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## The Corporate Income Tax: A Persistent Policy Challenge

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## THE CORPORATE INCOME TAX: A PERSISTENT POLICY CHALLENGE

by

*Jane G. Gravelle*

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**THE CORPORATE INCOME TAX: A PERSISTENT POLICY CHALLENGE***by**Jane G. Gravelle\****I. INTRODUCTION**

A newspaper article published in late October 2010 describes a scheme referred to as the “double Irish” with a “Dutch sandwich” that used a variety of rules to reduce taxes on the income of the search company Google to 2.4 percent.<sup>1</sup> The method involved transferring the intangible asset developed by Google in the United States to an Irish holding company, with another, active, Irish subsidiary of that firm selling advertisements in Europe. The sales subsidiary paid royalties, eliminating its own Irish tax. The royalties were diverted through a subsidiary in the Netherlands to avoid the 20 percent Irish withholding tax on royalties. The Netherlands subsidiary then made payments to the Irish holding company whose tax residence was in Bermuda, with no tax. As a result, the income avoided both the 35 percent U.S. corporate tax and the 12.5 percent Irish corporate tax. Although not a company that is a household name, Forest Laboratories, a drug company, used a similar scheme but, in its case, exported pills made in Ireland back to the United States.<sup>2</sup> Both articles described how many companies are using, or considering, such a plan.

These examples illustrate problems with enforcing the intent of the corporate tax with respect to multinational firms. At the same time, arguments are made both by multinationals, and some researchers, that the tax rate in the U.S. is too high and should be lowered to make U.S. firms competitive and that, in any case, the tax falls on labor and not capital. In some ways, the discussion of corporate tax issues has appeared to be

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1. Jesse Drucker, *Google 2.4 Percent Rate Shows How \$60 Billion Lost to Tax Loopholes*, Bloomberg, Oct. 21, 2010, <http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html>.

2. Jesse Drucker, *U.S. Companies Dodge \$60 Billion in Taxes in Global Odyssey*, Bloomberg, May 13, 2010, <http://www.bloomberg.com/news/2010-05-13/american-companies-dodge-60-billion-in-taxes-even-tea-party-would-condemn.html>.

transformed into a discussion of international corporate tax issues, as if only that issue matters.

The corporate income tax and issues associated with it have evolved from earlier years, when the economy was essentially a closed economy, assets and goods tended to be tangible, and the corporate tax was esteemed as a reliable and easily collectible source of revenue, whatever its other faults. Is the international evasion/avoidance rate a major or minor issue? How much have the issues that surrounded the corporate income tax evolved over time? Are the debates and research that have filled our law and economics journals still relevant, or are they obsolete? Should our domestic corporate tax rate be held hostage to the tax rates of other countries?

This study traces the evolution of the tax and its features alongside the evolution of ideas and research to the important issues surrounding the corporate tax in the past and whether they inform the present. As the past is examined, certain ideas that tend to be quickly rejected, at least by policy makers, such as making corporate returns public, were not only accepted in the early years, but an important justification for the tax. Some issues, such as revenue, always remain, while others, such as who bears the burden of the tax, moved from uncertain, to settled, to uncertain again. Some, such as the benefit principle of corporate taxation, have become obsolete. And yet other issues, such as the use of the corporate tax as a shelter from high income tax rates, seem to be ignored in the current debate over the corporate tax rate.

## II. IN THE BEGINNING

The corporate tax, enacted in 1909, predated the sixteenth amendment and the individual income tax, enacted in 1913.<sup>3</sup> It was enacted by a Republican Congress and President as an excise tax (hoping to protect it from the Supreme Court Decision outlawing the 1894 income tax).<sup>4</sup> The proximate cause of the tax was to avoid a potential confrontation between Congress and the courts arising from a push for a general income tax whose constitutionality was in question – a push that was made in the Senate by a combination of Democrats and liberal Republicans who sought to deflect high tariffs as well. Thus, ironically, the original corporate tax was supported by conservative Republicans and opposed by Democrats and liberal Republicans who supported a more general income tax.<sup>5</sup> In addition to

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3. See Corporate Tax Act of 1909, Pub. L. No. 61-4, ch. 6, § 38, 36 Stat. 11, 112 (1909) (imposition of corporate tax); U.S. Const. amend. XVI. (ratified Feb. 3, 1913); Revenue Act of 1913, Pub. L. No. 63-16, ch. 16, 38 Stat. 114 (1913) (imposition of income tax).

4. *Pollock v. Farmers' Loan and Trust Co.*, 157 U.S. 429 (1895).

5. An account of the 1909 congressional deliberations that led to the corporation income tax is presented in considerable detail in Sidney Ratner, *Taxation*

proposing a corporate tax to head off the general income tax and the potential pitfalls of another consideration by the Supreme Court, President Taft and the conservative Republicans proposed a constitutional amendment to allow an income tax.<sup>6</sup>

Despite the rather confusing state of affairs surrounding the first corporation income tax, the backdrop for this extraordinary chain of events was the growing popular support for the income tax and its ability to impose taxes on the wealthy, to reduce the concentration of power, and to provide for a flexible revenue source.<sup>7</sup> President Taft also argued that the tax would provide government and the public knowledge of gains and profits of corporations and prevent the abuse of power. The original measure was drafted to achieve several expectations of the president: additional revenue of \$50 million per year, government information about and supervision of corporations, and discouraging excessive borrowing. In the latter case, however, despite concerns that deducted interest would encourage the substitution of bonds for stock, the decision was made to allow the deduction of interest on bonds.<sup>8</sup> Returns were to be public. Nevertheless, even in this early debate, Senator Borah, one of the Republican insurgents who supported an income tax, raised the issue of whether the tax might be shifted to those who already bore the burden of government (that is, consumers who paid the tariffs).<sup>9</sup>

The House, under pressure from the President, agreed to the corporate tax in conference, but with the rate reduced from two percent to one percent.

