Combining a VAT With Corporate Tax Reform

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The United States soon will have to make difficult and even painful policy choices about taxes and spending if it is to have a stable economic future.

Many think the adoption of a VAT will be part of the solution. If Congress turns to a VAT or other broad-based consumption tax, it will be in part a condemnation of the current income tax system. Lawmakers will have concluded that the income tax is not up to the challenge of raising more revenue for deficit reduction.

The potential corporate tax base is too small to make a major contribution toward meeting our fiscal challenges. The corporate income tax, in good years, generates revenue amounting to between 2 and 2.5 percent of GDP. Were it even advisable, a dramatic increase in that total corporate tax burden could not contribute more than a few tenths of 1 percent of GDP to a budget solution, and increasing corporate taxes would move them in the wrong direction.

Many would argue that corporate and business taxes must be reduced to maintain our global competitiveness. Most observers are troubled by the fact that the U.S. corporate tax rate is substantially higher than the rates in other countries. Raising corporate taxes through rate increases is impossible. The alternative — broadening the corporate tax base — would require a combination of increases on domestic and international business that likely would undercut U.S. competitiveness, discourage capital investment, hamper innovation, and remove support for development of new industries.

If an administration and Congress turn to a VAT, an early question they must confront is how high a tax to adopt. Many will argue for a tax only large enough to meet a specific deficit reduction goal. Policymakers on both sides of the partisan divide, however, could reasonably conclude that a much higher VAT is
appropriate. A relatively low VAT rate — for example, 6 percent — could generate substantial deficit reduction revenue, but it would also leave significant room for increases for other purposes in the future. Imposing an initial VAT at a higher rate could make future rate increases much harder to enact and provide the revenue necessary to substantially restructure and reduce other taxes.

**Why Corporate Tax Reform?**

Political forces, as much as policy considerations, will determine whether an excess in VAT revenue could occur and what it could be used for. In this debate, corporate tax reform should be high on the list for consideration.

Individual taxpayers, especially lower- and middle-income taxpayers, have seen significant tax relief over the last 30 years. Corporate taxpayers have not participated in this bounty. The logical places to look for dramatic tax relief would be:

- the Economic Recovery Tax Act of 1981 (ERTA, the Reagan tax cuts);
- the Tax Reform Act of 1986 (the 1986 act);
- the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, the first Bush tax cuts); and
- the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA, the second Bush tax cut bill reducing taxes on capital gains and dividends); and
- the American Jobs Creation Act of 2004 (the Jobs Act).

Corporate taxpayers, however, would search in vain for any dramatic, permanent benefits in those five bills.

ERTA contained $54.7 billion of favorable corporate tax changes related to depreciation and leasing rules over a five-year period. This represented about 20 percent of the entire 1981 tax cut.\(^1\) However, the 1982 Tax Equity and Fiscal Responsibility Act clawed back much of those benefits with $31 billion of increases related to limitations on the investment tax credit, depreciation, and leasing, as well as another $9.1 billion in business tax

\(^1\)JCS-71-81.
increases. The Deficit Reduction Act of 1984 continued the clawback with $8.4 billion of increases related to leasing transactions. Finally, in the 1986 act, the investment tax credit was repealed ($118.7 billion over five years), and recovery periods were further modified ($7.7 billion). So the gains of 1981 were substantially eliminated by the end of 1986.

The 1986 act lowered corporate tax rates from 46 percent to 34 percent, but at the same time, it shifted $120 billion of tax burden from individuals to corporations. It also increased business taxes through new inventory capitalization rules, partial denial of meal and entertainment deductions, and the corporate alternative minimum tax.

In 2001 EGTRRA brought $1.35 trillion of tax reductions over 10 years. All of them benefited individuals. Corporate taxpayers benefited incidentally from changes related to employee benefits.

In 2003 JGTRRA reduced taxes by an estimated $349.7 billion over 10 years. Businesses received temporary bonus depreciation and increased small-business expensing, totaling a $10.1 billion temporary benefit.

In 2004 the Jobs Act provided a $76.5 billion benefit for businesses through the domestic production activity deduction (section 199). However, that benefit was fully offset with other tax increases, including repeal of the exclusion for extraterritorial income and reforms in leasing rules related to tax-indifferent parties.

