



THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM: AN UPDATE

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The President’s Framework for Business Tax Reform: An Update

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Introduction

America's system of business taxation is in need of reform. The United States has a relatively narrow corporate tax base compared to other countries—a tax base reduced by loopholes, tax expenditures, and tax planning. The resulting system distorts choices, such as where to produce, what to invest in, how to finance a business, and what business form to use. And it does too little to encourage job creation and investment in the United States while allowing firms to benefit from incentives to locate production and shift profits overseas. The system is also too complicated—especially for America's small businesses.

In 2012, the White House and the Treasury Department released *The President's Framework for Business Tax Reform*, outlining the need for reform of the business tax system and presenting the five elements of reform as envisioned by the President: eliminating loopholes and subsidies to broaden the base and lower the rate, strengthening American manufacturing and innovation, strengthening the international tax system, simplifying and cutting taxes for America's small businesses, and restoring fiscal responsibility without adding to the deficit. Since then, Members of Congress from both parties have put forward thoughtful tax reform proposals, including former House Ways and Means Committee Chairman Dave Camp and former Senate Finance Committee Chairman Max Baucus. Last year, a number of Senate Finance Committee working groups continued the reform effort, releasing a set of reports on different topics in tax reform. While the Administration does not agree with every component of these proposals, all of these efforts have underscored the need for and the urgency of business tax reform and advanced the discussion in meaningful ways.

The urgency of closing loopholes and reforming the tax system more broadly has grown since the *Framework* was released in 2012. Particularly notable is the recent wave of corporate inversions, transactions in which a U.S. corporation shifts its legal residence abroad to be deemed a foreign company for U.S. tax purposes, even as it frequently keeps management and business operations here. The Congressional Research Service identified 23 inversions since 2012, compared to only three in total in 2010 and 2011. In September 2014, the Treasury took action to limit companies' ability to undertake these transactions and reduce the economic benefits of inversions, a step that observers have credited with slowing the pace of inversions, and followed up with further steps in November 2015 and April 2016. However, a complete solution to the problem requires Congressional action. The President's Budget has proposed to stop corporate inversions and shut down a key strategy inverted firms use to shift taxable income outside the United States, but Congress has failed to act on these proposals. As a result, inversions continue to erode the U.S. tax base unnecessarily.

While inversions are a particularly prominent symptom of a broken tax system, and one that should be addressed immediately even absent broader business tax reform, the issues run much deeper. Even without changing the address on their tax returns, corporations can shift profits to low-tax countries in order to reduce their worldwide tax liability. Academic research suggests that the cost of profit shifting has increased substantially in recent years and may now cost the United States more than \$100 billion per year in foregone tax revenue. The global importance of this issue is highlighted by the successful development of comprehensive recommendations to address base erosion and profit shifting (BEPS) by the OECD BEPS Project, which were approved by the G-20 nations in November.

In the face of these challenges, inaction is not an option. The combination of the relatively high U.S. corporate rate and our complicated system for taxing multinational businesses has encouraged and

facilitated the erosion of the tax base. It also has made America a less attractive place to start and grow an international business, and complicated and distorted business decisions. Unwarranted tax preferences continue to narrow the tax base, requiring higher tax rates than would otherwise be necessary and encouraging investments in less-productive activities. Our high corporate tax rate, combined with other structural features of the tax code, penalizes traditional “C corporations” relative to other business forms and results in a significant tax advantage for financing investments using debt rather than equity, which, in turn, imposes broader economic costs from bankruptcy and financial fragility. Tax expenditures that benefit one industry over another, or one type of investment over another, encourage firms to seek out investments that receive preferential tax treatment but do not necessarily result in higher economic or social returns.

Reform should not only eliminate undesirable incentives; it should also provide incentives to support economic activities that benefit the broader economy. For this reason, policies to strengthen innovation, clean energy, and manufacturing, in addition to supporting America’s small businesses, are important components of the President’s approach to business tax reform. This agenda includes an expanded and simplified tax credit for research activities, enhanced provisions allowing small firms to write off more of the cost of new investments, and tax credits to support investments in clean energy. In December 2015, Congress enacted several important pieces of this agenda, including making permanent the Research and Experimentation (R&E) tax credit for the first time since its initial enactment in the early 1980s, enhancing incentives for small business investment, and extending tax credits for renewable energy production and investments in clean energy technology. However, while these steps reflect significant improvements in the law, the hard work of tax reform remains to be done. Moreover, in enacting these policies Congress did not offset their cost as it should have, increasing the importance of restoring fiscal responsibility to the tax reform effort. Consistent with the President’s long-standing principle that business tax reform must be revenue neutral in the long run, reform should be fully paid for, including paying for those provisions that have already been enacted.

This update reviews the need for reform of the U.S. business tax system and the key elements of the President’s Framework. In addition, it details the specific proposals the President has put forward, including a comprehensive approach to reforming the international tax system.

PRESIDENT OBAMA'S FIVE ELEMENTS OF BUSINESS TAX REFORM

- I. **Eliminate dozens of tax loopholes and subsidies, broaden the base, and cut the corporate tax rate to spur growth in America:** The Framework would eliminate dozens of different tax expenditures and fundamentally reform the business tax base to reduce distortions that hurt productivity and growth. It would reinvest these savings to lower the corporate tax rate to 28 percent, putting the United States in line with major competitor countries and encouraging greater investment in America.
- II. **Strengthen American innovation, clean energy, and manufacturing:** The Framework would expand incentives for research and development and clean energy while also refocusing the manufacturing deduction.
- III. **Strengthen the international tax system, including establishing a new minimum tax on foreign earnings to encourage domestic investment:** Our tax system should not give companies an incentive to locate production overseas or engage in accounting games to shift profits abroad, eroding the U.S. tax base. Introducing a 19 percent minimum tax on foreign earnings would help address profit shifting and discourage a global race to the bottom in tax rates.
- IV. **Simplify and cut taxes for America's small businesses:** Tax reform should make tax filing simpler for small businesses and entrepreneurs so that they can focus on growing their businesses rather than filling out tax returns.
- V. **Restore fiscal responsibility and not add a dime to the deficit:** Business tax reform should be fully paid for, which includes paying for provisions Congress has already enacted without offsets.

I. The Need for Reform

The U.S. corporate income tax combines the highest statutory rate among advanced economies with a base narrowed by loopholes, tax expenditures, and tax planning strategies. In addition to the corporate income tax, the United States operates a second, parallel system of business taxation for pass-through entities—businesses whose earnings are taxed on the owners' income tax returns rather than a separate entity-level return. The U.S. business tax system allows some companies to avoid significant tax liability, while others pay tax at a high rate. It distorts important economic decisions about where to produce, how to finance investments, and what industries and assets to invest in. The system also is too complicated, and that complexity hurts America's small businesses and allows large corporations to reduce their tax liability by shifting profits around the globe.

The current business tax system reduces productivity, output, and wages through its impact on the location of production and allocation of profits, the means of financing new investments, and the

allocation of investment across assets and industries.¹ The high statutory rate and complicated rules for taxing income in different countries can discourage firms from locating highly profitable investments in the United States. Reduced investment in turn reduces U.S. productivity and output. Loopholes that allow multinational firms to shift profits to low-tax jurisdictions abroad require higher taxes on domestic businesses and families to make up for the lost revenue. The significant tax preference for debt encourages excessive borrowing, which in turn increases bankruptcy costs and financial fragility, and thus reduces macroeconomic stability. Tax expenditures that privilege certain industries and assets encourage investment in low-return, lightly-taxed projects while high-return, but more heavily-taxed, projects are ignored.

The distortions caused by the U.S. corporate tax system are magnified by the relatively high statutory tax rate. The higher the tax rate, the more a firm benefits by claiming a special deduction, reducing its taxable income by increasing borrowing, or using aggressive strategies to shift profits offshore. Income shifting has also grown worse as the wedge between the U.S. statutory rate and rates in other countries has widened, and the absence of reform has left strategies used to shift income untouched.

Focusing exclusively on the U.S. statutory corporate tax rate, however, does not give a complete picture of how the tax code affects decision-making and the competitiveness of the U.S. economy and U.S. firms in world markets. Other indicators tell a more complete story. For example, the effective marginal tax rate on corporate investment in the United States—the expected tax rate on a hypothetical new investment—is slightly below the average for the G-7 (see Table 1).²

Table 1: G-7 Statutory Corporate Tax Rates (in Percent), 2015

Country	Statutory Corporate Tax Rate (including subnational taxes)	Effective Marginal Tax Rate (including subnational taxes) ^a
Canada	26.3	12.5
France	34.4	24.0
Germany	30.2	21.2
Italy ^b	31.3	5.2
Japan	32.1	24.5
United Kingdom	20.0	19.0
United States	39.0	18.1
G-7 Average Excluding the U.S.^c	29.6	19.4

Source: OECD and U.S. Department of the Treasury, Office of Tax Analysis.

^a EMTRs reported in this table include temporary incentives for investment, including 50% bonus depreciation in the United States.

^b The statutory rate for Italy includes the 3.9 percent IRAP regional production tax not in the reported OECD rate.

^c The G-7 average is calculated using 2014 gross domestic product (in current US dollars) as weights.

¹ For more discussion of the economic case for business tax reform, see: Council of Economic Advisers. “Economic Report of the President.” 2015. *Chapter 5*.

https://www.whitehouse.gov/sites/default/files/docs/cea_2015_erp_complete.pdf

² The effective marginal tax rates (EMTRs) reported in Table 1 take into account temporary incentives in place in 2015, including 50 percent bonus depreciation in the United States. EMTRs reported elsewhere in this update do not take these temporary incentives into account.

Business tax reform must consider and balance different measures. The fact that U.S. firms face a relatively high statutory rate but do not pay similarly high rates on marginal investments suggests the need for a reform of the corporate tax system that lowers the statutory rate while broadening the tax base to maintain at least the same level of revenue. A broader tax base with fewer unjustified loopholes and subsidies would level the effective marginal tax rates, regardless of the type and location of investments. As a result, decisions would more likely be made for business reasons and not for tax reasons, thus improving the overall quality of investment.

