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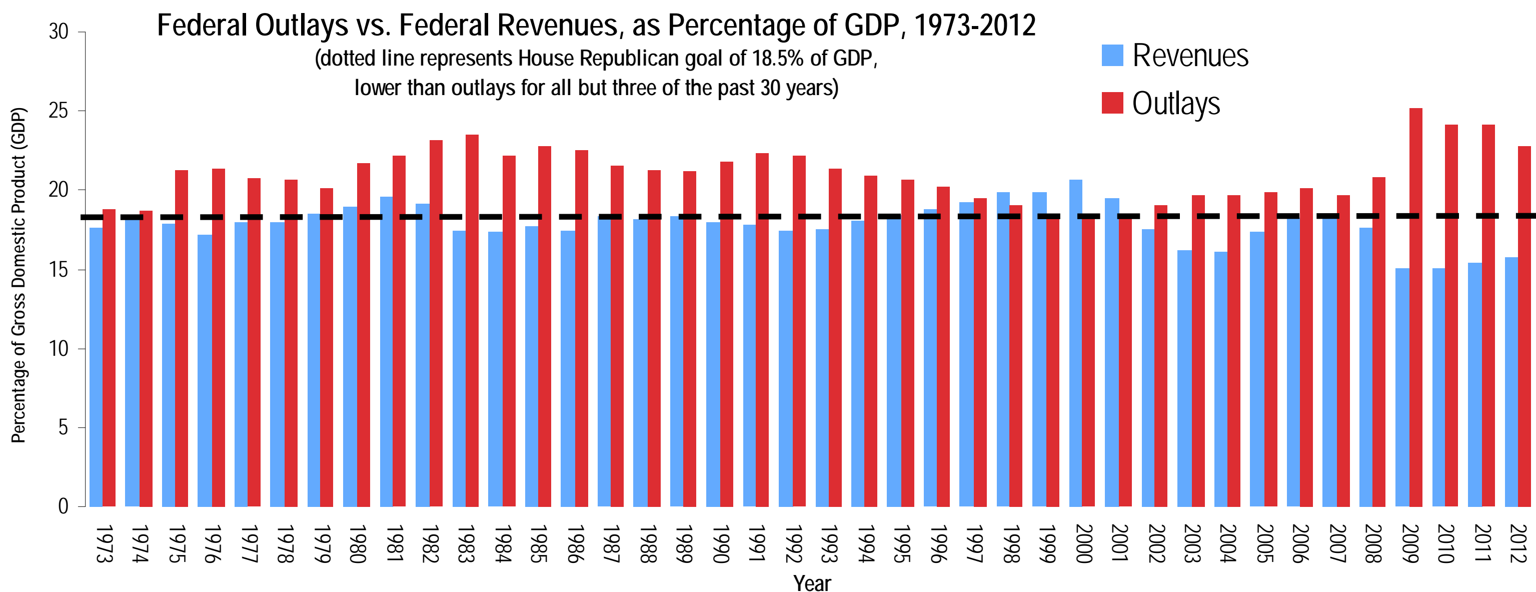
Tax Reform Goals: Raise Revenue, Enhance Fairness, End Offshore Shelters

Most Americans and politicians probably like the idea of “tax reform,” but not everyone agrees on what “tax reform” means. If Congress is going to spend time on a comprehensive overhaul of America’s tax system, this overhaul should raise revenue, make our tax system more progressive, and end the breaks that encourage large corporations to shift their profits and even jobs offshore.

Tax measures before Congress generally begin as proposals before the House Ways and Means Committee, and the current chairman, Dave Camp of Michigan, has defined tax reform as a process by which Congress would lower tax rates on corporations and wealthy individuals and then offset the cost by eliminating or reducing “tax expenditures” (subsidies provided through the tax code) so that the net result is no increase in revenue. Camp argues that the goals of tax reform should be to make the tax code simpler and to make American companies more “competitive,” although neither of these vague terms addresses the greatest problems with our tax system.

