

Background

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How to Fix the Tax Code: Five Pro-Growth Policies for Congress

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Abstract: *Among the many undue burdens that the current tax code places on American taxpayers and the economy, five stand out as particularly detrimental to job creation, investment, and economic recovery. From business-stifling taxation systems to the alternative minimum tax to insufficient tax relief for average citizens, The Heritage Foundation presents the five primary problems with the tax code—and the corresponding pro-growth solutions. It is time for Congress to act.*

The federal tax code takes a heavy toll on the economy. Among its many problems, the U.S. tax code slows down economic growth because it makes American businesses uncompetitive in the global marketplace. It also destroys jobs by discouraging individuals from working and investing, and businesses and entrepreneurs from taking on new risks.

The longer that Congress waits to address these and the host of other problems created by the tax code, the more American businesses will fall behind their competitors, and the more American jobs will be lost. With economic recovery slowing down and job creation stalled, businesses, workers, and families cannot wait any longer for Congress to act. The tax code needs fundamental reform to address all inefficiencies in the tax system and to make it less of a drain on the economy. Unfortunately, such far-reaching reform is a low priority in Congress right now. However, Congress can—and should—easily pass specific and vital pro-growth policies that would fix some of the most damaging problems imposed by the tax code.

Talking Points

- The U.S. tax code slows down economic growth because it makes American businesses uncompetitive in the global marketplace. It also destroys jobs by discouraging individuals from working and investing, and businesses and entrepreneurs from assuming new risks.
- Congress can—and should—easily pass five specific and vital pro-growth policies that would fix some of the most damaging problems imposed by the tax code.
- Congress should immediately: 1) Extend the 2001 and 2003 tax relief—permanently, and for all taxpayers; 2) Set the corporate income tax rate at the OECD average of 25 percent; 3) Eliminate the system of capital depreciation and allow immediate expensing of all capital purchases; 4) Tax small businesses at the entity level instead of passing their liability to the owners; and 5) Abolish the alternative minimum tax (AMT) completely.
- Otherwise, American jobs will continue to disappear.

This paper, in its entirety, can be found at:
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Following is a list of some of those problems and their solutions. It is not a complete accounting. These proposed reforms are among the most beneficial changes that Congress can make with broad bipartisan agreement in the current environment.

Problem #1: Congress Did Not Permanently Extend the 2001 and 2003 Tax Relief Package that Expires on December 31, 2010.

Solution: *Congress should immediately extend the 2001 and 2003 tax relief—permanently, and for all taxpayers.* Making the tax relief permanent would give individuals, families, businesses, and investors the certainty they need to make economic decisions about the future. An extension would also prevent a massive tax hike that would cripple the already languishing economy.

The 2001 and 2003 tax relief lowered taxes for all Americans and provided a stronger foundation for more robust economic growth. It did so by lowering marginal income tax rates and tax rates on dividends and capital gains. This increased the incentives for families to work and save more, and for businesses to invest more and assume new risks. These activities are the bedrocks of economic growth. The tax relief also provided tax reductions at a time when Americans were paying the highest federal tax burden in U.S. history.

The death tax will come back to life in 2011, at a punitive rate of 55 percent and an exemption of just \$1 million, unless Congress votes against it.

Despite the positive impact these policies have on the economy, they are at risk of expiring on the last day of 2010, or in two years should the recent compromise struck by President Obama and some Members of Congress become law. If the tax cuts do expire, income tax rates and tax rates on capital gains and dividends revert back to pre-tax-relief levels. Congress has known for a decade when this vital tax relief would expire, yet has done nothing to make it permanent and ensure that a steep tax increase on all taxpay-

ers never occurs. If Congress does not extend the tax relief before the end of the year, the economy will produce 800,000 fewer jobs annually between 2013 and 2019 than it would have had the tax cuts remained in place.¹ Similar job losses would result should the tax cuts expire in two years.