Reducing the number of tax expenditures and loopholes would reduce the complexity of the tax system and lessen the tax compliance burden for large corporations and small businesses alike. The proliferation of tax preferences has created the need for additional rules and regulations to ensure that incentives are limited to their intended beneficiaries. Small business owners have to spend time and money learning about tax incentives and often rely on third parties to help them navigate the thicket of complex tax rules, while large corporations employ lawyers and accountants to structure transactions to minimize taxes. The IRS has to spend resources monitoring and enforcing the rules. Disputes invariably arise between the IRS and taxpayers, and society expends resources adjudicating these disputes.

In sum, the tax expenditures and loopholes in the U.S. tax system, together with the structure of the corporate tax system, produce significant distortions that can result in a less efficient allocation of capital, reducing the productive capacity of the economy and U.S. living standards. The distortions created by the tax system are explored further below.

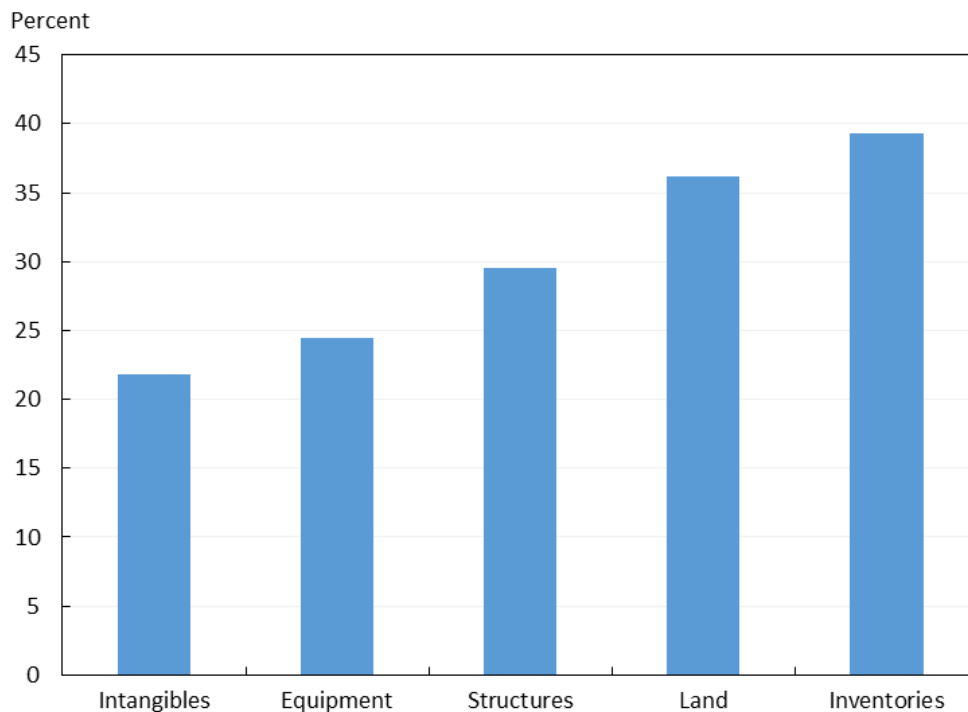
Distortions in the Form of Investment by Industry and Asset

Tax expenditures vary dramatically by industry. These differences manifest themselves in disparate average tax rates across industries. Table 2 shows effective actual federal corporate tax rates by industry for the period 2007-2010. The overall average federal tax rate for U.S. corporations was 23 percent—well below the federal statutory rate of 35 percent. Within that average, there was considerable variation by industry—from a low of a 14.5 percent average tax rate for utilities to a 30.3 percent average tax rate for construction. Tax preferences also lead to different effective marginal tax rates across types of assets, as Figure 1 illustrates.

Industry	Effective Actual Corporate Tax Rate
Utilities	14.5
Leasing	17.7
Transport and Warehouse	18.6
Mining	21.6
Agriculture, Forestry, Fishing	22.0
Real Estate	22.4
Manufacturing	22.4
Insurance	23.1
Finance	23.1
Information	24.2
Wholesale-Retail	27.9
All Services	29.4
Construction	30.3
Average Effective Actual Tax Rate	23.3

Source: U.S. Department of the Treasury, Office of Tax Analysis.

Figure 1: Effective Marginal Tax Rates by Asset Type for Corporations, 2015



Source: U.S. Department of the Treasury, Office of Tax Analysis.

The result is a tax system that distorts investment decisions. By allocating capital inefficiently, this system lowers living standards now and also could impede technological innovation.³ The pace of innovation is a key determinant of economic growth, and innovation tends to be directly related to those areas in which we make capital investments. Firms do not reap the benefits of technological advances until new capital is brought into production. Given this interplay between innovation and capital accumulation, the distortions created by the current corporate income tax may slow economic growth over the long term.

These challenges are particularly notable because subsidies in the current tax code contribute to low effective tax rates on fossil fuel and other extractive industries, even as we face long-term challenges requiring us to create a sustainable energy future. Income from an investment in structures for oil petroleum and natural gas faced an effective total marginal tax rate (including corporate and investor level taxes) in 2014 of about 19 percent as compared to a 36 percent rate for manufacturing buildings.⁴

Distortions in the Financing of Investment

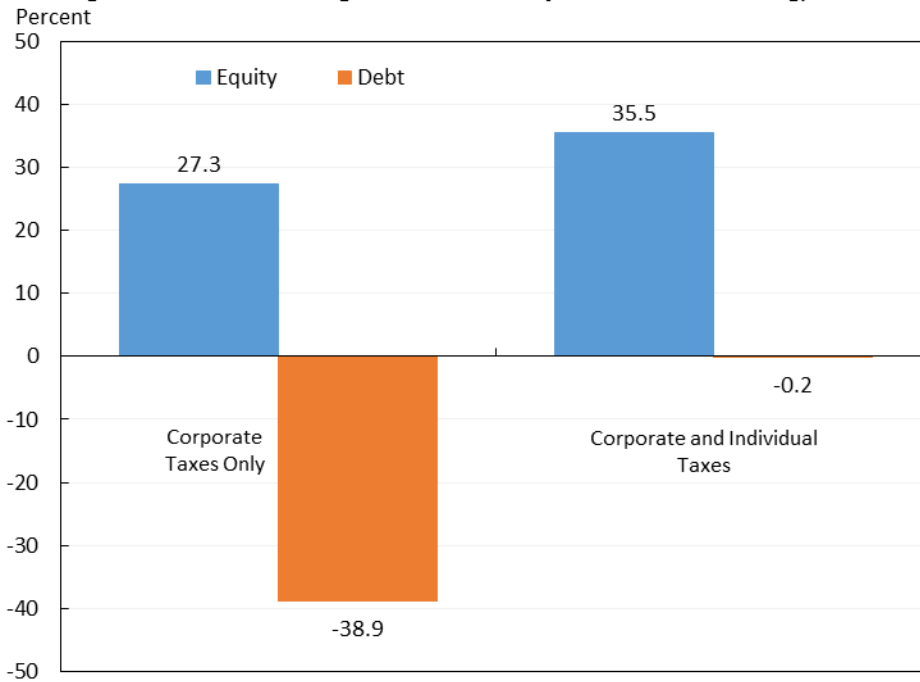
The current corporate tax code encourages corporations to finance themselves with debt rather than with equity. Specifically, under the current tax code, corporate dividends are not deductible in computing corporate taxable income, but interest payments are. This disparity creates a sizable wedge in the effective tax rates applied to returns from investments financed with equity versus debt. Profits generated by an equity-financed investment will be taxed at the 35 percent corporate rate, leaving 65 percent of the profits for dividend payments to shareholders. In contrast, profits from the same investment funded by debt will only be taxed to the extent they exceed the associated interest payments. Once the deductibility of interest is combined with accelerated depreciation, the cost of investments financed by debt capital declines even further. In fact, on average, debt-financed investments are subsidized (i.e., their effective marginal tax rate is negative), as income generated by such investments is more than offset by deductions for interest and accelerated depreciation.

For example, the effective corporate marginal tax rate on new equity-financed investment in equipment is 27 percent in the United States. At the same time, the effective marginal tax rate on the same investment made with debt financing is *negative* 39 percent. Accounting for both corporate and individual income taxes, the rates are 36 percent for equity-financed investment and close to zero percent for debt-financed investment (see Figure 2).

³ See, e.g., Alan J. Auerbach and Kevin Hassett. "Tax Policy and Business Fixed Investment in the United States." 1992. 47 *J. Pub. Econ.* 141; Dale W. Jorgenson and Kun-Young Yun, "Tax Policy and Capital Allocation." 1986. 88 *Scandinavian J. Econ.* 355.

⁴ Congressional Budget Office. "Taxing Capital Income: Effective Marginal Tax Rates Under 2014 Law and Selected Policy Options." 2014. https://www.cbo.gov/sites/default/files/113th-congress-2013-2014/reports/49817-Taxing_Capital_Income_0.pdf

Figure 2: Effective Marginal Tax Rates by Source of Financing, 2015



Source: U.S. Department of the Treasury, Office of Tax Analysis.