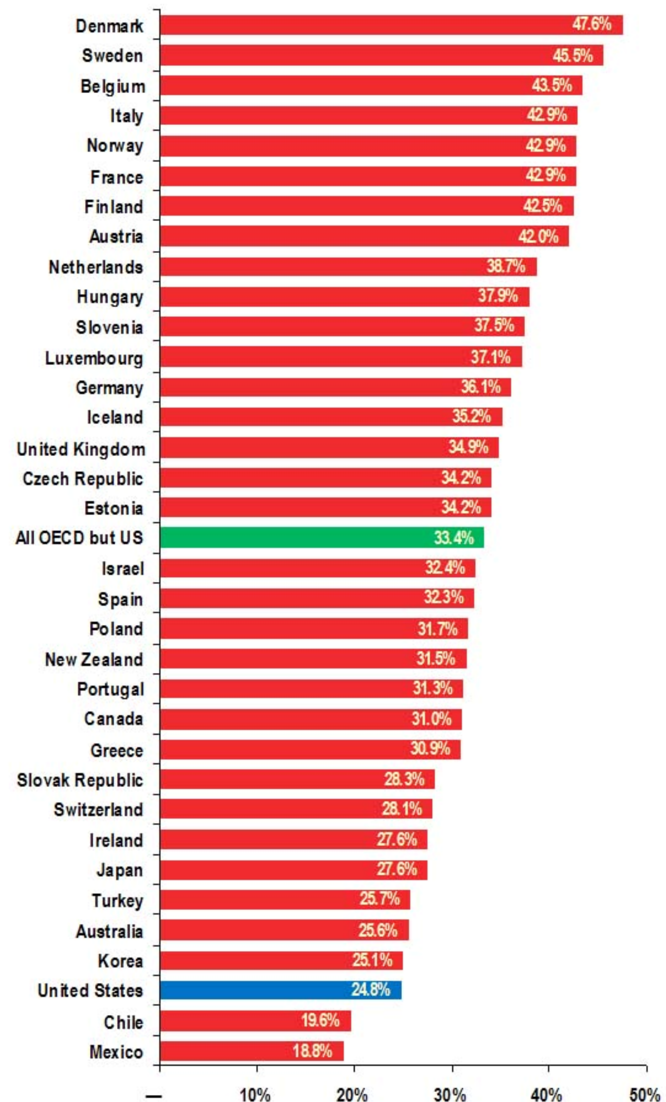


Source: Congressional Budget Office, Updated Budget Projections: Fiscal Years 2013 to 2023 (May 2013).

1. Tax Reform Should Raise Revenue — from Both the Personal Income Tax and the Corporate Income Tax

As illustrated by the bar graph on page one, in only four of the past thirty years has the federal government collected enough tax revenue to pay for all of federal spending. Advocates of small government argue that the resulting budget deficit must now be addressed entirely through cuts in federal spending, but this makes little sense given that federal spending last year was lower as a percentage of gross domestic product (lower as a percentage of the economy) than it was in 1983, the height of Ronald Reagan's presidency. (Federal spending is projected to continue falling somewhat as the economy slowly recovers and measures that counter the effects of the recession continue to wind down.)

Lawmakers' fixation with addressing the budget deficit with spending cuts rather than revenue increases has resulted in the "sequestration" of federal spending in effect today, which cuts even those programs that are supported by large majorities of Americans as investments in our economic future, like Head Start and medical research. The anti-tax fixation has also prevented Congress from funding a serious upgrade of our bridges, highways, ports and other infrastructure even though engineers agree that these upgrades are needed and economists agree that such investments would boost job creation.



The foolishness of lawmakers' reluctance to significantly increase tax revenue is obvious given that the United States is one of the least taxed of all the developed nations. In 2010, the most recent year for which there is complete data, the U.S. collected less tax revenue as a percentage of its economy than did any other OECD country besides Chile and Mexico.

