Some common examples of what are taken to be tax expenditures include the deduction for home mortgage interest and the exclusion from income of employer-provided health insurance. In some cases, tax expenditures could be viewed as government spending, such as the refundable aspect of

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necessarily agree with the implication that an income tax is the ideal tax. And it is not obvious that exemption levels or graduated tax rates are part of an ideal tax base, or a normal income tax, rather than to be seen as tax expenditures. *See* Daniel S. Goldberg, *The U.S. Consumption Tax: Evolution, Not Revolution*, 57 *TAX LAW.* 1, 27 (2003) ("Presumably, the ideal income tax would be based on the Haig-Simons definition of income. However, it is hard to distinguish deviations from such a definition, regarded as back-door spending, from provisions that are regarded as structural. For example, a rate structure deviating from a flat rate could easily be viewed as a series of cross subsidies, if the base system were a uniform rate income tax."); Boris I. Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 *NAT'L TAX J.* 244, 250 (1969) ("Assuming a consistent application of the Haig-Simons definition, however, there are many other areas that would generate 'tax expenditures' ... including ... personal and dependency exemptions."). *See also* David E. Pozen, *Tax Expenditures as Foreign Aid*, 116 *YALE L. J.* 869, 873 n.21 (2007) ("If the standard deduction were set at a lower rate, though, more taxpayers who donate would choose to itemize, which implies that some portion of the standard deduction acts as a tax expenditure in support of these marginal taxpayers' gifts.").

<sup>197</sup> STANLEY S. SURREY AND PAUL MCDANIEL, *TAX EXPENDITURES* (1985) at 3.

the earned income tax credit and the additional child tax credit, which is also refundable.<sup>198</sup> In other cases, tax expenditures could be viewed as a compromise between an income tax system and a consumption tax system, such as accelerated depreciation and the preferential tax treatment of capital gains. The following two tables list total tax expenditures (individual and corporate) and the top 10 tax expenditures for individuals (as measured by JCT).

**Table 4.10**

**Sum of Tax Expenditure Estimates by Type of Taxpayer, Fiscal Years 2014-2018<sup>199</sup>**

Fiscal Year	Individuals (billions of \$)	Corporations (billions of \$)	Total (billions of \$)
2014	1,036.2	154.4	1,190.6
2015	1,152.4	156.8	1,309.2
2016	1,305.5	177.7	1,483.2
2017	1,400.1	193.9	1,594.0
2018	1,466.0	205.0	1,671.0

As the above table demonstrates, the overwhelming percentage of tax expenditures benefits individuals rather than corporations. To give some perspective on the magnitude of individual tax expenditures, in 2014, the Federal government is estimated to collect \$1,390 billion in revenues from the individual income tax. That amount is slightly more than the individual tax expenditures (\$1,036.2 billion) for the same year.

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<sup>198</sup> The Joint Committee on Taxation shows the outlay effects in its revenue estimates and tax expenditures estimates.

<sup>199</sup> JOINT COMMITTEE ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2014-2018, JCX-97-14 (Aug. 5, 2014).

**Table 4.11**

**Ten Largest Tax Expenditures, 2014: Individuals<sup>200</sup>**

Tax Expenditure	Amount (billions of \$)
Exclusion of employer contributions for health care	143.0
Reduced rates of tax on dividends and long-term capital gains	96.5
Exclusion of contributions and earnings to retirement plans	70.9
Earned income tax credit	69.2
Deduction for mortgage interest	67.8
Exclusion for Medicare benefits	61.0
Child tax credit	57.3
Deduction of state and local income taxes, sales taxes and personal property taxes	56.5
Exclusion of untaxed Social Security and railroad retirement benefits	37.4
Deduction for charitable contributions	34.8

A common myth with regard to what are measured as tax expenditures is that they are loopholes. This is inaccurate. A loophole is something that Congress did not intend and would generally shut down, at least going forward, once it learned of the loophole. Tax expenditures, by contrast, were typically placed by Congress deliberately into the tax code for specific reasons. For example, two of the ten largest tax expenditures for individuals are the exclusion for employer-provided health insurance and the home mortgage interest deduction. On the corporate side, one of the largest tax expenditures is the temporary credit for research and development activities.

In much of the coverage of individual tax expenditures, it has been taken by some as an article of faith that they disproportionately benefit wealthy taxpayers. But the data show that individual tax expenditures tend to skew towards middle-income Americans or those below the Obama Administration’s definition of “rich” -- that is, singles with incomes below \$200,000 per year and married couples with incomes below \$250,000 per year. According to the Joint Committee on Taxation, taxpayers with income over \$200,000 bear 64 percent of the Federal

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<sup>200</sup> Id.

income tax burden while taxpayers earning under \$200,000 bear 36 percent of the Federal income tax burden.<sup>201</sup> With that in mind, it is interesting to look at which taxpayers benefit from the leading tax expenditures. Employer-provided health benefits and the deduction for self-employed health insurance overwhelming benefit (approximately 81 percent) those taxpayers with income below \$200,000.<sup>202</sup> Only 19 percent of the benefit goes to those taxpayers with income above \$200,000. As a result, by a ratio of over four to one, the employer-provided health benefits and the deduction for self-employed health insurance benefit taxpayers with income below \$200,000.

The home mortgage interest deduction mainly benefits -- approximately 58 percent -- those taxpayers with income below \$200,000.<sup>203</sup> Only 42 percent of the benefit of the mortgage interest deduction goes to those taxpayers with income above \$200,000. The earned income tax credit is a refundable credit, meaning that a taxpayer benefits from the credit even if the taxpayer has no Federal income tax liability. By definition, the credit is limited to low-income and middle-income taxpayers. As a result, 100 percent of the benefits of the earned income tax credit go to taxpayers earning less than \$200,000 per year.<sup>204</sup> Similarly, almost 100 percent of the benefits of the child tax credit go to taxpayers earning less than \$200,000 per year.<sup>205</sup>

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<sup>201</sup> Id. at 35. The income concept that the Joint Committee uses is adjusted gross income plus: (a) tax-exempt interest, (b) employer contributions for health plans and life insurance, (c) employer's share of FICA tax, (d) workers' compensation, (e) nontaxable Social Security benefits, (f) insurance value of Medicare benefits, (g) alternative minimum tax preference items, (h) excluded income of U.S. citizens living abroad, and (i) individuals' share of business taxes. Id.

<sup>202</sup> This is not strictly comparable as the figures for employer-provided health benefits and the deduction for self-employed health insurance are from 2011. U.S. HOUSE WAYS AND MEANS COMMITTEE, DISTRIBUTIONAL ANALYSES OF SELECTED TAX EXPENDITURES (June 2011) (based on data provided by the Joint Committee on Taxation), available at [http://democrats.waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/documents/Distributional\\_Analyses\\_of\\_Selected\\_Tax\\_Expenditures.pdf](http://democrats.waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/documents/Distributional_Analyses_of_Selected_Tax_Expenditures.pdf) (accessed Sept. 17, 2014).

<sup>203</sup> JOINT COMMITTEE ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2014-2018, JCX-97-14 (Aug. 5, 2014) at 37.

<sup>204</sup> Id. at 39.

<sup>205</sup> Id. at 41.

The deduction for state and local income taxes, state and local sales taxes, and personal property taxes splits almost the same as the distribution of the Federal income tax burden – 34 percent of the benefit goes to taxpayers earning less than \$200,000 per year and 66 percent goes to taxpayers earning more than \$200,000 per year.<sup>206</sup> The real estate tax deduction, like the home mortgage interest deduction, overwhelmingly benefits (63 percent) those taxpayers with income below \$200,000.<sup>207</sup> Only 37 percent of the benefit goes to taxpayers earning more than \$200,000 per year.<sup>208</sup>

The deduction for charitable contributions is one of the tax expenditures that distributes in the highest proportion to taxpayers above \$200,000 in income. Approximately 63 percent of the deduction goes to upper-income taxpayers.<sup>209</sup> However, it must be kept in mind that, overall, taxpayers with income over \$200,000 bear 64 percent of the Federal income tax burden. This means that proportionately, the charitable deduction benefits taxpayers over the \$200,000 level almost exactly equal to those taxpayers share of the Federal income tax burden (and many of those charitable contributions go to assist very low-income persons). The benefit of the tax-free portion of Social Security benefits goes overwhelmingly to seniors with incomes that are less than \$200,000. In fact, only six percent of the benefit goes to seniors with income over \$200,000.<sup>210</sup>

The preferential tax treatment for dividends and capital gains is a tax expenditure that distributes in the highest proportion to upper-income taxpayers. If we break the tax expenditure down into two separate tax expenditures (one for dividends and one for capital gains), we see that taxpayers with income over \$200,000 receive 64 percent of the benefit of the preferential tax

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<sup>206</sup> Id. at 38.

<sup>207</sup> The real estate tax deduction has a tax expenditure estimate of \$31.9 billion for 2014. Id. at 25.

<sup>208</sup> Id. at 37.

<sup>209</sup> Id. at 38.

<sup>210</sup> Id. at 36.



treatment for dividends – exactly equal to those taxpayers share of the Federal income tax burden.<sup>211</sup> The benefit of the preferential tax treatment of capital gains goes overwhelmingly (approximately 88 percent) to taxpayers with income over \$200,000.<sup>212</sup> Only 12 percent of the benefit goes to taxpayers with income less than \$200,000. However, it is helpful to keep in mind who bears the burden of the tax on dividends and capital gains. The Tax Policy Center has produced a table showing which taxpayers pay the capital gains tax and the tax on dividend income.

**Table 4.12**

**Taxes on Long-Term Capital Gains and Qualified Dividends -- 2011<sup>213</sup>**

Cash Income Level (thousands of dollars)	All Tax Units (thousands)	Percent of Tax Units with Capital Gains or Qualified Dividends	Percent of Tax Units that Pay Tax on Gains or Qualified Dividends	Average Capital Gains and Dividends for Recipients	Average Tax Paid on Capital Gains and Dividends by Those Paying Tax	Share of Total Federal Tax on Capital Gains and Dividends
Less than \$10	24,457	3.3	Insufficient data	1,577	Insufficient data	Insufficient data
\$10-\$20	28,266	4.5	0.2	1,432	256	0.0
\$20-\$30	20,763	8.1	0.6	1,888	128	0.0
\$30-\$40	17,188	10.0	2.3	2,039	80	0.0
\$40-\$50	13,691	11.8	3.8	2,359	170	0.1
\$50-\$75	19,752	18.7	10.7	2,746	278	0.8
\$75-\$100	13,684	25.5	13.9	3,591	457	1.2
\$100-\$200	18,322	40.8	34.1	6,864	843	7.2
\$200-\$500	5,366	68.4	65.5	23,495	3,744	17.9

<sup>211</sup> This is not strictly comparable as the figures for dividends and capital gains are from 2011. U.S. HOUSE WAYS AND MEANS COMMITTEE, DISTRIBUTIONAL ANALYSES OF SELECTED TAX EXPENDITURES (June 2011) (based on data provided by the Joint Committee on Taxation), available at [http://democrats.waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/documents/Distributional\\_Analyses\\_of\\_Selected\\_Tax\\_Expenditures.pdf](http://democrats.waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/documents/Distributional_Analyses_of_Selected_Tax_Expenditures.pdf) (accessed Sept. 17, 2014).

<sup>212</sup> Id.

<sup>213</sup> Tax Policy Center, *Taxes on Long-Term Capital Gains and Qualified Dividends – 2011*, available at <http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=3173&topic2ID=60&topic3ID=62&DocTypeID=1> (accessed Nov. 14, 2014).

\$500- \$1,000	907	83.5	79.0	76,303	12,551	12.2
More than \$1,000	433	90.1	87.8	815,505	116,702	60.4
All	163,869	16.4	9.8	20,652	4,590	100.0

As the table demonstrates, taxpayers with cash income of \$200,000 and above pay 90 percent of the total Federal income tax on capital gains and dividend income.<sup>214</sup> As a result, any preferential tax treatment for capital gains and dividends will benefit upper-income taxpayers more than lower-income taxpayers because it is the upper-income taxpayers that are overwhelmingly paying the tax.

In a pure consumption tax system, no tax would be imposed on dividends and capital gains, and they would not be considered tax expenditures. It should also be noted that, at a minimum, the tax rate on capital gains should not be raised above the revenue-maximizing rate. In other words, if raising the tax rate on capital gains results in a loss of revenue to the federal government, it should not be done.

#### D. Economic Growth Resulting from Tax Reform

In the fall of 2011, the nonpartisan Joint Committee on Taxation analyzed two proposals to broaden the individual income tax base.<sup>215</sup> In the first proposal, all personal exemptions, itemized deductions, and personal credits (except for the earned income tax credit and health premium assistance credits), and all above the line adjustments to personal income (except

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<sup>214</sup> Cash income, as defined by the Tax Policy Center, is a broader measure of income than AGI. It is equal to AGI plus (1) above-the-line adjustments, (2) employee contributions to tax-preferred retirement accounts, (3) tax-exempt interest, (4) nontaxable Social Security and pension income, (5) cash transfers, (6) the employer share of payroll taxes and (7) imputed corporate tax liability. See Tax Policy Center, *Income Measure Used in Distributional Analyses by the Tax Policy Center*, available at <http://www.taxpolicycenter.org/taxtopics/Explanation-of-Income-Measures-2013.cfm> (accessed Dec. 4, 2014).

<sup>215</sup> Memorandum from Thomas A. Barthold (no date). This document is included in the Appendix – Exhibit 3.

retirement savings deductions and the deduction for self-employment taxes) would be repealed. Tax rates would be reduced, the AMT would be repealed but the standard deduction would remain. Tax rates on capital gains would remain the same as current law in 2011 (zero and 15 percent in 2012, and 10 and 20 percent beginning in 2013).

The first proposal would broaden the tax base and reduce statutory income tax rates such that the proposal would be revenue neutral as measured by the conventional revenue estimate over a ten-year budget period (2012-2021). Under the second proposal, the same base broadening measures would be made as in the first proposal except statutory rates would be reduced only so much so that the proposal would raise \$600 billion in new revenue over the ten-year budget period. The proposals were measured against the current law baseline at that time, which generally assumed that the tax provisions enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 would expire for taxable years after 2012. The following table shows the two proposals and the tax law as scheduled to go into effect in 2013 (before the American Taxpayer Relief Act of 2012).

**Table 4.13**

**Statutory Tax Rates Under Present Law and Proposals**

2013 Income Brackets for Single Filers (estimated)	2013 Income Brackets for Joint Filers (estimated)	Statutory Tax Rates (% rate, present law)	Proposed Statutory Tax Rates (% rate, revenue neutral)	Proposed Statutory Tax Rates (% rate, raising \$600 billion)
<\$8,750	<\$17,500	15.00	11.40	12.00
\$8,750-\$35,500	\$17,501-\$59,300	15.00	11.40	12.00
\$35,501-\$86,000	\$59,301-\$143,350	28.00	21.28	22.40
\$86,001-\$179,400	\$143,351-\$218,450	31.00	23.56	24.80
\$179,401-\$390,050	\$218,451-\$390,050	36.00	27.36	28.80
>\$390,050	>\$390,050	39.60	29.01	31.68

The staff of the JCT analyzed the two proposals utilizing its Macroeconomic Equilibrium Growth (MEG) model.<sup>216</sup> The proposals were analyzed under the model with two varying assumptions – one related to the responsiveness of labor and the other related to how JCT believed the Federal Reserve might alter its monetary policy in response to possible macroeconomic effects of the tax policy changes. Both proposals reduce the overall effective marginal tax rate on labor, providing additional incentives for people to work and supplying more labor to the economy. A decrease in after-tax income generally reduces consumption demand, which can result in a decrease in GDP in the short-run. The Federal Reserve may take action to counteract such effects.

**Table 4.14**

**Percent Change in Real GDP Relative to Present Law (Percent Change for the Period)**

**Revenue Neutral Proposal**

		2011-2016	2017-2021	Long Run
Default Labor Elasticity	Aggressive Federal Reserve	0.4	1.1	1.6
	Neutral Federal Reserve	0.2	1.0	1.8
Low Labor Elasticity	Aggressive Federal Reserve	0.3	0.9	1.1
	Neutral Federal Reserve	0.2	0.8	1.3

**Raise \$600 Billion Proposal**

		2011-2016	2017-2021	Long Run
Default Labor Elasticity	Aggressive Federal Reserve	0.3	1.1	2.2
	Neutral Federal Reserve	0.0	0.7	2.1
Low Labor Elasticity	Aggressive Federal Reserve	0.2	0.9	1.7

<sup>216</sup> The MEG model is a basic macroeconomic growth model. See JOINT COMMITTEE ON TAXATION, MACROECONOMIC ANALYSIS OF VARIOUS PROPOSALS TO PROVIDE \$500 BILLION IN TAX RELIEF, JCX-4-05 (Mar. 1, 2005).

	Neutral Federal Reserve	0.0	0.6	1.7
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The above tables show the percent change in GDP under the two proposals relative to then current law, as estimated by JCT using its model and assumptions. Under the first, revenue neutral proposal, all of the simulations result in an increase in GDP. In the short-run, the increases range from 0.2 percent to 0.4 percent of GDP, while in the long-run, the increases range from 1.1 percent to 1.8 percent of GDP. Under the second, raising \$600 billion proposal, all of the simulations predict increases in GDP. In the short-run, the increases range from a negligible percent to 0.3 percent of GDP, while in the long-run, the increases range from 1.7 percent to 2.2 percent of GDP.

The revenue neutral proposal increases after-tax income more than the \$600 billion proposal resulting, in the short run, in increases in GDP slightly higher for the revenue neutral proposal. In the long-run, however, the \$600 billion proposal results in greater long-run growth than the revenue neutral proposal because it reduces the growth of Federal budget deficits, thereby reducing the crowding out of private investment by Federal borrowing (i.e., reducing upward interest rate pressure, and consequent reduced investment and GDP, caused by Federal borrowing).

**Table 4.15**

**Percent Change in Receipts Due to Change in GDP (Percent Change for the Period)**

**Revenue Neutral Proposal**

		2011-2016	2017-2021	Long Run
Default Labor Elasticity	Aggressive Federal Reserve	0.6	1.3	1.2
	Neutral Federal Reserve	0.4	1.1	1.8
Low Labor Elasticity	Aggressive Federal Reserve	0.5	1.1	0.4
	Neutral Federal Reserve	0.4	0.9	1.3

### Raise \$600 Billion Proposal

		2011-2016	2017-2021	Long Run
Default Labor Elasticity	Aggressive Federal Reserve	0.5	1.3	2.6
	Neutral Federal Reserve	0.2	0.9	2.1
Low Labor Elasticity	Aggressive Federal Reserve	0.4	1.1	1.9
	Neutral Federal Reserve	0.2	0.8	1.7

The above table shows the effects of the changes in GDP growth on Federal revenues, as a percent of baseline Federal receipts. Generally, higher GDP growth results in increases in the tax base, resulting in increases in receipts. The relationship between GDP growth and receipts is not constant because different portions of the tax base are taxed differently.

**Table 4.16**

### Percent Change in Real Producers' Capital Relative to Present Law (Percent Change for the Period)

#### Revenue Neutral Proposal

		2011-2016	2017-2021	Long Run
Default Labor Elasticity	Aggressive Federal Reserve	0.5	2.0	2.6
	Neutral Federal Reserve	0.4	1.6	2.6
Low Labor Elasticity	Aggressive Federal Reserve	0.4	1.8	1.4
	Neutral Federal Reserve	0.4	1.6	1.8

### Raise \$600 Billion Proposal

		2011-2016	2017-2021	Long Run
Default Labor Elasticity	Aggressive Federal Reserve	0.5	2.2	5.2
	Neutral Federal Reserve	0.3	1.6	4.5
Low Labor Elasticity	Aggressive Federal Reserve	0.4	2.1	4.2

	Neutral Federal Reserve	0.3	1.5	3.8
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The Joint Committee staff estimated that business investment would increase under both proposals because an increase in the after-tax return on capital provides an incentive for additional capital investment. In the long-run, investment increases more under the \$600 billion proposal than under the revenue neutral proposal because the former results in slightly lower deficits, and therefore less pressure of government borrowing in the financial markets.

**Table 4.17**  
**Percent Change in Real Residential Capital Relative to Present Law (Percent Change for the Period)**  
**Revenue Neutral Proposal**

		2011-2016	2017-2021	Long Run
Default Labor Elasticity	Aggressive Federal Reserve	-0.3	-1.0	-1.9
	Neutral Federal Reserve	-0.3	-1.1	-2.1
Low Labor Elasticity	Aggressive Federal Reserve	-0.3	-1.1	-2.9
	Neutral Federal Reserve	-0.3	-1.2	-2.8

**Raise \$600 Billion Proposal**

		2011-2016	2017-2021	Long Run
Default Labor Elasticity	Aggressive Federal Reserve	-0.1	-0.3	1.2
	Neutral Federal Reserve	-0.2	-0.7	0.4
Low Labor Elasticity	Aggressive Federal Reserve	-0.1	-0.4	0.4
	Neutral Federal Reserve	-0.2	-0.7	-0.2

In contrast, the elimination of the home mortgage interest deduction reduces the attractiveness of investment in housing, while increasing the attractiveness of investment in

business capital. In the long-run, the \$600 billion proposal may increase investment in housing as the result of slightly lower deficits thereby reducing the pressure of government borrowing.

**Table 4.18**

**Change in Interest Rates Relative to Present Law (Change in Basis Points)**

**Revenue Neutral Proposal**

		2011-2016	2017-2021	Long Run
Default Labor Elasticity	Aggressive Federal Reserve	-5	-6	30
	Neutral Federal Reserve	-5	-8	25
Low Labor Elasticity	Aggressive Federal Reserve	-5	-4	57
	Neutral Federal Reserve	-4	-5	44

**Raise \$600 Billion Proposal**

		2011-2016	2017-2021	Long Run
Default Labor Elasticity	Aggressive Federal Reserve	-9	-19	-56
	Neutral Federal Reserve	-9	-26	-41
Low Labor Elasticity	Aggressive Federal Reserve	-9	-18	-38
	Neutral Federal Reserve	-9	-23	-26

The JCT estimated that interest rates will decrease in the short-run under both the revenue neutral proposal and the \$600 billion proposal. In the long-run, however, interest rates will increase under the revenue neutral proposal because the proposal increases deficits relative to present law. In contrast, interest rates will decrease in the long-run under the \$600 billion proposal.



**Table 4.19**

**Percent Change in Private Sector Employment Relative to Present Law (Percent Change for the Period)**

**Revenue Neutral Proposal**

		2011-2016	2017-2021	Long Run
Default Labor Elasticity	Aggressive Federal Reserve	0.5	1.2	1.8
	Neutral Federal Reserve	0.4	1.2	2.0
Low Labor Elasticity	Aggressive Federal Reserve	0.4	1.0	1.4
	Neutral Federal Reserve	0.3	0.9	1.6

**Raise \$600 Billion Proposal**

		2011-2016	2017-2021	Long Run
Default Labor Elasticity	Aggressive Federal Reserve	0.4	1.0	1.5
	Neutral Federal Reserve	0.1	0.8	1.6
Low Labor Elasticity	Aggressive Federal Reserve	0.3	0.8	1.1
	Neutral Federal Reserve	0.1	0.6	1.2

As these JCT estimates demonstrate, tax reform that reduces the effective marginal tax rates on labor provides an incentive for people to work more, supplying more labor to the economy. The reason is that when effective marginal tax rates on labor are reduced, a person keeps a greater portion of wages from additional work. As a result, that person may want to work more. This is generally referred to by economists as the substitution effect. Somewhat offsetting the substitution effect is what is known as the income effect. If a person's average tax rate is reduced (measured by reductions in total tax payments), then that person may want to work less because the reduction in average tax rates increases the person's take home income. Tax reform that reduces marginal tax rates by more than average tax rates provides a net incentive for more labor supply. The

decrease in effective marginal tax rates is greater under the revenue proposal than the \$600 billion proposal thereby resulting in greater labor supply and increases in employment.

**Table 4.20**

**Percent Change in Consumption Relative to Present Law (Percent Change for the Period)**

**Revenue Neutral Proposal**

		2011-2016	2017-2021	Long Run
Default Labor Elasticity	Aggressive Federal Reserve	0.3	1.1	2.9
	Neutral Federal Reserve	0.2	1.1	3.0
Low Labor Elasticity	Aggressive Federal Reserve	0.2	1.1	2.4
	Neutral Federal Reserve	0.2	1.0	2.5

**Raise \$600 Billion Proposal**

		2011-2016	2017-2021	Long Run
Default Labor Elasticity	Aggressive Federal Reserve	0.1	0.9	2.9
	Neutral Federal Reserve	-0.1	0.6	2.9
Low Labor Elasticity	Aggressive Federal Reserve	0.0	0.7	2.4
	Neutral Federal Reserve	-0.1	0.5	2.4

Generally, increased growth facilitates more consumption. The revenue neutral proposal results in more employment and after-tax wage income in the long-run than the \$600 billion proposal and is therefore projected to provide a greater consumption response.

The results above provide just one example of how largely favorable macroeconomic results can stem from a policy of lowering rates and broadening tax bases. This is the case even from what JCT would score as being revenue neutral on the basis of its “static” score that

artificially constrains JCT to assume no changes in important macroeconomic aggregates like GDP.

In sampling the literature on the potential economic growth from tax reform, one oft-cited study is contained in a 2001 paper by David Altig, Alan J. Auerbach, Lawrence J. Kotlikoff, Kent A. Smetters and Jan Walliser.<sup>217</sup> The authors conducted a study simulating five different tax reform proposals, including a proportional (“flat”) income tax. The analyses show large economic gains available from tax reform even, in some cases, when attention is paid to compensating negatively affected participants in the economy during a transition from something like our current income tax system to alternative tax systems.

In 2005, economists Alan Auerbach and Kevin Hassett wrote that “. . . a large theoretical literature documents a wide range of positive effects of a move toward either an income tax with a broader base and lower rates, or a consumption tax. Based on results from a fairly large number of different models, the literature suggests that a wholesale switch to an ideal system might eventually increase economic output by between 5 and 10 percent, or perhaps a slightly wider range.”<sup>218</sup> In 1998, Victor Fuchs and colleagues surveyed 69 public finance specialists finding that the median respondent believed GDP growth would have been one percentage point per year lower for a lengthy period after 1986 if the tax code had not been reformed as part of the Tax Reform Act of 1986.<sup>219</sup>

On December 14, 2006, the staff of the Joint Committee on Taxation issued a report analyzing a revenue neutral proposal to modify the individual income tax by broadening the tax

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<sup>217</sup> Altig, et al., *supra* note 159.

<sup>218</sup> ALAN J. AUERBACH AND KEVIN A. HASSETT, TOWARD FUNDAMENTAL TAX REFORM 149-50 (2005).

<sup>219</sup> Victor R. Fuchs, Alan B. Krueger and James M. Poterba, *Economists’ Views about Parameters, Values, and Policy: Survey Results in Labor and Public Economics*, 36 J. ECON. LIT. 1387 (1998).

base and reducing statutory tax rates.<sup>220</sup> Real GDP is increased by the proposal in all of the simulations. In the short-run, the increases ranged from 0.1 percent to 1.2 percent of GDP, while in the long-run, the increases ranged from 0.2 to 3.5 percent of GDP.

On November 8, 2012, the CBO issued a report entitled, “Choices for Deficit Reduction.” Buried on page 25 of the report is a very brief discussion of tax reform and economic growth. The CBO writes, “If such restructuring [tax reform] strengthened the economy in the medium and long term, it would increase taxable income and thereby reduce deficits. However, the deficit reduction would probably be small relative to the gap between federal spending and revenues in the alternative fiscal scenario.”<sup>221</sup> The CBO then gave an illustration of a tax restructuring. If the effective marginal tax rate on labor income is reduced by five percentage points and the revenue loss is made up exactly by expanding the tax base, then according to a rough CBO estimate, GDP would rise by two percent (or less), which would boost tax revenues by less than half a percent of GDP, or less than \$100 billion in 2020.

Martin Feldstein, former chair of the Council of Economic Advisors, has written that the Tax Reform Act of 1986 was revenue neutral utilizing a traditional static analysis.<sup>222</sup> But, Feldstein notes, “the actual experience after 1986 showed an enormous rise in the taxes paid, particularly by those who experienced the greatest reductions in marginal tax rates.” Feldstein states that base broadening (through limiting the use of tax expenditures) with a 10 percent cut in all tax rates would be revenue neutral in a traditional static analysis. But, Feldstein notes that the experience after enactment of the Tax Reform Act of 1986 suggests that the combination of base

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<sup>220</sup> JOINT COMMITTEE ON TAXATION, MACROECONOMIC ANALYSIS OF A PROPOSAL TO BROADEN THE INDIVIDUAL INCOME TAX BASE AND LOWER INDIVIDUAL INCOME TAX RATES, JCX-53-06 (Dec. 14, 2006).

<sup>221</sup> CONGRESSIONAL BUDGET OFFICE, CHOICES FOR DEFICIT REDUCTION (Nov. 2012) at 25.

<sup>222</sup> Martin Feldstein, *The Tax Reform Evidence from 1986*, WALL ST. J., Oct. 24, 2011.

broadening and rate reduction would raise revenue equal to about four percent of existing tax revenue, which would translate to about \$40 billion for one year at the current level of taxable income, and more than \$500 billion over the next 10 years.<sup>223</sup>

On February 26, 2014, the JCT staff issued a macroeconomic analysis of House Ways and Means Committee Chairman Dave Camp's "Tax Reform Act of 2014."<sup>224</sup> That Act is 979 pages long with extensive reform of both the individual and corporate income tax systems. The centerpiece of the plan is the lowering of both the top individual and corporate tax rates to 25 percent with a 10 percent surtax on the individual side. Coupled with the lowering of both the individual and corporate tax rates is a significant broadening of the tax base. Under the Camp plan, a number of exclusions, deductions and credits would be eliminated or significantly scaled back. The result is a comprehensive tax plan that is almost revenue neutral -- it is scored to raise \$3 billion over 10 years -- and roughly distributionally neutral.<sup>225</sup>

In analyzing the macroeconomic effects of Chairman Camp's tax plan, the JCT staff utilized two models with a number of assumptions associated with each model, including assumptions about Federal Reserve policy and the responsiveness of labor.<sup>226</sup> The staff determined that the lower effective marginal tax rates provide an incentive for increased labor effort and, in some cases, increased business investment.

The JCT staff determined that, under the various modeling assumptions, Chairman Camp's tax plan would increase economic growth relative to the present law baseline over a ten-year

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<sup>223</sup> Id.

<sup>224</sup> JOINT COMMITTEE ON TAXATION, MACROECONOMIC ANALYSIS OF THE TAX REFORM ACT OF 2014, JCX-22-14 (Feb. 26, 2014).

<sup>225</sup> A tax proposal is distributionally neutral if it generates the same relative tax burdens across the income distribution as under current law.

<sup>226</sup> JCT staff used its Macroeconomic Equilibrium Growth (MEG) model and its Overlapping Generations (OLG) model to analyze Chairman Camp's proposal.

budget window. More specifically, GDP was projected to increase between 0.1 percent to as much as 1.6 percent over the period of 2014-2023. According to JCT staff, revenues generated from the plan fall within a range of \$50 billion to \$700 billion over a 2014-2023 budget window.

**Table 4.21**

**Percent Change in Real GDP Relative to Present Law (Percent Change for the Period)**

		Fiscal Years 2014-2018	Fiscal Years 2019-2023	Fiscal Years 2014-2023
<b>MEG</b>				
High Labor Elasticity	Aggressive Fed	0.2	0.2	0.2
	Neutral Fed	0.1	0.8	0.5
Low labor elasticity	Aggressive Fed	0.2	0.1	0.1
	Neutral Fed	0.1	0.7	0.4
<b>MEG, reduced investment response to taxation of multinationals</b>				
High labor elasticity	Aggressive Fed	0.3	0.3	0.3
	Neutral Fed	0.3	0.8	0.6
<b>OLG</b>				
Default IP elasticities		1.8	1.4	1.5
Reduced IP elasticities		1.8	1.4	1.6

The JCT analysis of the macroeconomic effects of Chairman Camp’s tax plan is important. It provides yet another analytical example showing that comprehensive tax reform can lead to significant economic growth. Independent of the assumptions or model used, the JCT determined that Chairman Camp’s tax plan would lead to higher GDP. In other words, all the results point in one direction – an increase in GDP.

**E. Simplification**

In reforming the tax system, the focus is generally on three criteria: efficiency, fairness, and simplicity. Unfortunately, simplification is often overlooked or relegated to secondary status in any tax reform discussion. Simplification means that compliance by the taxpayer and enforcement by the revenue authorities should be as easy as possible. Further, the ultimate tax liability should be certain. A tax whose amount is easily manipulated -- by investing in “tax

shelters,” for example -- can cause tremendous complexity for taxpayers, who attempt to reduce what they owe, and for the government authorities, who attempt to maintain government receipts.

Complexity should be a matter of concern for tax policymakers to the extent that it makes it more difficult, time-consuming, or expensive for taxpayers to comply with the law and IRS efforts to enforce it. The National Taxpayer Advocate has on more than one occasion, including in its 2012 annual report to Congress, listed tax-code complexity as the most serious problem facing taxpayers and the IRS.<sup>227</sup> There are a number of ways in which complexity can affect the Federal tax system. Some of the more commonly recognized effects are: decreased levels of voluntary compliance; increased costs for taxpayers; reduced perceptions of fairness in the tax system; and increased difficulties in the administration of the tax laws.<sup>228</sup>

The tax code has grown to almost four million words.<sup>229</sup> Since 2001, there have been approximately 4,680 changes to the tax code.<sup>230</sup> Approximately 56 percent of American households use paid preparers to do their individual income taxes and another 34 percent use tax software to assist them.<sup>231</sup> Taxpayers and businesses spend over six billion hours a year complying

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<sup>227</sup> See NATIONAL TAXPAYER ADVOCATE, 2012 ANNUAL REPORT TO CONGRESS (Dec. 31, 2012), available at <http://www.taxpayeradvocate.irs.gov/2012-Annual-Report/FY-2012-Annual-Report-To-Congress-Full-Report> (accessed Nov. 13, 2014).

<sup>228</sup> JOINT COMMITTEE ON TAXATION, STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, JCS-3-01 (Apr. 2001) at 6.

<sup>229</sup> NATIONAL TAXPAYER ADVOCATE 2012 ANNUAL REPORT TO CONGRESS, Vol. 1, *supra* note 227, at 6.

<sup>230</sup> *Id.*

<sup>231</sup> Written Testimony of John A. Koskinen, Commissioner of the Internal Revenue Service, Before the Senate Finance Committee on Regulation of Tax Return Preparers (Apr. 8, 2014), available at <http://www.finance.senate.gov/imo/media/doc/Koskinen%20Testimony.pdf> (accessed Dec. 4, 2014).

with tax-filing requirements with compliance costs totaling over \$170 billion annually.<sup>232</sup> The annual monetary compliance burden of the median individual taxpayer was \$258 in 2007.<sup>233</sup>

The U.S. income tax system has numerous provisions that are difficult to understand for the average taxpayer and even for tax professionals. For example, the tax code has about a dozen tax incentives for higher education and multiple definitions of a child. In analyzing data for 2009, the Government Accountability Office found that tax filers do not always choose the education tax incentives that maximize their potential tax benefits.<sup>234</sup> The GAO found that about 14 percent of filers -- 1.5 million of almost 11 million eligible returns -- failed to claim a credit or deduction for which they were eligible.<sup>235</sup> On average, these filers lost a tax benefit of \$466 with the total amount of lost tax benefits estimated to be \$726 million.<sup>236</sup> The GAO noted that “taxpayers might not maximize their tax benefits because they are unaware of their eligibility for the provisions or confused about their use.”<sup>237</sup>

There are many reasons for complexity in the Federal tax system. No single source of complexity can be identified that is primarily responsible for the state of the present tax law.<sup>238</sup> Some sources of complexity include: a lack of clarity and readability of the law; the use of the Federal tax system to advance social and economic policies; increased complexity in the economy;

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<sup>232</sup> NATIONAL TAXPAYER ADVOCATE 2012 ANNUAL REPORT TO CONGRESS, Vol. 1, *supra* note 227, at 5-6.

<sup>233</sup> *Id.* at 6.

<sup>234</sup> UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, HIGHER EDUCATION: IMPROVED TAX INFORMATION COULD HELP FAMILIES PAY FOR COLLEGE (May 2012).

<sup>235</sup> *Id.* at 27.

<sup>236</sup> *Id.*

<sup>237</sup> *Id.* at 29.

<sup>238</sup> JOINT COMMITTEE ON TAXATION, STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, *supra* note 228, at 5.



and the interaction of Federal tax laws with State laws, other Federal laws and standards, the laws of foreign countries and tax treaties.<sup>239</sup>

In addition, there is often a tension between fairness and simplicity. Simple statutes may not be fair because they lump together taxpayers who, in fairness, should be treated differently. Statutes that comprehensively address relevant distinctions between taxpayers leading to fairness tend to be complex. Also, an income tax system is, in many ways, more complex than other types of tax systems. For example, in an income tax system, capital costs must be depreciated or amortized over the asset's useful life. In contrast, under a consumption tax system, capital costs would be immediately deductible.

Unfortunately, although simplification is constantly mentioned as one of the three criteria in reforming the tax system, there seems to be little interest in simplification. In 2001, the Joint Committee on Taxation produced a three volume report on simplification of the tax laws.<sup>240</sup> It identified a number of areas of the tax laws that could be simplified and offered a number of recommendations. The report was well-received in the tax community.<sup>241</sup> Unfortunately, it was simply placed on the shelf where it has remained for the last 13 years. Even the Tax Reform Act of 1986 created tremendous complexity in many areas of the tax laws. In many cases, it was a trade-off between fairness and simplification.

Simplification often gets lost as part of any tax reform discussion. That should not happen. A complex provision -- such as the personal exemption phase-out (PEP), overall limitation on

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<sup>239</sup> Id.

<sup>240</sup> Id.

<sup>241</sup> See Christopher Bergin, Hey, *How About a Little Appreciation Here?* 91 TAX NOTES 853 (May 7, 2001) (“The ‘Study of the Overall State of the Federal Tax System and Recommendations for Simplification’ recently released by the staff of the Joint Committee on Taxation is one of the most significant contributions to tax literature and tax policy in the last 20 years. Period!”).

itemized deduction (Pease), or the AMT – may affect millions of taxpayers effectively forcing them to seek costly help from professional return preparers. This is troubling from a general tax policy standpoint and the policies underlying the particular provision.

#### F. Itemized Deductions

Under current law, individuals are permitted a number of deductions that, for the most part, are expenditures of a personal nature. For examples, medical expenses are deductible to the extent they exceed 10 percent of a taxpayer's adjusted gross income.<sup>242</sup> Charitable contributions are deductible up to, in general, 50 percent of a taxpayer's adjusted gross income, with any excess being carried forward for up to five years.<sup>243</sup> Interest on a home mortgage is fully deductible if the residence is either a principal residence or secondary residence of the taxpayer and to the extent that the mortgage does not exceed \$1 million for acquisition indebtedness or \$100,000 for home equity indebtedness.<sup>244</sup> State and local taxes, such as state and local income taxes, real property taxes, personal property taxes, and state and local sales taxes, are also deductible.<sup>245</sup> However, taxpayers that are subject to the AMT will lose many of their itemized deductions.<sup>246</sup>

As part of tax reform, several different approaches can be taken with respect to itemized deductions. Each itemized deduction can be examined and reformed or repealed. For example, the three largest itemized deductions are the home mortgage interest deduction, the deduction for state and local taxes and the charitable contribution deduction. Prior to the Tax Reform Act of 1986, individuals could deduct all interest payments. As part of the 1986 Act, Congress repealed

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<sup>242</sup> IRC sec. 213. For individuals who are 65 or older, the floor is 7.5 percent of AGI for years 2013 through 2016. IRC sec. 213(f).

<sup>243</sup> IRC sec. 170.

<sup>244</sup> IRC sec. 163(h)(3).

<sup>245</sup> IRC sec. 164. The deduction for state and local sales taxes expired on December 31, 2013, but may be renewed.

<sup>246</sup> IRC sec. 56(b).

the deduction for interest arising in a personal setting but retained the deduction for interest on a home mortgage noting that “encouraging home ownership is an important policy goal, achieved in part by providing a deduction for residential mortgage interest.”<sup>247</sup>

From a purely tax standpoint, some could argue that no deduction should be permitted for home mortgage interest. The imputed income from owner-occupied housing is not an item of gross income and is therefore not taxed under the current tax system. As a result, it could be argued that expenses associated with housing, such as home mortgage interest, should not be deductible. In examining the tax treatment of housing generally and residential mortgage interest in particular, Congress can look at a number of different approaches. To take one example, House Ways and Means Committee Chairman Dave Camp has proposed reducing the \$1 million limitation on acquisition indebtedness to \$500,000, coupled with a repeal of the deduction for interest on home equity indebtedness.<sup>248</sup>

The deduction for state and local taxes dates back to the beginning of our income tax system. A number of justifications have been advanced in support of the deduction. For example, in 1964, the Senate Finance Committee wrote:

In the case of property taxes . . . any denial of the deduction would result in an important shift in the distribution of Federal income taxes between homeowners and nonhomeowners. In the case of State and local income taxes, . . . the continued deductibility of these taxes represent[s] an important means of accommodation to take into account the fact that both State and local governments on one hand and the Federal Government on the other tap this same important revenue source. A failure to provide deductions in such a case could mean a combined burden of income taxes which in some cases would be extremely heavy.<sup>249</sup>

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<sup>247</sup> JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, JCS-10-87 (May 4, 1987) at 264.

<sup>248</sup> THE TAX REFORM ACT OF 2014, available at [http://waysandmeans.house.gov/uploadedfiles/ways\\_and\\_means\\_section\\_by\\_section\\_summary\\_final\\_022614.pdf](http://waysandmeans.house.gov/uploadedfiles/ways_and_means_section_by_section_summary_final_022614.pdf)

<sup>249</sup> U.S. SENATE FINANCE COMMITTEE, REVENUE ACT OF 1964, S. Rep. No. 830, 88<sup>th</sup> Cong., 2d Sess. (1964) reprinted in 1964-1 (Part 2) C.B. 505, 558.

With respect to state and local sales taxes, the Senate Finance Committee noted:

[I]f property and income taxes are to be deductible for Federal income tax purposes, it also is important to allow the deduction of general sales taxes. To deny the deductibility of general sales taxes while allowing deductions for the other major revenue sources would encourage State and local governments to use these other resources in place of the sales tax. . . . [I]t is important for the Federal Government to remain neutral as to the relative use made of these three forms of State and local taxation.<sup>250</sup>

Most tax scholars, however, believe that no deduction should be permitted for state and local taxes.<sup>251</sup> The taxes can be viewed as personal consumption expenditures, which should be nondeductible. The Treasury wrote in 1984:

The current deduction for State and local taxes in effect provides a Federal subsidy for the public services provided by State and local governments, such as public education, road construction and repair, and sanitary services. When taxpayers acquire similar services by private purchase (for example, when taxpayers pay for water or sewer services), no deduction is allowed for the expenditure. Allowing a deduction for State and local taxes simply permits taxpayers to finance personal consumption expenditures with pre-tax dollars.<sup>252</sup>

In addition, the subsidy provided by the deduction for State and local taxes disproportionately benefits those taxpayers in high-tax states. Those taxpayers in low-tax states, in essence, subsidize the public service benefits received by taxpayers in high-tax states.

The charitable contribution deduction can be viewed as benefiting charities and other non-profit organizations by increasing the flow of funds to hospitals, universities and other charitable organizations. In fact, Congress originally enacted the charitable contribution deduction in 1917 based on the concern that the increased taxes to fund World War I would lead to a decrease in charitable giving because individuals would have less surplus to donate.<sup>253</sup> In addition, the

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<sup>250</sup> *Id.*

<sup>251</sup> *See, e.g.,* BITTKER AND LOKKEN, *supra* note 144, at ¶ 32.1.1. (“tax theorists have, on the whole, been hostile to the deduction”).

<sup>252</sup> U.S. DEPARTMENT OF THE TREASURY, *TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH*, Vol. 2, (1984) at 62.

<sup>253</sup> *See* BITTKER AND LOKKEN, *supra* note 144, at ¶ 35.1.1.

provision can be viewed as benefiting the Federal government. In 1938, the House Ways and Means Committee wrote:

The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare.<sup>254</sup>

The staff of the Joint Committee on Taxation has noted that there are three economic rationales for the charitable contribution deduction.<sup>255</sup> First, if a donor makes a charitable contribution for purely altruistic reasons, the donor receives no benefit.<sup>256</sup> Second, charitable organizations may provide goods and services that benefit the larger community. In the absence of a subsidy, generally the private market provides fewer public goods than is optimal.<sup>257</sup> And third, many charitable organizations provide goods and services with significant spillover effects to the public.<sup>258</sup>

Alternatively, or in conjunction with an examination of each itemized deduction, a taxpayer could be limited on the amount of itemized deductions utilized in a given year. For example, economist Martin Feldstein and coauthors have proposed limiting the total value of the tax reduction resulting from tax expenditures to two percent of an individual's AGI.<sup>259</sup> The cap would

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<sup>254</sup> U.S. HOUSE WAYS AND MEANS COMMITTEE, REVENUE ACT OF 1938, H. R. Rep. No. 1860, 75<sup>th</sup> Cong., 3d Sess. (1938) reprinted in 1939-1 (Part 2) C.B. 728, 742.

<sup>255</sup> JOINT COMMITTEE ON TAXATION, PRESENT LAW AND BACKGROUND RELATING TO THE FEDERAL TAX TREATMENT OF CHARITABLE CONTRIBUTIONS, JCX-4-13 (Feb. 11, 2013).

<sup>256</sup> *Id.* at 33. The JCT has noted that “if people experience such a ‘warm-glow’ from giving, then donors can be said to benefit from their gifts. In this case, the donation is, at least in part, a personal expenditure and a deduction for the full amount of the donation should not be allowed under a comprehensive income tax system.”).

<sup>257</sup> *Id.*

<sup>258</sup> *Id.* The JCT also noted that “some argue[d] that money donated to charity should not be considered income at all, and thus should not be taxed.” *Id.* at 4.

<sup>259</sup> See Martin Feldstein, Daniel Feenberg and Maya MacGuineas, *Capping Individual Tax Expenditure Benefits*, 131 TAX NOTES 505 (May 2, 2011).

be based on the value of the tax expenditures and not on the amount of the deduction or exclusion. For example, an individual in the 25 percent tax bracket who pays home mortgage interest of \$10,000 would have a tax expenditure value of \$2,500 that could be subject to the cap depending on the individual's AGI. Under this approach, once the cap is exceeded, a taxpayer receives no further tax benefit from specified tax expenditures.

A similar proposal, advocated by Governor Mitt Romney in his 2012 presidential run, would limit itemized deductions to a flat dollar amount. For example, a taxpayer's itemized deductions could be limited to a total of \$20,000, consisting of any combination of itemized deductions. If a cap is imposed on itemized deductions, it would make sense to exclude the deduction for charitable contributions so that the tax incentive for charitable contributions would continue to apply even if the taxpayer had reached the cap. Under this approach, once the cap is exceeded, a taxpayer receives no further tax benefit from specified itemized deductions.

A third approach, advocated by the Obama Administration, is to limit the value of itemized deductions (and certain exclusions) to a certain percentage, such as 28 cents on the dollar.<sup>260</sup> For example, a taxpayer in the top tax bracket of 39.6 percent would not receive a tax savings of 39.6 cents for one dollar of deduction. Rather the value of the deduction would be reduced by almost 12 cents on the dollar to 28 cents on the dollar. In essence, under this approach, the taxpayer is denied the deduction (or exclusion) and then given a credit equal to 28 percent of the amount of the deduction (or exclusion) – although the taxpayer would receive a lesser benefit if in a lower tax bracket than the 28 percent bracket. Under this approach, a taxpayer continues to receive a tax benefit from specified tax expenditures once the taxpayer's tax bracket exceeds 28 percent,

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<sup>260</sup> See JOINT COMMITTEE ON TAXATION, DESCRIPTION OF CERTAIN REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2014 BUDGET PROPOSAL, JCS-4-13 (Dec. 2013) at 98.

although the benefit is limited to a 28 percent credit for each additional dollar of specified tax expenditures.

#### G. Employer-Provided Health Insurance

The single largest individual tax expenditure is the exclusion for employer-provided health insurance. The exclusion dates back over 50 years and possibly as long as 100 years. When Congress enacted the Federal income tax in 1913, no statutory provision expressly provided for an exclusion for employer-provided health insurance. The government issued two rulings – one in 1919 and the second in 1921.<sup>261</sup> The former ruling held that premiums were income to employees with the latter ruling reaching the opposite result (at least as to premiums for group life coverage).<sup>262</sup> During the 1930s, employer-provided health insurance began to spread as a result Franklin Roosevelt’s New Deal, which changed the ways Americans thought about government, business and economic security.<sup>263</sup> During World War II, the government imposed wage and price controls as a misguided and economically costly attempt to control inflation. The National War Labor Board (NWLB) concluded that employer-provided health insurance was exempt from wage controls. The NWLB’s decision “opened the floodgates to the institution of employee benefits programs as unions and management sought wage increases under the guise of fringe adjustments.”<sup>264</sup>

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<sup>261</sup> See Janemarie Mulvey, *The Tax Exclusion for Employer-Provided Health Insurance: Issues for Congress* (CRS) (Jan. 4, 2011) at 6.

<sup>262</sup> *Id.*

<sup>263</sup> See Joseph J. Thorndike, *The Deliberate Creation of the Most Expensive Tax Preference*, 137 TAX NOTES 1141 (Dec. 10, 2012).

<sup>264</sup> Beth Stevens, *Blurring the Boundaries: How the Federal Government Has Influenced Welfare Benefits in the Private Sector*, in *THE POLITICS OF SOCIAL POLICY IN THE UNITED STATES* 133 (Margaret Weir, et al., eds., 1988).

An IRS ruling in 1943 provided that employer contributions to group health insurance would not be taxed to the employees. Ten years later, the IRS issued a ruling reversing its position declaring that employer contributions to health insurance plans were income to employees. The next year, 1954, Congress enacted section 106 making it clear that employer contributions for employee health insurance are excluded from the employees' gross income.

Currently, employer-sponsored health insurance covers about 149 million non-elderly individuals.<sup>265</sup> In 2014, the average cost of employment-based health insurance is \$6,025 a year for single taxpayers and \$16,834 for family coverage.<sup>266</sup> Effective January 1, 2018, a new 40 percent excise tax will apply to so-called Cadillac plans – those health insurance plans with premiums in excess of \$10,200 for single taxpayers and \$27,500 for family coverage.<sup>267</sup>

The exclusion for employer-provided healthcare has been a feature of our income tax system for so long that it is politically difficult to touch. It affects millions of American taxpayers and if the exclusion is repealed, may result in a substantial tax increase. Because the subsidy is delivered in the form of an exclusion, many taxpayers may be unaware that the government has long been subsidizing their healthcare.<sup>268</sup>

A number of concerns have been raised with respect to the exclusion. It encourages workers to take compensation in the form of generous healthcare programs.<sup>269</sup> Because the exclusion reduces the after-tax cost of healthcare, is not transparent, and is not capped or limited,

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<sup>265</sup> THE KAISER FAMILY FOUNDATION AND HEALTH RESEARCH AND EDUCATIONAL TRUST, EMPLOYER HEALTH BENEFITS: 2014 SUMMARY OF FINDINGS (2014), available at <http://kaiserfamilyfoundation.files.wordpress.com/2014/09/8626-employer-health-benefits-2014-summary-of-findings1.pdf> (accessed Dec. 4, 2014).

<sup>266</sup> Id.