The death tax will also come back to life in 2011, at a punitive rate of 55 percent and a small exemption of just \$1 million unless Congress votes against it. The 2001 and 2003 tax relief phased out the death tax and then abolished it starting in 2010. But just like the other provisions in the tax relief, the abolition of the death tax expires at the end of this year. The death tax is not the scourge of the rich, as its proponents claim. It is a burden on family-owned businesses and a destroyer of jobs. Any compromise that reinstates the death tax, such as the current compromise under consideration, would allow the death tax to continue inflicting harm on the economy and the family-owned businesses that bear the brunt. It is time for Congress to abolish this harmful tax once and for all.

The economy remains in a badly weakened condition, and unemployment continues to linger around 10 percent. Tax hikes in these economic conditions could push the economy back into recession and keep jobless Americans in the unemployment lines longer. There is never a good time to raise taxes—and there is no school of economic thought that advocates doing so during a recession. Raising taxes now would only add insult to injury for Americans struggling to recover from the deepest economic downturn in a generation. Should the current Congress fail to do so, the incoming Congress's first priority should be to make the 2001 and 2003 tax cuts permanent for all taxpayers.

Problem #2: The Corporate Income Tax Makes American Business Uncompetitive.

International competition for jobs and capital is the fiercest it has ever been. To attract new businesses and new jobs, countries around the world must offer the most hospitable business climate possible. The friendlier a country's business climate,

1. William W. Beach, Rea S. Hederman, Jr., John L. Ligon, Guinevere Nell, and Karen A. Campbell, "Obama Tax Hikes: The Economic and Fiscal Effects," Heritage Foundation Center for Data Analysis Report No. CDA10-07, September 20, 2010, at <http://www.heritage.org/Research/Reports/2010/09/Obama-Tax-Hikes-The-Economic-and-Fiscal-Effects>.

the more businesses it will attract, and the more jobs will be created. The United States is falling far behind in this high-stakes global competition. Two factors make the American corporate tax system inhospitable to business: a high corporate tax rate, and taxation of businesses' "worldwide" income.

Solution: *Congress should immediately set the corporate income tax rate at the Organization for Economic Co-operation and Development (OECD) average of 25 percent. A rate on par with global competitors would make the United States more competitive than it is now, and would encourage businesses to expand—hiring employees in the United States, not in other countries. Congress should also switch to a "territorial tax" system—which would only tax businesses on the income they earn within U.S. borders—to put U.S. businesses on an equal footing with their global competitors.*

High corporate income tax. The United States' burdensome corporate income tax rate is one of the main reasons for its relative unattractiveness to U.S. and foreign companies wanting to do business in the U.S. The United States levies the second-highest corporate tax rate among the 30 developed countries in the OECD. Only Japan has a higher rate, and that could soon change. The Japanese government recently pledged to reduce its corporate income tax to be "commensurate" with that of other developed nations.² If the Japanese government follows through with its pledge, it will leave the United States in the unenviable position of charging the highest corporate income tax rate in the world.

The United States' burdensome corporate income tax rate is one of the main reasons for its relative unattractiveness to foreign—and U.S.—companies.

The average corporate income tax rate (including sub-national taxes) in the OECD is about 25 percent. The U.S. rate is 39.2 percent—more than 50 percent higher than the OECD average. Japan's rate currently rests at 39.5 percent.

The top marginal income tax rate is important to businesses because that rate determines how much the tax will reduce the return from each additional dollar of profit the business earns. The top marginal tax rate is a large determinant when businesses decide where to locate their next investment—and where they will hire new employees.

The United States has fallen behind the other countries in the OECD on this important factor largely by standing still. While the other countries aggressively reduced their rates in recent years, the U.S. bucked the trend by being the only country that increased its rate. Since 1990, of the 23 OECD members that had a corporate income tax at that time, 22 have reduced their rate. On average, the rate reduction was about 14 percentage points. The United States was the only country to increase its federal rate, from 34 percent to 35 percent in 1993. (See Chart 1.)

Unless Congress acts soon, the disadvantage that the high corporate tax rate imposes on American businesses will grow as other countries strive to advance their own standing relative to other countries. There is a bipartisan consensus that the corporate income tax rate must be lowered. The tax reform plan proposed by Senators Ron Wyden (D-OR) and Judd Gregg (R-NH) reduces the corporate income tax rate to 24 percent.