There are efforts in Congress to (slightly) change this situation. In March, the Senate approved a budget resolution that called for raising $975 billion over a decade from wealthy individuals and corporations, but did not provide any details on how to do so. But the House of Representatives approved a budget calling for an overhaul of the tax system that would limit or eliminate some

unspecified "tax expenditures" (subsidies provided through the tax code), but would use all the revenue savings to offset reductions in tax rates, resulting in no revenue increase at all. The two chambers' budget resolutions were never reconciled, so there is no overall budget plan guiding both the House and Senate at this time.

The $975 billion tax increase sought in the Senate budget resolution is the bare minimum revenue increase that should be considered acceptable. Our current tax laws are projected to collect revenue equal to 18.5 percent of the U.S. gross domestic product (GDP) in a decade. In other words, the U.S. will collect taxes equal to 18.5 percent of the American economy in a decade if Congress does nothing. (This figure was projected to be 19.1 percent of GDP when the budget resolutions were approved but has since been revised to 18.5 percent of GDP.)[1] The House budget resolution would maintain this level of revenue.

As illustrated by the bar graph on page one, in only three of the past thirty years has federal spending been at or below 18.5 percent of GDP.

Camp Calls for "Revenue-Neutral" Tax Reform, But His Proposal May Actually Be Revenue-*Negative*

Congressman Camp has called for a tax reform that reduces or eliminates tax expenditures and uses the revenue savings to offset rate reductions, so that there is no net change in the amount of revenue collected. But there are at least two reasons to fear that Camp could propose a tax overhaul that actually loses revenue, despite official estimates that it is "revenue-neutral."

The Congressional Joint Committee on Taxation (JCT) provides the official estimates of the revenue impacts of legislation before Congress. JCT typically provides estimates of the revenue impact over one decade. But there are several tax expenditures that Congress could restrict or repeal (like accelerated depreciation breaks) that could provide more revenue in the first decade after enactment than in subsequent years.

For example, accelerated depreciation basically allows companies to take deductions for equipment purchases more quickly than they otherwise would be allowed, which means that repealing accelerated depreciation would (to a certain extent) simply require companies to make more of their tax payments earlier. This type of timing shift could result in a projection of revenue savings in the first decade that seem sufficient to pay for the rate reduction Camp proposes, but that would be insufficient to offset those rate reductions in subsequent years.*

Another possibility is that the costly part of Camp's proposal — the rate reductions he hopes to include in his plan — could be slowly phased in later in the decade so that the full cost does not appear in the revenue estimate provided by JCT. The Bush-era tax cuts were phased in over a decade, so that their cost during the first decade after enactment would be only about half of their cost during the second decade.**

* For more, see Chye-Ching Huang, Chuck Marr, and Nathaniel Frentz, "Timing Gimmicks Pose Threat to Fiscally Responsible Tax Reform," Center on Budget and Policy Priorities, July 24, 2013. http://www.cbpp.org/cms/index.cfm?fa=view&id=3994

** Citizens for Tax Justice, "Another Decade of Bush Tax Cuts Will Cost More than Twice as Much as the First Decade," June 7, 2011.
http://ctj.org/ctjreports/2011/06/another_decade_of_bush_tax_cuts_will_cost_more_than_twice_as_much_as_the_first_decade.php

Tax reform should result in both the personal income tax and the corporate income tax raising more revenue than they raise today. Both of these taxes include "tax expenditures" (subsidies and special breaks provided through the tax code) that could be eliminated or at least reduced to generate revenue savings.

Some tax expenditures in the personal income tax, like the Earned Income Tax Credit (EITC), help to make our tax system progressive and serve other policy goals (the EITC has been found to encourage work) and should therefore be preserved. But other tax expenditures, like the preferential tax rates for capital gains and stock dividends, make our tax system much less progressive, cannot be shown to serve any policy goal, and should therefore be repealed. (The Congressional Budget Office (CBO) recently found that 68 percent of the benefits of this tax expenditure will go to the richest one percent of Americans in 2013.)[2]

The corporate income tax also includes tax expenditures that can be eliminated or restricted to generate revenue savings. Top among them is the rule allowing American corporations to "defer" paying U.S. taxes on their offshore profits, which will be explained in more detail further on in this report.

