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Is the Corporate Tax System "Broken"?

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IS THE CORPORATE TAX SYSTEM "BROKEN"?*

Karen C. Burke+

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I. INTRODUCTION

The slated expiration of the Bush Administration's tax cuts in 2010 highlights the instability of the current 15% rate on dividends and capital gains. Meanwhile, pressure has mounted to reduce U.S.

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* *Cf.* Henry M. Paulson, *Our Broken Corporate Tax Code*, WALL ST. J., July 19, 2007, at A15.

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corporate tax rates to improve competitiveness in an increasingly global economy. Much of the 1986 Act reform of the corporate tax—base-broadening combined with lower rates—has unraveled, leaving the United States with a high statutory corporate tax rate and narrow corporate tax base.[1] Despite renewed interest in base-broadening and loophole-closing, the goal of corporate tax reform remains elusive. On one hand, the Administration appears to favor increased expensing of investment as an incremental step toward fundamental tax reform.[2] On the other hand, current legislative proposals would broaden the corporate tax base and reduce the maximum corporate tax rate.[3] Thus far, proponents of corporate tax reform have largely sidestepped the controversial issue of whether the 2003 tax cuts on dividends and capital gains should be made permanent. Given the importance of the relationship between the maximum individual and corporate tax rates, the issue of corporate tax reform cannot be divorced from the issue of whether to extend the 2003 tax cuts and the accompanying revenue and distributional concerns.

Although the direction of corporate tax reform remains uncertain, current proposals should be viewed in light of the overall decline of the corporate tax as well as the strange transformation of the Administration's ill-fated 2003 dividend-exclusion proposal.[4] This article proceeds in three parts. The first part discusses the long-term decline in the role of the corporate tax in raising federal revenues and enhancing progressivity. Part two discusses how the Administration's 2003 proposal to eliminate double-level corporate taxation morphed into an unstable legislative compromise based on tax-rate parity for dividends and capital gains. Part three considers two contrasting alternative goals reflected in current proposals for reform of business taxation: reduced corporate tax rates and enhanced expensing of new

[1] *See, e.g.*, Michael J. Graetz, *Tax Reform Unraveling*, 21 J. ECON. PERSP. 69, 71, 81–82 (2007).

[2] *See generally* OFFICE OF TAX POLICY, U.S. DEP'T OF THE TREASURY, APPROACHES TO IMPROVE THE COMPETITIVENESS OF THE U.S. BUSINESS TAX SYSTEM FOR THE 21ST CENTURY (2007) [hereinafter TREASURY APPROACHES]. The report is a follow-up to the Treasury's conference on competitiveness in July 2007 and its earlier background paper. *See* U.S. DEP'T OF THE TREASURY, TREASURY CONFERENCE ON BUSINESS TAXATION AND GLOBAL COMPETITIVENESS: BACKGROUND PAPER 14 (2007) [hereinafter TREASURY BACKGROUND PAPER].

[3] *See, e.g.*, Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong. § 3001 (2007).

[4] *See generally* Steven A. Bank, *Dividends and Tax Policy in the Long Run*, 2007 U. ILL. L. REV. 533 (2007); Karen C. Burke & Grayson M.P. McCouch, *Turning Slogans Into Tax Policy*, 27 VA. TAX REV. 747 (2008).

investment. The article concludes that 1986-style base-broadening and reduced rates would improve competitiveness and limit tax sheltering opportunities, although a political consensus for such reform will be hard to forge and additional sources of revenue may be required to finance significant rate reductions.

II. DECLINE OF THE CORPORATE TAX

A. Long-Term Decline

Over the last half century, the corporate tax has declined significantly as a source of federal revenue and as a percentage of GDP. While corporate taxes accounted for nearly 30% of total federal revenues and 5.6% of GDP in 1953, by 2003 corporate taxes accounted for 7% of total federal revenues and 1.2% of GDP.[5] The decline of the corporate tax has been accompanied by increased reliance on the individual income and payroll taxes to fund revenue needs. The shrinking role of the corporate tax is the outcome of several factors—most notably, the expansion of S corporations and partnerships, which accounted for 36% of business net income in 2004.[6] The popularity of passthrough entities is attributable largely to the ability to avoid corporate-level taxes while retaining limited liability.[7] Since high-bracket taxpayers receive a disproportionate share of passthrough income, recent reductions in individual income tax rates have significantly benefitted this group of business owners.[8]

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[5] *See* Jane G. Gravelle, *The Corporate Tax: Where Has It Been and Where Is It Going*, 57 NAT'L TAX J. 903, 903–04 (2004). Corporate tax revenues temporarily spiked in 2006, but are expected to settle around 2% of GDP and 9% of total federal revenue. *See id.* at 904; *see also* Alan J. Auerbach, *Why Have Corporate Revenues Declined? Another Look*, 53 CESIFO ECON. STUD. 153, 153–54 (2007). The CBO recently revised downward its estimate of corporate tax revenues as a percentage of GDP. *See* U.S. CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2008 TO 2018, at 92–93 (2008) [hereinafter CBO, BUDGET OUTLOOK] (projecting corporate tax revenue declining to around 1.7% of GDP by 2018).

[6] Between 1980 and 2004, S corporations increased their share of business net income from 1% to 15%, while partnerships increased their share from 3% to 21%; during the same period, the share of sole proprietorships declined from 17% to 14%. *See* TREASURY BACKGROUND PAPER, *supra* note 2, at 14.

[7] Between 1980 and 2004, the noncorporate sector's share of net business income increased from 22% to 50%. *See id.* at 13. In 2004, the 17,500 largest C corporations generated nearly half of business net income and paid 91% of all corporate income taxes. *See id.* at 12.

[8] *See id.* at 16 (estimating that, in 2007, "84 percent of the tax reduction from the top rate reduction will go to flow-through business owners").

Beginning in the 1990's, the corporate tax has also been undermined by the explosion of tax shelters and aggressive tax planning, innovation in financial instruments, and migration of income abroad.[9] These developments give rise to concerns that the corporate tax may no longer serve as a secure and robust source of federal revenue.

B. *Role of Corporate Tax*

The decline of the corporate tax may undermine the progressivity of the tax system overall. While the ultimate incidence of the corporate tax remains hotly contested, traditional analysis generally assumes that the burden is borne by all owners of capital, rather than solely by corporate shareholders.[10] Because aggregate capital ownership is more concentrated among higher-income taxpayers than labor income or consumption, the corporate tax may be viewed as contributing to overall progressivity. The corporate tax would appear even more progressive if the burden were allocated entirely to shareholders, since this group is more affluent than owners of capital as a whole.[11] A recent study suggests that the "dramatic drop in progressivity [since the 1960's] at the upper end of the income distribution is due primarily to a drop in corporate taxes and to a lesser extent estate and gift taxes, both of which fall on capital

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[9] Tax shelter activity is viewed as playing a significant role in the gap between corporate "book" and "tax" income. *See generally* Mihir A. Desai, *The Divergence Between Book Income and Tax Income*, 17 TAX POL'Y AND THE ECON. 169 (James M. Poterba ed., 2003).

[10] For example, the CBO allocates corporate tax liabilities to households in proportion to their shares of capital income. *See* U.S. CONG. BUDGET OFFICE, HISTORICAL EFFECTIVE FEDERAL TAX RATES: 1979 TO 2005, at 3 (2007) [hereinafter CBO, HISTORICAL EFFECTIVE FEDERAL TAX RATES]. For an alternative approach assigning the bulk of the corporate tax burden to labor, see TREASURY APPROACHES, *supra* note 2, at 30–33, 52–53; *see also infra* notes 85–90 and accompanying text.

[11] At the opposite extreme, the corporate tax would appear regressive if the burden were allocated entirely to labor. *See* Thomas Piketty & Emmanuel Saez, *How Progressive is the U.S. Federal Tax System? A Historical and International Perspective*, 21 J. ECON. PERSP. 3, 7–8 (2007) (describing as a "middle-ground assumption" allocation of the corporate tax burden to capital income generally). *See generally* Alan J. Auerbach, *Who Bears the Corporate Tax? A Review of What We Know* (Nat'l Bureau of Econ. Res., Working Paper No. 11686, 2005). For an international perspective, see Mihir A. Desai et al., *Labor and Capital Shares of the Corporate Tax Burden: International Evidence* (2007), *available at* http://www.people.hbs.edu/mdesai/PDFs/Labor%20and%20Capital.pdf (suggesting the corporate tax burden is shared between labor and capital).

income."[12] The 2003 tax cuts have further reduced the total tax burden on corporate-source income.