<sup>267</sup> IRC sec. 4980I.

<sup>268</sup> See Edward D. Kleinbard, *Tax Expenditure Framework Legislation*, 63 NAT'L TAX J. 353 (June 2010).

<sup>269</sup> Id.



workers may opt for more insurance coverage than is necessary. As a result, most economists believe that a welfare or efficiency loss results from excessive health coverage. This contributes to rising health care costs and, generally, to resource misallocation.

It seems that the principal policy decision is whether to maintain (or even strengthen) the employment-based system of health care.<sup>270</sup> If so, then maintaining (or capping) the exclusion may be appropriate as termination of the exclusion could weaken the employment-based system of health care.<sup>271</sup> If, however, the goal is to move the health care system to individual market insurance or an expansion of public coverage, then ending (or phasing out) the exclusion may be the appropriate course of action.<sup>272</sup>

#### H. Alternative Minimum Tax

In 1969, Treasury Secretary Joseph Barr publicly announced that, in 1966, 154 taxpayers had adjusted gross income (“AGI”) of \$200,000 or more but no taxable income, including 21 taxpayers with AGI above \$1 million.<sup>273</sup> These taxpayers utilized a number of preference items, which were certain exclusions and deductions that reduced taxable income without reducing economic income.<sup>274</sup> The Senate Finance Committee wrote:

The fact that present law permits a small minority of high-income individuals to escape tax on a large proportion of their income has seriously undermined the belief of taxpayers that others are paying their fair share of the tax burden. It is essential that tax reform be obtained not only as a matter of justice but

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<sup>270</sup> See Mulvey, *supra* note 261, at 18.

<sup>271</sup> *Id.*

<sup>272</sup> *Id.*

<sup>273</sup> Statement of the Secretary of the Treasury Joseph W. Barr, Hearings on the 1969 Economic Report of the President Before the Joint Economic Comm., 91<sup>st</sup> Cong., 1<sup>st</sup> Sess. (1969); U.S. SENATE FINANCE COMMITTEE, TAX REFORM ACT OF 1969, S. Rep. No. 552, 91<sup>st</sup> Cong., 1<sup>st</sup> Sess. reprinted in 1969-3 C.B. 423, 430.

<sup>274</sup> Many of these taxpayers reduced their taxable income by excluding one-half of their long-term capital gains from income and using their itemized deductions against any remaining income. U.S. SENATE FINANCE COMMITTEE, TAX REFORM ACT OF 1969, S. Rep. No. 91-552, 91<sup>st</sup> Cong., 1<sup>st</sup> Sess. (1969) reprinted in 1969-3 C.B. 423, 431.

also as a matter of taxpayer morale. Our individual and corporate income taxes, which are the mainstays of our tax system, depend upon self-assessment and the cooperation of taxpayers. The loss of confidence on their part in the fairness of the tax system could result in a breakdown of taxpayer morale and make it far more difficult to collect the necessary revenues.<sup>275</sup>

In December 1969, Congress enacted a “minimum tax.” The minimum tax was an add-on minimum tax rather than an alternative minimum tax, which Treasury had proposed. Under the add-on minimum tax, a taxpayer’s preference items above an exemption amount were subject to a separate 10 percent tax, which was an addition to the taxpayer’s regular income taxes, hence the term add-on minimum tax.

Treasury released another report showing that, in 1974, 244 taxpayers had AGI of \$200,000 or more but no taxable income.<sup>276</sup> Partly in response to this report, in 1976, Congress made a number of changes to the minimum tax, including increasing the rate to 15 percent, decreasing the exemption amount, and adding new preference items. In 1978, Congress enacted the alternative minimum tax (“AMT”) but kept the add-on minimum tax for four more years, finally repealing it in 1982, and expanding the AMT in its place. The AMT was an entirely different tax regime from the regular tax with its add-on minimum tax. Under the AMT, a taxpayer would pay, in essence, the greater of his regular tax liability or his AMT liability, hence the substitution of the word “alternative” for “add-on” in the name.

In 1986, 1990 and 1993, Congress made a number of changes to the AMT. Congress designed the AMT to impact high-income taxpayers. The AMT, however, has had some impact

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<sup>275</sup> U.S. SENATE FINANCE COMMITTEE, TAX REFORM ACT OF 1969, S. Rep. No. 552, 91<sup>st</sup> Cong., 1<sup>st</sup> Sess. (1969) reprinted in 1969-3 C.B. 431.

<sup>276</sup> See Robert P. Harvey and Jerry Tempalski, *The Individual AMT: Why It Matters*, 50 NAT’L TAX J. 453, 454 (1997).

on middle-income taxpayers even though it was not designed to affect them. Approximately, four million taxpayers are impacted by the AMT every year.

In computing a taxpayer's AMT liability, the starting point is the taxpayer's taxable income as computed for regular income tax purposes. A number of alterations are made to taxable income in arriving at alternative minimum taxable income ("AMTI"). These alterations fall into one of two categories: adjustments and preference items. They usually increase taxable income but in a few cases decrease taxable income in arriving at AMTI. Some common examples of adjustment and preference items include:

- (1) no deduction for miscellaneous itemized deductions;
- (2) no deduction for home equity indebtedness unless the proceeds are used to substantially improve the residence;
- (3) no standard deduction and no deduction for personal exemptions;
- (4) no deduction for personal property, real property, and state and local income taxes;
- (5) inclusion in income of *certain* tax-exempt interest;
- (6) inclusion in income of stock exercised pursuant to incentive stock options; and
- (7) 150 percent declining balance method used for tangible personal property.

As a result of the adjustment and preference items, the income base under the AMT is generally broader than the income base under the regular tax system.

Once the adjustments and preferences are made in arriving at AMTI, the exemption amounts must be considered. The exemption amounts are \$78,750 for married couples and \$50,600 for single taxpayers and are indexed for inflation each year (for 2015, the exemption amounts are \$83,400 for married couples and \$53,600 for single taxpayers).<sup>277</sup> The exemption amount is subtracted from AMTI in arriving at the taxable excess. Once the taxable excess is determined, it is multiplied by the AMT rates, which are currently 26 percent and 28 percent.<sup>278</sup>

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<sup>277</sup> IRC sec. 55(d)(1). Rev. Proc. 2014-61, IRB 2014-47 (Nov. 17, 2014).

<sup>278</sup> Net capital gain is generally taxed at its regular tax rates so that the AMT accommodates the preferential rates for capital gains. IRC sec. 55(b)(3).

The 26 percent rate applies to taxable excess up to \$175,000, which is indexed for inflation (\$185,400 for 2015). Any taxable excess above \$175,000 is taxed at 28 percent. As a result of the rates and exemption amounts, the AMT is somewhat progressive. Taxpayers pay the greater of their regular income tax liability or their AMT liability.

The exemption amount is phased-out for upper-income taxpayers.<sup>279</sup> Generally, the exemption amount is reduced by an amount equal to 25 percent of the excess of AMTI over a set amount -- \$150,000 for married filing jointly and \$112,500 for single taxpayers (these dollar amounts are indexed for inflation -- \$158,900 for married filing jointly and \$119,200 for single taxpayers in 2015). Because of the phase-out of the exemption amount, the marginal AMT tax rate is raised by 25 percent multiplied by the AMT tax rate. In other words, if a taxpayer is in the phase-out range, the marginal AMT tax rates are 32.5 percent and 35 percent. Once the taxpayer has cleared the phase-out range, the marginal AMT tax rate again becomes 28 percent. This “bubble effect” may partially explain why very upper income taxpayers are generally not subject to the AMT. Under the regular income tax system, these very upper-income taxpayers are subject to a marginal tax rate of 39.6 percent as compared to 28 percent under the AMT.

As part of the American Taxpayer Relief Act of 2012, Congress indexed the AMT parameters for inflation. Congress was concerned about the projected increase in the number of individuals who would be affected by the AMT and the projected increase in tax liability for those affected. As a result, the following dollar amounts are indexed for inflation beginning in 2013: the dollar amounts dividing the 26 percent and 28 percent rates; the dollar amounts of the basic AMT exemption amounts; and the dollar amounts at which the phase-out of the basic AMT exemption amounts begin. The Tax Policy Center has estimated that even with indexing the AMT

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<sup>279</sup> IRC sec. 55(d)(3).

parameters for inflation, the number of AMT taxpayers will increase from 3.9 million taxpayers in 2013 to six million taxpayers in 2022.<sup>280</sup>

The AMT should be repealed for several reasons. First, the AMT is not achieving its intended purpose. It was originally intended to impact very high income taxpayers who paid little or no Federal income tax. Unfortunately, that is not what the AMT is doing today. It impacts millions of upper middle-income taxpayers. It also creates complexity in the tax law by having a second income tax system. In addition, if tax reform results in substantial base-broadening, then the broad base under the AMT would, in large part, be duplicative of the base resulting from tax reform.

#### I. Standard Deduction, Personal Exemptions, Dependency Exemptions, Head of Household Status and the Child Tax Credit

With the onset of World War II and the United States' growing need for revenue to finance the war effort, Congress made the income tax applicable to the masses. This resulted in a substantial compliance burden for millions of Americans who had to keep track of their itemized deductions. As a result, Congress enacted the standard deduction in 1944 as a means of simplifying compliance for most taxpayers. Today, approximately two-thirds of all taxpayers utilize the standard deduction.<sup>281</sup> The standard deduction in 2015 for married taxpayers is \$12,600 and \$6,300 for single taxpayers.

The personal exemption dates back to the beginning of the income tax system in 1913. The purpose of the personal exemption was to insulate a certain amount of income from taxation. The

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<sup>280</sup> Tax Policy Center, *Aggregate AMT Projections, 2012-2023* (Aug. 26, 2013), available at <http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=3968> (accessed Nov. 13, 2014).

<sup>281</sup> See Justin Bryan, *Individual Income Tax Returns – 2011*, 33 SOI BULLETIN 5, 8 (Fall 2013), available at <http://www.irs.gov/pub/irs-soi/13inreturnsfallbul.pdf> (accessed July 2, 2014).

personal exemption amount was intended to approximate the amount of money an individual would need to get by at a subsistence level (i.e., an amount needed for food, clothing and shelter). In 2015, the personal exemption amount is only \$4,000 – clearly an amount well below the subsistence level for an individual and only \$1,000 higher than the personal exemption amount in 1913.

The dependency exemption entered the tax laws in 1917. Required funding for World War I resulted in a decrease in the personal exemption amount. To offset the decrease, Congress enacted a modest dependency exemption of \$200. In 2015, the dependency exemption amount is the same as the personal exemption amount -- \$4,000 per dependent. The standard deduction, personal exemption, and dependency exemptions can be seen as creating a zero-percent tax bracket. In other words, an amount of income subject to a zero percent tax rate.

Congress enacted the head of household status in 1951. The Senate Finance Committee wrote that unmarried taxpayers who maintain a household for others “are in a somewhat similar position to married couples who, because they may share their income, are treated under present law substantially as if they were two single individuals each with half of the total income of the couple.”<sup>282</sup> The result was to extend to a head of household “approximately 50 percent of the benefit of the income-splitting device available to married couples filing joint returns.”<sup>283</sup> A taxpayer who qualifies as head of household is entitled to a larger standard deduction than a single taxpayer and the tax brackets are wider for head of household taxpayers. In 2015, the standard deduction for a head of household is \$9,250 -- \$2,950 higher than for a single taxpayer.

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<sup>282</sup> U.S. SENATE FINANCE COMMITTEE, REVENUE ACT OF 1951, S. Rep. No. 781, 82<sup>nd</sup> Cong., 1<sup>st</sup> Sess., Sec. III-B(2) (1951).

<sup>283</sup> Arthur H. Goodman, *Observations on the Revenue Act of 1951*, 20 FORDHAM L. REV. 273, 274 (1951).

Congress enacted the child tax credit in 1997. Congress was concerned that the tax laws did not adequately address a family's reduced ability to pay as the family's size increased. The decline of the value of the personal exemption was cited as evidence of the tax laws inadequately addressing a family's ability to pay. As originally enacted, the child tax credit was \$400 per child. Today, it is \$1,000 per child. Unlike the parameters of the standard deduction, personal exemption, dependency exemption, and head of household status, the parameters of the child tax credit are not adjusted for inflation.

In 2005, the President's Advisory Panel on Federal Tax Reform recommended that the standard deduction, personal exemption, dependency exemption, head of household status and the child tax credit be replaced by a Family Credit.<sup>284</sup> A Family Credit eliminates the redundancy with the standard deduction, personal and dependency exemptions, head of household status and the child tax credit. It also eliminates the complexity associated with the various deductions and credits. Under the Advisory Panel's plan, the Family Credit would be available to all taxpayers, and the amount of the credit would be set at a level to exempt subsistence amounts of income from tax. Each family would receive an additional credit for each child and each dependent. As a result, the Family Credit would not change the amount or availability of the existing deductions and credits related to the family but rather would ensure that these provisions accomplish their intended purposes as efficiently and as simply as possible.

The Family Credit would be a credit and not a deduction. Those taxpayers in a higher tax bracket would not receive a greater tax benefit than those in lower tax brackets. The credit would be available for all taxpayers and would not phase-out at higher income levels. Most, if not all,

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<sup>284</sup> REPORT OF THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM, ch. 5 (2005).

low-income taxpayers would be exempt from the Federal income tax as a result of the Family Credit.

In 2010, the Debt Reduction Task Force (DRTF) of the Bipartisan Policy Center proposed a universal child credit of \$1,600 per child, indexed for inflation, to replace the numerous tax provisions relating to children.<sup>285</sup> A taxpayer would only have to file once to qualify a child for the credit. After that, a taxpayer will automatically receive the credit for that child as long as the child resides in the taxpayer's house or attends school and until the child reaches adulthood. According to the DRTF, "the child credit will replicate, on average, the benefits that taxpayers receive for an additional child under current law."<sup>286</sup>

#### J. Earned Income Tax Credit (EITC) and Additional Child Tax Credit

Congress enacted the EITC in 1975.<sup>287</sup> It was originally intended to alleviate the impact of payroll taxes on low-income taxpayers. It has been expanded over the years and is designed to create an incentive for individuals to work. Because the EITC is refundable, claiming it lowers the total amount of taxes owed and can result in a refund if the amount of the credit exceeds the taxpayer's tax liability. To claim the credit, a taxpayer must have a job with income that is within certain thresholds. The income thresholds vary depending on the number of children that the taxpayer claims as dependents. For the year 2015, a single taxpayer with no dependent children with income of \$14,820 or less is entitled to an EITC up to \$503.<sup>288</sup> Married taxpayers with income

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<sup>285</sup> THE DEBT REDUCTION TASK FORCE, BIPARTISAN POLICY CENTER, RESTORING AMERICA'S FUTURE: REVIVING THE ECONOMY, CUTTING SPENDING AND DEBT, AND CREATING A SIMPLE, PRO-GROWTH TAX SYSTEM (Nov. 2010) at 35, available at <http://bipartisanpolicy.org/wp-content/uploads/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf> (accessed Dec. 2, 2014).

<sup>286</sup> *Id.* at 36.

<sup>287</sup> IRC sec. 32.

<sup>288</sup> Rev. Proc. 2014-61, IRB 2014-47 (Nov. 17, 2014).



up to \$53,267 or single taxpayers with income up to \$47,747 coupled with three or more qualifying children are eligible for the EITC up to \$6,242.<sup>289</sup> The EITC was enhanced as part of the American Recovery and Reinvestment Act of 2009 and then extended with a current scheduled expiration date at the end of 2017.

About 27 million taxpayers claimed the EITC in 2012 totaling over \$63 billion.<sup>290</sup> The EITC has been held by most as a success in terms of increasing work effort in the economy, reducing dependence on government, and reducing poverty. Two major concerns with respect to the EITC are that many low-income taxpayers who qualify for the credit are not claiming it, and that some taxpayers are improperly claiming it. In the former case, an estimated 15 to 25 percent of apparently eligible individuals fail to claim the credit.<sup>291</sup> This may be due to the complexity of both claiming the credit and computing the amount of the credit. In the latter case of taxpayers improperly claiming the credit, the Government Accountability Office has estimated that the IRS made approximately \$14.5 billion in improper EITC payments with an error rate of 24 percent for fiscal year 2013.<sup>292</sup>

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<sup>289</sup> Id.

<sup>290</sup> See Internal Revenue Service, *Earned Income Tax Credit; Do I Qualify?*, available at <http://www.irs.gov/uac/Newsroom/Earned-Income-Tax-Credit-Do-I-Qualify> (accessed Nov. 2, 2104).

<sup>291</sup> See THE PRESIDENT'S ECONOMIC RECOVERY ADVISORY BOARD, THE REPORT ON TAX REFORM OPTIONS: SIMPLIFICATION, COMPLIANCE, AND CORPORATE TAXATION (Aug. 2010) at 17, available at [http://www.whitehouse.gov/sites/default/files/microsites/PERAB\\_Tax\\_Reform\\_Report.pdf](http://www.whitehouse.gov/sites/default/files/microsites/PERAB_Tax_Reform_Report.pdf) (accessed Dec. 2, 2014).

<sup>292</sup> See United States Government Accountability Office, Testimony Before the Subcommittee on Government Operations, Committee on Oversight and Government Reform, House of Representatives, Improper Payments Government-Wide Estimates and Reduction Strategies Statement of Beryl H. Davis, Director Financial Management and Assurance, GAO-14-737T (July 9, 2014). See also TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, EXISTING COMPLIANCE PROCESSES WILL NOT REDUCE THE BILLIONS OF DOLLARS IN IMPROPER EARNED INCOME TAX CREDIT AND ADDITIONAL CHILD TAX CREDIT PAYMENTS (Sept. 29, 2014).

The additional child tax credit is another refundable credit for taxpayers (with children) who did not receive the full benefit of the child tax credit.<sup>293</sup> The additional child tax credit is equal to the lesser of the unallowed child tax credit or 15 percent of the taxpayer's earned income above \$3,000. If earned income does not exceed \$3,000 and a taxpayer has three or more qualifying children, then the taxpayer may be able to claim the additional child tax credit up to the amount of social security taxes paid for the year. Coordination is made between the EITC and the additional child tax credit. If the taxpayer is eligible for the EITC, the maximum amount of the additional child tax credit is the total amount of social security taxes less the amount of EITC for which the taxpayer is eligible.

The Treasury Inspector General for Tax Administration (TIGTA) has noted that for 2010, individuals who were not authorized to work in the United States were paid \$4.2 billion in refundable child tax credits.<sup>294</sup> TIGTA has written, "The payment of Federal funds through this tax benefit [additional child tax credit] appears to provide an additional incentive for aliens to enter, reside and work in the United States without authorization, which contradicts Federal law and policy to remove such incentives." Recently, TIGTA, using IRS data, estimated that the potential additional child tax credit improper payment rate for 2013 is between 25.2 percent and 30.5 percent, with potential improper payments totaling between \$5.9 billion and \$7.1 billion.<sup>295</sup>

In 2005, the President's Advisory Panel on Federal Tax Reform recommended that the EITC and the additional child tax credit be replaced by a Work Credit that would be coordinated

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<sup>293</sup> IRC sec. 24(d). The additional child tax credit was enhanced as part of the American Recovery and Reinvestment Act of 2009 and then extended with a current scheduled expiration date at the end of 2017.

<sup>294</sup> TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, RECOVERY ACT: INDIVIDUALS WHO ARE NOT AUTHORIZED TO WORK IN THE UNITED STATES WERE PAID \$4.2 BILLION IN REFUNDABLE CREDITS (July 7, 2011).

<sup>295</sup> See TIGTA REPORT, *supra* note 292.

with the Family Credit.<sup>296</sup> The Work Credit would be designed to maintain a work incentive comparable to the current law and, in addition, provide approximately the same amount of maximum credit as the EITC and the additional child tax credit. However, the computation of the Work Credit would be much simpler than current law's EITC and additional child tax credit so that both the under claim rate and the fraud rate would significantly decrease. More recently, the President's Economic Recovery Advisory Board (PERAB) made a similar observation that the EITC and the additional child tax credit could be harmonized.<sup>297</sup> PERAB noted that "[h]armonizing the rules governing eligibility, the definition of earned income, and the calculation of benefits for the EITC and the child tax credit would eliminate the multiple schedules required for families with three or more children."<sup>298</sup>

The Debt Reduction Task Force has proposed replacing the EITC with an earnings credit of 21.3 percent of the first \$20,300 of earnings, indexed for inflation, for each worker in the tax unit.<sup>299</sup> The earnings credit would be provided in real time through automatic adjustments in withholding. There would be no phase-outs, thereby preventing the creation of marriage penalties and work disincentives.

#### K. Retirement Plans

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<sup>296</sup> REPORT OF THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, *supra* note 284, at ch. 5.

<sup>297</sup> THE PRESIDENT'S ECONOMIC RECOVERY ADVISORY BOARD, *supra* note 291, at 17-20.

<sup>298</sup> *Id.* at 20.

<sup>299</sup> DEBT REDUCTION TASK FORCE, *supra* note 285, at 35. A later version of the tax plan advanced by the Debt Reduction Task Force would create a refundable earnings credit of 17.5 percent of the first \$20,000 of earnings. DEBT REDUCTION TASK FORCE, BIPARTISAN POLICY CENTER, DOMENICI-RIVLIN DEBT REDUCTION TASK FORCE PLAN 2.0, available at <http://bipartisanpolicy.org/wp-content/uploads/sites/default/files/D-R%20Plan%202.0%20FINAL.pdf> (accessed Dec. 2, 2014).

There are a number of retirement plans available to different types of employers. The following table illustrates the different sets of rules that apply to various employer-sponsored retirement plans.

**Table 4.22**  
**Employer-Sponsored Retirement Plans<sup>300</sup>**

	Payroll Deduction IRA	SEP	SIMPLE IRA Plan	SIMPLE 401(k)	Safe Harbor 401(k)	Traditional 401(k)	403(b)	457(b)
Sponsor/Eligible Employer	Any employer	Any employer	Employer with 100 or fewer employees and no other qualified plan	Employer with 100 or fewer employees and no other qualified plan	Any employer other than a state or local government	Any employer other than a state or local government	Public education employers and tax-exempt 501(c)(3) organizations	State and local governments; non-church tax-exempt organizations
Maximum Employee Contribution	\$5,500	\$0	\$12,500	\$12,500	\$18,000	\$18,000	\$18,000	\$18,000
Employer Contribution	None	Optional	Required	Required	Required	Optional	Optional	Optional
Maximum Total Employer Plus Employee Contribution	\$5,500	Lesser of 25 percent of compensation and \$53,000	\$12,500 by employee plus either match employee contributions (100% of first 3% of compensation ) or contribute 2% of employee's compensation	\$53,000 or 100 percent of compensation	\$53,000 or 100 percent of compensation	\$53,000 or 100 percent of compensation	\$53,000 or 100 percent of compensation	\$18,000 or 100 percent of compensation
Catch-up Contributions	\$1,000	\$0	\$3,000	\$3,000	\$6,000	\$6,000	Special rules apply	Special rules apply
When can funds be withdrawn without penalty?	Subject to IRA rules; after age 59 ½	Subject to IRA rules; after age 59 ½	Subject to IRA rules; after age 59 ½	Subject to 401(k) rules; after age 59 ½	Subject to 401(k) rules; after age 59 ½	Subject to 401(k) rules; after age 59 ½	After age 59 ½	After severance from employment or 59 1/2
Hardship withdrawal allowed?	No	No	No	Yes, if distribution is necessary to satisfy "immediate and heavy financial need"	Yes, if distribution is necessary to satisfy "immediate and heavy financial need"	Yes, if distribution is necessary to satisfy "immediate and heavy financial need"	Yes, if distribution is necessary to satisfy "immediate and heavy financial need"	Yes, for "unforeseeable emergency"
Loans allowed?	No	No	No	Yes	Yes	Yes	Yes	Yes

<sup>300</sup> INTERNAL REVENUE SERVICE, TAX-EXEMPT AND GOVERNMENT ENTITIES, CHOOSE A RETIREMENT PLAN, available at <http://www.irs.gov/pub/irs-pdf/p4484.pdf> (accessed Dec. 8, 2014); IR-2014-99 (Oct. 23, 2014).

In 2005, the President’s Advisory Panel on Federal Tax Reform proposed a plan to consolidate all employer-based defined contribution plans into one work-based account.<sup>301</sup> The panel would have retained the present law rules for defined benefit plans. The President’s Economic Recovery Advisory Board noted that they heard three different sets of criticisms aimed at the current retirement tax incentives.<sup>302</sup> First, the array of options makes it difficult to choose a plan and the complicated rules make it hard to understand the incentives thereby undermining the effectiveness of the incentives.<sup>303</sup> Second, administrative hurdles for employers sponsoring a plan can be quite significant (particularly for smaller employers) along with inequities caused by the different rules.<sup>304</sup> And finally, the distribution of benefits was not well aligned with the goals of increasing savings among groups with low savings rates.<sup>305</sup>

Some argue that the existing employer-based retirement accounts can be consolidated as well as simplified. For example, 401(k) plans, 403(b) plans and 457 plans are very similar except they are designed for different employers. 401(k) plans are designed for taxable employers, 403(b) plans for non-profit employers, and 457 plans for government employers. All three plans serve the same basic function and could be consolidated into one type of plan. However, the transition to a new system, particularly for governmental employers, would be time-consuming and expensive. And claims of confusion--the reason for expending the effort to consolidate plans in the first place--may be overstated. An employer only needs to know the rules of the type of plan the employer sponsors and does not need to know the rules of the other plans that they do not

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<sup>301</sup> REPORT OF THE PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, *supra* note 284, at ch. 5.

<sup>302</sup> THE PRESIDENT’S ECONOMIC RECOVERY ADVISORY BOARD, *supra* note 291, at 23.

<sup>303</sup> *Id.*

<sup>304</sup> *Id.*

<sup>305</sup> *Id.*

sponsor. There is even less potential confusion for employees because employees are not asked to choose between a 401(k), 403(b) or 457(b) arrangement. Employees are simply asked if they want to enroll in the plan being offered by the employer – or are automatically enrolled.

Uniform rules could be developed for eligibility, contribution and withdrawals. It may not be necessary for some plans to have rules permitting loans against the plan balance and other plans to have rules forbidding loans. In addition, some plans have rules permitting hardship withdrawals while other plans have rules forbidding hardship withdrawals. It may be helpful to harmonize such rules as much as possible.

If a consumption tax base or a wage tax base were adopted, then significant changes could be made to the various retirement plans. For example, the individual tax under the USA Tax is a consumption tax base allowing for an unlimited IRA. That being the case, many of the traditional defined contribution plans provisions could be repealed. If, however, the individual tax under the Flat Tax were adopted, then the various Roth accounts, such as Roth IRAs and designated Roth accounts in 401(k) plans, could be eliminated. The Roth retirement accounts represent a wage tax system and would be duplicative to the individual tax base under the Flat Tax.

#### L. Education Tax Incentives

The tax code contains a number of incentives for education. These provisions are difficult to understand for the average taxpayer and even for tax professionals. In analyzing data for 2009, the Government Accountability Office (GAO) found that tax filers do not always choose the education tax incentives that maximize their potential tax benefits.<sup>306</sup> The GAO found that about 14 percent of filers (1.5 million of almost 11 million eligible returns) failed to claim a credit or

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<sup>306</sup> UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, HIGHER EDUCATION: IMPROVED TAX INFORMATION COULD HELP FAMILIES PAY FOR COLLEGE (May 2012).

deduction for which they were eligible.<sup>307</sup> On average, these filers lost a tax benefit of \$466 with the total amount of lost tax benefits estimated to be \$726 million.<sup>308</sup> The GAO noted that “taxpayers might not maximize their tax benefits because they are unaware of their eligibility for the provisions or confused about their use.”<sup>309</sup> The following table illustrates the different sets of rules that apply to various education tax incentives that are intended to help taxpayers meet current education expenses.

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<sup>307</sup> Id. at 27.

<sup>308</sup> Id.

<sup>309</sup> Id. at 29.

**Table 4.23**

**Education Tax Incentives<sup>310</sup>**

	Scholarships, Fellowships, Grants and Tuition Reductions	American Opportunity Tax Credit	Lifetime Learning Credit	Student Loan Interest Deduction	Tuition and Fees Deduction (currently expired)
What is the benefit?	Amounts received may not be taxable	Credits can reduce the amount of tax  40% of the credit may be refundable (limited to \$1,000 per student)	Credits can reduce the amount of tax	Can deduct interest paid	Can deduct expenses
What is the annual limit?	None	\$2,500 credit per student	\$2,000 credit per tax return	\$2,500 deduction	\$4,000 deduction
What expenses qualify besides tuition and required enrollment fees?	Course-related expenses such as fees, books, supplies and equipment	Course-related books, supplies and equipment	Amounts paid for required books, supplies and equipment that must be paid to the educational institution	Books, supplies, equipment  Room and board  Transportation  Other necessary expenses	None
What education qualifies?	Undergraduate and graduate  K-12	Undergraduate and graduate	Undergraduate and graduate  Courses to acquire or improve job skills	Undergraduate and graduate	Undergraduate and graduate
What other conditions apply?	Must be in degree or vocational program  Payment of tuition and required fees must be allowed under the grant	Can be claimed for only four tax years (which includes years Hope credit was claimed)	No other conditions	Must have been at least half-time student in degree program	Cannot claim both deduction and education credit for same student in same year
In what income range do benefits phase out?	No phase-out	\$80,000 - \$90,000  \$160,000-\$180,000 for joint returns	\$55,000 - \$65,000  \$110,000 - \$130,000 for joint returns	\$65,000 - \$80,000  \$130,000 - \$160,000 for joint returns	\$65,000 - \$80,000  \$130,000 - \$160,000 for joint returns

<sup>310</sup> INTERNAL REVENUE SERVICE, PUBLICATION 970, TAX BENEFITS FOR EDUCATION, available at <http://www.irs.gov/pub/irs-pdf/p970.pdf> (accessed Nov. 2, 2014).



	Coverdell ESA	Qualified Tuition Program (QSP)	Education Exception to Addition Tax on Early IRA Distributions	Education Savings Bond Program	Employer-Provided Educational Assistance	Business Deduction for Work-Related Education
What is your benefit?	Earnings not taxed	Earnings not taxed	No 10% additional tax on early distribution	Interest not taxed	Employer benefits not taxed	Expenses deductible
What is the annual limit?	\$2,000 contribution per beneficiary	None	Amount of qualified education expenses	Amount of qualified education expenses	\$5,250 exclusion	Amount of qualifying work-related education expenses
What expenses qualify besides tuition and required enrollment fees?	Books, supplies, equipment  Expenses for special needs services  Payments to QTP  Higher education: room and board if at least half-time student  Elem/sec (K-12) education: tutoring, room and board, uniforms, transportation, computer access, supplementary expenses	Books, supplies equipment  Room and board if at least half time student  Expenses for special needs services  Computer technology, equipment and internet access (2010)	Books, supplies equipment  Room and board if at least half time student  Expenses for special needs services	Payments to Coverdell ESA  Payments to QTP	Books, supplies equipment	Transportation  Travel  Other necessary expenses
What education qualifies?	Undergraduate and graduate  K-12	Undergraduate and graduate	Undergraduate and graduate	Undergraduate and graduate	Undergraduate and graduate	Required by employer or law to keep present job, salary, status  Maintain or improve job skills
What are some other conditions that apply?	Assets must be distributed at age 30 unless special needs beneficiary	No other conditions	No other conditions	Applies only to qualified series EE bonds issued after 1989 or series I bonds	No other conditions	Cannot be to meet minimum educational requirements of present trade/business  Cannot qualify for new trade/business

In what income range do benefits phase-out?	\$95,000-\$110,000  \$190,000 - \$220,000 for joint returns	No phase-out	No phase-out	\$77,200-\$92,200  \$115,750 - \$145,750 for joint and qualifying widow(er) with a dependent child returns	No phase-out	No phase-out
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Generally, two reasons have been given for the various education tax incentives. First, college education costs are increasing and are a barrier to entry for those who cannot afford the costs. Second, college education is generally a good investment that can produce positive external benefits that extend beyond the individual benefits gained by those investing in education.

According to the National Center for Education Statistics, the cost of college education for the 2011-12 academic year -- annual prices for undergraduate tuition, room and board -- were estimated to be \$14,300 at public institutions and \$37,800 at private not-for-profit institutions.<sup>311</sup> Between 2001-02 and 2011-12, costs for undergraduate tuition, room and board at public institutions rose 40 percent, and costs at private not-for-profit institutions rose 28 percent, after adjustment for general price inflation.<sup>312</sup>

The high cost of a college education does create a barrier to entry. However, some portion of the barrier is alleviated by the U.S. Department of Education's Direct Loan Program (such as Stafford Loans), Federal Perkins Loans, Federal Work Study, Federal Supplemental Educational Opportunity Grants and the Federal Grant Program (such as Pell Grants) for lower income students. In fact, according to the John William Pope Center for Higher Education Policy, of the

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<sup>311</sup> NATIONAL CENTER FOR EDUCATION STATISTICS, FAST FACTS, TUITION COSTS OF COLLEGES AND UNIVERSITIES, available at <http://nces.ed.gov/fastfacts/display.asp?id=76> (accessed July 2, 2014).

<sup>312</sup> Id.

16.4 million undergraduate students enrolled in college in the United States in 2010, approximately 58 percent or 9.6 million students received Pell Grants.<sup>313</sup>

A frank conversation about higher education tax incentives must also consider whether Congress is encouraging higher education tuition inflation and a student-debt bubble. Do these incentives, which spur demand for higher education services, dull incentives of universities to operate efficiently? Are these incentives encouraging students to take on more debt and degrees than is warranted by the economic and professional gain they are likely to realize from their educational achievements?

In evaluating the education tax incentives, we use the same three factors that are used in evaluating all tax incentives: fairness, efficiency and simplicity. Some critical questions that arise when evaluating education tax incentives are whether federal subsidization of higher education is good policy and whether a tax subsidy would be provided more efficiently by direct spending.

In 1987, then Secretary of Education William Bennett stated that, in the long run, Federal financial aid programs lead to higher tuition as colleges capture some of the Federal aid to students.<sup>314</sup> Some studies have demonstrated the validity of the Bennett hypothesis.<sup>315</sup> Does the

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<sup>313</sup> See Jenna Ashley Robinson and Duke Cheston. *Pell Grants: Where Does All the Money Go?* Pope Center Series on Higher Education (June 2012).

<sup>314</sup> William Bennett, *Our Greedy Colleges*, N.Y. TIMES, Feb. 18, 1987.

<sup>315</sup> See, e.g., Michael J. Rizzo and Ronald G. Ehrenberg, *Resident and Nonresident Tuition and Enrollment at Flagship State Universities*, in COLLEGE CHOICES: THE ECONOMICS OF WHERE TO GO, WHEN TO GO, AND HOW TO PAY FOR IT (Caroline M. Hoxby, ed., 2004) (“Consistent with the Bennett hypothesis, we find substantial evidence that increases in the generosity of the federal Pell Grant program, access to subsidized loans, and state need-based grant aid awards lead to increases in in-state tuition levels. However, we find no evidence that nonresident tuition is increased as a result of these programs.”); Larry D. Singell, Jr. and Joe A. Stone, *For Whom the Pell Tolls: Market Power, Tuition Discrimination, and the Bennett Hypothesis* (Apr. 2003), available at <https://scholarsbank.uoregon.edu/xmlui/bitstream/handle/1794/114/2003-12.pdf?sequence=1> (accessed Dec. 4, 2014) (little evidence of the Bennett hypothesis among either public or lower-ranked private universities; for top-ranked private universities, increases in Pell grants appear to be more than matched by increases in net tuition); Stephanie Riegg Cellini and Claudia Goldin,

Bennett hypothesis apply to Federal student aid in the form of education incentives in the tax code? In other words, do colleges and universities capture the financial benefits of education tax incentives at the expense of eligible students and families? One recent economic paper indicates that is the case.<sup>316</sup>

As to simplicity, one noted tax scholar, Michael Graetz, has written, “Together [the education tax incentives] represent the greatest increase in federal funding for higher education since the GI Bill. But no one can tell you what they are, how they work, or how they interact. They have no doubt aided tuition increases so we now have higher education expenses growing at a rate exceeded only by healthcare. Planning to pay for college around these tax breaks is essentially impossible for middle-income families.”<sup>317</sup> The education tax incentives are very complex and, at a minimum, should be consolidated and reformed.

In 2005, the President’s Advisory Panel on Federal Tax Reform proposed that the credits and deductions for education be replaced with a Family Credit allowance of \$1,500 for all families with full-time students age 20 and under.<sup>318</sup> The Panel also recommended that families be allowed to save for future education expenses on a tax-free basis through a Save for Family account. Amounts saved in the account could be used for education, medical, new home costs and retirement savings and would be available to all taxpayers.

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*Does Federal Student Aid Raise Tuition? New Evidence on For-Profit Colleges*, NBER Working Paper Series, Working Paper 17827 (Feb. 2012) (“some credence to a variant of the ‘Bennett hypothesis’ that aid-eligible for-profit institutions capture a large part of the federal student aid subsidy”); Michael J. Graetz, *VAT as the Key to Real Tax Reform*, in *THE VAT READER: WHAT A FEDERAL CONSUMPTION TAX WOULD MEAN FOR AMERICA* (2011).

<sup>316</sup> See Nicholas Turner, *Who Benefits from Student Aid? The Economic Incidence of Tax-Based Federal Student Aid*, 31 *ECON. EDUC. REV.* 463 (2012).

<sup>317</sup> Michael J. Graetz, *VAT as the Key to Real Tax Reform*, *supra* note 315.

<sup>318</sup> REPORT OF THE PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, *supra* note 284, at ch. 5.

The American Institute for Certified Public Accountants (AICPA) has also proposed harmonizing and simplifying the education-related tax provisions.<sup>319</sup> The AICPA categorized the various education tax incentives into two categories: (1) those that are intended to help taxpayers meet current higher education expenses and (2) those that encourage taxpayers to save for future education expenses. The first category includes incentives such as the exclusion for qualified scholarships, deduction for tuition and fees, the Hope Credit, the American Opportunity Tax Credit and the Lifetime Learning Credit. The second category includes provisions such as educational savings bonds, qualified tuition programs and Coverdell Education Savings Account. It seems that a number of provisions in each of the two categories could be consolidated and simplified.

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<sup>319</sup> American Institute for Certified Public Accountants, *Compendium of Legislative Proposals, Simplification and Technical Proposals* (Feb. 2013), available at <http://www.aicpa.org/advocacy/tax/taxlegislationpolicy/downloadabledocuments/compendium%20of%20legislation%20proposals%20february%202013.pdf> (accessed Nov. 13, 2014).

## Chapter 5: Business Tax Reform

There seems to be a lot of interest in corporate tax reform, which is understandable given that the top U.S. corporate tax rate of 35 percent is about 10 percentage points higher than the average top corporate tax rate of the other Organization for Economic Development and Cooperation (OECD) countries. In fact, President Clinton, who proposed increasing the top corporate tax rate by one percentage point to 35 percent in 1993, noted that his administration did not want to exceed the OECD average.<sup>320</sup> But corporate tax reform should really be viewed as part of business tax reform. Unlike many other countries of the world, many U.S. businesses are conducted as partnerships, limited liability companies or S corporations. Such business entities are not subject to the corporate tax and therefore would not be directly affected by any corporate-only tax reform.

As is well known, the earnings of a corporation are taxed once at the corporate level and a second time at the shareholder level if the earnings are distributed in the form of a dividend to a taxpaying recipient.<sup>321</sup> As a result, the earnings of a corporation may be subject to two levels of taxation, a system generally referred to as the classical system of taxation.

For many years, the U.S. Treasury Department, the organized tax bar, and other interested parties have advanced a number of proposals to integrate the individual and corporate level of taxes. Eliminating the two-tier tax system would reduce or eliminate at least four distortions to economic and financial choices: (1) the incentive to invest in non-corporate businesses rather than corporate businesses, (2) the incentive to finance corporations with debt rather than equity, (3) the

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<sup>320</sup> See Laura Lorenzetti, *Clinton Says Corporate Tax Rate He Approved Needs to Change*, FORTUNE (Sept. 23, 2014).

<sup>321</sup> If the earnings of the corporation are not distributed, then a second level of tax may occur upon sale of the stock of the corporation resulting in capital gain to the selling shareholder.

incentive to either retain or distribute earnings depending on the relationship among the corporation, the shareholder and the capital gains tax rates, and (4) the incentive to distribute earnings in a manner to avoid or significantly reduce a second level of tax, such as payments giving rise to deductions or stock repurchases that give rise to basis recovery and capital gains.

It makes no sense today to have two levels of taxation of corporate earnings.<sup>322</sup> As a general proposition, if income is to be taxed, it should only be taxed once. In fact, it never really made sense to have two levels of taxation even in the early years of our income tax system. All business income should generally be subject to a single level of tax – either at the entity level or at the owner level. The difficult decision is not whether business income should be subject to more than one level of tax -- it should not -- but whether the business income should be taxed at the entity level or at the owner level. In 1987, Congress made a decision to distinguish partnerships taxed at the entity level or at the owner level depending on whether the ownership of the partnership was publicly traded.<sup>323</sup> Under the law, if the ownership was publically traded, the partnership would be taxed under the corporate tax regime. If the ownership was not publicly traded, then the partnership would be treated as a pass-through with the income taxed at the owner level. That distinction made sense in 1987 and may still make sense today. Having access to the capital markets is a reasonable and sensible dividing line between taxable and non-taxable

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<sup>322</sup> See Daniel Halperin, *Mitigating the Potential Inequity of Reducing Corporate Tax Rates*, TAX POLICY CENTER WORKING PAPER (July 29, 2009) at 5 (“Integrating the corporate and individual taxes is a more direct way of equating the treatment of pass-through entities with taxation of corporate income. As opposed to two levels of taxes, each lower than the top individual rate, integration taxes corporate earnings once, most commonly at the individual rate.”).

<sup>323</sup> IRC sec. 7704.

entities.<sup>324</sup> A dividing line based on gross receipts or total assets appears to be purely artificial and random.

Publicly traded entities should be subject to tax under the corporate tax regime. The earnings of such entities should be taxed at the entity level. However, any distributions made by such entity should either be deductible by the entity (“dividends paid deduction”) or excludable by the recipient (“dividend exclusion”). Integration of the corporate and individual taxes could be achieved by either method. A dividends paid deduction would generally be easy to implement and would largely equalize the treatment of debt and equity. Although special rules are generally needed in any integration proposal to address tax-exempt and foreign shareholders, existing tax rules could be modified to resolve any issues under a dividends paid deduction. If a dividends paid deduction is coupled with a withholding tax, it becomes equivalent to the shareholder imputation approach, which has been advocated by a number of tax scholars.<sup>325</sup>

Alternatively, a dividend exclusion approach could be implemented to achieve integration. Such an approach would not completely equalize the treatment of debt and equity; however, such an approach would probably be easier to implement than a dividends paid deduction, particularly with respect to tax-exempt and foreign shareholders.

Non-publicly traded entities should be treated as pass-through entities so that the income of such entities is taxed directly to the owners. Such pass-through treatment would apply whether the entity is formed as a corporation, partnership or limited liability company. The pass-through

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<sup>324</sup> See, e.g., Victor Fleischer, *Taxing Blackstone*, 61 TAX L. REV. 89 (2008); Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?* 39 CASE W. RES. L. REV. 965 (1989); David A. Weisbach, *Line Drawing, Doctrine and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627 (1999). Some have suggested that with the rise of private equity, a dividing line based on access to the capital markets may make less sense today than in 1987.

<sup>325</sup> See Michael J. Graetz and Alvin C. Warren, Jr., *Unlocking Business Tax Reform*, 145 TAX NOTES 707 (Nov. 10, 2014).



regime would be modeled along the lines of subchapter S and the partnership tax regimes.<sup>326</sup> If an administratively feasible system could be enacted to tax publicly-traded entities under a pass-through regime, then such an approach should be considered. In an ideal tax system, all business income would be taxed to the owners of the business.

In addition, the top U.S. corporate tax rate should be reduced to make U.S. corporations more competitive with their foreign counterparts. With a top corporate tax rate of 35 percent (coupled with an average four percent state corporate tax rate), U.S. companies face the highest corporate tax rate in the developed world.<sup>327</sup> The top corporate tax rate should be significantly reduced to bring the United States in alignment with other developed countries, if not lowered even further to make our system even more competitive. The top individual rate should also be substantially reduced. Having both corporate and individual rates at approximately the same percentages will achieve a large measure of parity in the taxation of business income, whether earned by a publicly-traded corporation, a non-publicly traded corporation, partnership, limited liability company or sole proprietorship.<sup>328</sup>

#### A. Background on Corporate Tax Integration

In 1909, Congress enacted a corporate income tax, and four years later, an individual income tax. As a result, beginning in 1913, both corporations and individuals were subject to income taxes. Congress minimized the risk of double taxation of corporate earnings by excluding dividends from the normal tax on individual income.<sup>329</sup> The corporate tax rate was also tied to the

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<sup>326</sup> See AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT – TAXATION OF PRIVATE BUSINESS ENTERPRISES, REPORTERS’ STUDY (1999).

<sup>327</sup> See Scott A. Hodge, *The Countdown is Over. We’re #1* (April 1, 2012), available at <http://taxfoundation.org/article/countdown-over-were-1> (accessed Nov. 14, 2014).

<sup>328</sup> See Halperin, *supra* note 322.

<sup>329</sup> See Steven A. Bank, *Is Double Taxation a Scapegoat for Declining Dividends? Evidence from History*, 56 TAX L. REV. 463 (2003).

individual tax rate. Dividends could, however, be subject to an individual surtax applied at progressive tax rates. By exempting dividends from the normal individual tax, Congress ensured that corporate and non-corporate income were treated in a similar manner. Corporate income was subject to both the one percent corporate income tax and the individual surtax (if applicable), but not to the normal individual tax. Non-corporate business income was subject to both the one percent normal individual tax and the individual surtax (if applicable), but not to the corporate income tax. As a result, the corporate income tax operated as a quasi-withholding provision for the individual income tax.<sup>330</sup>

In 1936, Congress enacted a split rate corporate income tax, which is a form of corporate integration.<sup>331</sup> Distributed income (i.e., income paid out as dividends) was taxed at rates ranging from eight percent to 15 percent. Undistributed income (i.e., retained earnings) was subject to an additional surtax with rates ranging from seven percent to 27 percent. The existence of the additional surtax on undistributed income encouraged a substantial increase in dividend payouts.<sup>332</sup> The Joint Committee on Taxation has written that during the two years the additional surtax was in effect (1936 and 1937), estimates were that dividend payouts increased by one-third as a result of the changed tax treatment.<sup>333</sup> In 1938, the undistributed income surtax was repealed.

For the next 35 years, interest in corporate integration remained mostly dormant.<sup>334</sup> But, in the early to mid-1970s, serious interest began in integrating the individual and corporate level

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<sup>330</sup> *Id.*

<sup>331</sup> See Jack Taylor, *Corporate Income Tax Brackets and Rates, 1909-2002*, STATISTICS OF INCOME BULLETIN (Fall 2003).

<sup>332</sup> See JOINT COMMITTEE ON TAXATION, TAX POLICY AND CAPITAL FORMATION, JCS-14-77 (Apr. 4, 1977) at 17.

<sup>333</sup> *Id.*

<sup>334</sup> During part of this time, there was very modest corporate integration. From 1954 until 1964, individual shareholders were permitted a credit for a fixed percentage of dividends received. A partial exclusion was also in effect from 1954 until 1986.

taxes in the United States.<sup>335</sup> Several factors contributed to this interest. First, businesses and some economists were arguing that the double taxation of corporate earnings was responsible for a shortfall in capital formation.<sup>336</sup> Integration, they believed, would help in relieving the capital shortage. Second, some major European countries had started providing partial dividend tax relief.<sup>337</sup> Third, in 1975, the Commission of the European Communities issued a proposal for a directive on the harmonization of company income taxes.<sup>338</sup> As part of the proposal, the Commission suggested that all nine member countries provide relief for 45 to 55 percent of the double taxation of dividends.<sup>339</sup> Also, a report by the Royal Commission on Taxation, commonly referred to as the Carter Commission, suggested that total integration might be feasible.<sup>340</sup>

On July 8, 1975, Secretary of the Treasury William Simon appeared as the first witness before the House Ways and Means Committee in series of hearings focusing on tax reform.<sup>341</sup> Secretary Simon stressed the need for integrating the individual and corporate taxes to keep pace with many foreign countries that had integrated their tax systems. Integration, Secretary Simon argued, would eliminate the bias in favor of debt, improve the efficiency of capital allocation, make the capital markets more competitive, lessen the tension between ordinary income and capital gain, and be a great help to utilities and other industries whose investors rely on a steady

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<sup>335</sup> See CHARLES E. MCLURE, JR., *MUST CORPORATE INCOME BE TAXED TWICE?* (1979) at 7.

<sup>336</sup> *Id.* at 8.

<sup>337</sup> *Id.*

<sup>338</sup> Commission of the European Communities, *Proposal for a Council Directive Concerning the Harmonization of Systems of Company Taxation and of Withholding Taxes on Dividends* (transmitted to the Council by the Commission on Aug. 1, 1975), *Bulletin of the European Communities*, Supplement 10/75.

<sup>339</sup> *Id.* at 20.

<sup>340</sup> ROYAL COMMISSION ON TAXATION, *REPORT OF THE ROYAL CANADIAN COMMISSION ON TAXATION*, vol. 4, ch. 19 (1966).

<sup>341</sup> Public Hearings Before the Committee on Ways and Means, House of Representatives, 94<sup>th</sup> Cong., 1<sup>st</sup> Sess., *On the Subject of Tax Reform (Part 1 of 5)*, July 8, 9, 10 and 11, 1975, at 1, 34-35.

stream of dividends. Simon noted the high cost associated with integration. He stated that the Joint Committee on Taxation and the Treasury Department were working on a joint, in-depth study of integration that would be ready after the August recess.

On July 31, 1975, Simon returned before the Ways and Means Committee with a specific proposal for integration.<sup>342</sup> Under Simon's proposal, corporations would deduct approximately half of their dividends paid. The remaining portion of the dividends would fall under the shareholder or imputation credit mechanism to relieve double taxation by allowing the shareholders a credit for the income taxes paid by the corporation.

In January 1977, the Treasury Department issued "Blueprints for Basic Tax Reform."<sup>343</sup> As part of its report, Treasury proposed full integration by having the income of a corporation flow-through to its shareholders.<sup>344</sup> As a result, corporate earnings would be fully taxed to the shareholders at the rates appropriate to each shareholder. Treasury also proposed a cash flow tax.

In April 1977, the Joint Committee on Taxation issued a pamphlet addressing the need for greater capital accumulation.<sup>345</sup> In accomplishing this goal, the JCT made several suggestions, including integrating the corporate and individual income taxes. The JCT discussed three methods of integration: an imputation credit in which the shareholders would claim a credit for the corporate income taxes allocable to the dividends received, a flow-through approach in which all corporate income would flow through to the shareholders along with the corporate income taxes

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<sup>342</sup> Public Hearings Before the Committee on Ways and Means, House of Representatives, 94<sup>th</sup> Cong., 1<sup>st</sup> Sess., On the Subject of Tax Reform (Part 5 of 5), July 29, 30 and 31, 1975, at 3843, 3852-3861.

<sup>343</sup> U.S. DEPARTMENT OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM (Jan. 1977).

<sup>344</sup> *Id.* at 68-75.

<sup>345</sup> JOINT COMMITTEE ON TAXATION, TAX POLICY AND CAPITAL FORMATION, *supra* note 332.

paid that would be creditable by the shareholders, and a dividends paid deduction in which corporations would deduct any dividends paid to the shareholders.

