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The House Republicans' Corporate Tax Cut

By Alexandra Thornton and Marc Jarsulic

March 2017

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Introduction and summary

House Republicans propose to change the way businesses are taxed as part of their June 2016 tax reform proposal, which they refer to as a "blueprint."[1] First, they want to repeal the corporate income tax, which has been in place since 1909[2] and is one of the most progressive federal taxes.[3] Then, they plan to replace it with a type of tax system that has never been tried before in the developed world[4]—a destination-based cash flow tax, or DBCFT—with a much lower tax rate. Under the DBCFT, corporations and other businesses would write off all expenses immediately but would no longer deduct interest on debt or expenses incurred outside the United States. No tax would be imposed on income from sales abroad, while the tax would be imposed on imports.

It is clear that a major goal of the House plan is to dramatically reduce the contribution that corporations and other businesses make to federal tax receipts. The plan represents an extraordinarily large tax cut for both corporations and other types of businesses, costing an estimated $1.3 trillion in the first 10 years after enactment. Much of the reduction would benefit the largest and most-profitable businesses, including those that have engaged in shifting profits and jobs out of the United States. This report considers whether a tax cut for corporations and other businesses is justified at this time.

According to the chair of the House Ways and Means Committee, Rep. Kevin Brady (R-TX), this part of the House blueprint is designed "to grow jobs, the economy, and wages" with "the lowest rates for businesses in modern history."[5]

However, the House business tax plan's ability to generate American jobs, stimulate economic growth, and increase wages is highly uncertain. Although proponents claim that there would be significant incentives for increased real investment in the United States, there is good reason to believe that this claim is not well-founded. Moreover, the DBCFT is unlikely to deliver an improved trade balance or eliminate corporate tax avoidance schemes, as its proponents claim. And it could have adverse effects on the real incomes of many American households.

While enacting the destination-based cash flow tax is a high priority for House Republicans, this change to the corporate tax is unlikely to benefit anyone other than corporations and the wealthy.

The House GOP destination-based cash flow tax

The House GOP plan would completely change the way corporations and other businesses are taxed. Because a destination-based cash flow tax has never been tried before in any developed country and because the House GOP tax blueprint provides only sketchy details, many questions remain about the tax. These include both technical questions about how it would operate across businesses and sectors and broader questions about its impact on the economy, investors, the federal budget, the nation's trading partners, emerging economies, consumers, and more. The following are the elements of the plan.

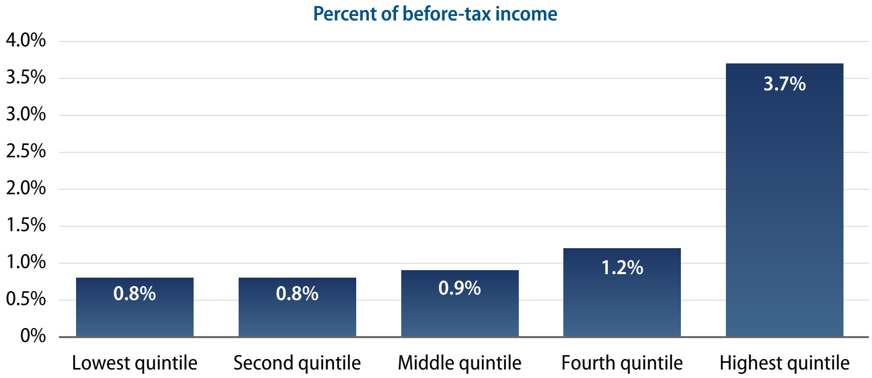
Repeals the current corporate income tax

The House GOP tax plan would effectively repeal the corporate income tax, which is one of the most progressive of the federal taxes. Economists generally assume that about three-quarters of the corporate income tax falls on owners and shareholders.[6] Individual shareholders enjoy substantial tax reductions since most stock is held in tax-exempt accounts, such as tax-preferred retirement accounts.[7] And capital gains and dividends that are taxed in the hands of individuals enjoy a significantly lower tax rate—a tax preference that primarily benefits high-income individuals.[8] Thus, the loss of the corporate level of tax by itself represents a large and permanent regressive change. For this reason, it is critical to understand how the entire tax reform package, including any replacement tax on corporations, would fall on individuals at different income levels.

FIGURE 1

The corporate income tax is highly progressive

Distribution of corporate income tax by income group



Source: Calculations based on data from Congressional Budget Office, "The Distribution of Household Income and Federal Taxes, 2013" (2016), available at https://www.cbo.gov/publication/51361.