In addition to raising revenue and enhancing progressivity, the corporate tax may also play an important role in backstopping the individual income tax.[13] Whenever the maximum corporate tax rate is lower than the maximum individual tax rate—as was the case before 1986—individuals can potentially enhance after-tax returns by investing through corporations and deferring realization of accrued gains. To the extent that shareholder-level gains are taxed at preferential rates (or may escape tax altogether if the stock is held until death), the combined burden of the double-level tax may often not be significantly greater than a single-level individual tax levied at ordinary income rates. The 1986 Act lessened the attractiveness of sheltering by raising the maximum corporate tax rate above the maximum individual rate and taxing both dividends and capital gains at ordinary income rates. The restoration of a capital gains preference in the 1990's—and even more significantly the 2003 tax cuts—may render sheltering once again attractive. The problem of sheltering would be exacerbated if, in the future, corporate tax rates are reduced without any corresponding change in dividend and capital gain tax rates. The current preferential 15% rate may also encourage financial engineering and conversion of returns to labor into tax-favored dividends and capital gain, thereby jeopardizing the effectiveness of the overall income tax.

C. Economic Distortions

The existence of a separate corporate tax has long been criticized as causing economic distortions, which are exacerbated to the extent that, for a given level of revenue, corporate tax preferences imply higher corporate tax rates. Significantly, the corporate tax tends to penalize investment in corporate rather than noncorporate form and to favor debt over equity. The Congressional Budget Office has recently estimated that the combined corporate-level and individual-

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[12] Piketty & Saez, *supra* note 11, at 22–23.

[13] *See* MICHAEL J. GRAETZ, 100 MILLION UNNECESSARY RETURNS: A SIMPLE, FAIR, AND COMPETITIVE TAX PLAN FOR THE UNITED STATES 111 (2008) (noting that the "the primary justification for a separate tax on corporate incomes is as a complement to the individual income tax"). Historically, double taxation may be viewed as "the result of the retained earnings problem rather than its cause." Steven A. Bank, *Is Double Taxation a Scapegoat for Declining Dividends? Evidence from History*, 56 TAX L. REV. 463, 532 (2003).

level effective tax rate—the effective total tax rate (ETTR)—on marginal corporate investments is around 26.3%, compared to the statutory maximum rate of 35% on corporate-level income alone.[14] Investment in the noncorporate sector is taxed even more lightly, since the effective tax rate is only around 20.6%.[15] While the ETTR on corporate equity-financed investments is 36.1% (slightly above the 35% statutory rate because of investor-level taxes), the rate on corporate debt-financed investments is actually negative 6.4% (a difference of 42.5 percentage points).[16] Debt-financed investments are subsidized because corporations may deduct accelerated depreciation and the nominal amount of interest (including an inflation premium); the benefit of the corporate deduction is not fully offset by taxes levied on interest recipients who may be lightly taxed (or not taxed at all). Significant differences in the tax burdens across different classes of assets reflect the magnitude of bonuses (or penalties) generated by accelerated depreciation and various investment subsidies.[17] While the 2003 tax cuts may ameliorate the uneven treatment of corporate/noncorporate investments and debt/equity investments, alternative reforms might well have proved less costly and more efficient.

Under a well-designed system of corporate-shareholder integration, all corporate income would be taxed once (and only once) at nonpreferential rates.[18] Under the current system, some corporate

[14] The 26.3% figure reflects a weighted average for a typical mix of debt and equity financing, as calculated by the CBO. *See* U.S. CONG. BUDGET OFFICE, COMPUTING EFFECTIVE TAX RATES ON CAPITAL 46–47 (2006); U.S. CONG. BUDGET OFFICE, TAXING CAPITAL INCOME: EFFECTIVE RATES AND APPROACHES TO REFORM 7, 8 tbl.1 (2005) [hereinafter CBO, TAXING CAPITAL INCOME]. The effective tax rate measures investment incentives based on future cash flows from a hypothetical investment that is assumed to break even (after payment of all taxes). The CBO computed effective tax rates based on the assumption that the 2001 and 2003 changes would be made permanent. *See id.* at 6–7.

[15] *See id.* at 8 tbl.1.

[16] *See id.* Under a fully integrated system, if taxes were imposed only on real economic profits (ignoring inflation), the tax rate on debt-financed investment would be zero, while the tax rate on equity-financed investment would be the statutory rate of 35%.

[17] *See id.* at 10–11 tbl.2. While Congress liberalized expensing in 2001 and 2003, it did not address depreciation allowances, which account for most of the variation across assets. Partial expensing played a significant role in the decline in average corporate tax rates in 2002–2004. *See* CBO, BUDGET OUTLOOK, *supra* note 5, at 95 (noting that average corporate tax rates fell to 15% in 2004 and remained near that level through 2004).

[18] *See generally* Michael J. Graetz & Alvin C. Warren, Jr., *Integration of*

income is taxed twice (both at the corporate and shareholder level), some is taxed only once (at either the corporate or shareholder level), and some is never taxed at all (or taxed only at preferential rates). More than half of all dividends are effectively not taxed at the individual level because they flow to tax-exempt entities, such as pension plans and 401(k)s.[19] While integration is generally perceived as offering potential efficiency gains, the magnitude of such gains would depend crucially upon the manner in which integration is implemented. Such efficiency gains would also need to be balanced against concerns about revenue loss and distributional issues. The revenue cost would be reduced to the extent that integration provided an impetus for serious reform aimed at broadening the corporate tax base and reducing or eliminating corporate tax preferences. While integration itself would tend to make the tax system less progressive, Congress could adjust tax rates to ensure any desired level of progressivity.[20] Indeed, elimination of double taxation of corporate earnings could be combined with taxing capital gains at ordinary-income rates to the extent not attributable to previously taxed corporate income.[21] While such an approach would be broadly progressive and potentially raise revenue,[22] it bears little resemblance to the President Bush's 2003 integration proposal and even less to the legislation enacted.

III. 2003 TAX CUTS: THE FIFTEEN PERCENT SOLUTION

A. Integration Proposal

In early 2003, the Bush Administration introduced a warmed-over version of earlier Treasury proposals for corporate-shareholder

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Corporate and Individual Income Taxes: An Introduction to the Issues, *in* INTEGRATION OF THE U.S. CORPORATE AND INDIVIDUAL INCOME TAXES: THE TREASURY DEPARTMENT AND AMERICAN LAW INSTITUTE REPORTS 3 (Michael J. Graetz & Alvin C. Warren, Jr. eds., 1998).

[19] *See* William G. Gale & Peter R. Orszag, *The Administration's Proposal to Cut Dividend and Capital Gains Taxes*, 98 TAX NOTES 415, 416 (Jan. 20, 2003).

[20] *See* Emil Sunley, *Corporate Integration: An Economic Perspective*, 47 TAX L. REV. 621, 643 (1992).

[21] To the extent that "the most compelling argument for lower capital gains tax rates on corporate stocks is as an offset to double taxation," elimination of double taxation would leave "no good reason to retain a tax preference for capital gains." Leonard E. Burman, *Taxing Capital Income Once*, 98 TAX NOTES 751, 751–52 (Feb. 3, 2003).

[22] *See id.* at 754.

integration.[23] The 2003 proposal was promoted as a temporary stimulus measure that would boost stock market prices, improve corporate governance by encouraging dividend distributions, and eliminate unfairness to investors penalized by double taxation.[24] In addition, the Treasury touted the proposal as an anti-tax shelter measure.[25] Constrained by budget pressures and political crosscurrents, the Administration was unable to realize its ambitious goal of eliminating double taxation. Instead, what emerged from a tortuous legislative process was a temporary reduction in the tax rate on dividends and capital gains, which President Bush signed into law as part of the 2003 Act.[26] Although the 2003 tax cuts were originally slated to expire in 2008, they were subsequently extended until 2010.[27]

The Administration's integration proposal provided for an exclusion at the shareholder level only for dividends paid from income previously taxed at the corporate level; dividends from nontaxed corporate income would have remained taxable as ordinary income.[28]

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[23] The Administration borrowed the substance of its dividend exclusion proposal from a 1992 Treasury Department study. *See* U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2004 REVENUE PROPOSALS 11–22 (2003) [hereinafter FY 2004 REVENUE PROPOSALS]; U.S. DEP'T OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE (1992). For a fuller discussion of the Administration's proposals and their policy implications, see Burke & McCouch, *supra* note 4, at 762–81; Bank, *supra* note 4.

