

COMPREHENSIVE TAX REFORM

The Time Is Now



Business
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Statement on Comprehensive Tax Reform

The Business Roundtable supports comprehensive tax reform of both the individual and corporate income tax systems to improve economic growth and provide for a simpler and more efficient tax system. The Business Roundtable commends the ongoing tax reform efforts of the Ways and Means Committee, led by Chairman Dave Camp (R-MI) and ranking member Sander Levin (D-MI); the Senate Finance Committee, led by Chairman Max Baucus (D-MT) and ranking member Orrin Hatch (R-UT); and the Administration led by President Barack Obama and Treasury Secretary Jack Lew.

Based on the expertise of Business Roundtable CEOs, this primer on tax reform is limited to an analysis of the corporate income tax system and the changes needed to update the corporate income tax to allow American companies to be competitive in markets both at home and abroad and return economic growth and job creation to the United States. The Business Roundtable supports corporate tax reform that is revenue neutral within the corporate sector, thereby ensuring that any reforms to the corporate tax system are financed strictly through broadening of the corporate income tax base. Given the need for the U.S. tax system to be competitive with the tax systems of our major competitors, all corporate revenues from base-broadening measures and loophole closing should be used only for corporate reform.

**A companion summary version of this Business Roundtable publication
is available at brt.org.**

Foreword by Governor John Engler

There is broad bipartisan agreement on the need for tax reform. Comprehensive reform is a matter of when, not if, because the current system is overly complex, inefficient and unsustainable. Making our tax system more efficient and more supportive of economic growth will have an immediate benefit to the U.S. economy — more and better-paying U.S. jobs.

We currently have a jobs problem and a growth challenge in the United States, but we must remain optimistic because many of the solutions can be implemented rather quickly. The failure to modernize our tax system has held back economic growth and hindered the ability of American companies and workers to compete in the global economy. Our corporate tax rate now is the highest among all industrialized countries. Our international tax system still is based on rules first adopted in 1909 that tax the worldwide income of American corporations, while most other advanced economies have adopted international tax rules that reflect the modern, competitive global marketplace.

The burdensome corporate tax system hinders economic growth, is inefficient and is in need of reform. The recommendations of expert panels established by President Barack Obama — including the President's Export Council; the President's Council on Jobs and Competitiveness; the President's Advanced Manufacturing Partnership Steering Committee; and the President's National Commission on Fiscal Responsibility and Reform, co-chaired by Alan Simpson and Erskine Bowles — have all included proposals for corporate tax reform that would provide:

- ▶ A lower, competitive corporate rate; and
- ▶ Changes to our international tax system that reflect the reality of a modern global marketplace.

President Obama's February 2012 *Framework for Business Tax Reform* calls for substantial reductions in the corporate tax rate, as does House Ways and Means Chairman Dave Camp's October 2011 discussion draft, which also proposes adoption of a territorial tax system for foreign income.

These reforms can be adopted in a fiscally responsible, revenue-neutral manner through tax reform that promotes economic growth and includes appropriate base-broadening measures. This approach is endorsed by President Obama in the Administration's FY 2014 Budget calling for revenue-neutral business tax reform. Base broadening can address existing distortions in the tax code and provide for more level taxation of diverse economic activities, thereby providing for a more efficient tax system. However, given the scale of changes needed for the U.S. tax system to be competitive with the tax systems of our major competitors and for these reforms to be revenue neutral under conventional government scoring, all revenues from base-broadening measures and loophole closing will need to be applied toward rate reduction and modernizing our international tax system.

This primer on tax reform provides an overview of the important corporate tax policy issues that reform must address and the benefits to the U.S. economy from undertaking reform. A modernized corporate tax system will allow American companies to better compete at home and abroad and will increase investment in the United States. The net result will be a more efficient tax system geared to economic growth and job creation in the United States.

The Business Roundtable urges Congress and the Administration to undertake comprehensive tax reform this year.

The case for tax reform is certain. The time for tax reform is long overdue.

What America's Leaders Are Saying about Tax Reform

"We know what it will take for America to win the future. We need to out-innovate, we need to out-educate, we need to out-build our competitors. We need an economy that's based not on what we consume and borrow from other nations, but what we make and what we sell around the world. We need to make America the best place on Earth to do business. ... Another barrier government can remove is a burdensome corporate tax code with one of the highest rates in the world."

President Barack Obama, February 7, 2011

"If we are serious about creating a climate for job creation, now is the time to adopt tax policies that empower American companies to become more competitive and make the United States a more attractive place to invest and create the jobs this country needs."

*Ways and Means Chairman Dave Camp (R-MI),
October 26, 2011*

"[W]e must simplify our tax code for America's families and businesses. It has been close to 30 years since the last major overhaul of America's tax code. In that time, our world has changed dramatically. ... Our tax code is now antiquated and acting as a brake on our economy, especially when compared with our overseas competitors. We need a pro-growth tax code that gives America's businesses the certainty they need to compete globally and plan and expand operations, instead of leaving them hoping for a continuation of temporary tax breaks."

*Senate Finance Committee Chairman Max Baucus (D-MT),
February 26, 2013*

"We need tax reform that protects working families, encourages economic growth and domestic job creation, and is fiscally responsible."

*Ways and Means Ranking Member Sander Levin (D-MI),
June 3, 2011*

"Every industrialized country around the globe understands that tax rates can determine whether or not businesses succeed or fail. And America's job creators know that to remain competitive abroad and create jobs here at home, we'll have to radically reform our nation's tax code, transition to a territorial tax system, and reduce our corporate tax rate to 25 percent. America's high corporate tax rate is a drain on economic growth, efficiency, job creation, and competitiveness. I want America to be number one in many things, but having the highest corporate tax rate is definitely not one of them."

*Senate Finance Committee Ranking Member Orrin Hatch
(R-UT), March 30, 2012*

"Our top priority is to strengthen the recovery by fostering private sector job creation and economic growth at a time when we must make sure our economy remains resilient to headwinds from beyond our shores. That means making it easier to sell American-made goods abroad and expand manufacturing in the United States. It means working with our partners around the globe and through organizations like the G20 to bolster the international financial system and promote global economic stability. It means moving forward on the work to complete financial reform so that the system is less vulnerable to crisis, with greater protections for investors and consumers. And it means reforming the tax system so American businesses can thrive and remain competitive."

Treasury Secretary Jacob Lew, February 13, 2013

"To preserve our international competitiveness, it is imperative that we seek to reduce the corporate tax rate from 35 percent and do it on a revenue-neutral basis. This will boost growth and encourage more companies to reinvest in the United States."

Senator Chuck Schumer (D-NY), October 9, 2012

"Among wealthy nations, we now have the second-highest corporate tax rate in the world, and because of recent changes in other countries we're now the only wealthy nation that taxes income earned overseas when it's brought back home."

*Former President Bill Clinton
(Excerpt from Back to Work: Why We Need Smart
Government for a Strong Economy, November 2011)*

Overview

Fast Facts

- ▶ The Organisation for Economic Co-operation and Development (OECD), a group of 34 advanced industrialized countries including the United States, calls the corporate income tax the most harmful type of tax for economic growth.
- ▶ Thirty of the 34 OECD countries have reduced their corporate tax rate since 2000; the United States is one of only two OECD countries with a higher statutory corporate tax rate today than in 1988.
- ▶ The United States now has the highest corporate tax rate among industrialized countries. Among all countries, only the Democratic Republic of Congo and Guyana have higher tax rates. Numerous studies also show that American companies on average have higher effective tax rates than their foreign competitors.
- ▶ The United States is the only G8 country to maintain a worldwide tax system on earnings from foreign markets; all other G8 countries and 28 of the 34 OECD countries use territorial tax systems.

Countries around the world have been focused on lowering their corporate tax rates and providing modern international tax rules to increase domestic investment and support the activities of their locally headquartered corporations as they seek to expand and sell into the global marketplace. The United States stands as an exception to this worldwide trend toward increased competitiveness.

Tax policy outside the United States reflects the growing recognition that a competitive corporate tax system plays an essential role in the dynamism of a nation's economy, its job growth and its workers' standard of living. Job creation depends on a vibrant private sector engaged in investing, hiring and innovating. The increased productivity resulting from private investment generates higher wages that allow each generation to achieve a rising standard of living.

With private-sector employment in the United States still millions of jobs below the levels reached before the 2007–09 recession, policies that add to job growth and make the nation's economy more internationally competitive must be a top priority. The United States is in urgent need of comprehensive tax reform to grow the U.S. economy and expand job growth.

Corporate Tax Rate

At 39.1 percent, the combined U.S. federal and state statutory corporate income tax rate is higher than the rate in any other country in the OECD. The U.S. rate is more than 14 percentage points higher than the 25 percent average rate of other OECD countries in 2012 (**Figure 1**).

In the 1986 tax reform act, the last major overhaul of the U.S. tax system, the United States lowered the top federal corporate tax rate from 46 percent to 34 percent, bringing the United States from one of the higher taxed countries in the industrialized world to one of the lowest. However, increased recognition of the importance of a pro-growth corporate tax system has led the rest of the world to reduce corporate tax rates since then, while the United States largely has stood still. Since 1988, the average OECD corporate tax rate has dropped more than 19 percentage points, while the U.S. federal rate has increased one percentage point to 35 percent (**Figure 2**).

Countries like Austria, Denmark, Finland, Germany, Norway and Sweden have cut their corporate tax rates by half since the late 1980s. After a series of rate cuts, Canada today has a federal corporate tax rate of 15 percent and, together with provincial taxes, has a combined average rate of approximately 26 percent. The United Kingdom has reduced its corporate rate over the last five years from 30 percent to 23 percent in 2013, with a further reduction to 21 percent planned to take effect in 2014 and 20 percent in 2015. Japan — which formerly had the highest corporate tax rate in the OECD — reduced its tax rate in 2012 and has enacted further rate reduction to take effect in 2015.

Figure 1

OECD Combined National and Subnational Corporate Tax Rates

Combined national and subnational top corporate tax rate

Rank in 2012		Rate in 2012	Enacted or proposed reductions, 2013–15
1	United States	39.1	
2	Japan	38.0	35.6
3	France	34.4	
4	Belgium	34.0	
5	Portugal	31.5	
6	Germany	30.2	
7	Australia	30.0	
8	Mexico	30.0	28.0
9	Spain	30.0	
10	Luxembourg	28.8	
11	New Zealand	28.0	
12	Norway	28.0	
13	Italy	27.5	
14	Sweden	26.3	22.0
15	Canada	26.1	
16	Austria	25.0	
17	Denmark	25.0	22.0
18	Israel	25.0	
19	Netherlands	25.0	24.0
20	Finland	24.5	20.0
21	Korea	24.2	
22	United Kingdom	24.0	20.0
23	Switzerland	21.2	
24	Estonia	21.0	20.0
25	Chile	20.0	
26	Greece	20.0	
27	Iceland	20.0	
28	Turkey	20.0	
29	Czech Republic	19.0	
30	Hungary	19.0	
31	Poland	19.0	
32	Slovak Republic	19.0	
33	Slovenia	18.0	15.0
34	Ireland	12.5	
OECD average, excluding United States		25.0	

Sources: OECD Tax Database (2012); Japan 2012 tax rate, Slovenia 2012 tax rate, and enacted or proposed reductions from current publications.

International Taxation

Another significant trend since the 1990s has been the increasing use in the rest of the world of tax systems that are more supportive of selling and competing in the global marketplace. Today, the United States stands as an outlier in the manner in which it taxes cross-border corporate earnings. The United States is the only G8 country to use a worldwide tax system, which imposes tax on the active foreign earnings of its corporations when the earnings are remitted home as a dividend. The other G8 countries and 28 of the 34 OECD countries use territorial tax systems that generally exempt from domestic taxation active foreign earnings remitted home as a dividend (**Figure 3**).

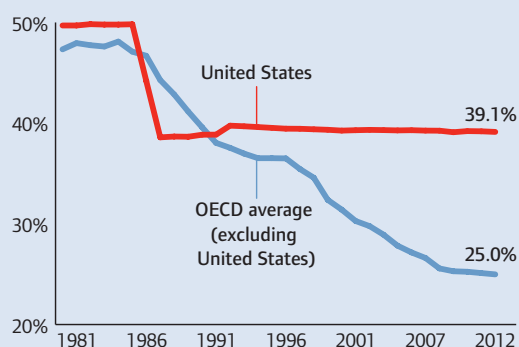
The U.S. worldwide tax rules date to the founding of the corporate income tax system in 1909. These rules were modified along the way, but they still are premised on the taxation of foreign earnings from active business operations when those earnings are paid home to the United States.

In the immediate post-World War II era, American companies were dominant players in global commerce, and unfavorable tax rules had less impact. But especially over the last 30 years, market competition from around the world has grown significantly. The

Figure 2

U.S. and Average OECD Statutory Corporate Tax Rates, 1981–2012

Combined national and subnational top corporate tax rate



Since 1988, the average OECD statutory corporate tax rate (excluding the United States) has fallen more than 19 percentage points, while the U.S. federal rate has increased 1 percentage point.

Source: OECD Tax Database (2012).

The current U.S. rate is based on the 35 percent federal tax rate and average state taxes of 6.36 percent. Because state taxes are deductible from federal taxes, the net combined tax rate is 39.1 percent.

Figure 3

Taxation of Foreign-Source Dividends, OECD Countries, 2012*Combined national and subnational top corporate tax rate*

Method of taxation	Countries		Dividend exemption percentage
Territorial Tax Systems Exempt foreign-source dividends from domestic income taxation through territorial tax system*	Australia, Austria, Canada, Czech Republic, Denmark, Estonia, Finland, Greece, Hungary, Iceland, Luxembourg, Netherlands, New Zealand, Poland, Portugal, Slovak Republic, Spain, Sweden, Turkey, United Kingdom		100% exemption
	Norway		97% exemption
	Belgium, France, Germany, Italy, Japan, Slovenia, Switzerland		95% exemption
Worldwide Tax Systems Worldwide system of income taxation with deferral and foreign tax credit	Country	2012 Tax Rate**	0% exemption
	Chile	20.0%	
	Ireland	12.5%	
	Israel	25.0%	
	Korea	24.2%	
	Mexico	30.0%	
	United States	39.1%	

* Territorial tax treatment providing exemption of foreign-source dividends often depends on qualifying criteria (e.g., minimum ownership level, minimum holding period, the source country, income tax treaty status and/or the source country tax rate).

** Refers to generally applicable tax rate, including surcharges, of combined central and subcentral government taxes.

establishment of market economies in formerly socialist or communist-controlled societies, rapidly growing emerging economies, and technological advancements in telecommunications have brought both opportunities to American companies and challenges in the pursuit of new global markets.

Cross-border trade and investment have given companies headquartered in any part of the globe the opportunity to expand into new consumer markets anywhere else in the world through both exports and local investment. This freedom of trade and investment has brought American products and services to billions of new consumers. At the same time, these forces have increased business competition. American and foreign corporations now actively pursue the same markets, both within the United States and around the world.

Heightened global competition facing American companies

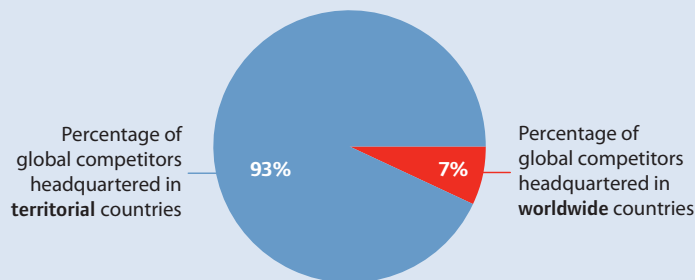
The increase in global competition facing American companies is reflected in a variety of statistics. To take just one measure, in 1960, American companies comprised 17 of the top 20 global companies ranked by sales. In 1985, the top 20 still included 13 American companies. In 2012, the latest data show just five American companies in the top 20.¹

With the growth of strong competition around the world, American companies now find that their closest foreign competitors are based in countries with corporate tax rates that are lower than the U.S. rate and with international tax systems that are more favorable to their global operations than the U.S. rules. In fact, of the 15 non-U.S. companies on Fortune's global top 20 list in 2012, 11 are headquartered in countries that use territorial tax systems. (Of the remaining four, three are state-owned companies headquartered in China, and the other is headquartered in Korea, which has a 24.2 percent combined national and subnational tax rate.) Within the OECD, 93 percent of the non-U.S. companies in the Global Fortune 500 in 2012 are headquartered in countries that use territorial tax systems (**Figure 4**).² Reflecting the increasing use of territorial systems around the world, in 1995 only 27 percent of the

Figure 4

Global Competitors of American Companies Predominantly Headquartered in Territorial Countries

Headquarters location of non-U.S. OECD companies in the Global Fortune 500, 2012



Source: Fortune (2012).

non-U.S. OECD companies in the Global Fortune 500 were headquartered in territorial countries.³

Other countries have responded to the growing importance of cross-border investment by adopting territorial tax systems to strengthen, attract and retain the headquarters operations of multinational corporations. Under these territorial systems, companies can compete on a level playing field with other companies in foreign markets and return these earnings home for

reinvestment. Reforming the U.S. international tax system to provide similar rules for American companies would enhance the global competitiveness of American-headquartered companies and strengthen the U.S. economy by removing barriers to returning foreign earnings for investment in the United States.

