*A Conversation with Alan D. Viard*

# Corporate Tax Overhaul Plan Targets Disincentives to Invest in the U.S.

*Alan D. Viard is a resident scholar at the American Enterprise Institute, a nonprofit research organization, and an expert on tax policy. He outlines his plan, developed with Eric Toder of the Urban Institute, for revising the tax code to make it less attractive for U.S. companies to shelter profits abroad.*

### Q. Why reform the U.S. corporate tax system?

The corporate income tax, in interaction with the individual income tax, has long-standing problems that would apply even if the U.S. economy were closed to international trade and investment. It penalizes equity-financed corporate investment relative to both debt-financed corporate investment and investment by flow-through business structures (such as sole proprietorships, partnerships, limited liability corporations and S corporations).

Corporate equity-financed corporate investments are penalized because their returns are taxed twice, with the corporation paying corporate income tax and the shareholders paying dividend and capital gains taxes. By comparison, interest income and income from flow-through businesses are taxed only once at the bondholder or business-owner level.

However, the corporate income tax has more serious shortcomings in today's globalized economy.

First, the corporate income tax discourages corporations from investing and booking profits in the United States. Foreign-chartered corporations pay U.S. corporate income tax on their U.S. profits, but not on their foreign profits. U.S.-chartered corporations immediately pay U.S. corporate income tax on their U.S. profits. They pay tax on their foreign profits only when the profits are brought back to the United States as dividends, and they are allowed to claim a credit for any foreign income taxes paid on the profits.

The U.S. tax system, therefore, gives both types of corporations an incentive to invest and book profits abroad rather than in the United States. By encouraging investment outside the United States, the corporate income tax reduces the U.S. capital stock, making workers less productive and driving down their wages.

Second, the corporate income tax discourages the use of U.S.-chartered corporations to invest abroad. As noted before, only U.S.-chartered corporations pay U.S. corporate income tax on their foreign profits. The U.S. tax system, therefore, creates an incentive to invest abroad through foreign-chartered rather than U.S.-chartered corporations.

Corporations have wide flexibility to act on the current tax system's perverse incentives, as they easily change where they book their profits and where they are chartered. For example, corporations can use a variety of accounting gimmicks to book profits abroad, and they can use "inversion" transactions to effectively swap a U.S. charter for a foreign charter.

### Q. What are the limitations of the leading corporate tax reform proposals now being considered?

Although the leading proposals mitigate some of the current tax system's problems, they aggravate other problems.

For example, some proposals call for higher taxes on the foreign profits of U.S.-chartered corporations. That would reduce the incentive for U.S.-chartered corporations to invest and book profits abroad. But it would not change the incentive for foreign-chartered corporations to do so and it would increase the incentive to do foreign investment through foreign-chartered corporations.

Other proposals go in the opposite direction, calling for lower taxes on the foreign profits of U.S.-chartered corporations. That would reduce the incentive to do foreign investment through foreign-chartered corporations. But it would increase the incentive for U.S.-chartered corporations to invest and book profits abroad.

Trade-offs are unavoidable so long as the tax system gives such large weight to where profits are booked and where corporations are chartered.

### Q. What is your plan and how would it solve the problems of the current system?

The plan would reduce the federal corporate tax rate from 35 percent to 15 percent. To ensure that the shareholders who receive corporate income continue to bear their fair share of the U.S. tax burden, the plan would increase the taxes collected from American shareholders.

American individual shareholders of publicly traded companies would be taxed on their dividends and capital gains at ordinary income tax rates (with a top rate of 43.4 percent) rather than the current preferential rates (with a top rate of 23.8 percent). Also, accrued capital gains would be taxed, and accrued capital losses would be deducted, each year as stock values rise and fall, even if the stock is not sold.

American individual shareholders would be allowed to claim credit against their taxes for their share of the corporate income taxes paid by the companies whose stocks they own. No similar credit would be provided to foreign shareholders or to nonprofit organizations and pension and retirement plans holding corporate stock.