Repeals the income tax treatment of pass-through businesses

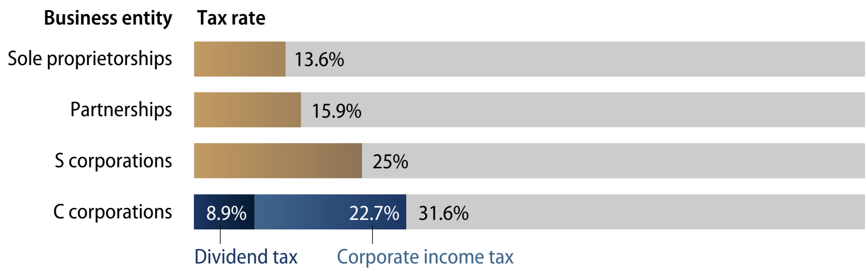
The House GOP tax plan also would effectively repeal the current income tax treatment of other types of businesses, such as S corporations, partnerships, and LLCs. These businesses are collectively known as pass-through businesses because they do not pay the corporate income tax, which only applies to regular corporations, or C corporations.[9] The earnings of pass-through businesses are only taxed on the individual tax returns of the owners and partners of the pass-through business.

Under current law, the theoretical top tax rate on pass-through business income is the top individual tax rate of 39.6 percent. However, the lack of corporate-level tax and the availability of numerous tax planning techniques under pass-through taxation mean that many pass-through businesses pay a lower overall effective tax rate than many of their C corporation competitors. The relative tax benefits available to pass-through businesses explain why there has been a surge in the growth of these businesses in the past 30 years, many of which are large and used to be C corporations.[10]

FIGURE 2

Pass-through businesses pay much lower taxes than C corporations

Average effective tax rate by type of business entity



Source: Michael Cooper and others, "Business in the United States: Who Owns It and How Much Tax Do They Pay?" Working Paper 104 (U.S. Department of the Treasury, 2015).

Under the House blueprint, pass-through businesses would calculate their taxable business income under the new DBCFT. They would continue to pass tax liability through to individual partners' personal returns, thus also continuing to avoid entity-level taxation, but the tax on that pass-through business income would be capped at 25 percent—far below the top rate currently applicable to pass-through income.

Capping the tax rate on pass-through income primarily benefits higher-income taxpayers with business income, including the owners of very large private equity firms. In an analysis of 2015 tax return data, the Tax Policy Center found that 92 percent of taxpayers who receive more than half of their income from business sources were in the 25 percent bracket or lower.[11]

Substitutes a cash flow tax

The House GOP blueprint would replace the current tax treatment of corporations and other businesses with a cash flow tax—a cousin of a value-added tax, or VAT.[12] A value-added tax imposes a tax on what each business adds to the value of a product.[13] A VAT is often described as a retail sales tax collected by businesses, but it is effectively a tax on cash flow.[14]

A cash flow tax is calculated by adding all the funds that flow into a business, mainly from sales, and subtracting all the funds that flow out, such as when a business purchases inventory, equipment, and other inputs.[15] Unlike with a value-added tax, however, the cash flow tax allows businesses to subtract expenditures for salaries and wages.

Taxing cash flow also means that all businesses of any size would immediately deduct the cost of all inputs—except land—rather than doing so ratably over time through depreciation. The simplicity theoretically gained by this, however, could be offset by a host of other factors, such as the inability to deduct net interest on debt, the complexity of changing to a whole new tax system, whether the business exports or imports goods and how many, whether exchange rates fully adjust to the new system, to what extent the business is able to pass the cash flow tax to its consumers through higher prices, and much more.

Eliminates tax on foreign business earnings

The cash flow tax proposed by the House GOP would tax cash flows based on their destination rather than where the underlying goods are produced. Only sales in the United States would be included in a business's cash flow, and only business expenditures made in the United States would be deductible. For this reason, it is referred to as a destination-based cash flow tax.