The ability of globally engaged American companies to be successful in world markets contributes to success at home. American parent companies with international operations employed 22.8 million workers in the United States in 2010 and, including their supply networks and spending by their employees, supported more than 63 million U.S. jobs.⁴ U.S. employment by American parent companies accounted for more than two-thirds of their worldwide employment. The average annual compensation paid in 2010 by American parent companies to their American workers was \$70,700, compared with \$52,900 for U.S. businesses without foreign operations.⁵

The Case for Corporate Tax Reform

A robust U.S. economy depends on strong American companies growing at home and abroad, as well as foreign-headquartered companies entering the U.S. market through U.S. investments employing American workers.

In many ways, however, the U.S. corporate tax system today works against the U.S. economy. Our high corporate tax rate discourages investments by American and foreign-headquartered companies in the United States. Our outdated system of international taxation also raises the cost to American companies of competing globally and returning earnings for investment at home, causing American companies to be less competitive in foreign markets and at home.

The combined effect of our high corporate tax rate and outdated international tax system is to slow the growth of the U.S. economy and create fewer and lower-paying jobs for American workers.

Corporate tax reform to modernize our tax system will enhance U.S. economic growth, increase U.S. investment, and provide for more and better-paying jobs. A competitive corporate tax rate and a more modern and competitive international tax system will provide a level playing field for American-based businesses, increasing the growth of U.S. companies, attracting investment to the United States, and enhancing and sustaining U.S. economic growth and job creation.

I. Jobs and Economic Growth Through Corporate Tax Reform

Fast Facts

- ▶ The corporate income tax is recognized by the Organisation for Economic Co-operation and Development (OECD) as the most harmful type of tax for economic growth.
- ▶ The burden of the corporate income tax falls on Americans in their roles as workers, consumers and savers.
- ▶ A growing body of evidence finds that workers bear from half to three-quarters of the corporate tax burden through lower wages.
- ▶ Corporate tax reform can increase economic growth and the living standards of Americans by increasing investment and employment in the United States.

Almost four years after the official end of the recession, private-sector employment remains millions of jobs below its prerecession levels. Policies that place the nation on a path of enhanced and sustained economic growth are needed to create employment opportunities for the millions of currently unemployed and the millions of additional Americans entering the labor force every year.

Economic growth is the means by which new jobs are generated, and higher wages, resulting from the productivity gains brought about by increased investment and technological innovations, provide rising living standards to American families.

High Corporate Income Taxes Restrain Economic Growth

The corporate tax system primarily affects economic growth through its effects on investment and entrepreneurial risk taking in the economy. Business investment encompasses a range of forward-looking expenditures, including investments in tangible capital, such as machinery and equipment, as well as investments in intangible capital, such as research and development (R&D). These risk-taking investments require an upfront expenditure of funds today in expectation of future profits.

Corporate income taxes affect both the amount and the location of business investment. The corporate income tax drives a wedge between the *pretax* and *after-tax* profitability of a given investment. Since corporations will choose to invest in projects with the highest *after-tax* rates of return, differences in corporate income taxes across countries can play an important role in the amount of business investment undertaken in each country. While many factors affect the location of business investment, including proximity to consumers and costs of production, some evidence suggests that business location decisions have become more sensitive to differences in taxation.⁶

Economic growth can be enhanced by reducing the level of taxation and establishing a tax system that provides for greater certainty and predictability. A tax system with stable and permanent rules reduces risks for businesses making long-term investments.

A vast analysis of the corporate income tax in countries around the world — both industrialized and developing countries — finds that the corporate income tax reduces gross domestic product (GDP) growth, reduces worker productivity, reduces domestic investment by domestic and foreign companies, and reduces entrepreneurship.⁷

These research findings have led the OECD to call the corporate income tax *the most harmful type of tax for economic growth*:

Corporate income taxes are the most harmful for growth as they discourage the activities of firms that are most important for growth: investment in capital and productivity improvements.⁸

Countries around the world are reducing their corporate tax rates and undertaking tax reform to provide for greater economic growth and increased national competitiveness. Tax systems that rely less on corporate income taxes can enhance economic growth as can reforms that implement the corporate income tax more efficiently.

Corporate Income Taxes Reduce Labor Income

Because the corporate income tax is collected from corporations rather than from individuals, a common misperception is that the tax is borne by corporations. However, corporations are merely legal entities. The corporate tax is a hidden tax that falls on individuals in some manner in their role as workers, consumers and savers. How exactly the burden is shared among individuals in these roles has been a matter of long standing economic study.

As Laura Tyson, the top economic adviser to former President Bill Clinton notes, “For many years, the conventional wisdom was that the corporate income tax was principally borne by the owners of capital in the form of lower returns. Now, with more mobile capital, workers are bearing more of the burden in the form of lower wages and productivity as investments move around the world in search of better tax treatment and higher returns.”⁹

A number of recent studies find that workers bear between half and three-quarters of the burden of the corporate income tax **(Box 1)**. Both the Congressional Budget Office (CBO) and the Treasury Department have adopted assumptions in their official distributional analyses that a portion of the corporate income tax is borne by labor.¹⁰

Implications for tax reform

The findings of these studies suggest that reforms that reduce the burden of the corporate income tax would provide significant benefits to workers through higher wages. As Laura Tyson states, “A high corporate tax rate not only undermines the growth and competitiveness of American companies; it is also increasingly ineffective as a tool to achieve more progressive outcomes in the taxation of capital and labor income.”¹¹ Shareholders also would benefit from corporate rate reduction, including the 50 percent of all American families who own corporate stock directly or through investments in mutual funds and tax-deferred retirement accounts, including employer-sponsored retirement plans such as 401(k) plans.¹²

Corporate Tax Reform Promotes Economic Growth

The U.S. economy clearly is in need of significant and sustained economic growth. Brookings Institution economists have estimated that at current rates of job creation, closing the jobs deficit created by the recent recession could take until the next decade.¹³ A competitive tax environment for America’s job creators is essential to providing the conditions to foster job creation, investment and economic growth. In summary, corporate tax reform to increase investment and employment in the United States is a vital component of needed policy changes.

How Much of the Corporate Income Tax Burden Falls on Workers?

Researchers examining the burden of the corporate income tax find across a wide range of settings that workers bear a substantial share of the corporate income tax burden, with several studies concluding that between half and three-quarters of the burden is borne by labor.

- ▶ An analysis of the U.S. corporate income tax by CBO finds that labor bears more than 70 percent of the burden of the corporate income tax, with the remaining 30 percent borne by domestic savers through a reduced return on their savings.¹⁴
- ▶ Based on a range of empirical and theoretical studies analyzing the incidence of the corporate income tax, a 2007 Treasury Department review concludes that labor “may bear a substantial portion of the burden from the corporate income tax.”¹⁵
- ▶ A study by American academic economists of the wages paid by American multinational companies operating in more than 50 countries concludes that labor bears 57 percent of the burden of the corporate income tax, with estimates ranging between 45 percent and 75 percent.¹⁶
- ▶ A study by European researchers of more than 55,000 companies in nine European countries concludes that workers bear approximately half of the burden of the corporate income tax in the long run.¹⁷
- ▶ A study by researchers at the National Bureau of Economic Research of state corporate income tax rate differences in the United States finds that unionized workers bear 54 percent of the burden of higher state corporate income taxes.¹⁸
- ▶ A study by economists at the American Enterprise Institute concludes that each \$1 increase in U.S. corporate income tax collections leads to a \$2 decrease in wages in the short run and a \$4 decrease in aggregate wages in the long term. This study implies that workers bear more than 100 percent of the burden of the corporate income tax. The authors believe that the large decline in wages in the long term is due to reductions in investment that reduce worker productivity. These reductions are not observable in studies focusing on short-run changes in tax rates.¹⁹

II. Competitiveness in the Global Economy

Fast Facts

- ▶ Global trade and cross-border investment represent an increasing share of worldwide economic activity, with trade rising by more than 50 percent and cross-border investment rising sixfold relative to world output over the past 30 years.
- ▶ The U.S. economy benefits from global engagement through increased exports of goods and services and earnings from foreign markets, with 63 million U.S. jobs supported by globally engaged companies and their supply chains.
- ▶ However, the global market share of American-headquartered companies is declining in the face of strong competition from foreign-headquartered companies with more favorable tax rules. The number of U.S.-headquartered companies in the Global Fortune 500 declined 26 percent between 2000 and 2012.
- ▶ Of the non-U.S. OECD companies in the Global Fortune 500 in 2012, 93 percent are headquartered in countries that use more favorable territorial tax systems, and all have a lower home-country corporate tax rate.

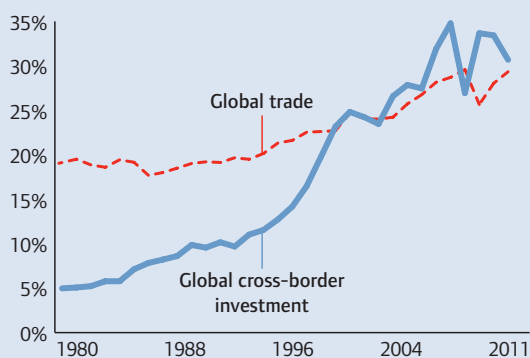
The U.S. economy still is the envy of the world. But the significant economic advantage the United States had in the last century — dubbed by some the American Century — has begun to wane. While once the United States could make policy decisions with little concern for global competitiveness, today we no longer have that luxury.

Advances in telecommunications, lower costs of transport, improvements in infrastructure, falling trade barriers and the adoption of market-based economies throughout the world have brought the world's populations closer together while heightening economic competition. These new markets bring enormous opportunities for America's economy, businesses and their workers. At the same time, expanding production by foreign-based companies has resulted in enhanced competition at home and abroad.

Figure 5

Increasing Importance of World Trade and Investment to Global Economies

World trade and foreign direct investment as a percentage of world GDP, 1980–2011



Sources: World Bank World Development Indicators for trade data and United Nations Conference on Trade and Development statistics database for foreign direct investment.

Global Trade and Investment Is Increasingly Important to World Economies

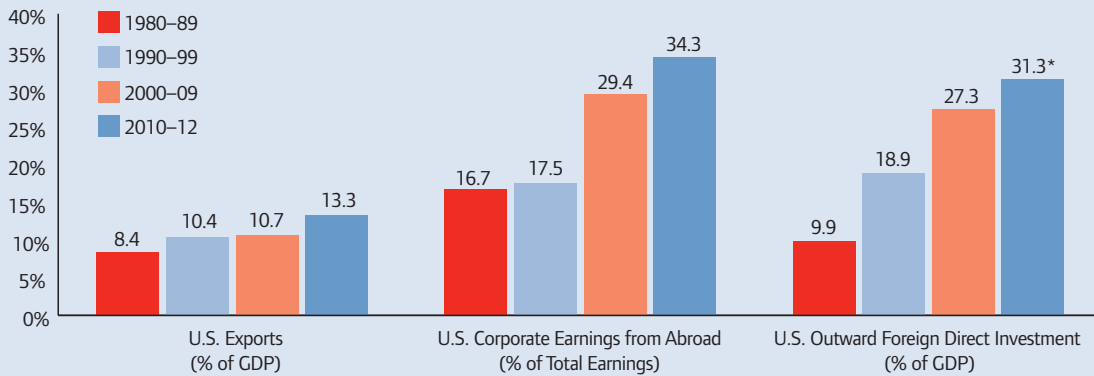
The growing global interconnections of the world's economies are evident in our daily life. Global trade has increased from 19 percent of world output in 1980 to 29 percent in 2011. Global cross-border investment has increased even more rapidly, rising from 5 percent of world output in 1980 to 31 percent in 2011 (**Figure 5**).

The United States also has increased participation in global markets over this period, expanding both trade and foreign direct investment relative to U.S. GDP (**Figure 6**):

- ▶ Exports of goods and services have increased to an average of 13.3 percent of GDP in 2010–12, up from an average of 8.4 percent of GDP in the 1980s.²⁰

Figure 6

Global Markets Provide an Increasing Benefit to the U.S. Economy, 1980–2012



*2012 data for U.S. outward foreign direct investment are not yet available (2010–11 shown).

Sources: Bureau of Economic Analysis, National Income and Products Accounts Tables 1.1.5 and 6.16 for data on corporate profits and exports as a share of GDP; United Nations Conference on Trade and Development statistics database for foreign direct investment.

- ▶ The share of total corporate earnings from abroad has increased to an average of 34.3 percent in 2010–12, up from an average of 16.7 percent in the 1980s.²¹
- ▶ Foreign direct investment by American companies has increased to an average of 31.3 percent of GDP in 2010–11 (the two most recent years for which data are available), up from an average of 9.9 percent of GDP in the 1980s.²²

U.S. Share of World Exports and Foreign Investment Is in Decline

Despite the increased importance of foreign markets to the U.S. economy, American companies have not kept pace with expanding global markets.

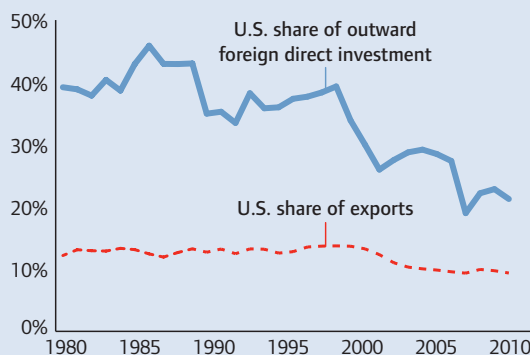
In 2011, exports from the United States accounted for about 9.4 percent of world exports, down from 17 percent in 1960. U.S. outward investment as a share of worldwide cross-border investment has declined even more significantly. In 2011, outward foreign direct investment from the United States accounted for about 21 percent of global cross-border investment, down from 39 percent in 1980 (**Figure 7**). With American companies responsible for a smaller share of world exports and cross-border investment, the U.S. economy is losing its share of the global marketplace to foreign competitors.

American companies account for a declining share of the Global Fortune 500

The declining relative importance of American companies in the world economy also is reflected in the rankings of the largest companies in the world. In 1960, American companies comprised 17 of the top 20 global companies ranked by sales. In 2012, the latest data show just five American companies in the top 20.²³

Figure 7

U.S. Share of Global Exports and Outward Foreign Direct Investment, 1980–2011



Sources: World Bank World Development Indicators for trade data and United Nations Conference on Trade and Development statistics database for foreign direct investment.

Among the companies listed in the Global Fortune 500, the number of U.S.-headquartered companies declined 26 percent between 2000 and 2012, from 179 to 132. The countries with the largest number of additions to the top 500 global companies over this period were the so-called BRICs: China added 63, India added seven, and Brazil and Russia each added five (**Figure 8**). In 2012, China was second to the United States in the number of companies in the top 500, up from 14th in 1995.

Growth of the emerging market economies will continue to offer new markets for American-produced goods and services — 95 percent of the world's population growth is forecast to be in emerging markets, with increasing spending by their middle-class populations relative to developed countries.²⁴ Goldman Sachs estimates that within the next 10 years emerging market economies in aggregate will be as large as industrialized economies.²⁵

American companies compete in these emerging markets with both locally headquartered companies as well as multinational companies headquartered in other developed countries. Within the OECD, 93 percent of the non-U.S. companies in the Global Fortune 500 in 2012 are headquartered in countries that use more favorable territorial tax systems, and all have a lower home-country corporate tax rate.²⁶ Reflecting the increasing use of territorial systems around the world, in 1995 only 27 percent of the non-U.S. OECD companies in the Global Fortune 500 were headquartered in territorial countries.

This heightened world competition makes U.S. corporate tax policy more important than ever. American companies require an internationally competitive tax system to compete on a level playing field with their most advanced competitors from around the world in markets at home and abroad. Wherever American companies compete abroad, they are virtually certain to be competing against foreign companies with more favorable tax rules. Corporate tax rules that hinder the competitiveness of American companies disadvantage American workers and impede the strength of the U.S. economy.

Figure 8

Global Fortune 500 Winners and Losers, 2012 vs. 2000

Country	Number of companies on Global 500		Change (decline or gain)
	2012	2000	
LARGEST DECLINES			
United States	132	179	-47
Japan	68	107	-39
United Kingdom	26	38	-12
Germany	32	37	-5
France	32	37	-5
LARGEST GAINS			
China	73	10	63
India	8	1	7
Brazil	8	3	5
Russia	7	2	5
Taiwan	6	1	5

Source: Fortune (2012 and 2000).

III. The U.S. Corporate Tax System at a Glance

Fast Facts

- ▶ Business income of C corporations is subject to two layers of tax — first under the corporate income tax and a second time when earnings are paid out as a dividend to shareholders under the individual income tax.
- ▶ The top combined federal corporate and individual tax rate on corporate income paid as a dividend is 51.25 percent in 2013, with state and local corporate and individual income taxes paid on top of this.
- ▶ Business income earned by pass-through entities (such as partnerships and S corporations) is taxed directly to their owners under the individual income tax rather than the corporate income tax.
- ▶ Business income of pass-through entities now accounts for the majority of business income of U.S. enterprises, exceeding that earned by C corporations. An average of more than 60 percent of all business income was earned by pass-through entities in the 10 most recent years.
- ▶ The United States is unique in having such a large pass-through business sector relative to other countries. As a result of the significant amount of business activity conducted in the United States by pass-through businesses, the ratio of corporate income tax to GDP is not a meaningful indicator of differences in the effective tax rate on corporate income between the United States and other countries.
- ▶ American companies are subject to both a high U.S. statutory tax rate and a high effective tax rate on corporate income relative to companies headquartered in other countries.