Both the personal income tax and the corporate income tax have been found to be porous by those who wish to avoid paying them. In recent years, high-income individuals like Warren Buffett and Mitt Romney have been found to have low effective income tax rates (pay low income taxes as a percentage of their incomes), largely because of the preferential income tax rates for capital gains and stock dividends.[3] At the same time, several very profitable corporations have benefited so much from corporate tax expenditures that they have paid very low, or even negative, effective income tax rates, as illustrated in the table to the right.

30 Corporations Paying No Total Income Tax in 2008-2010

Company ($-millions)	08-10 Profit	08-10 Tax	08-10 Rate
Pepco Holdings	$ 882	$ –508	–57.6%
General Electric	10,460	–4,737	–45.3%
Paccar	365	–112	–30.5%
PG&E Corp.	4,855	–1,027	–21.2%
Computer Sciences	1,666	–305	–18.3%
NiSource	1,385	–227	–16.4%
CenterPoint Energy	1,931	–284	–14.7%
Tenet Healthcare	415	–48	–11.6%
Atmos Energy	897	–104	–11.6%
Integrys Energy Group	818	–92	–11.3%
American Electric Power	5,899	–545	–9.2%
Con-way	286	–26	–9.1%
Ryder System	627	–46	–7.3%
Baxter International	926	–66	–7.1%
Wisconsin Energy	1,725	–85	–4.9%
Duke Energy	5,475	–216	–3.9%
DuPont	2,124	–72	–3.4%
Consolidated Edison	4,263	–127	–3.0%
Verizon Communications	32,518	–951	–2.9%
Interpublic Group	571	–15	–2.6%
CMS Energy	1,292	–29	–2.2%
NextEra Energy	6,403	–139	–2.2%
Navistar International	896	–18	–2.0%
Boeing	9,735	–178	–1.8%
Wells Fargo	49,370	–681	–1.4%
El Paso	4,105	–41	–1.0%
Mattel	1,020	–9	–0.9%
Honeywell International	4,903	–34	–0.7%
DTE Energy	2,551	–17	–0.7%
Corning	1,977	–4	–0.2%
TOTAL	$ 160,341	$ –10,742	–6.7%

Source: Citizens for Tax Justice and the Institute on Taxation and Economic Policy, "Corporate Taxpayers & Corporate Tax Dodgers, 2008-2010," November 3, 2011. http://ctj.org/corporatetaxdodgers/

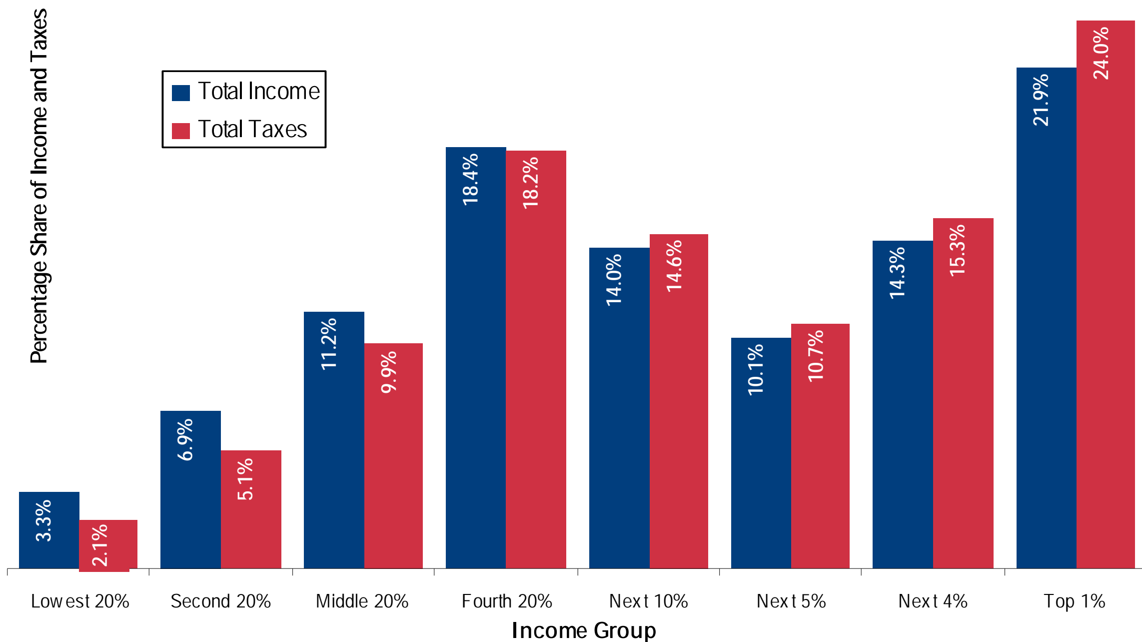
The figures in the table on page 4 are from CTJ's study of the Fortune 500 corporations that were consistently profitable for three years straight. Another finding from that study was that, of those profitable Fortune 500 corporations with significant offshore profits, two-thirds paid a higher effective corporate tax rate in the other countries where they do business than they paid in the U.S. In other words, there is ample evidence that American corporations are undertaxed in the U.S. and can reasonably be expected to contribute more in tax revenue.