In September 1977, the Treasury Department presented a proposal for integrating the individual and corporate income taxes.<sup>346</sup> Treasury proposed an imputation credit regime in which a portion of the corporate income tax would be treated as a withholding tax on dividends to the individual shareholders. The amount treated as a withholding tax would then be allowed as a credit in calculating the shareholder's tax liability. Ultimately, the Carter Administration decided not to pursue integration because of the complexity and the perceived need for an immediate economic stimulus.<sup>347</sup>

On February 2 and March 22, 1978, House Ways and Means Chairman Al Ullman (D-OR) introduced an integration proposal.<sup>348</sup> Under his proposal, shareholders would receive a tax credit equal to a percentage of their dividend income. The percentage would begin at 10 percent and gradually increase to 20 percent. Credits allowable to the shareholders would be limited to the amount in a shareholder credit account. Whenever allowable shareholder credits exceeded this limitation, a corporation would be given the choice of either paying a tax to the government that

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<sup>346</sup> U.S. DEPARTMENT OF THE TREASURY, TAX REFORM OPTION PAPERS NO. IX, BUSINESS TAX REDUCTIONS (Sept. 2, 1977), reprinted in Select Committee on Small Business, United States Senate, 1978 Tax Proposals Relating to Small Business: Analysis of Administration's 1978 Small Business Tax Proposals and Certain Alternative Approaches, 95<sup>th</sup> Cong., 2d Sess., Appendix II (1978).

<sup>347</sup> See Statement of Donald C. Lubick, Acting Assistant Secretary of the Treasury for Tax Policy, Integration of the Corporate and Individual Income Tax, before the Committee on Ways and Means of the House of Representatives, April 7, 1978, Treasury Department News Release, B-818.

<sup>348</sup> Partial Corporate Integration – Relief from Double Taxation of Dividends, Congressional Record, February 2, 1978, 2132-2134; Partial Corporate Integration – Relief from Double Taxation of Dividends, Congressional Record, Mar. 22, 1978, 7978-7980.

would be treated as additional shareholder credits or electing a lower rate of shareholder credit for the shareholders.

In 1982, the American Law Institute published a report on corporate taxation, which included a Reporter's Study on corporate distributions.<sup>349</sup> The Reporter's Study included three proposals, all of which were related to corporate integration. First, the Reporter proposed a dividends paid deduction in an amount not exceeding a statutorily specified rate on newly issued stock. The proposal was designed to better equalize the tax treatment of debt and equity and to relieve the bias against new equity. The Reporter also proposed a flat-rate, compensatory withholding tax on non-dividend distributions. This proposal was designed to address the bias in favor of non-dividend distributions. The Reporter's final proposal established differing tax treatment between direct and portfolio investment by a corporation in the stock of another corporation. A portfolio investment would no longer qualify for the dividends received deduction. A direct investment would still qualify for the dividends received deduction but the purchase of shares would be treated as a non-dividend distribution and therefore subject to the compensatory withholding tax.

In November 1984, the Treasury Department issued a report to substantially reform the U.S. income tax system.<sup>350</sup> As part of its report, which is generally referred to as Treasury I, Treasury proposed relief for the double taxation of corporate earnings. Treasury noted that there are two alternative ways to provide such relief: (a) an imputation credit regime in which a shareholder is given credit for a portion of the corporate tax attributable to the dividends received

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<sup>349</sup> AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT -- SUBCHAPTER C: PROPOSALS ON CORPORATE ACQUISITIONS AND DISPOSITIONS AND REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS (1982).

<sup>350</sup> U.S. DEPARTMENT OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH (1984).

or (b) a dividends paid deduction. Treasury opted for the dividends paid deduction believing it to be the simpler of the two methods. However, Treasury limited the deduction to 50 percent of the dividends paid based on revenue concerns.

In May 1985, President Ronald Reagan submitted to the Congress a revised version of the Treasury report on reforming the U.S. income tax system.<sup>351</sup> In the report, which is generally referred to as Treasury II, President Reagan proposed a dividends paid deduction to alleviate the double taxation of corporate earnings. However, the amount of the deduction was reduced from 50 percent (in Treasury I) to only 10 percent of the dividends paid, again based on revenue concerns.

In December 1985, the House of Representatives passed H.R. 3838, the Tax Reform Act of 1985. As part of the bill, the House included a 10 percent dividends paid deduction that would be phased-in over 10 years. The deduction would not be available to regulated investment companies (RICs), real estate investment trusts (REITs), S corporations, cooperatives subject to Subchapter T, domestic international sales corporations (DISCs) or foreign sales corporations (FSCs). The House included a provision treating a dividend received by a tax-exempt organization as unrelated business income subject to tax if the organization owned five percent or more of the vote or value of the corporation. The House also included a provision imposing an additional withholding tax on dividends paid to foreign shareholders. The House's dividends paid deduction proposal was not enacted as part of the Tax Reform Act of 1986.

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<sup>351</sup> THE WHITE HOUSE, THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH AND SIMPLICITY (1985).

In June 1989, the American Law Institute issued a supplemental study to its 1982 corporate tax study.<sup>352</sup> The ALI proposed a dividends paid deduction but only with respect to corporate equity acquired after the date of enactment (so-called new equity). The reasoning was that the capital markets had already discounted the price of pre-enactment corporate equity to reflect the two levels of taxation of corporate earnings. Any dividends paid deduction for pre-enactment corporate equity would result in an unjustified windfall to current shareholders.

In January 1992, the Treasury Department published a report on integrating the individual and corporate tax systems so as to tax business income only once.<sup>353</sup> Treasury noted that “most trading partners of the United States have integrated their corporate tax systems.” In its report, Treasury did not make any specific legislative recommendations but did discuss in detail four prototypes to achieve integration: a dividend exclusion prototype, a shareholder allocation prototype, a comprehensive business income tax (CBIT) prototype, and an imputation credit prototype. Under the dividend exclusion prototype, a shareholder would exclude a dividend from gross income. Under the shareholder allocation prototype, the income of the corporation would flow-through to the shareholders of the corporation. The shareholders would then pay tax on their respective shares of the income of the corporation. Under CBIT, a business enterprise would be subject to an entity level tax on its taxable income but would not be permitted to deduct interest or dividends in determining its taxable income. The bondholders and shareholders would not include interest or dividends in gross income.

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<sup>352</sup> AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: SUBCHAPTER C (SUPPLEMENTAL STUDY), REPORTER’S STUDY DRAFT (June 1, 1989).

<sup>353</sup> U.S. DEPARTMENT OF THE TREASURY, REPORT OF THE DEPARTMENT OF THE TREASURY ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEM: TAXING BUSINESS INCOME ONCE (Jan. 1992).



Under the imputation credit prototype, which Treasury listed under “Roads Not Taken,” a shareholder would be taxed on the gross amount of a dividend, which would include the cash dividend and the associated tax paid at the corporate level. The shareholder would then be given a credit equal to the amount of corporate tax associated with the dividend. Treasury briefly noted an additional method of achieving integration -- the dividends paid deduction, but also relegated it to the “Roads Not Taken.”

In December 1992, Treasury, in a supplemental report to its integration study, recommended that Congress adopt the dividend exclusion prototype to integrate the individual and corporate tax systems.<sup>354</sup> Treasury believed that the dividend exclusion prototype would be the most straight-forward and easily administered of the various integration prototypes that it had considered, would involve fewer transition costs and less disruption to financial markets, and would bear a closer resemblance to a schedular tax on business activity.<sup>355</sup>

In March 1993, the American Law Institute (ALI) published an extensive report on corporate integration.<sup>356</sup> The ALI proposed an imputation credit prototype to alleviate double taxation. In essence, the ALI proposal would convert the existing corporate income tax into a withholding tax with respect to income ultimately distributed to shareholders.

In January 2003, President George Bush presented his growth package in which dividends paid by a corporation would be excluded from a shareholder’s gross income.<sup>357</sup> Under President

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<sup>354</sup> U.S. DEPARTMENT OF THE TREASURY, A RECOMMENDATION FOR INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS (Dec. 1992).

<sup>355</sup> A schedular tax is a tax system in which income is divided into different classifications to, for example, apply different tax rates.

<sup>356</sup> AMERICAN LAW INSTITUTE, INTEGRATION OF INDIVIDUAL AND CORPORATE INCOME TAXES (1993).

<sup>357</sup> See JOINT COMMITTEE ON TAXATION, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT’S FISCAL YEAR 2004 BUDGET PROPOSAL, JCS-7-03 (Mar. 2003) at 18-33.

Bush's proposal, a corporation would maintain an Excludable Dividend Amount (EDA). The EDA would reflect income of the corporation that had been fully taxed. Any dividends paid by the corporation would be excludable from a shareholder's gross income to the extent of the EDA.

On February 27, 2003, House Ways and Means Chairman William Thomas (R-CA) introduced H.R. 2, the Jobs and Growth Tax Act of 2003, and Senators Don Nickles (R-OK) and Zell Miller (D-GA) introduced S.2, the Jobs and Growth Tax Act of 2003. The bills proposed an exclusion from gross income for dividends received by shareholders. If the excludable amount of dividends exceeded the dividends paid by the corporation during the year, the excess would be treated as an increase to the basis of stock in the corporation. The dividend exclusion proposal was dropped in favor of a reduced tax rate on dividend income when the bill was passed by the House in May 2003. In the Senate bill, which passed the Senate in May 2003, a provision was included that provided a dividend exclusion of 50 percent of the amount of the dividend in 2003 and then complete exclusion for the next three years.

In May 2003, Congress passed the Jobs and Growth Tax Relief Reconciliation Act of 2003. As part of the Act, Congress provided "preferential" tax treatment for dividend income to partially alleviate the double tax on corporate earnings. Most types of dividend income would be taxed the same as net capital gain, thereby being taxed at a rate no higher than 15 percent for individual shareholders. The preferential tax treatment for dividend income was scheduled to expire at the end of 2008 but was extended for two years by the Tax Increase Prevention and Reconciliation Act of 2005. It was extended again at the end of 2010 for another two years by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 and then made permanent with a rate no higher than 20 percent for individual shareholders by the American Taxpayer Relief Act of 2012.

In November 2005, the President's Advisory Panel on Tax Reform issued its report containing proposals to fix America's tax system.<sup>358</sup> The panel recommended two options that would integrate the individual and corporate level taxes. Under the first option, which the panel called the Simplified Income Tax (SIT) Plan, all dividends paid by U.S. corporations out of domestic earnings would be excluded from the shareholder's gross income. In addition, to help level the playing field between corporations that pay out earnings in the form of dividends and those corporations that retain their earnings, 75 percent of the capital gains on the sale of stock of U.S. corporations would be excluded from gross income. Under the second option, which the panel called the Growth and Investment Tax (GIT) Plan, a uniform tax would apply to a business's cash flow with the business not permitted to deduct interest or dividends. At the individual shareholder level, a flat rate tax of 15 percent would apply to dividends, interest and capital gains.

In August 2010, the President's Economic Recovery Advisory Board issued its report on tax reform options.<sup>359</sup> The board noted that one option to achieving tax neutrality with respect to the organizational form of business is through integration. The board gave as an example, the imputation credit method of achieving integration, noting that a number of OECD countries, including the United Kingdom, Canada and Mexico, have used such a system. The Board noted the revenue cost associated with integration but suggested that the cost could be offset by taxing corporate income at a higher tax rate at the individual level.

## B. Summary of Hearings Involving Corporate Tax Integration

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<sup>358</sup> THE PRESIDENT'S ADVISORY PANEL ON TAX REFORM, SIMPLE, FAIR AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM (Nov. 2005).

<sup>359</sup> THE PRESIDENT'S ECONOMIC RECOVERY ADVISORY BOARD, THE REPORT ON TAX REFORM OPTIONS: SIMPLIFICATION, COMPLIANCE AND CORPORATE TAXATION (2010).

On March 8, 2011, the Senate Finance Committee held a hearing titled “Does the Tax System Support Economic Efficiency, Job Creation and Broad-Based Economic Growth?” Several of the witnesses addressed integration of the individual and corporate income taxes as part of their testimony.

Dr. Alan Auerbach noted in his testimony that the corporate tax imposes important distortions that hinder economic activity.<sup>360</sup> According to his argument, the favorable tax treatment of debt encourages corporate borrowing. Auerbach found it hard to believe that the United States is still wedded to a tax system that encourages borrowing. But he also noted that while limiting the deductibility of interest would not only encourage equity financing and a more productive investment mix, it would also discourage investment overall by raising the corporate cost of capital. As a result, to implement corporate tax reform without discouraging investment, Auerbach proposed a cash-flow corporate tax to eliminate all net tax on new investments. The corporate tax on equity-financed investments and the corporate subsidy of debt-financed investments would both be eliminated.

Professor Michael Graetz noted that while many people say, in shorthand, that the United States has a double tax system of taxing corporate earnings, it is actually much more complex.<sup>361</sup> Some income earned at the corporate level is only taxed once at the corporate level, such as corporate income distributed as dividends to tax-exempt shareholders. Other income earned at the corporate level is only taxed once at the shareholder level, such as corporate income distributed as

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<sup>360</sup> Statement of Alan J. Auerbach, Does the Tax System Support Economic Efficiency, Job Creation and Broad-Based Economic Growth? Testimony Before the Committee on Finance, United States Senate (Mar. 8, 2011).

<sup>361</sup> Statement of Michael J. Graetz, Does the Tax System Support Economic Efficiency, Job Creation and Broad-Based Economic Growth? Testimony Before the Committee on Finance, United States Senate (Mar. 8, 2011).

deductible interest payments to taxable lenders. Finally, some income earned at the corporate level is not taxed at all, such as deductible interest payments to foreign and tax-exempt lenders. As a result, corporate income is sometimes taxed twice in the United States, sometimes taxed once, and sometimes not taxed at all.

Graetz noted the four commonly mentioned distortions created by the current U.S. system of taxing corporate earnings: disincentive for investment in new corporate capital, incentive for corporate financing by debt or retained earnings, incentive to distribute or retain corporate earnings, and incentive to distribute corporate earnings in tax-preferred forms. Graetz believed that it would be easier and better tax policy to collect taxes on business income from individual citizens and resident shareholders than from multinational business enterprises. In fact, according to Graetz's testimony, the current tax system could be improved by flipping the rates, so that a 15 percent tax rate applied to corporate income and a 35 percent tax rate applied to dividend recipients.

In addition, Graetz proposed converting a portion of the current corporate income tax into a creditable but nonrefundable withholding tax on distributions to both a companies' shareholders and bondholders. Ultimately, Graetz believed that because the corporate tax is a bad tax in which the economic burden appears to be borne, in substantial part, by labor (according to the most recent economic studies), shifting the tax burden from corporations to shareholders and bondholders may increase progressivity.

On August 1, 2012, the Senate Finance Committee held a hearing titled "Tax Reform: Examining the Taxation of Business Entities." Several of the witnesses addressed integration of the individual and corporate income taxes as part of their oral and written testimonies. Professor Alvin Warren noted that the current U.S. system of taxing corporate income distorts several

economic and financial choices.<sup>362</sup> The distortions depend on the relationship of four tax rates: the rate on corporate income, the rate on individual investment income, the rate on dividend receipts, and the capital gains rate on the sale of corporate shares. Professor Warren noted that attempts to integrate corporate and investor taxes have usually involved one of the following four approaches: shareholder credit for corporate taxes paid, corporate deduction for dividends paid, shareholder exemption for dividends received, and rate alignment. He recommended the shareholder credit method of integration because it would ensure that corporate income would be taxed only once at the same graduated rates applied to capital income earned by investors outside such entities.

### C. Description of Current Law

In general, corporations are treated as separate taxable entities.<sup>363</sup> As a result, a corporation must compute its taxable income on an annual basis and pay taxes to the U.S. government.<sup>364</sup> The income of the corporation is not taxable to its shareholders until it is distributed to them. If the corporation distributes cash or property to its shareholders, the distribution is treated as a dividend

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<sup>362</sup> Statement of Alvin C. Warren, Tax Reform: Examining the Taxation of Business Entities, Testimony Before the Committee on Finance, United States Senate (Aug. 1, 2012).

<sup>363</sup> One exception is the taxation of S corporations. IRC sec. 1363(a). The taxable income of an S corporation passes through the corporation and is taxed directly to the shareholders. IRC sec. 1366. As a result, an S corporation is not a separate taxable entity. An S corporation is limited to 100 U.S. shareholders and is only permitted to have one class of stock. IRC sec. 1361(b). However, even an S corporation may be subject to an entity level tax. If an S corporation was formerly a C corporation and has a net recognized built-in gain, it will be taxed on such gain at the highest corporate tax rate. IRC sec. 1374. If an S corporation has accumulated earnings and profits and gross receipts more than 25 percent of which are passive investment income, then it will be taxed on its excess net passive income at the highest corporate tax rate. IRC sec. 1375.

<sup>364</sup> IRC sec. 11.

to the extent of the corporation's earnings and profits.<sup>365</sup> The shareholder must include the dividend in gross income and pay taxes on it.<sup>366</sup>

Under current law, a corporation may not deduct a dividend. As a result, distributed corporate income may be taxed twice – once at the corporate level (by denying the corporation a deduction for any dividends paid) and a second time at the shareholder level (by requiring the shareholder to include the dividend in gross income). In contrast, corporate earnings distributed in the form of interest to creditors are subject to only a single level of tax at the creditor level (by requiring the creditor to include the interest in gross income). The corporation deducts the interest, thereby avoiding tax at the corporate level.<sup>367</sup>

Corporate income distributed as a dividend to tax-exempt shareholders is, in essence, taxed only at the corporate level – the dividend is not deductible to the corporation and not taxed to the tax-exempt shareholder.<sup>368</sup> In contrast, corporate earnings distributed in the form of interest to tax-exempt lenders are not subject to any tax. The corporation deducts the interest, and the tax-exempt lenders are not taxed on receipt of the interest. Corporate income distributed as a dividend to foreign shareholders is generally subject to two levels of tax. The corporation is not permitted to deduct the dividend, and the foreign shareholder is subject to a 30 percent withholding tax on the dividend.<sup>369</sup> However, the withholding tax may be reduced under an income tax treaty.<sup>370</sup> Corporate income distributed as interest to a foreign creditor is generally subject to no U.S. tax. The corporation may deduct the interest, and the foreign creditor is generally not subject to the 30

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<sup>365</sup> IRC sec. 316.

<sup>366</sup> IRC sec. 301(c); 61(a)(7).

<sup>367</sup> IRC sec. 163(a).

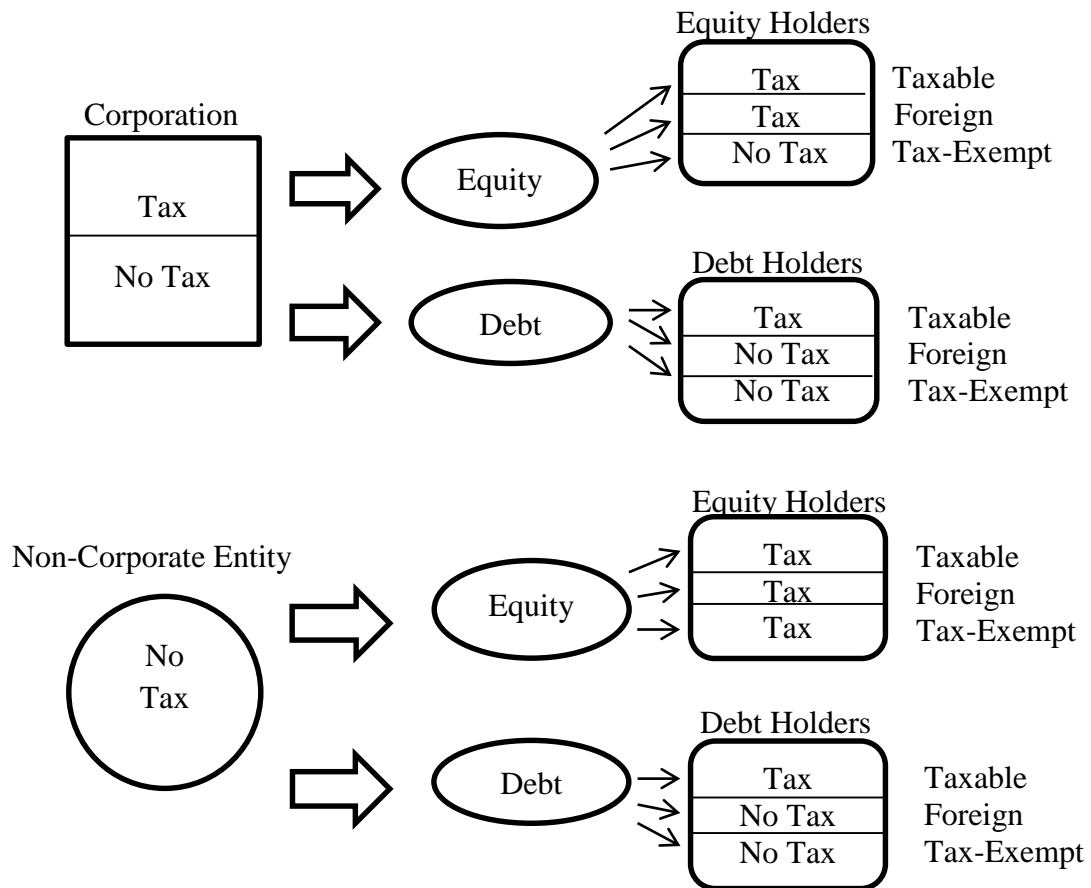
<sup>368</sup> IRC sec. 512(b)(1).

<sup>369</sup> IRC secs. 871, 881, 1441 and 1442.

<sup>370</sup> IRC sec. 894(a); U.S. Model Income Tax Convention, November 15, 2006, art. 10(2).

percent withholding tax under either the Internal Revenue Code or an income tax treaty.<sup>371</sup> As a result, corporate earnings paid out in the form of interest to tax-exempt lenders or foreign lenders may be subject to no U.S. tax.<sup>372</sup>

**Figure 5.1**  
**Taxation under the Classical System**<sup>373</sup>



<sup>371</sup> IRC sec. 871(h), 881(c), U.S. Model Income Tax Convention, November 15, 2006, art. 11(1).

<sup>372</sup> IRC sec. 61(a)(4) (interest is gross income); IRC sec. 512(b)(1) (interest received by tax-exempt organization not unrelated business taxable income unless received from a controlled entity); IRC secs. 871(h) and 881(c) (interest received by foreign lender is portfolio interest unless lender owns 10 percent or more of the corporate payor); U.S. Model Income Tax Convention, November 15, 2006, art. 11(1) (no withholding tax on U.S. source interest).

<sup>373</sup> TREASURY 1992 INTEGRATION REPORT, *supra* note 353, at 4.



If the shareholder receiving a dividend is a U.S. individual, the dividend may be taxed at preferential tax rates if the dividend is “qualified dividend income.”<sup>374</sup> Qualified dividend income refers to dividends from domestic corporations and qualified foreign corporations.<sup>375</sup> A qualified foreign corporation means any foreign corporation incorporated in a U.S. possession or eligible for benefits of a comprehensive income tax treaty with the United States.<sup>376</sup> In addition, a foreign corporation not otherwise treated as a qualified foreign corporation will be treated as such with respect to any dividends paid if the stock on which the dividend is paid is readily tradable on an established securities market in the United States. A dividend is qualified dividend income if the shareholder holds stock of the corporation for at least 61 days during the 121-day period beginning on the date that is 60 days before the date on which a share becomes ex-dividend with respect to the dividend.<sup>377</sup> Qualified dividend income is taxed at a maximum of 20 percent and, in some cases, may not be taxed at all.<sup>378</sup>

If the shareholder is a corporation, the dividend may either be excluded from the corporate shareholder’s gross income or the corporate shareholder may be permitted a dividends received deduction.<sup>379</sup> If the corporate shareholder owns at least 80 percent of the vote and value of the corporation paying the dividend, then both corporations are members of an affiliated group.<sup>380</sup> The affiliated group can elect to file a consolidated tax return in which case a dividend paid by one

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<sup>374</sup> IRC sec. 1(h)(11).

<sup>375</sup> IRC sec. 1(h)(11)(B).

<sup>376</sup> IRC sec. 1(h)(11)(C).

<sup>377</sup> IRC sec. 1(h)(11)(B)(iii).

<sup>378</sup> IRC sec. 1(h)(1)(B), (C), (D) (zero percent rate on adjusted net capital gain, which includes qualified dividend income, that would otherwise be taxed at 10 percent or 15 percent; 15 percent rate on adjusted net capital gain that would otherwise be taxed at 25 to 35 percent; 20 percent rate on adjusted net capital gain that would otherwise be taxed at 39.6 percent). In addition, a 3.8 percent net investment income tax can apply to qualified dividend income. IRC sec. 1411.

<sup>379</sup> IRC sec. 243.

<sup>380</sup> IRC sec. 1504.

member of the consolidated group to another member is excluded from the recipient member's gross income.<sup>381</sup>

If the corporate shareholder owns at least 80 percent of the vote and value of the corporation paying the dividend but does not elect to file a consolidated tax return, then the corporate shareholder may be entitled to a 100 percent dividends received deduction.<sup>382</sup> If the corporate shareholder owns 20 percent or more of the vote and value of the corporation paying the dividend, then the corporate shareholder is entitled to an 80 percent dividends received deduction.<sup>383</sup> If the corporate shareholder owns less than 20 percent of the corporation paying the dividend, then the corporate shareholder is entitled to a 70 percent dividends received deduction.<sup>384</sup>

If a corporation receives an extraordinary dividend with respect to any share of stock and the corporation has not held the stock for more than two years before the dividend announcement date, then the corporation must reduce its basis in the stock by the non-taxed portion of the dividend (i.e., the amount of the dividends received deduction).<sup>385</sup> If the non-taxed portion of the dividend exceeds the corporation's basis in the stock, the excess is treated as gain from the sale or exchange of such stock.<sup>386</sup> An extraordinary dividend means any dividend with respect to a share of stock if the amount of such dividend equals or exceeds ten percent (five percent for preferred stock) of the corporation's adjusted basis in such share of stock.<sup>387</sup>

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<sup>381</sup> IRC sec. 1502; Treas. Reg. sec. 1.1502-13(f)(2)(ii).

<sup>382</sup> IRC sec. 243(a)(3), (b).

<sup>383</sup> IRC sec. 243(c).

<sup>384</sup> IRC sec. 243(a)(1).

<sup>385</sup> IRC sec. 1059(a)(1).

<sup>386</sup> IRC sec. 1059(a)(2).

<sup>387</sup> IRC sec. 1059(c).

A distribution of money or property by a corporation to a shareholder will be treated as a dividend to the extent of the corporation's current and accumulated earnings and profits.<sup>388</sup> A shareholder who receives a distribution in excess of the corporation's earnings and profits treats the excess as a reduction in the basis of the shareholder's stock of the corporation.<sup>389</sup> Any amount in excess of the shareholder's basis is treated as capital gain.<sup>390</sup>

Earnings and profits is a term that is not defined in the Code, but is a measure of the economic income of a corporation that is available for distribution. In computing a corporation's earnings and profits, the starting point is the corporation's taxable income.<sup>391</sup> A number of adjustments are made to taxable income in arriving at the corporation's earnings and profits.<sup>392</sup> For example, tax-exempt interest is added to taxable income in determining a corporation's earnings and profits.<sup>393</sup> Dividends received from other corporations must be included in full without regard to the dividends received deduction. Depreciation deductions for tangible property are calculated under the alternative depreciation system.<sup>394</sup>

A corporation must keep track of its accumulated earnings and profits and current earnings and profits. Any distribution of money or property out of current or accumulated earnings and profits is treated as a dividend to the recipient.<sup>395</sup> Such distribution will reduce the corporation's earnings and profits.<sup>396</sup>

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<sup>388</sup> IRC secs. 316, 301(c)(1).

<sup>389</sup> IRC sec. 301(c)(2).

<sup>390</sup> IRC sec. 301(c)(3).

<sup>391</sup> Treas. Reg. sec. 1.312-6(a).

<sup>392</sup> IRC sec. 312.

<sup>393</sup> Treas. Reg. sec. 1.312-6(b).

<sup>394</sup> IRC sec. 312(k)(3).

<sup>395</sup> IRC sec. 316.

<sup>396</sup> IRC sec. 312(a).

The Code contains a number of limitations on the deductibility of interest. One provision is generally referred to as the earnings stripping rule.<sup>397</sup> If a corporation has a debt-to-equity ratio exceeding 1.5:1, pays or accrues disqualified interest and has excess interest expense for the taxable year, part of its interest deduction will be disallowed for the current year.<sup>398</sup> Any part of the interest expense disallowed as a deduction is carried forward as disqualified interest in the succeeding taxable year.<sup>399</sup>

The debt-to-equity ratio means the ratio that the total indebtedness of the corporation bears to the sum of the corporation's money and the adjusted basis of all of its assets reduced (but not below zero) by such total indebtedness.<sup>400</sup> Disqualified interest means any interest paid or accrued by the corporation to a related person if no U.S. income tax is imposed with respect to such interest.<sup>401</sup> A related person means any person who owns more than 50 percent of the corporation.<sup>402</sup> If any treaty between the United States and a foreign country reduces the rate of tax imposed on any interest paid or accrued by the corporation, such interest is treated as interest on which no tax is imposed to the extent of the same proportion of such interest as the rate of tax imposed without regard to the treaty reduced by the rate of tax imposed under the treaty bears to the rate of tax imposed without regard to the treaty.<sup>403</sup>

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<sup>397</sup> IRC sec. 163(j).

<sup>398</sup> IRC sec. 163(j)(1) and (2).

<sup>399</sup> IRC sec. 163(j)(1)(B).

<sup>400</sup> IRC sec. 163(j)(2)(C).

<sup>401</sup> IRC sec. 163(j)(3). Disqualified interest also includes any interest paid or accrued to a person who is not a related person if there is a disqualified guarantee (guarantee by a tax-exempt organization or foreign person) and no gross basis tax is imposed on such interest; and any interest paid or accrued by a taxable REIT subsidiary of a REIT to such trust.

<sup>402</sup> IRC sec. 163(j)(4).

<sup>403</sup> IRC sec. 163(j)(5)(B).

Excess interest expense means the excess (if any) of the corporation's net interest expense over the sum of 50 percent of the adjusted taxable income of the corporation plus any excess limitation carryforward.<sup>404</sup> The adjusted taxable income is the taxable income of the corporation computed without regard to net interest expense, the amount of any net operating loss (NOL) deduction, the manufacturing deduction, and any depreciation or amortization deductions.<sup>405</sup> The excess limitation carryforward is the excess of 50 percent of the corporation's adjusted taxable income over the corporation's net interest expense.<sup>406</sup> It is carried forward for up to three years.<sup>407</sup>

A tax-exempt organization is generally exempt from federal income tax.<sup>408</sup> If, however, the organization conducts any trade or business that is not substantially related to the exercise or performance of its charitable, educational or other purpose or function constituting the basis for the exemption, then it is subject to tax on its taxable income derived from such unrelated trade or business ("unrelated business taxable income").<sup>409</sup> A tax-exempt organization is subject to the corporate level tax on its unrelated business taxable income, which is generally referred to as UBIT (unrelated business income tax).<sup>410</sup> In computing a tax-exempt organization's unrelated business taxable income, dividends, interest, annuities, rents and royalties are generally excluded from gross income.<sup>411</sup>

A special rule applies if a tax-exempt organization receives or accrues a specified payment from another entity that it controls.<sup>412</sup> A specified payment means any interest, annuity, royalty,

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<sup>404</sup> IRC sec. 163(j)(2)(B).

<sup>405</sup> IRC sec. 163(j)(6)(A).

<sup>406</sup> IRC sec. 163(j)(2)(B)(iii).

<sup>407</sup> IRC sec. 163(j)(2)(B)(ii).

<sup>408</sup> IRC sec. 501(a).

<sup>409</sup> IRC secs. 501(b), 511, 512 and 513.

<sup>410</sup> IRC sec. 511(a)(1).

<sup>411</sup> IRC sec. 512(b).

<sup>412</sup> IRC sec. 512(b)(13).

or rent.<sup>413</sup> Control means, in the case of a corporation, ownership (by vote or value) of more than 50 percent of the stock in such corporation with constructive ownership rules applying.<sup>414</sup> A tax-exempt organization must include a specified payment as an item of gross income derived from an unrelated trade or business to the extent such payment reduces the net unrelated income of the controlled entity (or increases any net unrelated loss of the controlled entity).<sup>415</sup>

In general, non-resident alien individuals (NRAs) and foreign corporations are not subject to U.S. income taxation unless they earn U.S. source income.<sup>416</sup> If an NRA or foreign corporation has U.S. source income, then the income will be subject to either a 30 percent flat tax or graduated tax rates depending on whether the NRA or foreign corporation is engaged in a U.S. trade or business and whether such income is effectively connected to the U.S. trade or business.

In general, an NRA or foreign corporation is engaged in a U.S. trade or business if its profit-oriented activities in the United States, whether carried on directly or through agents, are considerable, continuous and regular.<sup>417</sup> In making the determination, both the quantity as well as

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<sup>413</sup> IRC sec. 512(b)(13)(C).

<sup>414</sup> IRC sec. 512(b)(13)(D).

<sup>415</sup> IRC sec. 512(b)(13)(A). As part of the Pension Protection Act of 2006, Congress provided that, if a tax-exempt organization receives an interest payment from a related entity, only the portion of the interest payment that is in excess of the amount which would have been paid or accrued if such payment met the requirements of section 482 is included in the tax-exempt organization's gross income. IRC sec. 512(b)(13)(E). This provision terminated on December 31, 2013, but may be renewed.

<sup>416</sup> Several categories of foreign source income may be subject to U.S. tax if the nonresident alien or foreign corporation has an office or other fixed place of business in the United States and such income is attributable to such office or fixed place of business. IRC sec. 864(c)(4)(B).

<sup>417</sup> See, e.g., *Inverworld v. Commissioner*, 71 TCM 3231 (1996), *reconsideration denied*, 73 TCM 2777 (1997); *Continental Trading, Inc. v. Commissioner*, 265 F.2d 40 (9<sup>th</sup> Cir. 1959) (Panamanian corporation's activities in the U.S. were casual or incidental transactions and did not rise to the level of a U.S. trade or business); Rev. Rul. 73-522, 1973-2 C.B. 226 (nonresident alien individual who owned U.S. real estate spent one week in U.S. entering into net leases was not engaged in a U.S. trade or business; activities in U.S. were sporadic rather than continuous, irregular rather than regular, and minimal rather than considerable).

the quality of U.S. activities is relevant. In addition, an agent's activities are generally imputed to the principal in determining whether the principal is engaged in a U.S. trade or business, whether the agent is a dependent agent (i.e., an employee) or an independent agent.<sup>418</sup> Special rules apply to the performance of personal services and the trading of securities and commodities in the United States by an NRA or foreign corporation.<sup>419</sup>

In order for a foreign corporation to have U.S. source income effectively connected to a U.S. trade or business, the income must be connected to such business under an asset use test, a business activities test, or the force of attraction principle.<sup>420</sup> The asset use test focuses on whether the income, gain, or loss is derived from assets used in or held for use in the conduct of such trade or business.<sup>421</sup> The business activities test focuses on whether the activities of such trade or business were a material factor in the realization of the income, gain or loss.<sup>422</sup> Both the asset use test and the business activities test apply to U.S. source fixed or determinable, annual or periodical (FDAP) income, such as dividends, interest and royalties, and also to U.S. source capital gains. The force of attraction principle applies to all other U.S. source income, such as income from the sale of inventory. Under the force of attraction principle, U.S. source income is automatically effectively connected income if the NRA or foreign corporation is engaged in a U.S. trade or business.<sup>423</sup>

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<sup>418</sup> See, e.g., *Lewenhaupt v. Commissioner*, 20 T.C. 151 (1953), *aff'd per curiam*, 221 F.2d 227 (9<sup>th</sup> Cir. 1955) (nonresident alien individual who owned real estate in the U.S. was engaged in a U.S. trade or business as result of the activities of a real estate agent in the U.S.); Rev. Rul. 70-424, 1970-2 C.B. 150.

<sup>419</sup> IRC sec. 864(b)(1) and (2).

<sup>420</sup> IRC sec. 864(c)(2) and (3).

<sup>421</sup> IRC sec. 864(c)(2)(A).

<sup>422</sup> IRC sec. 864(c)(2)(B).

<sup>423</sup> IRC sec. 864(c)(3).

A foreign corporation that has effectively connected income is also subject to a branch profits tax on its dividend equivalent amount.<sup>424</sup> The dividend equivalent amount is equal to the foreign corporation's effectively connected earnings and profits for the taxable year reduced for the increase in U.S. net equity and increased for the decrease in U.S. net equity.<sup>425</sup> The term "effectively connected earnings and profits" means earnings and profits that are attributable to income which is effectively connected (or treated as effectively connected) with the conduct of a U.S. trade or business.<sup>426</sup> U.S. net equity is equal to U.S. assets reduced by U.S. liabilities.<sup>427</sup> The branch profits tax is 30 percent of the dividend equivalent amount and can be reduced by an income tax treaty.<sup>428</sup>

An income tax treaty may substantially change the U.S. tax treatment of residents of countries with which the treaties were made. In general, an income tax treaty will lower the 30 percent withholding tax on U.S. source dividends, interest and royalties paid to a resident of the foreign treaty country.<sup>429</sup> In the case of business income, an income tax treaty typically bars the United States from taxing the business profits of a resident of a foreign treaty country unless the resident has a permanent establishment in the United States.<sup>430</sup> In addition, if the resident has a permanent establishment in the United States, then the United States may only tax the business profits that are attributable to such permanent establishment.<sup>431</sup>

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<sup>424</sup> IRC sec. 884.

<sup>425</sup> IRC sec. 884(b).

<sup>426</sup> IRC sec. 884(d).

<sup>427</sup> IRC sec. 884(c).

<sup>428</sup> IRC sec. 884(a), (e). U.S. Model Income Tax Convention, November 15, 2006, art. 10(8) (reducing the tax on the dividend equivalent amount to five percent).

<sup>429</sup> U.S. Model Income Tax Convention, November 15, 2006, arts. 10, 11 and 12.

<sup>430</sup> U.S. Model Income Tax Convention, November 15, 2006, arts. 5 and 7.

<sup>431</sup> U.S. Model Income Tax Convention, November 15, 2006, art. 7.



#### D. Distortions Created by a Classical System of Taxing Corporate Earnings

Generally, four reasons have been given to move from a classical system of taxation of corporate earnings to some form of integration of the individual and corporate tax systems.<sup>432</sup> First, under a classical system of taxation, investors have an incentive to invest in non-corporate rather than corporate businesses to avoid the two levels of tax on corporate earnings.<sup>433</sup> For example, S corporations and partnerships are not subject to an entity-level tax.<sup>434</sup> Rather the incomes of such entities flow-through to the owners of the entity, who are then taxed on their respective shares of the incomes. As a result, the incomes of S corporations and partnerships are subject to only a single level of tax and are highly favored by investors. In 1980, C corporations earned 75 percent of the net income earned by all businesses, with S corporations, partnerships and sole proprietorships earning a combined 21 percent of all net business income. By 1990, C corporations earned only 50 percent of the net income earned by all businesses, with S corporations, partnerships and sole proprietorships earning 37 percent. In 2000 and 2008, C corporations earned 35 percent and 22 percent, respectively, of the net income earned by all businesses, with S corporations, partnerships and sole proprietorships earning slightly less than half of the net income in 2000 (46 percent) and slightly more in 2008 (59 percent).

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<sup>432</sup> See ALI 1993 INTEGRATION REPORT, *supra* note 356, at 21-46; TREASURY I, *supra* note 350, at Vol. 2, 135-36; TREASURY 1992 INTEGRATION REPORT, *supra* note 353, at 1.

<sup>433</sup> This distortion is sometimes described as the classical system creating a disincentive for investment in corporate equity because of the additional burden of the corporate income tax.

<sup>434</sup> Two entity level taxes may be applicable to an S corporation if it has net recognized built-in gain or excess passive income. IRC secs. 1374 and 1375.

**Table 5.1**  
**Percentage Shares of Net Income, 1980-2008**<sup>435</sup>

	1980	1990	2000	2007	2008
All Businesses	100	100	100	100	100
C Corporations	75	50	35	36	22
RICs and REITs	5	12	18	17	20
S Corporations	1	8	13	14	18
Partnerships	3	3	18	23	26
Sole Proprietorship	17	26	15	10	15

More recently enacted business entity forms, such as limited liability companies (LLCs), limited liability partnerships (LLPs) and limited liability limited partnerships (LLLPs) are also generally taxed as pass-through entities.<sup>436</sup> Specialized entities, such as regulated investment companies (RICs), real estate investment trusts (REITs), real estate mortgage investment conduits (REMICs), cooperatives (subject to subchapter T) and domestic international sales corporations (DISCs) are also generally subject to a single level of tax.

Investors who want to invest in publicly traded companies may have an incentive to invest in publicly traded partnerships (PTPs) rather than publicly traded corporations. If certain requirements are met, PTPs are subject to a single level of tax at the partner level.<sup>437</sup> The main tax limitation on the use of PTPs is that 90 percent or more of a PTP's gross income must be qualifying income, which includes interest, dividends, real property rents, gain from the sale of real property,

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<sup>435</sup> INTERNAL REVENUE SERVICE, SOI TAX STATS – INTEGRATED BUSINESS DATA, available at <http://www.irs.gov/uac/SOI-Tax-Stats-Integrated-Business-Data> (accessed July 25, 2014).

<sup>436</sup> Under the check-the-box regulations that became effective in 1997, LLCs, LLPs, and LLLPs could elect to be taxed as corporations. In fact, one common planning technique is for investors to form an LLC and then elect to have the LLC taxed as an S corporation.

<sup>437</sup> IRC sec. 7704(c).

income and gain from mineral or natural resources, and income or gain from commodities or commodity futures.<sup>438</sup> If a PTP does not meet the qualifying income test, it will be taxed as a corporation.<sup>439</sup>

A second reason for moving from a classical system to an integrated system is that, under a classical system, owners of a corporation have an incentive to finance corporations with debt rather than equity because interest is deductible while dividends are not.<sup>440</sup> Consequently, corporate earnings distributed as dividends are potentially subject to both corporate and shareholder level taxes, while corporate earnings distributed as interest are taxable only to the creditor. The current system results in high effective tax rates on equity-financed investments and low effective tax rates on debt-financed investments. This distinction provides incentives for corporations to finance new investments with debt and also to retain debt in their capital structure. The increasing use of debt as a means of avoiding the two levels of taxes makes a corporation more vulnerable to the risks of bankruptcy and other downturns in the economy.

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<sup>438</sup> IRC sec. 7704(c), (d).

<sup>439</sup> IRC sec. 7704(a).

<sup>440</sup> This second distortion is sometimes described as the classical system creating an incentive for corporate financing by debt or retained earnings rather than by issuing new stock. *See* ALI 1993 INTEGRATION REPORT, *supra* note 356, at 25. To understand this, the financing comparisons must be: (1) investing retained earnings in the contemplated project, (2) distributing the retained earnings as a dividend and then issuing new debt in the same amount, and (3) distributing retained earnings as a dividend and then issuing new stock on which dividends will be paid. *Id.* Financing by retained earnings or borrowing “will yield equivalent results under the simplifying assumptions that *shareholder and corporate tax rates are equal, that the same dividend tax will always apply to corporate earnings distributed to shareholders, and that no capital gains tax are due during the period of retention.*” *Id.* The reasoning is that the use of retained earnings continues the application of the corporate income tax on income produced by the retained earnings but delays any shareholder tax on distributions. *Id.* at 26. The borrowing eliminates the corporate income tax as a result of the interest deduction but creates an immediate shareholder tax on distributions. *Id.* The issuance of new stock introduces an immediate shareholder tax on distributions and continues the corporate level tax. *Id.*

**Table 5.2**  
**Marginal Effective Tax Rates on New Investment<sup>441</sup>**

	Effective Marginal Tax Rate (%)
Business	30.1
Corporate Taxes Only	32.0
Financing	
Debt-Financed	-60.0
Equity-Financed	37.0
Corporate and Individual Taxes	
Financing	
Debt-Financed	-4.0
Equity-Financing	37.0
Non-corporate Business	26.0

The more favorable tax treatment of debt as compared with equity not only creates a greater incentive to utilize debt over equity, but also places tremendous significance on distinguishing debt from equity. Generally, on the issuance of a financial instrument, the corporation maintains that the instrument is debt for tax purposes while the government may counter that the instrument is equity. Traditionally, a number of factors were analyzed to determine whether an instrument was debt or equity. In 1969, Congress enacted Internal Revenue Code (IRC) section 385 authorizing the Treasury to issue regulations to determine whether an interest in a corporation is to be treated as debt or equity.

Treasury made several attempts through proposed regulations to distinguish debt from equity.<sup>442</sup> The first set of proposed regulations was issued in 1980 -- eleven years after Congress

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<sup>441</sup> See Jason Furman, *Business Tax Reform and Economic Growth*, 145 TAX NOTES 121, 126 (Oct. 6, 2014).

<sup>442</sup> See BORIS I. BITTKER AND JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* (7<sup>th</sup> ed. 2000) at ¶ 4.02[8][a].

enacted section 385. Treasury finalized the regulations with a delayed effective date but the regulations never became effective. Treasury then issued a new set of proposed regulations that were ultimately withdrawn. As a result, resolution of the debt versus equity issue remains extremely important but murky.<sup>443</sup>

The more favorable tax treatment of debt versus equity has also generated a number of complex rules in the tax laws limiting the interest deductions associated with debt. For example, if a corporation issues an applicable high-yield discount obligation (AHYDO), then the original issue discount (OID) of such obligation is bifurcated into (a) a deferred interest deduction in which the deduction is deferred until the interest is actually paid and (b) a non-deductible disqualified portion of the OID if the yield on the obligation exceeds the Applicable Federal Rate (AFR) plus six percentage points.<sup>444</sup> The holder of the AHYDO accrues the entire OID in gross income. However, if the holder is a corporation, then the corporation is entitled to a dividends received deduction with respect to the non-deductible disqualified portion of the OID.<sup>445</sup>

The favorable tax treatment of debt versus equity also arises in the cross-border context with related parties, generating a specific rule limiting the amount of the interest deduction.<sup>446</sup> A foreign corporation that conducts business in the United States through a U.S. subsidiary may want to capitalize the subsidiary with a large amount of debt and a minimal amount of equity. The interest paid by the U.S. subsidiary to its foreign parent is deductible. If the foreign parent is a resident of a country that has an income tax treaty with the United States, the interest may be free of any U.S. withholding tax.<sup>447</sup> As a result, the foreign parent can strip earnings out of its U.S.

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<sup>443</sup> Id.

<sup>444</sup> IRC sec. 163(e)(5).

<sup>445</sup> IRC sec. 163(e)(5)(B).

<sup>446</sup> IRC sec. 163(j).

<sup>447</sup> U.S. Model Income Tax Convention, November 15, 2006, art. 11(1).

subsidiary avoiding all U.S. income taxes (that is, the U.S. subsidiary issues debt to its parent, generating interest deductions and the foreign parent receives interest payments that are not subject to U.S. taxes, so the debt transaction yields U.S. tax savings). Under current law, the U.S. subsidiary's interest deduction is limited only if its debt-to-equity ratio exceeds 1.5:1, the interest it pays or accrues is disqualified interest and it has excess interest expense for the taxable year.<sup>448</sup> Any part of the interest expense disallowed as a deduction is carried forward as disqualified interest in the succeeding taxable year.<sup>449</sup> The requirement that the U.S. subsidiary's debt-to-equity ratio exceed 1.5:1 acts as a safe harbor, and many U.S. subsidiaries are able to keep their debt-to-equity ratio below the threshold.

The favorable tax treatment of debt versus equity also arises in the domestic acquisition context, generating some specific rules limiting the interest deduction. A corporation may utilize a significant amount of debt in the acquisition of another corporation. If the acquiring corporation has interest expense in excess of \$5 million per year with respect to "corporate acquisition indebtedness," then part of the interest expense will be disallowed as a deduction.<sup>450</sup> This provision was created in 1969 "to curb the growth of conglomerates during the roaring sixties."<sup>451</sup> In addition, the acquiring corporation may have large interest deductions creating a net operating loss. The acquiring corporation may carry a net operating loss back two years generating a refund of taxes producing an early cash flow benefit for the acquiring corporation.<sup>452</sup> Under current law, if a corporation acquires 50 percent or more of the vote or value of another corporation (or makes

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<sup>448</sup> IRC sec. 163(j).

<sup>449</sup> IRC sec. 163(j)(1).

<sup>450</sup> IRC sec. 279.

<sup>451</sup> See BORIS I. BITTKER AND LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS (3<sup>rd</sup> ed. 2000) at ¶52.7.1.

<sup>452</sup> IRC sec. 172(b)(1).

an extraordinarily large distribution), then the acquiring corporation may be limited in its ability to carryback any net operating loss incurred in the year of the acquisition or the two succeeding years.<sup>453</sup> The portion of the net operating loss attributable to interest deductions associated with the acquisition may not be carried back (but may be carried forward). The rule, enacted in 1989, was designed to address the use of debt in highly leveraged buyouts (and recapitalizations).

A third reason for change is that, under a classical system, owners of a corporation have an incentive to retain earnings or distribute earnings depending on the relationship among the corporation, the shareholder and the capital gains tax rates. Corporations with shareholders in high tax brackets may want to retain the earnings to defer any shareholder level income tax.<sup>454</sup> If the shareholders are tax-exempt or in a low tax bracket, the corporation may be encouraged to distribute earnings so that the shareholders may invest the earnings without bearing any future corporate level income tax. In addition, if the shareholders are individuals and sell the stock of the corporation, a second level of tax on corporate earnings is imposed, but only at the time of sale and at preferential capital gains rates. If the shareholders of the corporation are also corporations, then they will receive no preferential tax treatment for capital gains upon sale of the stock.<sup>455</sup> Corporations may, however, qualify for the dividends received deduction upon receipt of a dividend resulting in a 70 percent, 80 percent or 100 percent deduction to the corporate shareholder creating an incentive to distribute earnings.<sup>456</sup>

Finally, a classical system creates an incentive to distribute earnings in a manner to avoid a second level of tax, such as payments giving rise to deductions or stock repurchases that give

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<sup>453</sup> IRC sec. 172(h).

<sup>454</sup> If the shareholders are individuals, this is less of an issue today with dividends receiving preferential tax treatment. IRC sec. 1(h)(11).

<sup>455</sup> IRC sec. 1201(a).

<sup>456</sup> IRC sec. 243.

rise to basis recovery and capital gains. The corporation may pay out its earnings in the form of interest, salary, or rent, all of which would generate a deduction to the corporation thereby eliminating part or all of the corporate-level tax. For example, many closely-held C corporations pay little to no dividends to their shareholders. Much, if not all, of the earnings of those C corporations are distributed to the shareholders in the form of salary, which is deductible to the corporation.<sup>457</sup> Attempting to distribute corporate earnings in the form of deductible salary rather than non-deductible dividends has generated a tremendous amount of litigation over the years.

In *Menard v. Commissioner*,<sup>458</sup> the chief executive officer (CEO) of a closely held corporation owned all of the voting shares and 56 percent of the non-voting shares of the company. In 1998, he received total compensation of over \$20 million, of which approximately \$17.5 million was a bonus. The Seventh Circuit, in reversing the Tax Court, held that the CEO's compensation was not excessive. Judge Posner, writing for the Seventh Circuit, noted that the preferential tax treatment for dividend income that was enacted in 2003 resulting in partial integration makes the tradeoff between deductible salary taxed at ordinary income rates to the CEO/shareholder and nondeductible dividends taxed at preferential tax rates to the CEO/shareholder more complex but still significant.