[24] *See* William W. Bratton, *The New Dividend Puzzle*, 93 GEO. L.J. 845, 845 (2005). Critics predicted that the proposal would have little impact on stock prices and would be unlikely to be effective as a stimulus measure; the bulk of any additional dividends would likely end up in the hands of high-income investors who tend to save rather than spend. *See generally* Jane G. Gravelle, *Dividend Tax Relief: Effects on Economic Recovery, Long-Term Growth, and the Stock Market* (Cong. Res. Serv., Report No. RL31824, 2007); *id.* at 2-3 (describing dividend tax relief as "one of the least effective tax cuts for encouraging investment spending").

[25] *See* FY 2004 REVENUE PROPOSALS, *supra* note 23, at 12 (noting that proposal would "reduce incentives for certain types of corporate planning" because "shareholders will be exempt from tax only on distributions of previously taxed corporate income").

[26] *See* Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. 108–27, § 302, 117 Stat. 752 (2003) (amending I.R.C. § 1(h) and reducing maximum rate on dividends and capital gain to 15%). Congress considered but failed to adopt the Administration's original proposals. *See* H.R. 2, 108th Cong. § 201 (2003); S. 2, 108th Cong. § 201 (2003).

[27] *See* Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109–222, § 102, 120 Stat. 345 (2006).

[28] *See* FY 2004 REVENUE PROPOSALS, *supra* note 23, at 13–15 (describing "excludable dividend amount"). To preserve neutrality between distributed and

Thus, in the simplest case where earnings were fully taxed at the corporate level, the Administration's proposal generally achieved parity between distributed and retained earnings and eliminated any shareholder-level tax. If corporate income were fully (or partially) sheltered, however, the proposal did not neutralize the advantage to shareholders of extracting such earnings at preferential capital gain rates. A dividend distribution of fully-sheltered corporate earnings would attract an ordinary-income tax at the shareholder-level, since the dividend would be entirely includible. By contrast, if the same fully-sheltered corporate earnings were distributed in the form of a share repurchase, the distribution would attract a lower capital gain tax, leaving the shareholder with a higher after-tax amount. Since shareholders can extract corporate earnings through stock sales (or nondividend distributions treated as stock sales), the Administration's proposal was thus unlikely to have any significant effect on the tax-minimizing strategy of sheltering, retention, and repurchase.[29]

B. Fifteen Percent Solution

Whatever its merits as a corporate integration measure, the Administration's proposal failed to attract support from any major political constituency.[30] Instead, the proposal met resistance from business groups who saw it as complex, burdensome, and inimical to corporate-level tax preferences. Under pressure from Republican deficit hawks, Senate Finance Chairman Grassley agreed to limit the cost of any tax package in conference to $350 billion—less than half the amount sought by the Administration. Grassley reported a bill that included a pared-down dividend exclusion coupled with several corporate tax offsets. By the narrowest possible margin, a last-minute amendment by Senator Nickles prevailed on the Senate floor, which was far more costly than the modest exclusion in Grassley's original bill. While the Nickles "disappearing dividend exclusion" allowed the

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retained earnings, shareholders would be permitted to increase the basis of their stock to reflect a ratable share of fully-taxed retained earnings. *See id.* at 14 (describing "retained earnings basis adjustment").

[29] *See* Gale & Orszag, *supra* note 19, at 420 (suggesting that "an increase . . . in the effective tax rate on accruing capital gains" would be needed to achieve the Administration's "ostensible goals").

[30] *See* Burke & McCouch, *supra* note 4, at 772–76 (describing morphing of integration proposal in legislative process); Michael Doran, *Legislative Compromise and Tax Transition Policy*, 74 U. CHI. L. REV. 545, 576 (2007) (describing result as a "compromise outcome").

Administration to claim victory of sorts,[31] it was clear that the Administration had lost the support of key business groups who threw their support behind the House bill which abandoned any pretense of integration in favor of a straightforward tax rate cut for dividends and capital gains. The "15% solution" advocated by House Ways and Means Committee Chairman Thomas offered a "politically potent combination of tax cuts that benefited investors without jeopardizing existing corporate tax preferences."[32] In the end, the conference committee followed the House bill; by terminating the tax cuts at the end of 2008, the conferees brought the overall revenue cost down to $350 billion.[33]

C. Unstable Compromise

The legislation that emerged in 2003 is both bizarre and inherently unstable. Congress enacted a 15% rate for dividends regardless of whether such dividends were previously taxed at the corporate level. Simultaneously, in the guise of reducing double taxation of corporate earnings, Congress reduced the rate on all capital gains whether or not such gains are derived from retained earnings.[34] If tax-rate parity for dividends and capital gains were indeed perceived as permanent, it would be necessary to address the underlying premise of corporate tax provisions designed primarily to prevent bailout of corporate earnings at favorable capital gain rates. These anti-bailout provisions no longer serve much, if any, purpose, except potentially to defer recovery of basis. Far from making the tax system simpler and more efficient, the 2003 tax cuts open up fresh opportunities for tax avoidance and invite financial technicians to discover new ways to convert compensation, interest, and other ordinary income into tax-favored dividends.

The Administration's arguments for permanent extension of the 2003 tax cuts ignore the potentially significant differences between the effects of a temporary dividend tax cut and those of a permanent tax

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[31] The Administration's apparent support for the Nickles provision caused consternation even among stalwart supporters. *See* BRUCE BARTLETT, IMPOSTOR: HOW GEORGE W. BUSH BANKRUPTED AMERICA AND BETRAYED THE REAGAN LEGACY 61 (2006) (noting that even supporters were baffled by the Administration's insistence on "making dividends fully tax-free even if only for a single year, in hopes that it could extend the provision in later years").

[32] Burke & McCouch, *supra* note 4, at 774.

[33] *Id.*

[34] *See* Graetz, *supra* note 1, at 84.

cut. A temporary dividend tax cut has the perverse effect of encouraging dividend payouts in anticipation of an expected future rate increase.[35] Thus, for example, if the 2003 dividend tax cut is perceived as temporary, investors have an incentive to withdraw funds from corporate solution while the 15% rate remains in effect and the incentive becomes stronger as it becomes more likely that the 15% rate will be allowed to expire. The sunset provisions, combined with ever-increasing federal budget deficits, create an unstable fiscal situation which may require increases in both dividend and capital gain rates. If future capital gain rates are perceived as likely to rise above the current dividend tax rate, the bias toward current distributions may outweigh the advantages of sheltering, retention, and repurchase. The net result of the 2003 Act would then be to offer shareholders a one-time opportunity to extract corporate earnings on preferential terms with no adequate compensatory corporate-level tax.[36]

The Administration pressed for extension of the 2003 tax cuts based on incomplete and potentially misleading claims that the cuts had unleashed an "unprecedented" surge in dividend payouts, raised stock prices, and stimulated economic growth.[37] In announcing unexpectedly high collections of corporate and individual taxes in its 2006 mid-year review, the Office of Management and Budget credited the 2003 tax cuts with "stimulating and sustaining a strong economy."[38] The 2006 spike in tax revenues reflected the expanding share of pre-tax income going to corporations and wealthy individuals who pay tax at a higher rate than average earners.[39] In fact, any suggestion that the 2003 tax cuts are "paying for themselves" is inherently implausible. Even the Treasury's own dynamic analysis shows that the tax cuts have only modest potential to increase growth over a lengthy period, even assuming drastic spending cuts starting in

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[35] *See* Bank, *supra* note 4, at 573 (noting that in the absence of tax rate parity between current and future distributions, the 2003 Act "offered firms an incentive to distribute dividends currently").

[36] *See* Burke & McCouch, *supra* note 4, at 778–79.

[37] ECONOMIC REPORT OF THE PRESIDENT 76 (2005); ECONOMIC REPORT OF THE PRESIDENT 125–26 (2008); U.S. DEP'T OF THE TREASURY, INVESTING IN AMERICA'S FUTURE 9–10 (2006).

