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SOME OBSERVATIONS ON CORPORATE OR BUSINESS TAX REFORM

*Christopher H. Hanna**

FOR the last four years or so, there has been a lot of discussion of comprehensive tax reform. President Barack Obama has mentioned tax reform in his State of the Union Addresses, and his Administration has released a framework for business tax reform.¹ Early in 2014, then House Ways and Means Committee Chairman Dave Camp (R-MI) released a 979-page comprehensive tax reform plan.² Chairman Camp formally introduced the plan, entitled the Tax Reform Act of 2014, as H.R. 1 on December 11, 2014. That same day, then Senate Finance Committee Ranking Member Orrin Hatch (R-UT) released a 340-page report drafted by his staff, entitled “Comprehensive Tax Reform for 2015 and Beyond.”³

The push for tax reform seems to be coming from corporate America. This is quite different than the circumstances surrounding tax reform in 1986, the last time the United States enacted comprehensive tax reform. At that time, upper-income individuals were investing in a variety of tax shelters.⁴ The tax system was seen as collapsing with very low taxpayer morale.⁵ As a result, the push for tax reform 30 years ago was coming, in large part, from the individual side of the tax system. Today the United States has the highest statutory corporate tax rate in the developed world.⁶ In addition, its system of taxing the foreign income of U.S. corporations is viewed by many as outdated and out of step with the rest of the

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1. The President’s Framework for Business Tax Reform, A Joint Report by The White House and the Department of Treasury (Feb. 2012). The framework is just that—a 25-page document outlining five principles for business tax reform: eliminate loopholes and subsidies, broaden the tax base, and cut the corporate tax rate; strengthen American manufacturing and innovation; strengthen the international tax system; simplify and cut taxes for small businesses; and restore fiscal responsibility. *Id.* at 1.

2. See http://waysandmeans.house.gov/UploadedFiles/Statutory_Text_Tax_Reform_Act_of_2014_Discussion_Draft_022614.pdf (accessed Aug. 16, 2015).

3. Staff Report on Comprehensive Tax Reform for 2015 and Beyond, Prepared by the Republican Staff of S. Comm. on Finance, 113th Cong., S. Prt. No. 113-31 (Dec. 2014) (“Republican Staff Report”).

4. See Department of the Treasury, Tax Reform for Fairness, Simplicity, and Economic Growth, Vol. 1 (Nov. 1984) (“Treasury I”) at 6-9; Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1986, JCS-10-87 (May 4, 1987) (“1986 Bluebook”) at 6-11.

5. Treasury I, *supra* note 4, at 9; 1986 Bluebook, *supra* note 4, at 7.

6. See Republican Staff Report, *supra* note 3, at 180-82.

developed world.⁷ As a result, much of corporate America has been pushing for a significant reduction in the corporate tax rate and a shift to a territorial type of system in which the foreign income of U.S. corporations would either not be taxed or very lightly taxed by the United States.⁸

In looking at corporate America and tax reform, it is sometimes helpful to break corporate America into four groups. The first group is publicly-traded U.S. corporations. This group would include U.S. companies whose stock is traded on the NYSE or NASDAQ. The second group is non-publicly-traded U.S. corporations. This group would include large non-publicly-traded U.S. corporations, such as Cargill and Koch Industries, as well as small closely-held U.S. corporations. The third group is small foreign corporations, and the final group is large foreign corporations, such as Royal Dutch Shell, Samsung, and Toyota.

All four corporate groups are interested in corporate tax reform but, in many cases, have differing interests making corporate tax reform that much more difficult. The first group, publicly-traded U.S. corporations, generally views earnings per share (EPS) as the most important financial indicator.⁹ Many times, the expression, "P & L is King" is used to refer to the goal of this first group. P & L refers to profit and loss, which is used to calculate a company's EPS. A company's effective tax rate also impacts the calculation of its EPS. A lower effective tax rate will result in a higher EPS and vice versa. As a result, publicly-traded U.S. corporations almost always want reform of the corporate tax system that will result in a lower effective tax rate. This is most easily achieved by lowering the statutory corporate tax rate. In addition, tax provisions such as the research and development tax credit and the manufacturing deduction also lower a company's effective tax rate.¹⁰ These provisions are sometimes referred

