Five Must-Haves (and Five Nice-to-Haves) for Pro-Growth Corporate Tax Reform

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Properly done, corporate tax reform will increase domestic investment, productivity, innovation, and competitiveness of U.S. traded-sector industries.

The inauguration of a Republican president and Republican majorities in the U.S. Senate and House of Representatives make the next two years the most promising time for corporate tax reform in decades. Both the new president and the congressional leaders are supportive, listing it as one of the top three priorities for this year. Much of the groundwork on educating members and developing alternative policies has already been done. But what would a pro-growth, pro-innovation, and pro-competitiveness reform bill look like? What components are absolutely necessary as opposed to being preferable? This report provides the Information Technology and Innovation Foundation's (ITIF's) take on those questions.

ITIF believes that any bill emerging from Congress must include the following components in order to successfully boost innovation, productivity, and competitiveness:

1. A substantially lower corporate statutory rate.
2. A maximum rate on foreign profits of 15 percent, with credit for foreign taxes and the elimination of deferred taxes on foreign profits.
3. An enhanced research and development tax credit.
4. An innovation box.
5. Strong incentives for capital investment.

Congress should pass any tax reform that contains these provisions.

INTRODUCTION

Corporate tax reform is one of the most important actions Congress can take to boost economic growth over the next two decades and beyond.[1] Properly done, reform will increase domestic investment, productivity, innovation, and the competitiveness of U.S. traded-sector industries.

Tax reform is also long overdue. The last significant overhaul of taxes occurred in 1986, over three decades ago. Since then, world markets have become much more competitive: foreign markets are more important; international agreements have reduced trade barriers; capital is more mobile; and supply chains are global in scope. Partly in response, most countries have modified their corporate tax laws by lowering the statutory and effective rates and boosting or creating incentives, such as the research and development tax credit and the innovation box. The United States is long overdue in responding to these challenges.

Almost all observers agree that the current tax code is badly flawed. It imposes significant compliance costs on business and encourages global companies to move their headquarters overseas. Companies remaining in the United States face a strong incentive to keep foreign profits overseas rather than giving them back to shareholders or investing in the United States. Although the U.S. statutory rate was once one of the lower rates among developed countries, it is now the highest in the Organization for Economic Cooperation and Development, and the effective tax rate is also high.[2] Finally, a morass of different sections and regulations makes tax law complex and often rewards unproductive behavior.

Although the need for reform is clear, there are important reasons why tax reform has not happened yet. To start, significant differences exist both between the two parties and within them on what reform should look like. The sheer complexity of the tax code also makes it difficult for members of Congress and the public to understand the implication of each provision. And each provision, no matter its merits, benefits an interest group, and that group is likely to apply tremendous pressure to preserve it. Even companies that support the general idea of reform may devote most of their lobbying efforts to protect those provisions that benefit them most or oppose the ones that hurt them.

Moreover, the tax debate will not unfold a political vacuum; it will occur alongside myriad other legislative challenges also facing Congress, which could slow or stall its progress. Consider that President Obama came into office in 2009 with three legislative priorities: health care, financial reform, and climate change. The first two were not signed until the second year of his administration, and each barely passed on highly partisan votes. The third failed to emerge from Congress at all. This year tax reform must compete with health care and infrastructure, among other major issues, for congressional attention and floor time.

Against this backdrop, it will be helpful to focus on the key components that any tax reform must have in order to be successful. Other provisions, while beneficial, are not critical. By concentrating on the key components, Congress and the administration can conceivably speed the process of achieving consensus and avoid letting less-critical proposals bog down, or derail, the process.

MUST-HAVES

There are a number of "must-have" components of corporate tax reform that should be part of any final bill that President Trump signs.