Though this would be slightly below the OECD average, once individual state corporate taxes, which average about 5 percent, are factored in, it would be higher than the OECD average. Thus, this reduction is a minimum step.

Since other OECD nations will continue to aggressively lower their rates, Congress should commit to keeping the corporate income tax rate equal or below the OECD average to remain competitive in the global market.

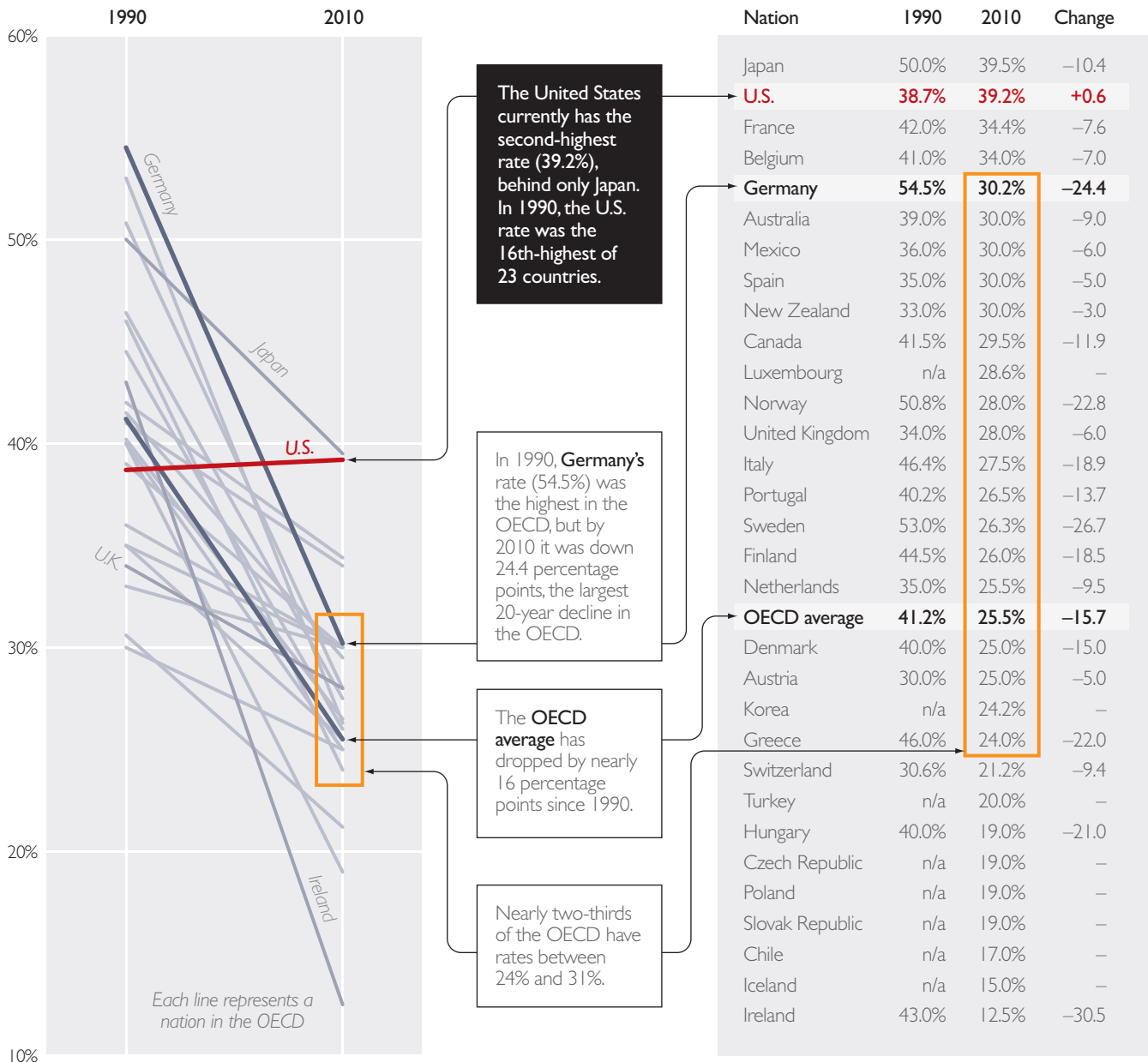
Moreover, states should keep in mind that, when added to the federal corporate tax rate, their own corporate taxes raise the rate for businesses operating within their borders above the OECD average.