7. See, e.g., Robert Goulder, *Bernie Sanders: Swimming Against the Tide* (Apr. 24, 2015), available at <http://www.taxanalysts.com/taxcom/taxblog.nsf/Permalink/UBEN-9VV GQF?OpenDocument> (accessed Aug. 16, 2015) ("Stated differently, a dollar of capital invested domestically should suffer the same tax burden as a dollar of capital invested abroad – otherwise, bad stuff happens. A tax system that ignores this principle would implicitly favor economic returns on capital deployed in foreign markets over capital deployed at home. And that would provide incentives for creating foreign employment relative to domestic employment. Or so the theory goes. The concept isn't necessarily wrong so much as antiquated. Don't tell the AFL-CIO, but it's difficult to reconcile capital export neutrality with today's global economy, capital mobility, and the emphasis governments place on tax competition. Most other countries threw in the towel on capital export neutrality a while ago. Looking at how subpart F has been neutered over the years, the United States doesn't seem serious about it either. One can quibble about whether that was a colossal mistake (Sanders clearly thinks it was), but that's where we are.").

8. See, e.g., Alliance for Competitive Taxation (ACT), available at <http://actontaxreform.com/> (accessed Aug. 16, 2015) (As described on its website, "ACT is comprised of leading American businesses from a broad range of industries that employ millions of Americans and compete in the global marketplace"; ACT's mission "supports comprehensive tax reform that lowers the corporate tax rate to 25% and establishes a modern globally competitive tax system that aligns the United States with the rest of the world.").

9. See Christopher H. Hanna et al., *CORPORATE INCOME TAX ACCOUNTING* ¶ 4.02[2] (2015).

10. *Id.* at ¶ 4.03[2].

to as permanent differences because they result in a permanent difference between a company's taxable income and its financial accounting income, which translates into a lower effective tax rate for publicly-traded U.S. corporations.¹¹

In contrast to permanent differences are temporary differences, which are provisions in the tax law that provide a temporary or timing difference between taxable income and financial accounting income.¹² Examples of temporary differences are accelerated depreciation and expensing of equipment purchases.¹³ Temporary differences do not lower a company's effective tax rate (as computed for financial accounting purposes).¹⁴ As a result, most publicly-traded U.S. corporations do not greatly value provisions such as accelerated depreciation and will, in most cases, eagerly trade accelerated depreciation for a corporate tax rate cut or a permanent difference, such as the research and development tax credit.

The second group composed of non-publicly-traded U.S. corporations almost always views cash flow as the most important financial indicator.¹⁵ Many times, the expression, "Cash is King" is used to refer to the goal of this second group. This group of companies has little to no interest in EPS or effective tax rates. Any provision in the tax law that enhances a company's cash flow is generally welcomed by this second group. Consequently, a corporate tax rate cut, a permanent difference (such as the research and development tax credit), and a temporary difference (such as accelerated depreciation) are all greatly valued by non-publicly-traded U.S. corporations. All of these tax provisions enhance a company's cash flow.

The third group composed of small foreign corporations almost always wants to avoid having to file a U.S. tax return. Many times that seems to be one of the most important objectives of a small foreign corporation with respect to the U.S. tax system. Such an objective is easily accomplished by a foreign corporation. A foreign corporation will almost always form a U.S. subsidiary to conduct business in the United States. As a result, the foreign corporation will not file a tax return with the United States. Rather, the U.S. subsidiary will file such a return. In addition, the U.S. subsidiary may include information identifying its foreign parent corporation, but the foreign parent will not file a tax return with the United States.¹⁶ The thinking appears to be that disclosure of information to the United States related to the foreign corporation will be less with the use of a U.S. subsidiary and interaction between the foreign corporation and the Internal Revenue Service may be less with a U.S. subsidiary.

11. *Id.* at chapter 4.

12. *Id.*

13. *Id.* at ¶ 4.04[2].

14. *Id.* at ¶ 4.05.

15. *Id.*

16. See I.R.C. § 6038A (2014) (information required to be furnished by a domestic corporation that is 25 percent (or more) foreign-owned).

