Volume 57 | Issue 3 Article 2

2012

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Recommended Citation

Michael C. Durst, *Some Suggestions for Tax Reform*, 57 Vill. L. Rev. 433 (2012).
Available at: https://digitalcommons.law.villanova.edu/vlr/vol57/iss3/2

Articles

SOME SUGGESTIONS FOR TAX REFORM

MICHAEL C. DURST*

I. INTRODUCTION

THIS Article is written at a time when the U.S. political process seems largely stalled as a result of fundamental disagreements concerning the desired role of government in national economic affairs, and hence the desired level of tax revenues. The stalemate has slowed, at best to a crawl, legislative movement toward comprehensive tax reform. This article is intended to convey a modest collection of ideas that, it is hoped, might be useful for consideration when the current legislative situation becomes more fluid. The article focuses most specifically on international issues, but as discussed below, for a number of practical reasons such issues cannot be addressed in isolation from broader questions of tax reform. Therefore, this article essentially works outward from a discussion of problems in the sphere of international taxation and suggests the kind of overall reform in which currently vexing issues—not only in the international field, but elsewhere—might be addressed in what is hoped can be seen as a politically and economically moderate manner.

II. SOME INTERNATIONALLY FOCUSED OBSERVATIONS

I will start with a brief—and admittedly somewhat argumentative—diagnostic review of the history of the rules that govern the international taxation of U.S.-based companies. Following the discussion of international rules, I will expand the focus to a brief consideration of how the different components of a reform—domestic as well as international—might fit together in a comprehensive and coherent package.

I think that our current international tax rules are, to a large extent, the result of historical accident. Soon after World War II, with the development of the new generation of wonder drugs by U.S. companies, pharmaceutical companies began to transfer patent licenses to what came to be known as "base companies" in low-tax countries. By the early 1960s, the Kennedy Administration thought that the revenue leakages from the use of base companies were excessive, and the Administration sought to eliminate the ability to shift income to low-tax jurisdictions. Many saw this as a

* Mike Durst is a columnist for the publication *Tax Notes.* This Article summarizes remarks that Durst made at the Villanova Law Review Norman J. Shachoy Symposium. Portions of this Article are adapted from a column published in *Tax Notes* on November 28, 2011, and are published here by permission of Tax Analysts, Inc.

move toward an economically unwise *de facto* tax increase on key U.S. businesses, and in any event the attempt to eliminate deferral proved politically infeasible. Accordingly, starting with the Revenue Act of 1962 and continuing over the course of the 1960s—with, of course, many modifications since the 1960s—Congress and the Treasury developed a system of rules that continued to allow deferral through income shifting, but sought to limit income shifting to some extent.

Then, as new intangibles-intensive industries, such as the electronics and later software industries, developed alongside the pharmaceutical industry, and as tax practitioners developed greater expertise in working with the applicable rules—with the controlled foreign corporation rules of subpart F and the transfer pricing rules—the practice of income shifting to low- and zero-tax countries grew. The introduction in the 1990s of the check the box rules, and of today's cost sharing rules, accelerated the expansion of income shifting. I think it is fair to say that today, the extent of income shifting by U.S.-based companies, to low- and zero-tax countries, extends far beyond what Congress and the Treasury could have envisioned during the 1960s.

I believe as well—and I know some may in all sincerity disagree—that the expansion of income shifting reflects some basic failures of policy-makers in the 1960s to foresee some of the substantive implications of the system they were creating. First, I think that the policy-makers of the 1960s didn't foresee that the courts would hold that the Treasury does not have the power to tax the transfer by a U.S. company of the right to conduct a potentially profitable business outside the United States. That is, I don't think it was foreseen, in the 1960s, that the transfer of a so-called "business opportunity" would be outside the reach of the transfer pricing rules.

When a U.S. company gives a subsidiary the right to try to replicate a proven business model overseas, the parent company has an expectation that the subsidiary probably will succeed in its efforts—that is, the expected return at the time of the transfer is positive. Yes, there is a chance that the subsidiary's efforts will fail, but the overall statistical expectation is that the subsidiary's efforts will succeed, and that the subsidiary will end up generating profits. If that expectation were not present, the company would not make the transfer.