This tax preference for debt financing has important macroeconomic consequences. First and foremost, outsized reliance on debt financing can increase the risk of financial distress and thus raise the likelihood of bankruptcy. Unlike equity financing, which can flexibly absorb losses, debt requires fixed payments of interest and principal and allows creditors to force a firm into bankruptcy. A solvent firm with limited liquidity that is struggling to make its debt payments may experience losses of customers, suppliers, and employees. It may engage in destructive asset “fire sales” and forgo economically profitable investments. In an attempt to avoid bankruptcy, levered firms faced with financial distress may resort to high-risk investments. In the broader context, a large bias towards debt financing in the tax code may lead to greater aggregate leverage, making the broader economy less resilient and more susceptible to severe downturns.⁵

Distortions in the Organizational Form of Businesses

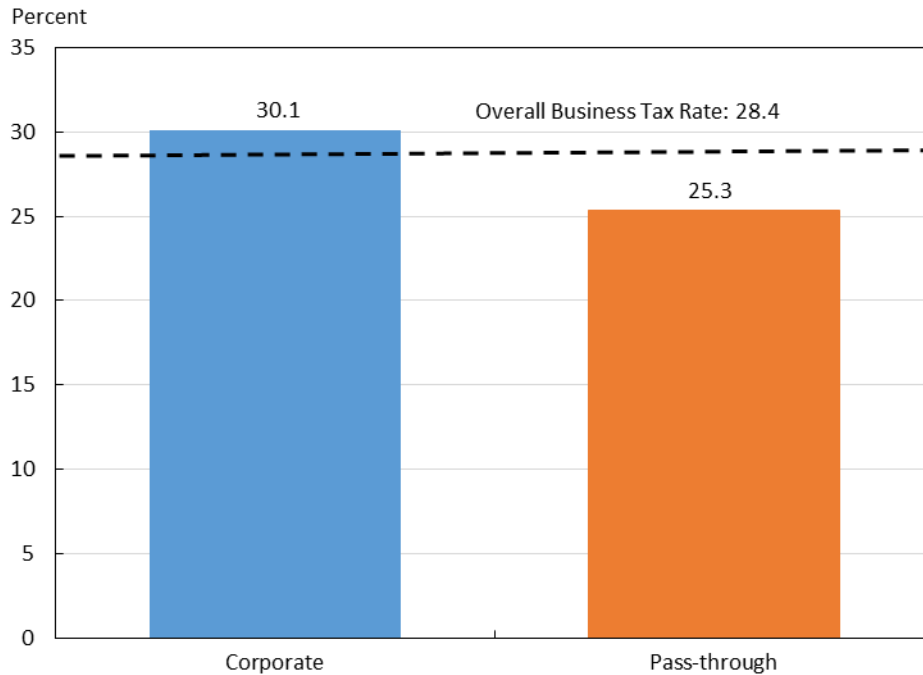
Businesses may be organized under a variety of different forms, including C-corporations, S-corporations, partnerships, and sole-proprietorships. These organizational forms offer varying legal, regulatory, and tax treatments. The primary difference in tax treatment lies between C-corporations, on the one hand, and S-corporations, partnerships, and sole-proprietorships, on the other. C-corporations are subject to the corporate tax, while pass-through entities are not. (These businesses are known as “pass-through” entities because profits pass through to owners and owners pay tax on their individual tax returns.)

The combined effect of the differences in tax treatment is a lower effective tax rate for pass-through entities relative to C-corporations. As shown in Figure 3, the effective marginal tax rate on new

⁵ See, e.g., Ruud A. De Mooij. “Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions.” 2011. 33 *Fiscal Studies* 489.

investment by C-corporations is now 30 percent, while the effective marginal tax rate on new investment by pass-through businesses is 25 percent.⁶

Figure 3: Effective Marginal Tax Rates, 2015



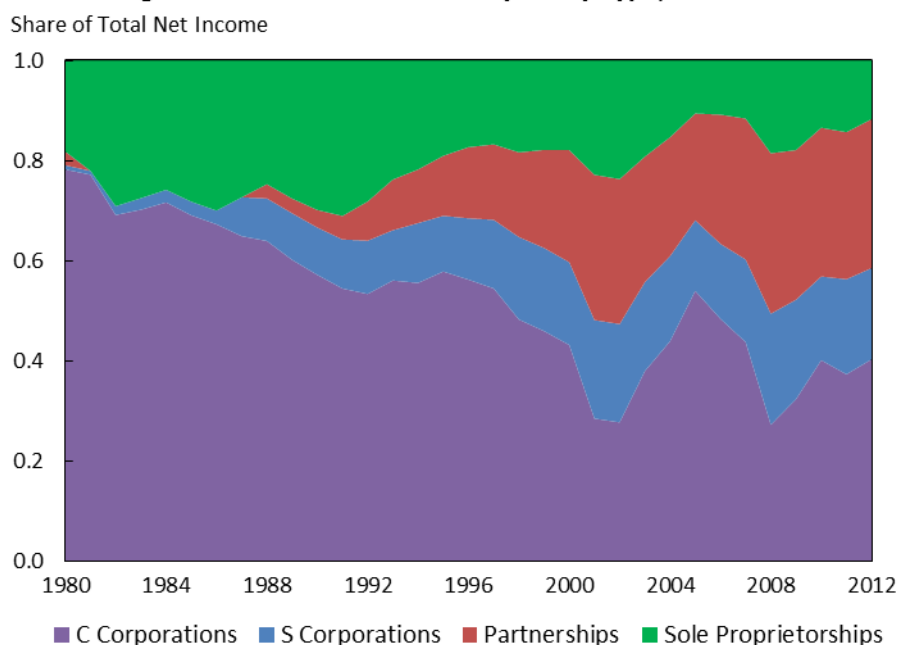
Source: U.S. Department of the Treasury, Office of Tax Analysis.

As a result, companies are increasingly choosing to organize themselves as pass-through businesses in order to avoid corporate tax liability. Pass-through businesses represented less than one quarter of net business income in 1980 but about 60 percent of net business income in 2012, the most recent year with data available (see Figure 4).⁷ While nearly all pass-through income in 1980 accrued to sole proprietorships, the share of income attributable to these entities has decreased over the last three decades. In their place, partnerships and S corporations have grown from a negligible share of business income to roughly half.

⁶ Calculations of the Treasury Office of Tax Analysis.

⁷ Internal Revenue Service (IRS). "Statistics of Income." www.irs.gov/taxstats.

Figure 4: Share of Net Income by Entity Type, 1980-2012



Source: Internal Revenue Service, Statistics of Income.
Note: Partnership net income was negative from 1981-1987. Negative income is not included in total income for the figure.

The ability of pass-through entities to take advantage of preferential tax treatment has placed businesses organizing as C-corporations at a disadvantage. By allowing pass-through entities preferential treatment, the tax code distorts choices of organizational form, which can lead to losses in economic efficiency.⁸

Distortions in the Location of Production and Allocation of Profits

The U.S. system for taxing multinational corporations rewards U.S. companies that shift their reported profits abroad to lower-tax jurisdictions and encourages inversions—transactions in which U.S.-based corporations relocate their tax residence to low-tax countries by merging with a foreign corporation. These incentives to manipulate tax rules in order to shift profits actually earned in the United States to low-tax jurisdictions erode the corporate tax base, requiring higher rates elsewhere to achieve the same revenue. They also impose significant costs on the U.S. economy by creating economic distortions that sometimes encourage firms to invest and grow business activities abroad rather than at home and by causing firms to devote resources to tax planning instead of productive investment. At the same time, the current tax system can impose a relatively heavy tax burden on the income from some investments that companies must make overseas and that compete with foreign-owned operations which can be taxed at lower rates, limiting the opportunities of U.S.-based firms and workers.

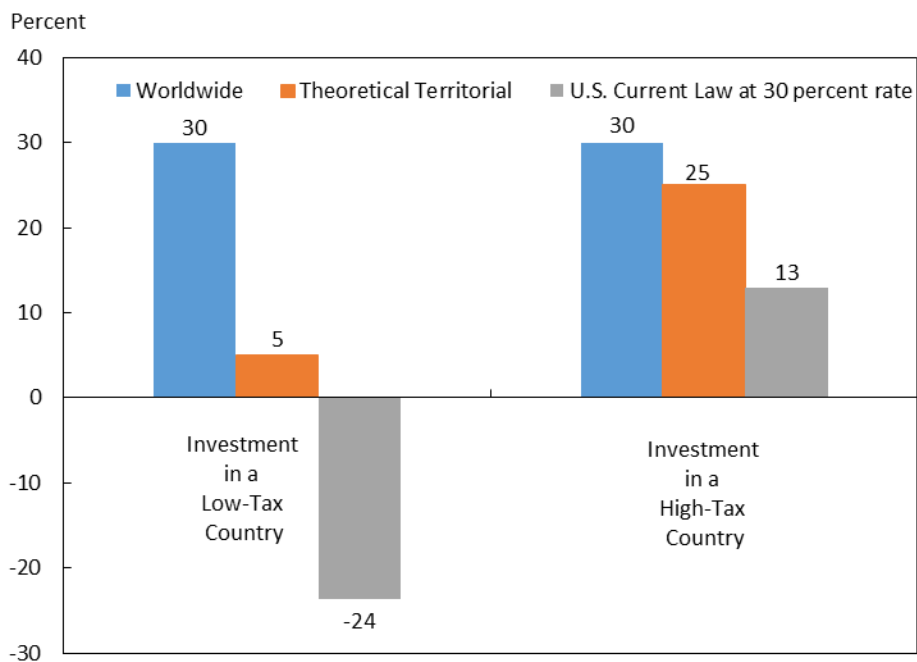
Several of these problems arise because the current U.S. tax system taxes foreign subsidiaries of U.S.-based multinationals on their overseas income (net of a tax credit for foreign taxes paid), but only when that income is repatriated to the United States, a rule called deferral (since it defers taxation of the

⁸ See, e.g., Austan Goolsbee. "The Impact of the Corporate Income Tax: Evidence from State Organizational Form Data." 2004. 88 *J. Pub. Econ.* 2283; Jeffrey K. Mackie-Mason and Roger H. Gordon. "How Much Do Taxes Discourage Incorporation?" 1997. 52 *J. Fin.* 477; Roger H. Gordon and Jeffrey K. Mackie-Mason. "Tax Distortions to the Choice of Organizational Form." 1994. 55 *J. Pub. Econ.* 279.

income). Because that income may be retained abroad indefinitely, the result is that firms may never face U.S. taxes on much of their foreign income, making the system much more like a territorial system—a system in which taxes are never paid on foreign income—for many companies. Because of deferral, U.S. corporations have a significant opportunity to reduce overall taxes paid by shifting profits to low-tax jurisdictions, either by moving their operations and jobs there or by relying on accounting tools and current transfer pricing practices to shift profits there.