2. Keiko Ujikane, "Japan Aims to Cut Company Tax to Spur Economic Growth," Bloomberg Businessweek, June 18, 2010, at <http://www.businessweek.com/news/2010-06-18/japan-aims-to-cut-company-tax-to-spur-economic-growth-update1-.html> (December 8, 2010).

Making the United States Less Competitive

To attract business and investment in a fiercely competitive global marketplace, every industrialized country except the United States has lowered its corporate income tax over the past 20 years. The United States has bucked that trend and *increased* its rate, creating a less-hospitable environment for corporations.

COMBINED CORPORATE INCOME TAX RATE IN THE OECD



Source: OECD, "Taxation of Corporate and Capital Income (2010)," Table II.1. "Corporate Income Tax Rate," at <http://www.oecd.org/dataoecd/26/56/33717459.xls> (December 9, 2010).

As such, states should keep their tax rates to a minimum. States that punish businesses with punitive rates like California's (8.84 percent), New Jersey's (9 percent), and Pennsylvania's (9.99 percent) will see businesses emigrate to other states—or countries—with lower rates, especially those with no corporate income tax.

Taxing worldwide income of American businesses.

A lower rate alone is not enough to place American companies on an equal footing with international competitors. Congress must also change how it taxes income that companies earn abroad. The United States is the only country in the world that levies its corporate income tax on income earned by its native businesses in foreign countries. This is a "worldwide" tax system. Every other government taxes its country's businesses only on the income they earn within their country's borders. This is a "territorial" tax system.

In combination with the high corporate income tax, the worldwide system of taxation increases the tax liability of each American business that wants to compete in the global marketplace. This puts these businesses at a steep disadvantage compared to competitors located outside the United States.

An American manufacturer of automotive brake pads that wants to sell its product in the United Kingdom is at a disadvantage against a German company that wants to do the same. The American business will pay the U.K.'s 28 percent corporate tax on the income it earns on its sale of brake pads there. Then the company will *also* pay another 11.2 percent (when factoring in the average state corporate tax rate) when it brings that income back to the United States after taking the foreign credit for the taxes paid in the United Kingdom (39 percent average rate in the United States minus the United Kingdom's rate). The German business, on the other hand, will pay only the 28 percent tax in the United Kingdom. It is free to repatriate the remainder of its earnings to Germany to invest and create jobs there without paying any additional tax.

The extra taxes that American companies must pay under the worldwide system are a direct reduction of business returns. Businesses from countries with territorial systems always have a built-in advan-

tage. Since the market usually does not allow an American business to charge more than its competitors, the business's shareholders and employees necessarily bear the cost of the extra tax. Lower shareholder returns mean that American businesses have a tougher time raising capital. That makes it more difficult for the business to expand and hire new employees in the United States. Workers bear the burden of the tax through lower pay or fewer jobs.

The economic effect can be even worse for the nation as a whole. Depending on the amount of extra taxes that U.S. businesses owe due to the worldwide system, and on the intensity of the competition, American businesses must often forgo moving into promising overseas markets altogether. Abdicating growing foreign markets slows down the growth of the businesses in the United States and prevents the creation of new jobs.

The extra taxes that American companies must pay under the "worldwide" system are a direct reduction of business returns.

The foreign tax credit prevents businesses from paying taxes twice on the same income. Because of the credit, businesses pay taxes on the difference between the tax rate in foreign countries and the rate in the U.S. This is supposed to mitigate the damage imposed by the worldwide system of taxation. In reality it does little to help as long as the tax rate in the U.S. remains high compared to other countries.

