Submission for the Record

House Ways and Means Committee Hearing on the Need for Comprehensive Tax Reform to Help American Companies Compete in the Global Market and Create Jobs for American Workers

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While the recent attention to the effects of the U.S. tax system on competitiveness, as exemplified by this hearing, has been heartening, the discussion still tends to suffer from political rhetoric that obscures the real issues. I appreciate the opportunity to submit this document in an effort to stimulate greater clarity.

Loopholes and Policy Choices

The U.S. tax system reflects a number of policy choices that were consciously intended to promote the success of American industry. In a time of fiscal crisis it is appropriate to examine the costs and benefits of those choices, but this should be done explicitly and with clear analysis. One bad political habit that has gotten out of hand is the labeling of such choices as "loopholes". A loophole, by definition, is not a policy choice, but rather is an unintended technical flaw in the law that allows policy to be undermined. A recent example of this abuse of language occurred in the 2010 discussion leading to the enactment of new § 901(m) of the Internal Revenue Code.

Congress has long permitted American companies to acquire foreign businesses and step up the tax basis of their assets, either through an election under § 338 for a corporation or an election under §754 for a partnership. This provided American companies with an advantage over foreign rivals. To take an example, say that an American company buys a foreign corporation for $100, and that corporation has zero tax basis in its assets and produces $100 of pretax earnings. If it is in a jurisdiction with a 25% tax rate, the country of operation will impose a tax of $25 on that income. If the acquirer had been a foreign company based in a territorial tax jurisdiction (as almost all foreign rivals are today), it would have paid the $100, received $75 after tax, and would receive no home-country benefit. It would not choose to make such a purchase. The American company, on the other hand, can make a § 338 election to step up the amortizable basis of the target's assets to $100. For U.S. tax purposes, then, there would be $100 of amortization to offset the $100 of pretax earnings, so the net U.S. tax would be zero. So far, this puts it on a par with its foreign rival – the target company has $100 of earnings reduced by $25 of local tax, with no residual tax imposed by the acquirer's home country. However, U.S. law used to then permit the acquirer's group to take a credit for the $25 of local tax against other foreign income, effectively neutralizing that foreign tax. The American company, then, could pay $100 and receive $100 of earnings after tax. It could economically acquire the target, and so it would beat out its foreign competitors in going after that growth opportunity.

Why would the United States offer its corporations such a subsidy? Because large multinational groups have large U.S. headquarters that produce a gratifyingly large number of high-paying American jobs, and

American groups tend to prefer American providers of services and other suppliers. The dominance of U.S.-based service firms, like the dominance of English as the language of international business, has been driven by the ability of American companies to grab opportunities that were unattractive to foreign competitors. This subsidy had a cost. The Joint Committee scored its elimination at $400 million a year. Prior Congresses thought was an acceptable price for ensuring that Americans were the global alpha hunters of the business world. A clear discussion on that cost-benefit analysis would have been interesting.

Instead, what we had was the branding of this hunter's subsidy as a "loophole," as though it was an unforeseen and secretive consequence of sections 338 and 754 that prior Congresses had been too ignorant to spot. Corporations, already demonized in the press, were not eager to stand up as the defender of a provision that was being held out to the public as an abuse rather than as a known and approved effort to preserve American primacy. Thus, it went away, and American companies lost their acquisition edge. Was that the best way to save $400 million a year, an amount that is rounding error relative to the hundreds of billions spent on artificial economic stimulus? We never had the side-by-side comparison of alternative economic expenditures that would tell us. We had labels and spin.

My point here is not to advocate restoration of that particular provision, but rather to discourage further displays of obscuring rhetoric that would prevent this Congress from engaging in the cool and logical analytics that would enable us to find the best ways to spend our limited funds and the least-bad ways to obtain our needed revenues. Let's examine one sacred cow as an example.

The Best Way to Encourage Investment?

Special low tax rates on capital gains and dividends are viewed as an important subsidy for encouraging business investment. Certainly, someone with cash to invest will be more eager to do so when he has the prospect of earning very-low-tax income. The political tendency, however, is to go from this truism to broad insinuations that anyone who suggests a re-examination of the wisdom of special capital gains rates is anti-business, anti-success, and likely a socialist leech. Let's instead line up the benefits of low capital gains rates side by side with other possible investment stimuli with a similar revenue cost. What do we see?

What fraction of investments do capital gains rates stimulate? It is a fact that there are a lot of Americans with more money than they could easily spend on consumables. The top 0.2% of the population, individually and collectively, has an extraordinary amount of money – that fraction receives 1/6th of all the individual pretax income in America. Will they take all that money and put it under a mattress if they might suffer ordinary tax rates on it? Not likely. They will keep their money at work earning those extraordinary sums for them. For them, capital gains rates influence how they invest their money, distorting the decisions they would make and encouraging them NOT to pursue the best pretax investment available, which is not a good thing. Capital gains rates will only increase investment within a band where people with cash are unsure whether they prefer to invest that cash for the future or spend it on consumption now. It would be interesting to know exactly how much money falls within that

band. I would guess that it is not a huge amount. Further, it seems unclear at the moment that having those people invest rather than spend is necessarily a good thing. We need consumer spending.