Indeed, because of deferral and other complex rules for the taxation of U.S. multinationals, the U.S. tax system can create greater incentives to manipulate the location of foreign income than would arise under either a pure territorial system or a pure worldwide tax system in which all foreign income was taxed when earned. In particular, simulations by Rosanne Altshuler and Harry Grubert, which assume a statutory corporate rate of 30 percent but otherwise match the features of current U.S. law, show that the effective marginal tax rate on investments by a hypothetical U.S. multinational in a low-tax country is -24 percent after accounting for shifting of intangibles, and the effective marginal tax rate on investments in a high-tax country is 13 percent after accounting for earnings stripping (Figure 5).⁹ These simulations suggest that, though the United States ostensibly imposes a worldwide tax, the difference in effective marginal tax rates between high-and low-tax jurisdictions abroad can look more like a territorial system. Moreover, the tax rates in both high-and low-tax countries can be well below the rates that would apply under either a true worldwide system or even a theoretically ideal territorial system unaffected by base erosion or profit shifting.

Figure 5: Effective Marginal Tax Rates in Several Tax Systems



Source: Grubert and Altshuler (2013).

⁹ Harry Grubert and Rosanne Altshuler. "Fixing the system: an analysis of alternative proposals for the reform of international tax." 2012. 66 *Nat. Tax J.* 671. For these computations, the low-tax country is assumed to have a statutory rate of 5 percent and the high-tax country a rate of 25 percent. The activities in each country and the associated tax planning strategies correspond to common behavior of U.S. companies in such countries.

Evidence shows that U.S. multinationals' decisions about where to invest are sensitive to effective tax rates in foreign jurisdictions.¹⁰ There also is strong evidence that corporations use accounting mechanisms to shift profits from where they are actually earned to tax havens and other low-tax jurisdictions. Table 3 shows profits of U.S. corporations reported in select, small countries with very low tax rates. In a number of cases, the amount of profits far exceeds the country's actual output, suggesting the degree to which companies use these countries to shelter profits that were quite obviously earned elsewhere. In 2010, for example, subsidiaries of U.S. companies ("controlled foreign corporations") reported profits in the Cayman Islands totaling more than 20 times that country's entire economic output. Even in the Netherlands, which has a much larger economy, U.S. controlled foreign corporation profits amounted to 17 percent of GDP. It is implausible that the high concentration of U.S. profits for the countries shown in Table 3 reflects the actual business activity of these firms rather than tax planning.

Country	Profits of U.S. Controlled Foreign Corporations as a Share of GDP
Bahamas	71%
Bermuda	1,614%
British Virgin Islands	1,804%
Cayman Islands	2,066%
Cyprus	14%
Ireland	42%
Luxembourg	127%
Netherlands	17%

Source: Jane G. Gravelle, Cong. Res. Service, Tax Havens International Tax Avoidance and Evasion (2015).

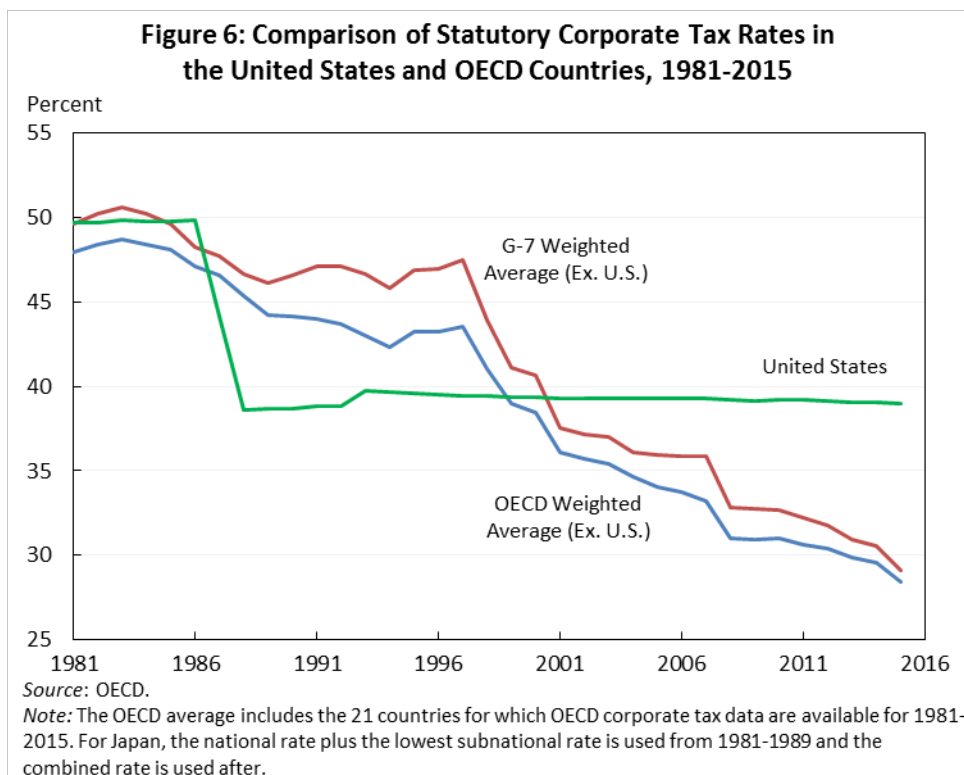
The U.S. tax system also provides incentives and opportunities for corporations to reduce their tax burdens by relocating their tax residence to a lower-tax country through a corporate inversion. A corporate inversion is a transaction in which a U.S.-based multinational firm merges with a foreign corporation and the U.S. parent of the group is replaced by the foreign corporation, typically located in a low-tax country. These transactions can substantially reduce the U.S. tax liability of the multinational group with only minimal changes to its operation. There is nothing illegal about corporate inversions, but these transactions point to a basic unfairness where corporations take advantage of the many benefits of operating in the United States—including reliable rule of law, intellectual property protection, government support for basic research, an educated workforce, and publicly-provided infrastructure—and then avoid paying their fair share of taxes.

One reason corporations pursue inversions is to remove the earnings of their foreign subsidiaries from the U.S. tax base. But another key incentive for inverting is to allow the corporation to reduce the taxes it pays on its *domestic* (U.S. source) income through base erosion (or income shifting) techniques such as earnings stripping and aggressive transfer pricing. For example, one common way for an inverted (or foreign-parented) corporation to move, or "strip" earnings from the U.S. corporate tax base to a low- tax

¹⁰ See, e.g., Rosanne Altshuler and Harry Grubert. "Taxpayer Responses to Competitive Tax Policies and Tax Policy Responses to Competitive Taxpayers: Recent Evidence." 2004. *Tax Notes Int'l: Special Reports*; Harry Grubert and John Mutti. "Taxes, Tariffs and Transfer Pricing in Multinational Corporation Decision Making." 1991. *73 Rev. Econ. And Stats.* 285.

jurisdiction, is for the company to borrow from a related foreign company in the low-tax jurisdiction, and pay interest that is tax deductible in the United States. Earnings stripping not only reduces corporate tax revenues, it also imposes competitive disadvantages on purely domestic U.S. firms and multinational firms that have maintained their U.S. residence.

In the last major tax reform in 1986, the United States cut its corporate rate to well below average for the advanced economies that comprise the Organization for Economic Cooperation and Development (OECD). Other countries followed suit by reducing their statutory corporate rates to the point where the U.S. statutory rate is now 11.5 percentage points above the OECD average (see Figure 6). The reduction in tax rates abroad has increased the incentive to shift income offshore. At the same time, the United States has failed to adequately protect its tax base by curbing income shifting and inversions directly.



The empirical evidence suggests that income-shifting behavior by multinational corporations is a significant and growing concern that should be addressed through tax reform.¹¹ The pre-tax profitability of controlled foreign corporations is negatively correlated with local country statutory tax rates, taking into account real economic factors such as financial structure, capital employed, and other non-transfer pricing operational aspects of multinational groups.¹² In addition to the evidence that companies generally shift income from high-tax foreign countries to low-tax foreign countries, there also is evidence

¹¹ See, e.g., Eric J. Bartelsman and Roel M.W.J. Beetsma. "Why Pay More? Corporate Tax Avoidance Through Transfer Pricing in OECD Countries." 2003. 87 *J. Pub. Econ.* 2225; Edward D. Kleinbard. "Stateless Income." 2011. 65 *Tax Law Rev.* 99.

¹² See, e.g., review of the literature, Department of the Treasury. "Ch. III: Study of Transfer Pricing." November 2007. *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties.* <https://www.treasury.gov/resource-center/tax-policy/Documents/ajca2007.pdf>; Jane Gravelle. "Tax Havens: International Tax Avoidance and Evasion" 2009. 62 *Nat'l Tax J.* 727.

of income shifting specifically from the United States to other countries.¹³ Income shifting from the United States to other countries significantly erodes the U.S. tax base and leads to lower corporate tax receipts, draining as much as \$100 billion in corporate revenue from the United States every year, according to one analysis.¹⁴ Evidence suggests that high statutory tax rates also may affect a company's willingness to locate in the United States following mergers and acquisitions.¹⁵

CORPORATE INVERSIONS

An extreme way for a U.S.-based multinational to shift profits out of the U.S. tax base is for the company to change its tax residence from the United States to another country by merging with a foreign firm in a transaction called an inversion. Over the past several years, a dramatic increase in actual and announced inversions has raised concerns about their effects on the U.S. tax base and on domestic business activity. While current law subjects inversions that appear to be based primarily on tax considerations to certain adverse tax consequences, it has become clear from the growing pace of these transactions that for many corporations, these consequences are acceptable in light of the potential tax and financial reporting benefits.

Expatriating or inverting to a low-tax country offers two primary tax benefits for a U.S. multinational. First, the corporation can reduce or eliminate any residual U.S. tax on foreign earnings—both taxes owed on foreign earnings that are unrepatriated at the time of the merger and future foreign earnings. Second, the transaction allows the inverted company to reduce its taxes on U.S. earnings by stripping taxable income out of the United States. Inverted firms can strip earnings by claiming deductions in the United States for interest paid to the new foreign parent. Inverted firms often increase their reported book earnings because their computed worldwide effective tax rate is reduced by the transaction.