Other legislation has renewed expiring provisions, created new incentives, and corrected problems in the law, but often at the cost of permanent tax increases on business. Thus, the burden of corporate income taxes has not fallen three decades after the beginning of the tax cut and tax reform revolution. At a minimum, this suggests that a serious debate about the rates, reach, and base of the corporate income tax is long overdue, as is an
effort to provide greater stability in the incentives that the tax code seeks to provide. Revenue generated from a VAT could make that debate possible.8

Corporate Rates

Since the United States chopped its corporate tax rate in 1986, other countries have followed suit and surpassed it. According to the latest data from the OECD, the current 35 percent top rate in the United States is the highest national rate among OECD countries and the second highest combined rate when figuring in subnational corporate taxes.9

And the trend continues as other countries, including major economies, continue to cut their top corporate rates. Germany cut its rate in 2007, and in June 2010 the United Kingdom announced that its current rate of 28 percent would begin dropping by a percentage point a year until it reaches 24 percent in 2014.10

Because of the growing rate differentials, many observers have argued that the United States must lower its corporate rate to remain competitive economically. Proponents of rate reduction argue that lower tax rates would attract capital investment both from non-U.S. firms seeking to expand U.S. activity, and from U.S. firms that would be encouraged to repatriate earnings that could be reinvested in the U.S. business or distributed as a dividend to shareholders who could redeploy the capital within the United States.

The widespread support for a lower corporate rate is demonstrated by the range of proposals from across the political spectrum. A few relatively recent proposals illustrate ways a rate reduction could be addressed.

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8House Budget Committee ranking minority member Paul Ryan, R-Wis., has suggested replacing the entire corporate income tax with a subtraction method VAT on businesses. See “A Roadmap for America’s Future,” Doc 2010-2100, 2010 TNT 19-31.
In 2007 then-House Ways and Means Committee Chair Charles B. Rangel, D-N.Y., introduced legislation that included a reduction of the corporate rate to 30.5 percent. Also in 2007, Treasury hosted a conference on business taxation and global competitiveness and issued a report suggesting that the corporate rate could be reduced to 27 percent by eliminating tax breaks. Earlier this year, Senate Finance Committee member Ron Wyden, D-Ore., and Sen. Judd Gregg, R-N.H., introduced comprehensive tax reform legislation that would lower the corporate rate to 24 percent.

Rangel would have paid for his full package of reforms with a surtax on upper-income individuals and a repeal of some business preferences — such as the section 199 domestic production deduction and the last-in, first-out method of accounting — while raising taxes on carried interests and making changes to the international tax rules. Wyden and Gregg’s legislation would eliminate several business tax preferences, including the section 199 deduction and some oil and gas benefits, to buy down the corporate rate.

The Reach of Corporate Taxes

The United States’ worldwide taxation approach — which generally taxes residents and business entities on their worldwide income regardless of where the income is earned — contrasts sharply with the approach taken by most of the rest of the world. Most of the OECD-member countries use some form of territorial system that taxes income earned within a country’s borders and exempts foreign-source income. Japan and the U.K. recently switched to territorial systems, leaving the United States, Chile, Ireland, Mexico, Poland, and South Korea as the only OECD countries that still have a worldwide system.
The debate over which system best fits the modern global economy is a major policy debate the other OECD countries have had and that the United States needs to have as well. The current system is rooted in policy decisions made in the early 1960s when the United States dominated global cross-border investment. The question coming from both ends of the political spectrum is whether a major overhaul is past due.

Critics of extraterritorial taxation say that the United States’ choice to stay out of step with the rest of the world is making it hard for American companies to compete globally. They also argue that the worldwide system discourages repatriation of earnings, thereby locking out domestic reinvestment.16

A move to a territorial tax is not, however, a foregone conclusion. Defenders of the worldwide system say the real challenge is to reform and strengthen the current extraterritorial tax system.17 The Obama administration favors the reform approach, having proposed several measures to strengthen the worldwide system.18 Although the most fundamental changes recommended by the administration have received little congressional support, Congress recently passed a series of foreign tax credit reforms as revenue offsets for spending rather than as part of a comprehensive approach to international tax issues.19

Excess VAT revenue could create the conditions necessary for a tough but thoughtful debate over territorial or extraterritorial taxation.