In order to limit the tax to cash flows within the United States, the tax must be adjusted at the border. This border tax adjustment would mean that companies that produce goods in the United States and sell them abroad would not have to pay the tax on revenue from those foreign sales. For this reason, most businesses that primarily export their goods support the DBCFT.[16]

At the same time, a U.S. business that imports goods for subsequent sale in the United States could not deduct the cost of those imported goods from its taxable sales in the United States. For this reason, businesses that import a lot of inputs for their manufacturing or import goods made elsewhere for subsequent sale in the United States tend not to support the DBCFT.[17]

A critical question is whether the DBCFT's border adjustment would be legal under international trade law, which requires that countries treat imported goods the same as domestic goods and do not provide unfair subsidies to their exports.[18]

World Trade Organization, or WTO, rules permit taxes to be adjusted at the border but only when those taxes are imposed on a product, as opposed to taxing the income of an individual or corporation.[19] For example, border adjustments are permitted for value-added taxes, which are imposed on products, and it is easy to see why VATs pass these tests. A border-adjusted VAT results in equal treatment for domestic products and imported products: Both domestic and imported products are taxed the same amount when sold within the VAT country, while no VAT is paid on the sale of either product outside of the country.

However, because the House GOP's DBCFT would exclude wage costs for domestically produced goods but would not exclude the wage costs embedded in the price of imported goods, imported goods would be at a disadvantage relative to domestic goods for sale within the United States. Many trade experts, such as Jennifer Hillman of Georgetown University and Joel Trachtman of Tufts University,[20] have stated that this would constitute an illegal tariff on imported products and would be a clear violation of WTO rules.[21] A related but non-WTO problem is the difficulty of enforcing such a tariff with respect to non-U.S. companies that sell products directly to final consumers in the United States, often through the internet.[22] This might be a particularly challenging problem with respect to sales of intangible goods, such as software. Similar problems arise in the context of VATs.

Experts have also questioned the legality under international trade law of the House proposal's exclusion of tax on exports since the United States arguably would be allowing U.S. exporters an income subsidy by providing them exclusion from the cash flow tax.[23] This problem could be worse depending on how the innumerable missing details of a final plan based on the House GOP blueprint are ultimately worked out. A business that mainly exports goods would build up a lot of deductions for domestic expenses that it would not be able to use because it likely would not have domestic sales revenue against which to deduct those expenses. If there is political pressure to allow these businesses to obtain a tax refund for all or part of these expenses, the potentially illegal export subsidy would be even larger. Alternatively, these firms could seek mergers with firms that could use the write-offs, but such tax-motivated mergers would not necessarily be optimal from an economic perspective.

Proponents of the DBCFT defend the cash flow tax border adjustment on grounds that it is the economic equivalent of imposing a VAT, similar to existing taxes in other countries, combined with a separate payroll tax cut for domestic employers.[24] However, the possibility that similar results could be accomplished in another hypothetical manner has not generally been an acceptable defense in WTO cases.[25] Moreover, setting WTO issues aside, cutting employers' payroll taxes would reduce payments into the Social Security trust fund. Unless those amounts were replaced, such an approach could threaten the stability of the Social Security benefits on which millions of elderly Americans rely. As for the claim that the DBCFT is the economic equivalent of a VAT plus a payroll tax reduction, this is a false equivalency since all other countries with a VAT also have retained their corporate income tax, which the House GOP tax plan does not do.

Cuts business tax rates substantially

The corporate tax rate for the new cash flow tax would be 20 percent in contrast to the current law's top corporate income tax rate of 35 percent. As mentioned above, the pass-through business tax rate under the House GOP blueprint would be 25 percent, substantially lower than the top pass-through tax rate of 39.6 percent under current law.

It is not clear why the House plan adopts such a low corporate tax rate. The tax is territorial—that is, it only affects the income or expenses of all companies within the United States, whether those companies are foreign or domestic. Conversely, income and expenses outside of the United States are ignored. Because of this, some experts, including proponents of a DBCFT, have pointed out that the tax eliminates tax rate competition between countries and that the tax rate may thus be set wherever needed to meet budget goals.[26]

In addition, corporate income tax receipts have declined historically, falling from roughly a 30 percent share of total tax receipts in the 1950s to about 10 percent in recent years. The nonpartisan Tax Policy Center estimates that the House blueprint's DBCFT would cost more than $1.3 trillion over 10 years when the rate reduction for pass-through businesses is included.[27] As discussed below, these tax cuts would mainly benefit wealthy individuals. The significant cost of these tax cuts would either increase the debt, be shifted to low- and middle-income taxpayers, or lead to deep cuts in programs that are important both to maintaining a robust economy for businesses and communities and for ensuring fundamental human living standards.