As an alternative to distributing earnings in the form of deductible payments, the corporation may distribute the earnings in the form of stock redemptions, thereby enabling the shareholders to benefit from both basis recovery and, in the case of individual shareholders, capital gains tax rates.<sup>459</sup> Over the years, individual taxpayers have attempted a number of transactions characterizing distributions of corporate earnings as stock redemptions rather than corporate

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<sup>457</sup> IRC sec. 162(a)(1).

<sup>458</sup> 560 F.3d 620 (7<sup>th</sup> Cir. 2009).

<sup>459</sup> IRC sec. 302.



distributions (i.e., dividends) creating a problem in distinguishing between nondividend and dividend equivalent distributions. Congress has responded with a number of provisions attempting to distinguish corporate distributions from redemptions of stock. With dividends currently taxed at capital gains rates for individual shareholders, the benefit of redemptions versus dividends is the basis recovery that is available for redemptions of stock.

#### E. Why Have Corporate Income Taxes

The Organization for Economic Cooperation and Development (OECD) has issued a tax and growth ranking listing various taxes from the least distortive to the most distortive in terms of economic growth.<sup>460</sup> The OECD wrote that recurrent taxes on immovable property (i.e., land taxes) are the least distortive in terms of reducing long-run GDP per capita.<sup>461</sup> This is followed by

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<sup>460</sup> See OECD TAX POLICY STUDIES, TAX POLICY REFORM AND ECONOMIC GROWTH, No. 20, 20-21 (2010).

<sup>461</sup> Id. Noting the efficiency of a tax on land values is not a new insight. American social reformer Henry George argued for a single tax on land values in his influential book, *PROGRESS AND POVERTY* (1879). The efficiency of land taxation has been noted by many influential thinkers since George. See, e.g., Milton Friedman, [http://www.cooperativeindividualism.org/friedman-milton\\_interview-1978.html](http://www.cooperativeindividualism.org/friedman-milton_interview-1978.html) (accessed Nov. 3, 2014) (“the least bad tax is the property tax on the unimproved value of land, the Henry George argument of many, many years ago”); William F. Buckley, <http://www.wealthandwant.com/themes/Buckley.html> (accessed Nov. 3, 2014) (interview with Brian Lamb, C-SPAN Book Notes, Apr. 2-3, 2000) (“Henry George ... said there is infinite capacity to increase capital and to increase labor, but none to increase land ... The effect of this would be that if you have a parking lot and the Empire State Building next to it, the tax on the parking lot should be the same as the tax on the Empire State Building ... I've run into tons of situations where I think the Single-Tax theory would be applicable. We should remember also this about Henry George, he was sort of co-opted by the socialists in the 20s and the 30s, but he was not one at all.... Plus, also, he believes in only that tax. He believes in zero income tax.”); William Vickrey, *The Corporate Income Tax in the U.S. Tax System*, 73 TAX NOTES 597, 603 (1996) (“a tax on site value, assessed independently of the use made of the land, is the one acceptable major tax that is almost completely devoid of distortionary effects and excess burden. Taxation won't cause land to move away, and, with minor exceptions, they're not making any more of it.”); Statement of James K. Galbraith, *Does the Tax System Support Economic Efficiency, Job Creation and Broad-Based Economic Growth? Testimony Before the Committee on Finance, United States Senate* (Mar. 8, 2011) (“as a general rule fixed assets – notably land – should be taxed more heavily than income. The tax on property is a good tax, provided it is designed to fall as heavily as possible on economic rents. ... Payroll taxes and profits taxes do interfere directly

consumption taxes; other property taxes and environmentally-related taxes; personal income taxes; and finally, corporate income taxes.<sup>462</sup> More specifically, the OECD notes that corporate income taxes are the most harmful taxes for economic growth because they discourage investment in capital and productivity improvements.<sup>463</sup>

The United States enacted the corporate income tax in 1909. Several reasons have been given for its enactment over 100 years ago – reasons that are still used today to justify the existence of the corporate income tax.<sup>464</sup> First, the corporate income tax is a means of regulating corporations, with the principal regulation being the filing of tax returns (which, in 1909, were to be made public). In a much broader sense, the corporate income tax serves as a vehicle to restrict the accumulation of power in the hands of corporate management. Second, taxing the corporation is an indirect way of taxing the shareholders. If there was no corporate income tax, a shareholder could shift income into a corporation achieving deferral of income until a dividend is paid or the shareholder sells the shares of stock. In addition, collecting a tax from a corporation may be easier than collecting tax from shareholders, particularly if there are a large number of shareholders or some of the shareholders are foreign persons. Finally, the corporate income tax has been justified

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with current business decisions. Taxes effectively aimed at economic rent, including land rent ... do not.”)

Query whether the increasing mobility of capital and labor, made possible by improved technology, makes the case for a land tax stronger than in decades past. That is, capital and labor are increasingly able to respond to taxation by moving away from the taxing jurisdiction. Land, however, does not have the option to move away. Could it be that, someday, increasing technology/mobility will make it so that by and large the only remaining tax base will be land?

<sup>462</sup> See OECD TAX POLICY STUDIES, TAX POLICY REFORM AND ECONOMIC GROWTH, *supra* note 460, at 20-21.

<sup>463</sup> *Id.* at 22.

<sup>464</sup> See Reuven Avi-Yonah, *Corporations, Society and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193, 1217-1219 (2004); Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L. J. 53, 66 (1990).

as a tax on the benefits of incorporation, primarily the limited liability a corporation provides to its shareholders.<sup>465</sup>

Over the years, each of the three reasons given for the existence of the corporate income tax has been questioned by tax scholars. Only the first reason, regulation of corporations by means of the corporate income tax, has survived scrutiny, particularly with regard to public corporations. Congress has utilized the corporate income tax as a means of regulating public corporations by rewarding certain activities it likes (e.g., various tax incentives) and punishing activities it dislikes (e.g., prohibition on deductions and credits).

The second reason for the existence of the corporate income tax, preventing deferral of income through use of the corporate form, may be sensible when dealing with public corporations with thousands of shareholders. But when dealing with non-public corporations, such corporations can be taxed on a pass-through basis eliminating any income deferral possibilities. In fact, many non-public entities, including non-public corporations, are taxed on a pass-through basis either as S corporations or as partnerships.

The final reason given for the corporate income tax, the benefits associated with incorporation, primarily focusing on limited liability, has little justification today. Limited liability companies, which began in Wyoming in 1977 and have spread to all 50 states and the District of Columbia, also provide limited liability protection to their owners (i.e., members). In addition, the limited liability partnership, which began in Texas in 1991, and has also spread to a number of states, also provides limited liability protection to its owners (i.e., the partners). As a result, many of the benefits of incorporation are also available to other business entities. In fact, some may

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<sup>465</sup> See THE INSTITUTE FOR FISCAL STUDIES, THE STRUCTURE AND REFORM OF DIRECT TAXATION (Report of a Committee Chaired by Professor J.E. Meade) (1978) at 145, 227.

argue that non-corporate entities provide non-tax benefits, in certain cases, that are better than corporate entities. For example, a judgment creditor of a shareholder can execute on the shareholder's stock of a corporation. In contrast, in some states, a judgment creditor of a partner (or member) is limited to obtaining a charging order. A charging order is a court-ordered remedy that entitles the holder of the order to receive distributions from the partnership (or limited liability company) until the judgment is satisfied. The holder of a charging order may not participate in the management of the partnership (or limited liability company) and cannot compel distributions.

#### F. The Need for Corporate Integration

The distortions caused by two levels of taxation of corporate earnings have been well documented for many years. As identified earlier, there are generally four distorted incentives that have been advanced in support of integration of the individual and corporate tax systems: the incentive to invest in non-corporate rather than corporate businesses, the incentive to finance corporations with debt rather than equity, the incentive to retain earnings or distribute earnings in a manner to avoid a second level of tax, and the incentive to distribute earnings in a manner to avoid a second level of tax.

The importance of integration appears to be greater for publicly traded companies than for non-publicly traded companies. Non-publicly traded companies have a number of options available to them to avoid the two levels of tax of corporate earnings. For example, many non-publicly traded companies are taxed as S corporations or partnerships. The number of S corporations has increased by an average annual rate of 7.42 percent from 1980 until 2008. By 2008, the number of S corporations had climbed to 4,049,944 from 545,389 in 1980.<sup>466</sup> The

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<sup>466</sup> INTERNAL REVENUE SERVICE, SOI TAX STATS – INTEGRATED BUSINESS DATA, available at <http://www.irs.gov/uac/SOI-Tax-Stats-Integrated-Business-Data> (accessed Nov. 2, 2014).

number of partnerships has increased by an average of 2.98 percent annually from 1980 to 2008. By 2008, the number of partnerships had climbed to 3,146,006 from 1,379,654 in 1980.<sup>467</sup> In contrast, the number of traditional or C corporations declined by an average annual rate of 0.69 percent from 1980 to 2008. By 2008, there were 1,782,478 C corporations, down from 2,163,458 in 1980.<sup>468</sup>

**Table 5.3**  
**Shares of Business Returns as a Percentage, 1980-2008<sup>469</sup>**

	1980	1990	2000	2007	2008
S Corporations	4	8	11	12	13
Partnerships <sup>470</sup>	11	8	8	10	10
Sole Proprietorships (Non-farm)	69	74	72	72	72
C Corporations	17	11	9	6	6

For many non-publicly traded companies that are taxed as C corporations, the shareholders may engage in what some call “self-help” integration. The shareholders may distribute the earnings of the corporation in a number of deductible forms, such as salary, rent or interest thereby eliminating much or all of the corporate level tax. If, for example, the earnings are distributed in the form of salary to a shareholder who is also an employee, the primary requirements for deductibility are that the salary be for services rendered and the amount be reasonable.<sup>471</sup> When

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<sup>467</sup> Id.

<sup>468</sup> Id.

<sup>469</sup> THE PRESIDENT’S ECONOMIC RECOVERY ADVISORY BOARD, *supra* note 359, at 75; INTERNAL REVENUE SERVICE, SOI TAX STATS – INTEGRATED BUSINESS DATA, available at <http://www.irs.gov/uac/SOI-Tax-Stats-Integrated-Business-Data> (accessed Nov. 2, 2014).

<sup>470</sup> Includes LLCs and LLPs.

<sup>471</sup> *See, e.g.*, IRC sec. 162(a)(1); *Menard v. Commissioner*, 560 F.3d 620 (7<sup>th</sup> Cir. 2009); *Exacto v. Commissioner*, 196 F.3d 833 (7<sup>th</sup> Cir. 1999); *Multi-Pak Corp. v. Commissioner*, 99 TCM 1567 (2010).

selling the corporation, the shareholders may engage in a number of tax planning strategies to avoid double taxation, such as treating a significant portion of the purchase price as consideration for personal goodwill.<sup>472</sup>

Some publicly traded companies are able to avoid the two levels of taxation by utilizing the partnership form of business. Publicly traded partnerships (PTPs) are limited partnerships (or limited liability companies) in which the interests are traded on an established securities market. A share in a PTP is called a “unit,” and PTP shareholders are called “unit holders.” PTPs are traded on the New York and NASDAQ stock exchanges.<sup>473</sup> A subset of PTPs is master limited partnerships (MLPs). An MLP is a PTP that operates an active business. There are about 117 MLPs on the market with a majority of them in the energy and natural resources areas.<sup>474</sup>

In 1987, Congress enacted changes in the tax law to tax PTPs as corporations. However, it provided two forms of relief for PTPs from the corporate tax. First, PTPs that were in existence on December 17, 1987, were transitioned for 10 years until December 31, 1997. After that time, these grandfathered PTPs had to meet a qualifying income test or be taxed as a corporation. However, in 1997, Congress permitted the grandfathered PTPs that did not meet the qualifying income test to elect to pay tax at 3.5 percent of their gross income for the taxable year from the active conduct of trades or businesses.<sup>475</sup> Second, PTPs that meet a qualifying income test will

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<sup>472</sup> See, e.g., *Martin Ice Cream v. Commissioner*, 110 T.C. 189 (1998); *Norwalk v. Commissioner*, 76 TCM 208 (1998); *Howard v. U.S.*, 448 Fed. Appx. 752 (9<sup>th</sup> Cir. 2011); *Soloman v. Commissioner*, 95 TCM 1389 (2008); *Muskat v. U.S.*, 554 F.3d 183 (1<sup>st</sup> Cir. 2009); *Kennedy v. Commissioner*, 100 TCM 268 (2010); *H & M, Inc. v. Commissioner*, 104 TCM 452 (2012); *Bross Trucking, Inc. v. Commissioner*, 107 TCM 1528 (2014).

<sup>473</sup> See NATIONAL ASSOCIATION OF PUBLICLY TRADED PARTNERSHIPS, available at <http://www.naptp.org/> (accessed July 31, 2014).

<sup>474</sup> Id. See THE YIELD HUNTER, MASTER LIMITED PARTNERSHIPS – ALPHABETICAL, available at <http://www.dividendyieldhunter.com/master-limited-partnerships-alphabetical> (accessed July 31, 2014).

<sup>475</sup> IRC sec. 7704(g).

not be taxed as corporations.<sup>476</sup> To meet the test, PTPs must have 90 percent or more of their gross income for the taxable year consist of qualifying income.<sup>477</sup> Qualifying income includes interest, dividends, real property rents, gain from the sale of real property, income and gain from mineral or natural resources, and income or gain from commodities or commodity futures.<sup>478</sup>

Under an integration proposal based on whether the entity is publicly traded, PTPs would be taxed under the corporate tax regime. As a result, a tax would be imposed at the entity level on the taxable income of the PTP. However, any dividends paid by a PTP would either be deducted by the PTP (under a dividends paid deduction approach) or excluded from the recipient's income (under a dividend exclusion approach) thereby alleviating the two levels of taxation.

For publicly traded companies that are not PTPs meeting the qualifying income test, integration is important to eliminate the distortions caused by the two levels of taxation. Many of these publicly traded companies file a consolidated tax return. As a result, double taxation is eliminated among the corporations in the consolidated group. So if one member of the group pays a dividend to another member of the group, the receiving member excludes the dividend from gross income.<sup>479</sup> However, if one member of the group pays a dividend to a shareholder that is not a member of the consolidated group, the shareholder must include the dividend in gross income leading to two levels of taxation.

#### G. Who Bears the Burden of the Corporate Income Tax

For many years, public-sector economists have researched and written on the issue of who bears the burden (or incidence) of the corporate income tax. Economists have agreed that the

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<sup>476</sup> IRC sec. 7704(c).

<sup>477</sup> IRC sec. 7704(c)(2).

<sup>478</sup> IRC sec. 7704(d).

<sup>479</sup> Treas. Reg. sec. 1.1502-13(f)(2)(ii).

burden falls on individuals and not corporations. An instinctual reaction may be that the burden is borne by the shareholders in the form of lower after-tax rates of return on their investments in the corporation.<sup>480</sup> But that ignores the possibility that the burden may be shifted to consumers in the form of higher prices, to workers in the form of lower wages, or to non-corporate capital as capital moves out of the corporate sector because of the lower after-tax returns offered by corporations.

Because of the uncertainty over who bears the burden of the corporate income tax, for many years, the Joint Committee on Taxation disregarded the tax in its distributional analyses.<sup>481</sup> In October 2013, the JCT issued a pamphlet analyzing the burden of both corporate income taxes and taxes on the business income of pass-through entities.<sup>482</sup> The JCT concluded that, in the short run, the entire tax burden falls on owners of capital. In a longer run, however, the burden of the corporate income tax is borne 75 percent by domestic capital and 25 percent by domestic labor. In the case of taxes on business income of pass-through entities, the JCT concluded that 95 percent is borne by domestic capital and five percent is borne by domestic labor.

Until recently, the CBO allocated the entire economic burden of the corporate income tax to owners of capital in proportion to their shares of aggregate capital income. In July 2012, the CBO reevaluated the research on the topic of corporate tax incidence and decided to allocate 75

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<sup>480</sup> This has been referred to as the naïve view. See William M. Gentry, *A Review of the Evidence on the Incidence of the Corporate Income Tax*, Department of the Treasury, OTA Paper 101 (Dec. 2007).

<sup>481</sup> See JOINT COMMITTEE ON TAXATION, READING JCT STAFF DISTRIBUTIONAL TABLES: AN INTRODUCTION TO METHODOLOGIES AND ISSUES, (Dec. 9, 2008) (“Individuals of course must ultimately bear the cost of the corporate income tax, but JCT staff agnosticism reflects the uncertainty as to *which* individuals bear that cost.”). Cf. JOINT COMMITTEE ON TAXATION, METHODOLOGY AND ISSUES IN MEASURING CHANGES IN THE DISTRIBUTION OF TAX BURDENS, JCS-7-93 (1993).

<sup>482</sup> JOINT COMMITTEE ON TAXATION, MODELING THE DISTRIBUTION OF TAXES ON BUSINESS INCOME, JCX-14-13 (Oct. 16, 2013).



percent of the corporate income tax to capital income and 25 percent to labor income in its distribution analyses.<sup>483</sup> Treasury has changed its incidence assumption for the corporate income tax over the last 20 years.<sup>484</sup> From 1990 until 2007, Treasury assumed the corporate income tax was borne entirely by capital.<sup>485</sup> In 2008, Treasury revised its assumption and allocated 76 percent to capital and 24 percent to labor.<sup>486</sup> Beginning in 2012, Treasury revised its assumption again and assumed 82 percent of the corporate income tax burden is borne by capital and 18 percent is borne by labor.<sup>487</sup>

Two underlying issues have challenged economists for years in determining the incidence of the corporate income tax: exactly which individuals bear the burden and how much of the burden do they bear. As to which individuals bear the burden, it could be borne by some combination of the shareholders of the corporation, investors in all capital because of a decrease in the overall return to capital, workers through a decrease in wages, and consumers through increased prices. As to how much of the burden the various individuals bear, because of the distortions caused by the corporate income tax, the economic burden of the tax may exceed the revenue raised by the tax.

In a landmark article published in 1962, Professor Arnold Harberger used a general equilibrium methodology, which recognized that tax changes in one market can affect prices and

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<sup>483</sup> See CONGRESSIONAL BUDGET OFFICE, THE DISTRIBUTION OF HOUSEHOLD INCOME AND FEDERAL TAXES, 2008 AND 2009 (July 2012).

<sup>484</sup> See Julie-Anne Cronin, Emily Y. Lin, Laura Power and Michael Cooper, *Distributing the Corporate Income Tax: Revised U.S. Treasury Methodology*, Department of Treasury, Office of Tax Analysis, Technical Paper 5 (May 2012).

<sup>485</sup> Id.

<sup>486</sup> Id.

<sup>487</sup> Id.

quantities in other markets.<sup>488</sup> The long-term tax burdens depended on how much these variables must change before a new equilibrium is achieved.<sup>489</sup> Harberger's model was closed (no capital flows between countries) and involved two sectors, corporate and non-corporate, and two factors, labor and capital. Harberger determined that:

in the long term, perfect mobility and the ability to substitute capital between corporate and noncorporate sectors implies that capital will move from the corporate to the noncorporate sector until the rates of return (after taxes) are equal among all types of capital. Thus, if the net return from corporate capital falls, the net return from noncorporate capital must fall as well, and capital in general, not corporate capital specifically, will bear the burden of the corporate income tax.<sup>490</sup>

As a result, Harberger concluded that capital, both corporate and noncorporate, bears about 100 percent of the corporate tax burden in a closed economy.

It is important to understand that Harberger assumed a closed economy in his study. Later research assumed that capital is perfectly mobile between countries but labor is not. These later studies have concluded that labor bears a significant burden of the corporate income tax. More specifically, as the economy becomes more open, capital becomes more mobile.<sup>491</sup> Moreover, the very nature of capital itself has evolved away from stocks of physical resources toward intangible outputs (represented by patents and the like) which are highly mobile in terms of where they are located. As a result, if a home country taxes capital, the capital will flee the home country to the rest of the world to obtain the higher after-tax world return. This shift in capital reduces the return to labor in the home country while increasing the return to labor abroad.

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<sup>488</sup> Arnold Harberger, *The Incidence of the Corporate Income Tax*, 70 J. POL. ECON. 215-240 (1962).

<sup>489</sup> See CONGRESSIONAL BUDGET OFFICE, THE INCIDENCE OF THE CORPORATE INCOME TAX (Mar. 1996) at 7.

<sup>490</sup> *Id.*

<sup>491</sup> See Peter A. Diamond and James A. Mirrlees, *Optimal Taxation and Public Production*, 61 AMER. ECON. REV. 261 (1971).

Capital will continue to move abroad until the point where the after-tax return to capital in the home country equals the after-tax world return. Therefore, if capital is perfectly mobile, home country labor will bear the entire burden of the corporate income tax. In fact, because of the deadweight loss caused by the outward shift of capital, the cost to the home country labor can exceed the tax revenue generated by the corporate income tax.<sup>492</sup> This suggests that open economies may be better off taxing home country labor directly as compared to imposing a corporate income tax that distorts the allocation of capital.<sup>493</sup> In a 1985 study, John Mutti and Harry Grubert showed that with perfect capital mobility, only 14 percent of the corporate tax burden fell on domestic capital.<sup>494</sup> If capital mobility is reduced, then the amount of tax that domestic capital bears is increased.

In a 1996 paper, the CBO made a number of observations and conclusions in determining the incidence of the corporate income tax: (1) the short-term burden of the corporate tax falls on shareholders or investors in general, (2) the long-term burden of corporate or dividend taxation is unlikely to rest fully on corporate equity, (3) in a closed economy, the long-term incidence falls on capital in general, (4) in the context of international capital mobility, the incidence may be shifted to labor or land but only to the degree that the capital and outputs of different countries can be substituted, and (5) in the very long term, burden is likely to be shifted to labor.<sup>495</sup>

In the last five to ten years, a number of researchers have attempted to determine the incidence of the corporate income tax. Generally the researchers fall into two groups: one group

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<sup>492</sup> See Wiji Arulampalam, Michael P. Devereux, and Giorgia Maffini, *The Direct Incidence of the Corporate Income Tax on Wages*, 56 EUR. ECON. REV. 1038, 1039 (2012).

<sup>493</sup> *Id.* at 1039.

<sup>494</sup> John Mutti and Harry Grubert, *The Taxation of Capital Income in an Open Economy: The Importance of Resident-Nonresident Tax Treatment*, 27 J. PUB. ECON. 291 (1985).

<sup>495</sup> CONGRESSIONAL BUDGET OFFICE, THE INCIDENCE OF THE CORPORATE INCOME TAX, *supra* note 489.

extends the Harberger model to determine how a hypothetical corporate income tax would affect the equilibrium return to capital and labor, while the second group relies on empirical evidence relating corporate tax rates to changes in wage rates.<sup>496</sup>

### 1. Theoretical Models

In a 2006 CBO working paper, William Randolph concluded that in an open economy:

. . . when capital is perfectly mobile and the tax does not affect the world prices of traded goods, domestic labor bears slightly more than 70 percent of the long run burden of the corporate income tax. The domestic owners of capital bear slightly more than 30 percent of the burden. Domestic landowners receive a small benefit. At the same time, the foreign owners of capital bear slightly more than 70 percent of the burden, but their burden is exactly offset by the benefits received by foreign workers [about 70 percent] and landowners [about one percent]. When capital is less mobile internationally, domestic labor's burden is lower and domestic capital's burden is higher.<sup>497</sup>

When changing the specifications, Randolph concludes that 59 to 91 percent of the burden falls on labor and 38 to 73 percent of the burden falls on capital.

In 1995, 2006 and 2008, Harberger published additional papers on the corporate tax incidence.<sup>498</sup> In his 2006 paper, assuming perfect substitution of capital and products, Harberger determined that 130 percent of the corporate tax burden fell on domestic labor. With imperfect product substitution, Harberger concluded that 96 percent of the burden falls on labor.

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<sup>496</sup> See Rosanne Altshuler, Benjamin Harris, and Eric Toder, *Capital Income Taxation and Progressivity in a Global Economy*, Tax Policy Center, (May 12, 2010).

<sup>497</sup> William Randolph, Congressional Budget Office, *International Burdens of the Corporate Income Tax* (Aug. 2006) at 44.

<sup>498</sup> See Arnold Harberger, *The ABCs of Corporation Tax Incidence: Insights into the Open-Economy Case*, in TAX POLICY AND ECONOMIC GROWTH (1995); Arnold Harberger, *Corporate Tax Incidence: Reflections on What is Known, Unknown and Unknowable*, in FUNDAMENTAL TAX REFORM: ISSUES, CHOICES AND IMPLICATIONS (John W. Diamond and George R. Zodrow, eds. 2008); Arnold Harberger, *The Incidence of the Corporate Income Tax Revisited*, 61 NAT'L TAX J. 303 (2008).

## 2. Empirical Studies

In a 2006 paper that was based on collecting and analyzing data of 72 countries over 22 years, Kevin Hassett and Aparna Mathur estimated the effect of corporate income tax on manufacturing wages.<sup>499</sup> The authors concluded that a one percent increase in the corporate tax rate is associated with a nearly one percent drop in wage rates. Four years later, the authors updated their research using data from 65 countries over 25 years.<sup>500</sup> The authors found that a one percent increase in the corporate income tax rate led to a 0.5 percent decrease in wage rates. So, for example, if the corporate income tax rate increased from 35 percent to 35.35 percent (a one percent increase), a \$10 per hour wage rate will decrease to \$9.95 per hour (a 0.5 percent decrease).

Based on data from 19 countries over 24 years, Federal Reserve economist Alison Felix estimated that a ten percentage point increase in the corporate tax rate of high income countries reduces average annual gross wages by seven percent.<sup>501</sup> Using U.S. data on corporate tax revenues and total wages, Felix predicted that labor's burden is more than four times the magnitude of the corporate tax revenue collected in the United States.<sup>502</sup> In addition, Felix wrote that the corporate tax appears to reduce the wages of both low-skill and high-skill workers to the same degree.<sup>503</sup>

Using data from American multinational companies operating in more than 50 countries between 1989 and 2004, Mihir Desai, Fritz Foley and James Hines estimated that between 45 percent and 75 percent of the burden of corporate taxes is borne by labor with a baseline estimate

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<sup>499</sup> Kevin Hassett and Aparna Mathur, *Taxes and Wages*, AEI Working Paper No. 128 (June 2006).

<sup>500</sup> Kevin Hassett and Aparna Mathur, *Spatial Tax Competition and Domestic Wages*, AEI Working Paper (Dec. 2010).

<sup>501</sup> R. Alison Felix, *Passing the Burden: Corporate Tax Incidence in Open Economies*, Federal Reserve Bank of Kansas City (Oct. 2007).

<sup>502</sup> *Id.*

<sup>503</sup> *Id.*

of 57 percent.<sup>504</sup> The balance of the burden is borne by capital. Based on data from 55,000 companies in nine major European countries over the period 1996 to 2003, Wiji Arulampalam, Michael P. Devereux, and Giorgia Maffini, estimated “that approximately 50 percent of an exogenous increase in tax is passed on in lower wages in the long run.”<sup>505</sup>

Robert Carroll uses data from the U.S. states for the years 1970 to 2007 to determine the effects of state corporate income tax changes on labor.<sup>506</sup> Carroll determines that states with comparatively low corporate income taxes have seen wages rise beyond what they would have otherwise. More specifically, Carroll determines that a one percent drop in the average corporate tax rate leads to a 0.014 percent rise in real wages five years later. That translates into a \$2.50 rise in wages for every one dollar reduction in state corporate income taxes. The converse is also true: a one percent increase in the average corporate tax rate leads to a 0.014 percent decrease in real wages five years later.

### 3. Review of Earlier Studies

Matthew Jensen and Aparna Mathur review the current studies on the incidence of the corporate income tax.<sup>507</sup> They write that “the practice of assigning the entire economic incidence of the corporate income tax to capital is certainly simplistic and probably wrong.”<sup>508</sup> They note that both the theoretical models and the empirical studies suggest that labor bears a significant portion of the corporate income tax burden. They conclude that the conservative estimate from

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<sup>504</sup> Mihir A. Desai, C. Fritz Foley, and James R. Hines, Jr., *Labor and Capital Shares of the Corporate Tax Burden: International Evidence* (Dec. 2007).

<sup>505</sup> Wiji Arulampalam, Michael P. Devereux, and Giorgia Maffini, *supra* note 492, at 1052.

<sup>506</sup> Robert Carroll, *The Corporate Income Tax and Workers' Wages: New Evidence from the 50 States*, Tax Foundation, Special Report No. 169 (Aug. 2009).

<sup>507</sup> Matthew H. Jensen and Aparna Mathur, *Corporate Tax Burden on Labor: Theory and Empirical Evidence*, 131 TAX NOTES 1083 (June 6, 2011).

<sup>508</sup> *Id.* at 1089.

the theoretical models is about 40 percent of the burden is borne by labor with the conservative estimate from the empirical models that 45 percent to 75 percent is borne by labor.

#### 4. Conclusion

It appears that 50 years after Harberger's groundbreaking article, it is still not clear from the economics literature precisely who bears the incidence of the corporate tax. However, it is clear that labor bears a significant fraction of the burden.

##### H. The Corporate Tax as a Revenue Source

The United States has a number of revenue sources including individual income taxes, payroll taxes, corporate income taxes, excise taxes, estate and gift taxes, and custom duties. Total federal revenues for 2013 were \$2.775 trillion.<sup>509</sup> Of this amount: individual income taxes were the single largest source of revenue at \$1.316 trillion, or 47 percent of the total; payroll taxes were second at \$948 billion, or 34 percent of the total; and corporate income taxes were a distant third at \$274 billion, or 10 percent of the total.

Corporate income tax revenues as a percentage of total federal revenues have steadily declined since peaking in 1943 at 39.8 percent.<sup>510</sup> By 1980, corporate tax revenues were only 12.5 percent of federal revenues, and two years later, only 8.0 percent. During much of the 1990s, corporate tax revenues averaged about 11.0 percent of federal revenues. In 2006, corporate tax revenues rose to 14.7 percent of federal revenues, eventually declining to 6.6 percent in 2009, 8.9 percent in 2010, and 7.9 percent in 2011. Most recently, corporate tax revenues have averaged about 10 percent of federal revenues.

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<sup>509</sup> CONGRESSIONAL BUDGET OFFICE, AN UPDATE TO THE BUDGET AND ECONOMIC OUTLOOK: 2014 TO 2014 (Aug. 2014) at 9.

<sup>510</sup> Id.

**Table 5.4**  
**Percentage Composition of Receipts by Source, 1940-2013<sup>511</sup>**

	Individual Income Taxes	Corporate Income Taxes	Social Insurance and Retirement Receipts	Excise Taxes	Other
1940	13.6	18.3	27.3	30.2	10.7
1950	39.9	26.5	11.0	19.1	3.4
1960	44.0	23.2	15.9	12.6	4.2
1970	46.9	17.0	23.0	8.1	4.9
1980	47.2	12.5	30.5	4.7	5.1
1990	45.2	9.1	36.8	3.4	5.4
2000	49.6	10.2	32.2	3.4	4.5
2006	43.4	14.7	34.8	3.1	4.0
2007	45.3	14.4	33.9	2.5	3.9
2008	45.4	12.1	35.7	2.7	4.2
2009	43.5	6.6	42.3	3.0	4.7
2010	41.5	8.9	40.0	3.1	6.5
2011	47.4	7.9	35.5	3.1	6.1
2012	46.2	9.9	34.5	3.2	6.2
2013	47.4	9.9	34.2	3.0	5.5

Corporate tax receipts depend heavily on the economy. When economic conditions are strong, corporate profits typically grow, leading to higher corporate tax revenues. For example, in 2006 and 2007, when the economy was strong, corporate tax receipts were \$354 billion and \$370 billion, respectively, which were 14.7 percent and 14.4 percent of federal revenues. When the economy is weak, generally corporate profits are down, generating lower corporate tax revenues. The economic downturn that took place in late 2008 led to a very weak economy in 2009 and 2010, which generated corporate tax revenues of \$138 billion and \$191 billion, respectively, which were 6.6 percent and 8.9 percent of federal revenues.

In 2011, there were 1,648,540 returns of active corporations (not including S corporations, REITs and RICs). However, the corporate income tax is paid predominantly by a very small

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<sup>511</sup> THE WHITE HOUSE, OFFICE OF MANAGEMENT AND BUDGET, HISTORICAL TABLES, available at <http://www.whitehouse.gov/omb/budget/Historicals/> (accessed Nov. 11, 2014).



number of corporations. In 2011, 345 corporations (about two one-hundredths of one percent of all active corporations) had an income tax liability (after credits) of \$100 million or more and paid a total of slightly more than \$141 billion of corporate income taxes.<sup>512</sup> This was about 64 percent of the total tax paid by all corporations. Approximately 8,500 corporations (about one-half of one percent of all active corporations), each with an income tax liability of \$1 million or more (after credits) paid almost \$209 billion of corporate income taxes, which was 95 percent of the total tax paid by all corporations.<sup>513</sup>

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<sup>512</sup> INTERNAL REVENUE SERVICE, SOI TAX STATS – TABLE 22 – RETURNS OF ACTIVE CORPORATIONS, OTHER THAN FORMS 1120S, 1120-REIT, AND 1120-RIC, available at <http://www.irs.gov/uac/SOI-Tax-Stats-Table-22>Returns-of-Active-Corporations,-Other-Than-Forms-1120S,-1120-REIT,-and-1120-RIC> (accessed Nov. 25, 2014).

<sup>513</sup> Id.

**Table 5.5**  
**Returns of Active Corporations, Other Than S Corporations, REITs and RICs**  
**Tax Year 2011<sup>514</sup>**

Size of total income tax after credits	Number of Returns of Active Corporations, Other Than S Corporations, REITs and RICs	Income Subject to Tax	Total Income Tax Before Credits		Foreign Tax Credit	General Business Credit	Prior Year Minimum Tax Credit	Total Income Tax After Credits
			Total	Income Tax				
Total	1,648,540	993,385,375	348,994,340	345,142,747	107,103,753	19,364,719	1,559,010	220,540,823
\$1 Under \$6,000	316,163	3,408,564	556,654	543,940	5,172	38,592	4,243	508,639
\$6,000 Under \$10,000	47,274	2,263,213	375,877	366,816	2,403	14,991	1,315	357,168
\$10,000 Under \$15,000	22,622	1,489,758	306,053	296,075	13,078	17,563	1,299	274,114
\$15,000 Under \$20,000	11,013	881,665	207,334	198,268	1,125	13,903	437	191,636
\$20,000 Under \$25,000	7,568	7,293,460	2,478,178	2,470,347	2,304,881	5,285	837	167,175
\$25,000 Under \$50,000	21,773	4,157,776	1,277,202	1,242,835	457,792	46,552	4,370	766,006
\$50,000 Under \$75,000	8,927	1,889,672	624,740	596,350	37,024	32,752	7,296	547,577
\$75,000 Under \$100,000	5,650	1,922,021	669,908	643,025	159,254	18,211	2,839	488,956
\$100,000 Under \$250,000	14,329	8,157,205	2,916,686	2,784,753	478,885	133,651	25,094	2,278,385
\$250,000 Under \$500,000	7,375	10,620,733	3,734,970	3,640,068	986,023	110,443	20,731	2,615,927
\$500,000 Under \$1,000,000	4,833	12,522,808	4,365,738	4,277,667	769,058	159,028	42,043	3,391,511
\$1,000,000 Under \$10,000,000	6,574	78,597,931	28,032,427	27,204,518	7,226,835	1,472,288	197,666	19,092,447

<sup>514</sup> Id.

\$10,000,000 Under \$50,000,000	1,334	117,696,369	41,764,847	41,194,865	9,095,638	2,790,086	310,770	29,348,362
\$50,000,000 Under \$100,000,000	275	88,569,459	31,531,837	31,064,137	9,042,403	2,617,270	480,222	19,356,863
\$100,000,000 or more	345	639,780,564	225,460,355	223,922,314	71,951,954	11,791,226	448,164	141,156,057

## I. Corporate Tax Expenditures

Every year, the Treasury Department and the Joint Committee on Taxation publish a list of tax expenditures, along with foregone revenue associated with each said expenditure, as required by the Congressional Budget and Impoundment Control Act of 1974 (the Budget Act). The Budget Act defines tax expenditures as “those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.”<sup>515</sup>

The following two tables list total tax expenditures and the top 10 tax expenditures for corporations.

**Table 5.6**

**Sum of Tax Expenditure Estimates by Type of Taxpayer, Fiscal Years 2014-2018<sup>516</sup>**

Fiscal Year	Individuals (billions of \$)	Corporations (billions of \$)	Total (billions of \$)
2014	1,036.2	154.4	1,190.6
2015	1,152.4	156.8	1,309.2
2016	1,305.5	177.7	1,483.2
2017	1,400.1	193.9	1,594.0
2018	1,466.0	205.0	1,671.0

<sup>515</sup> Congressional Budget and Impoundment Act Control Act of 1974, sec. 3(a)(3).

<sup>516</sup> JOINT COMMITTEE ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2014-2018, JCX-97-14 (Aug. 5, 2014).

As the table demonstrates the overwhelming percentage of tax expenditures benefit individuals rather than corporations. In the corporate context, the top 10 corporate tax expenditures are over 90 percent of the total dollars of tax expenditures directed to corporations.

**Table 5.7**

**Ten Largest Tax Expenditures, 2014: Corporations<sup>517</sup>**

Tax Expenditure	Amount (billions of \$)
Deferral for active income of controlled foreign corporations	83.4
Deduction of income attributable to domestic production activities	12.2
Deferral of gain on like-kind exchanges	11.7
Exclusion of interest on public purpose state and local government bonds	9.3
Deferral of gain on non-dealer installment sales	6.9
Credit for low income housing	6.8
Expensing of research and experimental expenditures	4.6
Reduced rates on first \$10 million of corporate taxable income	3.8
Inventory property sales source rule	3.0
Exclusion of investment income on life insurance and annuity contracts	2.7 (tied)
Special treatment of life insurance company reserves	2.7 (tied)

Similar to the taxation of individuals, the corporate tax base needs to be broadened with an elimination of almost all corporate tax expenditures. The Joint Committee on Taxation issued a memorandum dated October 12, 2011, estimating that if all corporate tax expenditures were repealed and utilizing only the portion of revenue attributable to C corporations, the top corporate tax rate could be lowered to 25 percent in a revenue neutral manner.<sup>518</sup>

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<sup>517</sup> Id.

<sup>518</sup> Memorandum from Thomas A. Barthold (Oct. 12, 2011).

Most of the economic literature supports elimination of most tax incentives in the corporate tax code, with exceptions such as subsidies for research and development. Economist Martin Sullivan, for example, has expressed the support by writing the following sentiments:

Free market economics tells us that the government should not interfere with private sector investment decisions. That's why economists gnash their teeth at lobbyists' pleadings, and that's why economists favor base-broadening tax reform. But tax breaks for science and technology are the rare exceptions to this anti-loophole rule. There are more benefits to research than the investing company will realize in higher profits, and so the free market, left to its own devices, will underinvest in technology. The hands off approach is not good economic policy when it comes to research. To promote growth, government should push research above free market levels. And that is why the research credit gets the economists' seal of approval.<sup>519</sup>

Research and development generate positive external effects, meaning that the social returns to research and development are typically much larger than the private returns. In the absence of government support for research and development, the private sector is likely to invest less in research and development than its potential social returns would warrant. As a result, two corporate tax expenditures that need to be retained are expensing of research and experimental expenditures and the credit for research and development. Unfortunately, the research and development tax credit has currently expired. Senator Hatch has introduced a bill simplifying and enhancing the research and development tax credit as well as making it permanent.<sup>520</sup>

In many years (but not 2014), one of the largest corporate tax expenditures is depreciation of equipment in excess of the alternative depreciation system.<sup>521</sup> A number of tax scholars have

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<sup>519</sup> Martin A. Sullivan, *Economic Analysis: Time for a U.S. Patent Box*, 133 TAX NOTES 1304 (Dec. 12, 2011).

<sup>520</sup> Greater Research Opportunities with Tax Help Act ("GROWTH Act"), S.1577, 112th Cong., 1st Sess. (Sept. 19, 2011).

<sup>521</sup> For 2014, the tax expenditure estimate for depreciation of equipment in excess of the alternative depreciation system is *negative* \$23.7 billion. It remains negative in 2015 and 2016 before becoming slightly positive in 2017. See JOINT COMMITTEE ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2014-2018, JCX-97-14 (Aug. 5, 2014) at 27.

advocated a cash-flow business tax.<sup>522</sup> Under such a system, investments in equipment and machinery would be immediately expensed. Such a system reduces the effective tax rate on equipment and machinery to zero. This is an observation generally credited to Dr. E. Cary Brown, who noted that immediately deducting the cost of an investment is equivalent to exempting the income of the investment from tax.<sup>523</sup> If the purchase of the equipment and machinery is debt-financed, then the effective tax rate actually becomes negative because of the combination of expensing and interest deduction on the debt. As a result, under such a system, the interest deduction on debt-financed equipment or machinery must be denied, or the loan proceeds must be included in income to avoid a negative effective tax rate.

As part of the Tax Reform Act of 1986, Congress modified the depreciation rules to produce effective tax rates on equipment and structures close to the statutory tax rates. This was accomplished by setting depreciation rules so that the present value of the depreciation deductions would be approximately equal to the present value of economic depreciation.<sup>524</sup> Economic depreciation is designed to approximate the actual decline in value of the equipment or structure.<sup>525</sup> The CBO has noted that the depreciation rules enacted in 1986 approximate economic depreciation if the inflation rate is about five percent annually.<sup>526</sup> Because the depreciation rules are not indexed

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<sup>522</sup> See ROBERT E. HALL AND ALVIN RABUSHKA, *LOW TAX, SIMPLE TAX, FLAT TAX* (1983); DAVID F. BRADFORD, *UNTANGLING THE INCOME TAX* (1986); ROBERT CARROLL AND ALAN D. VIARD, *PROGRESSIVE CONSUMPTION TAXATION: THE X TAX REVISITED* (2012).

<sup>523</sup> E. Cary Brown, *Business-Income Taxation and Investment Incentives*, in *INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSEN* 300, 300-16 (1948). Dr. Brown was an economics professor at the Massachusetts Institute of Technology.

<sup>524</sup> CONGRESSIONAL BUDGET OFFICE, *REDUCING THE DEFICIT: SPENDING AND REVENUE OPTIONS* (Mar. 2011) at 180.

<sup>525</sup> See Paul A. Samuelson, *Tax Deductibility of Economic Depreciation to Insure Invariant Valuations*, 72 *J. POL. ECON.* 604 (1964).

<sup>526</sup> CONGRESSIONAL BUDGET OFFICE, *REDUCING THE DEFICIT: SPENDING AND REVENUE OPTIONS*, *supra* note 524, at 180.

for inflation (i.e., depreciation deductions are based on the original cost of the asset), the rate of recovery was accelerated as part of the 1986 Act to offset the loss in present value due to the lack of inflation indexing.

#### J. Corporate Tax Rates

The United States has a progressive corporate tax rate structure with statutory rates beginning at 15 percent and culminating at 35 percent.<sup>527</sup>

**Table 5.8**

**U.S. Statutory Corporate Tax Rates**

Taxable Income	Rate
Up to \$50,000	15
Over \$50,000 but not over \$75,000	25
Over \$75,000 but not over \$10 million	34
Over \$10 million	35

As part of the rate structure are two surtaxes that, in essence, create two additional corporate tax rates. The first surtax of five percent reduces the rate advantage of the first two rate brackets. The second surtax of three percent reduces the rate advantage of the 34 percent tax bracket. The following table shows the corporate tax rates (including the surtaxes) at the taxable income threshold levels:

**Table 5.9**

**U.S. Statutory Corporate Tax Rates (Including Surtaxes)**

Taxable Income	Rate
Up to \$50,000	15
Over \$50,000 but not over \$75,000	25
Over \$75,000 but not over \$100,000	34

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<sup>527</sup> IRC sec. 11.

Over \$100,000 but not over \$335,000	39
Over \$335,000 but not over \$10,000,000	34
Over \$10,000,000 but not over \$15,000,000	35
Over \$15,000,000 but not over \$18,333,333	38
Over \$18,333,333	35

The Joint Committee on Taxation lists the progressive rate structure of the corporate tax as a tax expenditure.<sup>528</sup> The benefits of the progressive rate structure are almost entirely inapplicable to large U.S. corporations, many of which have taxable incomes in excess of \$18,333,333. Those corporations are currently subject to a flat 35 percent corporate tax rate. A greatly reduced corporate tax rate would be more consistent with the rate structure of much of the industrialized world.

**Table 5.10**  
**OECD Countries -- Statutory Corporate Tax Rates<sup>529</sup>**

Country	2012 Tax Rate (%)	2012 Ranking	2002 Tax Rate (%)	2002 Ranking	Change in Tax Rate 2002-2012 (percentage points)	Change in Ranking 2002-2012
Australia	30.00	6	30.00	19	0.0	13
Austria	25.00	17	34.00	13	-9.0	-4
Belgium	34.00	4	40.17	2	-6.2	-2
Canada	26.10	15	38.05	5	-12.0	-10
Chile	20.00	25	15.00	34	5.0	9
Czech Republic	19.00	30	31.00	17	-12.0	-13
Denmark	25.00	17	30.00	19	-5.0	2
Estonia	21.00	24	26.00	27	-5.0	3
Finland	26.00	16	29.00	23	-3.0	7
France	34.40	3	35.43	8	-1.0	5
Germany	30.20	5	38.90	4	-8.7	-1
Greece	20.00	25	35.00	9	-15.0	-16
Hungary	19.00	30	18.00	31	1.0	1
Iceland	20.00	25	18.00	31	2.0	6

<sup>528</sup> JOINT COMMITTEE ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2014-2018, JCX-97-14 (Aug. 5, 2014).

<sup>529</sup> See Scott A. Hodge, *The Countdown is Over. We're #1*, *supra* note 327.



Ireland	12.50	34	16.00	33	-3.5	-1
Israel	24.00	22	36.00	6	-12	-16
Italy	27.50	12	36.00	6	-8.5	-6
Japan	38.01	2	40.87	1	-2.9	-1
Korea	24.20	21	29.70	22	-5.5	1
Luxembourg	28.80	9	30.38	18	-1.6	9
Mexico	30.00	6	35.00	9	-5.0	3
Netherlands	25.00	17	34.50	12	-9.5	-5
New Zealand	28.00	10	33.00	14	-5.0	4
Norway	28.00	10	28.00	24	0.0	14
Poland	19.00	30	28.00	24	-9.0	-6
Portugal	26.50	13	33.00	14	-6.5	1
Slovak Republic	19.00	30	25.00	28	-6.0	-2
Slovenia	20.00	25	25.00	28	-5	3
Spain	30.00	6	35.00	9	-5.0	3
Sweden	26.30	14	28.00	24	-1.7	10
Switzerland	21.20	23	24.42	30	-3.2	7
Turkey	20.00	25	33.00	14	-13.0	-11
United Kingdom	25.00	17	30.00	19	-5.0	2
United States	39.20	1	39.30	3	-0.1	2
Simple Avg/Non-U.S. OECD	24.90		30.300		-5.4	
Weighted Avg/Non-U.S. OECD	29.30		35.40		-6.1	
Weighted Avg/Non-U.S. G-7	31.80		37.50			

In a world of capital mobility, corporate tax rates matter. Business decisions regarding where to invest are sensitive to corporate tax rates. As Laura Tyson, former chair of President Clinton’s Council of Economic Advisors, has written, “America’s relatively high rate encourages U.S. companies to locate their investment, production, and employment in foreign countries, and

discourages foreign companies from locating in the United States, which means slower growth, fewer jobs, smaller productivity gains and lower real wages.”<sup>530</sup>

Some have argued that while statutory corporate tax rates are important, the focus should be on effective corporate tax rates. The argument is that the United States corporate tax code contains a number of deductions and exclusions that narrow the corporate tax base, thereby substantially lowering the effective corporate tax rate relative to the statutory corporate tax rate. In 2011, the American Enterprise Institute (AEI) released a report comparing effective corporate tax rates in the OECD countries.<sup>531</sup> In its report, AEI wrote that “Even by this measure [effective corporate tax rates], the United States does much worse than other OECD countries.” The following table shows effective average tax rates (EATRs) and effective marginal tax rates (EMTRs) of OECD countries for 2009 and 2010. Effective marginal tax rates drive decisions about whether or not a business wishes to engage in fresh productive activities—that is, such rates are relevant to the marginal decisions related to acquisitions of productive labor and capital inputs.

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<sup>530</sup> Laura Tyson, *The Corporate Tax Conundrum*, Project Syndicate (May 3, 2012), available at <http://www.project-syndicate.org/commentary/the-corporate-tax-conundrum> (accessed Nov. 2, 2014).

<sup>531</sup> See Kevin A. Hassett and Aparna Mathur, *Report Card on Effective Tax Rates: United States Gets an F*, Tax Policy Outlook No. 1 (Feb. 2011), available at <http://www.aei.org/wp-content/uploads/2011/10/TPO-2011-01-g.pdf> (accessed Dec. 4, 2014).

**Table 5.11****Tax Rates (%) of OECD Countries, 2009 and 2010<sup>532</sup>**

Country	2010 EATR <sup>533</sup>	2010 EMTR <sup>534</sup>	2010 Statutory Combined Rate	2009 EATR	2009 World Bank EATR Estimate
Australia	22.2	17.0	30.0	22.2	25.9
Austria	20.8	18.2	25.0	20.8	15.7
Belgium	22.3	13.9	34.0	22.3	4.8
Canada	25.5	23.4	29.5	27.1	9.8
Chile	13.9	11.5	17.0	13.9	--
Czech Republic	18.4	18.1	19.0	19.4	7.4
Denmark	19.9	16.5	25.0	19.9	21.9
Finland	20.7	17.3	26.0	20.7	15.9
France	27.5	23.8	34.4	27.5	8.2
Germany	24.2	20.7	30.2	24.2	22.9
Greece	17.9	13.4	24.0	18.6	13.9
Hungary	15.7	13.4	19.0	16.6	16.7
Iceland	--	--	15.0	--	6.9
Ireland	10.9	9.7	12.5	10.9	11.9
Italy	24.3	22.6	27.5	24.3	22.8
Japan	33.0	30.5	39.5	33.0	27.9
Korea	18.1	13.6	24.2	18.1	15.3
Luxembourg	20.1	13.9	28.6	20.1	4.1
Mexico	28.4	27.7	30.0	26.5	--
Netherlands	19.4	15.1	25.5	19.4	20.9
New Zealand	--	--	30.0	--	30.4
Norway	24.2	22.1	28.0	24.2	24.4
Poland	16.2	14.1	19.0	16.2	17.7
Portugal	18.3	12.2	26.5	18.3	14.9
Slovak Republic	19.2	19.3	19.0	19.2	7.0
Spain	27.5	26.3	30.0	27.5	20.9
Sweden	18.5	12.6	26.3	18.5	16.4
Switzerland	15.4	10.9	21.2	15.4	8.9
Turkey	13.1	7.3	20.0	13.1	8.9

<sup>532</sup> Id. at 6. For Iceland and New Zealand, the authors of the report did not have enough information on depreciation allowances to compute the effective tax rates.

<sup>533</sup> The effective average tax rate (EATR) is the average rate a firm might expect to face on an investment project over the possible distribution of profitability. The EATR can impact location choices for productive activities. Id. at 3-4.

<sup>534</sup> The effective marginal tax rate (EMTR) is the tax liability incurred on an additional dollar of investment. The EMTR can impact the scaling of the productive activities conditional on the location. Id. at 4.