Some who argue against raising more tax revenue from corporations claim that the profits of corporations are already double-taxed because they are subject to the corporate income tax and then, after they are paid out as stock dividends to individuals, they are subject to the personal income tax. But this is not what usually happens because two-thirds of stock dividends paid out by corporations are actually paid to tax-exempt entities, which means they are never subject to the personal income tax.[4]

2. Tax Reform Should Enhance Progressivity

If Congress raises revenue, that would mean that someone must pay more in taxes, either because they lose tax expenditures or because they pay at higher rates. Such tax increases should be targeted as much as possible on the richest Americans. Contrary to a great deal of recent commentary, our tax system is not particularly progressive.

Shares of Total Taxes Paid by Each Income Group Will Be Similar to their Shares of Income in 2013



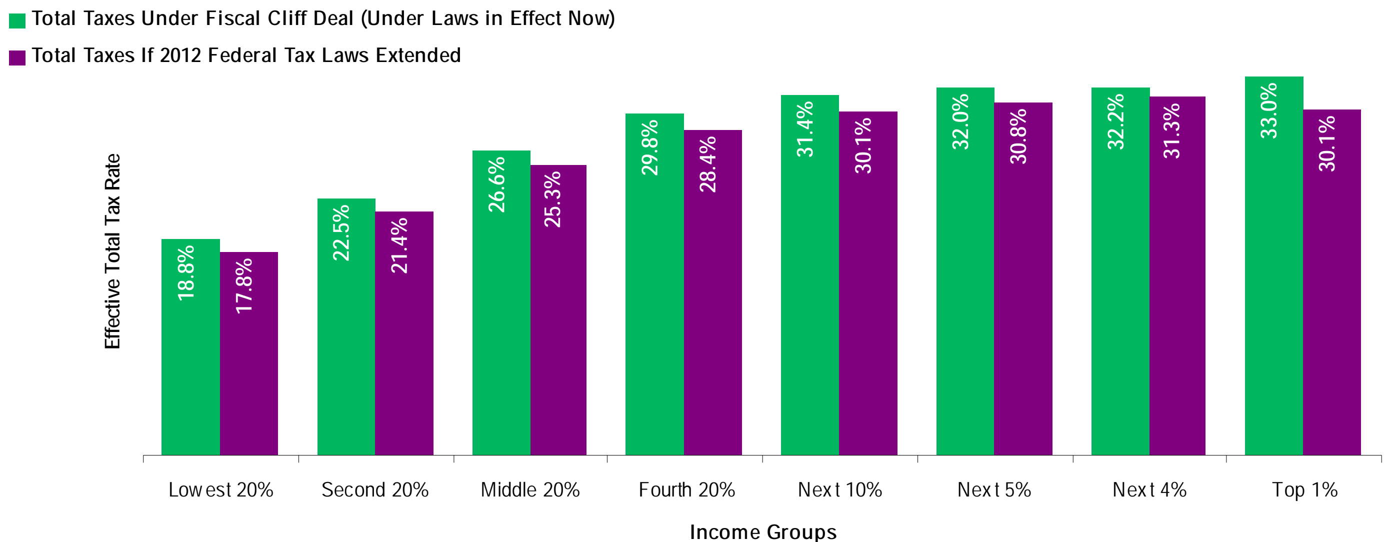
Source: Institute on Taxation and Economic Policy (ITEP) Tax Model, April 2013
Citizens for Tax Justice, April 2013.