In addition to providing a credit for foreign taxes paid, the tax code attempts to mitigate the damage caused by the worldwide system for United States businesses in another way. An American company does not have to pay U.S. corporate tax on foreign-earned income until the business brings the money back to the United States—a practice known as deferral. But deferral is also of little help to businesses because it merely delays a higher tax bill. Even with the delay, American companies are on an unequal footing with foreign competitors because the American companies have to pay taxes on their earnings eventually. To make up for the imbalance, businesses keep their foreign earnings abroad as long as possible—in most cases, indefinitely.

Some argue that Congress should do away with deferral to force businesses to repatriate their foreign earnings. But they misunderstand the motivation for businesses to keep their earnings offshore. It is not to cheat the United States out of tax revenue; it is to remain on equal footing with their global competitors.

Limiting deferral would not encourage businesses to bring capital back. In fact it would have the opposite effect. If there were no deferral, and the worldwide system and the high corporate tax rate remained in place, businesses would move permanently to other countries with more favorable tax treatment in order to escape the punitive United States corporate tax rate altogether—costing U.S. jobs in the process.

With or without deferral, the earnings of American businesses will not be invested back into the United States as long as the United States insists on the arcane worldwide tax system in conjunction with a high tax rate. The resulting reduction in capital lowers domestic job creation and stifles economic growth.

Neither the foreign tax credit nor deferral can reverse the damage caused by worldwide taxation. Only full repeal of this harmful policy, combined with a reduced corporate income tax rate, can do this.

Problem #3: The Individual and Corporate Income Taxes Discourage Capital Formation.

Solution: *Congress should eliminate the system of capital depreciation and allow immediate expensing of all capital purchases.* Eliminating depreciation would result in more jobs, higher wages, and more efficiency. Under the current tax system, businesses cannot deduct the cost of capital immediately. That means that when companies buy machines, tools, real estate, or other property to make their workers more efficient or the business more productive, they cannot immediately deduct the entire cost of those purchases from their income. Instead they can only deduct portions of the cost over several years by depreciating the value of the capital. This raises businesses' tax liability and their cost of acquiring important capital. A higher cost of capital means that businesses purchase less. Less capital means that businesses create fewer jobs and wages are lower for existing employees.

Higher capital costs mean that businesses purchase less. Less capital means that businesses create fewer jobs.

It does not matter whether a business pays the corporate income tax or pays taxes through the individual income tax through its various owners. Both tax systems fail to offer complete expensing for capital purchases. Recently enacted policies, such as temporary expensing for small businesses (small businesses can deduct the cost of certain capital purchases through 2010) and bonus depreciation (a faster depreciation schedule for certain capital purchases), are half measures that do not fully alleviate the damage the depreciation system inflicts on the economy. Permanent full expensing for all capital purchases by all businesses is the only way to rid the tax code of the harmful system of depreciation.

Depreciation schedules also influence the type of capital businesses acquire. Since different types of capital have different depreciation schedules based on the length of their useful lives, some forms of capital depreciate faster than others. This provides an incentive for businesses to choose forms of capital they can deduct faster, even though from an economic standpoint they would have been better off purchasing a longer-lasting asset. This misallocation of resources lowers economic efficiency and reduces the value of what the economy produces.

Problem #4: The Tax Burden on Small Businesses Is Too High.

Solution: *Congress should tax small businesses at the entity level instead of passing their liability to the owners, and it should lower the tax rate for small businesses to 25 percent.* Small businesses are often stuck in the middle of debates about the level of income taxes. Liberals and conservatives agree that taxes on small businesses should be lowered because small businesses are essential job creators. This debate is waged in the context of the individual income tax because small businesses, like sole proprietorships, limited liability corporations (LLCs), S-corporations, and general and limited partnerships,

all pay taxes through their owners' individual tax returns.

President Obama and the Democratic congressional leadership argue that income tax rates on high earners (\$250,000 and above) do not impact small businesses because few earn enough income to pay the top rates. However, the most productive small businesses—the ones that hire employees, offer goods and services widely, and take financial risks—do fall into the top tax brackets. Higher tax rates would significantly affect their profitability and their ability to expand, hire more employees, or raise salaries. To subject these most successful small businesses to higher taxes would cause them to cut back and hire fewer workers.