Although in popular terminology “business” and “corporation” are often used interchangeably, only certain businesses are subject to the corporate income tax. Most businesses in the United States are organized as pass-through entities, such as partnerships and S corporations. Income of pass-through entities is taxed to the owner of the business, typically under the individual income tax, rather than at the entity level as under the corporate income tax. Only a C corporation (named after Subchapter C of the tax code) is subject to the corporate income tax — a tax that is applied at the entity level separate from any tax levied on the owners of the corporation. In general, publicly traded corporations are taxable under the corporate income tax.

Double Taxation of Corporate Income

Dividends paid by a C corporation to its shareholders are subject to a second level of tax at the shareholder — or owner — level. In contrast, income of pass-through entities is subject to only a single level of tax to the owner.

This double taxation of C corporation income increases the cost of capital for C corporations and reduces the ability of C corporations to raise capital and make investments relative to a tax system that applies only a single level of tax. Partial relief from double taxation was enacted in 2003 as a temporary measure and was made permanent in 2013 through a reduction in the maximum individual tax rate on corporate dividends received by shareholders. In 2013, the top statutory tax rate applying to dividend income under the individual income tax is 20 percent, but combined with other federal income taxes it is as much as 25 percent.²⁷ Between 2003 and 2012, the top tax rate on dividend income under the individual income tax was 15 percent.

The total tax on corporate income under the federal income tax system is the sum of tax collected at the corporate level, individual income taxes paid on dividend income and capital gains taxes on corporate shareholdings.

In 2013, the combined tax burden on \$100 of corporate income, the net proceeds of which are distributed as dividends to a shareholder subject to the 20 percent dividend tax rate, is \$51.25 — that is, an effective tax rate of 51.25 percent on corporate distributions. This is the sum of \$35 in corporate income tax (35 percent corporate rate times \$100) plus \$13 in individual income tax collected on the dividend payment (20 percent individual tax rate times \$65 dividend) plus additional amounts collected from the reinstatement of the phaseout of itemized deductions and the new 3.8 percent Medicare tax on investment income **(Figure 9)**.²⁸ In addition, state income taxes may apply at both the corporate and individual levels.

Figure 9

Double Tax Collections on Corporate Dividend Payments, 2012–13

Federal income tax payments on \$100 of corporate taxable income distributed as a qualified dividend

Item	2012	2013
Corporate taxable income	\$100.00	\$100.00
Corporate income tax (35%)	\$35.00	\$35.00
After-tax corporate income	\$65.00	\$65.00
Dividend payment	\$65.00	\$65.00
<i>Individual income tax on dividend</i>		
Ordinary rate (15% in 2012, 20% in 2013)	\$9.75	\$13.00
Phaseout of itemized deduction (1.2% in 2013)		\$0.78
Medicare tax (3.8% in 2013)		\$2.47
Subtotal individual income tax (15% in 2012, 25% in 2013)	\$9.75	\$16.25
Total income tax	\$44.75	\$51.25

Note: Applicable state and local income taxes at the corporate and individual levels are in addition to the above.

Corporate Income Tax Payments

Corporate income tax payments in FY 2012 were \$242 billion, the fifth highest level in history, and 9.9 percent of total federal tax receipts.

While the argument has been made that corporate income tax collections have been declining over time relative to the size of the economy, it is important to recognize that since corporate profits vary over the business cycle, corporate income tax payments are quite variable.

Corporate income tax payments as a share of GDP reached a low of 1.0 percent in 2009 — the lowest percentage of GDP since 1936. The low percentage in 2009 reflected low profitability from the recession, tax losses and temporary investment incentives providing accelerated (“bonus”) depreciation deductions. Just a few years earlier, in 2006 and 2007, corporate income tax payments as a share of GDP reached 30-year highs. In 2012, corporate income taxes were 1.6 percent of GDP, slightly below the 1.9 percent average of the prior 40 years **(Figure 10)**.

In addition, an increasing share of business activity is now conducted by pass-through businesses directly subject to tax under the individual income tax rather than under the corporate income tax. Over the most recent 10 years for which detailed data are available (2001–10), net income of corporations averaged less than 40 percent of total business net income, while pass-through businesses accounted for an average of more than 60 percent of business net income.²⁹ In contrast, in the 10-year period of 1980–89, corporations earned an average of 70 percent of net business income while pass-through entities earned 30 percent.

The United States is unique in having such a large pass-through business sector relative to other countries.³⁰ As a result of the significant amount of business activity conducted in the United States by pass-through businesses, the ratio of corporate income tax to GDP is not a meaningful indicator of differences in the effective tax rate on corporate income between the United States and other countries **(Box 2)**.

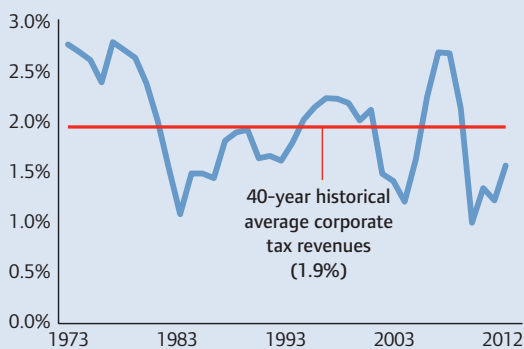
The vast majority of corporate income taxes are paid by America's largest corporations, which earn most of the country's corporate income. In 2009, the most recent year for which detailed data are available, more than 1.7 million corporations filed tax returns. Among large corporations, those with assets of \$250 million or more, 7,614 companies filed returns — representing 0.4 percent of all corporations. This tiny percentage of all corporations paid 82 percent of total corporate income tax in 2009 **(Figure 11)**.³¹

Among very large corporations, those with assets of \$2.5 billion or more, 1,531 companies filed returns, representing about 20 percent of large corporations and only 0.09 percent of all corporations. These very large corporations paid 80 percent of the corporate income tax attributable to large corporations and 65.4 percent of total corporate income tax in 2009.

This pattern of most corporate income tax payments being paid by the largest and very largest companies in America has been relatively constant over the past 10 years and is not due to the recent recession or recent changes in tax law.

Figure 10

Federal Corporate Income Taxes as a Percentage of GDP



Source: Congressional Budget Office (2013).

Figure 11

Large Companies Pay Nearly All of the Federal Corporate Income Tax

Corporate income tax returns and income tax payments, 2009

Item	All active corporations	Corporations with assets of \$250 million or more	Corporations with assets of \$2.5 billion or more
Number of returns	1,715,305	7,614	1,531
Number of returns as a percentage of all active corporations	100.0%	0.44%	0.09%
Total income tax after credits	\$205.0 billion	\$167.8 billion	\$134.0 billion
Total income tax after credits as a percentage of all active corporations	100.0%	81.9%	65.4%

Source: C corporation tabulations from Statistics of Income Division, Internal Revenue Service (2012).

Box 2

It's Not Just the Statutory Rate — Effective Corporate Tax Rates Also Are High

It is well known that the U.S. statutory tax rate is the highest in the OECD, but it is sometimes questioned whether American companies also face a high effective tax rate on income earned in the United States.

Some commentators have incorrectly claimed that U.S. effective tax rates on corporate income are below average since U.S. corporate income tax collections are a smaller share of GDP than the average of other OECD countries. However, this calculation ignores the larger pass-through sector in the United States relative to other advanced economies.

Studies examining effective tax rates on corporate income generally find that the U.S. effective tax rate is among the highest in the world. Four recent studies of corporate effective tax rates are described here.

- Cash Effective Tax Rates.** A World Bank study of corporate income taxes in 185 countries for 2013 finds that cash tax payments are higher for companies

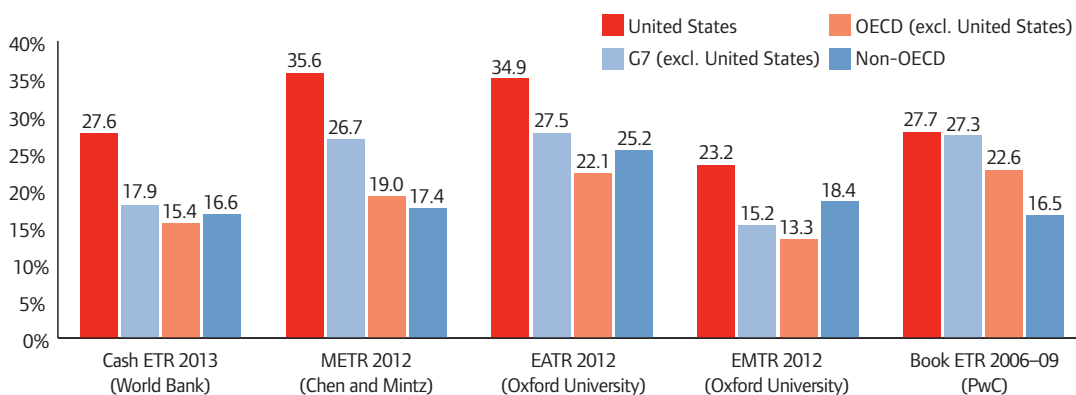
operating in the United States as a percentage of income than the average of other OECD and non-OECD countries.³² The U.S. cash effective tax rate of 27.6 percent is more than **12 percentage points higher** than the average of other OECD countries and **11 percentage points higher** than the average of non-OECD countries. The U.S. cash effective tax rate is the highest in the G7 and the second highest in the OECD.

- Marginal Effective Tax Rates.** A study by Canadian academics Duanjie Chen and Jack Mintz of the tax rates on new corporate investments in 90 countries for 2012 finds that the U.S. marginal effective tax rate of 35.6 percent is more than **16 percentage points higher** than the average of other OECD countries and more than **18 percentage points higher** than the average of non-OECD countries. The marginal effective tax rate reflects all taxes on capital, including income, property, sales and excise taxes. The U.S.

Figure 12

Corporate Effective Tax Rates

Effective tax rate (percent)



U.S. ranking of ETR (1 = highest)

	Cash ETR 2013 (World Bank)	METR 2012 (Chen and Mintz)	EATR 2012 (Oxford University)	EMTR 2012 (Oxford University)	Book ETR 2006-09 (PwC)
G7 rank	1	1	2	2	4
OECD rank	2	1	2	2	4

ETR: effective tax rate METR: marginal effective tax rate EATR: effective average tax rate EMTR: effective marginal tax rate

Sources: See discussion within this box for references.

marginal effective tax rate is the highest within the OECD.³³

- ▶ **Effective Average Tax Rates and Effective Marginal Tax Rates.** A study by researchers at Oxford University examines two measures of effective tax rates in 2012 for 33 OECD countries.³⁴ One measure, the effective average tax rate, considers the tax burden on a highly profitable corporate investment. The second measure, the effective marginal tax rate, considers the tax burden on a marginal investment that just breaks even. The study finds that the U.S. effective average tax rate of 34.9 percent is more than **12 percentage points higher** than the average of other OECD countries. The U.S. effective marginal tax rate of 23.2 percent is nearly **10 percentage points higher** than the average of other OECD countries. The United States has the second highest effective tax rate based on both the effective average tax rate and the effective marginal tax rate within the OECD.

- ▶ **Financial Statement Effective Tax Rates.** Another study, conducted by PricewaterhouseCoopers for the Business Roundtable, considers effective tax rates reported for financial statement purposes (book effective tax rates) for the four-year period of 2006–09 for the 2,000 largest companies in the world as ranked by the 2010 *Forbes* Global 2000 list.³⁵ The companies comprised both U.S.-based and foreign-based companies headquartered in 59 countries. The study includes both multinational companies and companies that are entirely domestic. The study finds that the book effective tax rate of U.S. companies of 27.7 percent is more than **five percentage points higher** than the average of companies based in other OECD countries. The U.S. book effective tax rate is the fourth highest among the 28 OECD countries included in the study.

IV. Tax Reform: A Competitive Corporate Tax Rate

Fast Facts

- ▶ Thirty of the 34 OECD countries have reduced their corporate tax rate since 2000; the United States is one of only two OECD countries with a higher statutory corporate tax rate today than in 1988.
- ▶ A lower corporate tax rate would make the U.S. economy more internationally competitive, increase U.S. jobs and investment, and improve the efficiency of the tax system. According to one academic study, a one percentage point decrease in the average corporate tax rate would result in an increase in real U.S. GDP of between 0.4 and 0.6 percent within one year of the tax cut.
- ▶ Studies throughout the OECD, the United States and Canada suggest that corporate rate reduction can result in increases in corporate income and GDP sufficient to make such rate reductions self-financing for government revenue collections.

The high U.S. corporate tax rate is an outlier among the world's economies. The high rate deters investment in the United States, reduces economic growth and results in lower wages for American workers. A competitive corporate rate is an important instrument for increasing U.S. economic growth and job creation.

A number of recent proposals have called for a lower corporate tax rate, including:

- ▶ President Obama's *Framework for Business Tax Reform* (February 2012);
- ▶ House Ways and Means Chairman Dave Camp's discussion draft (October 2011);
- ▶ The recommendations of the co-chairs of President Obama's National Commission on Fiscal Responsibility and Reform, former Senator Alan Simpson and former White House Chief of Staff Erskine Bowles (December 2010);
- ▶ The recommendations of the Bipartisan Policy Center task force co-chaired by former Senator Pete Domenici and Alice Rivlin (November 2010); and
- ▶ Senator Ron Wyden and Senator Dan Coats' Bipartisan Tax Fairness and Simplification Act (April 2011).³⁶

A lower corporate tax rate would make the U.S. economy more internationally competitive, increase U.S. jobs and investment, and improve the efficiency of the tax system.

A Lower U.S. Corporate Tax Rate Would Make the U.S. Economy More Competitive

As shown in **Figure 2**, the combined federal and state corporate tax rate of 39.1 percent is more than 14 percentage points higher than the 25 percent average rate in the rest of the OECD — a difference of nearly 60 percent. Other OECD countries have recognized the adverse consequences for their economies of a high corporate tax rate and have significantly reduced their corporate tax rates over time, with 30 of the 34 OECD countries reducing their corporate rates since 2000. The United States is one of only two OECD countries with a higher corporate tax rate today than in 1988, after the 1986 tax reform was fully phased in.³⁷

A reduction in the U.S. federal tax rate of about 15 percentage points, reducing the statutory rate from 35 percent to 20 percent, when combined with average state income tax rates of 6.4 percent, would provide U.S. corporations the same combined tax rate as the average of other OECD countries.³⁸ If the U.S. federal corporate tax rate were reduced to 25 percent, the combined U.S. corporate tax rate of 30 percent would place the U.S. rate five percentage points above the OECD average.

A Lower U.S. Corporate Tax Rate Would Increase Investment in the United States

The high corporate tax rate discourages investment in the United States by both American and foreign corporations.

While investment also is affected by other features of the corporate tax system, such as accelerated depreciation and tax credits, the corporate tax rate plays an especially significant role in influencing the location of some highly profitable investments.

The difference between the U.S. combined tax rate of 39.1 percent and the average OECD rate of 25 percent means that, after paying taxes on an equal amount of taxable income, a foreign corporation can reinvest an average of 23 percent more than an American company.³⁹ For investments with high returns, differences in depreciation allowances between the United States and other countries are unlikely to offset this significant disadvantage.⁴⁰

High-return investments are frequently based on research-intensive and innovative technologies. High-return investments may also be more internationally mobile and especially sensitive to tax rate differences. Reductions in the statutory tax rate can therefore be an important and effective policy tool for attracting these investments.⁴¹ By attracting such investments, corporate tax rate reduction can lead to particularly large productivity gains, as suggested by OECD studies.⁴² These investments benefit the economy by leading to higher worker productivity, higher wages, higher incomes and a rising standard of living over time.

A Lower U.S. Corporate Tax Rate Would Reduce Other Inefficiencies in the Corporate Tax System

If the corporate income tax is the most harmful tax for economic growth, as many believe, the corporate tax rate may be the most harmful element of the corporate income tax system.⁴³ Reductions in the corporate tax rate can generate a number of efficiency gains, including a reduced bias against the use of equity finance and a more efficient allocation of corporate capital across diverse assets.

Reduced bias against the use of equity finance

Because interest payments are deductible in calculating corporate taxable income, but payments of dividends are not, there is a tax bias against the use of equity to finance corporate investments in favor of debt finance.

Excessive reliance by companies on debt finance increases the risk of bankruptcy during periods of low profitability. Bankruptcy may impose a range of private and social costs if restructuring leads to layoffs, reorganization costs and loss of firm-specific know-how.

Total elimination of the bias against equity finance requires either providing a comparable deduction for the cost of equity finance — such as the allowance for corporate equity provided by some countries — or completely denying the deduction for interest expense, a policy that no country has adopted.⁴⁴

A reduction in the corporate tax rate, however, reduces the bias against equity finance. First, a lower corporate rate reduces the taxation of equity-financed investments. Second, since interest is deducted at the statutory corporate tax rate, a reduction in the tax rate increases the after-tax cost of debt finance. These two factors help reduce the bias against equity finance.⁴⁵ One study estimates that a 10 percentage point reduction in the corporate tax rate would reduce the proportion of a company's assets financed with debt by about three percentage points.⁴⁶ For a company with a debt-to-asset ratio of 30 percent, this would represent a 10 percent reduction in its debt ratio.

“The headline rate of corporation tax remains the most visible sign of how competitive our country is.”

**— U.K. Chancellor of the Exchequer
George Osborne, March 21, 2012**

More efficient allocation of corporate capital

Businesses undertake a wide range of capital investments in their productive activities, including investments in plant and equipment, office buildings, inventories, and land. Under an ideal tax system, a company would allocate its capital among these alternative investments in the same manner as in the absence of any taxes.