The proposed corporate tax was criticized by business interests as discouraging initiative, killing the profit motive, hampering recovery from the 1907 panic, and sanctioning government prying into business. After enactment it was challenged in court by numerous corporations. The rationale of the Supreme Court in finding the tax constitutional was that it was an excise tax on the privilege of doing business in the corporate capacity.<sup>10</sup>

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and Democracy in America, 265-297 (Octagon Books 1980) (1942) and in Roy G. Blakely & Gladys C. Blakey, *The Federal Income Tax*, 22-59 (Longmans, Green and Co. 1940). This debate is also discussed more briefly in John F. Witte, *The Politics and Development of the Federal Income Tax*, 74-75 (Univ. of Wis. Press 1967), and in W. Elliot Brownlee, *Federal Taxation in America*, 49-53 (Cambridge Univ. Press 2004) (1996).

6. See Stanley D. Solvick, *William Howard Taft and the Payne-Aldrich Tariff*, 50 *Miss. Valley Hist. Rev.* 424, 435 (1963).

7. Ratner, *supra* note 5; Brownlee, *supra* note 5.

8. Blakey, *supra* note 5, at 43, 46.

9. Ratner, *supra* note 5, at 288.

10. *Id.* at 295.

Thus, out of the hurried original adoption of the corporate income tax, some issues have remained a part of the policy debate to this day: the distributional effects and incidence of the tax, its usefulness as a revenue raiser, discouragement of corporate activity, and distorting debt-equity choices. The objective of corporate control and public information about corporations has faded, however, and tax returns are not public. Similarly, the benefit principle argued during the debate and considered by the courts as a justification is generally not accepted by economists as a rationale for the tax.<sup>11</sup>

### III. THE GROWTH OF THE INCOME TAX

#### A. *Tax Rates Rise*

By 1913, with the Republican party split, the Democrats were in power and a general income tax was enacted with bipartisan support,<sup>12</sup> an income tax which the corporate tax became a part of. Rates were low for both taxes and the tax was clearly aimed at the rich, although motivated also by revenue needs.<sup>13</sup> Tax rates were increased in 1916,<sup>14</sup> and according to Brownlee, the basic principle underlying the individual income tax was ability to pay, while the benefit principle supported the corporation tax.<sup>15</sup>

The debate over the corporate tax has been described as “whether the modern corporation was the central engine of productivity, which tax policy should reinforce, or whether it was an economic predator, which tax policy could and should tame.”<sup>16</sup> One could argue that, in some ways, that tension exists today. Another history, however, claims that the rise in the corporate tax was due to the pressing needs for war revenue and the deficit.<sup>17</sup> In any case, during World War I an excess profits tax was introduced and accounted for two-thirds of federal revenue.<sup>18</sup>

After World War I, when the excess profits tax accounted for the bulk of revenues, Republicans returned to power and enacted the Mellon tax

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11. Joseph A. Pechman, *Federal Tax Policy*, 135-36 (The Brookings Institution 1966).

12. See Revenue Act of 1913, *supra* note 3.

13. Brownlee, *supra* note 5, at 55.

14. Revenue Act of 1916, Pub. L. No. 64-271, ch. 463, 39 Stat. 756 (1916).

15. Brownlee, *supra* note 5, at 64.

16. Brownlee, *supra* note 5, at 61.

17. Witte, *supra* note 5, at 81-82.

18. Brownlee, *supra* note 5, at 64-65.

cuts.<sup>19</sup> The arguments for cutting taxes on corporations and high income individuals would seem familiar to someone observing the corporate tax debate today: tax reductions were necessary to stimulate economic expansion and restore prosperity, and high taxes caused damaging behavioral responses — reduction in entrepreneurial effort, passing the tax on to customers, and avoiding taxes by moving investments into tax favored avenues.<sup>20</sup>

Nevertheless, while the excess profits tax was eliminated, normal corporate taxes were retained. Unlike the individual income tax, where rates rose and fell during the two wars, the basic corporate top rates of around thirteen percent were retained after World War I, rose again in World War II to around forty percent, and were retained afterward, eventually rising to around fifty percent in early 1951, and remaining in that general neighborhood until 1986.<sup>21</sup> (The World War II excess profits tax was eliminated, however.)

#### *B. Interaction Between Corporate and Individual Tax*

Another issue addressed early on was the interaction between individual and corporate taxes. The individual income tax was initially imposed as a normal tax which was relatively low (one percent) and a surtax.<sup>22</sup> From the beginning of the income tax until 1936, dividends were excluded from the tax base for purposes of the normal tax.<sup>23</sup> Thus, there was early recognition of the double tax imposed under the corporate and individual income taxes.