The plan would dramatically reduce corporate income taxes, which are

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based on where profits are booked and corporations are chartered, and would increase shareholder taxes, which are based on where shareholders live.

### Q. What economic benefits would your plan have?

The tax penalty on corporate equity-financed investment would be greatly reduced by lowering the corporate income tax rate and allowing American individual shareholders to claim a credit for their share of corporate taxes paid by companies.

The incentive to invest and book profits abroad would be greatly reduced because the tax rate on U.S. profits would be 15 percent rather than 35 percent. The inflow of investment into the U.S. would expand the U.S. capital stock.

The incentive to do foreign investment through foreign-chartered corporations would be largely eliminated. U.S.-chartered corporations would owe little or no U.S. corporate income tax on their foreign profits because the U.S. tax rate would be reduced to 15 percent, against which they would still claim credit for foreign income taxes (which would often be larger than 15 percent of profits). U.S.-chartered corporations would therefore be much less disadvantaged relative to foreign-chartered corporations that do not pay U.S. corporate income tax on their foreign profits.

Americans owning shares of a corporation's stock would pay U.S. income tax on their dividends and accrued capital gains, regardless of where the corporation invested, booked profits or was chartered.

### Q. Why doesn't the plan repeal the corporate income tax entirely, which would eliminate the problems you've discussed?

An April 2014 version of the plan repealed the corporate income tax. However, the new version maintains a 15 percent corporate income tax in order to attain revenue neutrality, providing government the same total revenue as the current system. Keeping the corporate income tax would also ensure that some U.S. tax is imposed on foreigners who hold shares in companies investing in the United States, as the foreign shareholders would bear part of the burden of the companies' corporate income tax payments and, unlike American shareholders, would not be allowed to claim a credit for those tax payments.

### Q. Your plan would tax capital gains as they accrue, even if the shares had not been sold. How would shareholders pay tax on income they haven't realized?

Gains and losses on corporate stock would be averaged over many years, thereby protecting shareholders from facing large tax liabilities in any particular year. In most cases, shareholders should be able to pay their tax liabilities from dividends and other income, without selling any of their shares.

Also, the plan would exempt from tax the first $500 ($1,000 for married couples) of dividends and accrued capital gains each year, thereby helping small shareholders avoid potential problems posed by accrual taxation.

### Q. How would your plan affect government revenue? How would the plan affect the taxes paid by various income groups?

Estimates by the Urban-Brookings Tax Policy Center show that the plan would be approximately revenue-neutral, after including the taxes that would be paid on the additional profits that corporations would likely be induced to book into the United States. The estimates also show that the highest-income taxpayers would pay slightly more tax than they do today and that all other income groups would pay slightly less tax.

### Q. Won't moving the bulk of the tax burden from corporations onto individual shareholders be politically unpopular?

In reality, the plan moves tax collection, not tax burdens, from corporations to shareholders. Tax burdens can be borne only by people, not corporations and other artificial entities. The taxes now collected from corporations are presumably intended to impose a tax burden on the shareholders who own the corporations. Why not pursue that goal more openly by directly collecting the tax from shareholders, particularly if that approach avoids creating incentives to invest, book profits and charter abroad?

The plan actually moves tax burdens from *workers* to shareholders. Because the current corporate income tax encourages companies to invest abroad, thereby reducing the U.S. capital stock and making workers less productive, part of the corporate tax burden is currently shifted to workers in the form of lower wages. In contrast, because the increased taxes collected from shareholders under our plan would not encourage companies to invest abroad, the burden of those taxes is less likely to be shifted to workers.

Nevertheless, the perceived shift of the tax burden away from corporations (and the taxation of accrued capital gains) may make the plan unpopular in many circles. We do not expect the plan to be adopted in the near term. However, we believe that Congress, the president and the public will eventually recognize that some reform of this kind is necessary.

*For a more complete description of the plan, including its transition rules and other provisions, please see www.aei.org/publication/a-proposal-to-reform-the-taxation-of-corporate-income.*