United Kingdom	22.3	18.8	28.0	22.3	23.2
United States	29.0	23.6	39.2	28.9	27.6
Avg excluding United States	20.5	17.2	25.5	20.6	15.9

There have been numerous studies and reports, in addition to the AEI report, showing that the United States has a higher effective corporate tax rate than almost all other OECD countries.<sup>535</sup>

There have been a few studies, viewed as outliers, showing the opposite – that the U.S. effective corporate tax rate is lower than that of many developed countries.<sup>536</sup>

#### K. Methods of Partial or Complete Integration

Generally, eight methods have been advanced to achieve corporate tax integration, some of which we touched on earlier: (1) dividend exclusion, (2) shareholder allocation, (3) imputation (or shareholder) credit, (4) comprehensive business income tax (CBIT), (5) business enterprise income tax (BEIT), (6) dividends paid deduction, (7) mark-to-market for publicly traded stock and

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<sup>535</sup> See, e.g., Katarzyna Bilicka, Michael Devereux and Clemens Fuest, *G20 Corporate Tax Ranking 2011*, Oxford University Centre for Business Taxation (July 2011); Katarzyna Bilicka and Michael Devereux, *CBT Corporate Tax Ranking 2012*, Oxford University Centre for Business Taxation (June 2012); Christoph Spengel, Christina Elschner and Dieter Endres, *Effective Tax Levels Using the Devereux-Griffith Methodology*, (ZEW) Center for European Economic Research (Oct. 2012); PricewaterhouseCoopers, *Global Effective Tax Rates*, Report prepared for Business Roundtable (April 14, 2011); Kevin S. Markle and Douglas A. Shackelford, *Cross-Country Comparisons of Corporate Income Taxes*, 65 NAT'L TAX J. 493 (2012); Namryoung Lee and Charles Swenson, *Is It a Level Playing Field? An Analysis of Effective Tax Rates*, 54 TAX NOTES INT'L 685 (2009); KPMG, *COMPETITIVE ALTERNATIVES 2010: FOCUS ON TAX* (2010); PricewaterhouseCoopers, *Paying Taxes 2011: The Global Picture*, prepared for the World Bank and the International Finance Corporation (2011); Duanjie Chen and Jack Mintz, *New Estimates of Effective Corporate Tax Rates on Business Investment*, Cato Institute, TAX AND BUDGET BULLETIN (Feb. 2011); Andrew B. Lyon, *Another Look at Corporate Effective Tax Rates, 2004-2010*, 141 TAX NOTES 313 (Oct. 21, 2013).

<sup>536</sup> See, e.g., Reuven Avi-Yonah and Yaron Lahav, *The Effective Tax Rate of the Largest US and EU Multinationals*, University of Michigan Public Law Working Paper 25 (2011); U.S. Government Accountability Office, *Corporate Income Tax: Effective Tax Rates Can Differ Significantly from the Statutory Rate*, GAO-13-520 (May 2013).

flow-through for non-publicly traded entities, and (8) split rates on undistributed and distributed income.

### 1. Dividend Exclusion Method

Under current law, a shareholder that receives a dividend must include the dividend in gross income and pay taxes on it.<sup>537</sup> Under the dividend exclusion method, the shareholder would exclude the dividend from gross income. The Treasury Department proposed such a method in 1992, and President George W. Bush proposed a similar method in 2003.

The dividend exclusion method is a relatively simple method of achieving integration. The earnings of the corporation are taxed once at the corporate level. Under this method, when the earnings are distributed in the form of a dividend, the earnings are not taxed a second time as the dividend is excluded from the shareholders' gross income. The dividend exclusion method does not, however, equalize the tax treatment of debt and equity. Under the dividend exclusion method, dividends would not be deductible by the corporation. The recipient would, however, exclude the dividend from gross income. As a result, the earnings generating the dividend are subject to a single level of tax at the corporate level. In contrast, corporations would still deduct any interest payments to lenders, who would then include the interest received in gross income. Consequently, the earnings generating interest payments are subject to a single level of tax at the lender level. The different tax treatment of dividends and interest under the dividend exclusion method could be quite significant if the corporate tax rate varied significantly from individual tax rates.

The purpose of the dividend exclusion method is to eliminate the second level of tax on distributed income at the shareholder level. Therefore, if a corporation earns income and then

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<sup>537</sup> An exception to the general rule that a dividend is gross income upon receipt is if the payor and recipient are both members of the same consolidated group. In such case, the dividend is excluded from the recipient corporation's gross income. Treas. Reg. sec. 1.1502-13(f)(2)(ii).

distributes part or all of that income, the corporation will pay tax on the income but a second level of tax at the shareholder level is eliminated. As a result, the corporation's income is subject to only a single level of tax. If, however, a corporation's income has been sheltered from U.S. income tax through preferences or the income is foreign source income bearing only foreign income taxes, then an exclusion for dividends would eliminate the only U.S. tax on the distributed income. For example, assume a corporation's earnings are composed of \$100 of tax-exempt interest. The corporation is not taxed on the interest. If the corporation pays a dividend and the shareholder excludes the dividend from gross income, then the preference is passed through to the shareholder resulting in no U.S. tax. Consequently, under the dividend exclusion method, a corporation needs to determine its previously taxed income. Only dividends paid out of its previously taxed income are excluded from a shareholder's gross income to ensure that a corporation's income is subject to a single level of tax.

A corporation's previously taxed income is determined by computing an excludable dividend amount (EDA), sometimes referred to as an excludable distributions account. The EDA reflects income of the corporation that has been *fully* taxed. In making the calculation, a difficult decision has to be made regarding foreign tax credits that have been credited against U.S. tax liability. In its 1992 report, Treasury did not treat foreign income taxes the same as U.S. income taxes in computing the EDA.<sup>538</sup> As a result, any distribution of foreign earnings that have been shielded from U.S. income tax by the foreign tax credit would be taxable to shareholders when distributed as a dividend. The calculation of the EDA would be:

$$\frac{\text{U.S. tax paid for taxable year}}{0.35} \text{ minus U.S tax paid for the taxable year plus excludable dividends received}$$

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<sup>538</sup> In Treasury's subsequent December 1992 report, it recommended extending integration through the dividend exclusion method to foreign source income by flowing through creditable foreign income taxes. See TREASURY 1992 SUPPLEMENTAL INTEGRATION REPORT, *supra* note 354.

In both President Bush's 2003 proposal for dividend exclusion and the House's 2003 dividend exclusion proposal, foreign income taxes would be treated the same as U.S. income taxes. As a result, any distribution of foreign earnings that have been shielded from U.S. income tax by the foreign tax credit would not be taxable to shareholders when distributed as a dividend.

An important issue that arises under the dividend exclusion method is how to handle retained earnings, i.e., undistributed corporate equity income. The dividend exclusion method provides relief from double taxation only with respect to distributed income. As a result, a corporation may have an incentive to distribute earnings (to the extent of the corporation's EDA) rather than retain earnings. In addition, if no mechanism is utilized to address retained earnings, then a shareholder may suffer a second level of tax on the earnings of a corporation when selling shares of stock in the corporation resulting in a capital gain to the shareholder. As a result, most dividend exclusion proposals include a dividend reinvestment plan (DRIP).

Under a DRIP, if the corporation's EDA exceeds the dividends it pays, each shareholder's basis in its stock is increased on December 31<sup>st</sup> by the amount retained per share. The DRIP would reduce the corporation's incentive to distribute fully-taxed income and would alleviate the second level of tax that would occur on the shareholder's sale of stock of the corporation. A corporate shareholder receiving a dividend that is excluded from gross income would add the dividend to its EDA. This would prevent the imposition of an additional level of tax when the recipient corporation redistributes the excluded dividend to the recipient corporation's shareholders.

Under current law, qualified dividend income is taxed at a maximum of 20 percent when received by individual shareholders. That rate represents a compromise between an exclusion of dividend income, which would be a zero rate of tax, and full taxation of dividend income, which

would be taxed at a maximum rate of 39.6 percent. As a result, current law can be viewed as a partial dividend exclusion.<sup>539</sup>

## 2. Shareholder Allocation Method

Under current law, the earnings of an S corporation and a partnership flow through to the owners of the entity who are then taxed on the earnings at their respective tax rates. The shareholder allocation method would extend the flow-through approach utilized for S corporations and partnerships to all corporations. A corporation's income would be allocated among all the shareholders as it is earned. If a corporate level tax is imposed on the income of the corporation, the corporate tax would pass through to the shareholders as a credit. The shareholders would increase the basis in their shares of stock by the amount of income allocated to them reduced by the amount of the credit. Such a flow-through approach would extend the benefits of integration equally to both distributed income as well as retained earnings. As a result, it is thought to achieve a complete or full integration.

In its 1992 report, Treasury recognized the policy issues and administrative complexities in a shareholder allocation prototype. As an example of the policy issue, Treasury noted that to retain parity between retained and distributed earnings, the shareholder allocation prototype must extend tax preferences to shareholders and also exempt from U.S. tax any foreign source income that has not borne any U.S. tax.<sup>540</sup> With respect to some of the administrative complexities, the shareholder allocation prototype would require determining income allocations for outstanding

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<sup>539</sup> IRC sec. 1(h)(1)(B), (C), (D) (zero percent rate on adjusted net capital gain, which includes qualified dividend income, that would otherwise be taxed at 10 percent or 15 percent; 15 percent rate on adjusted net capital gain that would otherwise be taxed at 25 to 35 percent; 20 percent rate on adjusted net capital gain that would otherwise be taxed at 39.6 percent). In addition, a 3.8 percent net investment income tax can apply to dividend income. IRC sec. 1411.

<sup>540</sup> TREASURY 1992 INTEGRATION REPORT, *supra* note 353, at 27.



corporate stock and would require corporations to maintain capital accounts similar to those used under the partnership tax rules.<sup>541</sup> Treasury sketched out a shareholder allocation prototype that (1) did not pass through losses to shareholders, (2) retained the corporate level tax that would function as a withholding tax, (3) required corporations to report to shareholders only an aggregate of income and not separately report various categories of income, and (4) did not extend the benefits of integration to tax-exempt shareholders and foreign shareholders except by treaty.

In 1997, Congress enacted the electing large partnership (ELP) regime, which is a type of shareholder allocation method to address the administrative complexities of a pass-through regime for an entity with many owners. A partnership with 100 or more partners in the preceding partnership taxable year may elect to be subject to the ELP provisions.<sup>542</sup> Such elections of large partnerships combine most items of partnership income, deductions, credits and losses at the partnership level and passes through the net amounts to the partners. For example, the netting of capital gains and losses occurs at the partnership level with the net amount (net capital gain or net capital loss) flowing through to the partners.<sup>543</sup>

### 3. Imputation (or Shareholder) Credit Method

Under current law, a shareholder that receives a dividend must include the dividend in gross income and pay taxes on it.<sup>544</sup> The shareholder is not given credit for income taxes paid by the corporation on the distributed earnings. Under the imputation credit method, the shareholder would include the dividend in gross income along with a credit for income taxes paid by the

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<sup>541</sup> Id.

<sup>542</sup> IRC sec. 775.

<sup>543</sup> IRC sec. 772(a).

<sup>544</sup> An exception to the general rule that a dividend is gross income upon receipt is if the payor corporation and recipient corporation are both members of the same consolidated group. In such case, the dividend is excluded from the recipient corporation's gross income. Treas. Reg. sec. 1.1502-13(f)(2)(ii).

corporation. The shareholder would then utilize the credit to alleviate the second level of tax on the distributed earnings. A number of countries have adopted such an approach, and the American Law Institute proposed such an approach in 1993.

The imputation credit method is a more complex method of achieving integration when compared, for example, to the dividend exclusion method. Under the imputation credit method, corporations would continue to compute their taxable income under current law and pay taxes at rates up to 35 percent. Shareholders receiving a distribution treated as a dividend would gross-up the dividend and include the grossed up amount in gross income. The shareholders would then receive a credit equal to the difference between the grossed-up amount and the actual dividend received. Under the imputation credit method, a corporation must keep track of cumulative income taxes paid by maintaining a shareholder credit account (SCA), sometimes referred to as a taxes paid account. The amount of any income taxes paid by the corporation would be added to the SCA.

One of the commonly stated advantages of the imputation credit method is that the benefits of integration can be denied to foreign and tax-exempt shareholders by making the credit nonrefundable to such shareholders.<sup>545</sup> For example, assume a corporation pays a \$25 dividend with an \$11 credit attached to the dividend resulting in a total dividend to the shareholder of \$36. If the shareholder is in a 40 percent tax bracket, the shareholder will tentatively owe \$14.40 to the U.S. government; however, the credit of \$11 will reduce the amount owed to \$3.40. If the dividend is paid to a foreign or tax-exempt shareholder, then it may be subject to no U.S. tax. If the \$11 credit is refundable to the foreign or tax-exempt shareholder, then the earnings generating the dividend avoid even a single level of U.S. income tax. As a result, the credit can be made

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<sup>545</sup> See ALI 1993 INTEGRATION REPORT, *supra* note 356, at 52.

nonrefundable to foreign or tax-exempt shareholders resulting in the earnings being subject to a single level of U.S. tax at the corporate level.

The imputation credit method had been a commonly adopted method of integration among many European countries. In more recent times, however, a number of these countries have abandoned the imputation credit method, switching to the (partial) dividend exclusion method in some cases. For example, in 1972, the United Kingdom moved from a classical system of taxing corporate earnings to a partially integrated system utilizing the imputation credit method. However, it substantially abandoned the imputation credit method in 1999.<sup>546</sup> In 1976, Germany adopted the imputation credit method of integration.<sup>547</sup> Twenty-five years later, in 2001, Germany reformed its corporate tax system adopting a partial dividend exclusion.<sup>548</sup> France introduced integration in 1965 when it replaced its classical system with a partial imputation credit system.<sup>549</sup> In 2004, France abolished its imputation credit system, replacing it with a reduced tax rate on dividend income.<sup>550</sup> Finland and Norway also abandoned their imputation credit regimes.<sup>551</sup>

One of the reasons for a number of European countries abandoning the imputation credit method (and in some cases, switching to the (partial) dividend exclusion method) is that a number of European Court of Justice (formally Court of Justice of the European Union) decisions required that, among European Union member states, foreign dividends and domestic dividends be treated the same.<sup>552</sup> As a result, in the European Union, tax credits provided to resident shareholders but

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<sup>546</sup> See Yariv Brauner, *Integration in an Integrating World*, 2 N.Y.U. J.L. & BUS. 51, 72 (2005).

<sup>547</sup> *Id.* at 69.

<sup>548</sup> *Id.* at 70.

<sup>549</sup> *Id.*

<sup>550</sup> *Id.* at 71.

<sup>551</sup> *Id.* at 73-74.

<sup>552</sup> See Michael J. Graetz and Alvin C. Warren, *Dividend Taxation in Europe: When the ECJ Makes Tax Policy*, 44 COMM. MKT. L. REV. 1577 (2007).

denied to nonresident shareholders as well as tax credits provided for domestic source dividends but denied for foreign source dividends were considered discriminatory under European Union legislation.<sup>553</sup>

Current U.S. tax law contains a regime that is an imputation credit system. If a domestic corporation owns 10 percent or more of the voting stock of a foreign corporation from which it receives dividends in any taxable year, the domestic corporation is treated as having paid part or all of the foreign corporation's foreign income taxes.<sup>554</sup> The amount deemed paid by the domestic corporation is the same proportion of the foreign corporation's post-1986 foreign income taxes as the amount that the dividends bears to the foreign corporation's post-1986 undistributed earnings.<sup>555</sup> The domestic corporation may then credit the deemed paid foreign income taxes.<sup>556</sup> The domestic corporation must also treat the foreign income taxes that it is deemed to have paid as a dividend received from the foreign corporation.<sup>557</sup> For example, assume a domestic corporation owns 100 percent of a foreign subsidiary. The foreign subsidiary earns \$100 of income and pays \$20 of foreign income taxes. The foreign subsidiary distributes the remaining \$80 as a dividend to its domestic parent. The domestic parent has a \$20 (indirect or deemed) foreign tax credit and a dividend of \$100 (\$80 dividend received plus \$20 deemed foreign income taxes paid).

#### 4. Comprehensive Business Income Tax

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<sup>553</sup> See OECD TAX POLICY STUDIES, FUNDAMENTAL REFORM OF CORPORATE INCOME TAX, No. 16 (2007) at 124. It appears that a member state can tax foreign dividends with a tax credit while exempting domestic dividends if that does not disadvantage cross-border investment relative to domestic investment. See INSTITUTE FOR FISCAL STUDIES, TAX BY DESIGN: THE MIRRLEES REVIEW, Ch. 18: Corporate Taxation in an International Context (2011).

<sup>554</sup> IRC sec. 902.

<sup>555</sup> IRC sec. 902(a).

<sup>556</sup> IRC sec. 901(a).

<sup>557</sup> IRC sec. 78.

The differing tax treatment of debt and equity can be eliminated in one of two ways. One way is to treat equity the same as debt is currently treated by, for example, allowing a deduction for dividends. A second way is to treat debt the same as equity is currently treated by, for example, removing the deductibility of interest. The latter approach was taken by Treasury in its 1992 report when it introduced a comprehensive integration regime that it titled the comprehensive business income tax (CBIT).<sup>558</sup> Under CBIT, both corporate and non-corporate businesses would be treated alike. A business enterprise would compute its taxable income as under current law. However, the business would not be permitted to deduct either interest or dividends. In addition, lenders and shareholders would not include interest or dividends in gross income. As a result, only one level of tax is imposed on business income – at the entity level.

CBIT not only eliminates the two levels of tax on corporate earnings but also equalizes the tax treatment of debt and equity. Under CBIT, the business enterprise is denied a deduction for interest, which is consistent with the current law's treatment of dividends. At the investor level, under CBIT, the investor does not include either interest or dividends in gross income, again equalizing the treatment. The business enterprise is therefore indifferent in utilizing debt, new equity or retained earnings as a source of financing for its investments.

A variant of CBIT is the dual income tax that is used in some Scandinavian countries.<sup>559</sup> Under such a system, income from capital is taxed at a low flat rate while income from labor is taxed at higher progressive rates. If the dual income tax is imposed solely at the corporate level, then it would have a similar if not identical structure to CBIT.<sup>560</sup>

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<sup>558</sup> TREASURY 1992 INTEGRATION REPORT, *supra* note 353, at 39-60.

<sup>559</sup> See Edward D. Kleinbard, *An American Dual Income Tax: Nordic Precedents*, 5 NW. J. LAW & SOC. POL'Y 41 (2010).

<sup>560</sup> See Alan J. Auerbach, Michael P. Devereux and Helen Simpson, *Taxing Corporate Income*, in DIMENSIONS OF TAX DESIGN: THE MIRRLEES REVIEW (2010).

## 5. Business Enterprise Income Tax

A variation on CBIT is the business enterprise income tax (BEIT).<sup>561</sup> Unlike CBIT, however, which treats debt the same as equity, BEIT treats equity the same as debt through a comprehensive and coordinated system for taxing time value of money returns. Such a system is called the cost of capital allowance (COCA) system. BEIT would apply to both corporate and non-corporate businesses.

To understand the ideas behind COCA, it is helpful to understand that the return on capital can be divided into three components: the risk-free rate of return, the risk premium and so-called “supernormal” returns. The first component, the risk-free rate of return, is the time value of money return that represents the return to delaying consumption. The risk premium represents higher returns that one expects from a risky investment. Supernormal returns are thought of as returns derived from a unique or exclusive market position or asset. There are, of course, practical measurement difficulties in determining what ought to be thought of as an investor’s risk-free return and so-called “supernormal” returns.

Under BEIT, the business enterprise computes its taxable income as under current law. However, as a result of the COCA system, which is the centerpiece of BEIT, a business enterprise would deduct each year a time value of money charge (i.e., risk-free rate of return) on all capital invested in the business, whether the capital is invested in the form of debt or equity. The COCA deduction would replace the interest deduction and would provide a deduction for a time value of money charge on equity that is invested in the business.

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<sup>561</sup> See Edward D. Kleinbard, *Rehabilitating the Business Enterprise Income Tax*, The Hamilton Project, Discussion Paper 2007-09 (June 2007), available at [http://www.hamiltonproject.org/files/downloads\\_and\\_links/Rehabilitating\\_the\\_Business\\_Income\\_Tax\\_1.pdf](http://www.hamiltonproject.org/files/downloads_and_links/Rehabilitating_the_Business_Income_Tax_1.pdf) (accessed Nov. 14, 2014). See also Alvin C. Warren, *The Business Enterprise Income Tax: A First Appraisal*, 118 TAX NOTES 921 (Feb. 25, 2008).

The investors in the business enterprise would include in gross income each year a time value of money return (i.e., risk-free rate of return) on their investment in the business, whether the investment is in the form of debt or equity. This annual gross income inclusion would be made without regard to whether the investors receive cash or property from the business or the performance of the business.

Under BEIT, debt and equity would be treated equally. In addition, with one exception, the income of the business enterprise would be subject to one level of tax – split between the business enterprise and the investors. The risk-free rate of return would be taxed at the investor level, whether the investor was a debt holder or a shareholder. The risk premium and any supernormal returns would be taxed to the business enterprise.

If an investor has gain (or income) beyond the time value of money return that is included annually, then gain (or income) would be subject to an excess distributions tax. This could arise from a large cash distribution (whether denominated as interest or dividends) or the sale of the debt or stock at a gain. The excess distributions tax would be imposed at a low tax rate (say 10 percent) but would result in two levels of taxation of business income.

To illustrate BEIT, assume an investor funds a new business enterprise with \$1,000 and receives a security (which could be debt, stock or any combination) in return. The business enterprise purchases a depreciable asset for \$1,000, which it depreciates at \$200 per year for five years. Assume that the COCA rate is six percent. In the first year, the business enterprise's COCA deduction is \$60 (utilizing \$1,000 asset basis on the first day of the year). The investor's COCA inclusion is \$60, increasing the basis in the security to \$1,060. In year two, the business enterprise's COCA deduction is \$48 (\$800 asset basis times six percent). The investor's COCA inclusion is \$63.60 (\$1,060 asset basis times six percent), increasing the security's basis to

\$1,123.60. Assume that the investor then sells the security for \$1,200, which results in a gain of \$76.40. The gain is subject to the excess distributions tax. The new investor's basis in the security would be a cost basis of \$1,200, which would generate a COCA inclusion for the new investor's first year of ownership of \$72 (\$1,200 asset basis times six percent). The business enterprise's COCA deduction each year would be unaffected by the sale of the security.

The OECD has noted that several countries have adopted a system similar to BEIT – what the OECD refers to as the allowance for corporate equity (ACE) tax system.<sup>562</sup> The ACE tax system attempts to correct the differential tax treatment of debt and equity by providing a deductible allowance for corporate equity.<sup>563</sup> Austria utilized the ACE tax system in 2000 and 2004.<sup>564</sup> Italy implemented the system from 1997 to 2003 and then again in 2011.<sup>565</sup> Croatia implemented the ACE tax system from 1994 until 2001.<sup>566</sup> Brazil has had an ACE tax system since 1996, and Belgium adopted such a system in 2006.<sup>567</sup>

Somewhat related to the ACE tax system is the allowance for shareholder equity (ASE) tax system.<sup>568</sup> Similar to the ACE tax system, the ASE tax system also exempts the normal return on equity from double taxation. But, it does so at the shareholder level and not at the corporate level. As a result, the ASE tax system exempts interest payments from the corporate tax by providing the corporation an interest deduction while taxing the return on equity at the corporate level (by

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<sup>562</sup> See OECD TAX POLICY STUDIES, FUNDAMENTAL REFORM OF CORPORATE INCOME TAX, *supra* note 553, at 88, 130-131.

<sup>563</sup> *Id.* at 88.

<sup>564</sup> *Id.* at 130.

<sup>565</sup> *Id.* at 131. See Katarzyna Bilicka and Michael Devereux, *CBT Corporate Tax Ranking 2012*, *supra* note 533.

<sup>566</sup> See OECD TAX POLICY STUDIES, FUNDAMENTAL REFORM OF CORPORATE INCOME TAX, *supra* note 553, at 131.

<sup>567</sup> *Id.* at 130-31.

<sup>568</sup> *Id.* at 89, 135-139.



denying the corporation a deduction for the return on corporate equity). Norway implemented an ASE tax system in 2006.<sup>569</sup>

## 6. Dividends Paid Deduction

Under current law, with the exception of certain special taxing regimes, a corporation may not deduct dividends paid to its shareholders. However, a corporation may deduct interest paid or accrued to its creditors even if the creditor is also a shareholder of the corporation. Under the dividends paid deduction, a corporation would be permitted to deduct dividends paid to its shareholders. The shareholders would include the dividends in gross income. As a result, integration is achieved with respect to distributed corporate earnings. However, the dividends paid deduction would not achieve integration with respect to undistributed corporate income.

The dividends paid deduction brings the tax treatment of equity closer in line with the tax treatment of debt but does not achieve complete parity. Dividends would be deducted when paid by the corporation. Interest is deducted as it is accrued. Therefore, timing differences would still exist between equity and debt unless dividends were subject to accrual treatment (or interest expense deductions were subject to the cash method).<sup>570</sup>

Under the dividends paid deduction, an account would need to be maintained by the corporation to limit the amount of deductible dividends equal to the amount of income of the corporation that is subject to full taxation. This account would operate in a manner similar to the excludable dividend amount (EDA) under the dividend exclusion method. The account would operate to disallow a dividends paid deduction for dividends paid out of preference income or foreign source income sheltered from U.S. tax by foreign tax credits. Without such an account, a

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<sup>569</sup> Id. at 137-139.

<sup>570</sup> Current law does provide for accrual treatment with respect to the purchase of stripped preferred stock. IRC sec. 305(e).

corporation could pay deductible dividends out of preference income and use the deductions to offset income that would otherwise be subject to the corporate income tax.

Unlike the dividend exclusion method, a dividend reinvestment plan (DRIP) would probably not be suitable for the dividends paid deduction. Under the dividend exclusion method, the deemed dividend pursuant to a DRIP does not create any additional tax liability to the shareholders because the dividend is excluded from gross income. In contrast, under the dividends paid deduction, the tax liability for the dividend is at the shareholder level. As a result, a deemed dividend will create a tax liability with no corresponding cash. Such cash may be needed by the shareholders to pay the resulting tax liability.

In 1984, Treasury, as part of its Treasury I report, proposed a dividends paid deduction.<sup>571</sup> Treasury believed that the dividends paid deduction would be simpler than the imputation credit method that it also considered.<sup>572</sup> Treasury proposed limiting the deduction to 50 percent of the dividends paid based on revenue concerns.<sup>573</sup> In Treasury II, President Reagan proposed a dividends paid deduction of only 10 percent of the dividends paid, again based on revenue concerns.<sup>574</sup> In December 1985, the House of Representatives included a 10 percent dividends paid deduction, which would be phased-in over 10 years. The House's dividends paid deduction proposal was not enacted as part of the Tax Reform Act of 1986.

## 7. Mark-to-Market for Publicly Traded Stock and Flow-Through for Non-Publicly Traded Entities

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<sup>571</sup> TREASURY I, *supra* note 350, at 118-119.

<sup>572</sup> *Id.*

<sup>573</sup> *Id.* at 119.

<sup>574</sup> TREASURY II, *supra* note 351, at 122.

Under current law, a shareholder that owns stock in a corporation is not taxed on any appreciation in the stock until the stock is sold or some other realization event takes place. In addition, unless the corporation is an S corporation, the income of the corporation is taxed at the corporate level and does not flow through to the shareholders. The mark-to-market and flow-through method of integration has, as its name implies, two parts in achieving integration.<sup>575</sup> First, any stock of a publicly traded corporation would be marked-to-market on an annual basis. In addition, shareholders would be taxed on any dividends received from the corporation. Second, shareholders who own stock of a non-publicly traded corporation would be subject to tax on the earnings of the corporation on an annual basis.

Under the first component of the integration method, the corporate income tax would be repealed for publicly traded corporations. It would be replaced by imposing a mark-to-market taxing system on the shareholders of the publicly traded corporation. In addition, mark-to-market would also apply to any publicly traded debt. Two of the principal policies underlying the realization doctrine, difficulty of valuation and liquidity, are not present when dealing with publicly traded stock (or debt). If revenue loss is a concern, a modest corporate income tax could be imposed on a publicly traded corporation's accounting net income or aggregate shareholder mark-to-market income.

Under the second component of the integration method, the corporate income tax would also be repealed for non-publicly traded corporations. It would be replaced by a flow-through taxing regime in which the earnings of the corporation flow-through to the shareholders. The

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<sup>575</sup> See Joseph M. Dodge, *A Combined Mark-to-Market and Pass-Through Corporate Shareholder Integration Proposal*, 50 TAX L. REV. 265 (1995); Eric Toder and Alan D. Viard, *Major Surgery Needed: A Call for Structural Reform of the U.S. Corporate Income Tax*, available at [http://www.aei.org/wp-content/uploads/2014/04/-toder-viard-report\\_132524981261.pdf](http://www.aei.org/wp-content/uploads/2014/04/-toder-viard-report_132524981261.pdf) (accessed Oct. 30, 2014).

system would be modeled on but supersede the current subchapter S regime. To overcome any liquidity problems to the shareholders, the corporation would withhold tax on its net income. The tax would then be creditable against the shareholders' individual tax liabilities. Non-publicly traded debt would continue to be taxed on an accrual basis, which can be viewed as a proxy mark-to-market basis.

#### 8. Split Rates on Undistributed and Distributed Income

Under current law, the corporate income tax rates apply equally to both distributed income and undistributed (or retained) income. Under the split rate method of integration, a higher rate of tax would apply to undistributed income than to distributed income. In the extreme case, a zero percent tax would apply to distributed income. In such a case, the split rate method of integration becomes indistinguishable from the dividends paid deduction method of integration. For example, assume a corporation has taxable income of \$100 and the corporate tax rate is 35 percent. The corporation distributes \$30 of its earnings to shareholders. Under a dividends paid deduction approach, the corporation would have taxable income of only \$70 resulting in corporate income taxes of \$24.50. If instead a split rate method were adopted with a zero percent tax rate on distributed income, the corporation would be subject to tax at 35 percent on its undistributed income of \$70, again resulting in corporate income tax of \$24.50.

If the tax rate on distributed income is greater than zero but less than the tax rate on undistributed income, then the split rate method achieves results similar to a partial dividends paid deduction. For example, assume the corporate tax rate is 35 percent but the tax rate on distributed income is only 14 percent. If a corporation has taxable income of \$100 and distributes \$30, it would owe taxes of \$28.70 ([\$70 retained income times 35 percent] plus [\$30 distributed income

times 14 percent]). This split rate regime would be equivalent to a 60 percent dividends paid deduction (\$100 taxable income minus \$18 dividends paid deduction times 35 percent).

In 1936, Congress enacted a split rate corporate income tax, which is a form of corporate integration.<sup>576</sup> Distributed income was taxed at rates ranging from eight percent to 15 percent. Undistributed income was subject to an additional surtax with rates ranging from seven percent to 27 percent. The existence of the additional surtax on undistributed income encouraged a substantial increase in dividend payouts.<sup>577</sup> In 1938, the undistributed income surtax was repealed.

#### L. Equivalence Between Dividends Paid Deduction and Imputation Credit

One of the benefits of the dividends paid deduction is that, as to distributed earnings, only a single level of tax is imposed (at the shareholder level).<sup>578</sup> The imputation credit method also imposes only a single level of tax on distributed earnings at the shareholder level. Under the dividends paid deduction, a corporation's cash flow is increased as a result of the deduction for dividends paid. The increased cash flow may lead the corporation to increase the amount of dividends, or the corporation may retain the additional cash. In contrast, the imputation credit method leaves the additional cash flow from integration in the hands of the shareholders if the corporation does not change its dividend payouts as a result of integration.

To the extent that cash dividends are increased under the dividends paid deduction or cash dividends are decreased under the imputation credit method, equivalent results can occur between the two methods of integration. For example, assume the corporate tax rate is 30 percent, the cash distribution is \$25, the shareholder's tax rate is 40 percent, and the corporation's taxable income

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<sup>576</sup> See Jack Taylor, *Corporate Income Tax Brackets and Rates*, *supra* note 331.

<sup>577</sup> JOINT COMMITTEE ON TAXATION, TAX POLICY AND CAPITAL FORMATION, *supra* note 332, at 17.

<sup>578</sup> The dividends paid deduction also achieves near parity between the tax treatment of debt and equity with respect to distributed income.

is \$100. If, under the dividends paid deduction, the corporation increases the dividend to \$36 (\$25 divided by [1 minus the corporate tax rate]), then the dividends paid deduction yields equal results to the imputation credit method, as shown in Table 12.<sup>579</sup>

**Table 5.12**  
**Equivalence of Dividends Paid Deduction and Imputation Credit**

	Dividends Paid Deduction (\$)	Imputation Credit (\$)
Corporation's Taxable Income	100	100
Cash Distribution	36	25
Corporate Tax (30%)	19	30
Retained Corporate Earnings	45	45
Taxable Dividend to Shareholder	36	36
Gross Shareholder Tax (40%)	14	14
Shareholder Credit	0	11
Net Shareholder Tax Due	14	3
Net Shareholder Cash	22	22

If the dividends paid deduction is coupled with a withholding tax on dividends, it will also yield equivalent results to an imputation credit regime if the withholding tax rate is equivalent to the corporate tax rate and no change is made in the amount of cash dividends paid by the corporation in response to integration.<sup>580</sup> For example, assume the corporate tax rate is 30 percent, the withholding tax rate is 30 percent, the cash distribution is \$25, the shareholder's tax rate is 40 percent, and the corporation's taxable income is \$100. Then, Table 13 displays the equivalence.

<sup>579</sup> Alternatively, if the corporation decreased the cash dividend under the imputation credit method to \$17.5 (\$25 times (1 minus the corporate tax rate)), then the dividends paid deduction will yield equivalent results to the imputation credit regime.

<sup>580</sup> See ALI 1993 INTEGRATION REPORT, *supra* note 356, at 54-55.

**Table 5.13**

**Equivalence of Dividends Paid Deduction with Withholding Tax and Imputation Credit<sup>581</sup>**

	Dividends Paid Deduction (\$)	Imputation Credit (\$)
Corporation's Taxable Income	100	100
Cash Distribution	25	25
Corporate Tax (30%)		
On Taxable Income	19	30
Withholding on Distribution	11	0
Total	30	30
Retained Corporate Earnings	45	45
Taxable Dividend to Shareholder	36	36
Gross Shareholder Tax (40%)	14	14
Shareholder Credit (or Withholding)	11	11
Net Shareholder Tax Due	3	3
Net Shareholder Cash	22	22

**M. Integration Regimes Under Current Law**

Corporate integration is not totally absent from current U.S. tax law. Many non-publicly traded corporations can qualify as S corporations. An S corporation is only permitted to have one class of stock; can have no more than 100 shareholders; cannot have shareholders other than an individual, trust, estate or tax-exempt organization; and cannot have foreign persons as shareholders.<sup>582</sup> If a corporation qualifies as an S corporation, it is taxed as a pass-through entity, with only one level of tax at the shareholder level.<sup>583</sup>

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<sup>581</sup> Id.

<sup>582</sup> IRC sec. 1361(b)(1).

<sup>583</sup> S corporations that were formerly C corporations may be subject to an entity level tax in two situations: a tax on net recognized built-in gain (IRC sec. 1374) and a tax on excess passive income (IRC sec. 1375).

In addition, it is not uncommon for a business entity other than a corporation to be subject to the pass-through regime applicable to S corporations. For example, investors may form a limited liability company under state law, but check the box to have it taxed as a corporation for federal income tax purposes. The investors may then elect to have the LLC taxed as an S corporation, assuming they meet the S corporation requirements.

The tax code includes a number of special taxing regimes resulting in only a single level of tax on corporations. A corporation that is an investment company, including mutual funds, may be taxed under subchapter M of the Code, which applies to regulated investment companies (RICs). A RIC is a domestic corporation that is registered under the Investment Company Act of 1940 as a management company or unit investment trust, has in effect an election under the 1940 Act to be treated as a business development company, or is a common trust fund or similar fund excluded under the 1940 Act from the definition of investment company and is not included in the definition of common trust fund (under section 584(a)).<sup>584</sup> A RIC must earn 90 percent of its gross income from dividends, interest and gains on the sale of stocks and securities, and its investments must be diversified.<sup>585</sup> A RIC is required to distribute 90 percent or more of its income each year for which it is permitted a dividends paid deduction partially or completely eliminating the tax at the corporate level.<sup>586</sup> An excise tax is imposed on the RIC if it distributes less than 98 percent of its income (98.2 percent for capital gain net income).<sup>587</sup>

A corporation (or trust, or association) that invests or holds real estate may qualify as a real estate investment trust (REIT) under subchapter M of the code.<sup>588</sup> A REIT must have its beneficial

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<sup>584</sup> IRC sec. 851(a).

<sup>585</sup> IRC sec. 851(b).

<sup>586</sup> IRC sec. 852.

<sup>587</sup> IRC sec. 4982.

<sup>588</sup> IRC sec. 856.



ownership held by 100 or more persons. It must earn at least 95 percent of its gross income from dividends, interest, rents from real property, and gain from the sale of stock, securities and real property.<sup>589</sup> It must also earn at least 75 percent of its gross income from rents from real property, interest on mortgages and gain from the sale of real property.<sup>590</sup> A REIT must also be diversified. A REIT is required to distribute 90 percent or more of its income each year for which it is permitted a dividends paid deduction partially or completely eliminating the tax at the corporate level.<sup>591</sup> An excise tax is imposed on the REIT if it distributes less than 85 percent of its ordinary income (or 95 percent of its capital gain net income).<sup>592</sup>

A corporation (or any other entity) that invests or holds real estate mortgages may qualify as a real estate mortgage investment conduit (REMIC), also under subchapter M of the code.<sup>593</sup> A REMIC means any entity in which all of the interests are either regular interests or residual interests and as of the close of the third month beginning after formation, and at all times thereafter, substantially all of the assets consist of qualified mortgages and permitted investments.<sup>594</sup> A REMIC is taxed as a pass-through entity.<sup>595</sup> The holders of the regular interests are taxed as if they held a debt instrument.<sup>596</sup> The holders of the residual interests are currently taxed on their share of the taxable income of the REMIC that is not taken into account by the holders of the regular interests.<sup>597</sup> A REMIC is subject to a 100 percent tax on prohibited transactions,<sup>598</sup> a 100

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<sup>589</sup> IRC sec. 856(c).

<sup>590</sup> Id.

<sup>591</sup> IRC sec. 857.

<sup>592</sup> IRC sec. 4981.

<sup>593</sup> IRC sec. 860A.

<sup>594</sup> IRC sec. 860D(a).

<sup>595</sup> IRC sec. 860A(b).

<sup>596</sup> IRC sec. 860B(a).

<sup>597</sup> IRC sec. 860C.

<sup>598</sup> IRC sec. 860F.

percent tax on certain contributions after the startup date,<sup>599</sup> and is also subject to tax on net income from foreclosure property.<sup>600</sup>

A corporation (or other entity) may be a business that is owned, financed and controlled by the persons who use its services. If so, it may qualify as a cooperative, which is generally an organization in which the ownership is vested in the persons who are patrons of the organization, and the earnings are returned to the patrons. If a corporation is a cooperative it is subject to a special taxing regime under subchapter T of the code. As a general rule, dividends paid to the patrons may qualify for a dividends paid deduction.<sup>601</sup> If the cooperative is an exempt cooperative, in addition to deducting patronage dividends, it may also deduct dividends on capital stock and earnings derived from business done for the United States or from nonpatronage sources.<sup>602</sup>

A domestic corporation with income that is primarily derived from export sales, lease transactions, and other export-related activities may qualify as a domestic international sales corporation (DISC). Generally, the corporation must have at least 95 percent of its gross receipts for the taxable year classified as qualified export receipts.<sup>603</sup> If a corporation meets the requirements of a DISC, then it is not subject to tax.<sup>604</sup> Rather, the income of the DISC is taxed to the shareholders resulting in a single level of tax of the income of the DISC.<sup>605</sup>

If a domestic corporation owns 80 percent or more of the voting power and 80 or more of the value of another domestic corporation, then both corporations are members of an affiliated

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<sup>599</sup> IRC sec. 860G(d).

<sup>600</sup> IRC sec. 860G(c).

<sup>601</sup> IRC sec. 1382(b).

<sup>602</sup> IRC sec. 1382(c).

<sup>603</sup> IRC secs. 991 to 997.

<sup>604</sup> IRC sec. 991.

<sup>605</sup> IRC sec. 995.

group.<sup>606</sup> The basic principle is that the affiliated group may elect to be taxed on its consolidated taxable income, which generally represents the group's income with the outside world eliminating any intercompany profit or loss.<sup>607</sup> Any dividend paid by one member of the group to another member is excluded from the recipient member's gross income.<sup>608</sup>

If corporate integration is enacted, then some of the specialized tax regimes could be repealed. In addition, the importance of many of the requirements of the various specialized regimes may significantly decrease. For example, one of the hottest planning areas in tax law today is what activity qualifies an entity as a PTP or a REIT. With corporate integration, all business income would be subject to only one level of tax, which is the primary goal of qualifying an entity as a PTP or a REIT.

#### N. Corporate Integration in Other Countries

Most countries provide some relief from the double taxation of corporate earnings, usually at the shareholder level through the imputation credit, the dividend exclusion, or lower tax rates.<sup>609</sup> The trend in more recent times for European countries is a move away from the imputation credit regime to a modified classical or shareholder relief system in which dividends are taxed at a lower rate at the shareholder level.<sup>610</sup> One of the reasons for a number of European countries abandoning the imputation credit method was that tax credits provided to resident shareholders but denied to

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<sup>606</sup> IRC sec. 1504.

<sup>607</sup> IRC sec. 1502.

<sup>608</sup> Treas. Reg. sec. 1.1502-13(f)(2)(ii).

<sup>609</sup> See Robert Carroll, *The Economic Effects of the Lower Tax Rates on Dividends*, Tax Foundation, Special Report No. 181 (June 2010).

<sup>610</sup> See OECD CENTRE FOR TAX POLICY AND ADMINISTRATION, *TAX TRENDS IN OECD COUNTRIES* (July 2006) at 4.

nonresident shareholders, as well as tax credits provided for domestic source dividends but denied for foreign source dividends, were considered discriminatory under European Union legislation.<sup>611</sup>

**Table 5.14**  
**Corporate Integration in the OECD Countries<sup>612</sup>**

Country	Integration of Corporate and Individual Taxes
Australia	Full imputation credit
Austria	Classical system
Belgium	Classical system
Canada	Full imputation credit <sup>613</sup>
Chile	Full imputation credit
Czech Republic	Classical system
Denmark	Modified classical system (dividend income taxed at preferential rates when compared to interest income at the shareholder level)
Estonia	Dividend exclusion (no shareholder taxation of dividends)
Finland	Partial inclusion (a part of dividends received is included in the shareholder's taxable income)
France	Partial inclusion (a part of dividends received is included in the shareholder's taxable income)
Germany	Classical system
Greece	Classical system
Hungary	Other type of system
Iceland	Classical system
Ireland	Classical system
Israel	Classical system
Italy	Classical system with partial inclusion (a part of dividends received is included in the shareholder's taxable income)

<sup>611</sup> See OECD TAX POLICY STUDIES, FUNDAMENTAL REFORM OF CORPORATE INCOME TAX, *supra* note 553, at 124. It appears that a member state can tax foreign dividends with a tax credit while exempting domestic dividends if that does not disadvantage cross-border investment relative to domestic investment. See INSTITUTE FOR FISCAL STUDIES, TAX BY DESIGN: THE MIRRLEES REVIEW, *supra* note 553.

<sup>612</sup> See ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, OECD TAX DATABASE, available at <http://www.oecd.org/tax/tax-policy/tax-database.htm> (accessed Nov. 2, 2014).

<sup>613</sup> Since 2006, Canada has provided an enhanced gross up and dividend tax credit regime for dividends distributed by large corporations, which are subject to a higher statutory corporate tax rate than small businesses. As a result, Canada is operating a dual rate gross up and dividend tax credit regime providing full imputation credit. See ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, OECD TAX DATABASE, available at <http://www.oecd.org/tax/tax-policy/tax-database.htm> (accessed Nov. 2, 2014).

Japan	Modified classical system (dividend income taxed at preferential rates when compared to interest income at the shareholder level) <sup>614</sup>
Korea	Partial imputation (dividend tax credit at the shareholder level for part of the corporate income tax)
Luxembourg	Partial inclusion (a part of dividends received is included in the shareholder's taxable income)
Mexico	Full imputation credit
Netherlands	Classical system
New Zealand	Full imputation credit
Norway	Other type of system
Poland	Modified classical system (dividend income taxed at preferential rates when compared to interest income at the shareholder level)
Portugal	Modified classical system (dividend income taxed at preferential rates when compared to interest income at the shareholder level)
Slovak Republic	Dividend exclusion (no shareholder taxation of dividends)
Slovenia	Classical system
Spain	Modified classical system (dividend income taxed at preferential rates when compared to interest income at the shareholder level)
Sweden	Classical system
Switzerland	Modified classical system (dividend income taxed at preferential rates when compared to interest income at the shareholder level)
Turkey	Partial inclusion (a part of dividends received is included in the shareholder's taxable income)
United Kingdom	Partial imputation (dividend tax credit at the shareholder level for part of the corporate income tax)
United States	Modified classical system (dividend income taxed at preferential rates when compared to interest income at the shareholder level)

## O. Financial Accounting Treatment

<sup>614</sup> Japan has three methods for taxing dividends: withholding tax at a rate of 20.3 percent; self-assessment taxation at the same rate as the withholding tax; and aggregate taxation with a credit for dividends received. See ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, OECD TAX DATABASE, available at <http://www.oecd.org/tax/tax-policy/tax-database.htm> (accessed Nov. 2, 2014).

A corporation must determine its financial accounting income in accordance with generally accepted accounting principles. The resulting income figure is generally referred to as pretax financial income, or more commonly in practice, pretax book income. The corporation will also compute its income tax expense for the year, which is subtracted from pretax financial income. This calculation results in the corporation's net income.

In almost all cases, a corporation's pretax financial income will differ from its taxable income. The differences reflect, in large part, the different goals of the tax system and the financial accounting rules. The tax rules are designed, in theory, to promote equitable and efficient determination of tax liability and subsequent collection of revenue. In addition, the tax rules provide incentives for corporations to engage in activities based upon the priorities and revenue needs of the various taxing authorities. In contrast, the financial accounting rules are designed to paint a picture of the corporation's operations so that creditors, shareholders, management and other interested persons can evaluate the absolute and relative performance of the corporation.

As a general rule, when a corporation pays a dividend, it does not treat the dividend as an expense for financial accounting purposes and it does not deduct the dividend for federal income tax purposes. The corporation reduces its retained earnings by the amount of the dividend so that the dividend has no impact on the corporation's income statement. The different methods of integration can have a widely different effect on the financial accounting treatment of the corporation. If the dividend exclusion method of integration is adopted, the corporation's financial statements should remain unchanged from current law. If, however, the dividends paid deduction method is adopted, the financial accounting treatment may be quite beneficial to a corporation. The dividends paid deduction would create a permanent difference for the corporation, in that the dividend is deductible for tax purposes but is not an expense for financial accounting purposes.

By being a permanent difference, the dividends paid deduction would decrease a corporation's effective tax rate, thereby increasing its net income and its earnings per share.<sup>615</sup> It would also increase the corporation's cash flow.

To illustrate the financial accounting treatment of the dividends paid deduction, assume a publicly traded corporation has \$1 million of pretax financial income and \$1 million of taxable income. The corporation pays a dividend of \$300,000. The corporation's pretax financial income remains unchanged because the dividend is not an expense for financial accounting purposes. The corporation's taxable income is reduced to \$700,000. At a 35 percent corporate tax rate, the corporation will owe \$245,000 in corporate income taxes. The corporation's effective tax rate is lowered from 35 percent to 24.5 percent as a result of the dividends paid deduction.

**Table 5.15**  
**Dividends Paid Deduction and Financial Accounting**

	Current Law	Dividends Paid Deduction
Pretax financial income	\$1,000,000	\$1,000,000
Permanent differences:		
Dividends deduction	\$0	\$300,000
Taxable Income	\$1,000,000	\$700,000
Statutory tax rate	35%	35%
Total tax expense	\$350,000	\$245,000
Effective tax rate	35%	24.5%
After-tax financial income	\$650,000	\$755,000

It is possible that FASB would treat the dividends paid deduction as an item that does not impact the income statement or the effective tax rate reconciliation. More specifically, the tax savings from the dividends paid deduction would directly impact the corporation's retained earnings (or additional paid in capital) and bypass the income statement. In such case, the

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<sup>615</sup> FASB ASC 740-20-45-8(d).

dividends paid deduction would not reduce a corporation's effective tax rate but would still increase its cash flow.<sup>616</sup>

#### P. Tax-Exempt Shareholders

One of the most difficult issues in integrating the individual and corporate tax systems is the tax treatment of tax-exempt shareholders. The tax-exempt sector (excluding foreign shareholders) owns large amounts of corporate equity and debt. In its 1992 report, Treasury estimated that, at the end of 1990, the tax-exempt sector held about 37 percent of directly held corporate equity and 46 percent of outstanding corporate debt.<sup>617</sup> Most of this was held by pension funds and other retirement plans, which held 32 percent of directly held corporate equity and 45 percent of corporate debt.<sup>618</sup>

The Joint Committee on Taxation has released figures detailing the holdings of corporate equities and bonds for the years 1990, 2000 and 2010.

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<sup>616</sup> FASB's treatment of nonqualified stock options is an example of a corporate deduction that does not impact the effective tax rate. FASB ASC 718-740-35-3. For financial accounting purposes, a corporation generally must record an expense upon issuing a stock option. If the corporation records an expense upon issuance, it will also record a deferred tax asset with an offset to deferred tax expense. When the employee exercises the stock option in a later year, the corporation does not record any further expense. In addition, the corporation's tax benefit from the compensation deduction is not reflected on the income statement but rather is recorded to additional paid-in capital. As a result, the corporation's effective tax rate is unaffected by the exercise of the stock options even though the corporation's taxes paid to the U.S. government may have been significantly reduced.

<sup>617</sup> TREASURY 1992 INTEGRATION REPORT, *supra* note 353, at 67-68.

<sup>618</sup> *Id.*



**Table 5.16**  
**Holdings of Corporate Equities in Billions of Nominal Dollars, 1990-2010<sup>619</sup>**

Sector	Year-End Balance, 1990	Percent of Total, 1990	Year-End Balance, 2000	Percent of Total, 2000	Year-End Balance, 2010	Percent of Total, 2010
<b>Corporate Equities</b>	<b>3,531</b>	<b>100.0</b>	<b>17,575</b>	<b>100.0</b>	<b>22,962</b>	<b>100.0</b>
Household sector	1,961	55.5	8,147	46.4	8,240	35.9
Mutual funds	249	7.1	3,329	18.9	5,716	24.9
Foreign investors	243	6.9	1,483	8.4	3,071	13.4
State and local governments excluding retirement funds	5	0.1	93	0.5	115	0.5
Federal government and monetary authority	0	0.0	0	0.0	68	0.3
Commercial banks	2	0.1	12	0.1	38	0.2
Mutual savings bank	9	0.2	24	0.1	20	0.1
Insurance and pension funds	1,053	29.8	4,409	25.1	5,550	24.2
Life Insurance Companies	82	2.3	892	5.1	1,403	6.1
Private pension funds	606	17.2	1,971	11.2	2,012	8.8
State and local govt retirement funds	285	8.1	1,299	7.4	1,783	7.8

<sup>619</sup> See JOINT COMMITTEE ON TAXATION, PRESENT LAW AND BACKGROUND RELATING TO TAX TREATMENT OF BUSINESS DEBT, A REPORT TO THE JOINT COMMITTEE ON TAXATION, JCX-41-11 (July 11, 2011) at 59.