In fact, if one accounts for all the of the federal, state and local taxes that Americans pay, it turns out that the share of total taxes paid by each income group is roughly equal to the share of total income received by that group, as illustrated in the graph on page 5. For example, the poorest fifth of taxpayers will pay only 2.1 percent of total taxes this year, which is not so surprising given that this group will receive only 3.3 percent of total income this year. Meanwhile, the richest one percent of Americans will pay 24 percent of total taxes and receive 21.9 percent of total income in 2013.[5]

Claims that the rich pay a disproportionate share of taxes often focus only on the federal personal income tax and ignore the other taxes that people pay, like federal payroll taxes, federal excise taxes, and state and local taxes. Many of these other taxes are regressive, meaning they take a larger share of income from poor and middle-income families than they take from the rich.

Some politicians and observers believe that the legislation approved by Congress on New Year's Day to address the "fiscal cliff" (the scheduled expiration of several tax cuts and other measures at the end of 2012) made our tax system extremely progressive because it allowed parts of the Bush-era tax cuts to expire for the very richest Americans.

The truth is that this legislation also allowed the expiration of tax cuts for low- and middle-income people (cuts in Social Security payroll taxes) and that the overall distribution of taxes is therefore not much different than it was last year. This is illustrated in the graph below, which compares effective tax rates (including all federal



Source: Institute on Taxation and Economic Policy (ITEP) Tax Model, April 2013
Citizens for Tax Justice, April 2013.

state and local taxes) for each income group this year to what those rates would be if Congress had not allowed any of the tax cuts to expire at the end of last year.

3. Tax Reform Should Reduce — Rather than Expand — Opportunities for Corporations to Shift Profits and Jobs Offshore

Part of the debate over tax reform concerns how the U.S. should treat the offshore profits of American corporations. Under current law, American corporations get a credit against their U.S. taxes for any taxes they pay to a foreign government. This makes sense in theory, because it prevents double-taxation of the offshore profits of our corporations.

But on top of this, American corporations get another break which is more problematic. American corporations are allowed to "defer" paying whatever U.S. taxes are owed on the profits of their offshore subsidiary companies until those profits are officially brought to the U.S. The profits may accumulate offshore (at least for accounting purposes and tax purposes) for years without being subject to U.S. taxes, which provides a significant tax benefit. This break, "deferral," causes some major problems.

First, deferral can encourage American corporations to base their operations (and jobs) in a lower-tax country. Second, deferral encourages American corporations to use accounting gimmicks to make their domestic profits appear to be generated by subsidiary companies in countries with a very low tax or no corporate tax. These countries are known as tax havens, and the subsidiary companies are often shell companies that consist of nothing more than a post office box.

18 Companies That Likely Hold Profits in Tax Havens

Company Name	Unrepatriated Income $ Millions	Estimated Tax Bill $Millions	Implied Tax Rate
Shaw Group	$ 288	$ 111	39%
Express Scripts	66	24	37%
Amgen	22,200	7,900	36%
Advanced Micro Devices	386	137	35%
Qualcomm	16,400	5,800	35%
Gilead Sciences	7,250	2,540	35%
Wynn Resorts	334	117	35%
Eli Lilly	20,980	7,343	35%
AK Steel Holding	24	8	35%
Western Digital	6,300	2,100	33%
Tenneco	728	239	33%
Nike	5,500	1,800	33%
Dell	19,000	6,200	33%
Baxter International	10,600	3,400	32%
Microsoft	60,800	19,400	32%
Apple	82,600	26,071	32%
American Express	8,500	2,600	31%
Oracle	20,900	6,300	30%
Subtotal	$ 282,854	$ 92,090	**33%**