Genuine cross-border mergers can make the U.S. economy stronger by enabling U.S. companies to invest overseas and encouraging foreign investment to flow into the United States. But these transactions should be driven by genuine business strategies and economic efficiencies, not simply by a desire to avoid U.S. taxes.

There is nothing illegal about corporate inversions. However, the ability of a multinational corporation to take advantage of the many benefits of locating in the United States and then refuse to pay its fair share of taxes points to a basic unfairness in the tax system. That is why the President has called on Congress to stop corporate inversions and proposed two major anti-inversion measures. The first proposal limits the ability of U.S. firms to invert by providing that if a U.S. firm combines with a smaller foreign firm, the merged entity will be treated as a U.S. entity for tax purposes. The second proposal limits the ability of foreign-controlled companies to strip the U.S. corporate tax base using interest and reinsurance payments, addressing a major financial incentive for U.S. firms to seek inversions under current law.

¹³ Harry Grubert. "Foreign Taxes and the Growing Share of Multinational Company Income Abroad: Profits, Not Sales, Are Being Globalized." 2012. 65 *Nat'l Tax J.* 247.

¹⁴ Kimberly A. Clausing. "The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond." 2016. *Tax Notes*. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2685442

¹⁵ Harry P. Huizinga and Johannes Voget. "International Taxation and the Direction and Volume of Cross Border M&A." 2009. 64 *J. Fin.* 1217.

Though Congress has thus far failed to act, Treasury has used its existing authority under the tax laws to reduce the tax benefits of—and when possible, stop—corporate tax inversions. Treasury’s actions significantly diminish the ability of inverted companies to escape U.S. taxation. For some companies considering mergers, inversions may no longer make economic sense.

To date, Treasury has taken action to:

- Prevent inverted companies from accessing a foreign subsidiary’s earnings while deferring U.S. tax through the use of creative loans, which are known as “hopscotch” loans, and from restructuring a foreign subsidiary in order to access the subsidiary’s earnings tax-free.
- Close a loophole to prevent inverted companies from transferring cash or property from a foreign subsidiary to the new parent to completely avoid U.S. tax.
- Make it more difficult for U.S. entities to invert by strengthening the requirement that the former owners of the U.S. entity own less than 80 percent of the new combined entity.
- Block a particularly blatant form of inversion known as a “third country” inversion, where a U.S. firm merges with a firm based in one foreign country, but then locates its tax residence in a third country—essentially cherry-picking the tax rules under which they operate.
- Address “serial inverters” by ensuring that firms cannot avoid the existing anti-inversion rules by acquiring foreign-owned corporate groups that themselves have grown larger through inversions or acquisitions of U.S. firms.
- Limit the ability of firms to strip earnings out of the United States by treating certain payments between related parties as non-deductible dividends instead of deductible interest payments and otherwise strengthening the rules characterizing financial instruments as debt or equity for tax purposes.

While these actions have helped slow the pace and reduce the tax benefits of inversions, only Congress can put a stop to inversions. It can and should take action immediately. Ultimately, the best way to address the more fundamental problems in our tax system that are highlighted by inversions is through business tax reform that includes specific anti-inversion provisions. These provisions will need to be in place even after business tax reform is enacted because there will always be countries offering advantageous tax treatment where corporations can establish residence for tax purposes if rules allow.

Positive and Negative Externalities of Business Behavior

Business activity sometimes generates spillovers that benefit or harm other firms and the general public. For example, one firm’s investment in basic research may lead to new discoveries that benefit not just that firm but allow other businesses to develop new or better products as well. The beneficial effect of one firm’s activities on another is an example of a positive externality. The private market may underprovide research with spillover benefits because the firm paying for the research does not incorporate the potential benefits to other firms when deciding how much research to invest in.

In fact, numerous studies find that the total returns to research and development are significantly larger

than the private returns earned by the investors who fund it.¹⁶ This evidence suggests that the social returns range from one to two times the private returns, a disparity which leads to private-sector underinvestment in the absence of policies such as the Research and Experimentation (R&E) tax credit. Studies that directly evaluate the R&E credit find that each dollar of foregone tax revenue through the credit generally causes firms to invest at least one additional dollar in research and development.¹⁷

Not all spillovers are positive, however. Pollution, such as carbon pollution and particulate pollution from burning fossil fuels, imposes costs on society from climate change and impairments to health. Because firms do not bear the consequences of those costs, they may rely too heavily on pollution-intensive activities. Greenhouse gas emissions impose significant environmental costs, which will only continue to grow for future generations.¹⁸ Other pollutants, such as particulate matter and ozone, impose large immediate social costs in the form of increased rates of mortality and morbidity, and reduced quality of life.¹⁹ Many social costs of pollution are not borne by the firms making the decisions to invest in polluting activities, so firms may overinvest in those activities.

Well-designed tax policies can encourage greater investments in activities with positive spillovers, like research, and reduce reliance on pollution-intensive fuel sources.

II. The President's Framework for Business Tax Reform

The President's approach to business tax reform is intended to reduce the tax-induced distortions across industries, assets, means of financing, and different forms of business, and to address problems in our international tax system. These reforms are intended to encourage domestic investment and increase the productivity of those investments, to simplify the tax code for America's small businesses, to encourage certain business activities with clear external benefits, like clean energy and research, and to rationalize the tax treatment of multinational corporations—all in a way that is fiscally responsible over the short and long run.

Eliminate Loopholes and Subsidies, Broaden the Base, and Cut the Corporate Tax Rate

The President's Framework would eliminate dozens of different tax expenditures and fundamentally reform the business tax base to reduce distortions that hurt productivity and growth. It would reinvest

¹⁶ Bronwyn H. Hall, Jacques Mairesse, and Pierre Mohnen. "Measuring the Returns to R&D." 2010. *Handbook of the Economics of Innovation 2*.; Laura Tyson and Greg Linden. "The Corporate R&D Tax Credit and U.S. Innovation and Competitiveness: Gauging the Economic and Fiscal Effectiveness of the Credit." 2012. *Center for American Progress*.

¹⁷ Bronwyn H. Hall. "Effectiveness of Research and Experimentation Tax Credits: Critical Literature Review and Research Design." 1995. *Report for the Office of Technology Assessment, Congress of the United States*.; Bronwyn H. Hall and John Van Reenen. "How Effective are Fiscal Incentives for R&D? A Review of the Evidence." 2000. *29 Research Policy*.

¹⁸ U.S. Environmental Protection Agency (EPA). "Summary of Key Findings." 2015. *Climate Change in the United States: Benefits of Global Action*.

¹⁹ World Health Organization (WHO). "Fact Sheet No. 313: Ambient (outdoor) air quality and health." 2014.

the savings in reducing the maximum corporate tax rate from 35 percent to 28 percent and eliminating the corporate alternative minimum tax. This combination of a broader base and a lower corporate rate would alleviate the significant economic distortions identified above that cause businesses to base investment decisions on tax rules rather than economic returns, and it would lead to greater parity between large corporations and their large non-corporate counterparts. Furthermore, in conjunction with the Framework's proposal to modernize the international tax system and implement a minimum tax on foreign earnings, the lower U.S. corporate rate would encourage greater investment here at home and reduce incentives for U.S. companies to move their operations abroad or to shift profits to lower-tax jurisdictions. Where appropriate, the changes could allow adequate transition periods to permit affected parties to adjust to the new permanent tax rules.

The Framework would pay for cutting the corporate tax rate to 28 percent and for the business tax cuts that were recently enacted by reforming U.S. international system and by broadening the tax base in three major ways, including:

- **Addressing depreciation schedules.** Current depreciation schedules generally overstate the true economic depreciation of assets. Although this provides an incentive to invest, it comes at the cost of higher tax rates to raise a given amount of revenue. In an increasingly global economy, accelerated depreciation may be a less effective way to increase investment and job creation than reinvesting the savings from moving towards economic depreciation into reducing tax rates. Several prominent tax reform proposals have proposed to scale back accelerated depreciation to offset rate reductions, including the tax reform proposals put forward by Chairmen Camp and Baucus. Other large countries have taken a similar approach: paying for rate-lowering corporate tax reform at least in part by scaling back depreciation allowances.²⁰ Tax reform also is an opportunity to rationalize the relative lengths of depreciation schedules so that they better align with the economic lives of assets; in so doing, tax reform would reduce tax distortions that lead to misallocation of capital across assets and industries.
- **Reducing the bias toward debt financing.** A lower corporate tax rate by itself would reduce but not eliminate the bias toward debt financing. Reform should take additional steps to reduce the tax preference for debt-financed investment, such as by "haircutting" corporate interest deductions by a certain percentage. A tax system that is more neutral towards debt and equity will reduce incentives to overleverage and produce more stable corporate finances, making the economy more resilient in times of stress. In addition, limiting interest deductibility would finance lower tax rates and do more to encourage investment in the United States than many other ways to pay for rate reductions.
- **Eliminating dozens of business tax loopholes and tax expenditures.** The Framework starts from a presumption that we should eliminate all tax expenditures for specific industries, with a few exceptions that are critical to broader growth or address certain externalities. In particular, the Framework would:
 - *Eliminate "last in first out" accounting.* Under the "last-in, first-out" (LIFO) method of accounting for inventories, it is assumed that the cost of the items of inventory that are

²⁰ Alan J. Auerbach, Michael P. Devereaux, and Helen Simpson. "Taxing Corporate Income." 2008. *The Mirrlees Review: Reforming the Tax System for the 21st Century*.
http://eml.berkeley.edu/~auerbach/taxing_corporate_income_march_11.pdf

sold is equal to the cost of the items of inventory that were most recently purchased or produced. This assumption overstates the cost of goods sold and understates the value of inventories. The Framework would end LIFO, bringing us in line with international standards and simplifying the tax system.