Must-Have #1: A Lower Statutory Rate

When the 1986 Tax Reform Act lowered America's top statutory rate from 50 to 35 percent (39 percent when state taxes are included), the new rate was well under the average of other OECD countries.[3] Since then, most other countries have lowered their statutory rates, some substantially, in order to increase their competitiveness. As a result, the United States now has the highest statutory rate among both developed and OECD countries.[4] For example, Germany, the United Kingdom, and Canada all have substantially lower rates than the United States (30 percent, 20 percent, and 27 percent, respectively).[5]

Tax reform should lower the statutory rate to at least 25 percent, preferably to 20 percent, because a lower statutory rate reduces many of the other distortions in the tax code, including the burden of having a worldwide system. However, it also reduces the marginal effect of beneficial provisions such as bonus depreciation—because when tax rates get lower, there is less economic benefit in being able to further reduce taxable income or defer payments. Lawmakers therefore need to maintain the relative incentives of these programs by increasing their provisions.

Must-Have #2: Moving to a Territorial System and Eliminating Deferral

The vast majority of our competitors do not apply their corporate tax rate to foreign profits earned by their national companies. This levels the playing field between their domestic companies and foreign ones in overseas markets. In contrast, because the 35 percent U.S. federal rate applies to their global profits, American companies pay a much higher total tax than foreign companies when they sell into foreign markets. Moving toward a territorial system that only taxes domestic income would remove this disadvantage. Meanwhile, any added incentive for U.S. companies to relocate to foreign countries (by not having to pay the higher U.S. rate on those earnings) would be reduced by the lower statutory rate.

Few countries adopt a pure territorial system, however. As such, the United States should keep existing rules that treat pure investment income similarly to domestic income in order to reduce any incentive to send liquid investments abroad. Second, it makes sense for the United States to continue to tax foreign profits, but at a much lower rate, say 10 or 15 percent. Provided that companies retain the ability to subtract the foreign taxes they pay in each country from their U.S. liability, the minimum tax would only matter in the case of tax havens. In countries with higher taxes, the foreign tax credit would wipe out any U.S. liability. A minimum tax would therefore reduce the competitive advantage these countries now hold. Indeed, if other nations adopted similar policies, such tax havens would lose their economic reason for existing.

Under current law, foreign earnings are not subject to U.S. tax until they are formally brought back to the United States. Although this minimizes the competitive burden imposed by our worldwide system, it gives companies a strong disincentive to bring the money back and use it to pay dividends to shareholders or invest in America. Presently, an estimated $2.4 trillion of past profits remains abroad, much of this held by global, high-tech companies.[6] If the United States moves toward a territorial system, this ability to defer U.S. tax until the income is brought back into the country makes little sense.

Tax reform should also deal with the large amount of deferred earnings held abroad by imposing a one-time deemed repatriation of past profits. These funds would immediately be subject to ideally a much lower tax rate of 8 to 12 percent, whether or not they are brought back. In addition to a large amount of tax revenues, deemed repatriation would result in hundreds of billions of dollars being brought back to the United States and eliminate any incentive to keep past earnings abroad, either now or in the future.

Must-Have #3: An Enhanced Research and Development Credit

Many of the special provisions in the current tax code have little impact on social welfare. Some even reduce it. It makes sense to eliminate as many of these as possible and use the extra revenues to reduce the statutory rate. In some cases, however, tax expenditures improve social welfare by addressing serious market failures. One of these is the research and experimentation tax credit (also known as the R&D tax credit).

R&D is a key driver of the U.S. economy, as establishments in the United States, including in "traditional" industries, specialize more in innovation than they do in many other nations. However, economic research shows that companies are unable to capture the full benefit of their research and development.[7] A large portion of it escapes to benefit the broader economy. As a result, companies underinvest in research, reducing U.S. innovation, productivity, and competitiveness. The research and development tax credit for research they perform above a baseline is designed to remedy this failure. The Obama administration estimated that every dollar given back by the R&D tax credit resulted in an additional $2 of research. It estimated the social value of a dollar of this research at between $2 and $3.[8]