[38] U.S. OFFICE OF MGMT. & BUDGET, MID-SESSION REVIEW: BUDGET OF THE U.S. GOVERNMENT 2, FISCAL YEAR 2007, *available at* http://www.whitehouse.gov/omb/budget/fy2007/pdf/07msr.pdf.

[39] *See* Greg Ip & Deborah Solomon, *As Bigger Piece of Economic Pie Shifts to Wealthiest, U.S. Deficit Heads Downward*, WALL ST. J., July 17, 2007, at A2.

2017.[40] Had the Treasury's dynamic analysis not ignored the impact of debt financing, even these modest potential gains would have disappeared.[41]

Assessing the effectiveness of dividend relief on enhanced investment depends critically upon whether one accepts the "traditional view" or the "new view" of dividend taxation. The Treasury adheres to the traditional view under which dividend relief would lower effective tax rates on corporate investments and strengthen the overall incentive to save and invest.[42] By contrast, under the new view, dividend relief does little to stimulate overall investment and savings; rather than increasing incentives for corporate investment, it produces a windfall gain to existing shareholders by raising stock prices. Both of these views depend upon unsettled assumptions concerning corporate financing and the effect of dividend taxes on marginal investments.[43] To the extent that the old view and new view may be consistent with the behavior of different segments of firms in the economy, the ability of dividend relief to influence overall investment decisions is attenuated.[44] If the 2003 tax cuts are eventually financed through tax increases (rather than spending cuts), they would wind up reducing future growth.[45]

While the long-run economic effects of the 2003 tax cuts may largely depend on offsetting future changes in taxes and spending, investor-level relief clearly skews benefits to upper-income

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[40] *See* OFFICE OF TAX ANALYSIS, U.S. DEP'T OF THE TREASURY, A DYNAMIC ANALYSIS OF PERMANENT EXTENSION OF THE PRESIDENT'S TAX RELIEF 13–14 (2006) [hereinafter TREASURY DYNAMIC ANALYSIS].

[41] *See* William G. Gale & Peter R. Orszag, *An Economic Assessment of Tax Policy in the Bush Administration, 2001–2004*, 45 B.C. L. REV. 1157, 1204 (2004) (noting that even supporters of the 2003 tax cuts acknowledged that efficiency gains were "likely to be small"); Jane G. Gravelle, *Effects of Dividend Relief on Economic Growth, the Stock Market, and Corporate Tax Preferences*, 56 NAT'L TAX J. 653, 667 (2003) (concluding that "long run growth effects [of the dividend exclusion proposal] are negative if it is deficit-financed (and may be negative even if it is not)").

[42] *See* TREASURY DYNAMIC ANALYSIS, *supra* note 40, at 8.

[43] Under the new view, the burden of the corporate tax is assumed to be capitalized in the price of stock, so that lifting dividend taxes represents a windfall to existing shareholders. The new view holds that dividend taxes burden only the relatively small share of corporate investment funded through new shares rather than retained earnings. *See* Alan J. Auerbach & Kevin A. Hassett, *On the Marginal Source of Investment Funds*, 87 J. PUB. ECON. 205, 216 (2003) (noting the new view's prediction that "the level of dividend taxes has no impact on the incentive to invest or pay dividends").

[44] *See* TREASURY DYNAMIC ANALYSIS, *supra* note 40, at 8.

[45] *See id.* at 13–14.

taxpayers.[46] Any modest efficiency gains are outweighed by the regressive nature of the tax cuts and their impact on budget deficits. According to the Joint Committee on Taxation's most recent tax expenditure analysis, preferential rates on dividends and capital gains represent the single largest tax expenditure ($631.9 billion) in the federal budget for fiscal years 2007-2011.[47] The cost of extending the 15% dividend rate alone is over $216.5 billion for fiscal years 2008-2018, while extending the 15% capital gain rate adds another $101.5 billion for fiscal years 2008-2018.[48] Since the share of capital income received by the top 1% has become increasingly concentrated, the lower rates on dividends and capital gains are likely now more regressive than ever.[49] By providing investor-level relief, the Administration arguably chose the most regressive form of reducing the overall corporate tax burden.[50]

IV. OUTLOOK FOR THE FUTURE

Structural reform of business taxation is once again on the

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[46] In 2004, the top 2% of tax returns had 57% of taxable dividends and 79% of taxable capital gains. *See* Jane G. Gravelle, *Distributional Effects of Taxes on Corporate Profits, Investment Income and Estates* 2 (Cong. Res. Serv., Report No. RL32517, 2007). The top .5% of tax returns had 42% of taxable dividends and 65% of taxable capital gains. *See id.* The top 1% of tax returns had 32% of capital income and 11% of labor income. *See id.* at 5 ("[C]apital income taxes contribute to the progressivity of the tax system, even if they are applied at a flat rate (as is essentially the case of the corporate tax).").

[47] *See* STAFF OF JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2007–2011, at 28 (Joint Comm. Print 2007). The tax expenditure exceeds the cost of the exclusion of employer payments for health insurance ($628.5 billion) and the net exclusion of pension contributions and net earnings of employer plans ($607.3 billion) for 2007–2011. *See id.* at 33–34.

[48] *See* STAFF OF JOINT COMM. ON TAXATION, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2009 BUDGET PROPOSAL 311 (Joint Comm. Print 2008). Repeal of the estate tax would cost another $670 billion for fiscal years 2008-2018. *See id.*

[49] The CBO data suggests that nearly one third of the total federal taxes paid by the top 1% of households was attributable to their share of corporate taxes in 2004 and 2005. *See* CBO, HISTORICAL EFFECTIVE FEDERAL TAX RATES, *supra* note 10, at 5. *See id.* at 6 (allocating nearly three fifths of total corporate taxes to the top 1% of households in 2004 and 2005).

[50] Although the two types of reforms may be economically equivalent, a corporate-level tax cut is generally assigned to all owners of capital, whereas an investor-level tax cut is assigned to owners of corporate equity. *See* LEONARD E. BURMAN ET AL., TOWARD A MORE CONSISTENT DISTRIBUTIONAL ANALYSIS 232–33 (2005).

political agenda, driven by two divergent concerns. On one hand, reform of business taxation implicates concerns about tax equity and the search for revenue to offset budget deficits and help pay for reform of the individual income tax and the alternative minimum tax (AMT).[51] On the other hand, there is impetus for cutting business taxes based on concerns about the competitiveness of U.S. firms, particularly in light of rate cuts abroad and shifting of U.S. corporate profits to low-tax countries. While these two crosscurrents could converge around reforms involving base-broadening and rate reductions, the political environment for such reforms is much less favorable than in 1986. Constrained by the goal of revenue neutrality, the 1986 Act reforms were actually aimed at increasing expected revenues from the corporate tax, through lower rates on a broader base, to finance individual tax cuts.[52] Although current opportunities for base-broadening exist, internationalization may impose significant constraints on the use of the corporate tax to raise revenue.[53] Moreover, given the need for additional revenue to fund existing government programs and the expected future burdens imposed by an aging society, the goal of revenue neutrality itself may be unrealistic.

A. Rangel Proposal

Current proposals indicate support across a broad political spectrum for cutting corporate tax rates. While focused principally on AMT relief on the individual side, the omnibus tax bill introduced by House Ways & Means Committee Chairman Rangel in October 2007 would replace the two top corporate tax rates with a single lower rate (30.5%) and allow increased expensing for relatively small

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[51] *See* Graetz, *supra* note 1, at 77 (noting that, under current law, AMT collections will exceed collections from the regular tax by 2010). By contrast, the corporate AMT no longer raises significant revenue and could be eliminated as part of broad-based corporate reform; nevertheless, it would be necessary to address the nearly $30 billion of AMT credits outstanding. *See* TREASURY APPROACHES, *supra* note 2, at 105–06; Curtis P. Carlson, OFFICE OF TAX ANALYSIS PAPER 93: THE CORPORATE ALTERNATIVE MINIMUM TAX—AGGREGATE HISTORICAL TRENDS 2, 7 (2005) (attributing decline of the corporate AMT to changes in the AMT rules in the 1990's and temporary bonus depreciation enacted in 2002).

[52] *See* Graetz, *supra* note 13, at 122 (noting that the 1986 reform was "politically possible" because of the split within the business community between capital-intensive industries, which desired faster depreciation write-offs, and service companies, which benefitted from lower corporate tax rates).