According to the Treasury Department, 8 percent of small businesses earn enough to pay the top two marginal income tax rates.³ That is a relatively small share of businesses, but according to the same data from the Treasury Department, those 8 percent of small businesses earn 72 percent of all small-business income. They also pay 82 percent of all income taxes paid by small businesses.⁴

Liberals and conservatives agree that taxes on small businesses should be lowered because small businesses are essential job creators.

The vast majority of small businesses fall outside the top two brackets because many small businesses represent part-time efforts of their owners. Oftentimes the small business is a single person working on the side to pick up a few extra dollars. One-person businesses report the income they earn from that work on their tax forms as small business income even though they do not employ others. Raising the top two income tax rates would not affect many of these side businesses.

Confusion reigns about how to keep taxes on small businesses low because of a lack of transparent, easy-to-understand data about the amount of taxes they pay. This problem stems from the fact

that small businesses do not pay separate taxes. As described above, small-business taxes are paid through their individual owners' tax returns, mixing together various forms of income. If a small business is owned by more than one person, the income is spread out among the business's owners. This complicated system makes it difficult to determine the tax burden of small businesses. If small businesses paid taxes at the entity level instead of passing through their liability to their owners, this problem would abate: These businesses would calculate their tax liability the same way other businesses do—by subtracting from their gross revenues all deductible business expenses. The net income left after taxes could then be distributed to all the business's owners who would be free to do with it what they please. It would be part of their income but not taxable since the tax has already been paid. The business could also retain all or some of the earnings and invest the money in new equipment or additional workers.

Once Congress makes this important change to the tax code, it should then set the small-business tax rate to 25 percent to keep it equal with the corporate income tax rate. That way, businesses will not have an incentive to organize one way or another based on their taxes.

At 25 percent, the tax rate on small businesses would be lower than the 35 percent current rate or the 39.6 percent rate they will pay next year and in succeeding years under President Obama's tax hike plan. A lower tax rate for small businesses will encourage them to invest more and take on more risk. This will help them create more jobs and grow the economy faster.

Lower small-business taxes will also encourage entrepreneurs to open new businesses. Start-up companies need large amounts of capital in their formative years. A common source of that vital capital is the income that the business itself generates. Higher taxes shrink the pool of available income that the small business has to tap. If taxes are too high, an entrepreneur might conclude that creating

3. U.S. Department of Treasury conference on "Business Taxation and Global Competitiveness," July 26, 2007, p. 15.

4. *Ibid.*

a new venture is too risky. This would mean fewer jobs created. In the worst case scenario, the newest Microsoft, Apple, or Wal-Mart never gets out of the starting blocks. A lower rate for small businesses means there will be a great likelihood the economy will enjoy the benefits of the “next big thing.”

Problem #5: The Alternative Minimum Tax Raises Marginal Tax Rates and Provides an Annual Excuse for Congress to Raise Taxes.

Solution: *Congress should abolish the alternative minimum tax (AMT) completely.* Doing so would make the tax code less complex for families and free the resources they currently devote to paying the tax and complying with the tax code for more productive purposes. A more efficient use of resources will increase economic growth. The economy will also benefit from reducing marginal income tax rates for those subject to the AMT. The biggest benefit would be the elimination of an annual excuse for Congress to pretend it is cutting taxes.

The AMT is a secondary tax system set up by Congress in 1969. Its purpose at that time was to serve as a backstop to the primary tax code to ensure that a small number of super high-earning taxpayers were not able to legally use all the deductions, credits, and exemptions provided by Congress to reduce their tax liability too much, or completely. To do this, the AMT takes state and local tax deductions, personal exemptions, deductions for medical expenses and some mortgage interest deductions, to name a few, away from individual taxpayers. In 1970, the first year of the tax, 19,000 tax returns showed payments for the AMT. The IRS collected \$122 million, or about \$6,400 per AMT return. In 2009, 3.8 million returns had AMT liability and the tax collected totaled \$31.8 billion—more than \$8,300 per return.⁵

Taxpayers calculate their tax liability under the primary tax code first. If their income is above the AMT exemption (\$70,950 for married couples in 2009), they must then also calculate their tax bill a second time under the parameters of the AMT. Tax-

Perhaps the most troubling aspect of the AMT today is that it threatens middle- and low-income families with higher taxes.

payors subtract the AMT exemption from their income and the few deductions still allowed under the AMT. Taxpayers then apply two tax rates to their AMT taxable income. If their AMT liability is greater than their liability under the primary tax code, the taxpayers owe an additional amount of tax equal to the difference between their AMT liability and their liability under the primary code.