There are two credits, the regular and the alternative simplified credit. The regular credit gives companies a tax credit equal to 20 percent of their "qualified research expenditures" (QRE) in excess of a base amount. The simplified version gives a credit of 14 percent of QREs above 50 percent of average QREs for the past three years. Congress took a major step toward tax reform when the Protecting Americans from Tax Hikes (PATH) Act of 2015 made permanent a modified version of both credits In light of the fact that both versions of the credit fix a market failure while making the U.S. economy more competitive, any corporate tax reform package must, at a minimum, not weaken either version of the credit, and ideally should expand the Alternative Simplified Credit to at least 20 percent. This is especially important, since at least 26 other countries offer more generous credits.[9]

Must-Have #4: An Innovation Box

The research and development tax credit rewards companies for prospective research. However, it still subjects earnings from innovative activity to the high statutory rate. A lower rate would give companies a greater incentive to commercialize research. It is also important because the high statutory tax rate especially hurts firms that compete globally and gives U.S. firms a strong incentive to shift profits overseas. Inherent measurement problems and complicated transfer pricing rules make profits from intellectual property especially mobile. In order to attract more of these profits, many countries have instituted some sort of patent or innovation box that taxes qualifying profits at a much lower rate.[10] By insisting that companies perform much of the research or production in their country in order to qualify for the lower rate, countries also hope to lure more of the innovation-related economic activity to their shores.

Innovation boxes have attracted the attention of both House and Senate leaders. The attractiveness of such a box is closely linked to the statutory rate. Especially if tax reform is unable to lower the federal statutory rate below 20 percent, lawmakers should implement an innovation box that subjects the profits from innovative activity such as patents, royalties, and research to a much lower rate. The amount of income that qualifies for the lower rate should depend on the proportion of research and production done in the United States.[11]

As Congress considers new measures like the innovation box, lawmakers also should consider other incentives to spur more innovation, growth, and competiveness. For example, one challenge that many R&D-intensive startups face is that they cannot fully utilize the R&D credit, nor the net operating loss carry forward provisions because they are many years from profitability. For example, reforming Section 382 of the net operating loss rule to allow the losses by smaller R&D intensive startups to be used by a company they merge with or are acquired by would spur more innovation.

Must-Have #5: Enhanced Depreciation

Corporate tax liability does not match a company's cash flow. Although companies often spend hundreds of millions of dollars on new plants and equipment, they do not get to deduct these costs from their revenue immediately. Instead they are forced to write off the investment based on a somewhat arbitrary depreciation schedule. The result is increased risk and lower investment. Reduced corporate investment has been a major cause of slow growth over the last decade.[12] Since productivity boosts real incomes (either by increasing wages or by lowering prices), and capital increases worker productivity, then less investment also means slower per-capita income gains.

The tax code already contains several provisions allowing companies to write off their investments at a faster pace. The two main ones are Section 179 expensing and bonus depreciation. Section 179 allows smaller companies to immediately deduct up to $500,000 of qualifying property. The amount is reduced dollar for dollar once the investment in qualifying property exceeds $2 million. Bonus depreciation allows a company to deduct 50 percent of the adjusted basis of qualified property in the first year. The PATH Act made the $500,000 limit of Section 179 permanent and indexed it for inflation. It also extended bonus depreciation through 2019, although at reduced rates. Tax reform ideally should move to first year expensing, as discussed below. But at minimum, it should eliminate the $2 million threshold under Section 179 because it unfairly penalizes large companies. It should also make bonus depreciation permanent at the 50 percent level. Under these changes, every company would be able to expense the first $500,000 of investment as well as 50 percent of any remaining investment in the first year of service, which would encourage greater domestic investment and faster growth.

NICE-TO-HAVES

Tax reform involves a host of other complex issues in addition to the ones listed above. Some of these are important to the industries that benefit from them. But they are less important to the nation as a whole than the changes listed above. Nevertheless, there is a real danger that disagreements over a host of other items could prevent a majority of legislators from reaching agreement. Although many of these items are important, they should not be allowed to jeopardize the reform effort.