- *Eliminate oil and gas tax preferences.* The tax code currently subsidizes oil and gas production through tax expenditures that provide preferences for these industries over others. The Framework would repeal more than a dozen tax preferences available for fossil fuels.
- *Reform treatment of insurance industry and products.* The Framework would reform the treatment of insurance companies and products to improve information reporting, simplify tax treatment, and close loopholes, including one in which corporations shelter income using life insurance contracts on their officers, directors, or employees.
- *Reform the measurement and character of gains.* The Framework would reform the treatment of capital gains, including modifying rules for like-kind exchanges, which allow investors in certain assets to avoid realizing a capital gain—and thus to defer payment of tax—through a transaction structured as an exchange rather than a sale.

Ultimately, achieving a lower corporate tax rate and reducing special-interest provisions will require eliminating a wide variety of business tax exclusions, subsidies, and deductions. The proposals above, described in detail in the President’s Budget, represent the first step in that process.²¹

²¹ Additional details for specified proposals can be found in: Department of the Treasury. “General Explanations of the Administration’s Fiscal Year 2017 Revenue Proposals.” 2016. <https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf>

WALL STREET REFORM AND TAXATION OF THE FINANCIAL SECTOR

In response to the 2008 financial crisis, the worst since the Great Depression, the Administration achieved landmark reform of the Nation's financial system in 2010 with enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act. In the years since enactment, Federal agencies have helped make home, auto, and short-term consumer loan terms fairer and easier to understand for average consumers, improved transparency for investors in financial markets, and increased financial firms' planning for and resilience to future financial downturns. These actions are already curbing excessive risk-taking, closing regulatory gaps, and making our financial system safer and more resilient.

However, more work remains to be done as there is evidence that the financial sector represents a large and growing share of the economy in a manner that may create obstacles to shared growth.* Business tax reform can help address the downsides of an excessive financialization of the economy, including through some of the specific measures proposed in the President's Budget:

- *Impose a financial fee:* Excessive leverage undertaken by major financial firms was a significant cause of the recent financial crisis and is an ongoing potential risk to macroeconomic stability. The financial fee—a tax on large financial institutions based on the amount of their liabilities—can help remedy this by reducing the incentive for large financial institutions to use excessive leverage. The structure of this fee would be broadly consistent with the principles agreed to by the G-20 leaders. The President's proposal would take a direct action to combat the risk in the financial sector and its implications on broader market volatility.
- *Pay for doubling the budgets of key market regulators through increased transaction fees:* Expanding the budgets of the CFTC and SEC would allow them to improve monitoring of new developments in the markets and to continue to fulfill their missions in increasingly complex financial sectors. Fee funding the CFTC would shift the costs of regulatory services it provides from the general taxpayer to the primary beneficiaries of the CFTC's oversight, and fee rates would be designed in a way that supports market access, liquidity, and the efficiency of the Nation's futures, options, and swaps markets. Additionally, increasing the transaction fees that currently fund the SEC and imposing a similar fee to finance the CFTC would particularly affect high-frequency traders, which could help reduce certain risks in the market.
- *Close the carried interest loophole:* Taxing "carried interest" as ordinary income rather than tax-preferred capital gain would close a loophole for private equity and hedge fund managers. In addition, increasing the tax rate on capital gains would reduce the tax benefit of the carried interest loophole and any other strategy that involves converting income that would be taxed at regular rates to income taxed at the lower rates on capital gains.
- *Modernize taxation of certain financial products to prevent tax arbitrage:* Modernizing the taxation of financial products by taxing derivatives on a "mark-to-market" basis with gain or loss treated as ordinary income would reduce the ability of financial institutions and sophisticated taxpayers to craft financial products to arbitrage the disparate tax rules for financial products.

* See, e.g., Robin Greenwood and David Scharfstein. "The Growth of Finance." 2013. 27 *J. Econ. Perspect.* 3; Luigi Zingales. "Does Finance Benefit Society?" 2015. 70. *J. Fin.* 1327.

Strengthen American Innovation, Clean Energy, and Manufacturing

As noted above, a well-designed tax system can help address positive and negative spillovers of business behavior by encouraging those activities that provide broader benefits and discouraging activities that cause harm. The President's Framework identifies three areas where targeted incentives are appropriate: research and development, clean energy, and manufacturing.

To encourage greater innovation, make sustainable investments in clean energy and promote manufacturing, the President's Framework would:

- **Expand and simplify the R&E credit.** While the recent permanent extension of the R&E credit provides certainty for businesses investing in innovation and appropriately recognizes the positive spillovers research activity generates, further reforms should be made to make the credit even more effective. Currently, businesses must choose between two different credit formulas, including one so outdated that it takes into account the amount of a business's research expenses from 1984 to 1988. The President's Framework would simplify the credit by repealing the outdated formula, increase the credit rate from 14 to 18 percent, and enhance the credit for pass-through businesses.
- **Consolidate, enhance, and permanently extend key tax incentives to encourage investment in clean energy while repealing fossil fuel subsidies.** The President's Framework would make permanent the tax credits for the production of renewable electricity and investment in renewable energy technologies. These reforms would provide a strong, consistent incentive to encourage investments in renewable energy sources, like wind and solar. The production tax credit and investment tax credit for renewable electricity generation were recently extended for five years, but permanent tax incentives for clean energy investment are needed to meet the challenge of climate change and address the harmful consequences of pollution. In addition, the structure of the renewable production tax credit has required many firms to invest in inefficient tax planning through tax equity structures so that they can benefit even when they do not have tax liability in a given year because of a lack of taxable income. The President's Framework would eliminate the need for these strategies by making the production tax credit refundable. In addition to these reforms to support clean energy, the President's Framework would eliminate tax subsidies for oil and gas as described above.
- **Effectively cut the top corporate tax rate on manufacturing income to 25 percent by reforming the domestic production activities deduction.** The manufacturing sector plays an outsized role in the U.S. economy and is particularly important for future job creation, innovation, and economic growth.²² For this reason, the President's Framework would reform the current domestic production activities deduction. It would focus the deduction more on manufacturing activity and expand the deduction to 10.7 percent, effectively cutting the top corporate tax rate for manufacturing income to 25 percent.

²² For a review of the U.S. manufacturing sector, see generally: Department of Commerce. "The Competitiveness and Innovation Capacity of the United States." 2012.; President's Council of Advisors on Science and Technology. "Ensuring American Leadership in Advanced Manufacturing." 2011.; P. Gary Pisano and Willy C. Shih. "Restoring American Competitiveness." 2009. *Harvard Business Review*.; Erica Fuchs and Randolph Kirchain. "Design for Location? The Impact of Manufacturing Off-Shore on Technology Competitiveness in the Optoelectronics Industry." 2010. 56 *Mgmt. Science* 2323.; Michael Greenstone et al. "Identifying Agglomeration Spillovers: Evidence from Winners and Losers of Large Plant Openings." 2010. 118 *J. Pol. Econ.* 536.

INNOVATION BOXES

An innovation box is a special tax preference that applies a separate, lower, tax rate to income derived from patents and other types of intangible business property, such as copyrights, trademarks, trade secrets, and other forms of intellectual property (IP). Innovation boxes and related regimes in other countries vary in their tax rate, in the types of eligible IP, in the scope of qualifying income, and the treatment of IP-related expenses.

Advocates of an innovation box in the United States argue that applying a low tax rate to income associated with intellectual property provides an incentive for investments in research and innovation, can improve the international competitiveness of businesses that rely on IP by reducing their taxes, and can address concerns about the erosion of the U.S. tax base to lower-tax jurisdictions by encouraging firms to locate their IP in the U.S. for tax purposes.

Measured by the criteria of economic efficiency, the innovation box comes up short as a desirable tax policy tool. Compared to the R&E credit, an innovation box is less effective in encouraging innovation. The R&E credit provides benefits to firms undertaking new research which results in spillovers that enhance the productivity of businesses and workers economy-wide (including research that is difficult to commercially exploit). The evidence of the R&E credit's success is why the Administration supported permanent extension and continues to propose further enhancements.

By contrast, a U.S. innovation box would be costly and offer little potential to improve the overall domestic economy. Unlike the R&E credit, an innovation box has much less “bang for the buck” because it would provide windfall tax benefits for IP already in existence. In the United Kingdom, the introduction of a low-tax patent box reduced corporate tax revenues, even when companies reported more innovation-related income.* In the United States, the revenue costs of a similar tax incentive are likely to be especially large because of the disproportionately large share of innovation-related income U.S. multinationals earn from currently-taxed foreign royalty payments and the much larger domestic market. In essence, an innovation box is just another variation on a “race to the bottom” in the taxation of multinational firms, where countries compete to have the lowest tax rate on certain corporate activities, without concern for the funding of necessary public goods and services.

Innovation boxes also work against the broadly shared goal of simplifying the tax system. New tax rules and compliance checks would be needed to determine precisely how much income was associated with particular innovations. For instance, it would be difficult to determine how much of a drug company's income is due to investment in developing a patented drug versus investment in the manufacturing plant itself or in advertising and marketing activities. Corporations would have strong incentives to attribute as much income as possible to the tax-favored innovation to take advantage of preferential tax rates. These difficulties would lead to disputes between the IRS and taxpayers, resulting in increased hiring of lawyers and accountants instead of increased innovative activity.

The President's Framework, which provides support for innovation more efficiently through the R&E credit and which tackles the problems within our international tax system with a reform centered on the minimum tax, provides a better approach to addressing these challenges.

* Rachel Griffith, Helen Miller, and Martin O'Connell. “Ownership of intellectual property and corporate taxation.” 2014. 112 *J. Pub. Econ.* 12.

Strengthen the International Tax System to Encourage Domestic Investment

International reform should improve on the current broken and inefficient system under which firms must pay tax at the full U.S. tax rate but only when profits are repatriated. There is considerable debate as to how to reform the international tax code. One approach is to switch to a pure territorial system under which all active foreign income would be subject to zero or nominal U.S. tax. However, a pure territorial system could aggravate, rather than ameliorate, many of the problems in the current tax code. If foreign earnings of U.S. multinational corporations are not taxed at all, firms would have even greater incentive to locate operations abroad. Furthermore, corporations would have greater incentive to use accounting mechanisms to shift profits out of the United States. And the incentives for corporations to invert to low-tax jurisdictions in order to reduce their U.S. tax burdens through earnings stripping would remain. Alternative reform proposals to address the problem of profit shifting by providing a costly tax preference through an “innovation box,” as described above, would only exacerbate the race to the bottom in international tax rates.