At the same time, there was also concern about the use of corporations to shelter income of wealthy individuals from the higher individual surtaxes. From 1921 to 1936, a series of penalties on surpluses and improper accumulations were imposed.<sup>24</sup> Since undistributed earnings were not taxed until realized as capital gains (and then often at preferred rates) and dividend payments were discretionary, individuals who were subject to surtax rates that ranged as high as sixty-three percent during the period, as compared to corporate rates of around thirteen percent, could

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19. See Revenue Act of 1921, Pub. L. No. 67-98, ch. 136, 42 Stat. 227 (1921); Revenue Act of 1924, Pub. L. No. 68-174, ch. 233, 43 Stat. 253 (1924), Revenue Act of 1926, Pub. L. No. 69-19, ch. 27, 44 Stat. 9 (1926).

20. Witte, *supra* note 5, at 74.

21. For a history of income tax rates, see Pechman, *supra* note 11, at 313-23.

22. See *supra* note 3.

23. For a history of the tax treatment of dividends, see Jane G. Gravelle, *The Taxation of Dividend Income: An Overview and Economic Analysis of the Issues*, Congressional Research Service, April 1, 2008, RL31597.

24. Ratner, *supra* note 5, at 418, 466, 470.

avoid tax through this mechanism. How effective these penalties were is not known, but in 1936, President Roosevelt proposed to substitute a tax on undistributed earnings, with repeal of the penalty taxes and full inclusion of dividends in the individual income tax base. One of its purposes was to prevent leakage in the tax system. The final legislation retained the corporate tax but added a tax that was graduated according to undistributed profits.<sup>25</sup> The penalty tax was reduced for firms subject to this tax. Further increases in penalties on personal holding companies were adopted in 1937.<sup>26</sup>

With fierce business opposition to the undistributed profits tax and a recession in 1937, legislation was adopted to eliminate the undistributed profits tax, against Roosevelt's opposition.<sup>27</sup>

### *C. Publicity of Tax Returns*

A second issue in this early period was the publicity of tax returns.<sup>28</sup> As noted above, one of President Taft's objectives for the corporate tax in 1909 was to use the information gathered to aid in regulation and transparency. Corporate tax returns were initially public under the 1909 law, but that law was amended in 1910 to allow public inspection only at the direction of the President.<sup>29</sup> Treasury regulations permitted stockholders to inspect returns, and, in the case of corporations with publicly traded stock, access was available to all. In the 1913 law, information on individual returns was not revealed, although information on corporate returns was made available. In 1924, however, all tax returns were made public. After newspapers published lists of taxpayers and ran articles on local citizens, the disclosure of both was eliminated in 1926. Today tax returns are not public, and other relationships between taxpayers and the Internal Revenue Service are not known (although proposals for making corporate returns public were made in 2003 in the wake of the Enron collapse).<sup>30</sup> For example, in the Google case none of the details of the advance pricing agreement that permitted Google to transfer its intangible asset to Ireland are public.

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25. *Id.* at 472-73.

26. *Id.* at 477.

27. *Id.* at 474.

28. See David Lenter, Joel Slemrod & Douglas Shackelford, "Public Disclosure of Corporate Tax Return Information: Accounting, Economics and Legal Perspectives," *National Tax Journal*, Vol. 61, Dec. 2003, pp. 803-830 for a history of the disclosure of tax return information.

29. Blakey & Blakey, *supra* note 5, at 98.

30. Lenter, Slemrod & Shackelford, *supra* note 28.

#### IV. ISSUES AND RESEARCH IN THE EARLY YEARS

Some of the early arguments for the corporate tax have largely been abandoned, such as the claim that a tax is justified because of benefits received from the state (limited liability) or to reduce concentrations of power.<sup>31</sup> The most prominent issues surrounding these early years of the corporate income tax were the effects on the high income and possible disincentives, and, of course, the ability to raise revenue, issues that remain today.

Arguments that the corporate tax would soak the rich or devastate incentives were not based so much on evidence as on speculation. The infant economics research of the day did not have much to say about this issue.<sup>32</sup> Economists discussed the possibility that the tax would be shifted to consumers (echoing issues raised by Senator Borah in 1909) or possibly back to wages. Most economists believed that shifting could not occur in the short run, with profit maximizing firms, since setting a different price when the firm could not alter capital would not lead to maximum pre-tax profit, and therefore not to maximum after-tax profit.

With increasing reliance of economic research on more sophisticated statistical methods, in the 1950s a number of studies examining profit data were used to estimate whether the tax was shifted, culminating in the research by Krzyzaniak and Musgrave in 1963, which indicated that the tax was shifted in the short run.<sup>33</sup> If the tax falls on consumers in the short run or the long run, it is not a progressive tax that falls on higher incomes but a largely proportional tax falling on the same groups as the tariffs the tax initially replaced. These short run results tended to be viewed suspiciously by some economists, as they did not accord with theory.<sup>34</sup>

In 1962, about the same time that Krzyzaniak and Musgrave published their study, a seminal paper appeared by Arnold Harberger that was to shape the analysis of the corporate tax until the present.<sup>35</sup> Ultimately, the profession abandoned the attempt to estimate the incidence of the tax with direct statistical methods and instead turned to general equilibrium

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31. Pechman, *supra* note 11.