What kinds of investments do capital gains rates stimulate? To begin with, there is no tax difference between gain on a holding in a foreign company operating entirely abroad and a gain on a U.S. company operating 100% right here in the U.S.A. Moreover, individual investments in the shares of foreign companies, unlike investments by American companies in foreign subsidiaries (which do NOT, of course, benefit from special capital gains rates), do not generate American headquarters, services, or supply jobs, or any of the secondary and tertiary jobs that depend on the spending from those jobs. So, a large amount of the subsidy to capital gains flows abroad and provides no benefit to the American people. Of the remainder, quite a bit goes to people who do not create companies and jobs, but rather engage in destabilizing speculation. That group benefits when the economy bounces around, without regard to the underlying health of the economy. Then there are investments we like, investments in American start-up companies with a new idea that may be part of America's future. Do we need to subsidize all capital gains just to encourage this group? It's a rational question to ask.

Are there alternative subsidies that we could provide within a market context that would better stimulate the things we care most about, American business operations and high-paying American jobs? So far we don't seem to be doing a very good job of looking for them. There is discussion of broadening the base of business taxation while lowering corporate tax rates. Lowering corporate tax rates is clearly a helpful thing, but the Reagan-era formula that sort of worked back then is not so attractive in the 21st century. Now we are starting from behind, with a high corporate tax rate and a much less dominant global position than we used to have. Reasonable base-broadening measures within the purely business context will not provide enough revenue to lower rates to a point that would make America an attractive investment location – we would just become less bad. Less bad is better than more bad, but Americans used to have higher aspirations than that. Lowering corporate rates without lowering individual rates will increase corporate earnings lock-in, create distortions and stimulate sheltering activity. Lowering both corporate and individual rates would be very expensive when we are already in an economic hole. So, what else can we do? I offer just a few points as an example.

1) As a start, we should admit that it is possible to lower corporate effective rates through allowance of a full or partial dividends-paid deduction, rather than a decrease in the actual rates. This mechanism reduces the net revenue loss, since the corporation only gets a benefit when it pays out a dividend to someone who gets taxed on it. With the appropriate collateral actions, we could afford to take the effective corporate rate to zero without creating a distortion between corporate income and flow-through income, making America the best place on the planet for corporations to place their high-value operations and jobs. It would also solve all of the problems that have been troubling Congress regarding the taxation of the foreign operations of American companies. This would create great pressure on corporations to pay out their income as dividends and then have to convince investors to give it back. That could be viewed as good (economically efficient and pro-transparency and accountability) or bad (corporations would not like the loss of their ability to be lazy). Further, the reduction in the revenue loss would be only partial absent adjustments on the shareholder side. Currently, all

dividends are lightly taxed, and a large fraction of dividends flows to non-taxable parties or lightly-taxed foreign investors, which brings us to point 2.

2) We should admit that we can make policy choices on the treatment of dividend recipients. We can get rid of special tax rates on dividends and capital gains (at least on equity). If we don't want middle-class workers to get a net benefit from the reduction of corporate tax imposed with respect to the shares they hold in their IRAs and other retirement accounts, we can impose a withholding tax – or we can decide that we want them to have that benefit and make up the revenue elsewhere. We can choose to have a difficult discussion with our foreign treaty partners and boost withholding taxes to make up, in whole or in part, for the benefit of the dividends-paid deduction. All of these are choices, with pluses and minuses, which need to be rationally considered.
3) If we grant a full dividends-paid deduction, we can make other choices. Granting such a deduction would be the equivalent, in terms of foreign income, of having a territorial tax system (because the residual U.S. tax on *all* income, including the foreign income, could be eliminated at the corporate level.) The OECD treaty model allows countries a choice between granting foreign tax credits or just not imposing tax on the foreign income. So, with a dividends-paid deduction and some difficult conversations, we could also make that choice – perhaps choosing to switch to a foreign tax deduction and thus increasing the dividend pay-outs and further reducing the revenue loss. This is NOT a choice absent granting a full dividends-paid deduction, if we want to live up to our treaty obligations.
4) We could admit that it is possible to impose a progressive VAT, if the VAT is used to replace FICA taxes and provide an equivalent subsidy to retirees. Such a VAT would only have a net impact on people who earn more than the FICA limit or who earn their money other than through work. It would thus be an alternative to raising income taxes on upper-income people, if one truly prefers consumption taxes. It could also be used to replace state and local sales taxes, getting rid of local distortions and administrative nightmares. That is a choice. It should be rationally considered and discussed.

There are other policy choices available that are not currently receiving serious discussion. I hope that this Committee will take the lead in engaging in serious, rhetoric-free, analytical discussion to find the best policy choices for the American people.