In real-world tax systems, however, the allocation of capital among competing investments is likely to be influenced by the different cost recovery rules for each type of investment. Assets that are recovered more slowly for tax purposes than their true decline in value are disfavored relative to assets that are recovered more rapidly.

As a result, in practice, taxes cause businesses to allocate their capital among diverse assets in a different and less efficient manner than they would in the absence of these tax distortions.⁴⁷

A reduction in the corporate tax rate reduces the distorting effects of the corporate income tax system on the allocation of capital across all corporate investments. By reducing these distortions, corporations allocate capital among alternative investments more efficiently. More efficient allocation of capital results in greater output — and thus greater GDP — for any given amount of total investment.

Revenue Effects of Corporate Rate Reduction

A broad body of research suggests that stand-alone corporate rate reduction need not lead to a loss in corporate tax revenues and can actually increase overall tax revenues through the resulting increase in economic activity and economic growth.

- **Joint Committee on Taxation (JCT).** By convention, estimates by the JCT staff do not account for any changes in economic growth resulting from tax changes. Under this macrostatic assumption, the JCT estimates that each percentage point reduction in the corporate income tax would reduce government revenue collections by approximately \$10 billion annually.⁴⁸

In contrast to the conventional macrostatic assumption, a 2005 JCT study designed to evaluate the macroeconomic impacts of tax changes found that a reduction in the corporate tax rate was more growth enhancing than individual tax reductions, including individual rate reduction.⁴⁹ As a result of the additional economic growth resulting from corporate rate reduction, additional tax revenues are collected through so-called feedback effects. The JCT estimated that these feedback effects reduce the cost of corporate rate reduction by between 10 and 20 percent of conventional revenue estimates.⁵⁰

- **Academic research.** A number of research studies suggest that the growth-enhancing effects of corporate rate reduction are significantly greater than estimated by the JCT. A recent empirical study by researchers at Cornell University and the University of London of past corporate tax changes in the United States concludes that a reduction in corporate income taxes in the United States would be “approximately self-financing” due to significant increases in corporate income and GDP in response to these cuts.⁵¹ The study finds that a one percentage point decrease in the average corporate tax rate would result in an increase in real U.S. GDP of between 0.4 and 0.6 percent within one year of the tax cut.

Research by economists at the American Enterprise Institute concludes that corporate tax rates above 26 percent result in a loss of corporate tax revenues for OECD countries.⁵² Applied to the United States, this result suggests that corporate tax revenue would *increase* if the federal statutory corporate tax rate was lowered from 35 percent to 26 percent — and that a rate as low as 18 percent would generate the same corporate tax revenues as the current 35 percent tax rate without requiring any offsetting base broadening.⁵³

One U.K. academic study also finds that some OECD corporate tax rates are above the revenue-maximizing tax rate.⁵⁴ The study finds that at low corporate tax rates, increases in the tax rate may increase corporate revenues but that this effect disappears above moderate rates, whereby “further increases in the tax rate may actually reduce revenues.” Corporate tax revenues may be sensitive to the corporate tax rate by affecting overall investment levels, changing the location of economic activity between countries, and shifting activity between the corporate and noncorporate business sectors.

Canada's experience with corporate rate reduction

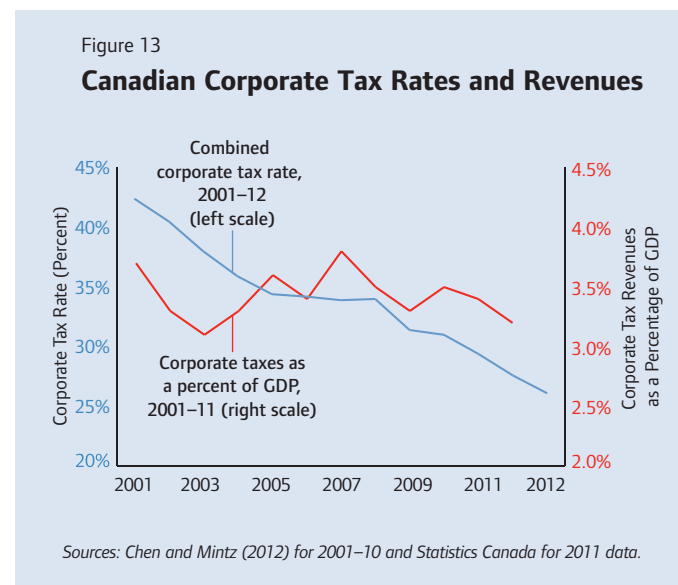
Canada has lowered its combined federal and provincial corporate rate from 40.5 percent to 26.1 percent since 2001, with the federal rate now at 15 percent.

Analysis of the recent Canadian experience provides strong evidence that a reduction in corporate tax rates can lead to offsetting increases in corporate tax revenues. Canada reduced its combined statutory corporate tax rate by more than 14 percentage points between 2001 and 2011. Despite this significant reduction — and a recession in 2009 — corporate tax revenues as a percentage of GDP have remained relatively constant over this period, as an increase in corporate taxable income compensated for the rate reduction (**Figure 13**).⁵⁵ Canadian employment has also risen steadily, apart from a brief decline during the 2009 recession.⁵⁶

Canada's experience is consistent with an earlier study by Canadian researchers that concluded that Canadian rate reduction would increase corporate tax revenues.⁵⁷ In addition to increased corporate tax revenue, increases in employment and wages would result in additional individual income tax revenue, payroll tax revenue and sales tax revenue.

“Creating jobs and growth in our economy is our top priority. ... We are creating the conditions for businesses to successfully compete in the global economy. ... Through our Government's low-tax plan for jobs and growth, we are continuing to send the message that Canada is open for business and the best place to invest.”

**— Canadian Finance Minister Jim Flaherty,
December 29, 2011**



V. Tax Reform: A Competitive International Tax System

Fast Facts

- ▶ Emerging markets will be responsible for 95 percent of the world's population growth and, within 15 years, will account for annual consumption nearly three times greater than in the United States today. These markets present enormous opportunities for American workers and American businesses.
- ▶ While expanding the export opportunities of American businesses is critical, American businesses also need to operate abroad to serve foreign customers. More than 90 percent of the sales by foreign subsidiaries of American companies are to foreign customers.
- ▶ Growing foreign operations leads to growth in U.S. operations. One study finds, for example, that for every 100 jobs added abroad in an American company's foreign subsidiaries an average of 134 American jobs are created at home in the company's domestic operations.
- ▶ Proposals for a move to a territorial tax system in the United States have been made by several commissions established by President Obama, including Simpson-Bowles, and from House Ways and Means Committee Chairman Dave Camp.
- ▶ A shift to a territorial tax system would enhance U.S. competitiveness in foreign markets, reduce the number of foreign takeovers of American companies and increase the reinvestment of foreign earnings in the U.S. economy.

Large and growing world markets present enormous opportunities for American workers and American businesses. With 95 percent of the world's population and 80 percent of the world's purchasing power located in markets outside the United States — and with economic and population growth rates in emerging economies expected to outpace developed country rates — growth at home requires successful engagement in world markets. Annual consumption in emerging markets alone is expected to grow to \$30 trillion over the next 15 years, nearly three times annual consumption spending in the United States today.⁵⁸

For American companies to succeed in these markets and the American economy to benefit from the expanded foreign market opportunities, American companies must not be placed at a competitive disadvantage by U.S. tax rules. Today, U.S. tax rules on international income are an outlier among developed countries and impede the ability of American companies to enter foreign markets on competitive terms and return those profits for investment in the U.S. economy.

American Companies Compete in the Global Marketplace with Operations at Home and Abroad

Be there to sell there

American companies compete in foreign markets through U.S. exports of goods and services and foreign investment — whether through joint ventures, foreign acquisitions or the establishment of new facilities.

American companies operate abroad to serve foreign customers. More than 90 percent of the sales by foreign subsidiaries of American companies are to foreign customers rather than for the U.S. market.⁵⁹ Localized foreign operations allow American companies to tailor their products to local needs and tastes and overcome transportation cost barriers that otherwise would make their products noncompetitive. A range of services provided by American companies can be performed only locally, including construction, utilities, retail trade and financial services.

Gaining access to natural resources

Natural resource industries, including mining, oil and natural gas, must locate operations where the resources can be obtained. The United States benefits when American companies develop these resource deposits.

The U.S. economy benefits from the foreign operations of American companies

Foreign operations can increase the demand for U.S. exports of other goods and services that are complementary to the local operations. As a result, growing foreign operations can lead to growth in U.S. operations.

One academic study focusing on U.S. manufacturers, for example, found that an increase in sales by an American company's foreign subsidiaries of 10 percent results in an increase in exports of goods from the United States by the American company of 6.5 percent on average.⁶⁰ The study also finds that an increase in foreign employment by an American company's foreign subsidiaries of 10 percent results in an increase in the number of the company's American workers of 6.5 percent on average. Given that U.S. employment of American multinationals is more than double their foreign employment, this translates into an average increase of 134 U.S. jobs for every 100 jobs added abroad.⁶¹ Increased foreign investment by a company's foreign subsidiaries also is found to increase the company's U.S. investment.

A study by economists in the U.S. International Trade Commission finds similar complementary relationships for service industry companies between growth in their foreign affiliate activities and increases in their U.S. employment. The study further estimates that the export of services by U.S. companies to their foreign affiliates supports 700,000 U.S. jobs. Additional U.S. employment is generated through the domestic supply chains of the U.S. parent companies.⁶²

While U.S. manufacturing jobs have been declining over time, the evidence points to productivity gains driven by technological change as the prime factor, not globalization. In fact, globally engaged U.S. manufacturers have had significantly smaller declines in their employment than U.S. manufacturers without foreign affiliates.⁶³ The ability to grow into foreign markets supports U.S. jobs.

Successful foreign operations of American companies benefit the U.S. economy and add jobs at home.

Worldwide and Territorial International Tax Rules

Unlike most OECD countries, the United States taxes American companies on their business income earned in foreign countries. Under the U.S. worldwide system, U.S. tax is assessed on active business earnings when they are remitted to the United States, with a tax credit for foreign income taxes paid in the country where the income was earned. The U.S. system thus imposes a second round of tax on foreign earnings, equal to the difference between the U.S. rate and the foreign rate on the remitted earnings. As a result, American companies pay tax on their international income twice — once in the foreign country where the earnings arise and then again when the earnings are remitted to the United States.

In contrast, 28 of the 34 OECD countries (and all other G8 countries) use territorial tax systems under which active business earnings remitted home as dividends are subject to little or no additional home-country tax. As shown in **Figure 3**, 20 of the 28 countries exempt 100 percent of qualifying dividends, while eight countries exempt between 95 and 97 percent of the qualifying dividends from domestic taxation. The 95 to 97 percent exemption typically results in a home-country tax rate of about 1 percent on the foreign dividend for multinational companies headquartered in these countries. The use of less than a 100 percent exemption by these eight OECD countries is sometimes justified as a substitute for any disallowance of domestic expenses that indirectly relate to the foreign earnings of a corporation. While a small reduction in the exemption below 100 percent is unlikely to create a repatriation barrier, some question whether in fact any such reduction is justified.⁶⁴

The move to territorial tax systems throughout the OECD is a relatively recent trend, with 20 of the 28 countries adopting territorial rules since the United States last undertook major tax reform in 1986 and 15 of the 28 countries adopting territorial tax systems since 2000.⁶⁵

Proposals for modernizing U.S. international tax rules by moving in the direction of a market-based territorial tax system have been made by House Ways and Means Committee Chairman Dave Camp and several commissions established by President Obama and his Administration:

- ▶ The 2010 report by the co-chairs of President Obama’s National Commission on Fiscal Responsibility and Reform (Simpson-Bowles) noted that a territorial system would “put the U.S. system in line with other countries, leveling the playing field” and would make “us more globally competitive.”⁶⁶
- ▶ President Obama’s Export Council in 2010 stated that “expansion abroad by U.S. companies is vital for establishing export-platforms for U.S.-produced goods” and recommended that “a competitive territorial tax system for the United States should broadly follow the practice of our trading partners.”⁶⁷
- ▶ President Obama’s Council on Jobs and Competitiveness in 2012 wrote: “Many Council members agree that the U.S. should shift to a territorial system of taxation in order to make America more competitive in global markets. ... Adopting a territorial tax system would bring us in line with our trading partners and would eliminate the so-called ‘lockout’ effect in the current worldwide system of taxation that discourages repatriation and investment of the foreign earnings of American companies in the U.S.”⁶⁸
- ▶ The Advanced Manufacturing Partnership Steering Committee of President Obama’s Council of Advisors on Science and Technology in 2012 recommended reforms to “create an internationally competitive tax system.” These reforms “must consider the tax treatment of overseas earnings of U.S. based corporations, including the consideration of a competitive partial exemption system similar to the type adopted recently by the U.K. ... Ultimately, comprehensive tax reform must ensure that U.S. companies are competitive when operating abroad and in the United States.”⁶⁹
- ▶ The Secretary of Commerce’s Manufacturing Council in 2011 recommended to “move the United States from a worldwide to a territorial tax system to reduce the double tax burden imposed by the United States to allow manufacturers to make greater investments in expansion, innovation, and job creation.”⁷⁰
- ▶ House Ways and Means Chairman Dave Camp (R-MI) proposed adoption of a territorial tax system as part of corporate tax reform in his discussion draft released in October 2011, noting that the proposal would “make the United States a more attractive place to invest and create the jobs this country needs.”⁷¹

The Worldwide Tax System Disadvantages the U.S. Economy

Numerous reasons have been advanced for why the United States should adopt a territorial tax system.⁷² The current worldwide tax system has two primary effects on American companies that hurt the U.S. economy: It reduces their competitiveness in foreign markets, and it discourages companies from bringing foreign earnings back for use in the United States.

Reduced foreign competitiveness

First, American companies that bring their foreign earnings home face an additional tax burden not faced by their foreign competitors. This extra tax can place American companies at a significant disadvantage relative to their foreign competitors — American companies must either generate a higher pretax return through other cost savings to earn the same after-tax return on their investments, or they must accept a lower after-tax return. Neither result may be sustainable.

As shown in **Box 3**, a Canadian multinational company with operations in the United Kingdom can earn an after-tax rate of return that is 31 percent higher than an American company with a comparable U.K. investment. Even when the American company is the most efficient producer, the difference in tax treatment faced by the American company may make it noncompetitive.⁷³

Box 3

U.S. Worldwide Tax System Uncompetitive with Territorial Systems

Consider two American and Canadian companies, each with active business operations in the United Kingdom. The U.K. statutory corporate tax rate is 23 percent in 2013, scheduled to decline to 21 percent in 2014 and 20 percent in 2015. Including tax incentives, it is assumed in this example that the U.K. tax system results in a 20 percent effective tax rate on corporate income.

Under the **Canadian international tax rules** — like those of most OECD countries — the Canadian company will pay the U.K. tax on its foreign earnings and will not owe any additional home-country tax when it remits its earnings home.

Under the **U.S. international tax rules**, if the American company remits its foreign earnings home, it will pay an additional 15 percent in U.S. federal tax (35 percent less a foreign tax credit of 20 percent), plus additional state taxes (an average of 4.1 percent, after deduction against federal taxes). The combined U.S. and U.K. tax rate of 39.1 percent imposed on the American company is more than 19 percentage points higher than the rate of tax paid by its Canadian competitor.

The tax differential allows the Canadian company to earn \$80.00 after tax on its investment compared to the \$60.90 earned by the American company, a 31 percent higher after-tax return (\$80.00/\$60.90).

Figure 14

After-Tax Net Income on Remitted Foreign Income for American and Canadian Companies Competing in the United Kingdom

American-owned foreign subsidiary		Canadian-owned foreign subsidiary	
Income	\$100.00	Income	\$100.00
Local U.K. tax	–\$20.00	Local U.K. tax	–\$20.00
U.S. federal and state tax	–\$19.10	Canadian tax	–\$0.00
Net income	\$60.90	Net income	\$80.00

Owing to the disadvantageous tax rules applying to the foreign operations of American companies, one academic study finds that when an American company merges with a foreign company, the U.S. tax treatment of foreign earnings makes it 8 percent more likely that the American company is the target of the acquisition rather than the acquirer, after controlling for other factors.⁷⁴ As a result, the acquiring foreign corporation can expand outside the United States without being subject to the worldwide tax rules that would apply if the American company were the acquirer.

While tax rules are just one of various factors affecting mergers and acquisitions, cross-border mergers in which American companies were the target of a foreign acquisition were 38 percent greater in value than those in which American companies were the acquirer of a foreign target between 1990 and 2011.⁷⁵ Over this period, foreign acquisitions of American companies exceeded American acquisitions of foreign companies by more than \$500 billion.

Limited reinvestment of foreign earnings in the U.S. economy

Second, because the additional U.S. tax is levied when dividends are remitted to the United States, American companies have an incentive to retain foreign earnings abroad rather than bring them back as dividends to the U.S. parents. Earnings may be retained abroad for reinvestment and expansion in physical facilities or retained in cash if companies foresee an eventual, if not immediate, use of the funds in their foreign operations. An estimated \$1.7 trillion in accumulated foreign earnings was held by the foreign subsidiaries of American companies in 2011.⁷⁶

This incentive to maintain funds abroad under the U.S. worldwide tax system is referred to as the lockout effect, as funds are effectively locked out of the United States. Multinationals headquartered in territorial countries do not face such a disincentive to the remittance of foreign earnings and can use such funds to expand operations at home, undertake research, make additional contributions to their pension plans, pay dividends to shareholders, pay down debt and make other uses of the funds in their domestic economies. The ability to access foreign funds for use at home results in a lower cost of capital for foreign-headquartered multinationals relative to American companies.

