Can the U.S. Corporate Tax Be Salvaged?

By Jeremy Scott — jscott@tax.org

The corporate tax no longer raises the revenue it used to for the federal government. According to President Obama's 2010 budget, corporate tax receipts totaled only $222 billion, less than 10 percent of total federal receipts. The tax now raises only about one-fifth that of individual income taxes, which totaled approximately $1 trillion.

There are several reasons for the declining importance of corporate taxes. Businesses are increasingly choosing passthrough entity structures that are not subject to corporate taxes. The economic downturn of 2008 is still depressing corporate profits, which reduces the tax base. And as the Obama administration is always quick to point out, many U.S. corporations are relocating operations offshore. Or perhaps they are simply moving profits offshore without really changing their business structure. That, at least, was the argument of Martin Sullivan several weeks ago, when he estimated that profit shifting through the use of transfer pricing rules was costing the United States at least $28 billion a year. (For Sullivan's analyses, see *Tax Notes,* Mar. 8, 2010, p. 1163; and *Tax Notes*, Mar. 22, 2010, p. 1439.)

What does the decline in corporate tax receipts mean for the nation's tax system? For starters, it means that individual income taxes and regressive payroll taxes have to do more of the heavy lifting to support federal spending. Some might argue, however, that there isn't much more that can be done to raise revenues through income taxation. This is where calls for a consumption tax, such as a federal VAT, derive their strongest support. If the corporate tax continues to collect fewer and fewer dollars, and if politicians are reluctant to raise individual tax rates, then some other source of revenue must be found. But taxpayers shouldn't be confused by VAT rhetoric. Whether it is through higher individual tax rates or through a VAT, middle-income earners will be responsible for making up for corporate tax shortfalls if the nation is to attain a sustainable federal deficit and fight the recent surge in the debt-to-GDP ratio.

And, of course, businesses will tell you that if the corporate tax system is broken, it is because rates are too high. The United States does have one of the highest statutory corporate tax rates in the world at 35 percent, although most studies will put the effective corporate tax rate at around 25 percent because of deferral and other base-contracting tax rules. (That would still be around the fifth highest in the world.) So business groups are pushing Congress for a corporate tax rate cut and a move to a territorial tax system, neither of which is likely to result in increased revenues — in fact, both reforms would probably only further marginalize the corporate income tax regime. Taxpayers should keep this in mind when they hear business lobbying groups complain about ''competitiveness'' and pressure Congress for further tax concessions. Every tax dollar Congress doles out to business in the form of a tax break, rate reduction, or favorable transfer pricing rule has to come from somewhere.

In the end, probably the only way to save the corporate tax is to enact some kind of 1986-like reform — reducing marginal rates while broadening the base to ultimately produce a gain in revenue. Unfortunately, the biggest proponent of that reform, Rep. Charles B. Rangel, has other problems on his mind at the moment.

Xilinx

Transfer pricing is at the heart of the decay of the U.S. corporate tax system, and even the judiciary is starting to chip away at the brittle foundation of international tax rules. Although the practitioner community is probably pleased about the Ninth Circuit's reversal of course in the *Xilinx* case, losses in high-profile transfer pricing cases like this simply reinforce the negative trends mentioned above. Lee Sheppard looks at the Ninth Circuit's revised opinion and can't even find a suitable metaphor for ''stupidity of the magnitude of the Ninth Circuit reversal of its previous decision.'' Sheppard believes that the new panel decision is inconsistent with congressional intent and also turns a safe harbor rule against the government. She is particularly incensed that the circuit court seems to have prohibited the IRS from using economic arguments to combat complicated taxpayer transactions. She writes that Congress needs to reassert control over section 482 soon or taxpayers will be able to shift income at will ''as long as they make the correct incantations.'' (For Sheppard's analysis, see p. 7.)

Commentary

Transfer pricing practices and the arm's-length standard have been under attack by many inside and outside Congress, especially in light of indications that significant profits are being shifted offshore to avoid U.S. tax. The focus of these critics is on tightening loopholes in transfer pricing and raising corporate tax revenue. But the U.S. international tax system is also under attack from business groups that say high corporate rates and a worldwide system are harming the competitiveness of multinationals. In a special report, Barbara Angus, Tom Neubig, Eric Solomon, and Mark Weinberger argue that the international tax system is at a crossroads. The authors believe that the U.S. system is outdated, overly complicated, and fails to support the goals of both government and business. They conclude that any reform of U.S. tax rules must bring the United States more in harmony with foreign tax regimes and must best support the needs of the government and business. (For the report, see p. 45.)

Economic recovery legislation has become increasingly focused on the use of tax expenditures rather than direct subsidies. This is largely a function of the political climate in Washington, where Republicans are skeptical of any increase in domestic spending but are more willing to accept tax expenditures as a form of tax cut. But even Democrats have become enamored of using the tax code to accomplish economic stimulus and social goals. Prof. Patrick Tolan Jr. writes that this use of tax expenditures is filled with conceptual flaws, gaps, and practical pitfalls. In the first of a two-part series, Tolan provides the background for rising tax expenditure revenue losses and explores the use of tax expenditures in the wake of the September 11, 2001, terrorist attacks (p. 67). He concludes that Congress's well-intentioned relief for victims relied on a flawed recovery model and generated ineffective rebuilding efforts. The second part will focus on transparency and accountability in the use of tax expenditures.

The first-time home buyer credit, enacted in 2008, is an example of a costly new tax expenditure. The credit was designed to combat the bursting of the housing bubble. Amourae Riggs and Sheldon Smith write that the credit has done a poor job of promoting the ideals of a desirable tax system (p. 94). As Tolan finds for tax expenditures generally, they find that the home buyer credit is inefficient, complicated, and only focused on short-term effectiveness.

In the recent film *Up in the Air*, George Clooney plays a consultant who handles layoffs for companies unwilling to confront their own employees to fire them. One theme of the movie concerns the use of face-to-face contact in conducting these "exit interviews." Diana Leyden believes that the IRS could learn a valuable lesson from the film and criticizes its reduction in face-to-face contact between Service employees and taxpayers (p. 93). She concludes that efficiency and cost savings are often illusory when it comes to computerizing and centralizing service-oriented businesses like the IRS. Hopefully, Leyden's recommendations will fare better than *Up in the Air* did at the Oscars, where it failed to receive an award despite six nominations.

Common trust funds have been a feature of the code since 1936. They predate the adoption of partnership tax rules in 1954 and use an early form of passthrough taxation to require participants to recognize their proportionate share of income and losses even if no distributions are made. Prof. Calvin Johnson argues that common trust funds resemble a living fossil and that their failure to conform to modern tax rules exposes them to abuse. Johnson proposes eliminating common trust funds or at least fixing their faults (p. 103). His Shelf Project proposal would allocate preexisting losses to new participants, but then simply disallow them. An alternative reform would be to simply eliminate the common trust form so that partnership antiabuse rules would be applied to the trusts automatically.

In Woodcraft this week (p. 115), Robert Wood looks at false imprisonment claims and criticizes the recent court decision in *Stadnyk*. Wood argues that false imprisonment claims by definition are physical and should be excludable from income. In a viewpoint, Theodore Groom opposes the new Medicare tax in the healthcare reconciliation package, concluding that it is not justified on either economic or fairness grounds (p. 100). Robert Willens addresses substance-over-form concerns when making section 338 elections (p. 113). ■