Nice-to-Have #1: Individual Tax Reform

Ideally, Congress would reform both individual and corporate taxes. But the consensus on the Hill seems to be that combined reform is too heavy a lift right now. Most efforts have been focused on reforming corporate taxes first, with the hope of turning to individual tax reform in a later Congress. In keeping with the admonishment not to let the perfect become the enemy of the good, such a division makes sense.

The poor prospects for individual reform have created opposition from small businesses who fear that lower corporate taxes will disadvantage them. As a result of the high corporate tax rate and flexible rules regarding organizational form, almost half of business income is now earned by pass-through entities in which income is taxed only once, at the individual level. The owners of these businesses claim that lowering the corporate rate will put small businesses at a disadvantage. These claims are false, mainly because pass-throughs will still only be taxed at the individual level, whereas corporate shareholders will also have to pay the corporate tax.[13] Moreover, as numerous studies and reports have shown, most small, non-C-corporations are currently favored by the tax code, so they pay significantly lower effective rates than larger, C corporations.[14] IRS data for active C and S corporations shows that in 2013 the total income tax paid as a share of total net income was 18.2 percent for corporations with more than $250 million in sales, but just 4.6 percent for firms with less than $5 million in sales.[15]

A number of proposals have tried to integrate the individual and corporate tax, largely by giving either giving corporations a deduction for dividends paid or giving shareholders a credit for any taxes paid at the firm level.[16] Starting in 2003, tax law attempted to deal with this by taxing dividends at a lower rate, currently 20 percent. This simply encouraged companies to pay dividends, rather than reinvest in growth-enhancing activities.[17] House

Republicans and the Trump administration would deal with this problem by extending lower corporate tax rates to pass-through entities.[18] However, unless this is accompanied by getting rid of the slew of special tax breaks for small firms, it will simply continue the already tilted tax playing field in favor of small firms, which as a group are much less productive and innovative than large firms. Moreover, solving this nation's problems will almost certainly require higher, not lower, taxes on Americans, especially those in the top tax bracket, through higher marginal rates and taxing capital gains and dividends as regular income. Trying to reconcile the individual and corporate sides in a way that gives the wealthy a tax break would do little or nothing to spur growth, but would likely derail the process of corporate tax reform. Thus, if individual tax reform is included in any package, it should lead to higher rates and more revenue, especially for top earners, not lower and less.

Nice-to-Have #2: A Lower Effective Corporate Rate

Most policymakers also believe that tax reform should be revenue neutral. To be sure the nation faces a serious long-term budget and debt problem that will require both increased taxes on individuals and entitlement reform (especially raising the retirement age for Social Security and Medicare) to solve. Revenue neutrality of overall tax reform (corporate and individual) is therefore important, but with a few caveats. First, congressional leadership has already mandated that budget estimates of tax reform include the dynamic effects of higher economic growth. These effects can be significant for corporate reform (although not for individual tax reform). Second, ITIF believes that, while budget neutrality is important, creating economic growth is even more important. Moreover, the gross amount of debt is less important than its ratio to national income or GDP. Any policies (spending or tax) that effectively spur productivity growth should be enacted even if they increase the budget deficit. Third, any neutrality should be across the corporate and individual code, with less revenue coming from the corporate side and more from the individual side.

In addition, shifting the burden of taxes from innovative and internationally traded industries onto domestic ones that do not face global competition is likely to increase competitiveness and growth. Stronger economic growth and a more globally competitive tax code require a reduction in the effective tax rate these kinds of firms pay. This is one reason why policies such as the R&D credit and the innovation box are so important to complement statutory rate reduction. Simply reducing the statutory rate without reducing the effective rate, particularly on traded and innovation-based sectors, will do little to spur growth or improve competitiveness. Indeed, depending on how the lower rate is paid for, it could harm growth (e.g., if the R&D credit is eliminated) and competitiveness (if the domestic production deduction, section 199, is eliminated). This is why ITIF encourages Congress to lower the statutory corporate rate while maintaining or creating incentives that support innovation and competitiveness.