If only half the accumulated \$1.7 trillion in foreign earnings came back to the United States in response to enactment of a market-based territorial tax system, the funds freed up for use at home would exceed the increased government spending and tax relief provided under the 2009 American Recovery and Reinvestment Act.⁷⁷ The CBO estimates that the 2009 act resulted in as many as

Box 4

Temporary Tax Provisions Supporting U.S. International Competitiveness

Two longstanding international tax provisions to improve the competitiveness of American companies operating in foreign markets have been enacted and temporarily renewed repeatedly. The policy goals of these two provisions should be made permanent under a reformed tax system.

Active Financing Income. A basic principle of the U.S. tax system is that active foreign business earnings of subsidiaries of American companies are not taxed in the United States until such earnings are remitted back to the U.S. parent. This basic principle of deferral has also been the law for active financial services income for nearly the entire history of the tax code, until it was changed in 1986. Since 1997, the principle of deferral for active financial services income has been a temporary provision of the tax code and has been extended numerous times. The current temporary provision expires at the end of 2013.

U.S. financial service companies — including banking, securities and insurance companies — compete in foreign markets around the world with other financial institutions to provide financial services locally to foreign customers. Commercial clients of these financial service companies look to a financial institution that can meet their needs worldwide — not just in the United States. The ability of U.S. financial service companies to be competitive in foreign markets increases the jobs they provide in the United States. In addition, U.S. financial service companies providing their services to foreign customers can help boost exports of U.S. goods by assisting in the financing of these goods to foreign customers.

In the absence of the active financing temporary provision U.S. financial service companies would face a significant tax disadvantage relative to their foreign-headquartered

competitors. Failure to make this provision permanent under a reformed system would harm the competitiveness of American companies and reduce U.S. jobs.

Look-Through Rule. American companies can redeploy income between a foreign subsidiary earning active business income and a related foreign subsidiary in another country through the payment of dividends, interest, rents or royalties without being subject to current U.S. taxation on the payment under this temporary provision. The look-through rule “looks through” to the underlying source of income to determine whether such income is active foreign business income eligible for deferral or passive income that would be subject to current U.S. taxation. The look-through rule was first effective in 2006 and is currently scheduled to expire at the end of 2013.

The look-through rule permits income to be redeployed efficiently among related foreign subsidiaries. Because the cost of financing through internal funds is generally lower than use of external funds, a firm will generally first wish to use internal funds before tapping external sources of finance. The look-through rule allows U.S. companies to redeploy internal funds between foreign subsidiaries without creating a tax barrier to such transfers.

The look-through rule helps maintain the competitiveness of American companies operating in foreign markets. Without the look-through rule, foreign operations might require greater use of external funds or greater reliance on funds drawn directly from the U.S. parent. This rule should be made permanent under a reformed system to facilitate the redeployment of foreign earnings and enhance the competitiveness of American companies competing abroad.

10.8 million more full-time equivalent jobs between 2009 and 2012. In addition to the immediate return of billions of dollars of past foreign earnings upon enactment, a market-based territorial tax system also would encourage American companies to return future foreign earnings for investment in the United States.

Addressing Concerns About Adoption of a Territorial Tax System

Concerns have been expressed that the adoption of a territorial tax system could provide American companies an incentive to shift U.S. activities offshore or would lead to a loss of the U.S. tax base. A mistaken impression from one recent study has contributed to concerns that adoption of a territorial tax system would lead to a loss of U.S. employment.⁷⁸

Although the study was initially interpreted by some as concluding that a territorial tax system would lead to a loss of 800,000 U.S. jobs, this conclusion was immediately challenged,⁷⁹ and a subsequent clarification by the author stated that the “analysis does not speak to the effects on jobs in the United States.”⁸⁰ Instead, the author stated that the analysis described how *employment of the foreign subsidiaries* of American companies may change in low-tax countries.

While the magnitude of the foreign subsidiary job effects is subject to some disagreement, it should not be surprising that changes in tax rules that allow American companies to be more competitive in foreign markets would lead to increased growth in these markets. In other words, subsidiaries of U.S. companies will become more successful in obtaining foreign projects and market share that, without a change to a territorial system, would have likely gone to foreign-based competitors. These effects may be greatest in the foreign locations where the additional U.S. tax on dividend repatriations is the highest under the current U.S. worldwide tax system. However, as noted earlier in this section, greater employment by foreign subsidiaries of American companies generally is *not* associated with reduced U.S. employment. Directly countering the argument that job gains abroad are at the expense of jobs at home, studies show that increases in foreign employment are associated with increases in U.S. employment of the same company.⁸¹ Yet another way of viewing this is whether the U.S. economy is more likely to benefit from successful engaging in foreign markets or ceding these markets to foreign-based competitors.

Further, given that the vast majority of other OECD countries have carefully considered and then adopted territorial tax systems as a means to improve the competitiveness of their domestic economies, it would be surprising if territorial systems led to a loss of domestic employment.⁸²

A related concern is that adoption of a “pure” territorial tax system would provide firms an incentive to use “accounting mechanisms to shift profits out of the United States.”⁸³ It should be noted that the tax systems of all countries with territorial or worldwide systems address these concerns by enforcing transfer pricing rules that require intrafirm transactions be conducted using the same prices that would apply to third-party “arm’s-length transactions.” Enforcement of transfer pricing rules is required under current law because the high U.S. corporate tax rate results in greater taxation for income earned in the United States than income earned abroad that remains reinvested outside the United States. If the United States adopted a territorial tax system, it would continue to enforce transfer pricing rules to ensure that the arm’s-length standard is maintained just as other countries do.

The United States and many other countries, including those with territorial tax systems, also use controlled foreign corporation (CFC) rules to buttress the transfer pricing system by taxing currently certain foreign income that is passive or that can easily be moved out of the home country to low-tax countries. Proposals for a territorial tax system in the United States would generally retain CFC rules for other than active business income. To the extent necessary, the adoption of a market-based territorial system could be accompanied by a review of transfer pricing and CFC rules to further safeguard against any incremental shifting of income from the United States to low-tax countries that might occur as a result of the territorial system. However, it would be important to ensure that any such safeguards are specifically targeted and designed to minimize both the adverse impact on the competitiveness of U.S. companies and any increases in compliance and administrative burden.

Compared to the current U.S. tax system, corporate tax reform that reduced the U.S. statutory corporate tax rate in combination with the adoption of a market-based territorial tax system could reduce incentives to shift profits from the United States by reducing the differential in the rate at which profits are taxed in the United States and other countries.

In considering whether additional rules or safeguards are needed to protect the U.S. tax base, it is important that policymakers distinguish between practices of American companies (as well as their foreign competitors) that reduce *foreign tax burdens on foreign income* from those that result in a reduction of *U.S. tax on U.S. income*. The former — a reduction in foreign tax burdens — does not reduce U.S. tax revenues and enhances the competitiveness of American companies in foreign markets. Enacting policies that would require American companies to pay more foreign tax does not advance U.S. interests.

It is understandable that policymakers need assurance that tax changes adopted as part of tax reform do not provide incentives that would reduce U.S. employment or lead to a loss of the U.S. tax base. At the same time, it should be noted that a failure to adopt competitive international tax rules for American companies will result in a more slowly growing U.S. economy as American companies are less able to sell American goods and services in foreign markets. In addition, a gradual loss of American-headquartered companies through cross-border mergers is likely to continue as their foreign operations are more profitably held by foreign-headquartered companies, resulting in a loss of jobs associated with headquarters support activities, both directly within these companies and through their supply chains. As a result, maintaining the current U.S. worldwide tax system likely will result in a loss of the U.S. tax base over time and is not an appropriate policy for maximizing U.S. jobs and U.S. economic growth.

VI. Fiscally Responsible Corporate Tax Reform

Fast Fact

- ▶ A uniformly applied corporate tax system — with a broader base, a competitive corporate tax rate and modernized international tax rules and without temporary and uncertain provisions — would result in greater economic growth and job creation for the United States, with no loss in tax revenue.

Corporate tax reform can promote the competitiveness of the United States by allowing businesses to compete on a level playing field with each other and by providing a tax structure that is competitive with other advanced economies. To ensure that corporate tax reform benefits the economy without increasing the deficit, the Business Roundtable supports appropriate revenue-neutral corporate tax reform that includes appropriate base-broadening measures that would provide a competitive corporate tax rate and a more modern and competitive international tax system. In addition, such reform should be revenue neutral entirely within the corporate sector and not impose burdens on small business to pay for corporate reforms.

The experience of other countries that have reduced their corporate tax rates, as well as analysis of past corporate tax increases in the United States reviewed in Section IV, indicates that corporate rate reduction need not result in a loss of corporate revenue, as the lower corporate rates themselves stimulate the economy and lead to an increase in corporate income and GDP.⁸⁴ As noted in Section I, the corporate income tax is believed by the OECD and economists to be the most harmful tax for economic growth, so reductions in this tax can have greater effects on growth than similar reductions in other taxes.⁸⁵ In determining the overall effects on tax revenue from corporate rate reduction, it is important to account for these dynamic effects of corporate tax reform on economic growth.

The Rationale for Replacing Targeted Incentives with Overall Rate Reduction

Partly to incentivize certain activities as well as to alleviate the adverse impacts of the high U.S. corporate tax rate, policymakers have introduced over the years a wide range of special provisions, typically in the form of enhanced deductions or tax credits, that operate to reduce the rate of tax on specified business activities. While such provisions reduce the overall rate of tax on qualifying activities, they are viewed by many as less efficient from an economy-wide perspective than a broadly applicable across-the-board incentive or overall rate reduction. This is because narrowly applicable incentives divert resources away from other valuable business activities that may generate higher pretax returns and greater value for consumers.

In 1984 the Treasury Department, in drawing up initial plans for legislation that became the Tax Reform Act of 1986, explained the rationale for replacing targeted incentives with overall rate reduction:

One of the primary advantages of a free market economy is its tendency to allocate economic resources to their most productive uses. For example, market forces lead business firms to produce what consumers want in ways that are relatively efficient and economical. Any tax inevitably discourages the type of activity that is taxed. An ideal tax system would, however, interfere with private decisions as little as possible. ... Any deviation from this principle represents implicit endorsement of government intervention in the economy — an insidious form of industrial policy based on the belief that those responsible for tax policy can judge better than the marketplace what consumers want, how goods and services should be produced, and how business should be organized and financed.⁸⁶

Tax-induced distortions adversely affect economic growth. As the Treasury Department further explained:

Preferential tax treatment of certain industries — industrial policy implemented through tax policy — causes too much labor and capital to flow into the favored industries, and too little into other sectors. ... The result of all this tax-induced interference with market forces is lost opportunities for productive investment and needless sacrifice of national output. Economic growth, a primary goal of the study of fundamental tax reform, depends on a neutral tax system — one that would not hinder the potential for growth inherent in a free market economy.⁸⁷

Narrowly designed special incentives can be complicated to administer and can create substantial uncertainty for taxpayers as to whether they will qualify for the incentive. Some activities very similar in nature to the qualifying activity may not be eligible for the incentive even though they yield greater economic benefits. To avoid distortions that would divert resources from higher value activities, tax incentives need to consider the full range of value-creating economic activities. Designing a single incentive to encourage all of these activities as efficiently as a reduction in the corporate tax rate is difficult, if not impossible.

Tax incentives frequently are enacted as temporary provisions. A business may be uncertain whether an activity initiated in response to a temporary tax incentive will be completed before the expiration of the incentive. When the incentive expires, the business may not know whether the government will restore the incentive to cover periods since its expiration. The uncertainty of temporary provisions reduces their efficacy. Greater economic growth can be achieved through permanent provisions covering the broadest range of activity, such as that attainable through corporate rate reduction.

Tax Expenditures

Many view base-broadening reforms as those that would reduce or eliminate tax expenditures. The staffs of the JCT and the Department of the Treasury prepare lists of “tax expenditures” annually.⁸⁸ The JCT and the Treasury Department identify any tax provision in the form of a credit, deduction or exclusion that is an exception to baseline income tax rules as a tax expenditure when it can be viewed as an alternative to other policy instruments, such as spending programs, for those undertaking particular activities. Tax expenditures are identified for provisions affecting both corporations and individuals. It should be noted that some analysts take issue with the terminology of “tax expenditures” and the labeling of particular provisions as tax expenditures that they believe make the tax system fairer or more efficient. Some also point out that identification of such provisions relies at times on an arbitrary specification for the baseline system against which they are measured.⁸⁹

Figure 15

Revenue from Repeal of Major Domestic Corporate Tax Expenditures

Provisions with tax revenue exceeding \$10 billion, FY 2012–21

Provision	10-year revenue, FY 2012–21 (\$ billions)
Accelerated depreciation of equipment (in excess of alternative system)	\$506.8
Expensing of research and experimental expenditures	\$152.2
Domestic production activities deduction	\$127.0
Last-in, first-out inventory accounting method	\$62.7
Credit for low-income housing	\$33.0
Deferral of gain on like-kind exchanges	\$16.0
Completed contract rules accounting method	\$13.9

Source: Joint Committee on Taxation (October 27, 2011).

To the government, the cost of providing special tax incentives comes in the form of reduced corporate income tax collections. The JCT estimates that in 2012 more than 80 separate tax expenditures each accounted for more than \$50 million in reduced corporate income tax revenue.⁹⁰

These provisions cover a range of specific activities and are intended for a variety of reasons. While a history and rationale for the specific provisions is beyond the scope of this study, a reduction or elimination of these provisions without a substitution of alternative policy instruments would in some cases reduce the level of the targeted activities undertaken.⁹¹ In some cases, a reduction in the activity could be viewed as economically undesirable. For example, tax subsidies for undertaking R&D frequently

are justified as intended to increase the amount of R&D undertaken in the economy. R&D, and the know-how it generates, creates spillover benefits to society for which the company undertaking the R&D cannot be fully compensated. As a result, in the absence of research subsidies, too little R&D may be undertaken.⁹² For this reason, use of these or any other specific provisions as base broadeners must be weighed carefully relative to the economic benefits achieved through the other components of tax reform.

The JCT has provided preliminary estimates of the tax revenue that could be raised through the elimination of 21 corporate tax expenditures on domestic commerce as part of tax reform that provided a lower statutory corporate tax rate.⁹³ The JCT estimates that repeal of these provisions would provide sufficient revenue to reduce the corporate tax rate to 28 percent in a revenue-neutral manner. The seven largest tax expenditures (those with 10-year revenue exceeding \$10 billion) are shown in **Figure 15**. These seven provisions account for 95 percent of the revenue raised from the elimination of the major tax expenditures estimated by the JCT.

Incentives for New Investment Versus Across-the-Board Corporate Rate Reduction

Some argue that a special tax provision available for only new investment could more directly stimulate economic activity relative to a reduction in corporate tax rates because the special incentive could be claimed only if the new investment is undertaken whereas the rate reduction is not guaranteed to result in new economic activity.⁹⁴

Some evidence, however, suggests that corporate rate reduction could be more effective in attracting highly profitable investments to the United States than an incentive in the form of a tax deduction or credit. For a highly profitable investment, the tax savings from accelerating the deduction for depreciation allowances, for example, are small relative to a reduction in the rate of tax on the income from the investment. A company choosing where to locate its most profitable investments is likely to be more influenced by a lower tax rate on the investment than an enhanced deduction (**Box 5**).

A 2007 study by the U.S. Department of the Treasury notes that the trend in OECD countries over the past two decades has been to reduce corporate tax rates but to at least partially offset these reductions through less accelerated depreciation allowances.⁹⁵

As noted in Section IV, rate reduction also can improve the efficiency of the tax system by reducing the bias in favor of debt finance and result in a more efficient allocation of corporate capital across diverse assets.

Base-Broadening Tax Reform

Economic growth and job creation would be enhanced through corporate tax reform providing a reduced statutory tax rate and a competitive territorial tax system. The experience of other countries suggests that the cost of these reforms is at least in part self-financing, as the added economic growth increases tax revenues. To the extent required, appropriate base-broadening reforms that limit tax expenditures and other special provisions can ensure that corporate tax reform does not result in a reduction in tax revenues. The use of any specific provision as part of revenue-neutral tax reform must be carefully weighed against the economic benefits achieved through the other components of tax reform. Implementation of comprehensive reform should include transition rules to minimize taxpayer uncertainty while legislation is being formulated and to avoid retroactive taxation. Further, because increases in the corporate income tax adversely affect economic growth, any base-broadening provisions should be kept to the minimum necessary to provide for corporate rate reduction and improving the competitiveness of the U.S. international tax system.

Corporate Rate Reduction as an Investment Incentive

Conventional economic models have emphasized incentives such as accelerated depreciation over rate reduction to encourage business investment.⁹⁶ As noted by others, however, when businesses earn positive profits on their investments and have a choice about where to locate their profit-making investments, corporate rate reduction can be a more effective way to increase investment and economic growth.⁹⁷

President Obama's *Framework for Business Tax Reform* notes that "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."⁹⁸

Martin Sullivan, chief economist for *Tax Notes*, describes in 2006 testimony to the Senate Finance Committee the reasons why corporate rate reduction may be more effective than incentives like accelerated depreciation:

In this new era of corporate taxation, it is not accelerated depreciation and tax credits that are the big draw for corporate investment. It's the reduction of corporate tax rates.