[53] *See* Graetz, *supra* note 1, at 85.

businesses.[54] Taken alone, the corporate tax cuts would result in an estimated revenue loss of $364 billion over the period 2008-2017, but the accompanying package of revenue raisers would result in a slight increase in overall corporate tax revenue.[55] The single largest revenue offset would be repeal of the section 199 deduction, enacted in 2004, which lowers the effective tax rate for certain domestic manufacturing activities.[56] Other revenue raisers include codification of the economic substance doctrine,[57] deferral of deductions associated with foreign-source income that is not currently taxed,[58] and a one-time change in inventory accounting methods. The Rangel bill would also treat net income allocated to a partner as ordinary compensation income if the partnership holds certain types of assets and the partner provides certain types of services.[59]

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[54] *See* Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong. (2007). *See generally* David L. Brumbaugh, *Business Tax Issues in 2007* (Cong. Res. Serv., Report No. RL33890, 2007) (describing Rangel proposal); Jeffrey H. Birnbaum, *Democrat Proposes Overhaul of Taxes: Rangel Would Annul AMT, Shift Burden*, WASH. POST, Oct. 26, 2007, at D01.

[55] *See* Staff of Joint Comm. on Taxation, *Estimated Revenue Effects of Proposals Contained in "The Tax Reduction and Reform Act of 2007," Fiscal Years 2008–2017*, 2007 TNT 209–17 (Oct. 29, 2007).

[56] When fully phased in, the section 199 deduction is equivalent to a rate reduction of 3.15 percentage points, since only 91% of the remaining corporate income is taxed at a 35% rate. *See* I.R.C. § 199(a). Although section 199 proved irresistibly popular in Congress in 2004, it is widely viewed as inordinately complex. *See* TREASURY BACKGROUND PAPER, *supra* note 2, at 8–9 (noting that section 199 requires "a completely new set of accounting distinctions" and forces nearly all taxpayers "to make transfer pricing determinations").

[57] Given the government's recent success in litigating tax shelter cases, the estimated revenue gain ($3.8 billion over ten years) is attributable mainly to penalties associated with codification of the economic substance doctrine.

[58] By contrast, recent legislation has moved in the direction of expanding deferral of income earned overseas. *See generally* Mihir A. Desai & James R. Hines, Jr., *Old Rules and New Realities: Corporate Tax Policy in a Global Setting*, 57 NAT'L TAX J. 937 (2004); TREASURY APPROACHES, *supra* note 2, at 54–65 (considering move toward a territorial tax system that would exempt active income earned by U.S. businesses abroad).

[59] *See* Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong. § 710 (2007). While the "carried interest" provision is broadly applicable, concern about the growth of private equity firms and hedge funds operating in partnership form has prompted proposed legislation that would classify as a corporation any publicly-traded partnership that derives income from asset management or investment advisory services. *See, e.g.*, STAFF OF JOINT COMM. ON TAXATION, PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS AND RELATED ISSUES, 49–50 (Joint Comm. Print 2007). Exempting such entities from

A central difference between the Rangel proposal and the 1986 compromise is that increasing corporate tax revenues is no longer a realistic option available to pay for lower individual rates. Under the Rangel proposal, the maximum individual rate would instead be increased to pay for AMT relief and would significantly exceed the maximum corporate tax rate.[60] If the 2003 tax cuts on dividends and capital gains are allowed to sunset after 2010, the capital gains rate will be restored to 20% and qualified dividends will be taxed at ordinary income rates. While the higher individual income tax rate would reduce the benefits of passthrough treatment for high-income business owners, corporate income would remain subject to potential double taxation. Under the Rangel proposal, the combined shareholder-level and corporate-level tax would depend on the portion of earnings distributed as dividends and the effective capital gain rate on share repurchases.[61] The sharp increase in the dividend tax rate would provide a one-time incentive to bail out corporate earnings immediately prior to the effective date of the rate change. Thereafter, the relatively low tax rate on share repurchases would favor retention over distribution, while the disparity between the maximum corporate tax rate and the maximum individual income tax rate would create shelter opportunities.

To reduce the bias in favor of retention under the Rangel proposal, capital gains could be taxed at the same rate as dividends. Given the ad hoc political compromise that resulted in the 15% rate for both capital gains and dividends, supporters of the 2003 Act may be hard pressed to justify maintaining these low rates, particularly if corporate tax rates are reduced.[62] If the lower maximum corporate tax

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corporate treatment could reduce future corporate tax revenue.

[60] Under the Rangel proposal, the top rate on individuals would be increased to 44.2% (39.6% plus 4.6% surcharge) after 2010. *See* Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong. § 1021 (2007).

[61] If all earnings were distributed as dividends, the maximum combined tax burden would increase from 44.8% under current law to 61.2% after 2010. If all earnings were retained and eventually withdrawn at capital gain rates, the maximum combined tax burden would be somewhat lower than under current law. *See* Tom Neubig & Estelle Dauchy, *Rangel's Business Tax Reforms: Industry Effects by Sector*, 117 TAX NOTES 873, 876 tbl. 3 (Nov. 26, 2007).

[62] Although taxing both capital gains and dividends at ordinary income tax rates would offer the greatest potential for simplification, a possible compromise would be to tax both capital gains and dividends at 25%; thus, the tax rate on capital gains would be increased from 20% to 25% while the tax rate on dividends would be reduced from 39% to 25%. *See* Graetz, *supra* note 13, at 95–96 (noting that "it is not at all clear that any revenue lost by taxing capital gains at 15 percent . . . rather than

rate is aimed at promoting international competitiveness, an argument could be made for limiting the tax benefit to publicly-traded firms that are most likely to compete globally. As a political matter, however, it may be quite difficult to deny the benefit of corporate tax rate cuts to small privately-held firms whose owners seek to avoid higher individual rates on passthrough income.[63] Thus, the Rangel proposal could affect choice-of-entity decisions and revive the issue of whether privately-held firms should be permitted to choose between the single-tax and double-tax systems to minimize taxes.[64]

B. Treasury Approach

During 2007, the Treasury also turned its attention to corporate tax reform. The Treasury's background paper, issued in July 2007, focused primarily on efficiency issues and international comparisons.[65] After the 1986 Act, the maximum U.S. statutory corporate tax rate was among the lowest in the Organisation for Economic Co-operation and Development (OECD); it is now one of the highest, even though U.S. corporate tax collections as a percentage of GDP are less than the OECD average.[66] Many OECD countries have responded to tax competition by reducing corporate tax rates and broadening the corporate tax base. These base-broadening efforts appear generally to have contributed significantly, despite lower rates, to stabilizing the proportion of corporate taxes as a share of GDP.[67] Thus, the simple story of a "race to the bottom" as a result of tax competition for

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say, 20 or 25 percent, is compensated for by increased savings, investment, or economic growth").

[63] If the lower tax rate on business income were available to passthrough entities, there would be a tremendous incentive to convert wages into a distributive share of profits, thereby reducing the tax burden on high-income business owners. *Cf.* TREASURY APPROACHES, *supra* note 2, at 50–51 (carving out business income of passthrough entities for a "special reduced business tax rate as part of the individual income tax"; the special rate would be set equal to the maximum corporate rate).

[64] *See* AM. LAW INST., FEDERAL INCOME TAX PROJECT—TAXATION OF PRIVATE BUSINESS ENTERPRISES: REPORTER'S STUDY 45–47 (1999).

[65] *See* TREASURY BACKGROUND PAPER, *supra* note 2, at 1.

[66] *See id.* at 41 (noting that the U.S. ratio of corporate taxes to revenues (2.2%) is below the OECD average (3.4%)); *id.* at 36 ("Now the United States is once again a high corporate tax rate country.").