Nice-to-Have #3: Border Adjustability

During the summer of 2016, House Republicans released the outlines of a comprehensive approach to corporate tax reform.[19] A key part of their proposal involves a borderadjustable tax. Under the House plan, the profits from overseas sales would not be taxed. In contrast, imports would be taxed, either by subjecting importers to an immediate tax or by denying companies a deduction for the cost of foreign inputs. Border adjustability is a key component of the value-added taxes that most U.S. competitors employ to boost their competitiveness.

Border adjustment boosts exports and reduces imports, although some of this effect will be offset by a rise in the exchange rate. It also reduces incentives for U.S. companies to go abroad in search of a lower tax rate. Although border adjustability has the above merits, it represents a major departure from current practice and may have been introduced too late to be part of the current round of reform.

Nice-to-Have #4: Immediate Expensing

The House proposal would also shift the corporate tax from an accounting to a cash basis. As a result, companies would be allowed to deduct the full cost of any investments immediately. Immediate expensing would have a significant effect on the after-tax cost of capital investment and promote more investment and productivity growth. However, lower rates and permanent bonus depreciation would also spur investment, although not as much as full expensing, or even better, an investment tax credit. While immediate expensing would be desirable, the pursuit of a pure cash system should not be allowed to jeopardize passage of a strong reform bill.

Nice-to-Have #5: Interest Deductibility

A third component of the House plan is the elimination of interest deductibility. Under current law, corporations can deduct interest payments as a cost of doing business. One of the political attractions of the House plan is that it raises a significant amount of revenue, which can then be used to lower the statutory rate. Another is that it addresses the current incentive to finance investment with debt rather than equity. Because companies can deduct interest payments but not dividends to shareholders, the marginal tax rate for debt is significantly lower than that for equity.[20]

Eliminating deductibility would have a significant negative impact on many capital-intensive industries, however. It also violates the basic principal that if a payment is taxed as income for the recipient, it should normally be treated as a deductible expense for the payer. It would be better to eliminate the discrepancy between debt and equity by allowing companies to deduct dividends, thereby eliminating the double taxation of income at both the corporate and individual level.[21] However, the problem with this is that it costs more money, requiring either offsets elsewhere or a lower corporate rate reduction. In any case, a significantly lower statutory rate once again reduces the saliency of this argument because the economic cost of losing a deduction falls with the tax rate. Therefore, disagreements on the treatment of interest should not be allowed to hold up the broader reform effort.

CONCLUSION

It is easy to underestimate the job before Congress. It must carve sufficient time for hearings and floor debate out of a crowded schedule that is always vulnerable to unexpected events. It must educate staff and members about a vast array of complicated tax provisions and push them toward a consensus that can pass both chambers and get the president's approval. And it must do all of this in the face of fierce lobbying from virtually every major industry and major company in America, including the small business lobby, and from many progressives who will reflexively oppose lower taxes on corporations.

In order to succeed, members need to concentrate on the relatively few criteria identified above that will have the greatest effect on economic growth and innovation. Leaders need to push the hardest for consensus on these items and then move quickly toward compromises on other issues.

ENDNOTES

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ERRATA

This report has been updated to correct an error on page 6: IRS data for active C and S corporations shows that in 2013 the total income tax paid as a share of total *net income*—not as a share of total *receipts*—was 18.2 percent for corporations with more than $250 million in sales, but just 4.6 percent for firms with less than $5 million in sales.

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ABOUT ITIF

The Information Technology and Innovation Foundation (ITIF) is a nonprofit, nonpartisan research and educational institute focusing on the intersection of technological innovation and public policy. Recognized as one of the world's leading science and technology think tanks, ITIF's mission is to formulate and promote policy solutions that accelerate innovation and boost productivity to spur growth, opportunity, and progress.

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