FIGURE 3

Corporate income taxes have declined as a share of total federal revenue

Share of total federal revenue from corporate income tax

Source: Office of Management and Budget, "Historical Tables," Table 2.2, available at http://www.whitehouse.gov/omb/budget/Historicals (last accessed September 2015).

Raises many complex technical questions

There is a substantial list of technical questions about how the DBCFT would operate in practice across businesses. This is partly because of gaps in details about how the tax would be structured. In addition, even where some details are known, those details give rise to more questions about potential abuses of the new system.

For example, under the House GOP tax plan, the tax rates that apply to corporate cash flows, pass-through income, ordinary individual income, and individuals' capital income are specified in the plan but are all different. When different types of income have different tax rates, there is always potential for taxpayers to seek ways to recharacterize income in ways that would lower their overall tax liability. Rules designed to prevent such recharacterization can be complicated and difficult to craft.

Whole sectors are left out of the blueprint, most notably the financial services sector but also the tax treatment of financial cash flows in businesses that are not engaged in finance-related businesses. It is not clear what approach is ideal, let alone how any recommended approach to handling financial transactions would work in practice across the billions of financial transactions that happen every day.

As David Weisbach of the University of Chicago Law School points out, the House GOP tax plan is a "massive break from the past."[28] The United States has little expertise on consumption-based taxes, and, as Weisbach says, "It is easy to make mistakes by relying on an understanding of how income taxes work."[29]

Analysis

Corporations and large pass-through businesses do not need a tax cut

Analysis of the effects of the House blueprint on corporations and large non-C corporation businesses must begin with the dramatic reduction it would provide in the share of taxes paid by these taxpayers. This reduction is being proposed at a time when corporate profits make up a large share of national income, the corporate share of total tax receipts has declined to one-third of what it was decades ago, and income inequality is very high. Because the corporate tax burden falls primarily on the owner-shareholders of corporations, reducing corporations' tax share mainly benefits wealthy individuals who hold those shares.

Large non-C corporation or pass-through businesses, which would also be subject to the DBCFT under the House proposal, would see a substantial reduction in their taxes as well. Because the structure of the proposal for pass-through businesses is simply a 25 percent cap on the tax rate they would pay, the actual and direct beneficiaries are, again, wealthier individuals.

Moreover, any large tax cut for corporations and big non-C corporation businesses—whether accomplished through the existing income tax or through replacing the income tax with a cash flow tax—would have negative implications for the overall progressivity of the tax code. This could result in a shift in the tax burden from corporations and the wealthy onto middle-class Americans. Alternatively, it could force deep cuts in federal programs that contribute to a strong economy, such as legal and transportation infrastructure, or in federal programs that ensure that all Americans have access to basic human living standards, such as Medicare, Medicaid, and Social Security.[30]

Reducing U.S. taxes on corporations would provide limited incentive to make real investments and create jobs in the United States

Many experts and organizations are beginning to provide detailed analysis of the host of challenges posed by the House GOP tax blueprint. In addition to those cited above, these include tax experts Reuven Avi-Yonah and Kim Clausing, as well as several budget, economic, and tax policy nonprofits.[31] Their analyses deserve strong consideration. Some of the concerns they raise may be addressed when lawmakers present legislative language for the proposal, while others may be more difficult to resolve.

The following analysis focuses specifically on:

1. The primary claim advanced in support of the proposal that its design would encourage greater investment and employment in the United States
2. How a shift from the current corporate income tax to the DBCFT would affect average Americans