Because of the statistical expectation of success, companies would not transfer business opportunities to unrelated companies without requiring substantial compensation. Our transfer pricing laws, however, do not require U.S. companies to receive arm's length compensation when they transfer business opportunities to related companies. The result is that our transfer pricing laws permit the tax-free transfer of huge amounts of income-generating potential overseas, without a requirement that arm's length consideration be paid.

I think, in addition, that the architects of our international corporate tax system failed to appreciate the consequences of permitting the sourcing of business income to be determined by the terms of contracts, including both contracts for the license of intangibles and other contracts that allocate risks and rights to income, that are made between members of commonly controlled groups. The related companies that are party to such contracts all have precisely the same owners—precisely the same ultimate shareholders. These contracts therefore involve no genuine adverse bargaining and do not apportion risks and rewards in any real economic sense. Market forces impose no discipline on the terms of such contracts; instead, the parties are free to draft such contracts with the sole objective of moving anticipated income to the lowest-tax jurisdiction. Not surprisingly, permitting taxpayers to rely on intragroup contracts for tax purposes has amounted to an open-ended invitation to shift income to low- and zero-tax countries.

I have listed only two central errors that I think policy-makers made in the 1960s, and which have been perpetuated until the present time. More could, I think, be said along these lines, but I am not sure that offering a more detailed bill of particulars right now would be useful.

So I will move on to the question of whether the income shifting which currently occurs inflicts damage that should be redressed as part of tax reform. Again, opinions may differ, but I am personally convinced that the shifting of income under our current tax rules has serious adverse consequences for the United States.

First, it seems apparent to me that the current rules—particularly by allowing the tax-free transfer of business opportunities from the United States—have drained off a large chunk of our corporate tax base. This erosion of the tax base has, I believe, led to chronic shortfalls in revenue collections from the corporate income tax. These shortfalls have in turn contributed to the maintenance of a statutory corporate rate that is much higher than is consistent with adequate levels of corporate investment and employment in the United States. Every tenth of a percentage point in the corporate tax rate directly reduces the expected after tax rate of return from business investment. No other component of the tax system so directly and predictably diminishes incentives for business investment. By tending to push corporate tax rates higher, income shifting discourages investment and employment in this country.

A second economic problem raised by income shifting does not directly involve transfers of property out of the United States, but nevertheless inflicts economic harm on this country. Our current international rules, particularly the rules of subpart F, make it easier for U.S. multinationals to shift, to low- and zero-income countries, income that is earned from manufacturing outside the United States than it is to shift income from manufacturing inside the United States. Ed Kleinbard explains this problem well in his recent writing.[1] The relative ease of shifting foreign-earned, but not U.S.-earned, manufacturing income to low- and zero-tax countries creates an incentive for U.S.-based companies to shift their mix of investment and employment away from the United States.

I am not in a position to know the quantitative significance of this apparent bias toward non-U.S., as opposed to U.S., investment. I am, further, not sure that economic science is capable of measuring the effects of this bias with any degree of confidence. I will say, though, that in practice, I have seen U.S. businesses choose to locate substantial operations overseas rather than here, predominantly for tax reasons. I think this is unfortunate and, indeed, unacceptable.

But the most serious harm from our current international tax rules, I think, is not a tendency to erode the tax base, or to skew investment and employment away from the United States. The most serious harm is not economic at all. The income shifting that I have described is "perfectly legal," as the phrase goes, but the image that it presents to the public—an image that has been made available to the public by leading journalists—is, I think, deeply harmful. The public sees our most important business corporations, and policy-makers in Congress and elsewhere in Washington, colluding, albeit legally, to shift hundreds of billions of dollars of income to mailbox companies in countries where the companies perform little if any business activity. Institutions in our society which should be among the most worthy of respect appear to be engaged in a kind of behavior that typically would be associated with society's least savory actors. This spectacle cannot possibly be failing to contribute to what is already an unhealthy erosion of public respect for governmental and business institutions.