NOTE: All figures are for the end of each company's most recent fiscal year. Apple has subsequently released data for the first quarter of FY13 showing that its offshore holdings have increased to $102 billion.
Source: Most recent 10-K annual financial reports for each company

There is ample evidence of specific American corporations holding their profits in offshore tax havens. Some corporations divulge, in their public filings with the Securities and Exchange Commission, how much they would pay in U.S. taxes if they "repatriated" their offshore profits (officially brought their offshore profits to the U.S.) And some of these corporations — like American Express, Apple, Dell, Microsoft, Nike and others — indicate that they would pay nearly the full U.S. corporate income tax rate of 35 percent.[6] This is another

way of saying that these corporations would receive very little, if any, credits to offset foreign taxes paid, because they have not paid much, if anything, in taxes to any foreign government.

This is an indication that the corporations' offshore profits are held (officially, at least) in countries with no corporate income taxes — tax havens. Most of the countries that have consumer markets and developed economies where American companies can sell products also have corporate taxes. Most countries that do not have corporate income taxes are small countries like Bermuda and the Cayman Islands that provide little in the way of real business opportunities but are useful to multinational corporations as tax havens.

There is also evidence that this type of corporate tax avoidance using tax havens is extremely widespread. Recent data from the Congressional Research Service (CRS) confirms that this sort of corporate tax dodging involving offshore tax havens is happening on a massive scale. Luxembourg and Bermuda serve as two examples of tax havens. CRS recently found that the profits that American corporations claim (to the IRS) to have earned through their subsidiaries in Luxembourg in 2008 equaled 208 percent of that country's gross domestic product (GDP). That's another way of saying American corporations claim to have earnings in Luxembourg that are twice as large as that nation's entire economy, which is obviously impossible.

The profits that American corporations claimed to have earned through subsidiaries in Bermuda equaled 1,000 percent of that tiny country's economy.[7] It is clear that most of the profits American corporations claim are earned by their subsidiaries in these tax havens are not the result of any real business activity there.

The most straightforward and simple solution to these problems is to eliminate "deferral." This would mean that all the profits of American corporations are subject to the U.S. corporate income tax whether they are domestic profits or foreign profits generated by offshore subsidiaries. There would be no incentive for an American corporation to move its operations offshore or to make its U.S. profits appear to be generated in an offshore tax haven.

American corporations would continue to receive a credit against their U.S. taxes for corporate taxes paid to any foreign government (the foreign tax credit), just as they do now, to prevent double-taxation.

More limited, but still useful, reforms have been proposed by President Obama to limit the worst abuses of deferral. For example, one of the administration's proposals would end the practice of corporations taking deductions against their U.S. taxes for interest expenses related to offshore activities, until the profits from those offshore activities are included in U.S. taxable income. Other proposals from the administration would address situations in which American corporations pay inflated royalties to their tax haven subsidiaries for the use of intellectual property so that they can claim to have

low U.S. profits; and situations in which foreign tax credits are used to offset U.S. taxes more than is necessary to avoid double-taxation, to list just two examples.[8]

Unfortunately, Ways and Mean Chairman Dave Camp proposes to *expand* deferral into an even larger break for offshore corporate profits. Instead of allowing American corporations to defer paying U.S. taxes on their offshore profits, Camp proposes to exempt those profits from U.S. taxes forever. This proposal, which is euphemistically called a "territorial" tax system, would increase the problems that are caused now by deferral. If allowing American corporations to defer paying U.S. taxes on their offshore profits encourages them to shift profits and jobs offshore, then *exempting* those profits from U.S. taxes would logically increase these incentives.[9]

Much of the discussion during Congressional hearings about the U.S.'s international tax laws relate to the idea that the U.S. should have rules that make American companies "competitive" abroad. However, the word "competitive" is often used by corporate CEOs who testify before Congressional committees to describe anything making it easier for their companies to generate profits abroad — through actual business activities abroad or by continuing accounting gimmicks by which domestic profits are characterized as "foreign" — and then get those profits to their shareholders. Several corporate CEOs have argued that a territorial system would make their companies more "competitive."

