Corporate Tax Reform in Theory and in Politics

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Martin Sullivan, Corporate Tax Reform: Taxing Profits in the 21st Century (Apress, 2011).

To find out what is going on with corporate tax reform, read Martin Sullivan. Read his columns, and read his book, *Corporate Tax Reform: Taxing Profits in the 21st Century* . Read him because he squarely tackles the interaction of theory and politics in the area of tax policy.

Academic theories of legislative process make more sense in context. Daniel Shaviro's analysis of the 1980's individual base-broadening, rate-lowering reform package is a case in point. In the area of corporate tax reform, scholars have worked with the understanding, developed for example by William Eskridge, Philip Frickey and Elizabeth Garrett, that the U.S. legislative process favors the status quo. Against this backdrop, Jennifer Arlen and Deborah Weiss argue that agency costs further hamper reform because managers favor policies like accelerated depreciation that provide targeted incentives for new corporate investment, even though shareholders prefer policies that also enrich existing investment. Michael Doran builds on the Arlen and Weiss analysis with a public choice account of heterogeneity of interests among different corporations. The result, he argues, is an incentive for corporations that disproportionately benefit from a certain tax break, for example the research and development credit, to lobby energetically to keep that tax break rather than supporting more general reform proposals like base-broadening and rate-lowering.

Corporate Tax Reform and Sullivan's related columns connect academic theories about corporate income tax reform to the political morass facing current corporate income tax reform proposals. Like Doran, Sullivan emphasizes heterogeneity of interests. It is possible to identify three broad factions in corporate tax reform: global U.S.-parented multinational corporations, domestic incorporated businesses, and domestic unincorporated businesses. And within each faction, there are significant differences in specific interests. In his book, Sullivan devotes two chapters and an appendix to corporate tax expenditures, which are one main source of the differences between and within factions.

As Sullivan explains in two other chapters, the call for business tax reform is prompted in part by the fact that the existing system permits U.S. parent corporations to defer paying U.S. income tax on significant chunks of income allocated to non-U.S. subsidiaries and to instead allocate that income to low- or zero-tax jurisdictions. Edward Kleinbard and J. Clifton Fleming, Robert Peroni and Stephen Shay have described this phenomenon in separate articles. Harry Grubert's work shows that the average effective foreign tax rate on non-U.S. income earned by U.S. parented multinational corporations dropped to 16% in 2004 compared to about 21% in 1996 and that U.S. policy changes such as the 1997 promulgation of the "check-the-box" entity classification rules correlate with increased ability to shift profits offshore for tax purposes. Media reports about Google and other corporations have highlighted egregious examples of corporations with dramatically low rates of tax on non-U.S. income, further pushing international corporate tax reform to the forefront.

One leading idea, put forth for example by House Ways and Means Chairman Dave Camp in 2011, is to join the worldwide trend and establish a "territorial" corporate income tax system which would exempt non-U.S. business income from U.S. tax. The Camp proposal would exempt 95% of foreign-source dividends from tax, thus approaching a 0% rate of tax on non-U.S. income. It would lower the top U.S. corporate income tax rate statutory rate from 35% to 25%, which happens to be the OECD average. And it would eliminate business tax breaks like accelerated depreciation, the research credit, the domestic production activities deduction, and last-in, first-out accounting. On each of these points – territoriality, rate lowering, and base broadening – Sullivan observes on-the-ground politics that

comport with Doran's balkanized interest group predictions in the area of corporate tax reform.

Territoriality. Territoriality adoption could increase or decrease the effective tax burden on global multinationals, depending on the rules allocating income and deduction items between U.S. and non-U.S. as well as business and non-business categories. Sullivan's observations bear out Doran's prediction of the interest group reaction to this tension. Specifically, he reports that global U.S.-parented multinationals, gathered under the umbrella of the "WIN" America campaign, are focused less on the overall corporate tax rate, and more on the move to a territorial system and on the details of income and deduction allocation rules within such a system. WIN coalition members include Cisco, Google and Pfizer. Although Sullivan suggests that members of this group may have congruent interests, writing that a territoriality proposal "must be devoid of any significant expense allocation, thin capitalization, and anti-deferral rules to get the support of this group," one wonders whether subgroups within the group value different territoriality sweeteners differently.

Lower Rate. As Sullivan tells it, members of the competing "RATE" Coalition, including domestically-focused corporations like Ford, Macy's and UPS, are more concerned with the reduction of the top corporate rate than their WIN coalition counterparts. Yet he also explains that within the RATE coalition there exist disparate lobbying interests used to focusing on different tax breaks. For example, LIFO accounting disproportionately benefits oil companies; while accelerated depreciation, the research credit and the domestic production activities deduction benefit the "manufacturing and technology sectors," but not "retailers, wholesalers and financial corporations."

Base Broadening. Sullivan has also considered targeted small business tax breaks. This raises a third element of the business tax reform debate — the tension between the interests of incorporated and unincorporated businesses. Unincorporated businesses would suffer from the repeal of tax breaks like accelerated depreciation, but would not benefit from reduced maximum statutory corporate income tax rates. Stephen Shay has recently pointed this out. The status quo advantage provided by the legislative process favors the interests of unincorporated businesses. But here, too, there is the question of balkanization within the faction. Will a desire to maintain the advantage of the domestic production activities deduction motivate small U.S. manufacturers to focus energy on avoiding the repeal of that provision rather than joining a larger group whose goal is to block reform legislation entirely?

Theories and histories about political process and tax reform are important in part because they may increase understanding of current reform debates. But such an understanding requires information about the specific political factions and subfactions relevant to a particular issue. In *Corporate Tax Reform* and related columns, Sullivan provides just this information.

Sullivan sees revenue-neutral business tax reform that accomplishes the goal of rate reduction as a remote possibility. But he also has a deep understanding of the contours of the interaction among business tax reform interest coalitions and the degree to which balkanization within these factions may trump their broader interests. Look to Martin Sullivan's existing and future work to provide the connection between theory and politics on this important and developing issue.

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