The AMT makes the already Byzantine tax code even more complex and raises the marginal tax rates of those to whom it applies. This decreases the incentive to work, save, and invest, slowing down economic growth.

Perhaps the most troubling aspect of the AMT today is that it threatens middle-income and low-income families with higher taxes. Though Congress did not design the AMT with this intent, Congress did not set the exemption amount to increase each year with inflation when it passed the AMT 40 years ago. As time passed, the original exemption amount decreased relatively as income levels rose. Congress periodically increased the exemption amount but never set the threshold to rise with inflation. Congress must now pass a “patch” each year to increase the exemption amount so that the AMT does not raise the taxes of low-income and middle-income families.

The yearly exercise provides an annual excuse for Congress to raise other taxes. Under pay-as-you-go (PAYGO) budget rules, Congress must offset all tax cuts by equal reductions in spending or increases in other taxes. Because of a flawed revenue baseline constructed by the Congressional Budget Office (CBO), Congress wrongly considers the yearly patch of the AMT a tax cut. Extensions of long-held tax policies and prevention of a tax

5. Tax Foundation, “History of Alternative Minimum Tax (AMT) Returns and Liability, 1970–2005,” at <http://taxfoundation.org/files/amthistory-20070323.xls> (December 12, 2010), and Tax Policy Center, “Tax Facts: AMT Filers and Revenue, 1970–2008,” at <http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?DocID=538&Topic2id=30&Topic3id=36> (December 9, 2010).

increase are not tax cuts; nevertheless, the CBO scores the AMT patch as such each year.⁶

Due to the PAYGO rules, when Congress extends the AMT patch, it must offset the phantom revenue that the AMT would have raised if it applied to middle-income and low-income families. The amount of revenue Congress needs to offset the AMT patch is considerable since, if Congress did not patch the AMT, the threshold unadjusted for inflation would capture many middle-income and low-income families, raising their taxes.

For tax year 2009, 4 million taxpayers paid the AMT. Unless Congress acts soon, 27 million will pay the AMT for 2010 because the patch expires.⁷ The additional 23 million AMT taxpayers add up to large amounts of fictional revenue. In 2011, the AMT patch will require Congress to find more than \$65 billion in offsets if it continues to insist on wrongly calling the patch a tax cut.⁸ Since spending cuts are rare in Congress, increasing other taxes is usually how Congress offsets the non-existent cost of the AMT patch.

It is long past time to end the yearly AMT charade and take away Congress's annual excuse to raise taxes needlessly. A stronger economy will be an added and much-needed benefit of abolishing the AMT.

Conclusion

Despite being long overdue, fundamental tax reform is not high on the President's or Congress's agenda right now. But Congress should make five basic pro-growth changes to the tax code now. If it does, the competitiveness of United States businesses will greatly improve and economic growth will be stronger now and in the future. If Congress does not, American businesses will continue to lag behind their global competitors and our tax code will remain a burden holding the economy back from its full potential.

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6. For more information, see J. D. Foster, "Making Good Policy Out of a Bad AMT," Heritage Foundation *Backgrounder* No. 2082, October 31, 2007, at <http://www.heritage.org/Research/Reports/2007/10/Making-Good-Policy-Out-of-a-Bad-AMT>.
7. Congressional Budget Office, "The Individual Alternative Minimum Tax," January 15, 2010, p. 3, at http://www.cbo.gov/ftpdocs/108xx/doc10800/01-15-AMT_Brief.pdf (December 10, 2010).
8. Joint Committee on Taxation, "Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposal," March 15, 2010, at <http://www.jct.gov/publications.html?func=startdown&id=3665> (December 9, 2010).