Why the change? There are several reasons.

First, as economies move away from manufacturing—as intangible assets become more important than plant and equipment, as the rate of profitability per dollar of physical capital increases—it is a straightforward matter of arithmetic that rates play a larger role than conventional incentives in determining the after-tax profit of investment decisions.

Second, as transportation and communications costs have dropped, and trade barriers and currency controls have also declined, there is more cross-border investment than ever. In the old days—say, before 1995—economists were thinking about how to use taxes to get a domestic firm to boost its domestic investment on the margin, for example, by 3 or 4 percent. In that case—that is, in the case of investment of borderline profitability—traditional incentives can mean a lot. And because this was the type of investment governments were trying to encourage, using tax credits and depreciation was a revenue-efficient way for governments to provide investment incentives.

But with increased capital mobility, economists have changed their thinking about how taxes motivate investment. Under the new paradigm, governments are trying to influence location decisions of multinationals. Because these decisions involve large chunks of investment—not just those marginally profitable—tax rates matter more than tax credits.

Finally, as mobile as capital may be, profits are more mobile. In deciding where to channel profits, tax rate differentials are all important, and conventional incentives don't matter at all.

What does all this mean? It means that without increasing the deficit and without changing the overall tax burden on the corporate sector, a government can protect its revenue base, increase investment, and increase competitiveness.⁹⁹

VII. Conclusion

Corporate tax reform done right can grow the economy by increasing domestic investment and increasing the competitiveness of American companies in global markets. A faster-growing U.S. economy will produce more and better paying jobs both now and for future generations of Americans.

The problems with our current corporate tax system are well known, and the reforms that are needed are clear. The U.S. corporate tax system has failed to keep pace with the changing global economy, with the last comprehensive restructuring of the tax system occurring in 1986. Today the U.S. corporate tax system is an outlier at a time when capital is more mobile and the world's economies are more interconnected than at any time in history.

Our current tax system discourages capital investment in the United States and impairs the ability of American companies to compete abroad. The United States has the highest corporate tax rate among advanced economies and is one of the few remaining advanced economies to maintain a worldwide tax system. It is the least competitive corporate tax system among advanced economies — when we should be striving to make it the most competitive. The end result of this tax system is a more slowly growing economy, resulting in fewer jobs and lower wages for American workers.

Tax reform to improve economic growth and job creation in the United States should at a minimum result in a tax system that is as competitive as the tax systems of our trading partners. A competitive corporate tax rate and a competitive market-based territorial tax system like those of other OECD countries will promote investment in the United States and provide a level playing field for American-based businesses to compete globally. Together these reforms provide the basis for enhancing and sustaining U.S. economic growth and job creation.

Appendix A. Summary of Major Corporate Tax Reform Plans

This appendix and the accompanying table (**Figure 16**) summarize several recent corporate income tax reform proposals: President Obama's *Framework for Business Tax Reform*; House Ways and Means Chairman Dave Camp's discussion draft; the recommendations of former Senator Alan Simpson and Erskine Bowles, co-chairs of President Obama's National Commission on Fiscal Responsibility and Reform; the recommendations of the Bipartisan Policy Center task force co-chaired by former Senator Pete Domenici and Alice Rivlin; and Senator Ron Wyden's and Senator Dan Coats' Bipartisan Tax Fairness and Simplification Act.

President's Framework for Business Tax Reform (February 2012)

President Obama's *Framework* would reduce the corporate tax rate to 28 percent, with further reductions for manufacturers, and eliminate a number of tax expenditures.¹⁰⁰ The plan would establish a minimum tax on the foreign earnings of U.S. companies. The plan would make the research credit permanent and increase the credit rate for the alternative simplified credit. The plan recommends reforms that would treat large pass-through entities on a basis more comparable to large corporations. **Figure 16** provides a summary of other provisions in the proposal.

House Ways and Means Chairman Dave Camp's Discussion Draft (October 2011)

House Ways and Means Chairman Dave Camp (R-MI) released in October 2011 a discussion draft setting forth a 25 percent corporate tax rate and adopting reforms to provide a territorial tax system for active foreign business income.¹⁰¹ Supplementary materials released by the Ways and Means Committee state that the rate reduction would be achieved on a revenue-neutral basis by broadening the tax base and that the territorial system would be revenue neutral through accompanying international reforms.

The discussion draft includes detailed legislative language for the territorial tax system, providing a 95 percent exemption (in the form of a dividends received deduction) for qualifying foreign dividends. The draft would apply a tax at a rate of 5.25 percent on all pre-enactment foreign earnings as a transition rule. The draft also includes a "thin capitalization" rule that would disallow a portion of net interest expense if a U.S. company had excessive domestic debt relative to its worldwide leverage and its domestic interest deductions exceeded a specified percentage of its domestic taxable income. Further, the draft proposes three alternative rules for expanding controlled foreign corporation rules as possible anti-abuse rules to protect the U.S. tax base.

Domestic base-broadening reforms were not specified in the discussion draft.

President's National Commission on Fiscal Responsibility and Reform (Simpson-Bowles, December 2010)

President Obama's National Commission on Fiscal Responsibility and Reform, co-chaired by former Senator Alan Simpson and former White House Chief of Staff Erskine Bowles, recommended reducing the corporate tax rate to a range between 23 and 29 percent and providing a territorial tax system.¹⁰² The cost of these reforms would be offset by the elimination of all business tax expenditures.

Bipartisan Policy Center Task Force (Domenici-Rivlin, November 2010)

The deficit reduction recommendations of the Bipartisan Policy Center, co-chaired by former Senator Pete Domenici and former Congressional Budget Office and Office of Management and Budget Director Alice Rivlin, included reducing the corporate tax rate to 27 percent.¹⁰³ The plan would eliminate numerous tax expenditures. The plan would maintain the U.S. worldwide tax system with deferral.

Bipartisan Tax Fairness and Simplification Act (Wyden-Coats, April 2011)

Senator Ron Wyden (D-OR) and Senator Dan Coats (R-IN) introduced the Bipartisan Tax Fairness and Simplification Act (S. 727, 112th Cong.) in April 2011. The legislation, similar to legislation previously co-sponsored by Senator Wyden and former Senator Judd Gregg, would reduce the corporate tax rate to 24 percent. The legislation would repeal a number of tax expenditures.

The legislation would subject all foreign earnings of U.S. companies to current taxation, without deferral, and would restrict the use of foreign tax credits by imposing a per-country foreign tax credit limitation. The legislation would provide a temporary one-year period during which foreign earnings could be repatriated at a maximum tax rate of 5.25 percent.

The legislation would deny a deduction for a portion of gross interest expense. Interest income of recipients would be fully included in taxable income.

Figure 16

Summary of Recent Corporate Tax Reform Proposals

Item	Current law	President's Framework for Business Tax Reform 2012	
Top Statutory Corporate Tax Rate	35%	28%	
Taxation of Active Foreign-Source Income	Taxed when repatriated (deferral) with credit for foreign income taxes.	Impose a minimum tax on foreign earnings; provide 20% tax credit for expenses of moving operations to the United States; tax currently "excess profits" associated with intangible income earned in low-tax jurisdictions.	
Corporate Alternative Minimum Tax	Corporations pay the greater of 20% of alternative minimum taxable income or regular corporate tax.	Not specified.	
Domestic Production Deduction	Up to 9% deduction of qualified production activities income.	Target and increase deduction to 10.7% (results in 25% tax rate on qualifying manufacturing income); larger deduction for advanced manufacturing.	
Research & Development (R&D) and Research & Experimentation (R&E)	R&D costs may be deducted as incurred ("expensed"). A credit is allowed for qualified R&E costs, determined under one of three methods, through 2013.	Make R&E credit permanent and increase credit rate for the alternative simplified credit.	
Capital Cost Recovery	Modified accelerated cost recovery system; temporary 50% bonus depreciation through 2013; \$500,000 of investment may be 100% expensed in 2013 subject to phaseout.	Reduce acceleration of depreciation allowances; allow small businesses to expense up to \$1 million in investment; eliminate special depreciation rules for corporate aircraft.	
Inventory Methods	Businesses may account for inventories under the last-in, first-out (LIFO) method of accounting and the lower of cost or market (LCM), in addition to other methods.	LIFO inventory method is disallowed. Allow cash accounting for businesses with up to \$10 million in gross receipts.	
Deduction of Interest Expense	Limited to bona fide debt (sec. 385). Earnings stripping rules apply to interest paid to or guaranteed by related nontaxable person (sec. 163(j)).	Consider reduced deductibility of interest expense; defer deduction for interest expense allocable to foreign investment until related income is taxed in the United States.	
Other General Business Credits	More than 30 tax credits.	Make tax credit for production of renewable electricity permanent and refundable.	
Other Tax Expenditures	More than 75 tax expenditures.	Eliminate tax expenditures for specific industries, including oil and gas tax preferences, and reform treatment of insurance industry and products.	
Pass-Through Businesses	Income of pass-through businesses is not subject to an entity-level tax; business owners are subject to income tax on their share of pass-through business income.	Consider modifications to establish greater parity between large corporations and large noncorporate businesses. Small businesses would not be affected.	

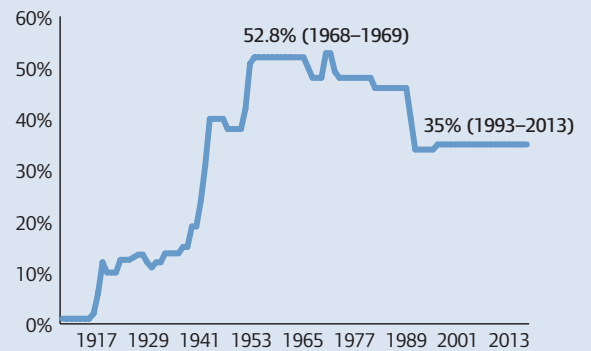
	House Ways & Means Chairman Camp, discussion draft 2011	Simpson-Bowles (President's National Commission on Fiscal Responsibility and Reform) 2010	Domenici-Rivlin (Bipartisan Policy Center) 2010	Wyden-Coats (S. 727) 2011
	25%	23%–29% (“illustrative plan” provides 28% rate)	27%	24%
	Adopt a territorial system that exempts 95% of active foreign earnings; require 5.25% tax on pre-existing unremitted foreign earnings (with a foreign tax credit); adopt anti-abuse rules to address income shifting and protect the U.S. tax base.	Adopt a territorial system.	Repeal inventory property sales source rule.	Repeal deferral and impose per-country foreign tax credit limitation. Repeal inventory property sales source rule. Provide a one-year temporary dividends received deduction for foreign earnings.
	Not specified.	Repealed.	Repealed.	Repealed.
	Not specified.	Repealed.	Repealed.	Repealed.
	Not specified.	Expensing of R&D costs repealed. R&D costs would be amortized over five years. No R&E credit.	Present-law expensing of R&D costs. No R&E credit.	Present-law expensing of R&D costs. No R&E credit.
	Not specified.	Repeal accelerated depreciation. Replace with Alternative Depreciation System (ADS) of present law.	Present law.	Repeal accelerated depreciation. Replace with ADS. Allow expensing for businesses with up to \$1 million of gross receipts.
	Not specified.	LIFO inventory method is disallowed with appropriate transition.	Disallow LIFO and LCM inventory methods.	Disallow LCM valuation method. Inventory accounting not required for business with less than \$1 million of gross receipts.
	A “thin capitalization rule” would disallow a portion of net interest expense of U.S. multinational companies that have excessive domestic interest expense relative to worldwide leverage and adjusted taxable income.	Present law.	Present law.	Inflation component of gross interest expense is not deductible (all interest income remains taxable).
	Not specified.	Repealed.	Repealed.	Credit for enhanced oil recovery repealed.
	Not specified.	Repealed.	Repealed.	Repeal selected tax expenditures, including percentage depletion for oil and gas.
	Not specified.	Present law.	Present law.	Present law.

Appendix B. Federal Statutory Corporate Tax Rates, 1909–2013

- ▶ The initial corporate income tax in 1909 (enacted as an excise tax on corporate income) imposed a 1 percent tax on corporate income in excess of \$5,000.
- ▶ The top tax rate ranged from 10 percent to 19 percent between 1918 and 1939.
- ▶ The top corporate rate increased to 40 percent during World War II.
- ▶ The maximum tax rate reached 52.8 percent in 1968 and 1969, comprising a 48 percent regular tax and a 10 percent surtax.
- ▶ The top corporate tax rate was reduced by the 1986 tax reform act, with the top rate reduced over two years from 46 percent to 34 percent.
- ▶ In 1993, the corporate tax rate was increased to 35 percent, where it remains.

Figure 17

Top Federal Statutory Corporate Tax Rate, 1909–2013



Source: IRS Statistics of Income.

Appendix C. Major Corporate Tax Developments, 1909–2012

Congress Taxes Corporate Income

- ▶ 1909: Federal excise tax imposed on corporations based on income; tax imposed on worldwide income with a deduction for foreign taxes
- ▶ 1913: Federal income tax enacted after ratification of 16th Amendment; new law incorporates existing corporate tax, with top rate of 1 percent

Tax Rate Gradually Rises to 52 Percent

- ▶ 1918: Top rate of 12 percent; allows foreign tax credit (FTC) in place of a deduction for foreign taxes
- ▶ 1919: Top rate reduced to 10 percent
- ▶ 1922: Top rate of 12.5 percent
- ▶ 1936: Top rate of 15 percent
- ▶ 1938: Top rate of 19 percent
- ▶ 1939: Enactment of Internal Revenue Code of 1939 — restates and revises existing tax law
- ▶ 1940: Top rate of 24 percent
- ▶ 1941: Top rate of 31 percent
- ▶ 1942: Top rate of 40 percent
- ▶ 1946: Top rate of 38 percent
- ▶ 1950: Top rate of 42 percent
- ▶ 1952: Top rate of 52 percent

Developments from 1954 Code until Tax Reform Act of 1986

- ▶ 1954: Enactment of Internal Revenue Code of 1954 — restates and revises existing tax law; enacts current deductibility of research and experimental expenditures
- ▶ 1962: Revenue Act of 1962 — enacts subpart F limits on deferral, investment tax credit (ITC)
- ▶ 1964: Revenue Act of 1964 — top rate of 50 percent
- ▶ 1965: Top rate of 48 percent (surcharges applied in 1968–70)
- ▶ 1969: Tax Reform Act of 1969 — repeals ITC
- ▶ 1971: ITC restored; Domestic International Sales Corporation (DISC) provisions enacted
- ▶ 1976: Tax Reform Act of 1976 — extends ITC; expands net operating loss carryover; modifies FTC, DISC, other international tax rules
- ▶ 1979: Top rate of 46 percent (under Revenue Act of 1978); ITC permanently extended
- ▶ 1981: Economic Recovery Tax Act of 1981 — adopts new Accelerated Cost Recovery System; enacts research tax credit
- ▶ 1982: Tax Equity and Fiscal Responsibility Act of 1982 — limits certain corporate tax incentives
- ▶ 1984: Deficit Reduction Act of 1984 — enacts Foreign Sales Corporation (FSC) provisions; postpones certain tax reductions to reduce deficit

Tax Reform Act of 1986 Reduces Corporate Rate

- ▶ 1986: Tax Reform Act of 1986 — revises and restates existing tax law as the Internal Revenue Code of 1986; enacts modified Accelerated Cost Recovery System; repeals ITC; enacts phased reduction in corporate tax rate for 1987–88; enacts corporate alternative minimum tax; makes extensive changes to international tax rules
- ▶ 1987: Top rate of 40 percent
- ▶ 1988: Top rate of 34 percent

Rate Increase, Other Developments

- ▶ 1993: Top rate of 35 percent; section 197 amortization of goodwill and section 162(m) compensation deduction limitation enacted
- ▶ 2000: FSC regime repealed; Extraterritorial Income (ETI) regime enacted
- ▶ 2004: ETI regime repealed; section 199 domestic production activities deduction and section 965 temporary foreign earnings repatriation enacted

Appendix D. U.S. Employment by Corporations and Other Businesses

Business activity is conducted through different legal forms of organization, including corporations, partnerships and sole proprietorships, for various business and tax reasons.

For tax purposes, only business income of so-called C corporations (named after Subchapter C of the tax code) is subject to the corporate income tax. For the most part, businesses seeking to raise capital in publicly traded markets are required to be taxed under the corporate income tax as C corporations. Dividend distributions of corporate earnings from C corporations to individual shareholders are subject to a second level of tax under the individual income tax system when received by the shareholder.

In contrast business income of S corporations (named after Subchapter S of the tax code), partnerships, limited liability corporations and sole proprietorships is attributed directly to their owners and is taxed under the individual income tax system rather than at the entity level.

In 2009, private-sector businesses employed 97.8 million full-time and part-time employees and had total payrolls of \$4.2 trillion.¹⁰⁴ C corporations employed 53.6 million workers and had payrolls of \$2.6 trillion, accounting for 55 percent of business employment and 62 percent of business payrolls (**Figure 18**).

Figure 18

Employment by Businesses, 2009

Business	Employees (millions)	Percentage of total	Payroll (\$ billions)	Percentage of total
C corporations	53.6	55%	2,627.0	62%
S corporations	27.9	29%	991.9	24%
Partnerships	11.5	12%	457.2	11%
Sole proprietorships	4.8	5%	136.9	3%
TOTAL	97.8	100%	4,213.0	100%

Notes: Employee counts and payroll are of paid employees; proprietors and partners are excluded. Business employment excludes nonprofit and government-sector employment. Percentages may not total 100 due to rounding.