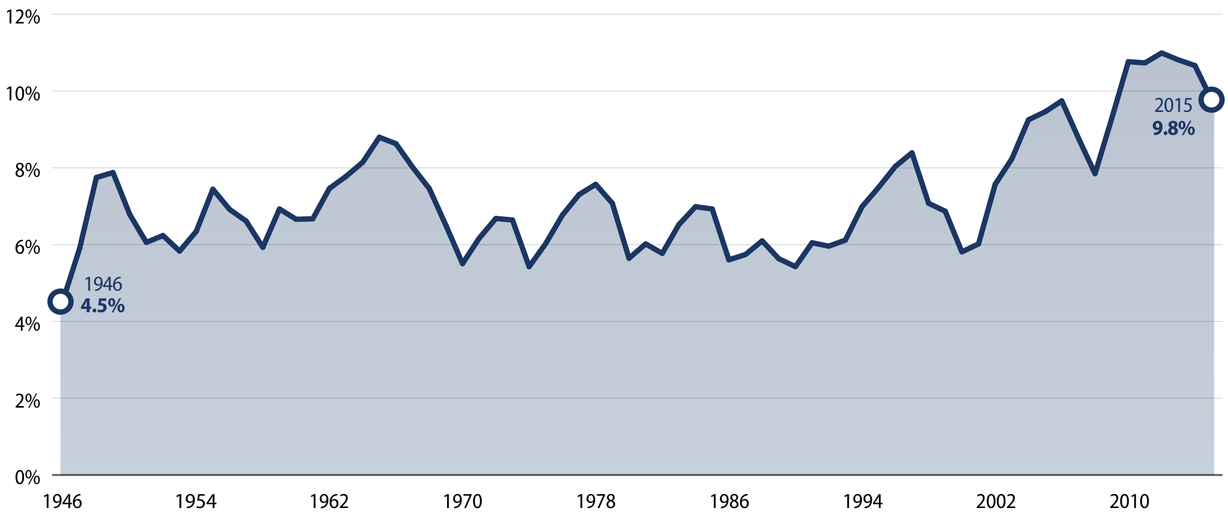
The House GOP proposal appears to offer two incentives to increase investment in the United States—a reduction in corporate taxation for investment that produces goods and services sold in the United States and a border tax regime that eliminates taxation for any income earned from exports. The economic effects of both incentive changes are uncertain.

First, the behavior of U.S. corporations over the past two decades shows that robust after-tax profitability has not translated into robust real investment. Although corporate profits have increased as a share of net national income in that period, corporate investment as a share of net income has declined. Corporations have been quite profitable and awash with cash for a sustained period, but this has not translated into increased U.S. investment. It is hard to explain how a cut in the U.S. corporate tax rate would make the United States a substantially more attractive location for U.S. or foreign multinational corporations.[32]

FIGURE 4

Corporations are capturing an elevated share of national income

After-tax corporate profits as a share of national income



Source: Bureau of Economic Analysis, "National Income and Product Accounts Tables," Table 1.12, available at http://www.bea.gov/iTable/index_nipa.cfm (last accessed February 2017).

Moreover, empirical evidence suggests that differences in corporate tax rates play a relatively small role in determining the location of foreign direct investment. The effect of other factors—such as labor force skills, infrastructure, market size, legal institutions, and macroeconomic stability—are much larger determinants of actual investment activity than changes in tax policy.[33]

However, even if the border tax regime did have a positive effect on the decision of multinational corporations to site real export-oriented operations in the United States, there also would be significant costs to the nation. This is because the corporations would not pay any income tax on their exports, while still exploiting the benefits of federal expenditures on infrastructure, education, scientific research, and national defense. Even if exchange rates adjust, firms that exclusively export would be effectively subsidized by the federal government because they would be paying no corporate tax at all. In exchange for allowing corporate free-riding, the United States might see an increase in domestic employment. However, it is not clear that overall there would be a net gain for the U.S. economy.

In addition to the blueprint's uncertain effect on location of business operations, its provisions allowing full expensing of capital outlays while restricting the deduction of interest expenses to the extent of any interest income would likely result in reduced investment for the firms that typically are identified as job creators, such as small innovative firms and startups.[34] These firms rely on both equity investment and debt. Thus, they are likely to be worse off under the House blueprint than under current law, which offers better than economic depreciation in many instances while allowing broader deduction of interest expenses.

Despite claims that the House GOP proposal would eliminate tax rate competition between the United States and its trading partners, the proposal nevertheless would represent a giant step downward in the international race to the bottom on corporate tax rates. Unlike any other country with a VAT, the House GOP plan would eliminate the corporate income tax and replace it with a consumption tax—a cash flow tax.[35] This arguably would make the United States a tax haven of sorts and could entice foreign firms to relocate in the United States in order to reduce their tax liabilities abroad. But any advantage this produced would only last as long as it goes unmatched by other nations. It easily might prove to be transitory, while the corporate tax cut would result in a permanent reduction in federal tax receipts.

U.S. firms would still have incentive to shift income outside the United States

By design, the House GOP blueprint would impose no tax on active income from U.S. firms' business activities abroad. In addition, profits earned abroad by subsidiaries of U.S. parent companies could be returned to the U.S. parent tax-free, with the apparent exception of income earned from passive investments abroad.