32. For a review of this research, see Jane G. Gravelle, *Corporate Income Tax: Incidence, Economic Effects and Structural Issues*, in John G. Head & Richard Krever, *Tax Reform in the 21st Century*, 359-61 (Kluwer Law International BV 2009).

33. Marian Krzyzaniak & Richard A. Musgrave, *The Shifting of the Corporation Income Tax: An Empirical Study of Its Short-run Effect upon the Rate of Return* (Johns Hopkins Press 1963).

34. Gravelle, *supra* note 32, at 360-61.

35. Arnold Harberger, *The Incidence of the Corporate Tax*, 70 *J. Polit. Econ.* 215, 215-40 (1962).

models of the corporate tax which embedded economic relationships such as the substitutability of labor for capital in production and the substitutability across goods by the consumer. Harberger's analysis indicated that the corporate tax was spread, but spread to other forms of capital, with its incidence the same as a general tax on capital. In this view, the tax remained a progressive one.

## **V. THE 1950S TO THE 1980S: THE ERA OF INVESTMENT SUBSIDIES AND ECONOMIC MODELING OF THE CORPORATE TAX**

### *A. Modeling the Corporate Tax and Integration Proposals*

The Harberger model revolutionized thought about the corporate tax. In this model, initially a simple two-sector model that could be solved on paper, corporations raised prices to their consumers as capital left the corporate sector, but prices in the noncorporate sector fell. Assuming consumers did not vary systematically across the goods they purchased, there was no effect on tax burden through this mechanism. As capital migrated to the noncorporate sector, its greater abundance reduced its rate of return, while as capital left the corporate sector the return rose but not enough to fully offset the tax. For reasonable assumptions about the ability of firms to substitute capital and labor and consumers to substitute products, wages were left unchanged and the entire burden was borne by capital.

The model, however, also highlighted efficiency issues, and created a method of estimating the magnitude of the distortions in production (too much capital in the noncorporate sector and too little in the corporate sector) and consumption (too much noncorporate output). Subsequent models explored many variations. In general, they found the incidence results to persist despite many modifications.<sup>36</sup> Many of these modeling exercises stressed the distortions arising from the corporate tax, not only in the allocation of capital between the corporate and noncorporate sectors, but also in debt-equity ratios, dividend payout ratios, and lock-in effects from taxes on capital gains.<sup>37</sup>

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36. For a review of closed economy models and incidence, see Jennifer C. Gravelle, Cong. Budget Office, *Corporate Tax Incidence: Review of General Equilibrium Estimates and Analysis* 35-41 (2010), available at [http://www.cbo.gov/ftpdocs/115xx/doc11519/05-2010-Working\\_Paper-Corp\\_Tax\\_Incidence-Review\\_of\\_Gen\\_Eq\\_Estimates.pdf](http://www.cbo.gov/ftpdocs/115xx/doc11519/05-2010-Working_Paper-Corp_Tax_Incidence-Review_of_Gen_Eq_Estimates.pdf).

37. See Jane G. Gravelle, *Economic Effects of Taxing Capital Income* 75-90 (1991) for a review.

### *B. Integration Proposals*

Economists increasingly began to discuss ways of integrating the corporate and individual income tax. One integration method, already considered in 1936, was to tax undistributed earnings at the corporate level and dividends at the individual level.<sup>38</sup> Ideally, to eliminate the differences between corporate and noncorporate investment, corporations should be treated as partnerships, with each stockholder taxed directly on his or her share. But it has become clear that with modern corporations and millions of shares constantly changing hands, this purist approach will not work. The undistributed profits tax approach was now referred to as a dividend deduction. If the corporate rate and the top individual rate were close together, taxes could be eliminated at the individual level, but that was not the case during this era. Other alternatives were to provide a dividend credit for firm taxes paid on dividends. In general, the best approach depended on other elements of the tax structure, and, as will be seen subsequently, on the importance of the open economy.<sup>39</sup>

### *C. Savings and Risk*

Increasingly complex models also considered the effects of capital income taxes on savings (although this effect was not unique to the corporate tax). Most direct evidence on savings rates found little evidence of a relationship between tax rates and savings rates.<sup>40</sup> Dynamic models that either treated the economy as one infinitely-lived person, or that included cohorts of individuals with finite life spans, found mixed results for savings effects depending on the model and whether the capital income tax was replaced with a wage tax or a consumption tax.<sup>41</sup> Many economists came to have reservations about these models that depicted super-rational, perfectly-informed individuals making savings decisions.

Finally, economists had long recognized that capital income taxes offset some of their burden with the reduced variance of return: when income falls, the government shares in the reduction, just as it shares in the rise. With perfect offset of losses, indeed, one could argue that there is no burden of the tax.<sup>42</sup>

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38. See *supra* notes 24-26 and accompanying text.

39. Gravelle, *supra* note 37, at 90-93 (reviewing alternative approaches).

40. *Id.*

41. Gravelle, *supra* note 32, at 374-375 for a review.

42. See, e.g., Evsey V. Domar & Richard A. Musgrave, Proportional Income Taxation and Risk-Taking, 58 Q. J. Econ. 388 (1944); Roger Gordon, Taxation of Corporate Capital Income: Tax Revenues vs. Tax Distortions, 100 Q. J. Econ. 1 (1985).