Source: U.S. Census Bureau, U.S. Department of Commerce, Statistics of U.S. Businesses.

Large and Small Businesses

Large firms, defined as those with 500 or more employees, employed 50 percent of all workers in businesses and accounted for 55 percent of business payrolls in 2009.¹⁰⁵ Among C corporations, large firms employed 38.2 million workers and had payrolls of \$1.9 trillion in 2009.

Both large and small business enterprises play an important role in the economy. One survey of large American companies with international operations finds that nearly one-quarter of all of their domestic business purchases are from U.S. small businesses, accounting for \$1.52 trillion in sales by U.S. small businesses in 2010.¹⁰⁶

Recent research has identified new businesses, which typically start as small businesses, as playing a disproportionate role in contributing to job growth.¹⁰⁷ New businesses may be created to develop new ideas and technologies, and their success leads to rapid growth. However, when one examines businesses of the same age, this research finds no evidence that small firms create jobs at a faster rate than large firms. Instead, it finds that net job creation is roughly in proportion to the amount of employment in each size class of firms.

Appendix E. Profile of American Companies with International Operations

American parent companies with international operations employed 22.8 million workers in the United States in 2010, the latest year for which preliminary data are available.¹⁰⁸ U.S. employment by these companies accounted for more than two-thirds of the worldwide employment of their combined U.S. and majority-owned foreign operations.

The average annual compensation paid in 2010 by American parent companies to their American workers was \$70,700, compared with \$52,900 for U.S. businesses without foreign operations.¹⁰⁹

American companies with international business operations typically are large firms with 500 or more employees. Of the 2,347 U.S. multinational parent companies in 2009, nearly 75 percent had 500 or more employees. These large firms employed 99 percent of American workers who are employed by U.S. multinational corporations.¹¹⁰

As with their significant employment base in the United States, American companies with international operations conduct most of their activity in the United States. More than 75 percent of the compensation paid by these companies to employees is in the United States, and more than two-thirds of the value added from the worldwide activities of these companies arises in the United States.¹¹¹ American parent companies undertook \$438 billion of capital expenditures in plant and equipment in the United States in 2010, representing more than 70 percent of their worldwide capital investment.¹¹²

U.S. parent companies with foreign affiliates directly accounted for 48 percent of all U.S. exports in 2010.¹¹³

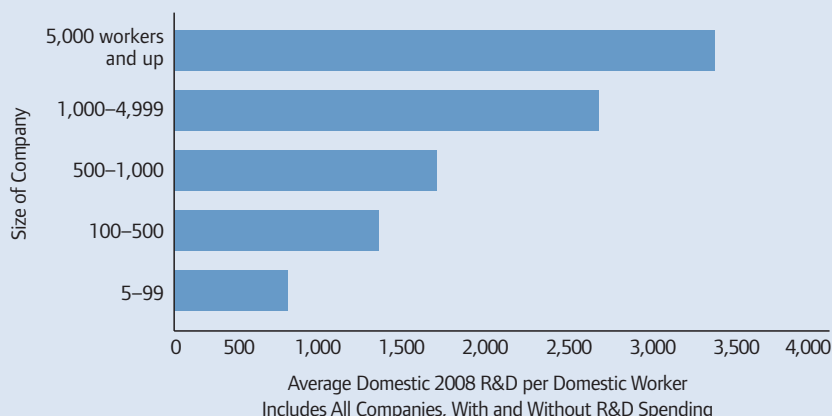
Research has shown that increased sales by foreign affiliates of U.S. parent companies are typically associated with greater U.S. employment, greater U.S. investment, and increased exports of goods and services from the United States by the U.S. parent company.¹¹⁴ Findings of one study suggest that an average of 134 U.S. jobs are created in the parent company's U.S. operations for every 100 jobs added abroad in its foreign affiliates.¹¹⁵

Research and Development (R&D) and Productivity of American Parent Companies

R&D expenditures by American parent companies in the United States were \$213 billion in 2010 and represented 84 percent of their worldwide R&D expenditures.¹¹⁶ In 2009, R&D by American parent companies accounted for 73.4 percent of all research undertaken by American companies in the United States.¹¹⁷ Sales to foreign markets help support domestic R&D by providing a larger base of sales over which to spread the costs of developing new products and processes.

Figure 19

Average R&D per Employee Increases with Company Size



Source: Michael Mandel, *Scale and Innovation in Today's Economy*, Progressive Policy Institute (December 2011).

A study by Michael Mandel of the Progressive Policy Institute, based on National Science Foundation data, finds that large firms on average undertake significantly more R&D per employee than small firms.¹¹⁸ This study reports that companies employing more than 5,000 workers had research expenses averaging \$3,368 per worker in 2008. Per-worker R&D expense declined for all smaller sized firms, with the smallest companies — those employing from 5 to 99 workers — spending an average of \$793 per worker on R&D, less than a quarter as much **(Figure 19)**. In addition, the study finds that companies spending more on research achieve significantly more innovations.

A study by Federal Reserve Board economists finds that American companies with international operations are responsible for significant increases in U.S. labor productivity. The study finds that these companies were responsible for more than three-fourths of the increase in labor productivity in the U.S. corporate sector between 1977 and 2000 and all of the labor productivity growth in the U.S. corporate sector in the late 1990s.¹¹⁹

Research by the Bureau of Economic Analysis finds that American manufacturing companies with foreign operations were 16 percent more productive than companies that operated only in the United States.¹²⁰ Further, this productivity advantage increases with the global scope of a company's operations. In 2008, American companies operating in 10 or more countries had 54 percent greater value added per employee than those companies operating in just one foreign country and 21 percent greater value added per employee than companies that operated in two to nine foreign countries.¹²¹ Higher worker productivity in turn is the key determinant of higher wages and a higher standard of living for American workers.

Given the importance of R&D activities in fostering technological advancements and productivity gains, it is important that tax policy not diminish the ability of large companies to compete successfully globally. Worldwide operations of these companies provide the scale that allows these companies to invest in risky R&D activities.

Appendix F. Glossary of Tax Terms

The language of tax experts can be confusing, even to experienced audiences. To help decisionmakers understand the complex issues of taxation, the Business Roundtable has compiled this glossary that defines some of the most frequently used tax terms.

- ▶ **Accelerated Depreciation:** Depreciation method under which tax deductions for depreciation are taken more rapidly than the decline in economic value of an asset. (Also see *Bonus Depreciation*, *Depreciation* and *Expensing*.)
- ▶ **Active Financing Income Rule:** U.S. tax rules generally defer taxation of income from an active foreign business until that income is remitted to the U.S. parent. Under subpart F rules, interest and related income of a foreign subsidiary generally are subject to current taxation without benefit of deferral. These rules historically have aimed at requiring current taxation of income that is *passive* or easily moveable, although some forms of *active* income also are subject to these rules. The active financing income rule in present law is a temporary measure to permit deferral of certain types of income derived from the *active* conduct of a banking, finance or insurance business. This provision, most recently extended in January 2013, expires for taxable years beginning after December 31, 2013.
- ▶ **Active Income:** Income earned by a corporation through the active conduct of a trade or business, in contrast to income earned from a passive investment activity.
- ▶ **Advance Pricing Agreement (APA):** A binding agreement between a taxpayer and a taxing authority (unilateral) or two taxing authorities (bilateral) on the taxpayer's transfer pricing method for specific transactions.
- ▶ **Affiliates:** Entities that are related through a common ownership interest. This relationship can occur between a parent corporation and a subsidiary or through common ownership, such as brother-sister corporations.
- ▶ **Allocation:** The process of assigning income or expenses to a specific jurisdiction or categories of income and/or expenses based on their association with that jurisdiction or category. Allocation differs from apportionment as the former generally involves identifying how specific items of income or expense should be assigned to a jurisdiction or category.
- ▶ **Alternative Minimum Tax, Corporate:** Federal tax rules require companies to compute tax liability under the regular rules of the income tax system and then a second time under an alternative calculation that disallows many deductions, exemptions and business tax credits but applies a lower statutory rate of tax (20 percent). Corporations are required to pay the larger of their regular tax liability or the alternative tax amount.
- ▶ **Amortization:** The systematic, straight-line reduction of the basis of an intangible asset, in the form of a deduction, over the useful life of the asset. As in the case of depreciating tangible assets, U.S. tax law provides guidance for the length of the useful life for different types of intangible assets.
- ▶ **Apportionment:** The process of assigning income or expenses among jurisdictions or categories, usually through use of a formula.
- ▶ **Arm's-Length Standard:** Under current law, transactions between a U.S. parent company and its foreign subsidiaries are required to use the same prices that the parent company and its foreign subsidiaries would use with unrelated companies. This principle of determining internal transfer prices using the same terms as would apply with unrelated companies is also known as the arm's-length standard. It allows for agreement by countries with potentially conflicting interests to use a well-accepted principle for determining the source of income in cross-border transactions between related parties.
- ▶ **Average Tax Rate:** The percentage of a taxpayer's income used to pay tax. The rate is determined by dividing the tax liability of the taxpayer by its taxable income.
- ▶ **Base Broadening:** Changes to tax rules that expand the tax base. When discussed in the context of income tax reform, such proposed changes typically increase the measure of taxable income by repealing or limiting deductions or exclusions from income or by repealing or limiting tax credits that reduce income tax liability.
- ▶ **Bonus Depreciation:** A temporary provision providing partial or full expensing of an asset in the year the asset is placed in service. In years the provision has been in effect, the amount of expensing permitted in the first year has been 30, 50 or

100 percent, depending on the asset's placed-in-service date. The basis of each qualifying asset is adjusted by the amount of bonus depreciation taken before applying standard depreciation rules. Bonus depreciation of 50 percent is permitted for certain assets placed in service in 2012 and 2013.

- ▶ **C Corporation:** A corporation that is subject to tax at the entity level under Subchapter C of the Internal Revenue Code.
- ▶ **CFC Look-Through Rule:** In May 2006, Congress enacted a temporary “look-through” exception for subpart F with respect to payments of dividends, interest, rents and royalties between related controlled foreign corporations (CFCs). The rule provides that such payments will not give rise to subpart F income (thereby permitting deferral) to the extent the payments come from active, nonsubpart F earnings of the payer CFC. In effect, the provision “looks through” the form of payment to the underlying source of income. The provision was adopted to permit foreign subsidiaries of U.S. companies to redeploy active foreign earnings in a manner similar to that permitted by most U.S. trading partners. This exception from subpart F, extended in January 2013, expires for taxable years beginning after December 31, 2013.
- ▶ **“Check-the-Box” Election:** An election that allows an American company (or individual) to choose how an entity it owns, either domestic or foreign, will be treated for U.S. tax purposes. Before the check-the-box election was created, entities were determined to be corporations or pass-through entities based on detailed review of their characteristics.
- ▶ **Combined Corporate Tax Rate:** The tax rate of a corporation that includes the federal income tax rate as well as any state and local income tax rates, reduced by the benefit of any deduction allowable at the federal level for the state and local taxes. The average combined corporate tax rate for U.S. corporations in 2012 is 39.1 percent: 35 percent federal rate plus an average state and local rate of 4.1 percent net of deductibility at the federal level (6.4 percent before deductibility at the federal level).
- ▶ **Consumption Tax:** A tax levied on the value of a good or service to the ultimate consumer. Types of consumption taxes include sales tax, use tax, value added tax (VAT), and goods and services tax (GST). Sales and use taxes are assessed on the sale or use of a good or service, whereas a VAT or GST is levied at each stage of the supply chain with the total cost being borne by the ultimate consumer.
- ▶ **Controlled Foreign Corporation (CFC):** A foreign corporation in which more than 50 percent of the voting power or value of the stock is held by U.S. shareholders. Only a U.S. shareholder that owns 10 percent or more of the stock of the foreign corporation is included in this determination. Subpart F rules apply to foreign subsidiaries that are CFCs.
- ▶ **Defer Deduction of Interest Expense Related to Deferred Income:** A proposal in the President's FY 2014 budget that would require taxpayers to defer the deduction of their interest expense that is properly allocated and apportioned to foreign source income that is not taxable in the current year. The deferred interest expense would become deductible when deferred foreign earnings are repatriated to the United States and therefore become subject to taxation.
- ▶ **Deferral:** The United States defers collecting taxes on earnings of the foreign subsidiaries of U.S.-based corporations until those earnings actually are paid to the U.S. parent, with some exceptions (see *Subpart F*). Most frequently, repatriated foreign earnings are paid as a cash dividend to the U.S. parent company. This method of taxation mirrors the tax treatment of individual shareholders in a domestic corporation, who are not taxed on the earnings of the corporation until they receive a distribution from the corporation. All OECD member countries and other developed nations that tax the worldwide earnings of their globally operating corporations permit some form of deferral or otherwise exempt such earnings from domestic taxation.
- ▶ **Depreciation:** The systematic reduction of the basis of fixed assets, in the form of a deduction, for the basic wear and tear and loss of value over the useful life of the assets. U.S. tax rules provide specifications for the useful life of many types of assets.
- ▶ **Disregarded Entity:** An entity that is 100 percent owned by one owner and is not considered separate from its owner for tax purposes. The owner may make a check-the-box election to treat a wholly owned entity as disregarded. All assets, liabilities, income, deductions, etc. of the disregarded subsidiary are included with those of the owner.
- ▶ **Dividend:** A taxable distribution, for which a corporation has enough earnings and profits to cover the payment, to the shareholders of the corporation. Although dividends are taxable income to the receiving shareholders, they are considered reductions in retained earnings of the distributing company and therefore are not deductible by the payer.

- ▶ **Dividends Received Deduction (DRD):** A deduction a corporation may take on a percentage of certain dividends received from another corporation. Dividends that qualify generally must come from a domestic corporation. The percentage of the DRD generally is 70 percent of the dividend received. However, the DRD is 100 percent for dividends received from another member of same affiliated group of corporations. A temporary provision enacted in 2004 provided for an 85 percent DRD for dividends received from a controlled foreign corporation (see *Homeland Investment Act*).
- ▶ **Domestic Production Activities Deduction:** A deduction of 9 percent (previously 3 percent in 2005 and 2006 and 6 percent in 2007, 2008 and 2009) of U.S. taxable income or qualified production activities income, whichever is less, for domestic producers of goods. The deduction is limited to 50 percent of the wages the taxpayer paid to employees, as reported on W-2s for the year. The deduction relates to taxable income earned for goods produced in the United States. This deduction is often referred to as the “Section 199 deduction” for the Internal Revenue Code section that provides the deduction.

 - o *Domestic Production Gross Receipts (DPGR)* are the gross receipts associated with the sale, exchange, lease, rental or license of qualifying production property that has been manufactured, produced, grown or extracted completely or significantly within the United States by the taxpayer; gross receipts from the taxpayer’s domestic production of qualified films, electricity, natural gas or potable water; and gross receipts from construction of real property in the United States and related engineering or architectural services on such property performed in the United States.
 - o *Qualified Production Activities Income (QPAI)* is the measure of income for purposes of the domestic production activities deduction, equal to the amount of DPGR that are greater than the cost of goods sold and other deductions properly allocated to such receipts.
 - o *Qualified Production Property (QPP)* is property that is considered tangible personal property, computer software or a sound recording.
- ▶ **Double Taxation:** The taxing of income at two levels. Domestically, double taxation occurs when a corporation is taxed on its earnings and the earnings are subject to tax again (as a dividend) when they are distributed to the corporation’s shareholders. Internationally, double taxation occurs when any item of income is taxed in the foreign country where it was earned and then taxed again by the taxpayer’s home country due to a limitation or denial of credits for the taxes previously paid to the foreign country for that income. Jurisdictional double taxation refers to the system of taxation under which foreign income is subject to tax once in the source country where the income was earned and the income is subject to a second level of additional tax in the home country of the taxpayer, even after receiving a credit for foreign taxes paid. Jurisdictional double taxation arises under worldwide systems of taxation, such as in the United States.
- ▶ **Earnings and Profits (E&P):** A tax accounting term describing a measure of income or surplus used to determine if a corporation has enough economic means to cover distributions. E&P is calculated through adjustments to taxable income. Current E&P is the E&P from the current tax year and is accounted for as of the end of the year, before consideration of any distributions made during the year. Accumulated E&P is the amount of E&P from prior years that has not been reduced previously through distributions. Ordering rules require distributions to first reduce current E&P and then accumulated E&P. If more is distributed in a year than total E&P of the corporation, shareholders receive a return of capital up to their basis. Any remaining distribution is treated as a capital gain or loss.
- ▶ **Earnings Stripping Rules:** Current U.S. tax rules defer deductions for interest expense associated with related-party debt if incurred by a thinly capitalized U.S. subsidiary of a foreign corporation. For purposes of these rules, debt of such a U.S. corporation guaranteed by its foreign owner is considered related-party debt.
- ▶ **Effective Average Tax Rate:** Sometimes used as a synonym for effective tax rate but used by economists to evaluate the rate of tax paid on a highly profitable investment. It provides a measure of the disincentive effects of a tax system for undertaking such investments. (Contrast with *Average Tax Rate*, *Effective Tax Rate* and *Marginal Effective Tax Rate*.)
- ▶ **Effective Marginal Tax Rate:** See *Marginal Effective Tax Rate*.
- ▶ **Effective Tax Rate:** Effective tax rates typically measure the average rate of tax relative to a measure of income (sometimes other than taxable income). For example, book effective tax rates measure tax payments relative to financial statement income. (Somewhat different concepts are *Effective Average Tax Rate* and *Marginal Effective Tax Rate*.)