However, there would still be many ways for firms to game this system in cases where the final customer is not in the United States. For example, as noted in a paper by Avi-Yonah and Clausing: [36]

> *A U.S. pharmaceutical with foreign subsidiaries could develop its intellectual property in the United States (claiming deductions for wages, overhead and R&D), and then sell (i.e., export) the foreign rights to its Irish subsidiary (at the highest price possible). The proceeds would not be taxable. Ireland would allow that subsidiary to amortize its purchase price. This creates tax benefits in each jurisdiction by reason of the different regimes. If the Irish subsidiary manufactures drugs, the profits could be distributed up to the U.S. parent tax-free under a territorial system.*

In addition, although the House blueprint would allow dividends from active operations of foreign-controlled subsidiaries to be repatriated tax-free, passive income earned overseas would be taxed under the retained Subpart F of the Internal Revenue Code. Together, these provisions might encourage firms with passive income to establish small real operations abroad in order to facilitate recharacterization of passive income as active. It would be difficult for U.S. tax authorities to distinguish passive income and income from active operations, especially where products or services contain elements of both. This is a problem under the current U.S. tax system and could be exacerbated by the House tax plan.

The border tax would be unlikely to improve net exports and could adversely affect U.S. households

The current corporate income tax is one of the most progressive of the federal taxes. The House blueprint essentially eliminates the corporate level of tax and substitutes a VAT—one that is modified by allowing firms to deduct domestic labor inputs and adjusted at the border. In the longer run, the border tax adjustment theoretically should prevent the new tax from affecting the trade balance, but there may be significant adverse effects on consumers.

The tax on imports and the rebate on exports together are unlikely to result in an improved trade balance if exchange rates adjust fully. If the equilibrium trade balance is unchanged, these tax changes should lead to an appreciation in the dollar exchange rate—any competitive advantage U.S. firms gain from the tax change would be offset by the disadvantage of a stronger dollar—which would restore net exports to their equilibrium level.[37]

However, changes in exchange rates and domestic responses to price changes are not uniform for all products and can be incomplete or take time. This could cause importers to be harmed in the short run. Empirical evidence on the effects of existing U.S. tariffs shows that they act as regressive taxes, falling disproportionately on low- and middle-income households.[38] The proposed border tax adjustment could easily have the same effects but on a much larger scale.

To see how the border tax adjustment could increase consumer prices, consider the example of oil, for which there is a single world price and contracts are written in U.S. dollars. If the world price of oil is $50 per barrel, a 20 percent U.S. tax on imports would not only raise the price of imported oil to $60 but also raise the price of all oil sold in the United States to $60.[39] By simple arbitrage, a U.S. oil producer can net $50 for every barrel of oil it exports and pay no tax or sell domestically and pay the cash flow tax. This places a $50 floor on the net price the producer will accept, and every barrel the producer sells domestically for less than $60 would net less than an export sale. This arbitrage condition is strong and results in the full cost of the tax being passed on to U.S. consumers in the form of higher gas prices. Exchange rate appreciation could counter this effect, but when and to what extent is uncertain.

The cash flow tax is essentially a value-added tax that exempts labor costs. Proponents claim that this tax would fall exclusively on consumption from rents—that is, returns that exceed a normal return.[40] Even if this were true, eliminating the deduction for labor costs would be an obvious change to address the WTO issue above or to address a need for additional revenue in the future. At that point, the cash flow tax would operate as a VAT on wages as well. This would be regressive since it would make labor more expensive, which could cause firms to reduce compensation. And as mentioned above, all other countries that have VATs have also retained a corporate income tax, which is a progressive tax that reduces the need for reliance on the VAT for revenue.

Conclusion

A great deal of analysis must be done before a DBCFT such as the one proposed in the House GOP blueprint is seriously considered. In the meantime, Congress should shore up the tax code so that corporations and large businesses of all kinds pay their fair share of taxes, helping to fund infrastructure, the legal system, the education system, and many other critical services that government provides to ensure a vibrant economy, good jobs, and basic human living standards for all.

About the authors

Marc Jarsulic is the Vice President for Economic Policy at the Center for American Progress. He has worked on economic policy matters as deputy staff director and chief economist at the Joint Economic Committee, as chief economist at the Senate Banking Committee, and as chief economist at Better Markets. He has practiced anti-trust and securities law at the Federal Trade Commission, the Securities and Exchange Commission, and in private practice. Before coming to Washington, D.C., he was professor of economics at the University of Notre Dame. He earned an economics Ph.D. at the University of Pennsylvania and a J.D. at the University of Michigan. His most recent book is *Anatomy of a Financial Crisis*.

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