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17 See, e.g., Edward D. Kleinbard, “Throw Territorial Taxation From the Train,” Tax Notes, Feb. 5, 2007, p. 547 (recommending the United States reject territoriality and adopt a better worldwide approach); and testimony of Stephen E. Shay before the House Ways and Means Subcommittee on Select Revenue Measures, June 22, 2006, Doc 2006-12169, 2006 TNT 121-36 (recommending base-broadening reforms and noting that the current U.S. system can yield more taxpayer-favorable results than a territorial system). In 2009 Shay became deputy assistant secretary for international tax affairs at Treasury.


The Tax Base

The Rangel, Wyden-Gregg, and 2007 Bush Treasury reform proposals discussed above suggest that rate reduction could be financed through a broadening of the tax base. The Bush administration’s work also suggests expensing of capital investment as an alternative or complement to rate reduction.

Many would argue that the corporate tax base is too broad. A recitation of all the recurring debates about the corporate income tax base — from the AMT to the treatment of net operating losses — is unnecessary for our purposes here. Two examples, however, illuminate the challenges: the almost annual fight over expiring business tax provisions that Congress treats as must-do legislation and the constant reconsideration of capital cost recovery at each economic downturn.

According to the Joint Committee on Taxation, there were more than 60 income tax extenders in 2009 and more than 40 expiring in 2010.20 The on-again, off-again quality of extenders that are allowed to lapse creates tax planning havoc for practitioners and can have severe economic effects on an industry. For example, the American Wind Energy Association says that annual installation of wind capacity drops precipitously in years when the production tax credit was not renewed.21

The research credit provides another example of the seemingly schizophrenic nature of our approach to the corporate tax base. There is wide consensus that the credit is necessary to keep American business competitive with major trading partners who give generous research incentives. Even with this consensus, Congress has never made the credit permanent. Since it was enacted in 1981, the research credit has been extended 14 times and was allowed to lapse for one year (from July 1, 1995, to June 30, 1996).

The capital cost recovery rules were liberalized in 1981, then tightened and tweaked over the next five years. The rules have

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remained stable since 1986, although many argue they are outdated (the asset life classifications were mostly set 30 to 50 years ago) and bear little relation to assets’ true economic depreciation. The 2007 Treasury report on business taxation and competitiveness said the current system distorts the measurement of capital income and suggested expensing as the best way to stimulate investment. Congress seems to agree, as it has used bonus depreciation several times over the last 10 years to spur investment when the economy is lagging.

Conclusion

Deficit reduction efforts may present a rare opportunity to reshape corporate taxation in ways that address long-standing concerns and create a tax system appropriate for the 21st century. Changing the existing tax system, however, will not be easy. Adoption of a VAT would disturb existing expectations of taxpayers, raise important transition issues, and open debates on saving incentives and the taxation of financial products and services.

A simple review of tax footnotes to financial statements would demonstrate the extent to which the system creates relative winners and losers. Taxpayers with significant deferred tax assets essentially are prepayers of tax relative to their book income, while those with deferred liabilities are postpayers. Firms in those positions could have sharply contrasting views of any effort to level the playing field.

Those taxpayers with significant deferred assets would fear that the value of those assets could be eroded by any tax reform that significantly reduces the corporate rate. Taxpayers with deferred liabilities might be perceived as receiving tax windfalls through any rate reduction.

Introduction of a VAT as an additional tax, rather than a replacement tax, could assist in smoothing transition problems

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23Treasury background paper, supra note 12.
and would interject a whole new set of considerations into the basic debate. Proponents of a VAT as a replacement for the entire income tax have long argued that it would encourage saving and capital investment and effectively create a territorial tax that would advantage U.S. exports. The extent to which an add-on VAT would justify less aggressive action on capital cost recovery or territoriality will be hotly debated.

As difficult as those debates will be, they must take place. The time to have them must be when the country is renegotiating the basic fiscal contract between taxpayers and government.