Federal Govt Retirement Funds	0	0.0	67	0.3	134	0.6
Other insurance companies	80	2.3	191	1.1	220	1.0
Brokers and dealers	10	0.3	77	0.4	117	0.5
Funding corporations	0	0.0	0	0.0	26	0.1

**Table 5.17**  
**Holdings of Corporate Bonds in Billions of Nominal Dollars, 1990-2010<sup>620</sup>**

Sector	Year-End Balance, 1990	Percent of Total, 1990	Year-End Balance, 2000	Percent of Total, 2000	Year-End Balance, 2010	Percent of Total, 2010
<b>Corporate bonds</b>	<b>1,733</b>	<b>100.0</b>	<b>4,827</b>	<b>100.0</b>	<b>11,332</b>	<b>100.0</b>
Household sector	238	13.7	551	11.4	1,763	15.6
Mutual funds	77	4.4	549	11.4	1,551	13.7
Foreign investors	209	12.0	842	17.4	2,447	21.6
State and local governments excluding retirement funds	16	0.9	84	1.7	161	1.4
Federal government	0	0.0	0	0.0	1	0.0
Commercial banks	89	5.1	266	5.5	747	6.6
Savings institutions and credit unions	76	4.4	109	2.3	74	0.7
Insurance and pension funds	956	55.2	1,983	41.1	3,149	27.8
Life	567	32.7	1,215	25.2	2,027	17.9

<sup>620</sup> Id.

Insurance Companies						
Private pension funds	158	9.1	266	5.5	484	4.3
State and local govt retirement funds	142	8.2	314	6.5	312	2.8
Federal govt retirement funds	0	0.0	1	0.0	3	0.0
Other insurance companies	89	5.1	188	3.9	323	2.8
Government sponsored enterprises	0	0.0	131	2.7	294	2.6
Finance companies and REITs	44	2.6	183	3.8	201	1.8
Brokers and dealers	29	1.7	104	2.2	184	1.6
Funding corporations including financial stabilization programs	0	0.0	25	0.5	760	6.7

The tax-exempt sector generally includes entities that fall into one of two categories. The first category is composed of various types of retirement plans (or accounts), such as 401(k) plans, IRAs, and pension plans.<sup>621</sup> As part of these retirement plans, a trust (or account) is created to hold the assets of the plan for the benefit of the participants in the plan. Depending on the type of retirement plan, the contribution of assets to these trusts may result in either a deduction or an exclusion to the plan participant. The earnings of the trust are exempt from tax. When the trust

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<sup>621</sup> IRC sec. 401

distributes the earnings to the participants, a participant may be taxed on receipt, depending on the type of retirement plan.

The second category of tax-exempt entities is composed of various organizations, such as charities, religious institutions, educational organizations, and hospitals, in which the earnings do not inure to the benefit of any particular individuals.<sup>622</sup> These organizations are generally corporations and community chests, funds, or foundations. They are exempt from income tax and, in certain cases, contributions to such organizations may be deductible to the contributor.<sup>623</sup>

Under current law, the earnings of a corporation may be subject to a single level of tax or even no tax when the earnings are distributed to tax-exempt investors. If a corporation distributes its earnings in the form of a dividend to a tax-exempt shareholder, the corporation is not permitted to deduct the dividend but the tax-exempt shareholder will exclude the dividend from gross income for purposes of UBIT.<sup>624</sup> As a result, a single level of tax is imposed at the corporate level on the distributed earnings.<sup>625</sup> If a corporation distributes its earnings in the form of interest to a tax-exempt shareholder, then the corporation will deduct the interest and the tax-exempt shareholder will again exclude it from gross income for UBIT purposes.<sup>626</sup> This form of distributed corporate earnings is therefore subject to no tax.

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<sup>622</sup> IRC sec. 501.

<sup>623</sup> IRC sec. 170.

<sup>624</sup> IRC sec. 512(b)(1).

<sup>625</sup> Dividends that are paid out of corporate preference income may be subject to no tax.

<sup>626</sup> IRC sec. 512(b)(1). As part of the Pension Protection Act of 2006, Congress provided that, if a tax-exempt organization receives an interest payment from a related entity, only the portion of the interest payment that is in excess of the amount which would have been paid or accrued if such payment met the requirements of section 482 is included in the tax-exempt organization's gross income. IRC sec. 512(b)(13)(E). This provision terminated on December 31, 2013, but may be renewed.

The difficulty in adopting integration with respect to tax-exempt investors is that achieving the policy goals of taxing business income once and equalizing the treatment of debt and equity will necessarily affect the tax position of tax-exempt investors relative to current law because current law is so far out of alignment with the two policy goals. In other words, the defects in current law will result in either increasing or decreasing the tax burden on tax-exempt investors to equalize the tax treatment of debt and equity. For example, if the dividend exclusion method is adopted, corporate income distributed in the form of a dividend will only be taxed once at the corporate level. But, under current law, corporate income distributed as interest to a tax-exempt organization is not taxed at all. As a result, to achieve the policy goals of taxing business income once and equalizing the tax treatment of debt and equity, the interest deduction must be eliminated (or, as a proxy to achieve a single level of tax, the tax-exempt investor must include the interest in gross income for purposes of UBIT).

If the dividends paid deduction is adopted to achieve integration, then parity is achieved between debt and equity because the corporation will deduct both interest and dividend payments but the goal of a single tax on business income is not satisfied. The tax-exempt investors will, under current law, exclude the interest and dividends from gross income for purposes of UBIT. As a result, under the dividends paid deduction, tax-exempt investors would have to be taxed on both interest and dividends. This could be accomplished through a new compensatory withholding tax or requiring the tax-exempt investors to include interest and dividends in gross income for purposes of UBIT.<sup>627</sup>

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<sup>627</sup> Alternatively, rather than requiring the tax-exempt shareholder or lender to include the dividend or interest in gross income for purposes of UBIT, the dividend or interest could be classified as a disqualified dividend or disqualified interest and the dividends paid deduction and interest deduction denied to the payor corporation. This alternative approach may be difficult if the tax-exempt investors own stock in a corporation through a mutual fund.

Under some methods of integration, tax-exempt shareholders pose few problems. For example, under CBIT, the business enterprise would not be permitted to deduct any interest or dividend payments and the recipient would exclude both interest and dividends from gross income. This result would apply even if the recipient was a tax-exempt shareholder. The earnings of the business enterprise are subject to a single level of tax at the entity level whether the earnings are distributed to tax-exempt shareholders or taxable shareholders. If the business enterprise has preference income or foreign source income shielded by foreign tax credits, then issues can arise under CBIT with respect to tax-exempt shareholders.

#### Q. Foreign Shareholders

Similar to tax-exempt shareholders, foreign shareholders can pose difficult problems in moving towards an integrated tax system. Also, like tax-exempt shareholders, foreign shareholders own large amounts of corporate equity and debt. In 1990, foreign investors owned 6.9 percent of all corporate equities and 12 percent of all corporate bonds.<sup>628</sup> In 2000, the percentages increased to 8.4 percent and 17.4 percent, respectively, and in 2010, the percentages were 13.4 percent and 21.6 percent, respectively.<sup>629</sup>

Under current law, foreign shareholders that receive dividends from U.S. corporations are subject to a 30 percent withholding tax.<sup>630</sup> In many cases, the withholding tax is reduced by an income tax treaty to 15 percent, five percent or even zero percent in some more recent U.S. income tax treaties.<sup>631</sup> The tax treatment of dividends paid to foreign investors is quite different and

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<sup>628</sup> See Tables 5.16 and 5.17.

<sup>629</sup> *Id.*

<sup>630</sup> IRC secs. 871(a)(1); 881(a), 1441, and 1442.

<sup>631</sup> Under the United States Model Income Tax Convention of November 15, 2006, the withholding tax rate for dividends is decreased to five percent for corporate recipients that directly own at least 10 percent of the voting stock of the corporation paying the dividend, and 15 percent in all other cases. Art. 10 (2). The zero percent rate applies to dividends received from 80 percent owned

usually more punitive than the tax treatment of interest payments to foreign investors. Under current law, most interest payments to foreign investors are exempt from U.S. taxation as bank deposit interest or portfolio interest.<sup>632</sup> In addition, when interest payments are subject to U.S. taxation, in many cases the withholding tax on interest is reduced by an income tax treaty to ten percent or zero.<sup>633</sup> In 2008, more than \$659.7 billion in U.S. source payments were made to foreign recipients. The two largest categories of payments to foreign persons were interest and dividends. In 2008, interest payments to foreign persons were \$355.1 billion and dividend payments were \$122.9 billion. However, because dividends are more often taxed at closer to the 30 percent withholding tax rate than interest payments, the tax on dividends made up 72 percent of all withholding taxes in 2008 even though dividends accounted for only 18.6 percent of all U.S. income paid to foreign persons. The tax on interest payments made up only 10.4 percent of the total withholding taxes in 2008 even though interest income accounted for 53.8 percent of all income paid to foreign persons.

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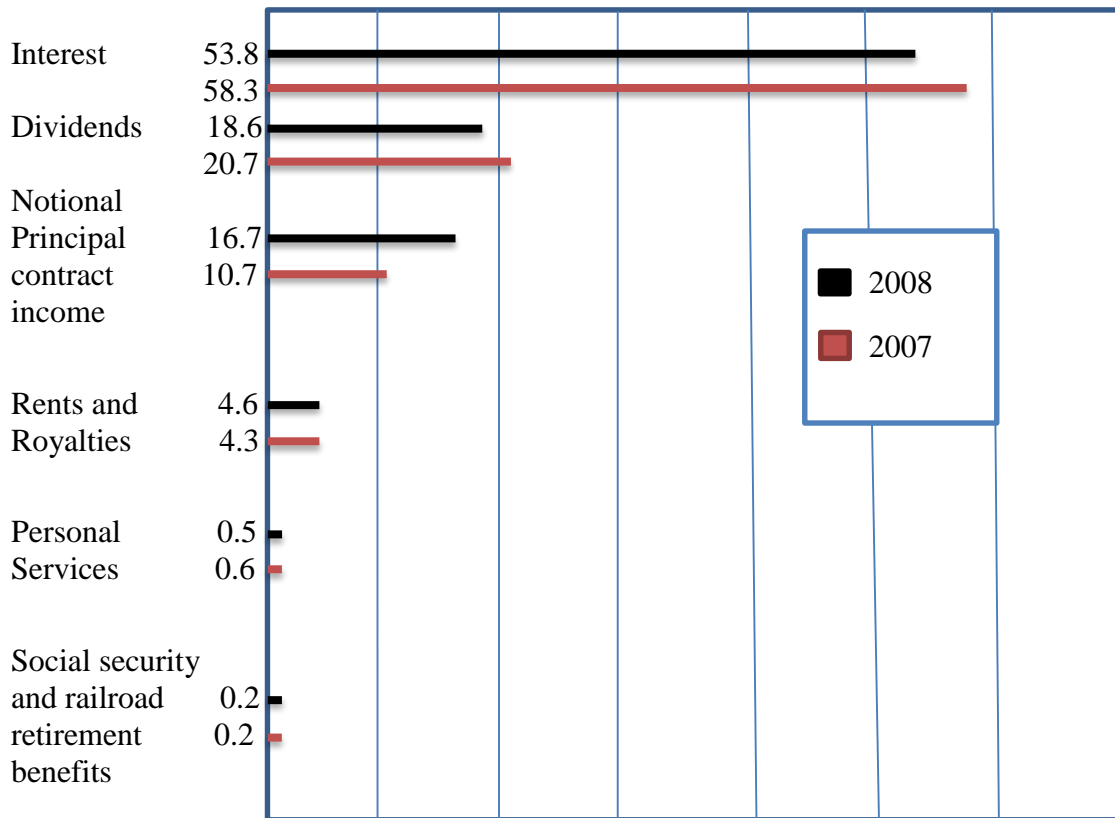
corporate subsidiaries if certain conditions are met in the case of U.S. tax treaties with Australia, Belgium, Denmark, Finland, France, Germany, Japan (more than 50 percent owned corporate subsidiaries), Mexico, Netherlands, New Zealand, Sweden and the United Kingdom. *See* INTERNAL REVENUE SERVICE, PUBLICATION 901, available at [http://www.irs.gov/publications/p901/ar02.html#en\\_US\\_publink1000219595](http://www.irs.gov/publications/p901/ar02.html#en_US_publink1000219595) (accessed Nov. 2, 2014).

<sup>632</sup> IRC secs. 871(h), 871(i), 881(c), and 881(d).

<sup>633</sup> Under the United States Model Income Tax Convention of November 15, 2006, the withholding tax rate for interest payments is zero. Art. 11(1).

Figure 5.2

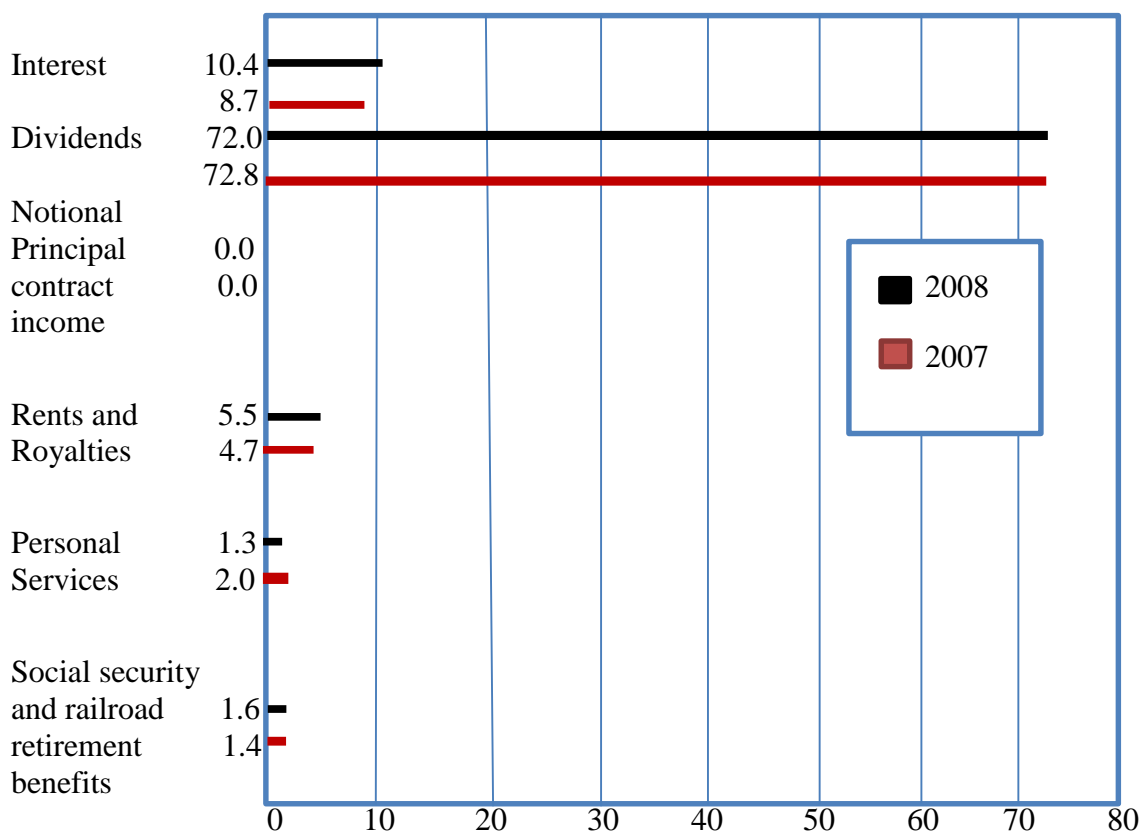
Percentage of Total Income Paid to Foreign Persons  
by Income Type, 2007 and 2008<sup>634</sup>



<sup>634</sup> See Scott Luttrell, *Foreign Recipients of U.S. Income, 2008*, STATISTICS OF INCOME BULLETIN 235-36 (Spring 2011).



**Figure 5.3**  
**Percentage of Total Taxes Withheld on Foreign Persons**  
**by Income Type, 2007 and 2008<sup>635</sup>**



Under current law, the earnings of a corporation may be subject to a double level of tax, a single level of tax, or even no tax when the earnings are distributed to foreign investors. If a corporation distributes its earnings in the form of a dividend to a foreign shareholder, the corporation is not permitted to deduct the dividend and the dividend is subject to a 30 percent withholding tax, resulting in two levels of tax. If the foreign shareholder is a corporation and owns 80 percent or more of the payor corporation (more than 50 percent in the case of a Japanese

<sup>635</sup> Id.

corporate recipient), then the dividend may be free of any U.S. withholding tax under an income tax treaty resulting in only a single level of tax at the corporate level.<sup>636</sup> If a corporation distributes its earnings in the form of interest to a foreign lender, then the corporation may deduct the interest payment, which, in many cases, will be free of any U.S. withholding tax. The distributed corporate earnings are therefore subject to no U.S. tax.

The difficulty in adopting integration with respect to foreign investors is that achieving the policy goals of taxing business income once and equalizing the treatment of debt and equity will necessarily affect the tax position of foreign investors relative to current law because current law is far out of alignment with the two policy goals. For example, if the dividend exclusion method is adopted, corporate income distributed in the form of a dividend will only be taxed once at the corporate level. But, under current law, corporate income distributed as interest to foreign lenders is, in most cases, not taxed at all. As a result, to achieve the policy goals of taxing business once and equalizing the tax treatment of debt and equity, the interest deduction must be eliminated (or, as a proxy to achieve a single level of tax, the foreign investor must be subject to the full withholding tax on the interest payment).

If the dividends paid deduction is adopted to achieve integration, then parity is achieved between debt and equity because the corporation will deduct both interest and dividend payments but the goal of a single tax on business income may not be satisfied. The foreign investor will, in most cases under current law, not be subject to tax on the interest and may, in many cases, be subject to a reduced rate of tax on any dividends. As a result, under the dividends paid deduction method, either a new compensatory withholding tax on both interest and dividends should be enacted to ensure a single level of tax on business income, or Congress can override existing tax

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<sup>636</sup> See *supra* note 631.

treaties, disallowing a reduction in withholding tax rates for interest and dividend payments.<sup>637</sup> The former action would be preferable.

Under some methods of integration, foreign shareholders pose few problems. For example, under CBIT, the business enterprise would not be permitted to deduct any interest or dividend payments and the recipient would exclude both interest and dividends from gross income. This result would apply even if the recipient was a foreign shareholder. The earnings of the business enterprise are subject to a single level of tax at the entity level whether the earnings are distributed to foreign shareholders or taxable shareholders. If the business enterprise has preference income or foreign source income shielded by foreign tax credits, then issues can arise under CBIT with respect to foreign shareholders.

#### R. Preferences

One of the most difficult issues in any integration proposal is the tax treatment of corporate tax preferences and whether such preferences should be passed on to the shareholders. Preferences can arise in a number of different forms although generally they fall into one of two categories. The first type creates a permanent difference between a corporation's taxable income and its pretax financial income. Some examples would include interest on a state or local bond, the manufacturing deduction, or percentage depletion in excess of the basis of the investment. The second type of preference creates a timing difference or temporary difference between a corporation's taxable income and pretax financial income. Some examples include accelerated depreciation and bonus depreciation.

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<sup>637</sup> Congress would also have to address the portfolio interest rule and consider enactment of a portfolio dividend rule.

Under current law, there are generally two mechanisms that limit a corporation's use of tax preferences.<sup>638</sup> The first is earnings and profits. Earnings and profits is a term that is not defined in the Code. Generally, it is designed to measure the economic income of the corporation that is available for distribution. In computing a corporation's earnings and profits, the starting point is the corporation's taxable income.<sup>639</sup> A number of adjustments are made to taxable income in arriving at the corporation's earnings and profits. For example, tax-exempt interest, which is a preference item of a permanent nature, is added to taxable income in determining a corporation's earnings and profits.<sup>640</sup> Depreciation deductions for tangible property, which are preference items of a temporary nature, are calculated under the alternative depreciation system in determining earnings and profits.<sup>641</sup> As a result, earnings and profits include most corporate tax preferences. A corporation must keep track of its accumulated earnings and profits and current earnings and profits.

Any distribution of money or property out of current or accumulated earnings and profits is treated as a dividend to the recipient and is therefore taxed to the recipient. As a result, earnings and profits define the pool of corporate earnings that is taxable as dividends when distributed to shareholders. Income that is tax preferred at the corporate level will be taxed when distributed as a dividend to shareholders. Such distribution will reduce the corporation's earnings and profits.

The second mechanism that limits a corporation's use of tax preferences is the corporate alternative minimum tax (AMT). The corporate AMT is a flat 20 percent tax imposed on a corporation's alternative minimum taxable income less the exemption amount.<sup>642</sup> A corporation's

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<sup>638</sup> See TREASURY 1992 INTEGRATION REPORT, *supra* note 353, at 63.

<sup>639</sup> Treas. Reg. sec. 1.312-6(a).

<sup>640</sup> Treas. Reg. sec. 1.312-6(b).

<sup>641</sup> IRC sec. 312(k)(3).

<sup>642</sup> IRC sec. 55.

alternative minimum taxable income is the corporation's taxable income determined with certain adjustments and increased by a number of preference items.<sup>643</sup> For example, interest on specified private activity bonds is a tax preference item under the corporate AMT and is added to taxable income in arriving at alternative minimum taxable income.<sup>644</sup> Depreciation deductions for tangible personal property, which are treated as adjustments under the corporate AMT, are calculated using the 150 percent declining balance method.<sup>645</sup> A corporation must pay the AMT if the computation of tax under the AMT is greater than the computation of its tax under the regular tax. The corporate AMT serves to limit the use of tax preferences to reduce tax on retained, as well as distributed, earnings.<sup>646</sup>

Under a full or complete integration approach, the corporate tax preferences would flow through the corporation to the shareholders. This would achieve results similar to the taxation of partnerships and their partners. Those in favor of passing corporate tax preferences through to the shareholders maintain that doing so would achieve equivalence between businesses conducted in corporate form and those conducted in non-corporate form (such as partnerships or limited liability companies).

If, however, the goal of integration is to tax business income of a corporation once, then corporate tax preferences should not be passed through to shareholders. Passing such preferences through to shareholders can permit business income to avoid all Federal income tax. For example, if a corporation earns \$100 of tax-exempt income, it will pay no taxes on such income. If the corporation then pays a \$100 dividend, the dividend should be taxed to the shareholder. In a

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<sup>643</sup> IRC secs. 56 and 57.

<sup>644</sup> IRC sec. 57(a)(5).

<sup>645</sup> IRC sec. 56(a)(1). If the straight-line method of depreciation was used for the regular tax, then it is also used for the corporate AMT.

<sup>646</sup> TREASURY 1992 INTEGRATION REPORT, *supra* note 353, at 63.

distribution-related integration system, some mechanism is needed to ensure that preferences do not pass through to shareholders. Under the dividend exclusion method, the excludable dividend amount (EDA) is the mechanism utilized to ensure that dividends paid out of corporate tax preferences are not excluded from the shareholder's gross income. Under the imputation credit mechanism, a compensatory withholding tax could be utilized to ensure that preferences are not passed through to shareholders or the shareholder credit account (SCA) could be utilized to ensure that credits are allowed only to the extent of corporate taxes paid. Under the dividends paid deduction, the qualified dividends account (QDA) ensures that corporations can only deduct dividends paid out of income that is fully subject to the corporate income tax.

One of the difficult issues with respect to preferences is the treatment of foreign source income that has been shielded from U.S. tax by foreign tax credits. Should such foreign source income be treated as preference income in a similar manner as, for example, tax-exempt interest? For example, assume utilization of the dividend exclusion method, and a corporation has \$100 of foreign source income for the year against which it has paid \$35 in foreign income taxes. The U.S. corporate tax rate is 35 percent so the corporation has a tentative U.S. tax liability of \$35 but then credits the foreign income taxes resulting in no taxes owed to the U.S. government. If the corporation then pays a dividend to its shareholder, should the dividend be excluded from the shareholder's gross income? If so, then no U.S. tax will have been paid on the corporate earnings distributed as a dividend. If the shareholder includes the dividend in gross income, then the corporate earnings distributed as a dividend can be viewed as having been subject to two levels of tax (the foreign income tax at the corporate level and the U.S. tax at the shareholder level).

In its 1992 report, Treasury did not treat foreign income taxes the same as U.S. income taxes in computing the EDA.<sup>647</sup> As a result, any distribution of foreign earnings that have been shielded from U.S. income tax by the foreign tax credit would be taxable to shareholders when distributed as a dividend. In both President Bush's 2003 proposal for dividend exclusion and the House's 2003 dividend exclusion proposal, foreign income taxes would be treated the same as U.S. income taxes. As a result, any distribution of foreign earnings that have been shielded from U.S. income tax by the foreign tax credit would not be taxable to shareholders when distributed as a dividend.

#### S. Retained Earnings and Sales of Stock

When a corporation retains earnings, generally the value of its stock will increase. If the corporation has paid taxes on its retained earnings, then the portion of the gain on the sale of stock due to the retained earnings should not be taxed in an integrated tax system. If it is, then the retained earnings are, in essence, subject to two levels of tax – once at the corporate level and a second time at the shareholder level on the sale of the stock.

Generally, appreciation in the value of stock leading to capital gain on the sale of the stock can arise in one of five ways.<sup>648</sup> First, it can arise due to fully taxed retained earnings of the corporation. In such case, taxing such portion of the gain leads to double taxation. Second, it can arise due to retained preference income of the corporation. Taxing the portion of the gain due to retained preference income would produce a single level of tax because the retained preference income has not been taxed at the corporate level. Third, capital gains may be attributable to the

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<sup>647</sup> In Treasury's subsequent December 1992 report, it recommended extending integration through the dividend exclusion method to foreign source income by flowing through creditable foreign income taxes. See TREASURY 1992 SUPPLEMENTAL INTEGRATION REPORT, *supra* note 354.

<sup>648</sup> TREASURY 1992 INTEGRATION REPORT, *supra* note 353, at 82.

unrealized appreciation in the value of corporate assets. Taxing this component of the capital gain on the sale of the stock may lead to double taxation of the unrealized appreciation. The unrealized appreciation is taxed first at the shareholder level on sale of the stock, and a second time at the corporate level when the corporation disposes of its assets. Fourth, the appreciation in stock value may be attributable to changes in the anticipated value of corporate earnings. Finally, appreciation in stock value may be due to inflation.

Under the dividend exclusion method, eliminating the double tax on corporate retained earnings can be achieved through a dividend reinvestment plan (DRIP). Under a DRIP, a corporation is either permitted or required to declare deemed dividends to the extent of its excludable dividend account (EDA). The shareholders are treated as receiving the excludable dividends and then contributing the dividends back to the corporation, increasing the shareholders' bases in their stock.

Implementing a DRIP under, for example, the dividends paid deduction poses more difficult problems. The shareholders would be deemed to receive a dividend to the extent of the corporation's qualified dividend account (QDA). Unlike the dividend exclusion method, however, the deemed dividends under the dividends paid deduction would be taxable to the shareholders. Consequently, by not actually receiving any cash (or property), the shareholders may have some difficulty in paying the resulting tax liability.

A rough cut approach to eliminating the double taxation that can arise due to fully taxed retained earnings is to provide preferential tax treatment for capital gains from the sale of stock. The portion of the capital gain on the stock sale due to fully taxed retained earnings should ideally bear no tax in an integrated tax system. But other components of the capital gain on the stock sale,



such as the portion of the gain due to retained preference income, should be taxed. Therefore, a preferential tax rate on capital gain from the sale of stock may achieve rough justice.

#### T. Corporate Dividend Policy Response to Integration

Prior to the Jobs and Growth Tax Relief and Reconciliation Act of 2003 (JGTRRA), distributed corporate income could be subject to an effective tax rate as high as 60.74 percent.<sup>649</sup> As part of the 2003 Act, Congress provided preferential tax treatment for “qualified dividend income.” Qualified dividend income refers to dividends from domestic corporations and qualified foreign corporations.<sup>650</sup> A qualified foreign corporation means any foreign corporation if the corporation is incorporated in a U.S. possession or the corporation is eligible for benefits of a comprehensive income tax treaty with the United States.<sup>651</sup> In addition, a foreign corporation not otherwise treated as a qualified foreign corporation will be treated as such with respect to any dividends paid by the corporation if the stock on which the dividend is paid is readily tradable on an established securities market in the United States. A dividend is qualified dividend income if the shareholder holds stock of the corporation for at least 61 days during the 121-day period beginning on the date that is 60 days before the date on which such share becomes ex-dividend with respect to such dividend.<sup>652</sup> Qualified dividend income is taxed at a maximum of 20 percent

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<sup>649</sup> Corporate earnings less 35 percent corporate tax rate times 39.6 percent individual tax rate plus 35 percent. At the time of enactment of the dividend rate cut, the top individual ordinary income rate was 38.6 percent resulting in a maximum effective tax rate of 60.09 percent.

<sup>650</sup> IRC sec. 1(h)(11)(B).

<sup>651</sup> IRC sec. 1(h)(11)(C).

<sup>652</sup> IRC sec. 1(h)(11)(B)(iii).

and, in some cases, may not be taxed at all.<sup>653</sup> As a result of taxing qualified dividend income at a maximum of 20 percent, distributed corporate income is taxed at a maximum of 48 percent.<sup>654</sup>

A number of papers have been written analyzing the effects of the preferential tax treatment for qualified dividend income on dividend payouts by corporations. The aggregate dividends paid by corporations had been steadily increasing from 1988 until 1997 and then started declining from 1998 until 2002. In 2003, aggregate dividends began increasing again before declining in 2009 and 2010. In addition, dividend initiations, both regular and special dividends, increased dramatically in the third quarter of 2003; however, in subsequent quarters, dividend initiations gradually declined, returning to the level in the several quarters preceding the dividend tax cut.<sup>655</sup>

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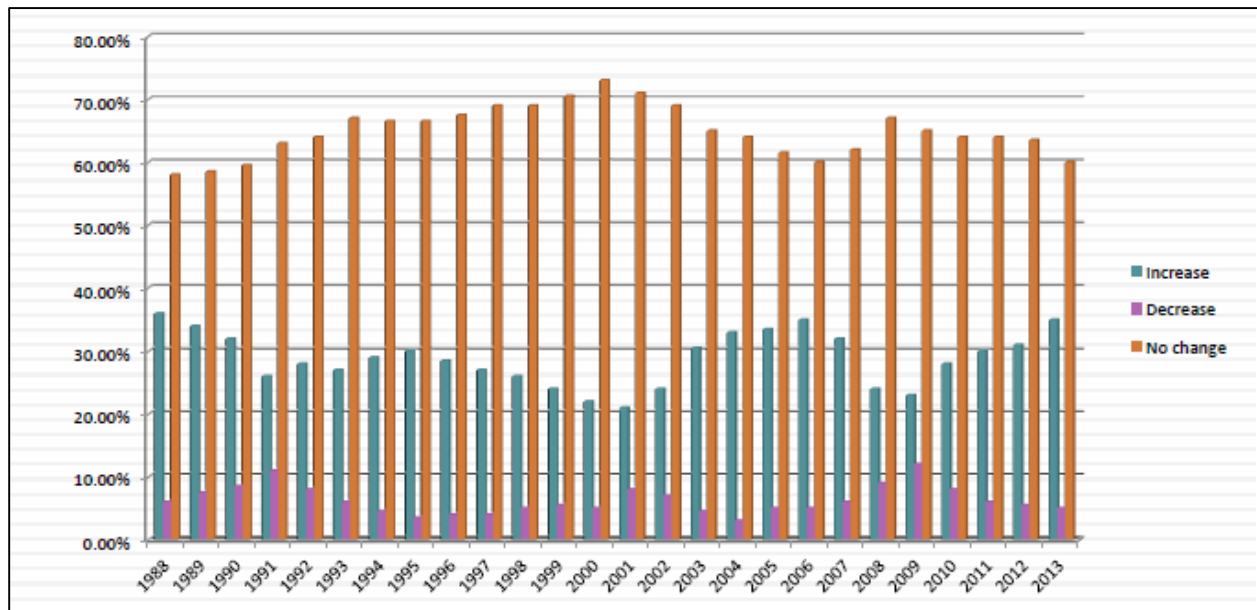
<sup>653</sup> IRC sec. 1(h)(1)(B), (C), (D) (zero percent rate on adjusted net capital gain, which includes qualified dividend income, that would otherwise be taxed at 10 percent or 15 percent; 15 percent rate on adjusted net capital gain that would otherwise be taxed at 25 to 35 percent; 20 percent rate on adjusted net capital gain that would otherwise be taxed at 39.6 percent). In addition, a 3.8 percent net investment income tax can apply to dividend income. IRC sec. 1411.

<sup>654</sup> Corporate earnings less 35 percent corporate tax rate times 20 percent individual tax rate plus 35 percent. If the 3.8 percent net investment income tax is included, distributed corporate income is taxed at a maximum of 50.47 percent.

<sup>655</sup> See Alon Brav, John R. Graham and Campbell R. Harvey, *The Effect of the May 2003 Dividend Tax Cut on Corporate Dividend Policy: Empirical and Survey Evidence*, 61 NAT'L TAX J. 381, 384 (2008).

**Figure 5.4**

**Dividend Changes at U.S. Companies<sup>656</sup>**



A number of authors have attempted to determine to what extent the increase in dividends after May 2003 was due to the preferential tax treatment for qualified dividend income. Raj Chetty and Emmanuel Saez argue that the May 2003 tax cut led to increases in dividend payments by those corporations already paying dividends as well as increased dividend initiations.<sup>657</sup> Others have reached similar conclusions.<sup>658</sup> Those same studies also found strong evidence that regular and special dividends rose and share repurchases fell after Congress reduced the dividend tax

<sup>656</sup> See Aswath Damodaran, *Returning Cash to the Owners: Dividend Policy*, available at <http://people.stern.nyu.edu/adamodar/pdfiles/acf4E/presentations/divintro.pdf> (accessed Nov. 14, 2014).

<sup>657</sup> Raj Chetty and Emmanuel Saez, *Dividend Taxes and Corporate Behavior: Evidence from the 2003 Dividend Tax Cut*, 120 Q. J. ECON. 791 (2005).

<sup>658</sup> See Brandon Julio and David L. Ikenberry, *Reappearing Dividends*, 16 J. APPLIED CORP. FIN. 89 (2004); Jennifer L. Blouin, Jana Smith Raedy and Douglas A. Shackelford, *The Initial Impact of the 2003 Reduction in the Dividend Tax Rate* (Sept. 2004), available at [http://www.fsa.ulaval.ca/html/fileadmin/pdf/Departement\\_comptables/Communication\\_seminaires.pdf](http://www.fsa.ulaval.ca/html/fileadmin/pdf/Departement_comptables/Communication_seminaires.pdf) (accessed Dec. 4, 2014).

rate,<sup>659</sup> dividend changes were smallest in corporations in which the largest investor was an institutional type not affected by the dividend rate cut,<sup>660</sup> and dividends increased disproportionately at firms in which the executives owned the most stock.<sup>661</sup>

Alon Brav, John Graham and Campbell Harvey found that while there was a temporary increase in dividend initiations, it was not long lasting.<sup>662</sup> In addition, while there was an increase in dividend payments after the dividend tax cut, there was a dramatically larger increase in share repurchases, which did not benefit from the tax cut.<sup>663</sup> In a survey of 328 financial executives, Brav, Graham and Campbell found that, among the factors that affect a company's dividend policy, the dividend tax rate reduction was less important than the stability of future cash flows, cash holdings, and the historic level of dividends.<sup>664</sup>

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<sup>659</sup> See Blouin, et al., *supra* note 658, at 26.

<sup>660</sup> See Chetty and Saez, *supra* note 657.

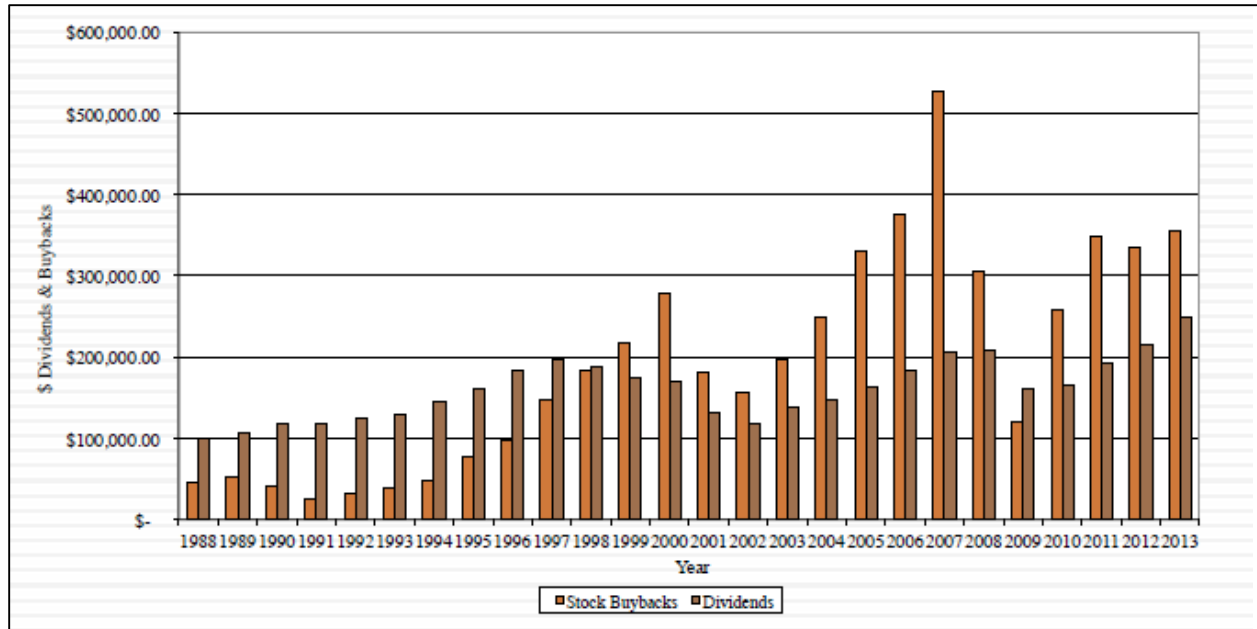
<sup>661</sup> See J.R. Brown, N. Liang and S. Weisbenner, *Executive Financial Incentives and Payout Policy: Firm Responses to the 2003 Dividend Tax Cut*, 62 J. FIN. 1935 (2007).

<sup>662</sup> See Alon Brav, John R. Graham, and Campbell R. Harvey, *supra* note 655, at 384.

<sup>663</sup> *Id.* Cf. Jennifer L. Blouin, Jana Smith Raedy and Douglas A. Shackelford, *Did Firms Substitute Dividends for Share Repurchases after the 2003 Reductions in Shareholder Tax Rates?* NBER Working Paper No. 13601 (2007), available at <http://www.nber.org/papers/w13601.pdf> (accessed Dec. 4, 2014) (finding evidence that companies substituted dividends for share repurchases because the reduction in dividend tax rates (from 38.6 percent to 15 percent) was greater than the reduction in capital gains rate (from 20 percent to 15 percent); substitution was greater in the percentage of company owned by individual investors).

<sup>664</sup> See Alon Brav, John R. Graham, and Campbell R. Harvey, *supra* note 655, at 388-391.

**Figure 5.5**  
**Stock Buybacks and Dividends: Aggregates for U.S. Firms, 1988-2013**<sup>665</sup>



Jesse Edgerton has documented that dividend payouts by real estate investment trusts (REITs) also rose sharply after enactment of the dividend tax cut even though dividends from REITs did not qualify for the rate cut.<sup>666</sup> Edgerton further documents that the ratio of dividend payouts to corporate earnings had little change after the rate cut, and the ratio of dividend payouts to share repurchases fell dramatically. Edgerton concludes that a large increase in corporate earnings that began in early 2003 and investor demand for dividends (due to the corporate scandals

<sup>665</sup> See Aswath Damodaran, *Returning Cash to the Owners: Dividend Policy*, available at <http://people.stern.nyu.edu/adamodar/pdfiles/acf4E/presentations/divintro.pdf> (accessed Nov. 14, 2014).

<sup>666</sup> Jesse Edgerton, *Effects of the 2003 Dividend Tax Cut: Evidence from Real Estate Investment Trusts* (Apr. 23, 2010), available at <http://www.federalreserve.gov/pubs/feds/2010/201034/201034pap.pdf> (accessed Dec. 4, 2014).

in 2001 and 2002) were the primary causes of increased dividend payouts after enactment of the dividend tax cut, with the rate cut playing only a modest role.

Eric Floyd, Nan Li and Douglas Skinner find that both aggregate repurchases and dividends increased during the 2000s.<sup>667</sup> The authors find that the increases were driven by an increase in earnings and the extent to which those earnings were paid out. If taxes were the most important factor, then the authors believe that there should have been an increase in dividend initiations and the size of dividends as well as a substitution from repurchases to dividends. The authors find no evidence that this took place. In fact, the authors find that the mix of dividends and repurchases shifted toward repurchases in the mid-2000s.

#### U. Pass-Through Business Entities

The United States differs from many other countries in that a large and increasing portion of business income is earned by pass-through entities, such as partnerships, limited liability companies and S corporations. The increasing amount of business income earned by pass-through entities is a trend that has taken place over the last 30 years. In 1980, C corporations earned 75 percent of the net income earned by all businesses, with S corporations, partnerships and sole proprietorships earning a combined 21 percent of all net business income.<sup>668</sup> By 1990, C corporations earned only 50 percent of the net income earned by all businesses, with S corporations, partnerships and sole proprietorships earning 37 percent.<sup>669</sup> In 2000 and 2008, C corporations earned 35 percent and 22 percent, respectively, of the net income earned by all

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<sup>667</sup> Eric Floyd, Nan Li and Douglas J. Skinner, *Payout Policy Through the Financial Crisis: The Growth of Repurchases and the Resilience of Dividends*, Working Paper No. 12-01, The University of Chicago (Oct. 2011).

<sup>668</sup> INTERNAL REVENUE SERVICE, SOI TAX STATS – INTEGRATED BUSINESS DATA, available at <http://www.irs.gov/uac/SOI-Tax-Stats-Integrated-Business-Data> (accessed Nov. 13, 2014).

<sup>669</sup> *Id.*

businesses, with S corporations, partnerships and sole proprietorships earning slightly less than half of the net income in 2000 (46 percent) and slightly more in 2008 (59 percent).<sup>670</sup>

In a recent report, the GAO emphasized the need to improve tax compliance for partnerships and S corporations.<sup>671</sup> In the most recent study of S corporations, the IRS, using 2003-2004 data, estimated that about 15 percent of their income was misreported – an average of \$55 billion for 2003 and 2004.<sup>672</sup> Using IRS data, the GAO estimated that about \$91 billion per year of partnership and S corporation income was being misreported by individuals for 2006 through 2009, which resulted in about \$19 billion of lost revenue per year.<sup>673</sup>

For years, tax scholars have searched for the pass-through paradigm, raising a number of important questions. Is there a need to have different pass-through taxing regimes? Can the various pass-through regimes be consolidated into one regime? Attempting to have one regime has always been met with great resistance from the members of the practicing bar who have mastered one or both of the two main regimes contained in subchapters K and S. They seem to be following the saying: “An old complexity is better than a new complexity particularly if you are an old lawyer.” If the separate pass-through regimes are to be retained, then certain conforming changes should be enacted. For example, the treatment of pass-through income for self-employment tax purposes differs depending upon whether the pass-through entity is a partnership or an S corporation.<sup>674</sup> If the income is earned by a partnership, then a general partner is subject

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<sup>670</sup> Id.

<sup>671</sup> U.S. Government Accountability Office, *Partnerships and S Corporations: IRS Needs to Improve Information to Address Tax Noncompliance*, Report to the Chairman, Committee on Finance, U.S. Senate, GAO-14-453 (May 2014).

<sup>672</sup> Id. at 10 (IRS did not publish the results of the study but rather presented selected results from the study at the 2009 IRS Research Conference).

<sup>673</sup> Id. at 14.

<sup>674</sup> In December 1994, Treasury issued proposed regulations treating certain members of an LLC as limited partners for self-employment tax purposes. In January 1997, Treasury withdrew the

to self-employment tax on his distributive share of the partnership income.<sup>675</sup> A limited partner, however, is not subject to self-employment tax on her distributive share of partnership income.<sup>676</sup> In contrast, shareholders of an S corporation are not subject to self-employment taxes on their distributive shares of the S corporation income.<sup>677</sup> The self-employment tax rules should be harmonized for partnerships and S corporations.<sup>678</sup>

Another area that could be harmonized is the tax treatment of employees of pass-through entities. In a partnership, a partner is not permitted to be an employee of the same partnership.<sup>679</sup> In an S corporation, a shareholder may also be an employee of the S corporation. There does not seem to be a good policy reason why a partner cannot also be an employee of the same partnership.<sup>680</sup> The issue commonly arises when an employee of a partnership is given an equity interest in the same partnership. A number of planning techniques have been developed over the years to avoid having a partner being an employee of the same partnership. One coming technique is to have the taxpayer as an employee of a lower-tier partnership and be granted an equity interest

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1994 proposed regulations and issued new proposed regulations in an attempt to establish a single set of rules that apply identical standards to all entities classified as a partnership. As part of the Taxpayer Relief Act of 1997, Congress prohibited Treasury/IRS from issuing temporary or final regulations relating to the definition of a limited partner for self-employment tax purposes that would be effective before July 1, 1998. The 1997 proposed regulations have never been finalized.

<sup>675</sup> IRC sec. 1402(a).

<sup>676</sup> IRC sec. 1402(a)(13).

<sup>677</sup> Rev. Rul. 59-221, 1959-1 C.B. 225.

<sup>678</sup> See, e.g., JOINT COMMITTEE ON TAXATION, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, JCS-02-05 (Jan. 27, 2005) at 95; JOINT COMMITTEE ON TAXATION, ADDITIONAL OPTIONS TO IMPROVE TAX COMPLIANCE (Aug. 3, 2006) at 29, available at <http://www.finance.senate.gov/newsroom/chairman/release/?id=196654d7-c5d3-4847-b6ed-0d6a3d5c3d56> (accessed Oct. 30, 2014).

<sup>679</sup> Rev. Rul. 69-184, 1969-1 C.B. 256.

<sup>680</sup> See *Armstrong v. Phinney*, 394 F.2d 661 (5<sup>th</sup> Cir. 1968) (partner can render services to partnership in capacity as an employee at least for purposes of section 119 (exclusion for meals and lodging)). See also James B. Sowell, *Partners as Employees: A Proposal for Analyzing Partner Compensation*, 90 TAX NOTES 375 (Jan. 15, 2001).



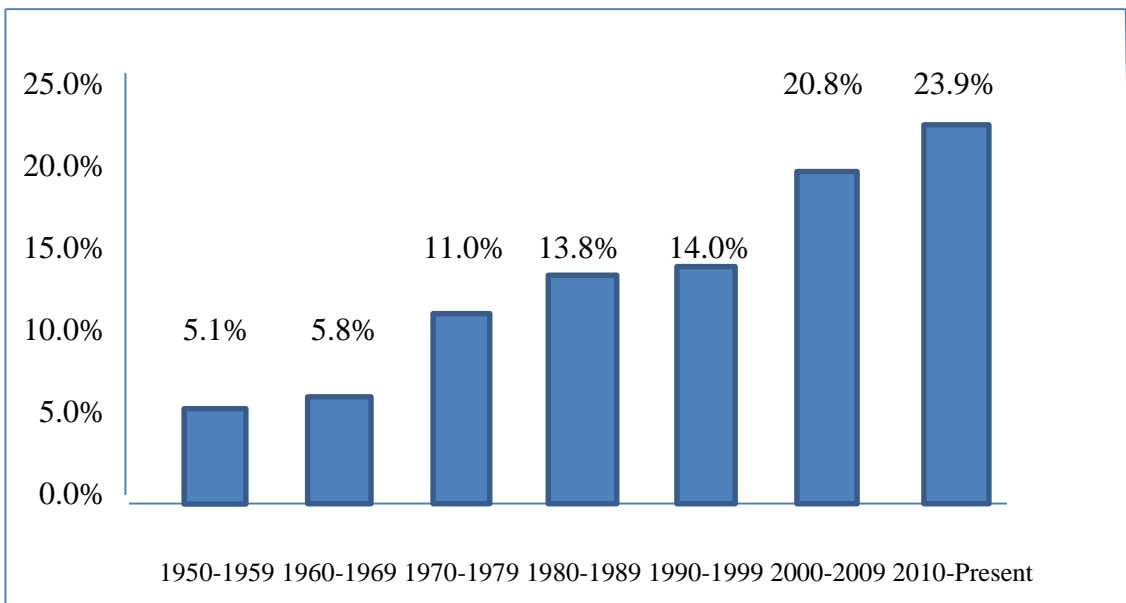
in an upper-tier partnership. As a result, the taxpayer will not be an employee and partner of the same partnership. Maybe it makes more sense to allow a taxpayer to be an employee and partner of the same partnership (at least for certain purposes of the tax laws).

## Chapter 6: International Tax Reform

During the last tax reform effort in 1986, international taxation played a smaller role in the reform discussion than it does today. In 1986, most U.S. multinationals earned a small percentage of income abroad. Today, that percentage is much higher and is increasing on a yearly basis.

**Figure 6.1**

**Profits from Overseas Operations Growing as a Percentage of Total Profits<sup>681</sup>**



For some U.S. multinationals, the increase in foreign profits as a percentage of total profits has been dramatic. Just 10 years ago, U.S. multinationals such as Microsoft, General Electric, Cisco, and Merck earned substantially less than half of their income abroad. Today, however, these U.S. multinationals earn most of their income outside of the United States.

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<sup>681</sup> See J.P. MORGAN, NORTH AMERICA EQUITY RESEARCH (June 27, 2011), available at [http://www.politico.com/static/PPM191\\_110629jpmorgan.html](http://www.politico.com/static/PPM191_110629jpmorgan.html) (accessed Nov. 13, 2014).

**Table 6.1**

**Foreign Share of Worldwide Profits of Some U.S. Multinationals<sup>682</sup>**

	1998-2000 Average Share (%)	2008-2010 Average Share (%)
Microsoft	17	60
General Electric	39	82
Cisco	33	79
Merck	28	57

With so many U.S. multinationals earning significant amounts of income abroad, it is important that our international tax rules operate in a manner that is fair, competitive and efficient. Unfortunately, that is not the case under our current system. We are seeing clues all around us suggesting that our international tax system is not working properly. In fact, most would say that our international tax system penalizes U.S. companies relative to their foreign competitors thereby affecting the competitiveness of American businesses. For example, the idea of reincorporating or inverting a U.S. corporation to become a foreign corporation was practically unheard of 30 years ago. In fact, the first highly publicized inversion did not take place until 1983 when McDermott Corporation inverted to Panama. In the last 10 to 20 years, however, a number of U.S. corporations have reincorporated abroad. The first wave of inversions took place in the late 1990s and early 2000s. A number of U.S. corporations, such as Ingersoll-Rand Inc., Tyco International, Nabors Industries Ltd., and Cooper Industries, inverted, becoming domiciled in countries such as Bermuda and the Cayman Islands.

In just the last couple of years, a second wave of corporate inversions has taken place with a number of U.S. corporations, such as Aon Corp., Eaton Corp., and Rowan Companies, Inc., inverting to foreign jurisdictions. And a number of additional U.S. corporations, such as

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<sup>682</sup> See MARTIN A. SULLIVAN, CORPORATE TAX REFORM (2011) at 80.