But rules that make it easier for an American corporation to profit in, say, China, may or may not be good for average Americans. If the company has real operations in China, that may complement its operations in the U.S. (perhaps because certain management functions and research in the U.S. support the offshore operations) or they might actually substitute for operations in the U.S., meaning American workers are replaced with foreign workers. Unfortunately, the substitution effect is almost certainly greater than the complementary effect. Martin Sullivan has found that between 1999 and 2008, U.S. multinational corporations have created 2.4 million foreign jobs while reducing their U.S. workforce by 1.9 million positions. He concludes that "U.S. multinational corporations are not net domestic job creators." [10]

One thing that lawmakers should agree on is to avoid rules that actually encourage American companies to carry out operations offshore rather than in the U.S. Deferral does encourage this, and expanding deferral into an exemption for offshore profits would encourage this even more.

The much more significant "competitiveness" issue for the U.S. economy concerns the ability of American companies that are purely domestic companies (and which are sometimes smaller companies) to compete with the American multinational corporations that are able to receive a tax advantage by abusing deferral to make their U.S. profits appear to be generated in offshore tax havens. The environment that many business leaders claim to want — an environment in which businesses compete without interference from government — does not exist so long as our tax laws

continue to provide this benefit to those businesses that can take advantage of offshore tax havens. Adopting a territorial tax system would only deepen this problem.

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[1] Congressional Budget Office, "Updated Budget Projections: Fiscal Years 2013 to 2023," May 14, 2013. http://cbo.gov/publication/44172

[2] Citizens for Tax Justice, "Reforming Individual Income Tax Expenditures," July 15, 2013. http://ctj.org/ctjreports/2013/07/reforming_individual_income_tax_expenditures.php

[3] Citizens for Tax Justice, "How to Implement the Buffett Rule," October 19, 2011. http://ctj.org/ctjreports/2011/10/how_to_implement_the_buffett_rule.php

[4] Citizens for Tax Justice, "Fact Sheet: Why We Need the Corporate Income Tax," June 10, 2013. http://ctj.org/ctjreports/2013/06/fact_sheet_why_we_need_the_corporate_income_tax.php

[5] For more see Citizens for Tax Justice, "Who Pays Taxes in America in 2013?," April 1, 2013. http://ctj.org/ctjreports/2013/04/who_pays_taxes_in_america_in_2013.php; Citizens for Tax Justice, "New Tax Laws in Effect in 2013 Have Modest Progressive Impact," April 1, 2013. http://ctj.org/ctjreports/2013/04/new_tax_laws_in_effect_in_2013_have_modest_progressive_impact.php

[6] Citizens for Tax Justice, "Apple Is Not Alone," June 2, 2013. http://ctj.org/ctjreports/2013/06/apple_is_not_alone.php

[7] Mark P. Keightley, "An Analysis of Where American Companies Report Profits: Indications of Profit Shifting," Congressional Research Service, January 18, 2013.

[8] Citizens for Tax Justice, "Working Paper on Tax Reform Options," February 4, 2013. http://ctj.org/ctjreports/2013/02/working_paper_on_tax_reform_options.php

[9] For more, see Citizens for Tax Justice, "Fact Sheet: Why Congress Should Reject A 'Territorial' System and a 'Repatriation' Amnesty," October 19, 2011. http://ctj.org/ctjreports/2011/10/fact_sheet_why_congress_should_reject_a_territorial_system_and_a_repatriation_amnesty.php; Citizens for Tax Justice, "Congress Should End 'Deferral' Rather than Adopt a 'Territorial' Tax System," March 23, 2011. http://ctj.org/ctjreports/2011/03/congress_should_end_deferral_rather_than_adopt_a_territorial_tax_system.php

[10] Testimony of Martin A. Sullivan before the Committee on Ways and Means, U.S. House of Representatives, January 20, 2011.