III. THE SHAPE OF COMPREHENSIVE REFORM?

I would like now to sketch out my own very incomplete thoughts about where reform might be headed. These thoughts are intended to reflect what I think are two important principles: (i) that reform, if it is to be effective, needs to involve many different parts of the tax system, not just the corporate income tax; and (ii) that especially given our stressed economy, we need to be mindful of the need to minimize disincentives for investment and employment by U.S. businesses.

In particular, while I believe that the income shifting that is now rampant among U.S. companies causes unacceptable damage to this country, I also believe that income shifting opportunities should not be ended without dramatically reducing the statutory corporate tax rate. To eliminate income shifting without substantially lowering the statutory rate would impose a large additional tax burden increase on many important U.S.-based

1. *See* Edward D. Kleinbard, *Stateless Income's Challenge to Tax Policy*, 132 TAX NOTES 1021 (2011); Martin A. Sullivan, *Economic Analysis: "Stateless Income" Is Key to International Reform*, 131 TAX NOTES 1315 (2011).

corporations, including companies involved in valuable technological innovation. I think this would be very inadvisable.[2]

The combination of international tax reform with a substantial corporate rate reduction, though, will plainly be a net revenue loser. Responsible fiscal policy will, I believe, require us to make up that revenue, and indeed generate additional revenues, from other components of the tax system. This is why we cannot reform our international tax system without a comprehensive reform that extends beyond the corporate tax.

Now, in broad outline, what might a reformed system look like? Well, that's a large question, and I cannot pretend to offer anything even close to a comprehensive answer. In various installments of the column that I write for *Tax Notes*, I have tried to offer a broad list of features that a reformed system might include[3]—although I recognize that there are counterarguments to each of the suggestions that I make.

Specifically, key components of my admittedly far from complete picture of reform include: (i) eliminating income shifting opportunities through a revitalized subpart F, and also probably eliminating other provisions that narrow the corporate tax base; (ii) dramatically reducing the corporate tax rate—I have suggested a rate as low as 15 percent; (iii) the recovery of revenue, and the generation of additional revenue for deficit reduction, through increased rates and some curtailment of deductions for the highest-bracket individual taxpayers; (iv) technical measures to prevent the reduction of the corporate rate from inviting high-bracket individual taxpayers to use corporations as vehicles for tax deferral; and (v) a "superdeduction" for employee compensation paid by businesses that are operated as sole proprietorships or in passthrough form, since these businesses will not benefit from a reduction in corporate rates but should, I think, receive incentives for the creation of jobs.

I am aware that the goal of raising additional revenue through rate increases on individual high-bracket taxpayers poses particular political problems in the current environment. It may well be preferable on some grounds—both political and economic—to raise that revenue through a value added tax (VAT) or another new consumption tax, rather than from the individual income tax. I believe, however, that attempts to institute a

2. The personal skepticism toward corporate income taxation as an institution, which this Article displays, reflects thirty years of work within the corporate tax system during which the defects of the tax have become progressively more evident. For a comprehensive bill of particulars against the corporate income tax, on economic as well as political grounds, see Yariv Brauner, *The Non-Sense Tax: A Reply to New Corporate Income Tax Advocacy,* 2008 MICH. ST. L. REV. 591. Although I do not, alas, consider it desirable, on fiscal grounds and other grounds, to eliminate the corporate tax entirely, I believe that the economic case for minimizing it is overwhelming.

3. Michael C. Durst, *An Employment, Equity, and Competitiveness Tax Act*, 132 TAX NOTES 1435 (2011); Michael C. Durst, *Radical Centrism and the Corporate Income Tax*, 132 TAX NOTES 1059 (2011); Michael C. Durst *Small Businesses, Passthroughs, and Centrist Tax Reform*, 133 TAX NOTES 247 (2011).

new consumption tax are likely to be more problematic, politically, than increased rates on high-income individuals. Further, a new consumption tax might be difficult to implement without adversely affecting the progressivity of the tax system. Moreover, my own admittedly approximate computations suggest that high-bracket rate increases under the individual tax can raise the additional revenues that are needed while still keeping maximum rates very low by historical standards—that is, significantly less than fifty percent. I may be unduly pessimistic about the prospects for a VAT or other consumption tax, and I may be overly optimistic about political prospects for raising additional revenue from the individual income tax. The main point, though, is that effective corporate and international tax reform will cost revenue, and that unavoidably, the lost revenue and more will need to be recovered from other components of the tax system.