Medtronic, Burger King, and Mylan, have recently announced plans to invert. In the new wave of inversions, the country of domicile is typically Ireland, Canada, Switzerland, the United Kingdom and other European countries. By reincorporating or inverting, these former U.S. corporations may, among other reasons, be attempting to avoid paying U.S. taxes on their foreign earned income, may simply desire to subject their earnings to a much lower corporate tax rate, may be stripping earnings from the U.S. tax base, or may be attempting to free up the cash held by their foreign subsidiaries.<sup>683</sup>

For example, the United Kingdom has a corporate tax rate of 21 percent (scheduled to be reduced to 20 percent in 2015) and a newly enacted system in which it generally only taxes earnings within its borders. While Ireland purportedly has a worldwide tax system, in practice it is a de facto territorial system, coupled with a corporate tax rate of only 12.5 percent.<sup>684</sup> Avoiding paying taxes on foreign earned income or paying a much lower corporate tax rate allows U.S. multinationals that relocate to these jurisdictions to be more competitive in today's global economy. In addition, the United States has an incomplete set of rules to prevent foreign multinational corporations from stripping the U.S. tax base.

A new company, if it is being properly advised on tax issues, would almost certainly benefit from incorporating in a foreign jurisdiction rather than the United States. In a hearing before the Senate Finance Committee in March 1999, Bob Perlman, the Vice President of Taxes for Intel

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<sup>683</sup> See U.S. DEPARTMENT OF THE TREASURY, REPORT TO THE CONGRESS ON EARNINGS STRIPPING, TRANSFER PRICING AND INCOME TAX TREATIES (Nov. 2007) at 3 (“However, there is strong evidence of earnings stripping by the subset of foreign-controlled domestic corporations consisting of inverted corporations (i.e., former U.S.-based multinationals that have undergone inversion transactions).”).

<sup>684</sup> *But see* Statement of the Irish Finance Minister Michael Noonan, T.D. (Oct. 14, 2014) (“I am ... changing our residency rules to require all companies registered in Ireland to also be tax resident. This legal change will take effect from the 1st of January 2015 for new companies. For existing companies, there will be provision for a transition period until the end of 2020.”).

Corporation, told the committee, “Let me begin by stating that if Intel were to be founded, I would strongly advise that the parent company be incorporated outside the United States. Our tax code competitively disadvantages multinationals simply because the parent company is incorporated in the United States.”<sup>685</sup> Mr. Perlman received quite a bit of criticism for his comments, but, unfortunately, he was correct. In 2004, the United States enacted a provision to prevent U.S. companies from leaving for tax purposes.<sup>686</sup> We think it makes more sense to look at our international tax rules to determine what is encouraging companies to invert or relocate and reform our system rather than simply working along the margins in attempts to address only the symptoms of a much larger problem.

Another clue that our international tax system is not working properly is that U.S. multinationals benefit from earning income abroad and then are, in a sense, penalized when they repatriate those earnings to the United States. In 2014, U.S. multinationals have billions of dollars in earnings that are essentially trapped offshore as a result of our international tax system. According to recent studies, U.S. multinationals had over \$2 trillion in earnings held offshore, with a large percentage held in cash or cash equivalents.<sup>687</sup> Under our international tax system, the Federal government does not tax those earnings until they are repatriated to the United States. As a result, the U.S. multinationals simply leave the vast majority of their earnings offshore.<sup>688</sup> That

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<sup>685</sup> International Tax Issues Relating to Globalization, Hearing Before the Committee on Finance, U.S. Senate, 106<sup>th</sup> Cong., 1<sup>st</sup> Sess. 11 (Mar. 11, 1999).

<sup>686</sup> IRC sec. 7874.

<sup>687</sup> See Audit Analytics, *Overseas Earnings of Russell 1000 Tops \$2 Trillion in 2013* (Apr. 1, 2014), available at <http://www.auditanalytics.com/blog/overseas-earnings-of-russell-1000-tops-2-trillion-in-2013/> (accessed Nov. 14, 2014); Douglas Holtz-Eakin and Gordon Gray, *Ending the Lockout of Overseas Earnings: An Update* (Aug. 7, 2013), available at <http://americanactionforum.org/research/ending-the-lockout-of-overseas-earnings-an-update> (accessed Nov. 14, 2014).

<sup>688</sup> In a report issued in 2011, the United States Senate Permanent Subcommittee on Investigations conducted a survey of 27 U.S. corporations that collectively had a total of \$538 billion in

is not to say, of course, that even cash and cash equivalents are held offshore solely because of taxes. Nonetheless, one can summarize our current international tax system as one that encourages U.S. multinationals to earn income abroad and then punishes those same multinationals when they bring the earnings back to the United States.

#### A. Summary of Hearings Involving International Tax Reform

On September 8, 2011, the Senate Finance Committee held a hearing titled “Tax Reform Options: International Issues.” Three of the four witnesses strongly urged enactment of a territorial type of tax system.

Dr. James Hines advocated a territorial type of tax system in the form of a dividend exemption system.<sup>689</sup> He stressed that such a system would stimulate greater economic activity and greater labor demand in the United States. He also noted that the opposite would also be true – that a worldwide no deferral system would reduce the productivity of U.S. operations and thereby reduce economic activity in the United States. Dr. Hines “estimated the net tax burden on American firms from the U.S. system of worldwide taxation to be in the neighborhood of \$50 billion per year, well exceeding revenue collections, since a significant portion of the net burden comes in the form of the associated efficiency cost.”

Philip West also advocated a dividend exemption system.<sup>690</sup> He noted that our current tax code appears to be a detriment in the global success of U.S. multinationals. Although there was

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undistributed foreign earnings at the end of 2010. Of that amount, almost half (46 percent) of the funds were actually held in U.S. financial institutions. UNITED STATES SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS, OFFSHORE FUNDS LOCATED ONSHORE, MAJORITY STAFF ADDENDUM (Dec. 14, 2011).

<sup>689</sup> Statement of James R. Hines, Jr., Tax Reform Options: International Issues, Testimony Before the Committee on Finance, United States Senate (Sept. 8, 2011).

<sup>690</sup> Statement of Philip R. West, Tax Reform Options: International Issues, Testimony Before the Committee on Finance, United States Senate (Sept. 8, 2011).

no clear empirical evidence to show such a detriment, Mr. West wrote that there was substantial anecdotal evidence. He also pointed out that the U.S. international tax rules were designed during a time when the United States was the dominant world economy and the major market for U.S. companies. Today, however, significant growth is occurring outside the United States and non-U.S. markets are critical for the growth of U.S. businesses. Yet, according to West, our international tax rules have remained unchanged for many years and look fundamentally different than our trading partners. The worldwide nature of our tax system is more similar to developing countries than our trading partners, many of which exempt foreign-earned income.

Scott Naatjes strongly supported a territorial tax system while making a number of important observations.<sup>691</sup> While academics and policy makers spend a considerable amount of time worrying about whether overseas expansion by U.S. multinationals is synergistic with or a substitute for U.S. investment and employment, Naatjes believed that was the wrong question to ask. Because global capital markets will ensure that efficient non-U.S. investments are made with or without a U.S. multinational, the proper question is whether it will be relatively more synergistic to U.S. employment and the U.S. tax base to have the non-U.S. investment made by a U.S. multinational or a foreign multinational. Naatjes noted the numerous benefits if the non-U.S. investment is made by a U.S. multinational, such as enhanced U.S. employment and economic strength, increased U.S. tax revenues, enhanced competitiveness and market intelligence.

Naatjes also thought that the idea that a worldwide tax system without deferral would solve the problem of trapped cash as effectively as a territorial tax system misses the point. He writes that “we want our multinationals to be mobile and competitive.” The trapped cash is the symptom

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<sup>691</sup> Statement of Scott M. Naatjes, Tax Reform Options: International Issues, Testimony Before the Committee on Finance, United States Senate (Sept. 8, 2011).

of the real problem, which is our antiquated tax system. According to Naatjes, getting the cash home through a more burdensome tax system only makes it worse. He also addressed the idea that companies should be taxed based upon their place of management and control. He quickly dismissed this idea as such an approach would put corporate headquarters at risk of leaving the United States.

On July 22, 2014, the Senate Finance Committee held a hearing titled “The U.S. Tax Code: Love It, Leave It, or Reform It!” Two of the witnesses strongly urged adoption of a territorial type of tax system.

Dr. Mihir Desai wrote in his testimony that “[r]eforms should be focused exclusively on advancing U.S. welfare with particular attention on reforms that will improve American wages.”<sup>692</sup> He noted that this goal is mistakenly thought to be achieved by limiting the foreign activities of U.S. firms because such foreign activities can be viewed as diverting economic activity away from the United States. Desai notes that the evidence suggests just the opposite. As firms expand globally, they also expand domestically. He concludes that “American welfare can be advanced by ensuring that investments in the United States and abroad are owned by the most productive owner and that American firms flourish abroad, a goal advanced by the territorial regime that has now been adopted by most comparable countries.”

Dr. Peter Merrill wrote that, since the last major tax reform in 1986, the importance of foreign markets to the success of U.S. businesses has increased and international competition from foreign-based companies has also increased.<sup>693</sup> During this same time period, other countries have

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<sup>692</sup> Statement of Mihir A. Desai, The U.S. Tax Code: Love It, Leave It, or Reform It! Testimony Before the Committee on Finance, United States Senate (July 22, 2014).

<sup>693</sup> Statement of Peter R. Merrill, The U.S. Tax Code: Love It, Leave It, or Reform It! Testimony Before the Committee on Finance, United States Senate (July 22, 2014).



reduced their corporate tax rates and moved from worldwide to territorial tax systems. As a result, the United States has become an outlier with respect to its tax system. The United States needs to reform its tax system by lowering the corporate tax rate and adopting a territorial type of tax system, which would bring it in line with international norms, and would enhance the ability of U.S. multinationals to compete in the global marketplace.

#### B. Theories of International Taxation

International tax issues have become an important if not integral part of any contemporary tax reform discussion. For years, tax scholars have debated whether the U.S. international tax regime should be modeled on the principle of capital export neutrality or capital import neutrality. *Capital export neutrality* occurs when the overall burden of taxation on capital owned by residents of a particular country is the same whether that capital is invested at home or abroad.<sup>694</sup> If capital export neutrality is met, the tax system neither encourages nor discourages capital export, and therefore the investors' choice to invest at home or abroad is not influenced by tax considerations. For example, if a U.S. multinational earns income in the United States, it is taxed at the U.S. corporate tax rate of 35 percent. If the U.S. multinational earns income in a foreign country, under capital export neutrality, it should again be taxed at the U.S. corporate tax rate of 35 percent (with a credit for any foreign income taxes paid). As a result, the U.S. multinational will pay a tax of 35 percent on its income whether the income is earned in the United States or abroad. Capital export neutrality has generally been associated with worldwide taxation coupled with a credit for foreign income taxes.

In contrast, the theory of *capital import neutrality* holds that the international tax system should have equal tax treatment for all capital invested within a particular country regardless of

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<sup>694</sup> THE ENCYCLOPEDIA OF TAXATION AND TAX POLICY 45 (Joseph J. Cordes, et al., eds. 2005).

the residence of the investor.<sup>695</sup> For example, if a U.S. multinational earns income in the United States, it is taxed at the U.S. corporate tax rate of 35 percent. If the U.S. multinational earns income in a foreign country, under capital import neutrality, the income earned in that foreign country is exempt from U.S. tax. The theory is that a foreign multinational earning income in its home country will only pay tax to that country, so a U.S. multinational should not be disadvantaged by paying tax in a foreign jurisdiction and a residual tax to the United States. Capital import neutrality has generally been associated with territoriality – the idea that a particular country, as a general rule, should only tax income earned within its borders.

Other international tax theories have developed over time, including the theory of *national neutrality*, which emphasizes the importance of the nation’s economic well-being in tax policy.<sup>696</sup> This is in contrast with emphasizing the importance of global economic well-being in tax policy. To illustrate national neutrality, assume a U.S. multinational can earn a 10 percent return on its investment in the United States. It can also earn a 10 percent return on its investment in a foreign country. However, any foreign income taxes it pays may only be deducted (as a cost of doing business) and not credited against its U.S. tax liability. If the foreign country’s tax rate is 30 percent, then the U.S. multinational’s return from its investment in that country is only seven percent after it pays the foreign income taxes. As a result, the U.S. multinational will likely choose to invest in the United States at ten percent rather than investing in a foreign country at seven percent.

If the U.S. multinational can earn a 14 percent rate of return on its investment in the foreign country, then it will still forego that investment because after payment of the foreign income taxes,

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<sup>695</sup> Id. at 50.

<sup>696</sup> Id. at 267.

the rate of return is only 9.8 percent (14 percent return taxed at a 30 percent rate), less than the 10 percent return from an investment in the United States. The U.S. multinational will need to earn a return of 14.3 percent (or greater) in the foreign country to invest there rather than the United States. A 14.3 percent rate of return becomes a 10.01 percent return after payment and deductibility of foreign income taxes, ever so slightly higher than the 10 percent return than can be earned in the United States. National neutrality in the United States would generally be achieved by allowing U.S. multinationals to deduct rather than credit foreign income taxes. If one assumes a worldwide tax system, then global economic well-being may be better achieved with a credit for foreign income taxes.

More recently, several tax scholars have introduced the theory of *capital ownership neutrality*, the goal of which is to have tax rules that do not distort ownership patterns.<sup>697</sup> Capital ownership neutrality requires a U.S. multinational to be as competitive as any other bidder in pursuing a foreign acquisition. In a world in which other countries have adopted exemption systems of taxing foreign income, this can only be achieved if the United States moves to a tax system that exempts foreign business income from U.S. tax and also allows a deduction in the United States for all domestically incurred expenses, whether or not attributable to earning the exempt foreign income.<sup>698</sup> As a result, capital ownership neutrality is generally achieved through

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<sup>697</sup> See Mihir A. Desai and James R. Hines, Jr., *Evaluating International Tax Reform*, 56 NAT'L TAX J. 487 (2003).

<sup>698</sup> Allowing all domestically incurred expenses to be deductible, even when such expenses generated exempt foreign-source income, is presumably required to achieve capital ownership neutrality because other countries allow such expenses to be deductible. To the extent other countries did not allow such expenses to be deductible, query whether capital ownership neutrality would still require the United States to allow such deductions. To the extent other countries had a higher domestic corporate tax rate than the United States and to the extent they allowed such deductions against domestic source income, would capital ownership neutrality require the United States to increase its domestic corporate tax rate so that such deductions would be equally valuable

territoriality, similar to capital import neutrality. If, however, the other countries were to shift to a worldwide tax system, which is clearly not anticipated, then the United States would achieve capital ownership neutrality by adopting a worldwide tax system.<sup>699</sup>

Since the early part of our income tax system, the United States has adopted, for the most part, the principle of capital export neutrality in taxing income earned outside the United States. For example, as part of the Revenue Act of 1918, the United States became the first country to enact a system in which income taxes paid to a foreign country on income earned offshore could be credited against U.S. income taxes.<sup>700</sup> Such a system is evidence of capital export neutrality. Three years later, as part of the Revenue Act of 1921, the United States limited the crediting of foreign income taxes to ensure that a taxpayer's foreign tax credits could not exceed the taxpayer's U.S. tax liability on the taxpayer's foreign source income.<sup>701</sup>

The international tax regime that was developed in the 1920s has survived for almost 90 years. There have been some significant changes to the international tax regime over the years, such as in 1962 when the controlled foreign corporation rules were enacted. But the fundamental principles have remained mostly intact for nearly nine decades. The time has come to rethink and reform our international tax system. When the fundamentals were put in place in the 1920s, the

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in the United States as in other countries? Could allegiance to capital ownership neutrality trigger a "race to the top"?

<sup>699</sup> Some countries have a worldwide tax system, and other countries have a territorial type of tax system. If capital ownership neutrality requires that it be applied by the United States so that any U.S. multinational corporation will be at least as competitive as any foreign multinational corporation, if not more so, then query whether the United States should have a territorial type of tax system. That is, if all countries had a worldwide tax system, then capital ownership neutrality would require the United States to have a worldwide tax system, but since at least some countries will likely have a territorial type of tax system, arguably the capital ownership neutrality would require the United States to have a territorial type of tax system.

<sup>700</sup> See Michael J. Graetz and Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021 (1997).

<sup>701</sup> Id.

United States was a net exporter of capital.<sup>702</sup> Today, the United States is a net importer of capital. The United States remains an important force in the global economy; however, significant growth and opportunity for multinational firms is occurring outside the United States. About 75 percent of the world's purchasing power and almost 95 percent of the world's consumers are outside of America's borders.<sup>703</sup> The U.S. international tax system was designed at a time when U.S. companies had minimal competition from foreign companies when competing in foreign countries.<sup>704</sup> Today, numerous foreign companies are competing with U.S. multinationals in almost every part of the world.

The U.S. international tax system is designed for a corporate tax system in which the earnings of the corporation are subject to two levels of tax – once at the corporate level and a second time at the shareholder level.<sup>705</sup> If the United States were to integrate the corporate and individual tax systems so that business income is only taxed once, the U.S. international tax system would also need to be reformed. Finally, the U.S. international tax system was designed when U.S. companies did not have significant amounts of earnings trapped offshore. The “lockout effect” created by the current international tax system is a symptom of a problem, namely, that the current rules are not working well.

A report issued in late 2011 by the Senate Permanent Subcommittee on Investigations partly involved a survey of 27 U.S. corporations that collectively had a total of \$538 billion in undistributed foreign earnings at the end of 2010.<sup>706</sup> Of that amount, almost half (46 percent) of

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<sup>702</sup> See Bret Wells and Cym H. Lowell, *Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin*, 65 TAX L. REV. 535 (2011).

<sup>703</sup> OFFICE OF THE UNITED STATES TRADE REPRESENTATIVE, ECONOMY AND TRADE, available at <http://www.ustr.gov/trade-topics/economy-trade> (accessed Nov. 14, 2014).

<sup>704</sup> See Wells and Lowell, *supra* note 702.

<sup>705</sup> See Graetz and O'Hear, *supra* note 700, at 1025.

<sup>706</sup> UNITED STATES SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, *supra* note 688.

the funds were actually held in U.S. financial institutions. The tax code permits such earnings to be held in U.S. financial institutions without triggering the 35 percent residual U.S. tax.<sup>707</sup> As a result, the report concludes that a large amount of offshore earnings are not trapped and that a repatriation holiday is therefore unnecessary and would exacerbate existing tax unfairness. We believe that the funds are trapped in that they cannot be deployed in the United States, except for the narrow exceptions contained in section 956(c)(2), without triggering a large U.S. tax. That is, even the money in U.S. banks is trapped in that it cannot be used in the United States more broadly. The findings in the report are only further proof that the U.S. system for taxing international income needs to be reformed.

### C. Revenues from the U.S. International Tax System

For the years 2007, 2008 and 2009, U.S. multinationals reported \$392.5 billion, \$413.3 billion and \$416.8 billion of foreign source net income, respectively, on their tax returns.<sup>708</sup> However, the U.S. international tax system raises only about \$25 to \$30 billion per year.<sup>709</sup> This is the residual U.S. tax that is collected on foreign source income. The following table shows the residual U.S. tax from 2007, 2008, and 2009.

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<sup>707</sup> IRC sec. 956(c)(2).

<sup>708</sup> See INTERNAL REVENUE SERVICE, SOI TAX STATS – CORPORATE FOREIGN TAX CREDIT TABLE 1, available at <http://www.irs.gov/uac/SOI-Tax-Stats-Corporate-Foreign-Tax-Credit-Table-1> (accessed Nov. 12, 2014). These figures do not include amounts of income that were deferred from U.S. taxation.

<sup>709</sup> Id.

**Table 6.2**

**Foreign Tax Payments and Credits, 2007, 2008 and 2009<sup>710</sup>**

Item	2007 (billions of \$)	2008 (billions of \$)	2009 (billions of \$)
Current Foreign Taxes Paid	99.1	121.2	104.4
Minus Reduction (Largely for Oil and Gas Taxes)	10.3	14.7	11.9
Plus Carryover	29.2	49.7	72.5
Equals Total Foreign Tax Credits Available	117.9	156.2	165.1
Foreign Tax Credit Limit	114.0	122.5	123.3
Foreign Tax Credits Claimed	86.5	100.4	93.6
Residual U.S. Tax (Limit minus Claimed)	27.5	22.1	29.7

D. The Need for a Territorial Tax System

Put simply, the United States needs to adopt a territorial type of tax system. Such a system would solve the lockout problem discussed above. In addition, a territorial type of tax system would help achieve parity between U.S. companies and their foreign competitors. Foreign companies are currently taxed by the United States only on income earned in the United States. As a result, foreign companies are taxed by the United States on a territorial basis while, once again, the U.S. taxes American companies on their worldwide income. Taxing U.S. companies on a territorial basis would ensure that our tax system is no longer biased in favor of foreign businesses. In addition, most developed countries of the world have adopted a territorial tax system with the United Kingdom and Japan being two of the most recent countries to do so. Adopting a territorial type of tax system would achieve parity with our global trading partners and

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<sup>710</sup> Id.

increase the competitiveness of U.S. multinationals vis-à-vis their foreign competitors, most of which are based in countries with territorial tax systems.

There are many different types of territorial tax systems, with the most common being a dividend exemption system. Under such a system, sometimes referred to as a participation exemption system, a percentage of any dividend received by a U.S. multinational from its foreign subsidiaries would be exempt from U.S. taxation. The percentage of the dividend exempt from U.S. tax could be adjusted to approximate the amount of expenses allocated to the foreign income or to address revenue concerns. Specific measures would need to be enacted to prevent erosion of the U.S. tax base.

A number of countries have adopted a dividend exemption system. Of the 34 OECD countries, 28 have adopted a territorial tax system in the form of a dividend exemption.<sup>711</sup> Only six of the 34 OECD countries have a worldwide tax system (Chile, Ireland, Israel, Korea, Mexico, and the United States).

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<sup>711</sup> See PricewaterhouseCoopers, *Evolution of Territorial Tax Systems in the OECD* (Apr. 2, 2013), available at [http://www.techceocouncil.org/clientuploads/reports/Report%20on%20Territorial%20Tax%20Systems\\_20130402b.pdf](http://www.techceocouncil.org/clientuploads/reports/Report%20on%20Territorial%20Tax%20Systems_20130402b.pdf) (accessed July 1, 2014).



**Table 6.3**

**Tax Treatment of Foreign Source Dividends<sup>712</sup>**

Country	Dividends From Foreign Affiliates Exempt?	Percentage of Exemption (%)	Are Indirect Expenses Related to Foreign Income Deductible?
Belgium	Yes	95	Yes
Canada	Yes	100	Yes
France	Yes	At least 95	Yes
Germany	Yes	95	Yes
Italy	Yes	95	Yes
Japan	Yes	95	Yes
Netherlands	Yes	100	Yes
Spain	Yes	100	Yes
Switzerland	Yes	100	Yes
United Kingdom	Yes	100	Yes
Brazil	No	N/A	Generally No
Russia	Yes	100	Yes
India	No	N/A	Yes
China	No	N/A	Yes

If we were to adopt and transition to a dividend exemption system, a number of questions arise. First, what should be done with existing foreign earnings that have not been repatriated to the United States? Other countries have taken different approaches to answering this question. The United Kingdom and Japan, for example, gave a free pass to such earnings meaning that no tax was collected on the foreign earnings that predated the transition.

We believe three principles should guide Congress in determining the taxation of the pre-enactment foreign earnings: (1) no continuing lock-out; (2) no windfall to U.S. multinationals; and (3) no windfall to the U.S. government. A significant part of the reason to transition to a territorial tax system is to get rid of the lock-out effect. If the pre-enactment foreign earnings are

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<sup>712</sup> See PricewaterhouseCoopers, *A Comparison of Key Aspects of the International Tax Systems of Major OECD and Developing Countries* (May 10, 2010), available at [http://businessroundtable.org/uploads/studies-reports/downloads/BRT\\_14\\_country\\_international\\_tax\\_comparison\\_20100510.pdf](http://businessroundtable.org/uploads/studies-reports/downloads/BRT_14_country_international_tax_comparison_20100510.pdf) (accessed Nov. 13, 2014).

subject to U.S. tax only if the earnings are brought back to the United States, then this will continue the lock-out effect. So, the earnings should be mandatorily deemed repatriated and taxed accordingly.

If all earnings are deemed repatriated immediately and taxed at the full U.S. tax rate, then this would be a windfall to the U.S. government. It would be far worse than the expectations of U.S. multinational corporations. These companies have come to expect and rely on indefinite deferral and have done so reasonably. But mandatory deemed repatriation is necessary to be done with the lock-out effect. Thus, the deemed repatriation could be spread out over many years (to more closely resemble the pre-enactment experience of repatriation of dividends) and/or the U.S. multinational corporations could be subjected to a lower U.S. corporate tax rate on the repatriated earnings.

A corporate tax rate on the pre-enactment earnings lower than 35 percent, considered in a vacuum, would be a windfall to U.S. multinational corporations. The earnings were earned, almost entirely, when a 35 percent corporate tax rate was in effect. Any corporate tax rate less than 35 percent would be a better deal than they expected. However, one should consider that a deemed mandatory repatriation is a worse deal than U.S. multinational corporations expected. So, the worse than expected deal of deemed mandatory repatriation could arguably be offset with the better than expected deal of a lower than 35 percent tax rate.

To illustrate one approach, House Ways and Means Chairman Dave Camp has proposed taxing the pre-enactment foreign earnings in the form of cash or cash equivalents at 8.75 percent with any remaining pre-enactment foreign earnings taxed at 3.5 percent.<sup>713</sup> Foreign tax credits would be partially available to offset the tax. The tax would be payable over eight years.

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<sup>713</sup> THE TAX REFORM ACT OF 2014, available at <http://waysandmeans.house.gov/>

Adoption of a territorial type of tax system initially sounds like a dramatic change from our current law. Many tax scholars would describe our international tax system as a worldwide system with a foreign tax credit to alleviate double taxation. And territorial taxation is generally viewed as the opposite end of the spectrum from worldwide taxation. But if we look closer at our current tax system, we will see that, in many respects, we already have a territorial type of tax system.

Typically, when a U.S. multinational decides to conduct business in a foreign country, it sets up a corporation in that country. We refer to that foreign corporation as a foreign subsidiary. When the foreign subsidiary earns income, that income will typically be taxed by that foreign country. However, the United States will generally not tax the earnings of the foreign subsidiary until the earnings are brought back to the United States, typically by way of a dividend from the foreign subsidiary to the U.S. multinational. We refer to the process of bringing earnings back to the United States as “repatriation.”

If the U.S. multinational does not repatriate the earnings of the foreign subsidiary, then generally no U.S. tax is owed on those earnings. This is referred to as deferral. As a result, many U.S. multinationals defer repatriating earnings for many, many years. If we take into account the time value of money, deferring a tax on the foreign earnings reduces the effective tax rate on those earnings – in some cases, dramatically.

**Table 6.4**

**Effective Tax Rate (%) Per Dollar of Income Deferred by a 35 Percent Rate Taxpayer for Different Deferral Periods and Interest Rates**

Nominal Interest Rate (%)	1 year	3 years	5 years	10 years	20 years	30 years
2	34.31	32.98	31.70	28.71	23.55	19.32
4	33.65	31.11	28.77	23.64	15.97	10.79
6	33.02	29.39	26.15	19.54	10.91	6.09
8	32.41	27.78	23.82	16.21	7.51	3.48
10	31.82	26.30	21.73	13.49	5.20	2.01
12	31.25	24.91	19.86	11.27	3.63	1.17
14	30.70	23.62	18.18	9.44	2.55	0.69

In some cases, a U.S. multinational may desire to repatriate earnings thereby subjecting those earnings to U.S. tax. However, some U.S. multinationals have, for many years, utilized planning techniques to minimize the U.S. tax on repatriation. For example, some U.S. multinationals repatriate the foreign earnings by way of a royalty payment. The U.S. multinational licenses intangible property to its foreign subsidiary and the subsidiary then pays a royalty to the U.S. multinational. Some foreign countries impose a withholding tax on the royalty but generally that tax is fairly minor and may be reduced completely by an income tax treaty between the United States and the foreign country. As a result, the U.S. multinational will owe significant U.S. taxes upon receipt of the royalty from its foreign subsidiary. However, many U.S. multinationals have excess foreign tax credits. These are credits for foreign income taxes paid that the U.S. multinational has been unable to utilize. As a result, a U.S. multinational may utilize these excess foreign tax credits to eliminate the U.S. tax on the royalty.<sup>714</sup> This is known as “cross-crediting.”

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<sup>714</sup> See Harry Grubert, *Enacting Dividend Exemption and Tax Revenue*, 54 NAT’L TAX J. 811 (2001).

Therefore, the U.S. multinational may repatriate its foreign earnings and avoid paying any U.S. tax – a result nearly identical to a territorial type of tax system.

Another planning technique that a U.S. multinational may utilize is to invest foreign earnings in certain types of U.S. investments, such as deposits with U.S. banks or obligations of the United States. Generally, if a controlled foreign corporation invests its earnings in U.S. property, such investments are treated as a repatriation of earnings to the U.S. multinational.<sup>715</sup> However, an exception is provided for deposits with U.S. banks or obligations of the United States.<sup>716</sup> Such investments do not trigger the U.S. tax on repatriation.

Rather than forcing U.S. multinationals to develop techniques to avoid paying the U.S. tax on repatriation, which well-advised U.S. multinationals have successfully been able to accomplish, it makes more sense to adopt a tax system in which such earnings are not taxed by the United States when earned, as under current law, and not taxed when repatriated.

We had a similar experience, although on a much smaller scale, in 1984 with U.S. multinationals being subject to a punitive rule, and then planning around that rule. Prior to 1984, U.S. multinationals would raise funds in the Eurobond market. However, European investors shied away from purchasing bonds issued by U.S. multinationals because the interest on those bonds was subject to a 30 percent U.S. withholding tax. As a result, U.S. multinationals had to increase the interest rate on the bonds to attract European investors, thereby raising the cost of capital to the U.S. firms. U.S. multinationals developed a planning technique utilizing the income tax treaty with the Netherlands Antilles. A U.S. multinational would establish a subsidiary in the Netherlands Antilles. The subsidiary would issue bonds to investors as part of the Eurobond

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<sup>715</sup> IRC sec. 956.

<sup>716</sup> IRC sec. 956(c)(2).

market. Any interest paid by the subsidiary was free of any withholding tax as Netherlands Antilles did not impose such a tax. The funds raised by the foreign subsidiary were lent to the U.S. multinational, which would guarantee the payments on the bonds. This was known as a Dutch sandwich. In 1984, Congress enacted a provision to permit U.S. multinationals to do directly (issue bonds to European investors free of withholding taxes) what they were already doing indirectly (issue bonds to European investors free of withholding taxes through a Netherlands Antilles subsidiary).

Many U.S. multinationals avoid repatriating their foreign earnings by using those earnings to make foreign acquisitions. For example, in 2011, U.S.-based Microsoft acquired Luxembourg-based Skype for \$8.5 billion in cash. A number of commentators believed the deal was driven in large part by the U.S. international tax system. Microsoft had a large amount of cash that was trapped offshore and utilized that cash in making the acquisition. One news service reported, “It’s hard to say whether Microsoft will succeed in integrating Skype into Office or Xbox Live or any of their other plans, but it almost doesn’t matter: They have put nearly dead cash to work.”<sup>717</sup> The news story concluded that, “In the meantime, expect more questionable deals abroad as U.S. companies look to open their cash vaults held overseas.”<sup>718</sup>

The financial accounting rules also play an important role in preventing U.S. multinationals from repatriating foreign earnings. When a U.S. multinational earns income abroad through its foreign subsidiary, that income is included in the consolidated income statement of the U.S. multinational. However, if the U.S. multinational represents that the income of the foreign

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<sup>717</sup> Steve Goldstein, *Microsoft-Skype Deal Shows Need for Tax Reform*, Marketwatch (May 10, 2011), available at <http://www.marketwatch.com/story/microsoft-skype-deal-shows-need-for-tax-reform-2011-05-10> (accessed Nov. 13, 2014).

<sup>718</sup> *Id.*

subsidiary is indefinitely reinvested and that it is not practicable to determine the U.S. tax on such income, then the U.S. multinational does not record any U.S. tax expense for such income.<sup>719</sup> So, in essence, the U.S. multinational includes the income of the foreign subsidiary in its consolidated income statement but does not include any U.S. tax expense for the income. This results in a lower effective tax rate, greater net income, and greater earnings per share for the U.S. multinational. The downside is that the U.S. multinational cannot repatriate its foreign earnings without adversely affecting its effective tax rate, net income and earnings per share. Under a territorial type of tax system, U.S. multinationals would no longer have to represent that its foreign earnings were permanently reinvested and would be free to repatriate foreign earnings without incurring U.S. tax expense.

A major issue in adopting a territorial type of tax system involves expenses of the U.S. multinational that are allocated to the foreign earned income. A basic principle of income tax is that no deduction should be permitted for expenses that produce exempt income.<sup>720</sup> For example, if an investor purchases a tax-exempt bond, which are bonds issued by state and local governments, any expenses allocated to the income generated by the bond are not deductible because the income on the bond is not subject to tax. If such expenses were deductible, a negative tax would result. The same principle should apply for a territorial type of tax system.

A U.S. multinational incurs expenses, some of which are allocated to the income of the foreign subsidiary. Such foreign income may be exempt from U.S. tax under a territorial type of tax system and therefore expenses allocated to such income should not be deductible for U.S. tax purposes. Generally, expenses fall into one of four categories. The first and probably largest

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<sup>719</sup> FASB ASC 740-30-25-17 and FASB ASC 740-30-50-2.

<sup>720</sup> See IRC sec. 265.

category for most U.S. multinationals is interest expense. Interest expense would be allocated between U.S. and foreign source income and then allocated further between the exempt income of the controlled foreign corporation (i.e., foreign subsidiary) and any other foreign earnings on a pro-rata basis based on assets or gross income.<sup>721</sup>

A second category, research and experimental expenses, would also be allocated between U.S. income and foreign income. The amount allocated to foreign income would then be allocated further, first to taxable royalties and similar payments (cost-sharing and royalty-like sale payments), then to earnings of the controlled foreign subsidiary (divided between exempt and non-exempt earnings of the CFC) and finally to other foreign income.<sup>722</sup> The third category, general and administrative expenses, would be allocated to exempt income of the controlled foreign corporation in the same proportion that the exempt income of the controlled foreign corporation bears to the entire income of the U.S. multinational group.<sup>723</sup> Finally, stewardship expenses may be allocable (directly or indirectly) to exempt income of the controlled foreign corporation.<sup>724</sup> Treasury would have to draft detailed expense allocation regulations, similar to current law (for purposes of the limitation on the foreign tax credit).

Rather than determining exactly what expenses are allocable to the exempt income of a controlled foreign corporation, the United States could, similar to other countries, utilize an approximation of expenses approach. In other words, rather than exempting 100 percent of the dividends from a foreign subsidiary, only a portion, say 95 percent, is exempt.<sup>725</sup> As a result, a

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<sup>721</sup> See JOINT COMMITTEE ON TAXATION, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, JCX-02-05 (2005) at 190.

<sup>722</sup> Id.

<sup>723</sup> Id.

<sup>724</sup> Id.

<sup>725</sup> Some countries do not allocate expenses and still permit 100 percent of the dividends from a foreign subsidiary to be exempt from tax. See Table 6.3.



small portion of the dividend, for example, five percent, is taxed by the home country. This is generally referred to as a “proxy” approach as the taxable portion of the dividend is a proxy for the expenses that would be allocated to the foreign income. So rather than disallow a portion of each of the four categories of expenses, many countries have adopted an approach in which a small percentage of the dividends received from the foreign subsidiary is taxed by the home country. Countries adopting such an approach typically tax five percent of the dividends received by the home company from its foreign subsidiaries. This tax is designed to approximate the amount of expenses that would be allocated to the income of the foreign subsidiary if an allocation of expenses approach were adopted. Utilizing such an approximation approach may greatly simplify the adoption of a territorial type of tax system, although an allocation of expenses approach is already required under present law (for example, in calculating the limitation on foreign tax credits).

**Table 6.5**

**Percentage of Dividend Exemption<sup>726</sup>**

Territorial: 100% Participation Exemption	Territorial: 95%-99% Participation Exemption
Australia	Belgium
Austria	France
Canada	Germany
Czech Republic	Italy
Denmark	Japan
Estonia	Norway
Finland	Slovenia
Greece	Switzerland
Hungary	
Iceland	
Luxembourg	
Netherlands	
New Zealand	
Poland	
Portugal	
Slovakia	

<sup>726</sup> PricewaterhouseCoopers, *Evolution of Territorial Tax Systems in the OECD*, supra note 711.

Spain	
Sweden	
Turkey	
United Kingdom	

Whether the expense allocation approach or the proxy approach is adopted greatly affects the revenue score associated with a territorial proposal. For example, a simplified territorial tax system without full expense allocation could be scored as a revenue loss of \$130 billion over 10 years.<sup>727</sup> In contrast, a territorial tax system with full expense allocation could raise between \$40 billion and \$76 billion over 10 years.<sup>728</sup> The Joint Committee on Taxation and the President’s Advisory Panel on Tax Reform have released dividend exemption approaches in which expenses are allocated to the income of the foreign subsidiary. If the proxy approach is adopted, then the amount of the dividend from the foreign subsidiary that is taxed by the United States should reasonably approximate the amount of expenses allocated to the income of the foreign subsidiary and should probably also be in line with international standards.

Some research suggests that, for certain industries, an appropriate percentage under the proxy approach may be in the neighborhood of 25 to 30 percent.<sup>729</sup> In other words, under the dividend exemption approach, approximately 70 to 75 percent of the dividend received from a controlled foreign corporation should be exempt from U.S. tax with 25 to 30 percent of the

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<sup>727</sup> THE PRESIDENT’S ECONOMIC RECOVERY ADVISORY BOARD, *supra* note 359, at 90.

<sup>728</sup> *Id.* CONGRESSIONAL BUDGET OFFICE, REDUCING THE DEFICIT: SPENDING AND REVENUE OPTIONS (Mar. 2011) at 187.

<sup>729</sup> *Cf.* Stephen E. Shay, J. Clifton Fleming, Jr. and Robert J. Peroni, *Territoriality in Search of Principles and Revenue: Camp and Enzi*, 141 TAX NOTES 173, 201 (Oct. 14, 2013) (noting that taxing five percent of the dividend from a foreign subsidiary “likely understates the U.S. expenses that properly would be allocable to exempt foreign income under existing allocation rules (and these rules already underallocate deductions to foreign income).”; “appears likely that expenses properly allocable to foreign income but not charged out to foreign affiliates would materially exceed the five percent of exempt dividends haircut in the Camp and Enzi proposals”).

dividend taxed by the United States. The non-allocation of interest expense is equivalent to taxing approximately 15 percent of the dividend.<sup>730</sup> The non-allocation of general and administrative expenses is equivalent to taxing about 10 percent of the dividend.<sup>731</sup> Enacting a 70 to 75 percent dividend exemption may be proper from a tax policy standpoint but would make the United States an outlier compared to other countries that have adopted a dividend exemption system and would perpetuate the lock-out effect. In addition, a 25 to 30 percent inclusion does not take account of a firm's individual circumstances.

Rather than allocating expenses or exempting a portion of any dividend received by a U.S. multinational from its foreign subsidiaries, the simplest approach may be to simply impose a “proxy” tax on the earnings of the foreign subsidiary. The tax would be a proxy for the non-allocation of expenses of the U.S. multinational to the earnings of the foreign subsidiary. The United States could impose the proxy tax on an annual basis on the earnings of the foreign subsidiary. As a result, deferral of foreign earnings would be eliminated and a modest tax could be imposed on such earnings. Of course, the behavioral effects from not disallowing deductions for expenses that generated exempt foreign source income could be appreciable. In addition, elimination of deferral of foreign earnings would be a significant change from current law.

In adopting a territorial type of tax system, an issue arises as to the tax treatment of the income of foreign branches. Certain industries, such as the banking sector, may utilize branches

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<sup>730</sup> See U.S. DEPARTMENT OF COMMERCE, BUREAU OF ECONOMIC RESEARCH, NONFINANCIAL CORPORATE BUSINESS – GROSS VALUE ADDED AND PRICE, COSTS AND PROFITS, available at <http://www.gpo.gov/fdsys/pkg/ECONI-2014-02/pdf/ECONI-2014-02-Pg3-1.pdf> (accessed Nov. 14, 2014); INTERNAL REVENUE SERVICE, SOI TAX STATS – RETURNS OF ACTIVE CORPORATIONS – TABLE 6, available at <http://www.irs.gov/uac/SOI-Tax-Stats>Returns-of-Active-Corporations-Table-6> (accessed Nov. 14, 2014).

<sup>731</sup> See Rosanne Altshuler and Harry Grubert, *Where Will They Go if We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations*, 54 NAT'L TAX J. 787, 798 (2001).

rather than corporations in conducting business in a foreign country. Under a pure territorial tax system, the income of the foreign branch would be exempt from taxation in the home country. If the United States adopts a dividend exemption approach, then the issue of taxation of foreign branch income becomes more problematic. At one end of the spectrum would be for the United States to fully tax the income of the foreign branch on an annual basis as under current law. This is the approach that Japan has taken under its dividend exemption system.<sup>732</sup> At the other end of the spectrum would be for the United States to exempt from taxation the income of the foreign branch. This is the approach taken in countries such as the United Kingdom<sup>733</sup> and Australia.<sup>734</sup> If the income from a foreign branch is exempt, then a number of issues would need to be resolved, such as what constitutes a branch, the income allocated to the branch, the scope of the exemption (such as active income versus passive income), the amount of the exemption, the treatment of losses of the foreign branch and the taxation of property transferred by the U.S. multinational to the foreign branch. The branch could be treated as a foreign subsidiary of the U.S. multinational thereby, in a sense, equalizing the tax treatment of a (controlled) foreign subsidiary and a foreign branch.<sup>735</sup>

#### E. Concerns Regarding a Territorial Tax System

A significant concern of many tax scholars regarding the adoption of a territorial tax system is that such a system may lead to erosion of the U.S. tax base. More specifically, if income earned

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<sup>732</sup> See JOINT COMMITTEE ON TAXATION, BACKGROUND AND SELECTED ISSUES RELATED TO THE U.S. INTERNATIONAL TAX SYSTEM AND SYSTEMS THAT EXEMPT FOREIGN BUSINESS INCOME, JCX-33-11 (May 20, 2011) at 30.

<sup>733</sup> *Id.* at 43. The United Kingdom adopted such an approach effective July 19, 2011.

<sup>734</sup> *Id.* at 16.

<sup>735</sup> See HOUSE WAYS AND MEANS COMMITTEE, COMPREHENSIVE TAX REFORM, available at <http://waysandmeans.house.gov/taxreform/> (accessed Nov. 13, 2014) (House Ways and Means Chairman Dave Camp's discussion draft on international tax reform treating a foreign branch of a domestic corporation as a CFC).

in the United States is subject, say, to a 25 percent corporate tax rate, but income earned offshore is subject to very little or no U.S. tax, then U.S. multinationals may be encouraged to shift income offshore through aggressive transfer pricing. Such multinationals may also shift expenses to the United States so that those expenses may be deducted at a 25 percent rate. Anti-base erosion measures would need to be enacted to protect the U.S. tax base. For example, the United States could enact a measure that treats income earned in a low-tax foreign jurisdiction as subject to immediate U.S. tax unless significant business activity were conducted in the foreign jurisdiction.

In Japan, a parent company is considered to receive dividends from its foreign subsidiary located in a low-tax foreign jurisdiction if the income of the foreign subsidiary is subject to an effective tax rate of less than 20 percent.<sup>736</sup> In other words, the income of the foreign subsidiary is immediately taxed to its parent corporation if the income is subject to a low effective foreign tax rate. If adopted in the United States, such a rule would discourage if not outright prevent U.S. multinationals from shifting income to low-tax or no-tax jurisdictions. This rule is sometimes referred to as the low-tax kick-in. However, Japan also provides an exception to the low-tax kick-in rule if the foreign subsidiary is actually doing business in the foreign country.<sup>737</sup> If the low-tax kick-in rule is adopted, then the business exception makes sense.<sup>738</sup> If a U.S. multinational sets up a foreign subsidiary in a country that has a low corporate tax rate or grants the U.S. multinational (and its foreign subsidiary) a tax holiday, the income of the foreign subsidiary should not be immediately taxed to its U.S. parent if the foreign subsidiary is actually doing business in the

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<sup>736</sup> See JOINT COMMITTEE ON TAXATION, BACKGROUND AND SELECTED ISSUES RELATED TO THE U.S. INTERNATIONAL TAX SYSTEM AND SYSTEMS THAT EXEMPT FOREIGN BUSINESS INCOME, JCX-33-11 (May 20, 2011) at 29.

<sup>737</sup> Id. at 29-30.

<sup>738</sup> A difficult question arises as to how broad to make the business exception to the low-tax kick-in rule. Should it be applied on a country-by-country basis or on a broader basis, such as a regional basis?

foreign country. House Ways and Means Chairman Dave Camp had a provision similar to the Japanese low-tax kick-in rule in his dividend exemption proposal that was released on October 26, 2011, and Senator Mike Enzi (R-WY) also had such a provision in his dividend exemption proposal that was released on February 9, 2012.<sup>739</sup>

In a report issued in November 2013, the Berkeley Research Group analyzed the effects if the United States adopted a territorial tax system.<sup>740</sup> The Berkeley Group noted that U.S. multinationals could be divided into two groups: (1) “indefinite deferrers” -- those that have ready access to capital markets and determine that deferral of the active foreign income is a profit-maximizing decision, and (2) “non-indefinite deferrers” -- those that have limited access to capital markets and do not find deferral to be a profit-maximizing decision.<sup>741</sup> The Berkeley Group, utilizing JCT data, estimated that about 70 percent of active foreign income is earned by indefinite deferrers (ID) and 30 percent by non-indefinite deferrers (NID).<sup>742</sup>

The Berkeley Group noted that switching to a territorial tax system will have little effect on the incentives of IDs to shift income on which they currently pay U.S. income taxes.<sup>743</sup> The fact that the IDs have not already shifted the underlying assets generating the income suggests that there are no tax benefits to doing so.<sup>744</sup> In addition, IDs have no current incentive to shift any income that they shield from U.S. income taxes through the use of excess foreign tax credits, such

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<sup>739</sup> HOUSE WAYS AND MEANS COMMITTEE, COMPREHENSIVE TAX REFORM, available at <http://waysandmeans.house.gov/taxreform/> (accessed Nov. 13, 2014); S.2091, United States Job Creation and International Tax Reform Act of 2012, 112<sup>th</sup> Cong., 2d Sess. (2012).

<sup>740</sup> Berkeley Research Group (prepared by Eric Drabkin, Kenneth Serwin and Laura D’Andrea Tyson), *Implications of a Switch to a Territorial Tax System in the United States: A Critical Comparison to the Current System* (Nov. 2013).

<sup>741</sup> *Id.* at 12.

<sup>742</sup> *Id.* at 13.

<sup>743</sup> *Id.* at 22.

<sup>744</sup> *Id.*

as cross-crediting on foreign source royalty income. Under a territorial tax system, however, IDs may have an incentive to assign intangible assets to a controlled foreign corporation thereby, in essence, converting foreign source royalty income into exempt foreign source dividend income. The Berkeley Group posited that the tax savings from shifting intangible assets abroad “are likely to be small because such shifts will require taxable compensating payments to U.S. parents.”<sup>745</sup>

In the case of NIDs, the Berkeley Group found that few tax incentives currently exist to shift income abroad. Under a territorial tax system, however, NIDs would have a tax incentive to shift income. As a result, the Berkeley Group concluded that income shifting in switching to a territorial tax system will most likely come from NIDs and not from IDs.<sup>746</sup>

Some economists are concerned that adoption of a territorial tax system would lead to U.S. multinationals shifting greater amounts of business operations from the United States to foreign countries. For example, they argue that manufacturing that is currently taking place in the United States could be shifted to lower-tax foreign jurisdictions. That is unlikely to happen for a number of reasons. Consider a proposal to reduce the corporate tax rate from 35 percent to at least 25 percent (and possibly lower), bringing the rate in line with much of the developed world. A lower corporate tax rate decreases the incentive to shift business operations out of the United States. Second, taxes are a factor regarding where to locate business operations but it is rarely the main factor. In a survey of 287 manufacturing companies, labor costs were listed as the most important factor in selecting locations for manufacturing operations or supplier operations.<sup>747</sup> After labor

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<sup>745</sup> Id.

<sup>746</sup> Id.

<sup>747</sup> Accenture, *Manufacturing’s Secret Shift: Gaining Competitive Advantage by Getting Closer to the Customer* (2011), available at [http://www.accenture.com/SiteCollectionDocuments/PDF/Accenture\\_Manufacturings\\_Secret\\_Shift.pdf](http://www.accenture.com/SiteCollectionDocuments/PDF/Accenture_Manufacturings_Secret_Shift.pdf) (accessed Nov. 13, 2014). See also Council on Foreign Relations, *Standard Deductions: U.S. Corporate Tax Policy* (Apr. 2014) (“Other factors

costs, the next three most important factors identified in the survey were proximity to the market, skills of the workforce and, finally, taxes. So while taxes may be a factor, they are usually just that – a factor. Most tax planning involves shifting income abroad, not shifting jobs abroad. As a result, although a territorial tax system may put more pressure on our transfer pricing rules and our sourcing rules, it is highly unlikely to result in shifting a significant number of jobs abroad.

In its report issued in November 2013, the Berkeley Group analyzed the shifting of business operations abroad if the United States adopted a territorial tax system.<sup>748</sup> Consistent with the survey of manufacturing companies, the Berkeley Group determined that U.S. multinationals decide whether to locate their economic activities outside the United States based on market access and access to low-cost inputs.<sup>749</sup> The Berkeley Group noted that, under the current tax system, IDs have already shifted economic activities abroad when the benefits of market access and low-cost inputs exceeded the costs of establishing and operating foreign subsidiaries.<sup>750</sup> In addition, the Berkeley Group stated that it was reasonable to assume “that IDs have already made investment decisions about the location of their real economic activities to take full advantage of the current [tax] system.”<sup>751</sup> If the United States switched to a territorial tax system, then IDs might shift some additional economic activities abroad as a result of the elimination of the costs associated with the lock-out effects.<sup>752</sup> However, such additional shifting would likely be small.<sup>753</sup>

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like lower wages, proximity to fast-growing markets, and government investment incentives are much larger inducements for U.S. corporations to invest overseas than is tax policy.”).

<sup>748</sup> Berkeley Research Group, *supra* note 740.

<sup>749</sup> *Id.* at 5.

<sup>750</sup> *Id.* at 6.

<sup>751</sup> *Id.*

<sup>752</sup> *Id.*

<sup>753</sup> *Id.*



With respect to NIDs, the Berkeley Group noted that a switch to a territorial tax system will strengthen the tax incentives to shift economic activities abroad.<sup>754</sup> Because NIDs cannot take advantage of deferral under the current tax system, shifting to a system in which repatriated income is not subject to U.S. tax will provide an incentive for NIDs to earn income from business activities in lower-tax foreign countries.<sup>755</sup> However, such lower-tax foreign countries cannot generally provide the market access, low-cost inputs, and infrastructure the NIDs need in shifting business activities. In addition, the tax rates in foreign countries that can provide market access and low-cost inputs tend to be relatively high and, as a result, the shifting of economic activities abroad by NIDs will likely be small.<sup>756</sup>

Finally, a line of economic thinking believes that the current international tax system “discourages foreign asset ownership generally, and in particular discourages the ownership of assets in low-tax foreign countries.”<sup>757</sup> A move to a territorial tax system results in greater productivity associated with improved incentives for asset ownership thereby enhancing productivity of labor in the United States. Three economists have found that for American firms between 1982 and 2004, a 10 percent greater foreign capital investment is associated with a 2.6 percent greater domestic investment, and a 10 percent greater foreign employee compensation is associated with 3.7 percent greater domestic employee compensation.<sup>758</sup> More generally, foreign investment has a positive effect on domestic exports and research and development spending resulting in greater demand for domestic output.