[67] *See* Richard J. Vann, *Trends in Company Shareholder Taxation: Single or Double Taxation?*, 88 CAHIERS DE DROIT FISCAL INTERNATIONALE 21, 25–28 (2003); *see also* Martin A. Sullivan, *Economic Analysis: A New Era in Corporate Taxation*, 110 TAX NOTES 440 (Jan. 30, 2006).

increasingly mobile capital may be too simplistic.[68] The U.S. statutory corporate tax rate (adjusted for the section 199 deduction) is virtually identical to the average G-7 rate, and the U.S. and G-7 effective tax rates are also quite close.[69] Thus, the data do not unambiguously support the notion that "the U.S. is a high tax country with respect to investment" or that it would "become so . . . if some reductions occur in the future in other countries."[70] The United States has a relatively low average corporate tax rate (corporate tax divided by corporate profits), suggesting that the United States may have a "higher than average level of corporate tax preferences" and a correspondingly narrow corporate tax base.[71]

If all corporate preferences were abolished, the Treasury background paper concluded, the corporate tax rate could be cut to around 27% or, alternatively, businesses could be allowed to expense roughly two fifths of investment costs.[72] In a subsequent report released in December 2007, the Treasury appeared to veer away from a rate-cutting, base-broadening approach in favor of partial expensing of new investment.[73] The Treasury expressed concern that a revenue-neutral reform might fail to allow a sufficiently dramatic corporate tax rate cut to improve U.S. international competitiveness.[74] By

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[68] *See* James R. Hines, Jr., *Corporate Taxation and International Competition, in* TAXING CORPORATE INCOME IN THE 21ST CENTURY 268, 268 (Alan J. Auerbach et al. eds., 2007) (exploring the puzzle of "why growing international capital mobility has not significantly reduced reliance on corporate income taxation").

[69] Without taking into account the section 199 deduction, the U.S. statutory corporate tax rate is 39% (including state-level taxes), while the G-7 average is 36%. *See* TREASURY BACKGROUND PAPER, *supra* note 2, at 35 tbl. 5.1. The United States has an average equity-financed effective tax rate but a below average debt-financed effective tax rate. *See id.* at 37–38.

[70] Jane G. Gravelle & Thomas L. Hungerford, *Corporate Tax Reform: Issues for Congress* 25 (Cong. Res. Serv., Report No. RL34229, 2007).

[71] TREASURY BACKGROUND PAPER, *supra* note 2, at 41.

[72] *See id.* at 7.

[73] Although the Treasury report does not advocate any specific approach, its quantitative measures suggest that partial expensing would have more significant economic benefits than lower rates on a broader base. *See* TREASURY APPROACHES, *supra* note 2, at ii; Martin A. Sullivan, *Beyond the Conventional Wisdom: Rate Cuts Beat Expensing*, 118 TAX NOTES 456, 458–59 (Jan. 28, 2008); *see also* ECONOMIC REPORT OF THE PRESIDENT 83 (2007) (noting that expensing has more "bang for the buck" than statutory rate reductions).

[74] *See* TREASURY APPROACHES, *supra* note 2, at 44 (broadening the tax base would allow the maximum corporate rate to be reduced to 28%); *see id.* at iii (noting that the United States would still have "the fifth highest tax rate" in the OECD if the corporate tax rate were reduced to 28%). If accelerated depreciation were retained, a

implication, paying for tax rate cuts by broadening the corporate base might reduce or even eliminate any economic gains by increasing the effective tax burden on capital income.[75]

While rate-cutting and base-broadening could be accomplished within the existing hybrid income-tax system, the Administration evidently prefers expensing as an incremental step toward a consumption tax.[76] Unlike the traditional emphasis on neutrality and efficiency through low rates on a broad base, expensing would effectively exempt the return from new investment without providing any benefit for existing investment eligible for depreciation deductions.[77] Thus, the expensing approach focuses on boosting capital formation rather than on enhancing competitiveness and increasing efficiency by narrowing the range of effective tax rates on different types of corporate investment. While suggesting that economic gains could be significantly enhanced by reducing the corporate tax rate even more steeply or moving toward fuller expensing, the Treasury acknowledged that base-broadening alone would not pay for these more ambitious reforms.[78] Thus, the fundamental choice would seem to be between revenue-neutral base-broadening and an overall reduction in the tax burden on business income, regardless of revenue neutrality. Concerns about the Administration's commitment to revenue-neutral reform of business taxes have been fueled by recent claims of a "free lunch" based on behavioral responses to a significantly lower revenue-maximizing

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revenue-neutral reform would permit the U.S. corporate tax rate to be reduced only to 31%, leaving the United States with "the third highest tax rate" in the OECD. *See id.* at ii–iii.

[75] *See id.* at 44 (noting that "repeal of special tax provisions means a higher tax burden" on investments); *id.* (noting that a revenue-neutral reform would likely yield "negligible or small gains").

[76] *See* COUNCIL OF ECONOMIC ADVISERS, EXECUTIVE OFFICE OF THE PRESIDENT, ANNUAL REPORT 80 (2007) [hereinafter CEA ANNUAL REPORT] ("Overall, full expensing . . . is an important step in the transition to a full consumption tax.").

[77] *See id.* Full expensing for new investment would reduce the relative value of existing investment. *See id.* (describing the decline in value as "equivalent to an unavoidable tax on existing capital [which represents] a transition cost of full expensing").

[78] *See* TREASURY APPROACHES, *supra* note 2, at 45 (describing alternatives of reducing the maximum corporate tax rate to 20% or allowing 65% expensing of new investment); *see also* R. Glenn Hubbard, *The Corporate Tax Myth*, WALL ST. J., July 26, 2007, at A13 ("[E]conomically wise base-broadening alone is not likely to finance a significant [corporate tax] rate cut.").

corporate rate.[79]

Since partial expensing may be viewed as an incremental step toward full expensing, it is instructive to consider the 2005 Advisory Panel's tax reform proposals coupling a cash-flow business tax with an add-on 15% tax on individual investment income.[80] The add-on investor-level tax presumably reflects a sound judgment that taxing wages alone is not politically viable. The investor-level tax not only fails to satisfy the consumption-tax goal of eliminating all taxes on capital income, but also creates a significant incentive to shelter investment income in a business.[81] Under the Advisory Panel's approach, businesses would be forced to give up existing depreciation and interest deductions in return for exemption of the normal return on business investments (through immediate expensing), coupled with a 30% business tax levied on risky and supranormal returns.[82] Because transition relief would be extremely costly, the Advisory Panel provided only a five-year phase-out of deductions for depreciation and interest.[83] Thus, taxpayers with heavily debt-financed assets would potentially lose a significant fraction of both interest and depreciation deductions, and no relief would be provided on turnover of current inventories. The Advisory Panel supported its claims of distributional neutrality by modeling the business tax component (essentially a VAT

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[79] *See* Gravelle & Hungerford, *supra* note 70, at 8 ("The issue of a Laffer curve has not been part of the debate [over the corporate tax in the past] because the notion of a revenue-maximizing rate other than at very high rates is inconsistent with most of the models of the corporate tax."). *Compare* Chris Edwards, *Is the U.S. Corporate Tax in the Laffer Zone?*, 117 TAX NOTES 1073 (Dec. 10, 2007) *with* Jane G. Gravelle & Thomas L. Hungerford, *The Corporate Tax Rate: Response to Edwards*, 117 TAX NOTES 1293 (Dec. 24, 2007).

[80] *See* PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 158–164, 182–185 (2005) (discussing the Growth and Investment Tax, a variant of a "flat tax" with a carve-out for wages taxed at the individual level). The Advisory Panel's principal alternative, the so-called "Simplified Income Tax," would exclude 100% of dividends and 75% of capital gains on stock sales. *See id.* at 124–25. The alternative proposal is a political nonstarter, since it would require elimination of deductions for mortgage interest and state and local taxes. *See* Graetz, *supra* note 1, at 87.

[81] *See* PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, *supra* note 80, at 182 (noting that the plan is not a "true consumption tax" because of the add-on investor-level tax). The 15% rate would apply only to investments held outside of tax-exempt savings accounts. *See id.* at 159–60.

[82] *See id.* at 162–64, 172–75; Graetz, *supra* note 1, at 87 (noting that "tax reform along these lines is not a practical alternative").

[83] *See* PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, *supra* note 80, at 172–73.

with a subtraction for wages) "as if it were an income tax" that would fall disproportionately on high-income taxpayers.[84]

Conspicuously absent from the Treasury's initial background paper was any consideration of the distributional implications of corporate tax reform. In its December 2007 report, the Treasury provided two alternative sets of assumptions for the purpose of analyzing distributional effects–one assigning the burden of the corporate tax entirely to owners of capital and the other assigning most of the burden to labor.[85] According to the Treasury, the alternative assumption reflects the "increasingly common view that a substantial portion of the corporate income tax is borne by labor," building on some recent empirical studies concerning the influence of increased international capital mobility and openness of markets.[86] Based on the underlying assumption that any reforms—base-broadening or partial expensing—would be "revenue neutral on capital income" over the budget period, it is hardly surprising that the Treasury found virtually no change in the overall distribution of the federal tax burden, particularly given the small magnitude of the corporate tax and relatively constant shares of different types of

[84] Jane G. Gravelle, *The Advisory Panel's Tax Reform Proposals* 7–8 (Cong. Res. Serv., Report No. RL 33545, 2006); PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, *supra* note 80, at 175 (claiming plan would "largely preserv[e]" the existing distribution of the tax burden). *See id.* at 185–86. Replacing the corporate tax with a subtraction-method VAT (along the lines of the Advisory Panel's proposal or the Treasury's "business activities tax") would appear less regressive if the burden of the corporate tax falls substantially on labor rather than solely on owners of capital. *See* TREASURY APPROACHES, *supra* note 2, at 32–33.