IV. SEEKING POLITICAL BALANCE

By coupling the elimination of international income shifting practices with a dramatic decline in the corporate rate, my proposals combine elements that respond to traditional Republican Party concerns, and others that respond to traditional Democratic Party concerns. That mix is important, since I do not think there is any route to comprehensive tax reform that does not involve political tradeoff and political compromise of the traditional kind.

Of course, the short list I have offered provides at best only the barest framework for comprehensive reform. Every item on the list poses significant problems of feasibility and implementation, and every item on the list is likely to be highly problematic to one or more political constituencies. Building an effective reform package will involve a large amount of technical work, as well as political creativity in crafting trade-offs and compromises.

And so we come back to the problem with which these remarks started—namely that right now, the formal legislative process is unable to make much progress toward solving the many problems, especially the problem of political compromise—that comprehensive tax reform presents. Therefore, it is necessary for non-governmental experts, the "government in exile," to move the processes of technical refinement and political compromise forward until the legislative environment opens up once again.

V. TWO SUGGESTIONS

Given the complexity of the task ahead, are there any nuggets of advice that I might offer as finishing touches to this article—as, perhaps the dessert course to the luncheon at which these thoughts originally were presented? Any such attempted nuggets will, of course, reflect my own preconceptions, but with that caution in mind, let me offer two suggestions.

First, because I believe that effective tax reform will require a political willingness to reduce the corporate rate, I think that successful reform will require willingness among some constituencies, which historically have supported relatively high levels of corporate taxation, to reconsider that position. High corporate tax rates are at least as inimical to the interests of American labor as they are to the interests of corporate shareholders and management. I think that a vigorous but self-disciplined public debate, showing the effects of high corporate tax rates on all sectors of our population, could, perhaps more than any other single factor, help make comprehensive tax reform feasible.

A second prerequisite to an effective tax policy debate is that those who hold leadership roles within, and who advocate on behalf of, companies that today benefit from international income shifting opportunities, and from other means of obtaining greatly reduced effective corporate tax rates, refrain from the posture that the status quo is the only acceptable outcome of debate over comprehensive tax reform. Yes, there are many reasons why promoting the status quo might appear to be in the interests of the corporations' shareholders, from a short-term perspective. Tax reform is a risky business, and some companies that now enjoy low effective rates will risk seeing those rates increased. Therefore, there may well be an incentive to try to forestall the entire process of tax reform. This incentive imparts to the tax system its own internally generated tendency toward stasis, in addition to the stasis produced by the broad political logjam that we face today.

In the long and even intermediate terms, though, retention of our tax regime, without fundamental and comprehensive reform, is a recipe for growing economic and even social harm that will hurt everyone. I am not suggesting that those who represent corporate interests refrain from advocating the perceived financial interests of shareholders. But the advocacy of shareholder interests needs to be leavened by a recognition that the well-being of those shareholders depends on the country's overall economic and political well-being.

Now, there may be substantive arguments that our current international tax system, with all its ramifications for the rest of the tax system, is an optimal system, so that tax reform would be counterproductive *per se*. In my own judgment, though, the defects in our current tax rules are glaring, and the harm that those rules cause is serious. I will even go so far as to say, and I know some will disagree, that some attempts to defend the status quo have become so strained, intellectually, as to have lost credibility. I think it important that instead of falling into the trap of arguing for stasis, corporate leadership instead devote its considerable energy and skill toward promoting a re-designed tax system that will promote the country's economic and social well-being far better than the current system.

To sum up, the task of tax reform is, for the moment, stalled, and once restarted it will face substantial obstacles. I am confident, though, that those with expertise in tax policy in this country have the intellectual and technical skills, the commitment to the country's overall well-being, and the impulse toward moderation and constructive interchange that will be needed if viable reform plans are to be devised. Much of the hard work of designing a workable and centrist system can be begun now, so that when the current polarization of the political system moderates, the ideas needed to fashion a viable tax reform will be available.