*D. Investment Subsidies*

While economic analysis was making strides in modeling the incidence of the corporate tax, and to some extent other behavioral effects, events were occurring within the corporate tax that created new challenges: the growth of investment subsidies. A variety of preferences had occurred in the corporate tax beginning in the early years; indeed, depreciable lives had been largely left to the taxpayer's discretion (although the straight-line method was required).<sup>43</sup> Not surprisingly, this freedom to set deductions led to revenue shortfalls, and in 1934 the Internal Revenue Service began to prescribe useful lives.<sup>44</sup>

If the lives and methods were correct, income would be taxed at higher than the statutory rate with inflation because depreciation deductions were not stated in current dollars. With the statutory rate at fifty-two percent in 1954, the effective rate on new investment at the firm level was estimated at sixty-three percent.<sup>45</sup> (This measure of effective tax rate examines a prospective investment and estimates the pre-tax return given a required after-tax, with the effective tax rate the difference in returns as a share of the pre-tax return).

In 1954, adoption of accelerated methods appeared to bring depreciation in line with statutory rates at prevailing inflation rates, with an effective tax rate of fifty percent.<sup>46</sup> But in 1962, the adoption of an investment tax credit and shorter depreciable lives led to an estimated forty-two percent rate.<sup>47</sup> The statutory rate was cut to forty-eight percent by the 1964 legislation.<sup>48</sup> The investment credit was on-again, off-again during the 1960s and inflation increased substantially in the late sixties causing effective tax burdens to rise which largely offset new shorter lives introduced in 1971.<sup>49</sup> Dramatically shorter lives in 1981, however, pushed effective rates towards thirty-five percent, as compared to a statutory tax rate of forty-six percent.<sup>50</sup>

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43. Gravelle, *supra* note 37, at 263-67 (providing a history of depreciation policy and the investment credit).

44. Revenue Act of 1934, Pub. L. No. 73-216, 48 Stat. 680 (1934).

45. See Jane G. Gravelle, *The Corporate Tax: Where Has It Been and Where is It Going?*, 57 *Nat'l Tax J.* 903, 905 (2004).

46. Revenue Act of 1954, Pub. L. No. 83-591, § 167, 68A Stat. 5 (1954); Gravelle, *supra* note 45, at 905.

47. Revenue Act of 1962, Pub. L. No. 87-834, § 38, 76 Stat. 1009 (1962); Rev. Proc. 62-21, 1962-2 C.B. 418; Gravelle, *supra* note 45, at 905.

48. Revenue Act of 1964, Pub. L. No. 88-272, 78 Stat. 19 (1964).

49. Revenue Act of 1971, Pub. L. No. 92-178, § 109, 85 Stat. 508 (1971).

50. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981); Gravelle, *supra* note 45, at 905.

This era of fluctuating tax rates and varying investment subsidies ended in the mid 1980s when inflation began to subside and stabilize, and the Tax Reform Act of 1986 broadened the base and lowered the rate.<sup>51</sup> The statutory corporate rate was lowered to thirty-four percent, the investment credit was repealed, and depreciation more in line in present value with economic depreciation was enacted. The tax rate in 1987 was estimated to be about the same as the statutory rate, although that rate has since declined a few percentage points because of the further decline in inflation (partially offsetting an increased depreciable life for nonresidential buildings and a one percentage point increase in the corporate rate).<sup>52</sup>

Economists experienced some lags in coming to terms with how to analyze these subsidies, as well as the effects of inflation, on overall investment and on investment in assets of different durabilities. The first modern theory examining investments in depreciable assets was not published until 1963, and taxes were not immediately incorporated into the analysis.<sup>53</sup> Through some auspicious developments in theory and in evidence on economic depreciation rates, along with devising a simple method of communicating with policy makers (effective tax rates), economists could show how investment subsidies produced distortions across assets of durability and could, indeed, lead to negative tax rates, as was the case in 1981.<sup>54</sup> While this analysis may not have been responsible for the eliminating of subsidies in 1986, it provided analytic support for these revisions.

#### *E. The Corporate Tax World After 1986*

In a closed economy world, the corporate tax was beginning to look quite sensible. Rates were actually slightly above the top individual rate (although that did not last past 1993) and, for that reason, it was possible to consider some different integration methods, such as eliminating taxes at the individual level on dividends. In the late 1980s, the Treasury Department engaged in an extensive study of corporate integration and exclusion of dividends at the individual level was considered a possible option.<sup>55</sup> The Treasury studied a comprehensive business income tax (CBIT) that taxed

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51. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

52. Gravelle, *supra* note 45, at 905.

53. Dale Jorgenson, *Capital Theory and Investment Behavior*, 53 *Am. Econ. Rev.* 247 (1963); Gravelle, *supra* note 32, at 372-374 (discussing the forces that came together, both theoretical and empirical, that allowed economists to access investment subsidies).

54. Gravelle, *supra* note 45, at 905.

55. U.S. Dept. of Treasury, *Report on Integration of the Individual and Corporate Tax Systems*, Washington, D.C., U.S. Government Printing Office, 1992.

earnings from debt and equity only at the firm level. A reduction in the tax rate on dividends was enacted in 2003, although it was a temporary part of the Bush tax cuts.<sup>56</sup> Other developments in the tax system, such as the large fraction of corporate stock now held in tax-exempt retirement plans, made reducing individual level taxation less expensive. Inflation rates were lower which, along with lower firm level rates, reduced the debt equity distortion. Depreciation methods appeared to treat different assets in a relatively neutral fashion.