[85] *See* TREASURY APPROACHES, *supra* note 2, at 52–53 (allocating 70% of the corporate tax burden to labor under alternative assumption); *see also* CEA ANNUAL REPORT, *supra* note 76, at 82 (2007) ("In the long run, labor bears most of the burden of the corporate tax."); *see also* Hubbard, *supra* note 78. Under an open-economy model, the burden of the corporate tax could be shifted to labor because, while capital may migrate abroad, labor is less mobile; the assumptions necessary for this outcome, however, are quite narrow. *See infra* note 90 and accompanying text.

[86] TREASURY APPROACHES, *supra* note 2, at 52. *See id.* at 31–33 (describing recent empirical research on the relationship between cross-border variations in corporate taxes and wages). *Cf.* Gravelle & Hungerford, *supra* note 70, at 29–30 (noting that recent cross-country studies purporting to show that the burden of the corporate tax falls mainly on labor "yield unreasonable results" and "suffer from econometric flaws"); WILLIAM W. GENTRY, OFFICE OF TAX ANALYSIS PAPER 101: A REVIEW OF THE EVIDENCE ON THE INCIDENCE OF THE CORPORATE INCOME TAX 15 (2007) (noting that "theoretical models suggest the estimated effects [of recent cross-country studies] are implausibly large," but that "the evidence suggests rethinking the common assumption that capital bears all of the corporate income tax").

capital income within each income class.[87] By contrast, even if a significant portion of the corporate tax is assigned to labor, cutting corporate taxes in isolation would be distinctly regressive based on changes in after-tax income.[88]

The Treasury's assumption that the bulk of the corporate tax burden is borne by labor is inconsistent with the claim that the 2003 tax cuts on dividends and capital gains were needed to eliminate unfairness to investors penalized by the double tax. Depending on controversial assumptions concerning the responsiveness of savings to tax incentives,[89] it may be relatively easy to portray the burden of any tax on capital (including the corporate tax or the estate tax) as reducing capital formation and hence falling mainly on labor, regardless of whether the economy is assumed to be open or closed.[90] While the notion that the corporate tax is progressive, even if distortionary, has come under increasing challenge recently, the Treasury's revisionist incidence analysis should presumably be viewed mainly from the perspective of politics rather than economics. If past reform efforts are any guide, there will undoubtedly be considerable political pressure to skew the incidence analysis to support competing claims concerning the progressivity or regressivity of alternative

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[87] TREASURY APPROACHES, *supra* note 2, at 53.

[88] According to one recent study, more than half of the benefit of a $50 billion annual reduction in corporate taxes would flow to the top 1% of households if the corporate tax is borne entirely by owners of capital, while about one third of the benefit would flow to the top 1% of households if the corporate tax is borne equally by labor and owners of capital. *See* AVIVA ARON-DINE, CENTER ON BUDGET AND POLICY PRIORITIES: WELL-DESIGNED, FISCALLY RESPONSIBLE CORPORATE TAX REFORM COULD BENEFIT THE ECONOMY 14 (2008).

[89] While the 2004 Economic Report of the President clearly relies on savings effects for the argument that capital income taxes fall mainly on labor, the 2007 Economic Report of the President "simply asserts, without reference to theory or empirical evidence, the view that the corporate income tax burden falls on labor through savings effects." Gravelle, *supra* note 46, at 13; *see id.* at 6 n.3.

[90] *See* Jane G. Gravelle & Kent A. Smetters, *Does the Open Economy Assumption Really Mean That Labor Bears the Burden of a Capital Income Tax?*, 6 ADVANCES IN ECON. ANALYSIS & POL'Y 1, 33 (2006). Recent experience suggests that countries tend to follow each other in reducing corporate taxes, in which case "the closed-economy model is the right one to use." Arnold C. Harberger, *Corporate Tax Incidence: Reflections on What is Known, Unknown, and Unknowable*, *in* FUNDAMENTAL TAX REFORM: ISSUES, CHOICES, AND IMPLICATIONS 284, 301–302 (John W. Diamond & George R. Zodrow eds., 2008); *see id.* at 301 (suggesting that "the choice between an open and a closed economy is a matter of *scenarios*, not of reality").

reforms.[91] Indeed, the distributional impact of the 1986 reforms and the 1993 increase in the maximum corporate rate from 34% to 35% would look quite different if labor were assumed to bear most of the burden of the corporate tax. Moreover, a corporate tax cut that is not accompanied by significant base broadening would ultimately need to be paid for by increasing taxes or reducing spending. Thus, the distributional effect of reducing the corporate tax rate cannot be assessed without knowing how such a rate cut would ultimately be financed.[92]

C. Superiority of Rate Cuts and Base-Broadening

In very general terms, the Rangel proposal and the Treasury reports suggest two competing options for corporate tax reform: if existing corporate preferences are cut back, the revenue gain could be used to reduce corporate tax rates or, alternatively, to provide enhanced expensing of new investment. In terms of both equity and efficiency, rate-cutting combined with base-broadening along the lines of the 1986 Act may be viewed as the preferable approach. While the current high statutory rates are quite distortionary, the U.S. corporate tax raises comparatively little revenue. Lowering the corporate tax rate would reduce the bias in favor of debt financing, investment in noncorporate form, and shifting of corporate profits to low-tax jurisdictions.[93] Moreover, lowering the corporate tax rate would discourage corporate tax shelters, thereby helping to finance rate cuts and prevent further erosion of the corporate tax base. As the European experience suggests, rate-cutting and base-broadening may be the best means of preserving the corporate income tax as a significant source of revenue.

By contrast, partial expensing without disallowing interest deductions would invite massive sheltering that would undermine both the individual and corporate tax bases. Allowing both expensing and deductibility of interest would yield negative tax rates and encourage debt-financed investments that would be uneconomic

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[91] *See* Gravelle & Smetters, *supra* note 90, at 1 (noting that the Joint Committee on Taxation "avoided the incidence controversy altogether by ignoring the corporate tax in its distributional analysis" of the 1986 Act).

[92] *See* ARON-DINE, *supra* note 88, at 15 (concluding that low and middle-income households would be hurt most if a corporate rate reduction were paid for by splitting the financing cost equally among all households).

[93] *See* TREASURY APPROACHES, *supra* note 2, at 43.

before taking taxes into account.[94] While expensing would exempt the normal return from investment, a lower corporate tax rate would reduce the burden on all corporate income, including supranormal returns from risk-taking and innovation.[95] Expensing would have little effect on cross-border income-shifting, while lower corporate tax rates would help to attract and retain highly profitable investments by multinational corporations.[96] Indeed, the business community's preference for lower corporate tax rates rather than enhanced expensing may help to explain its tepid response to the 2005 Advisory Panel's report.[97] Given revenue constraints, the Treasury's expensing approach would likely be politically unacceptable without limitations on deductibility of interest on corporate debt. Thus, the business community may perceive that the realistic choice is between lower corporate tax rates coupled with continued deductibility of interest, on the one hand, and expensing combined with disallowance of interest deductions, on the other hand. Although expensing of investment would provide a timing benefit, this immediate advantage could be more than offset by higher deferred tax liabilities if corporate tax rates were increased in the future.[98]

The Treasury's suggestion that "a larger [corporate] tax rate reduction or greater partial expensing" could move the United States

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[94] *See* CBO, TAXING CAPITAL INCOME, *supra* note 14, at 10–11 (explaining that introducing expensing without simultaneously eliminating interest deductions could lead to negative effective tax rates of as high as 87.5% on debt-financed business investments). Nevertheless, the Treasury considered that partial expensing would likely not give rise to distortions sufficient "to warrant a substantial change in the tax treatment of interest." TREASURY APPROACHES, *supra* note 2, at 49 n.67.