- ▶ **Excess Returns Proposal:** To reduce the incentive for taxpayers to engage in certain related-party transactions, the Obama Administration has proposed expanding subpart F income to include a new category of “excess” income attributable to intangibles transferred from the United States to low-taxed controlled foreign corporations (CFCs). Under the President’s FY 2014 budget proposal, if a U.S. person transfers (directly or indirectly) an intangible from the United States to a related CFC (a “covered intangible”), certain excess income from transactions connected with, or benefiting from, the covered intangible is treated as subpart F income if the income is subject to a foreign effective tax rate of less than 15 percent. “Excess intangible income” is defined as the excess of gross income from transactions connected with, or benefiting from, such intangible over the costs (excluding interest and taxes) properly allocated and apportioned to this income, increased by a percentage mark-up.
- ▶ **Exemption System:** See *Territorial Tax System*.
- ▶ **Expensing:** A term used to describe when a taxpayer deducts the full cost of property in the year it is placed in service, rather than capitalizing the asset and deducting its value over time, as with depreciation. The rules under Section 179 of the Internal Revenue Code allow expensing of qualified property. Bonus depreciation rules for assets placed in service for certain years are eligible for partial or full expensing of qualifying property.
- ▶ **Extraterritorial Income (ETI):** Gross income earned by the taxpayer from foreign trading gross receipts on U.S. exports. Under prior law, ETI could be excluded from gross receipts when determining taxable income of a U.S. taxpayer. ETI was enacted to replace the Foreign Sales Corporation regime. The World Trade Organization (WTO) deemed the ETI rules to be an export subsidy, which is illegal under international trade laws. ETI rules were repealed in the American Jobs Creation Act of 2004 and replaced with the domestic production activities deduction.
- ▶ **First-In, First-Out (FIFO):** A method used to value inventory on hand at the end of a tax year. Under FIFO, items are sold in the same order they were purchased or manufactured. As a result, stock on hand at the end of the year consists of the latest goods purchased or produced. FIFO matches current sales with the cost of the earliest acquired or manufactured inventory.
- ▶ **Foreign Base Company Income (FBCI):** A type of foreign income that is subject to current U.S. taxation under subpart F rules whether or not distributed to U.S. shareholders. The four categories of FBCI are:

 - o *Foreign Personal Holding Company Income* is income that consists of dividends, interest, royalties, rents and other kinds of investment income;
 - o *Foreign Base Company Sales Income* is income that is derived from the purchase and sale of property involving a related party where the property originates outside the country in which the controlled foreign corporation (CFC) is organized and is sold for use outside such foreign country;
 - o *Foreign Base Company Services Income* is services income arising on behalf of a related person outside the country in which the CFC is organized; and
 - o *Foreign Base Company Oil Related Income* is income arising from the sale of oil and gas products except where the income is earned in the country in which it is extracted.
- ▶ **Foreign Sales Corporation (FSC):** A corporation formed under the laws of a foreign country or U.S. possession (other than Puerto Rico), meeting certain requirements, that exports U.S. goods. Under prior law, an FSC could treat a portion of its foreign trade income as tax exempt, and the remaining income was eligible for a generous dividends received deduction. The World Trade Organization declared the FSC system to be illegal, and U.S. tax laws permitting the entities were repealed in 2000, with the exception of transition rules.
- ▶ **Foreign Tax Credit (FTC):** To avoid double taxation of foreign income, the United States provides a credit against U.S. income tax for income tax paid to the host country. Without this credit, significant double taxation would make foreign investments noncompetitive for U.S.-based international companies. The FTC is subject to various limitations to ensure that a U.S. company pays at least as much tax on its worldwide income as it would pay on the same income earned at home.
- ▶ **Foreign Tax Credit (FTC) Pooling:** A proposal included in the Obama Administration’s FY 2014 budget for restricting the amount of FTC that could be claimed against U.S. tax on foreign income. Under current U.S. tax law, foreign income taxes deemed paid by a controlled foreign corporation (CFC) are determined by taking the post-1986 foreign income taxes of the

distributing CFC and multiplying that amount by the dividend paid over the post-1986 undistributed earnings and profits of the distributing CFC. The FTC pooling proposal would restrict a U.S.-based multinational group's deemed-paid FTCs to the average rate of total foreign tax paid on total foreign earnings, including CFCs not remitting foreign income. The proposal effectively treats all of a taxpayer's CFCs as a single CFC for FTC purposes.

- ▶ **G8:** Also known as the Group of Eight, includes Canada, France, Germany, Italy, Japan, Russia, the United Kingdom and the United States.
- ▶ **Goods and Services Tax:** See *Value Added Tax*.
- ▶ **Homeland Investment Act:** Part of the American Jobs Creation Act of 2004 that provided for a one-time 85 percent dividends received deduction (DRD) on distributions remitted to U.S. corporations from controlled foreign corporations. The dividend eligible for the DRD was limited to an amount that was in excess of average repatriated earnings from prior tax years. Calendar year taxpayers had to receive the eligible dividend by December 31, 2005, to benefit from the DRD.
- ▶ **Incidence of Tax:** The economic burden of a tax. The person bearing the incidence of the tax can be different from the person legally responsible for the tax payment.
- ▶ **Intangible Property:** Property that cannot be touched, such as a patent, copyright, noncompete agreement or goodwill. Intangible property with a limited life may be amortized, rather than depreciated, over time.
- ▶ **Intellectual Property:** Property that is generally intangible in nature that is protected by copyrights, patents, trademarks, trade names, etc.
- ▶ **Investment Tax Credit:** A credit for investment in certain business or income-producing depreciable property for rehabilitation, energy or therapeutic discovery purposes that is part of the general business credit. Prior to 1986, a comprehensive investment tax credit was available for general tangible personal property, subject to limitations, placed in service during the tax year.
- ▶ **Last-In, First-Out (LIFO):** Method used for valuating inventory on hand at the end of the year that treats the items most recently produced or purchased by a taxpayer as sold first. Any goods purchased or produced during a year that remain on hand at the end of that year create a "layer." A layer is depleted only when all goods from the current year are considered sold and any layers that had since been created have already been depleted. The objective of LIFO is to match current sales with current replacement costs. To use LIFO for tax purposes, taxpayers must also use LIFO for financial statement purposes. This stipulation is known as the LIFO conformity requirement.
- ▶ **Limited Liability Company (LLC):** An entity in which the liability of its members (owners) is limited to their investment in the entity. The default tax treatment of a multiple-member LLC is as a partnership. Single- and multiple-member LLCs may elect to be taxed as a corporation. A single-member LLC that does not elect to be treated as a corporation is disregarded for tax purposes.
- ▶ **Lockout Effect (Repatriation):** The disincentive for a U.S. company to remit earnings from a foreign subsidiary for reinvestment in the United States due to the additional layer of tax that would be required under the U.S. worldwide tax system, compared to the ability to repatriate funds with little or no additional tax under the territorial tax systems of most other OECD countries.
- ▶ **Marginal Effective Tax Rate:** Used by economists to evaluate the rate of tax paid on an investment on which the after-tax profits are just sufficient to cover the investor's opportunity cost of capital. Also referred to as the "effective marginal tax rate." The marginal effective tax rate provides a measure of the disincentive to undertake additional new investment. (Contrast with *Effective Average Tax Rate*.)
- ▶ **Marginal Tax Rate:** The tax rate at which a taxpayer's last dollar of income is taxed.
- ▶ **Partnership:** An association of two or more persons (or entities) engaged in a business for profit. Under U.S. law, partnerships are not taxable at the entity level; instead, items of income, deduction, gain and loss flow through to the tax returns of the ultimate owners.

o *General Partnership* is a partnership in which all partners have joint and several liability for debts.

o *Limited Partnership* is a partnership with general and limited partners. General partners manage the business and share full responsibility for debts of the company. Limited partners do not participate in managing the business, and their liability is limited to their investment in the company.

- ▶ **Pass-Through Entity:** An entity that is not itself taxed but instead allocates its items of income, deduction, gain and loss to its owners, who will include such items with their income to be taxed. Partnerships, limited liability companies and S corporations are all generally considered pass-through entities.
- ▶ **Passive Income:** Income earned in the form of interest, dividends and similar investment income through investment activities of the taxpayer (as opposed to income earned from the taxpayer's active conduct of a trade or business).
- ▶ **Patent Box (Innovation Box):** A tax regime adopted by a number of countries over the past decade that applies a reduced rate of corporate tax to income resulting from qualifying intellectual property (IP). Since 2001, seven European Union countries — Belgium, France, Hungary, Luxembourg, Netherlands, Spain and the United Kingdom — have adopted patent boxes that tax qualifying IP income at a reduced rate ranging between 5 percent and 15 percent. The U.K. patent box, set to begin in 2013, applies a 10 percent tax rate to qualifying income.
- ▶ **Repatriated Earnings:** Income earned by a foreign subsidiary that has been brought back to a taxpayer's home country, generally in the form of a dividend. U.S. tax is usually assessed when foreign income is repatriated.
- ▶ **Revenue Neutral:** Changes to the tax system that result in no change in total revenue collections by the government. Revenue-reducing changes are exactly offset by other changes that increase tax revenue.
- ▶ **S Corporation:** A domestic small business corporation that for U.S. tax purposes has elected to have items of income, deduction, gain and loss flow through to shareholders. These items are apportioned on a per-share, per-day basis. To be an S corporation, businesses must meet and maintain certain requirements, including: (1) there are no more than 100 shareholders (attribution rules apply to determine one shareholder), (2) shareholders may only be individuals (and certain estates or trusts thereof), (3) shareholders may not be non-U.S. persons and (4) the company may only have one class of stock.
- ▶ **Single-Member LLC:** A limited liability company owned 100 percent by one member. Under U.S. tax law, the default treatment of a single-member LLC is as a disregarded entity, or not separate from its owner. A single-member LLC may elect to be taxed as a corporation separate from its owner.
- ▶ **Sole Proprietorship:** An unincorporated business owned by one individual, who is liable for all debts of the company. For U.S. tax purposes, all taxable profits and losses are not considered separate of the owner, who is liable for self-employment tax on income earned through the sole proprietorship.
- ▶ **Source Rules:** Rules used to allocate worldwide income, expenses and taxes into U.S. amounts and foreign amounts. In general, income is sourced to the place where the activity occurred that gave rise to the income, netted against directly related expenses.
- ▶ **Statutory Tax Rate:** The rate, as provided by law, that a taxpayer applies to net taxable income to determine tax liability. The top U.S. federal statutory corporate income tax rate is 35 percent.
- ▶ **Subpart F:** U.S. shareholders owning 10 percent or more of a controlled foreign corporation (CFC) are subject to U.S. tax currently on certain income earned by the CFC whether or not such income is actually distributed to the U.S. parent (i.e., without the advantage of deferral). These rules historically have aimed at requiring current taxation of income that is *passive* or easily moveable, although some forms of *active* income are also subject to these rules. Income subject to tax under subpart F includes certain insurance income and foreign base company income (defined previously).
- ▶ **Tax Expenditure:** Provisions in the Internal Revenue Code that provide taxpayers with favorable treatment relative to an assumed baseline tax system, generally through a special deduction, credit, exclusion, exemption or lower rate.
- ▶ **Tax Information Exchange Agreement (TIEA):** A treaty between two governments to share tax-related information to reduce tax evasion.

- ▶ **Tax Treaty:** A formally signed, executed and ratified agreement between two governments negotiated to promote international trade and investment by reducing (or eliminating) the double taxation of income. U.S. tax treaties are negotiated by the Treasury Department subject to approval by the Senate.
- ▶ **Territorial Tax System:** Under a territorial or “exemption” system, the active foreign earnings of a foreign subsidiary are not subject to tax by the home country when paid as a cash dividend to the parent corporation. In 2012, 28 of the 34 OECD countries, including all G8 countries other than the United States, followed a territorial or exemption approach, with the remainder following a worldwide approach.
- ▶ **Thin Capitalization Rule:** Taxpayers with foreign related-party debt that have a high debt-to-equity ratio (i.e., are thinly capitalized) may be disallowed deductions of interest payments related to the excess debt.
- ▶ **Transfer Pricing:** U.S. tax law requires that taxpayers report income earned on cross-border transactions with related parties by setting appropriate internal prices for these transactions. Transfer pricing is the methodology by which these internal prices are determined. The transfer pricing system is enforced by the Internal Revenue Service through audits, advance pricing agreements and the rule-making process. Foreign governments also enforce and monitor transfer pricing to ensure that the foreign government taxes its proper portion of profits sourced to it.
- ▶ **Value Added Tax (VAT):** The VAT is the most common form of consumption tax in the world. Like a sales tax, a VAT is imposed on the final consumption of goods and services. Unlike a sales tax, which is collected once on the sale to the end user, a VAT is imposed on the value added at every stage of the supply chain. To avoid a cascading of the tax, each buyer in the supply chain, except the ultimate consumer, recovers the VAT paid through either the credit method or subtraction method. Under the credit method, VAT is collected on sales to other businesses or the ultimate consumer with an offsetting credit for VAT paid on purchases from other businesses. Under the subtraction method, the value added is determined by subtracting deductible pretax purchases from other businesses from pretax gross receipts from sales to other businesses or the ultimate consumer.
- ▶ **Withholding Tax:** A tax that is collected and paid to a taxing authority by the taxpayer that is the source of the income, rather than the taxpayer that has earned the income. For example, employers generally are required to withhold income tax from compensation paid to their employees. In international taxation, withholding taxes are often imposed on passive income, such as royalties, dividends and interest.
- ▶ **Worldwide Interest Allocation:** The American Jobs Creation Act of 2004 modified the interest expense allocation rules by providing a one-time election to allocate and apportion third-party interest expense of U.S. members of a worldwide affiliated group to foreign-source income for foreign tax credit limitation purposes in an amount equal to the excess, if any, of (1) the worldwide affiliated group’s interest expense multiplied by the ratio of total foreign assets of the group over worldwide assets over (2) third-party interest expense incurred by foreign members of the group that otherwise would be allocated to foreign sources. This worldwide fungibility approach is considered a benefit for U.S. taxpayers with foreign affiliates that incur significant interest expense. This provision was originally effective for tax years beginning after December 31, 2008. The effective date has since been delayed several times; as of 2012, the effective date is for tax years beginning after December 31, 2020.
- ▶ **Worldwide Tax System:** Under a worldwide system of taxation, all foreign earnings of a domestic corporation are subject to tax in the home country. In practice, countries following a worldwide approach, including the United States, permit deferral on most forms of active foreign earnings until such income is paid to the domestic corporation. Within the 34 countries of the OECD, six countries follow a worldwide approach, with the other 28 countries following a territorial or exemption approach. Worldwide countries in the OECD are Chile, Ireland, Israel, Korea, Mexico and the United States.

Endnotes

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- 20 U.S. Bureau of Economic Analysis, *National Income and Products Accounts*, Table 1.1.5.
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- 26 Based on countries of companies in the 2012 Global Fortune 500, available at http://money.cnn.com/magazines/fortune/global500/2012/full_list/. Non-U.S. OECD companies represent 258 of the Global 500 companies, with 240 (93 percent) of these companies being based in territorial OECD countries. The United States has the highest combined statutory corporate tax rate within the OECD.
- 27 The phaseout of itemized deductions adds 1.2 percent, and the net investment income tax, sometimes referred to as the Medicare contribution tax, adds an additional 3.8 percent tax.
- 28 For comparison, the maximum individual federal tax rate on self-employment income earned from a pass-through is 44.6 percent in 2013 (comprised of 39.6 percent top individual statutory rate, 1.2 percent phaseout of itemized deduction and 3.8 percent Medicare tax) up from 37.9 percent in 2012 (35 percent top individual statutory rate and 2.9 percent self-employment Medicare tax). Certain pass-through business income is not subject to the Medicare tax.
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- 36 These proposals are summarized in more detail in Appendix A.
- 37 OECD corporate tax database and country research. Chile's corporate tax rate has increased from 10 percent to 20 percent since 1988. For OECD countries formed as independent countries after 1988, the current corporate rate is compared to the rate at the time the country was founded. For Hungary, the current corporate tax rate is compared to the rate established in 1989, when Hungary adopted reforms as part of its transition to a market economy.
- 38 Because state income taxes are deductible against federal taxes, the combined statutory tax rate takes into consideration the after-tax cost of state income taxes.
- 39 After taxes the investment in other OECD countries yields an average of \$75 compared to slightly less than \$61 in the United States, a difference of 23 percent.
- 40 Martin Sullivan notes that this is true even with expensing, the most accelerated form of depreciation. "With expensing, low-profit investments are favored over high-profit investments. Therefore when a government chooses expensing over lower rates, it is adopting a policy that attracts and retains low-profit investment at the expense of high-profit investment." Martin A. Sullivan, "Beyond the Conventional Wisdom: Rate Cuts Beat Expensing," *Tax Notes*, January 28, 2008, p. 463.
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- 44 International Monetary Fund, Fiscal Affairs Department, "Debt Bias and Other Distortions: Crisis-Related Issues in Tax Policy," June 12, 2009.
- 45 Alex Brill calculates a substantial narrowing of the marginal effective tax rates on corporate investment financed by debt and equity resulting from a reduction in the statutory corporate tax rate. See Alex Brill, "Corporate Tax Rates: Receipts and Distortions," *Tax Notes*, December 22, 2008.

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