## VI. INTERNATIONAL TAX ISSUES: THE SPOILER?

Even as the corporate tax was being reformed, events were leading to new wrinkles in corporate tax policy making: the increasingly open economy, the growing importance of intangible assets, and more sophisticated methods of avoiding the corporate tax through international profit shifting.

### A. *History of Foreign Tax Provisions*

Through most of the development of the corporate income tax, not a great deal of attention had been paid to international issues. Legal principles meant that income of foreign subsidiaries was not subject to U.S. tax until it was repatriated (paid to the parent as a dividend). For income that was taxed, the first corporate tax allowed a deduction for foreign taxes paid, which was converted into a credit in 1918.<sup>57</sup>

In 1921, foreign tax credits were limited to the aggregate U.S. tax due on foreign source income (the “overall limit”). At that time, the two basic features of U.S. tax with respect to foreign source income were the same as those today: taxes on foreign source income could be deferred indefinitely and taxes paid to foreign countries in excess of the U.S. tax could be used to offset U.S. tax on income from low tax countries (cross-crediting). In addition to cross-crediting by country, differential foreign tax rates that vary by type of income could be cross credited.

During various periods in history, beginning in 1932, an alternative per-country limit which applied on a country-by-country basis was allowed or required, although regulations that sourced income to holding companies rather than the sources of their income allowed firms to achieve overall

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56. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752 (2003).

57. The history of international tax provisions is discussed in detail, through 1989, in William P. McClure & Herman B. Bouma, *The Taxation of Foreign Income from 1909 to 1989: How a Tilted Playing Field Developed*, 43 *Tax Notes* 1379, 1381 (1989).

limits on their own. The per-country limit was eliminated in 1976.<sup>58</sup> However, income has been separated at various times into different foreign tax credit baskets by type of income which prevent cross-crediting. In the 1986 Tax Reform Act, the initial Treasury and Administration proposals were to reinstate the per-country limit, but the bill ultimately expanded the number of foreign tax credit baskets from two to several.<sup>59</sup> In 2004, numerous baskets were returned to two baskets, passive and active.<sup>60</sup>

In 1961, the Kennedy administration proposed to tax foreign source income currently (except for non-tax-haven income in less developed countries).<sup>61</sup> While this provision was not adopted, certain passive income that was easily shifted was currently taxed (referred to as Subpart F income). In the early 1970s, the Burke-Hartke proposals to eliminate deferral and end the foreign tax credit received attention, but had no success. In 1978, President Carter again proposed ending deferral.<sup>62</sup>

Despite these attentions to international tax issues, most principal decisions about the corporate tax were made without much consideration for these concerns. The Tax Reform Act of 1986 was no exception: the rate of the tax was chosen to be revenue neutral and close to the top marginal individual tax rate. Nevertheless, the tax rate reduction in the U.S., along with rate reductions that also occurred in the U.K. and Ireland, led to a trend in falling rates around the world.<sup>63</sup> In 1982, statutory tax rates, including sub-national taxes, were fifty percent or higher in the G-7 and Australia, except for Italy (thirty-nine percent) and Canada (forty-four percent), with indications of significant variations in the effective tax rates on investment in equipment and buildings.<sup>64</sup> By 2005, they ranged from thirty percent to

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58. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1720 (1976).

59. Tax Reform Act of 1986, Pub. L. No. 99-514, § 904, 100 Stat. 2085 (1986).

60. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004).

61. Message from the President of the United States Relative to Our Federal Income Tax System, Apr. 20, 1961, Reprinted as M. R. Doc. No. 87-140, at 6-7 (1961).

62. President Jimmy Carter, Tax Reduction and Reform Message to the Congress (Jan. 20, 1978), available at <http://www.presidency.ucsb.edu/ws/index.php?pid=31055>.

63. See Cong. Budget Office, Corporate Income Tax Rates: International Comparisons (2005), available at <http://www.cbo.gov/ftpdocs/69xx/doc6902/11-28-CorporateTax.pdf>.

64. Jane G. Gravelle, Economic Effects of Investment Subsidies, in Tax Reform in Open Economies: International and Country Perspectives 38, 39, (Iris Claus, et al. eds., 2010).

forty percent.<sup>65</sup> One could argue that the U.S. started the “race to the bottom.”

The open economy with international investment, as well as trade, changes the nature of some of the traditional issues and policy proposals.

### *B. Revenue and Compliance*

First, with respect to revenue and compliance, collecting the corporate tax is more difficult. The tax gap for corporations was estimated in 2001 at about \$32 billion, or about fifteen percent of revenues at that time,<sup>66</sup> but some authors estimate another \$30 billion of revenue was lost in international profit shifting.<sup>67</sup> Estimates vary substantially, and the cost may have increased with the increasing importance of intangible assets that are difficult to value, as well as new techniques made possible by “check-the-box” rules. (These rules allow a firm to elect to recognize or disregard a subsidiary).