[95] *See* ECONOMIC REPORT OF THE PRESIDENT 135 (2008) ("In contrast to expensing, a corporate tax rate cut lowers the tax on both normal and supra-normal returns.").

[96] *See* TREASURY APPROACHES, *supra* note 2, at 43 (noting that a lower rate would make the United States "a more attractive place in which to invest"); *id.* at 44 (noting that, unlike a rate cut, "partial expensing . . . [would not] reduce the tax disincentive to repatriating foreign earnings").

[97] *See generally* Graetz, *supra* note 1, at 87 (noting that "U.S. businesses will not relish giving up their interest deductions in exchange for immediate expensing of investments"); Tom Neubig, *Where's the Applause? Why Most Corporations Prefer a Lower Rate*, 111 TAX NOTES 483 (Apr. 24, 2006). Because most intangibles are already written off immediately, many businesses would derive no additional benefit from more liberal expensing; moreover, businesses that expect supranormal returns should generally prefer lower rates to exemption of the risk-free portion of investment returns.

[98] The assumption that expensing would exempt the normal investment return is subject to the important caveat that tax rates remain constant.

"from its current position as a high-tax rate country to a low-tax rate country" suggests a painless solution that ignores the need for tradeoffs and revenue concerns.[99] If the lobbying surrounding the 2003 tax cuts provides any lesson, it seems highly unrealistic to expect that business would be willing to give up all existing tax preferences in return for an across-the-board rate cut.[100] Given revenue constraints, business tax reform will inevitably create both winners and losers. While there is clearly much room for base-broadening, it may be necessary to secure additional sources of revenue to help finance a significant reduction in corporate tax rates. Thus, corporate tax reform might well provide another reason for introducing a low-rate VAT, thereby reducing reliance on the individual income tax and corporate tax and aligning the mix of U.S. taxes more closely to that of other OECD countries.[101] Given the demonstrated workability of the VAT around the world, the United States should consider a low-rate VAT to supplement the existing corporate tax.[102] Retaining the existing corporate tax alongside a low-rate VAT would avoid the need to address a host of difficult and costly transition issues that would arise if the existing corporate tax were replaced with a cash-flow business tax.

There is a risk that the Administration's slogan of increased corporate competitiveness may be used as a pretext for providing additional tax cuts for high-income investors and business owners. Echoing the notion that labor already bears most of the burden of the

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[99] TREASURY APPROACHES, *supra* note 2, at 45. The Treasury's focus on high statutory rates ignores the fact that the United States has a relatively narrow corporate tax base.

[100] The initial reaction to the Treasury's 2007 conference on competitiveness was that it was "not possible or realistic" to eliminate the tax preferences on the Treasury's hit list. Heidi Glenn, *Business Leaders Would Give Up Tax Breaks for Lower Rates*, 116 TAX NOTES 324, 327 (July 30, 2007) (quoting Michael J. Boskin); Joanne M. Weiner, *U.S. Corporate Tax Reform: All Talk, No Action,* 116 TAX NOTES 716 (Aug. 27, 2007).

[101] *See* TREASURY APPROACHES, *supra* note 2, at 14 (noting that the United States "relies less heavily on general consumption taxes . . . than all other OECD countries" and is "the only OECD country without a VAT"); Graetz, *supra* note 13, at 124–25 (suggesting that a low-level VAT would be essential to permit a reduction in the corporate tax rate to 15–20%).

[102] *See* Graetz, *supra* note 13, at 200–03 (proposing mix of taxes that would include a low-level VAT as well as reformed corporate and estate taxes); *id.* at 82 (cautioning against "American exceptionalism" in tax reform). While the Treasury considered replacing the U.S. corporate tax with a consumption-type "business activities tax," there is no reason for the United States to invent novel forms of consumption taxation. *See* TREASURY APPROACHES, *supra* note 2, at 19–42.

corporate income tax, Glenn Hubbard, the former chairman of the Council of Economic Advisors, has suggested recently that "workers collectively would be better off if they voted for higher taxes on labor with corresponding cuts in the corporate tax."[103] Although the underlying assumption may be that the benefits of lower corporate tax rates and increased after-tax profits would trickle down to U.S. workers, there is no guarantee that such a result would occur. In assessing the realistic prospects of any business tax reform, it is important to recognize that a robust corporate tax apparently remains politically popular; indeed, the underlying uncertainty about who bears the corporate tax burden "contributes to the public view that the tax is probably paid by someone else."[104] Eliminating the regressive 2003 tax cuts on dividends and capital gains would help to pay for a modest reduction in corporate tax rates. In terms of business tax reform, there appears to be an emerging consensus that rate-cutting combined with base-broadening may be a more important goal than corporate integration.[105]

V. CONCLUSION

By cutting dividend taxes without ensuring that corporate earnings would be fully taxed, the Bush Administration "gave the carrot away" and squandered its best opportunity for achieving corporate-shareholder integration.[106] Although the 2003 tax cuts were defended in terms of providing investor-level relief and eliminating the unfairness of the double tax, current proposals would reduce the tax burden at the corporate level. Shareholder-level relief cannot be

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[103] Hubbard, *supra* note 78.

[104] Graetz, *supra* note 13, at 110.

[105] Under the new view of dividends, the benefits of corporate-shareholder integration are less significant than under the old view. *See* CBO, TAXING CAPITAL INCOME, *supra* note 14, at 36 ("In essence, the double taxation of income derived from corporate equity creates less of a distortion under the new view, so integration would accomplish less."). In response to nondiscrimination concerns, many European countries have recently adopted a partial-dividend exclusion approach in lieu of full or partial shareholder credits for corporate taxes previously paid. *See* Michael J. Graetz & Alvin C. Warren, *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 YALE L.J. 1186, 1208–12 (2006).

[106] Gale & Orszag, *supra* note 41, at 1230 (noting that the dividend tax cut "undermines the political viability of true corporate tax reform" because it fails to "combine the carrot of addressing the 'double taxation' of dividends with the stick of closing corporate loopholes and preferential tax provisions, to ensure that corporate income is taxed once and only once—but at least once").

divorced from reform of the corporate-level tax. Lower corporate tax rates would lessen the economic gains from integration of corporate and shareholder taxes, further undermining the argument for extending the 2003 tax cuts. Allowing the 2003 tax cuts to sunset would not only allow greater flexibility in reducing corporate tax rates but would also curtail a costly and regressive windfall and help pay for lower corporate tax rates. Since individual income tax rates may significantly exceed the maximum corporate tax rate in the future, there would be greater need to prevent use of corporations to shelter individual income taxed at higher rates.

The Administration's piecemeal approach to business taxation does not move in the direction of a well-designed consumption tax. Enhanced expensing combined with continued deductibility of interest would provide a strong incentive to use corporate debt financing and open new tax shelter opportunities.[107] Noncorporate business owners would have an incentive to use debt financing not only to eliminate investment income but also to reduce taxes on compensation. If the withering of the corporate tax is to be halted, 1986-style reform that combines the carrot of rate-cutting with the stick of base-broadening seems to offer the most promising approach. The United States would do well to follow the example of its major competitors which have broadened their corporate tax bases and lowered their corporate tax rates, thereby enhancing competitiveness and preserving the corporate tax as a source of revenue. More substantial reduction of the corporate tax rate may require additional revenue sources such as a low-rate VAT that would also help to finance other needed reforms, including reform of the AMT. In an era of escalating and intractable budget deficits, reducing corporate tax rates without replacing the lost revenue is no longer a realistic option.

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[107] For an alternative corporate tax reform that would eliminate the debt-equity distinction, see generally EDWARD D. KLEINBARD, REHABILITATING THE BUSINESS INCOME TAX (2007) (proposing "business enterprise income tax" (BEIT) that would allow cost of capital allowance and depreciation deductions). *See also* Alvin C. Warren, *The Business Enterprise Income Tax: A First Appraisal*, 118 TAX NOTES 921 (Feb. 25, 2008). By taxing supranormal returns at the corporate level and normal returns at the investor level, the BEIT potentially offers an attractive model of corporate-shareholder integration. *See generally* Daniel N. Shaviro, *Why the BEIT Proposal Shouldn't Be Discounted*," 118 TAX NOTES 1048 (Mar. 3, 2008).