Tax reform must balance the need to reduce tax incentives to locate overseas with the need for U.S. companies to be able to compete overseas for the investments and operations absolutely necessary to serve and expand into foreign markets in ways that benefit U.S. jobs and economic growth. This will be a difficult and complex undertaking but one that should be guided by the criteria of what system best promotes the jobs, growth, and standard of living of American workers and their families.

In 2015, as part of the Budget, the President released a detailed international tax plan built on the reform principles expressed in the Framework for Business Tax Reform. The President’s plan, which is centered around a new per-country minimum tax on foreign earnings, would improve on the current system in three broad ways:

- **Reducing firms’ ability to avoid the U.S. tax system by shifting profits overseas.** The minimum tax on foreign earnings would ensure that no matter what tax planning techniques a U.S. firm engages in, and no matter where it reports its profits, it would still face a tax rate of at least 19 percent. Unlike the current system, there would be no “deferral” of tax—the minimum tax would apply to profits in the year they are earned. The minimum tax would stop our tax system from generously rewarding companies for moving profits offshore. In addition, other elements of the plan would make it harder to shift profits overseas by limiting interest stripping, transfer pricing abuses, and inversions.
- **Reducing the incentive to shift production overseas.** The current system encourages firms to shift production overseas to take advantage of indefinite tax deferral on the resulting earnings—and to establish a legal foothold in a foreign country to enable even more earnings to be shifted there on paper. The minimum tax would also reduce these incentives by ensuring that the earnings of U.S. multinationals’ foreign subsidiaries are taxed on a current basis at a rate of at least 19 percent.
- **Increasing the global competitiveness of U.S. corporations.** American multinationals often have legitimate non-tax reasons to locate production overseas, either to serve local markets or because of specific competitive advantages to overseas production. Other countries with territorial systems effectively do not tax firms on their overseas production, and so those firms incur no taxes when earnings are distributed to the parent company in its home country (that is, upon “repatriation”). In addition, foreign resident companies that produce locally face only that

country's corporate tax rate. In contrast, U.S. companies face relative high explicit or implicit repatriation taxes, and therefore may operate at a tax disadvantage. In order to balance the two goals above with the desire not to disadvantage American multinationals vis-à-vis their competitors, the plan sets the global minimum tax rate lower than the full 28 percent rate proposed for reform—and offers a deduction for income from active business investment.

Specifically, to achieve these objectives, the President's plan would:

Institute a 19 percent minimum tax on foreign earnings

Foreign earnings would be subject to current U.S. taxation at a rate of 19 percent less a foreign tax credit equal to 85 percent of the per-country average foreign effective tax rate. The minimum tax would be imposed on foreign earnings regardless of whether they are repatriated to the United States, and all foreign earnings could be repatriated without further U.S. tax. Thus, under the proposal, all active earnings of foreign subsidiaries of U.S. firms (controlled foreign corporations, or CFCs) would be subject to U.S. tax either immediately or not at all. Passive or highly mobile income such as dividends, interest, rents, and royalties would continue to be subject to full U.S. tax on a current basis under the existing "Subpart F" rules.

To help maintain international competitiveness, the minimum tax base would be reduced by an allowance for corporate equity (ACE). The ACE allowance would provide a risk-free return on equity of the CFC invested in active assets. In effect, this would allow U.S. based firms to exclude from tax all costs associated with foreign investments—including the cost of equity financing—providing an even playing field for U.S. firms operating abroad relative to their foreign competitors. At the same time, however, it would ensure that companies cannot avoid U.S. tax on excess profits, such as those shifted abroad.

Foreign source royalty and interest payments received by U.S. persons would continue to be taxed at the full U.S. statutory rate but, in contrast with current law, could not be shielded by excess foreign tax credits associated with dividends. Foreign branches would be treated like CFCs. Interest expense incurred by a U.S. person that is allocated and apportioned to foreign earnings on which the minimum tax is paid would be deductible at the applicable minimum tax rate on those earnings. No deduction would be permitted for interest expense allocated and apportioned to foreign earnings for which no U.S. income tax is paid.

Impose a one-time tax on unrepatriated earnings

Because the global minimum tax eliminates taxes on the repatriation of earnings, some adjustment must be made to account for the large stock of unrepatriated earnings on which no U.S. tax has been paid. One approach would separately track that stock of earnings, and tax it upon repatriation. That approach, however, would be administratively burdensome, inequitable by treating firms differently depending on their repatriation history, and overly generous by allowing continued deferral plus a lower corporate tax rate.

Consequently, the President's plan would impose a mandatory one-time tax on CFCs' previously untaxed earnings at a reduced rate of 14 percent. A proportional credit would be allowed for the amount of foreign taxes associated with such earnings. The accumulated income subject to the one-time tax could then be repatriated without any further U.S. tax. The revenue from the one-time tax is dedicated primarily to funding transportation infrastructure investment.

Restricting deductions for excessive interest to curb “earnings stripping”

Claiming deductions for interest is a common technique used by multinational firms to erode the U.S. tax base. Under current law, foreign multinational groups are able to load up their U.S. operations with related-party debt and use the interest deductions to shift up to half of their U.S. earnings to low-tax jurisdictions. This ability gives foreign multinationals a competitive advantage over purely domestic firms, which have to pay U.S. tax on all of their earnings from U.S. operations. The proposal would address over-leveraging of a foreign-parented group’s U.S. operations relative to the rest of the group’s operations by limiting U.S. interest expense deductions to the U.S. subgroup’s interest income plus the U.S. subgroup’s proportionate share of the group’s net interest expense.

Limit inversions

The President’s plan would limit inversions by preventing firms from acquiring smaller foreign firms and changing their tax residence as a result. In addition, the proposal would prevent firms from changing their tax residence to any country where they do not have substantial economic activities if their operations in the United States are more valuable than their operations in the other country and they continue to be managed and controlled in the United States.

Close loopholes and stop strategies that facilitate base erosion and profit shifting

While the minimum tax and the reduction in the corporate rate would reduce the incentives for erosion of the U.S. base by domestic firms, the difference in tax rates would still provide a tax advantage for firms able to shift profits to their foreign affiliates. And more importantly, foreign-owned and inverted corporations would still have strong incentives to strip earnings out of the United States to low-tax jurisdictions. Hence, additional reforms are necessary to reduce incentives to shift income and assets overseas. Therefore, the President’s plan tightens rules governing cross-border transfers of intangible property and closes loopholes by expanding the scope of the existing “Subpart F” rules. It restricts the use of “hybrid” arrangements that take advantage of differences in tax rules to generate so-called “stateless income”—income that is not subject to tax in any country.

These proposed reforms to the U.S. international system are consistent with the cooperative efforts of the United States and other countries to establish principles for addressing the shared challenge of base erosion and profit shifting by multinational firms. At the June 2012 G-20 Summit, the leaders of the world’s largest economies identified the actions of multinational companies to reduce their tax liabilities by shifting income into low- and no-tax jurisdictions as a significant global concern. The leaders instructed their governments to develop an action plan to address these issues. The resulting action plan to address base erosion and profit shifting (BEPS) was endorsed by President Obama and other world leaders at the 2015 G-20 Summit. The BEPS project made a number of recommendations and the OECD and G20 countries have committed to minimum standards in the areas of: requiring country-by-country reporting of income, assets, employees, and taxes paid; fighting harmful tax practices; improving dispute resolution; and preventing “treaty shopping.” In the area of transfer pricing (where concerns about profit shifting were prevalent), existing international standards have been updated and strengthened. With respect to recommendations on hybrid securities (treated as debt in some jurisdictions and as equity in others) and on rules governing interest deductibility, countries have agreed on the general tax policy direction reflected in the Administration’s proposals, which would require Congressional action in the United States. The BEPS project also generated guidance based on best practices that focus on the areas of disclosure and “CFC” rules (rules for taxing mobile income of foreign subsidiaries). Finally, participants

agreed to draft a multilateral instrument that countries may use to implement the BEPS work on tax treaty issues. All these steps have established principles for appropriate taxation of multinational firms and have set the stage for the OECD and G-20 countries to implement these approaches in their own tax systems.

Simplify and Cut Taxes for America's Small Businesses

America's small businesses face a tax code that is unduly complex. Often, these firms, unlike large businesses, are not engaged in complex transactions, and yet they must spend significant time and resources trying to comply with the tax code. Small businesses are disproportionately burdened with tax compliance, and the cost of this burden is substantial.

In 2004, small businesses devoted between 1.7 and 1.8 billion hours and spent between \$15 and \$16 billion on tax compliance. On average, each small business devoted about 240 hours complying with the tax code, and spent over \$2,000 in tax compliance costs. An overwhelming share of the time burden is due to recordkeeping, while most of the money burden is spent on compensation for paid tax preparers.²³

For some small businesses, the cost of tax compliance is particularly burdensome. In 2004, 9.7 percent of small businesses spent over \$5,000 in tax compliance and 11.2 percent devoted in excess of 500 hours to compliance. Moreover, for very small businesses, the burden of tax compliance can approach the total amount of taxes paid. For example, for small businesses with between \$10,000 and \$20,000 in annual receipts, the money burden of compliance is between 6.8 and 7.8 percent of receipts while the time burden amounts to about half—between 51.9 and 52.9 percent—of total receipts.²⁴

The high compliance cost for small businesses is a drag on innovation and entrepreneurship. Outlays for tax preparation and recordkeeping are resources small business owners could have invested elsewhere. The large amount of time spent on recordkeeping and understanding tax provisions means that small business owners have less time and energy for innovation and business development. There are other costs to complexity as well. Frustration with the tax code may eventually lead to weakened compliance and a higher gap between taxes owed and taxes paid. Moreover, complexity weakens the ability of tax policy to achieve its intended purpose. For example, small business owners might not take advantage of investment incentives, such as the President's proposed expansion of section 179 expensing provisions, if they feel the tax code is too complex overall to understand.