### *C. Reconsideration of Who Bears the Burden*

The open economy also led to a reconsideration of who bears the burden. In the 1980s, economists began to make the point that in a small open economy with rates of return and worldwide prices of a single good fixed, labor bears 100% of the burden of a capital income tax.<sup>68</sup> This effect occurs through the migration of capital to other countries in the face of the tax, with a smaller capital stock lowering the wage rate. However, the share falling on labor falls as the size of the economy grows, and also if perfect mobility of capital and perfect substitutability of products does not exist.

A review of open economy models of increased sophistication showed five important drivers of incidence: country size, capital intensity of the taxed and traded sector, factor substitution in production, capital mobility, and product substitution.<sup>69</sup> Based on empirical estimates, one review of these models and evidence suggested about sixty percent of the tax

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65. *Id.* at 39.

66. James Bickley, Cong. Research Serv., R40219, *Tax Gap, Tax Enforcement, and Tax Compliance Proposals in the 111th Congress* (2010).

67. For a review of estimates of the revenue cost of international profit shifting, see Jane G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, 62 *Nat'l Tax J.* 736 (2009).

68. See, e.g., Laurence Kotlikoff & Laurence H. Summers, *Tax Incidence in Handbook of Public Economics* (Alan J. Auerbach & Martin S. Feldstein, eds., vol. 2 1987).

69. Gravelle, *supra* note 30.

fell on capital and forty percent on labor.<sup>70</sup> The author also pointed out two issues that pushed the incidence further towards falling on capital. First, if debt is taken into account, and is more mobile, higher tax rates could have the opposite effect by increasing capital inflows and benefitting labor, since debt is subsidized at the firm level.<sup>71</sup> (Two factors cause debt to be subsidized, rather than taxed at a zero rate: the ability to deduct the inflation portion of the interest rate and the tax subsidies allowed through accelerated depreciation and other provisions that reduce the effective tax rate on the flow of income below the statutory rate). Secondly, if all countries estimate incidence as if their tax were the only tax, the overall burden of worldwide taxes would be incorrect, as, worldwide, the tax falls on capital.<sup>72</sup> This point is particularly important if countries tend to raise or lower their taxes in response to others. If only the differential from the average tax rate worldwide tax rate is allocated in part to labor, over ninety percent of the burden falls on capital.<sup>73</sup>

A series of empirical studies, reminiscent of the 1950s, also tried to estimate corporate tax incidence directly through statistical methods, and tended to show a link between the corporate tax and wages (largely using cross country studies) but the results of these studies have been subject to criticism, showing the positive relationships to depend heavily on specification.<sup>74</sup>

Despite open economy challenges, it still appears that the corporate tax is a progressive tax that largely falls on capital income.

#### *D. Economic Efficiency Issues and Constraints on Integration*

The open economy issue led to consideration of a new distortion, allocation of capital worldwide. For outbound capital, although multinationals claimed neutrality and fairness require treatment of foreign subsidiaries to be the same as their local competitors (which implied that foreign source income not be taxed), economic theory indicated world wide efficiency required equal treatment of foreign and domestic investment (requiring current taxation and foreign tax credits). Policies that maximized national welfare required current taxation of foreign source income and a deduction for foreign taxes.<sup>75</sup>

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70. *Id.* at 25.

71. *Id.* at 28.

72. *Id.* at 30.

73. *Id.* at 31-33.

74. Jane G. Gravelle & Thomas L. Hungerford, *Corporate Tax Reform: Should We Really Believe the Research?*, 121 *Tax Notes* 419 (2008).

75. These issues are discussed in Jane G. Gravelle, *International Corporate Income Tax Reform: Issues and Proposals*, 9 *Fla. Tax Rev.* 471 (2009).

Multinational firms also argued U.S. taxes should be cut to make the United States a more competitive location. According to economic theory, however, for inbound treatment, worldwide efficiency was in turn driven by tax rates in the U.S. versus tax rates faced by various countries' firms in other places. Optimal taxation from the U.S. standpoint depended on the mobility of capital and on the foreign parent's tax rate.<sup>76</sup>

Open economy considerations with respect to inbound treatment also complicate corporate tax integration. In an open economy, it is better to impose corporate source taxes at the individual level, where taxes apply on a residence/ownership basis, than at the firm level, which can affect allocation of capital. The exemption of a large amount of income from tax at the individual level through tax exempt retirement funds now becomes a liability in integrating the tax without losing too much revenue. Also, reducing the subsidy for debt finance, either directly through limiting interest deductions or indirectly through lower tax rates, becomes less attractive if debt is more highly mobile than equity.

## VII. POLICY OPTIONS

The most important corporate policy issue is the proposal to cut the corporate tax, with or without base broadening, in order to be "competitive" with other countries. A recent article, for example, proposes to cut the tax rate to twenty-five percent<sup>77</sup> and the tax reform proposal advanced by Senators Wyden and Gregg cut the corporate rate to twenty-four percent.<sup>78</sup> Despite proposals to expand the corporate tax base, such expansion is difficult, for a variety of economic and political reasons.<sup>79</sup> In addition, although these reforms would reduce the revenue cost, they would offset the reduction in the effective tax rate. Thus, it is likely that a revenue loss, perhaps a significant one (in the neighborhood of \$100 billion per year) would arise.<sup>80</sup>

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76. *Id.*

77. See Kevin Hassett, *End, Don't Extend, Bush Tax Cuts for a Fresh Start*, Bloomberg, Nov. 7, 2010, <http://www.bloomberg.com/news/2010-11-08/end-don-t-extend-bush-tax-cuts-to-start-new-commentary-by-kevin-hassett.html>.