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<sup>754</sup> Id.

<sup>755</sup> Id.

<sup>756</sup> Id.

<sup>757</sup> See Mihir A. Desai, C. Fritz Foley, James R. Hines, Jr., *Domestic Effects of the Foreign Activities of U.S. Multinationals* (May 2008), available at <http://www.people.hbs.edu/ffoley/fdidomestic.pdf> (accessed Nov. 14, 2014).

<sup>758</sup> Id.

If the United States adopts a territorial type of tax system, there may be an incentive for U.S. multinationals to locate their debt in the United States so as to generate deductible interest. A large part of the debt may be related to financing foreign operations, which creates foreign income that is exempt from U.S. tax. As a result, the United States may need to adopt some sort of thin capitalization rule to prevent a U.S. multinational from deducting an excess amount of interest expense. The rule could focus on the U.S. multinational's net interest expense for the year (the excess of interest expense over interest income) with limitations based on the debt to equity ratio of the U.S. multinational and the amount of net interest expense relative to the U.S. multinational's taxable income for the year.

#### F. Patent or Innovation Box

Consideration should also be given to a patent or innovation box. A patent box is a tax incentive granted for certain income arising from the exploitation of intellectual property. Generally, the incentive is a reduction in the corporate income tax with respect to the income of the intellectual property. A number of countries have enacted special taxing provisions for income generated by intellectual property, and Ireland is currently contemplating such a move.<sup>759</sup>

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<sup>759</sup> See Margaret Burow, *Ireland to Stop New "Double Irish" Arrangements in 2015*, 145 TAX NOTES 279 (Oct. 20, 2014).

**Table 6.6**

**Comparison of EU Patent Box Regimes and U.K. Proposal<sup>760</sup>**

Tax Factors	Belgium	France	Hungary	Luxembourg	Netherlands	Spain	U.K.
Nominal tax rate	6.8%	15%	9.5%	5.76%	5%	15%	10%
Qualified IP	Patents and supplementary patent certificates	Patents, extended patent certificates, patentable inventions, and industrial fabrication processes	Patents, know-how, trademarks, business names, business secrets, and copyrights	Patents, trademarks, designs, domain names, models, and software copyrights	Patented IP or R & D IP	Patents, secret formulas, processes, plans, models, designs, and know-how	Patents, supplementary protection certificates, regulatory data protection, and plant variety rights
Qualified income	Patent income less cost of acquired IP	Royalties net of cost of managing qualified IP	Royalties	Royalties	Net income from qualified IP	Gross patent income	Net income from qualifying IP
Acquired IP?	Yes, if IP is further developed	Yes, subject to specific conditions	Yes	Yes, from non-directly associated companies	Yes, if IP is further self-developed	No	Yes, if further developed and actively managed
Cap on benefit?	Deduction limited to 100% of pretax income	No	Deduction limited to 50% of pretax income	No	No	Yes, six times the costs incurred to develop the IP	No
Includes embedded royalties?	Yes	No	No	Yes	Yes	No	Yes
Includes gain on sale of qualified IP?	No	Yes	Yes	Yes	Yes	No	Yes
Can R & D be performed abroad?	Yes, if qualifying R & D center	Yes	Yes	Yes	Yes for patented IP; strict conditions for R & D IP	Yes, but must be self-developed by the licensor	Yes

<sup>760</sup> Peter R. Merrill, et al., *Is It Time for the United States to Consider the Patent Box?* 134 TAX NOTES 1665, 1667 (Mar. 26, 2012).

Credit for tax withheld on qualified royalty?	Yes	Yes	Yes	Yes	Yes, subject to limitations	Yes, subject to limitations	Yes
Year enacted	2007	2001, 2005, 2010	2003	2008	2007, 2010	2008	2013
Applicable to existing IP?	IP granted or first used on or after Jan. 1 2007	Yes	Yes	IP developed or acquired after Dec. 31, 2007	Patented IP developed or acquired after Dec. 31, 2006	Yes	Yes

A patent box can be viewed as providing a back end tax benefit with respect to intellectual property.<sup>761</sup> Front end tax benefits would include the research and development tax credit and expensing for research and experimental expenses.<sup>762</sup> These are tax incentives provided at the front end of the innovation chain or process. Currently, the research and development tax credit has expired in the United States. As a result, probably more pressure currently exists to provide a reduced tax rate for income from intellectual property. If Congress enacts an enhanced (and simplified) research and development tax credit, as proposed by Senator Hatch in September 2011, less pressure will perhaps be placed on the need for a patent box.<sup>763</sup>

Another reason for the United States to consider enactment of a patent box is for such a regime to act as a carrot with respect to the development and retention of intellectual property in the United States. Currently, a number of U.S. multinationals migrate their intellectual property through cost-sharing arrangements with their foreign subsidiaries that are located in no-tax or low-tax jurisdictions. A territorial tax system might create even greater incentives for U.S.

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<sup>761</sup> See Martin A. Sullivan, *Economic Analysis: Time for a U.S. Patent Box*, 133 TAX NOTES 1304 (Dec. 12, 2011).

<sup>762</sup> IRC secs. 41 and 174.

<sup>763</sup> Greater Research Opportunities with Tax Help Act (“GROWTH Act”), S.1577, 112th Cong., 1st Sess. (Sept. 19, 2011).

multinationals to migrate their intellectual property abroad. If the United States enacts a patent box, then that can be the carrot or incentive needed to convince U.S. multinationals to conduct their research and development in the United States and retain ownership of the intellectual property in the United States. The two main concerns regarding adoption of a patent box are the complexity associated with determining the income attributable to the intellectual property and the game-playing that may take place in making such determination. It is, in any event, important to enact an enhanced and simplified research and development tax credit, on a permanent basis, that provides a benefit on the front end of the innovation chain. If a patent or innovation box is enacted, consideration should also be given to providing a tax incentive for U.S. multinationals to migrate existing intellectual property back to the United States from abroad.<sup>764</sup>

#### G. Worldwide Tax System with No Deferral

Some tax scholars have advocated a worldwide tax system with no deferral.<sup>765</sup> Upon initial glance, such a system has some surface appeal to it. It would take much of the pressure off of the

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<sup>764</sup> Under current law, a cost-sharing arrangement, which may result in the location of intellectual property in a foreign corporation, rather than in an affiliated U.S. corporation, still fully qualifies for the research and development tax credit. *See, e.g.*, Priv. Ltr. Rul. 89-45-029 (Aug. 15, 1989); Priv. Ltr. Rul. 89-14-026 (Jan. 3, 1989). That is, if for example, U.S. multinational and foreign subsidiary, in the same section 41(f)(5) controlled group of corporations, enter into a cost-sharing agreement whereby foreign subsidiary pays its share of the research and development that is performed by the employees of the U.S. multinational, and thus the resulting intellectual property is located in part in the foreign subsidiary, the research and development tax credit is allowed in full -- there is not even a partial disallowance of the credit. If a goal of U.S. tax policy should be that U.S. persons retain ownership of intellectual property, query whether Priv. Ltr. Ruls. 89-45-029 and 89-14-026 are consistent with that goal.

<sup>765</sup> *See, e.g.*, Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99 (2011); Robert J. Peroni, J. Clifton Fleming, Jr. and Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999); Statement of Reuven S. Avi-Yonah, Tax Reform Options: International Issues, Testimony Before the Committee on Finance, United States Senate (Sept. 8, 2011). In 2010, Senators Ron Wyden (D-OR) and Judd Gregg (R-NH) introduced a bill with a worldwide tax system with no deferral. Bipartisan Tax Fairness and Simplification Act of 2010, S. 3018, 111<sup>th</sup> Cong., 2d Sess. (Feb. 23, 2010). The next year, Senators Wyden and Dan Coats (R-IN) introduced a substantially identical bill that again

transfer pricing rules and the source rules. It would eliminate the concern that U.S. multinationals would shift income offshore. It would also eliminate the concern, which we believe is unfounded, that U.S. multinationals would shift business operations offshore. Such a system, however, would clearly place the United States outside of the world norm. Among developed countries, only Brazil has what some consider a worldwide tax system with no deferral.<sup>766</sup> Two countries, New Zealand and Finland, switched from a territorial tax system to a worldwide tax system.<sup>767</sup> In both cases, the countries switched back to a territorial tax system.<sup>768</sup>

More importantly, such a system is, substantively, bad tax policy. U.S. companies that earn income in a foreign country through a foreign subsidiary should not be taxed on that income by the United States. For example, assume a U.S. multinational conducts business in a foreign country. The foreign country imposes a 20 percent tax rate. If a foreign multinational based in a jurisdiction with a territorial tax system also does business in the same foreign country, it will only pay a 20 percent foreign income tax. In contrast, if the United States adopts a worldwide tax system with no deferral, the U.S. multinational will pay the 20 percent foreign income tax and will then pay a residual U.S. tax on an annual basis. Why should we penalize our own multinationals relative to foreign multinationals based in a jurisdiction with a territorial tax system, and place the United States multinational in a globally uncompetitive position?

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contained a worldwide tax system with no deferral. Bipartisan Tax Fairness and Simplification Act of 2011, S. 727, 112th Cong., 1st Sess. (Apr. 5, 2011).

<sup>766</sup> See Ernst & Young, Global Tax Alert, *Brazil Enacts Tax Reform* (May 15, 2014), available at [http://www.ey.com/Publication/vwLUAssets/Brazil\\_enacts\\_tax\\_reform/\\$FILE/2014G\\_CM4420\\_Brazil%20enacts%20tax%20reform.pdf](http://www.ey.com/Publication/vwLUAssets/Brazil_enacts_tax_reform/$FILE/2014G_CM4420_Brazil%20enacts%20tax%20reform.pdf) (accessed Nov. 14, 2014); Linneu de Albuquerque Mello, *Taxation of Income Earned Outside of Brazil – Brazilian CFC Rules*, paper presented at the International Taxation and Competitiveness Conference hosted by American Tax Policy Institute (Oct. 17, 2011).

<sup>767</sup> PricewaterhouseCoopers, *Evolution of Territorial Tax Systems in the OECD*, *supra* note 711.

<sup>768</sup> *Id.* at 7 (New Zealand repealed its territorial tax system in 1988 but switched back in 2009; Finland repealed its territorial tax system in 1990 and switched back in 2005).

Alternatively, what if a foreign country offers a tax holiday period for a number of years. The foreign multinational based in a jurisdiction with a territorial tax system will pay no taxes to the foreign country offering the tax holiday and also no home country taxes. The U.S. multinational, however, will pay no taxes to the foreign country for the holiday period but will owe significant residual U.S. taxes under a worldwide system with no deferral. Why should we penalize our U.S. companies if they are able to negotiate a tax holiday period with a foreign country? The answer is, of course, that we should not.

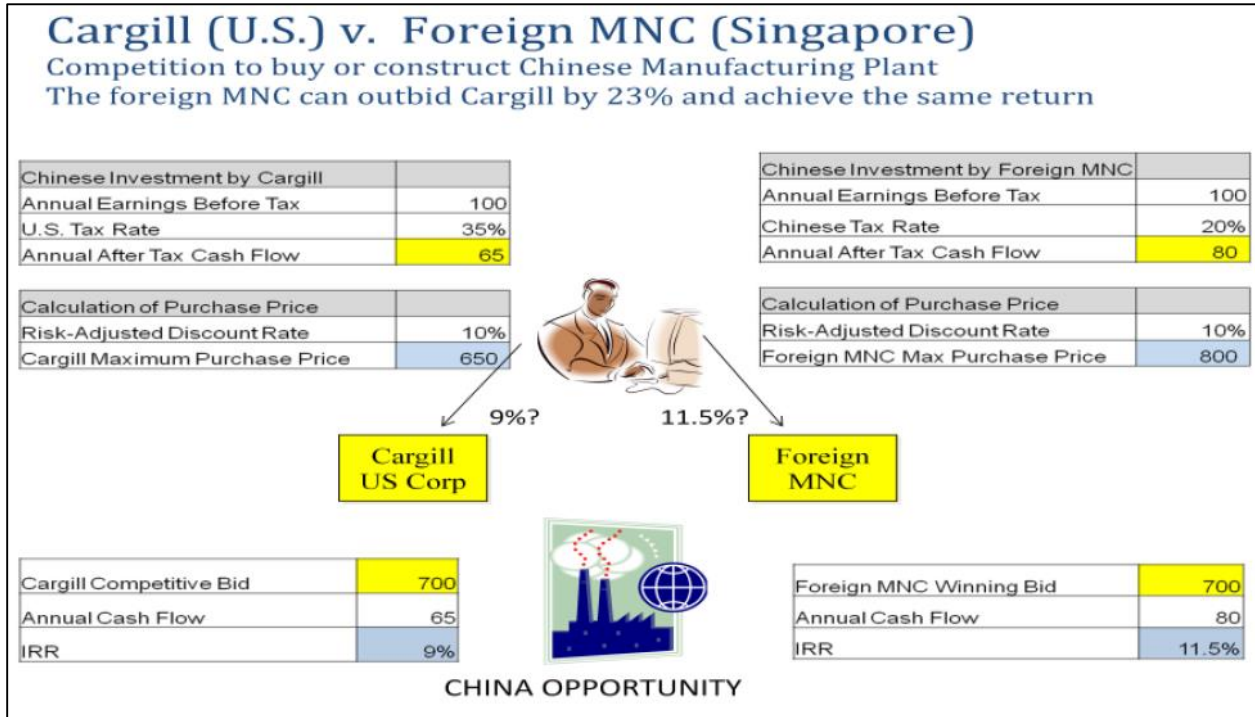
A simple example will also demonstrate how a worldwide no deferral system would impact a U.S. multinational buying or constructing a foreign manufacturing plant.<sup>769</sup> Assume that a U.S. multinational (Cargill) and a foreign multinational located in a jurisdiction with a territorial tax system are bidding to buy or construct a Chinese manufacturing plant. The U.S. multinational and foreign multinational each has a 10 percent required return on investment and would generate similar pre-tax returns on the investment. The profit from the investment in China is expected to be taxed at a 20 percent rate. The U.S. multinational pays a 35 percent U.S. corporate tax on the income from the project with no deferral. The foreign multinational pays only a 20 percent tax to China because it is located in a jurisdiction with a territorial tax system. The result is that the foreign multinational can outbid the U.S. multinational by approximately 23 percent while earning the same 10 percent rate of return. It could also match any bid offered by the U.S. multinational and still achieve a higher rate of return. Figure 6.2 shows (1) the results of the foreign multinational outbidding the U.S. multinational while earning the same rate of return, and (2) the foreign multinational matching the bid of the U.S. multinational and achieving a higher rate of return.

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<sup>769</sup> See Statement of Scott Naatjes, Tax Reform Options: International Issues, Testimony Before the Committee on Finance, United States Senate (Sept. 8, 2011).

Figure 6.2

Competition to Buy or Construct a Foreign Manufacturing Plant<sup>770</sup>



A worldwide tax system with no deferral would almost certainly result in more corporations formed outside of the United States and probably more U.S. corporations reincorporating or inverting elsewhere. Foreign corporations would only be taxed by the United States on income earned in the United States and not on worldwide income. In fact, the current inversion phenomenon that the United States is experiencing seems to confirm that a worldwide no deferral system is the wrong tax policy.

A change to a worldwide system with no deferral would almost certainly require a change in the determination of whether a corporation is a domestic or foreign corporation. Under current law, the determining factor is where the corporation was created or organized.<sup>771</sup> If, for example,

<sup>770</sup> Id.

<sup>771</sup> IRC sec. 7701(a)(4), (5).



a corporation is formed in Delaware, it is a domestic corporation. If, however, the corporation is formed in Mexico, it is a foreign corporation. Such a straightforward and simple determination would probably be subject to abuse under a worldwide tax system with no deferral. As a result, if the United States were to adopt a worldwide no deferral tax system, it would arguably also need to adopt a “managed and controlled” test in determining whether a corporation is domestic or foreign.<sup>772</sup> Although such a test has been adopted by a number of our trading partners, it can be difficult to administer, thereby departing from the certainty under present law.

Under the managed and controlled test, some countries have focused on where the board of directors meet. If that is the standard, then the test can be easily manipulated to avoid having a corporation classified as a domestic corporation by having the board of directors meet outside the United States. If the managed and controlled test focuses on the location of senior management, then it could lead to an exodus from the United States of corporate headquarters, which would result in the loss of valuable, high-paying jobs and the support jobs necessarily surrounding managers and controllers. Such a test may have made sense a number of years ago. But, today, the relocation of corporate headquarters from the United States to countries like England or Switzerland could result if the United States were misguided enough to enact a managed and controlled test.

#### H. Minimum Tax

Some have proposed a minimum tax on the foreign income of U.S. multinationals.<sup>773</sup> Such a tax could be interpreted in one of two ways: a foreign minimum tax or a U.S. minimum tax. If

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<sup>772</sup> Such a test would probably be in addition to (not in lieu of) the place of incorporation test.

<sup>773</sup> THE WHITE HOUSE AND THE U.S. DEPARTMENT OF THE TREASURY, THE PRESIDENT’S FRAMEWORK FOR BUSINESS TAX REFORM: A JOINT REPORT BY THE WHITE HOUSE AND THE DEPARTMENT OF TREASURY (Feb. 2012) at 14.

the reference is to a foreign minimum tax, then such a provision could operate as a low-tax kick-in category of subpart F. For example, assume the foreign minimum tax rate is set at 15 percent, and a CFC earns income in a foreign jurisdiction subject to an effective tax rate of 12.5 percent. Under a foreign minimum tax, the income of the CFC would be subject to immediate full U.S. tax with a credit for foreign income taxes paid by the CFC. If the reference to a minimum tax refers to a U.S. minimum tax, then the income of the CFC would be subject to an immediate U.S. tax with a partial, or full, credit for foreign income taxes paid by the CFC.

### I. Foreign Corporations

The current wave of corporate inversions has shined a spotlight on the U.S. tax treatment of foreign corporations. The “juice” in a corporate inversion is usually described as the earnings stripping that takes place after the inversion.<sup>774</sup> More specifically, a foreign parent corporation loans funds to its U.S. subsidiary. The U.S. subsidiary makes interest payments on the loan deducting the interest payments in computing its taxable income for U.S. tax purposes. If the foreign parent corporation is a resident of a country with an income tax treaty with the United States, the interest payment by the U.S. subsidiary will be subject to a reduced rate or zero rate of withholding tax. The end result is that the U.S. tax base has been stripped by the interest payments.

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<sup>774</sup> See Statement of Pamela F. Olson, Hearing on Corporate Inversions, Before the Committee on Ways and Means, 107th Cong., 2d Sess. (June 6, 2002), 2002 TAX NOTES TODAY 110-31 (“A revision of these rules is needed immediately to eliminate what is referred to as the real ‘juice’ in an inversion transaction. The prevalent and increasing use of foreign related-party debt in inversion transactions demonstrates the importance to these transactions of the tax reductions achieved through interest deductions and the need to act now to eliminate this benefit.”); Statement of Pamela F. Olson, Hearing to Consider the Nomination of Pamela F. Olson, Before the Committee on Finance, 107th Cong., 2d Sess. (Aug. 1, 2002), 2002 TAX NOTES TODAY 154-27 (“We believe very firmly that we need to take away what we refer to as ‘juice’ in the transactions, remove the kinds of tax minimization opportunities that the Code presents for companies undertaking an inversion transaction. So we think if we can eliminate the reasons for undertaking the transactions, the transactions will not occur.”).

Similar results can be achieved with royalty payments, management service fees and reinsurance premiums.

In 2007, the Treasury Department released a study on earnings stripping, transfer pricing and tax treaties.<sup>775</sup> In its study, the Treasury Department did not find conclusive evidence of earnings stripping by foreign corporations that had not inverted.<sup>776</sup> However, the Treasury Department did find strong evidence that U.S. corporations that inverted engaged in earnings stripping.<sup>777</sup>

A number of proposals have been advanced to limit earnings stripping by foreign corporations.<sup>778</sup> Most of the proposals focus on section 163(j) which, if applicable, limits the interest deduction of a U.S. corporation. If a corporation has a debt-to-equity ratio exceeding 1.5:1, pays or accrues disqualified interest and has excess interest expense for the taxable year, part of its interest deduction will be disallowed for the current year. Any part of the interest expense disallowed as a deduction is carried forward as disqualified interest in succeeding taxable years.

Disqualified interest means any interest paid or accrued by the corporation to a related person if no U.S. income tax is imposed with respect to such interest. A related person means any person who owns more than 50 percent of the corporation. If any treaty between the United States and a foreign country reduces the rate of tax imposed on any interest paid or accrued by the corporation, such interest is treated as interest on which no tax is imposed to the extent of the same proportion of such interest as the rate of tax imposed without regard to the treaty reduced by the

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<sup>775</sup> U.S. DEPARTMENT OF THE TREASURY, REPORT TO THE CONGRESS ON EARNINGS STRIPPING, *supra* note 683.

<sup>776</sup> *Id.* at 31.

<sup>777</sup> *Id.*

<sup>778</sup> Martin A. Sullivan, *The Many Ways to Limit Earnings Stripping*, 144 TAX NOTES 377 (July 28, 2014).

rate of tax imposed under the treaty bears to the rate of tax imposed without regard to the treaty. Excess interest expense means the excess (if any) of the corporation's net interest expense over the sum of 50 percent of the adjusted taxable income of the corporation plus any excess limitation carryforward. The adjusted taxable income is the taxable income of the corporation computed without regard to net interest expense, the amount of any NOL deduction, the manufacturing deduction, and any depreciation or amortization deductions. The excess limitation carryforward is the excess of 50 percent of the corporation's adjusted taxable income over the corporation's net interest expense. It is carried forward for up to three years.

The various proposals to tighten section 163(j) usually involve eliminating the 1.5:1 debt-equity ratio, which acts as a safe harbor. In other words, a corporation that satisfies the 1.5:1 debt-equity ratio avoids the application of section 163(j) with the result that none of its interest deduction is disallowed. In addition, a number of proposals would lower the determination of excess interest expense from the current threshold of 50 percent of adjusted taxable income to 25 percent of adjusted taxable income. Also, some proposals would repeal the excess limitation carryforward and limit the carryforward period for interest disallowed as a deduction.

A couple of proposals would go significantly beyond tightening of section 163(j). For example, Michael Durst has proposed limiting deductions for all cross-border payments – not just interest payments – to a related party in a zero-tax or low-tax jurisdiction.<sup>779</sup> Such an approach would apply equally to all companies doing business in the United States, whether U.S.-owned or foreign owned. Bret Wells and Cym Lowell have proposed a similar idea.<sup>780</sup> Under their proposal, a base-protecting surtax would apply to all payments from a U.S. business to a foreign related

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<sup>779</sup> Michael C. Durst, *Congress: Deduction Curbs May Be Most Feasible Fix for Base Erosion*, 138 TAX NOTES 1261 (Mar. 11, 2013).

<sup>780</sup> Wells and Lowell, *supra* note 702.

party. The surtax rate would approximate the income tax on the outbound payment. If the U.S. business can show the IRS that the surtax should be a lesser percentage through a Base Clearing Certificate (similar to an Advance Pricing Agreement), it can pay the surtax at that lesser percentage.

#### J. Non-Resident U.S. Citizens

The United States is the only industrialized country in the world that imposes citizenship-based taxation.<sup>781</sup> In other words, the United States taxes its citizens on their worldwide income even if the citizen resides outside the United States and has no connection to the United States other than citizenship. The roots of citizenship-based taxation date back to the 1924 U.S. Supreme Court case of *Cook v. Tait*.<sup>782</sup> In that case, the Supreme Court held that neither the U.S. Constitution nor international law is violated by taxing a U.S. citizen who was permanently domiciled in Mexico and received income from real and personal property located in Mexico. Two years after the Supreme Court's decision in *Cook v. Tait*, Congress enacted the foreign earned income exclusion for U.S. citizens working abroad. As originally enacted, as part of the Revenue Act of 1926, the foreign earned income exclusion had no dollar limitation and applied as long as the individual was a bona fide nonresident of the United States for more than six months during the taxable year. Today, the foreign earned income exclusion is limited to \$100,800 for 2015 with the requirement that the U.S. citizen must be a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year or is physically present in a foreign country or countries for at least 330 full days during any period of 12 consecutive months.

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<sup>781</sup> Reference is usually made to Eritrea as another country that imposes citizenship-based taxation.

<sup>782</sup> 265 U.S. 47 (1924) (the Court referred to a regulation promulgated under the Revenue Act of 1921 that provided that U.S. citizens, wherever resident, are liable for U.S. income tax even if they own no assets in the United States and receive no income from U.S. sources).

The United States needs to rethink its taxing rules for nonresident U.S. citizens.<sup>783</sup> If a U.S. citizen is living and working abroad with some permanence, and the primary nexus the individual has to the United States is citizenship, we think it makes sense to tax the individual, as a general rule, only on income from U.S. sources.<sup>784</sup> A test would need to be developed to determine at what point a U.S. citizen is considered a nonresident of the United States and then at what point the U.S. citizen is considered to be a resident again. Some factors that may be considered include the permanence and purpose of the stay abroad, residential ties to the United States, residential ties to the foreign country, and regularity and length of visits to the United States. The test could be adopted, in some part, from the existing rules that are used to determine residency of alien individuals, i.e., those individuals who are not U.S. citizens.<sup>785</sup> In addition, an exit tax could be applied when the U.S. citizen is considered a nonresident and no longer subject to U.S. worldwide taxing jurisdiction. If the U.S. citizen later becomes a resident and then becomes subject to U.S. worldwide taxing jurisdiction, then the individual's basis in her assets would be the fair market value of the assets at the time she again becomes a resident.

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<sup>783</sup> One proposal has been developed by American Citizens Abroad. See American Citizens Abroad, *Residence Based Taxation: A Necessary and Urgent Tax Reform* (March 2013), available at <https://americansabroad.org/files/6513/6370/3681/finalsubrbtmarch2013.pdf> (accessed Nov. 14, 2014).

<sup>784</sup> Such tax could be collected by withholding.

<sup>785</sup> IRC sec. 7701(b).

## Chapter 7: Conclusion

Tax reform is a matter of economic necessity. Indeed, our nation's broken tax code is one of the major roadblocks standing between the United States and sustained economic prosperity. Of course, reforming our tax system will not be easy. In fact, the prospect is much more difficult today than in 1986. The tax code is more complicated than it was in 1986 with numerous expiring provisions and hundreds of tax expenditures. In 1986, Congress reduced individual income taxes by about \$120 billion over five years while raising corporate income taxes by an almost identical amount. Such an approach would neither be possible nor desirable in the current economic and policy climate as U.S. corporations are already facing the highest corporate tax rate in the developed world along with an antiquated international tax system that, in many cases, penalizes U.S. corporations when compared to their foreign competitors.

Any proposed tax system should be friendly to savings and investments of individuals. A low corporate tax rate would make the United States more attractive for business investments. The integration of the corporate and individual income taxes would eliminate economic distortions that currently exist, including the perverse incentive for owners of corporations to finance corporations with debt rather than equity. Moreover, replacing our worldwide tax system with a territorial type of tax system would make U.S. businesses more competitive with their foreign counterparts.

We believe that economic growth and job creation are critical in today's environment. If tax reform is done properly, a large body of economic literature shows that increased economic growth will result. With six years of weak growth in jobs and the economy and concerns about continued, longer-term, weakness, it is important to enact tax reform that can increase jobs in America and U.S. economic growth. Economic growth and job creation go hand-in-hand, and

both serve to bring in greater revenues that can be used to pay down our national debt. Tax reform can help get the economy moving again, create new jobs and get our fiscal house in order.



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## **Appendix**

Exhibit 1 – Memorandum from Thomas A. Barthold (no date)

Exhibit 2 -- Memorandum from Thomas A. Barthold (Apr. 29, 2011)

Exhibit 3 -- Memorandum from Thomas A. Barthold (no date)

**Congress of the United States**  
JOINT COMMITTEE ON TAXATION  
Washington, DC 20515-6453

**MEMORANDUM**

**TO:** Mark Prater, Jim Lyons, Christopher Hanna, Tony Coughlan, and Caleb Wiley  
**FROM:** Thomas A. Barthold *TAB*  
**SUBJECT:** Information on Income Tax Liability for Tax Year 2014

---

This memorandum is in response to your request of October 27, 2014, for information on the percentage of taxpayers who will have no income tax liability. In particular, you requested an update of a memorandum we provided to you in April, 2011, that contained estimates of the number and percentage of taxpayers in 2009 with no tax liability.

For tax year 2014, we estimate there will be 175.9 million tax filing units, 91.9 million will be single returns, 57.9 million will be joint returns, 23.1 million will be head of household or qualifying widow returns, and 2.9 million will be married filing separate returns.

Of the 91.9 million single returns, we project 36.3 million will have zero income tax liability, 11.5 million will receive a refundable credit, and 44.2 million will have a positive income tax liability for 2014. For the 57.9 million married filing joint returns, we project 6.9 million will have zero income tax liability, 10.0 million will receive a refundable credit, and 41.0 million will have a positive income tax liability in 2014. For the 23.1 million head of household and qualifying widower returns, we project 1.0 million will have zero income tax liability, 15.2 million will receive a refundable credit, and 7.0 million will have a positive income tax liability in 2014. For the 2.9 million married filing separate returns, we project 0.4 million will have zero income tax liability, 0.2 million will receive a refundable credit, and 2.3 million will have a positive income tax liability for 2014.

In summary, for tax year 2014, approximately 25 percent of all tax units, including filers and non filers, will have zero income tax liability, approximately 21 percent will receive a refundable credit, and approximately 54 percent will have a positive income tax liability.

In your previous request, you asked for the percentage of primary taxpayers and spouses that pay no income tax. For tax year 2014 we estimate approximately 22 percent of primary taxpayers and spouses, including filers and non filers, are part of tax units that will have zero income tax liability, approximately 20 percent will receive a refundable credit, and 58 percent will have a positive income tax liability.

**Congress of the United States**  
JOINT COMMITTEE ON TAXATION  
Washington, DC 20515-6453

APR 29 2011

**MEMORANDUM**

**TO:**

**FROM:**



**SUBJECT:** Information on Income Tax Liability for Tax Year 2009

---

This memorandum is in response to your request of April 15, 2011, for information on the percentage of taxpayers who will have no income tax liability for tax year 2009.

Unfortunately, we do not have final data from tax year 2009. However, as part of our modeling for the future forecast period we create forecasts ("backcasts") of prior years to bridge the model from the actual data year (2007) to the forecast period. Consequently, we have a backcast for 2009. Any estimate for 2009 will obviously have errors associated with it. After analyzing the advance data for 2009, we believe that our backcast for 2009 is an acceptable proxy for the actual 2009 results.

For tax year 2009, we estimate that there would be 164.4 million tax filing units, 81.1 million would be single returns, 58.9 million would be joint returns, 21.7 million would be head of household returns, and 2.5 million would be married filing separate returns.

Of the 81.1 million single returns, we project 26.8 million will have zero income tax liability, 16.6 million will receive a refundable credit, and 37.8 million will have a positive income tax liability for 2009. For the 21.7 million head of household returns, we project 1.0 million will have zero income tax liability, 15.4 million will receive a refundable credit, and 5.3 million will have a positive income tax liability for 2009. For the 58.9 million married filing joint returns, we project 7.3 million will have zero income tax liability, 16.2 million will receive a refundable credit, and 35.5 million will have a positive income tax liability for 2009. For the 2.5 million married filing separate returns, we project 0.4 million will have zero income tax liability, 0.5 million will receive a refundable credit, and 1.6 million will have a positive income tax liability for 2009.

In summary, for tax year 2009, approximately 22 percent of all tax units, including filers and non filers, will have zero income tax liability, approximately 30 percent will receive a refundable credit, and approximately 49 percent will have a positive income tax liability.

Because single filer returns and head of household returns include only a primary taxpayer while married filing joint returns include a primary taxpayer and spouse, you requested that we calculate the percentage of primary taxpayers and spouses that appear on returns that pay no income tax. For tax year 2009, approximately 19 percent of primary taxpayers and spouses, including filers and non filers, are part of tax units that will have zero income tax liability,

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**TO:** Mark Prater and Jim Lyons  
**SUBJECT:** Information on Income Tax Liability for Tax Year 2009

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approximately 29 percent will receive a refundable credit, and 52 percent will have a positive income tax liability.



**Congress of the United States**  
JOINT COMMITTEE ON TAXATION  
Washington, DC 20515-6453

**MEMORANDUM**

**TO:** Mark Prater  
**FROM:** Thomas A. Barthold *T.A.B.*  
**SUBJECT:** Macroeconomic Analysis

---

This memorandum is a partial response to your request for an analysis of the macroeconomic effects of several proposals to modify the individual income tax by broadening the tax base and reducing statutory tax rates relative to several different baseline assumptions about tax law. In particular, this memorandum provides analysis of two proposals relative to the present law baseline.

**OVERVIEW**

The following discussion analyzes the macroeconomic effects of two proposals to broaden the individual income tax base and reduce tax rates relative to those that exist under present law. The first proposal would eliminate personal exemptions and most deductions and credits. It would reduce tax rates and repeal the alternative minimum tax ("AMT"). The first proposal would broaden the tax base and reduce statutory income tax rates such that the proposal would be revenue neutral as measured by the conventional revenue estimate over the current 10-year budget period (2012-2021). The second proposal would make the same changes to the tax bases, and reduce statutory income tax rates such that the proposal would raise approximately \$600 billion as measured by the conventional revenue estimate over the current 10-year budget period. This analysis is performed relative to the present law baseline, which generally assumes that the tax provisions enacted in the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA") of 2001 and the Jobs and Growth Tax Relief Reconciliation Act ("JGTRRA") of 2003 expire for taxable years beginning after 2012. We assume these proposals would be effective for taxable years beginning after December 31, 2012.

We analyzed these proposals using the Joint Committee staff macroeconomic equilibrium growth model ("MEG"). In general, the lower marginal rates made possible by the base broadening provide additional incentives for work and investment, which are predicted to result in an increase in real gross domestic product, business investment, and employment. Investment in housing is likely to be reduced by the proposal. While within the budget period the first proposal is revenue neutral, it loses revenue relative to present law starting in the second half of the period, primarily because of the effects of repealing the alternative minimum tax. In the longer run, increasing deficits relative to present law lead to crowding out of private investment activity due to government borrowing. The second proposal, which raises \$600 billion within

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the budget period, generally reduces crowding out, and results in higher output in the long run. The extent of the changes depends on the sensitivity of individual labor choices to changing marginal rates, as well as on how the proposal affects the overall Federal government debt and interest rates and on Federal Reserve Board monetary policy.

## DESCRIPTION OF PROPOSALS

Under both proposals, all personal exemptions, itemized deductions, and personal credits except for the earned income credit and health premium assistance credits, and all above-the-line adjustments to personal income except for retirement savings deductions and the deduction for self employment taxes would be repealed. The largest categories of deductions repealed are present-law deductions for home mortgage interest expenses, State and local taxes, and charitable contributions. The alternative minimum tax would also be repealed. The standard deduction would remain.

Under present law, statutory tax rates on individual ordinary income are structured in a progression through six tax brackets through 2012, and through five brackets beginning in 2013 (when the lower two brackets become combined into one). For the first proposal, which would reduce statutory rates such that the overall effect is revenue neutral within the 10-year budget period, the statutory rates that apply to ordinary income beginning in 2013 are reduced by 24 percent. For the second proposal, which is designed to raise approximately \$600 billion over the budget period, the statutory rates applied to ordinary income are reduced by 20 percent. Table 1 provides a summary of individual ordinary income tax rates by 2013 income bracket for single and joint filers under present law and under the two proposals.

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**Table 1.—Statutory Tax Rates Under Present Law and Proposal**

2013 Income Brackets for Single Filers (estimated)	2013 Income Brackets for Joint Filers (estimated)	Statutory Tax Rates (present law)	Proposed Statutory Tax Rates (revenue neutral)	Proposed Statutory Tax Rates (raising \$600 billion)
<\$8,750	<\$17,500	15	11.4	12.0
\$8,750-\$35,500	\$17,501-\$59,300	15	11.4	12.0
\$35,501-\$86,000	\$59,301-\$143,350	28	21.28	22.4
\$86,001 - \$179,400	\$143,351-\$218,450	31	23.56	24.8
\$179,401-\$390,050	\$218,451-\$390,050	36	27.36	28.8
>\$390,050	>\$390,050	39.6	29.01	31.68

**Conventional estimate of the effects of the proposal - long run and short-run**

Using our conventional revenue estimating methodology, the individual income tax as modified by the first proposal is expected to result in approximately the same amount of Federal individual income tax receipts during the 2012-2021 budget period as the present law individual income tax, and the second proposal is expected to raise approximately \$600 billion over that period. Beyond 2021, the first proposal will lose increasing amounts of revenue relative to present law because the present-law tax rate structure results in receipts growing more rapidly than the economy after 2013--primarily because increasing numbers of taxpayers become subject to the alternative minimum tax as normal inflation and income growth push them above the present-law unindexed thresholds. (Under present law, single filers with income below \$33,750 and joint filers with incomes below \$45,000 are exempt from the AMT. Because these amounts are not indexed, over time, more and more people who are currently in the 15 percent tax bracket will be pushed over the AMT thresholds and be taxed at rates of 26 and 28 percent.) Correspondingly, effective marginal tax rates under present law increase over time, particularly for moderate income taxpayers (who are not currently subject to the AMT), and thus the lower statutory rates combined with elimination of the AMT under the proposal result in effective marginal tax rates decreasing relative to present law in the long run. The new tax base and rate structure under the proposals, which eliminate the alternative minimum tax, do not produce the same rate of increase in revenues as under present law. Because receipts are lower in the long

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run, the first proposal results in growing government debt relative to present law tax receipts in the long run. Because the second proposal raises revenues relative to present law inside the budget period, it initially reduces the growth of government debt, but eventually the lower rates combined with the repeal of the AMT make the second proposal lose revenue relative to baseline projections outside the budget period as well.

The following analysis was performed using the Joint Committee on Taxation staff's Macroeconomic Equilibrium Growth (MEG) model.<sup>1</sup> We analyze the proposal using varying assumptions about Federal Reserve policy and about the responsiveness of labor to changes in effective marginal tax rates and average taxes for each proposal.

## RESULTS

Following is a series of tables that show the effects of this proposal on real (inflation adjusted) gross domestic product ("GDP"), real business and residential capital stock, employment, and consumption.

Results from each policy simulation for each variable are presented as percentage changes from the present-law baseline forecast values for the variable in Tables 2-8 below. The Joint Committee staff configures the present-law baseline forecasts for Federal government receipts and spending in each of the macroeconomic models to approximate the January 2011 forecast of the Congressional Budget Office<sup>2</sup> as closely as possible. The baseline beyond 2021 is extrapolated to approximate long-run expected Federal government receipts and expenditures under present-law as closely as possible. While it is impossible to incorporate unknowable intervening circumstances, such as intervening policy changes, major resource or technological discoveries or shortages, these models are designed to predict the long-run effects of policy changes, assuming other unpredictable influences are held constant. To provide information

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<sup>1</sup>A detailed description of the MEG model and its behavioral parameters may be found in: Joint Committee on Taxation, *Macroeconomic Analysis of Various Proposals to Provide \$500 Billion in Tax Relief*, (JCX-4-05), March 1, 2005, and Joint Committee on Taxation, *Overview of the Work of the Staff of the Joint Committee on Taxation to Model the Macroeconomic Effects of Proposed Tax Legislation to Comply with House Rule XIII.3(h)(2)*, (JCX-105-03), December 22, 2003.

<sup>2</sup> Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2011-2021*, January 26, 2011.

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**TO:** Mark Prater  
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about the longer run effects of the policy, the tables also report the percent change in each economic variable in 2035, which is referred to in the tables as "long run."

**A. Effects on Real Gross Domestic Product**

Growth responds to changes in the after-tax return to capital, average and marginal tax rates on labor, and changes in the after-tax cost of housing capital versus the after-tax cost of producers' capital. It also responds to changes in Federal Reserve policy. Changes in tax rates on interest, dividend, and capital gains income, as well as on business profits accruing to pass-through entities, affect the after-tax return to capital. Both proposals reduce the overall effective marginal tax rate on labor, providing additional incentives for people to work, supplying more labor to the economy. These proposals do not change the tax rate on capital gains (zero and 15 percent through 2012 and generally 10 and 20 percent thereafter), but they do reduce taxes on dividend and interest income and business profits of pass-through entities, thus increasing the after-tax return to capital. In addition, elimination of the mortgage interest deduction reduces the attractiveness of housing as an alternative to business investment. These elements provide incentives for more business investment. Both of these effects contribute to incentives for both short-term and long-term growth.

Another effect of tax policy on growth operates through the policy's effects on after-tax income. A decrease in after-tax income generally reduces consumption demand, which can result in a decrease in GDP in the short-run, particularly when the economy is operating at less than full capacity. The Federal Reserve Board may take action to counteract such effects in a period when the economy is operating below capacity. The simulations labeled "Aggressive Fed" in the following tables reflect the effects of the Federal Reserve Board taking strong measures to counteract demand effects of policies. The simulations labeled "Neutral Fed" reflect the Federal Reserve Board targeting a fixed money growth rate, thus allowing the contractionary demand effects of these tax policies to operate.

In general, under most modeling assumptions both the revenue neutral proposal and the \$600 billion proposal are projected to result in increases in economic activity, as measured by changes in real gross domestic product ("GDP"), relative to present law. The revenue neutral proposal produces more growth effects in the short run, while the \$600 billion proposal produces more growth effects in the longer run.

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**Table 2.—Percent Change in Real GDP Relative to Present Law  
 (Percent Change for the Period)**

		11-'16	17-'21	Long Run
<b>Revenue Neutral</b>				
Default Labor Elasticity	Aggressive Fed	0.4	1.1	1.6
	Neutral Fed	0.2	1.0	1.8
Low Labor Elasticity	Aggressive Fed	0.3	0.9	1.1
	Neutral Fed	0.2	0.8	1.3
<b>Raise \$600 billion</b>				
Default Labor Elasticity	Aggressive Fed	0.3	1.1	2.2
	Neutral Fed	0.0	0.7	2.1
Low Labor Elasticity	Aggressive Fed	0.2	0.9	1.7
	Neutral Fed	0.0	0.6	1.7

**Table 3.—Percent Change in Receipts due to change in GDP  
 (Percent Change for the Period)**

		11-'16	17-'21	Long Run
<b>Revenue Neutral</b>				
Default Labor Elasticity	Aggressive Fed	0.6	1.3	1.2
	Neutral Fed	0.4	1.1	1.8
Low Labor Elasticity	Aggressive Fed	0.5	1.1	0.4
	Neutral Fed	0.4	0.9	1.3
<b>Raise \$600 billion</b>				
Default Labor Elasticity	Aggressive Fed	0.5	1.3	2.6
	Neutral Fed	0.2	0.9	2.1
Low Labor Elasticity	Aggressive Fed	0.4	1.1	1.9
	Neutral Fed	0.2	0.8	1.7

Table 2 shows the effects of these policies on real gross domestic product, relative to what is projected under present law. In all of the simulations of the first proposal to lower

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ordinary income tax rates on a revenue neutral basis, real gross domestic product increases. In the short-run, the increase ranges from 0.2 percent of GDP to 0.4 percent of GDP, while in the long-run, the increase ranges from 1.1 percent to 1.6 percent of GDP. The simulations that assume less labor responsiveness ("Low Labor Elasticity") result in smaller changes in GDP. Because the tax changes increase average tax rates on wages for lower income earners in the short-run (due to the loss of certain tax credits and the personal exemption) the GDP effect is lower in the short-run in Neutral Fed simulations that allow for those increases to exercise negative effects on consumption. In the longer run, as average income tax rates are lower under the proposal than under present law, the Aggressive Fed simulations result in lower growth, as the Fed works to counteract increasing demand effects.

All of the simulations of the second proposal to raise \$600 billion also predict increases in real gross domestic product. The increases range from a negligible percent to 0.3 percent in the very short run, and from 1.7 percent to 2.2 percent in the long run. Effects of the labor supply and Federal Reserve policy assumptions in simulations of this proposal are similar to those for the first proposal. Because the \$600 billion policy reduces after-tax income by more than the revenue neutral policy, in the short-run, increases in GDP are slightly higher for the revenue neutral policy, reflecting less of a negative effect on consumer demand from the neutral policy relative to the \$600 billion policy. In the long-run, however, this is reversed. The \$600 billion policy results in more long-run growth than the revenue neutral policy because it reduces the growth of Federal budget deficits, thus reducing the crowding out of private investment by Federal borrowing.

Table 3 shows the effects of the changes in GDP growth on Federal revenues, as a percent of baseline Federal receipts. Generally, higher GDP growth results in increases in the tax base, which results in increases in receipts. The relationship between GDP growth and receipts is not constant because different portions of the tax base are taxed at different rates.

In the following sections on Capital Stock, Employment, and Consumption effects, the influence of these proposals on each of these components of growth and the economy can be seen in more detail.

## B. Effects on the Capital Stock

All of the simulations for both policies result in an increase in producers' capital stock (Table 4), and in a reduction in residential capital stock (Table 5). Reduction of effective marginal rates on interest income provides some increase in the after-tax return on capital, which provides an incentive for additional capital investment. The elimination of the mortgage interest

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deduction reduces the attractiveness of investment in housing, while increasing the attractiveness of investment in business capital. In the long-run, investment increases more under the \$600 billion proposal than under the revenue neutral proposal because the former results in slightly lower deficits, and thus less pressure of government borrowing in the financial markets.

Finally, Table 6 shows the effects of the policies on corporate interest rates. Combined, these tables provide an indication of the increase in business investment, reduction in housing investment, and the influence of changes in the interest rate resulting from deficit changes on these results. Of particular note, interest rates are projected to increase in the long run under the revenue neutral proposal because the proposal generates increasing deficits relative to present law. In contrast, interest rates are projected to decrease in the long run under the \$600 billion proposal. Commensurately, capital stock and GDP increase more in the long run under the \$600 billion proposal than under the revenue neutral proposal.

**Table 4.—Percent Change in Real Producers' Capital Relative to Present Law  
 (Percent Change for the Period)**

		11-'16	17-'21	Long Run
<b>Revenue Neutral</b>				
Default Labor Elasticity	Aggressive Fed	0.5	2.0	2.6
	Neutral Fed	0.4	1.6	2.6
Low Labor Elasticity	Aggressive Fed	0.4	1.8	1.4
	Neutral Fed	0.4	1.6	1.8
<b>Raise \$600 billion</b>				
Default Labor Elasticity	Aggressive Fed	0.5	2.2	5.2
	Neutral Fed	0.3	1.6	4.5
Low Labor Elasticity	Aggressive Fed	0.4	2.1	4.2
	Neutral Fed	0.3	1.5	3.8



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**Table 5.—Percent Change in Real Residential Capital Relative to Present Law  
 (Percent Change for the Period)**

		11-'16	17-'21	Long Run
<b>Revenue Neutral</b>				
Default Labor Elasticity	Aggressive Fed	-0.3	-1.0	-1.9
	Neutral Fed	-0.3	-1.1	-2.1
Low Labor Elasticity	Aggressive Fed	-0.3	-1.1	-2.9
	Neutral Fed	-0.3	-1.2	-2.8
<b>Raise \$600 billion</b>				
Default Labor Elasticity	Aggressive Fed	-0.1	-0.3	1.2
	Neutral Fed	-0.2	-0.7	0.4
Low Labor Elasticity	Aggressive Fed	-0.1	-0.4	0.4
	Neutral Fed	-0.2	-0.7	-0.2

**Table 6.—Change in Interest Rates Relative to Present Law  
 (Change in Basis Points)**

		11-'16	17-'21	Long Run
<b>Revenue Neutral</b>				
Default Labor Elasticity	Aggressive Fed	-5	-6	30
	Neutral Fed	-5	-8	25
Low Labor Elasticity	Aggressive Fed	-5	-4	57
	Neutral Fed	-4	-5	44
<b>Raise \$600 billion</b>				
Default Labor Elasticity	Aggressive Fed	-9	-19	-56
	Neutral Fed	-9	-26	-41
Low Labor Elasticity	Aggressive Fed	-9	-18	-38
	Neutral Fed	-9	-23	-26

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## C. Effects on Private Sector Employment

Reductions in effective marginal tax rates on labor - that is, increases in the portion of wages from additional work effort that a person keeps - provide an incentive for people to work more, supplying more labor to the economy. Somewhat offsetting that effect, reductions in total tax payments (as measured by changes in the average tax rate), increase peoples' total take home income; provide an incentive for people to work less. Policies that reduce marginal tax rates by more than average tax rates provide a net incentive for more labor to be supplied by the economy. These proposals reduce marginal and average tax rates on labor overall, although the elimination of credits and personal exemptions results in an increase in average and marginal tax rates relative to present law on lower income earners within the 10-year budget window. They also reduce effective marginal tax rates by more than they reduce average tax rates overall. In the longer run, effective marginal tax rates on all groups are somewhat lower relative to present law because of the removal of the AMT. There are, therefore, incentives for increases in labor supply and employment under both proposals. The relative decrease in effective marginal rates is greater under the revenue neutral proposal than under the \$600 proposal, thus resulting in greater labor supply and employment increases. The lower labor supply elasticity simulations provide some indication of the importance of assumptions about labor supply response to this analysis.

Table 7 shows the effects of these proposals on employment.

**Table 7.—Percent Change in Private Sector Employment Relative to Present Law  
 (Percent Change for the Period)**

		11-'16	17-'21	Long Run
<b>Revenue Neutral</b>				
Default Labor Elasticity	Aggressive Fed	0.5	1.2	1.8
	Neutral Fed	0.4	1.2	2.0
Low Labor Elasticity	Aggressive Fed	0.4	1.0	1.4
	Neutral Fed	0.3	0.9	1.6
<b>Raise \$600 billion</b>				
Default Labor Elasticity	Aggressive Fed	0.4	1.0	1.5
	Neutral Fed	0.1	0.8	1.6
Low Labor Elasticity	Aggressive Fed	0.3	0.8	1.1
	Neutral Fed	0.1	0.6	1.2

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## D. Effects on Consumption

Table 8 shows how the two proposals affect consumption relative to present law. In addition to the interaction between consumption demand and short-term economic growth, consumption is often of interest as an indicator of individuals' well-being. Generally, the increased growth facilitates more consumption. The revenue neutral change, which results in more employment and after-tax wage income in the longer run, is projected to provide a greater consumption response than the \$600 billion proposal. In the short-run, consumption increases more under Aggressive Federal Reserve simulations (which fight the contractionary effects of increases in average tax rates on wages). Reduced labor supply responses also result in less consumption.

**Table 8.—Percent Change in Consumption Relative to Present Law  
 (Percent Change for the Period)**

		11-'16	17-'21	Long Run
<b>Revenue Neutral</b>				
Default Labor Elasticity	Aggressive Fed	0.3	1.3	2.9
	Neutral Fed	0.2	1.1	3.0
Low Labor Elasticity	Aggressive Fed	0.2	1.1	2.4
	Neutral Fed	0.2	1.0	2.5
<b>Raise \$600 billion</b>				
Default Labor Elasticity	Aggressive Fed	0.1	0.9	2.9
	Neutral Fed	-0.1	0.6	2.9
Low Labor Elasticity	Aggressive Fed	0.0	0.7	2.4
	Neutral Fed	-0.1	0.5	2.4

## E. Conclusion

Broadening of the individual income tax base through elimination of many preferences in the form of deductions, exemptions, and tax credits allows for a reduction in effective marginal tax rates for most individual income taxpayers. This policy also reduces preferential tax treatment of investment in housing relative to producers' capital. Both of these effects provide incentives for more work and investment in the business capital, thus increasing total output

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potential. The extent of the growth predicted in different macroeconomic model simulations can vary significantly depending on assumed behavioral parameters, and Federal Reserve policy response.