We have made considerable strides in reducing this burden. President Obama has signed into law numerous tax cuts for small businesses. In December, Congress significantly simplified and cut taxes for small businesses by permanently extending enhanced section 179 expensing, and also made permanent a provision excluding investments in small businesses from capital gains tax. However, more work needs to be done. Tax reform should make tax filing simpler for small businesses and entrepreneurs so that they can focus on growing their businesses rather than filling out tax returns, and it should cut their taxes.

The President's Framework proposes several tax cuts and tax simplification measures, the end result of which is that the vast majority of small businesses would not pay any tax on amounts reinvested in the business and almost all small businesses would pay taxes based on an income measure closer to their

²³ Donald DeLuca et al. "Aggregate Estimates of Small Business Taxpayer Compliance Burden." 2007. *IRS Research Bulletin*.

²⁴ *Id.* The tax burden can also vary by industry, with small businesses in manufacturing, construction, and retail trade devoting more time to compliance than businesses in other industries.

bank statement: deducting their expenses—including funds reinvested in their businesses—and paying tax based on their profits. Specifically, the President’s Framework would:

- **Allow small businesses to expense up to \$1 million in investments.** Since taking office, the President has secured increases in the maximum amount of qualified investments that small businesses can expense to \$500,000—with that provision made permanent at the end of 2015. Under the President’s Framework, and as proposed in the Budget, small businesses would be allowed to expense up to \$1,000,000 of qualified investments. This expansion would provide significant tax relief to America’s small businesses and would allow them to avoid the complexity of tracking depreciation schedules.
- **Allow cash accounting for businesses with up to \$25 million in gross receipts.** Cash accounting is much simpler than the accrual accounting generally required by the tax law. Cash accounting does not require tracking payables and receivables and does not require complicated calculations that allocate costs to inventories and other assets, and that stipulate when such costs can be used to reduce taxable income.
- **Simplify additional accounting rules for small business and harmonize eligibility.** Current law contains several small business exceptions from various accounting requirements based on a taxpayer’s average annual gross receipts. Exception thresholds vary between \$1 million and \$25 million of gross receipts, depending on the specific accounting rule and the legal status and business activity of the taxpayer. The Framework would simplify and expand these exceptions by creating a uniform small business threshold at \$25 million in average annual gross receipts—thus exempting more than 99 percent of all businesses. Satisfaction of the \$25 million gross receipts test would allow any small business to use the cash method of accounting (as described above), not apply the uniform capitalization rules, and use alternative inventory methods of accounting.
- **Quadruple the deduction for start-up costs.** This proposal would quadruple the amount of start-up expenses entrepreneurs can immediately deduct from their taxes from \$5,000 to \$20,000. This offers an immediate incentive for investing in starting up new small businesses, and it also simplifies accounting for small businesses, which must otherwise write off start-up expenses over a 15-year period.
- **Reform and expand the health insurance tax credit for small businesses.** This credit, created in the Affordable Care Act, helps small businesses afford the cost of health insurance. The Budget’s proposed reform would allow small businesses with up to 50 workers to qualify for the credit (up from 25), provide a more generous phase-out schedule, and substantially simplify and streamline the tax credit’s rules.

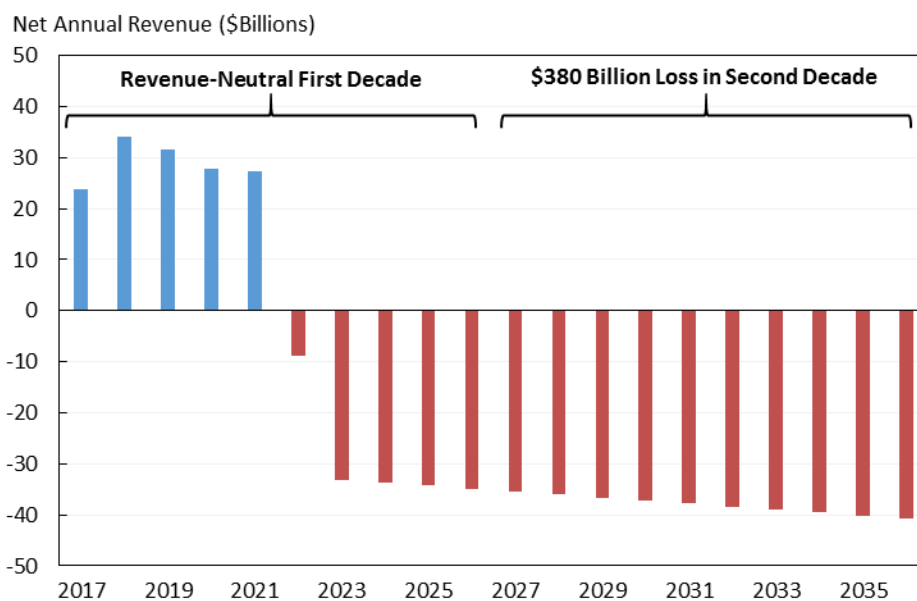
Restore Fiscal Responsibility

The federal budget deficit has fallen by about three-quarters since 2009, from a peak of nearly 10 percent of GDP to 2.5 percent of GDP in fiscal year 2015. While great progress has been made in bringing the federal deficit down, the United States still faces a medium- and long-term deficit, in part reflecting the legacy of past policies that were not paid for at the time they were enacted and that will continue to add to deficits and debt in the future. Most recently, this past December, Congress enacted many important elements of the President’s vision for business tax reform, but did so without paying for the costs. While

business tax reform has the potential to help the economy, these benefits could be more than offset if the reform effort adds to the medium- and long-run deficit challenge. Reforming the business tax system must be done in a fiscally responsible manner, including paying for December’s business tax cuts. In addition to paying for those tax cuts already enacted, the President’s Framework would fully pay for all other incentives extended or enhanced within business tax reform.

Furthermore, reform must not lose revenue in the short-term or long-run, which is why the President’s Framework would not use temporary revenues associated with timing shifts to pay for tax cuts with long-run costs (such as permanent corporate tax rate reductions).

Figure 7: Fiscally Irresponsible Tax Cuts: Using Transition Tax Revenue to Finance Permanently Lower Rates



Source: CEA calculations.
 Note: The figure displays the net effect of the Budget's 14 percent transition tax and a corporate rate cut calibrated to be revenue neutral in the first decade.

Fiscally responsible business tax reform poses a particular challenge because many of the policies proposed to offset the cost of a lower corporate tax rate affect the timing of revenues. For example, changes in the timing of depreciation allowances shift deductions between years but do not change the number of dollars ultimately deducted. Using policies with higher initial revenues to “pay for” permanent tax cuts over ten years generates large revenue losses in the long run and therefore is not fiscally responsible. For example, as shown in Figure 7, if the one-time revenues from the Administration’s proposed toll charge on unrepatriated profits were used to offset the ten-year cost of a permanent reduction in the corporate income tax rate, a package that appears revenue-neutral in the first ten years would lose roughly \$380 billion in the second decade, and even more thereafter. For this reason, the one-time revenues raised by business tax reform should be matched with one-time investments or deficit reduction, as the President’s Framework proposes.

FISCALLY RESPONSIBLE USE OF TRANSITION REVENUES TO INVEST IN INFRASTRUCTURE

As part of the transition to a reformed business tax system, the President's plan would impose a one-time toll charge of 14 percent on the more than \$2 trillion of untaxed foreign earnings that U.S. companies have accumulated overseas, raising nearly \$300 billion. Because these revenues are one-time in nature, they should be matched with one-time costs. The President proposes to dedicate these transition revenues to a significant one-time infrastructure investment, which would be both pro-growth and fiscally responsible. Temporary revenues do not justify long-term costs, such as a reduction in the corporate tax rate, which would ultimately increase deficits and debt.

The economic importance of robust infrastructure is well-established. Maintaining a well-functioning system of roads, airports, railways, and waterways is crucial to the American economy. Businesses must be able to easily and reliably move their products to market. Workers and consumers must be able to rely on a well-designed transportation network so that they can safely and easily get back and forth to work, to stores, and to visit friends and relatives. Furthermore, investing in infrastructure creates jobs for Americans in construction and many other related industries.

Unfortunately, America's roads, bridges, and other transportation systems are badly in need of upgrades and repairs. For example, about two-thirds of America's major roads are rated in less than good condition and one quarter of U.S. bridges need rehabilitation, replacement, or significant maintenance and repair to remain in service or do not meet current design standards and traffic needs. Furthermore, our transportation system is not equipped to address growing challenges, including climate change, congestion, and increased urbanization.

The President proposes a transformational investment in infrastructure through his 21st Century Clean Transportation Plan. Using the one-time revenue from transitioning to a new international tax system, as well as revenue from a new oil fee, the President's plan would transform our transportation system using targeted Federal investments to stimulate State and local investments in smarter, cleaner, and regional transportation systems, and to accelerate the adoption of low-carbon technologies, autonomous vehicles, and intelligent transportation systems. It would also expand transportation options for communities around the country and increase the resilience of the nation's infrastructure, without adding to the deficit.

Conclusion

Tax reform is difficult in any environment, but the President firmly believes that the economic benefits of a more efficient business tax system represent an opportunity for economic growth and improved living standards that we should seize. In the four years since the release of the *President's Framework for Business Tax Reform*, the need for reform has only grown more apparent. The most recent wave of corporate inversions poses a long-term threat to the U.S. tax base that Congress should act now to stop, even while it continues to deliberate on broader reform.

The President remains committed to working with Congress to make pro-growth business tax reform a

reality. There is sincere interest in business tax reform from many Members of Congress across the political spectrum and meaningful overlap among the proposals offered by Democrats and Republicans—even as there are critical differences. This updated Framework accounts for new developments in the business tax system and reiterates the President’s core principles—including that tax reform should make the code more efficient, strengthen manufacturing and innovation, fix the international system, simplify and cut taxes for small businesses, and restore fiscal responsibility—to set the stage for Congress and the Administration to work together to reform the business tax system.