78. S. 3018, 111th Cong. § 201 (2010). This bill also ended deferral and instituted a per-country foreign tax credit limit.

79. See Jane G. Gravelle, *Practical Tax Reform for a More Efficient Income Tax*, 30 *Va. Tax Rev.* 389 (2010). Some of the most significant revenue raisers are unlikely to be revised, among them lengthening the depreciable lives for equipment.

80. For example, for 2013, when the economy has recovered, corporate revenues are projected at \$350 billion, and a rate reduction to twenty-five percent would reduce the yield by \$100 billion. See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2010 to 2020* (2010), at 79, <http://www.cbo.gov/ftpdocs/108xx/doc10871/01-26-Outlook.pdf>.

The argument for lowering the corporate rate to attract capital relates largely to increasing inbound investment, since, as discussed below, there are a variety of tools that could be used to reduce outbound investment by corporations. However, inbound equity appears to be less than ten percent of the total potential corporate tax base, and when capital outside the corporate sector and debt are taken into account, about four percent of the total U.S. capital stock.<sup>81</sup> To lower the U.S. corporate rate for the objective of attracting more inbound capital, given important needs for revenue, concerns about distribution, and the creation of tax shelters for the wealthy, seems to be the tail wagging the dog. Nor is a lower rate likely to increase U.S. welfare, as the additional tax revenue on new inbound investment would be offset by lost tax revenue from the lower tax rate on earnings on existing imported capital income.<sup>82</sup> In addition, lowering the rate could accomplish little if it reduces the import of more mobile debt-financed capital. Perhaps more importantly, if history is a guide, it is likely that other countries would further lower their tax rates, offsetting the effects of lowering the U.S. rates.

While reducing the U.S. tax rate might stem the flow of outbound investment, an alternative is to increase U.S. taxation of foreign source income (or provide some revenue neutral combination of increasing taxation of foreign source income with some small reduction in the rate). Some options, such as combining an end to deferral with a per- country foreign tax, probably could raise a significant amount of revenue, perhaps as much as \$60 billion.<sup>83</sup> President Obama's Fiscal Year 2011 budget proposes three

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81. For data on corporate profits including those associated with inbound and outbound capital (repatriated) see Bureau of Economic Analysis, National Income and Product Accounts Data, Table 6.16D, Corporate Profits by Industry (2011), <http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=239&ViewSeries=NO&Java=no&Request3Place=N&3Place=N&FromView=YES&Freq=Year&FirstYear=2004&LastYear=2009&3Place=N&Update=Update&JavaBox=no>. For data on unrepatriated profits, see Bureau of Economic Analysis, International Economic Accounts (2011), <http://www.bea.gov/international/index.htm>. Estimates assume the corporate capital stock is half of the total capital stock and that debt shares are one third, as reported in Gravelle, *supra* note 32, at 293.

82. The optimal tax rate is  $1/(1+e)$  where  $e$  is the elasticity of inbound capital. See Gravelle, *supra* note 48, at 476.

83. Tax expenditures estimates project a revenue gain from ending deferral without changes in the foreign tax credit at \$13 billion for Fiscal Year 2013. See Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2009-2013 (2010), at 29, <http://www.jct.gov/publications.html?func=startdown&id=3642>. Limiting the foreign tax credit should increase that amount significantly as well as raise revenue from repatriating income. The Joint Committee on Taxation has estimated a revenue gain of \$66 billion in Fiscal Year 2013 for the combination of a per- country foreign tax credit limit and ending deferral (estimate provided by Senator Ron Wyden).

significant revisions: disallowing a current deduction for parent company interest for the share equal to the share of profits not repatriated, restricting the share of foreign tax credits available to the share of income repatriated, and taxing the excess return to intangible transfers to a foreign subsidiary as Subpart F income.<sup>84</sup> These provisions would raise about \$10 billion in the short run and \$7 billion in the long run.

The principal reservations about increased taxation of foreign source income, such as eliminating deferral and restricting credits, tend to be two-fold. Companies might invert (move their headquarters abroad) and investors could avoid the increased taxation of foreign source income by investing in foreign corporations. Inversion could be limited by restrictions similar to those enacted in 2004 (treating these firms as U.S. firms for a long period of time),<sup>85</sup> or other stricter provisions (treating firms permanently as U.S. firms, imposing an exit tax, or basing headquarters on a facts and circumstances determination). Changes in individual portfolio investment cannot be used to target particular subsidiaries of multinational firms, but rather reflect the tax burden of the entire firm. Some small shifts in investment may occur as rates of return change due to any tax revision, but do not seem a specific barrier to international tax revisions.

Stricter treatment of foreign source income would also reduce the ability to shift profits. Google's method of tax avoidance would not operate without deferral.

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84. See U.S. Department of Treasury, *General Explanation of the Administration's Fiscal Year 2011 Revenue Proposals* (2010), <http://www.bsmlegal.com/PDFs/008GreenBook2011.PDF>. One of the proposals, disallowing splitting of foreign tax credits from income, has already been enacted. 26 U.S.C. § 909 (2010).

85. American Job Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004).