The fourth group, large foreign corporations, will almost always use a U.S. subsidiary to conduct business in the United States. An important part of tax reform for large foreign corporations is to preserve the deduction for interest payments from the U.S. subsidiary to the foreign parent.¹⁷ Many times a foreign corporation will fund its U.S. subsidiary with a loan. The interest payments on the loan from the U.S. subsidiary to the foreign parent will be deducted by the U.S. subsidiary and, in many cases, will be free of the 30 percent U.S. withholding tax that typically applies to such payments because the foreign parent is a resident of a country that has a comprehensive income tax treaty with the United States.¹⁸ The result is that the U.S. tax base is stripped by the interest payments. As a result, the United States is greatly concerned by the tax consequences of interest payments from a U.S. subsidiary to its foreign parent corporation. In contrast, the foreign corporation and its U.S. subsidiary want to preserve the interest deduction that is currently available to the U.S. subsidiary without any further tightening of the interest deduction rules.¹⁹

In 2012, there were 1,617,739 returns of active corporations (not including S corporations, real estate investment trusts (REITs), and regulated investment companies (RICs)).²⁰ However, the corporate income tax is paid predominantly by a very small number of corporations. In 2012, 411 corporations (less than three one-hundredths of one percent of all active corporations) had an income tax liability (after credits) of \$100 million or more and paid a total of slightly more than \$177 billion of corporate income taxes. This was about 66 percent of the total tax paid by all corporations. Approximately 9,600 corporations (a little more than one-half of one percent of all active corporations), each with an income tax liability of \$1 million or more (after credits), paid almost \$255 billion of corporate income taxes, which was about 96 percent of the total tax paid by all corporations.

Corporate tax reform should really be viewed as part of business tax reform. Although corporate America has been pushing for tax reform the

17. See, e.g., Organization for International Investment (OFII), available at <http://www.ofii.org/> (accessed Aug. 16, 2015) (As described on its website, "Created more than two decades ago, the Organization for International Investment (OFII) is a non-profit business association in Washington, D.C. representing the U.S. operations of many of the world's leading global companies, which insource millions of American jobs." OFII notes that "'Thin Capitalization Rules' found in Internal Revenue Code Section 163(j) limit tax deductions companies can take on loans from related and unrelated parties (with a parent company guarantee). Though these rules apply on paper to both domestic and foreign-based firms, in practice, they overwhelmingly target U.S. subsidiaries of foreign companies because they are more likely to seek financing from a parent company to conduct business in the U.S.").

18. See, e.g., U.S. Model Income Tax Convention, Article 11(1) (2006).

19. See I.R.C. § 163(j) (limiting interest deductions to 50% of adjusted taxable income if the U.S. subsidiary's debt-to-equity ratio exceeds 1.5:1 and the subsidiary has excess interest expense).

20. Internal Revenue Service, SOI Tax Stats – Table 22 – Returns of Active Corporations, Other than Forms 1120S, 1120-REIT, and 1120-RIC, available at <http://www.irs.gov/uac/SOI-Tax-Stats-Table-22>Returns-of-Active-Corporations,-Other-Than-Forms-1120S,-1120-REIT,-and-1120-RIC> (accessed Aug. 16, 2015).

last several years, the pass-through entities have also joined in the push for reform.²¹ They argue that reform only for corporations would be unfair to the pass-through entities. Unlike many other countries of the world, most U.S. businesses are conducted as pass-throughs, such as partnerships, limited liability companies, S corporations, or sole proprietorships. Such business entities are not subject to the corporate tax and therefore would not be directly affected by any corporate-only tax reform. The income of such business entities passes through the entity and is taxed to the owners of the entity. For example, the income of a partnership is not taxed to the partnership, but rather passes through the partnership and is taxed to the partners of the partnership.

Many non-publicly-traded companies are taxed as S corporations or partnerships. The number of S corporations has increased by an average annual rate of 6.59 percent from 1980 until 2012.²² By 2012, the number of S corporations had climbed to 4,205,452 from 545,389 in 1980. The number of partnerships has increased by an average of 2.85 percent annually from 1980 to 2012. By 2012, the number of partnerships had climbed to 3,388,561 from 1,379,654 in 1980. In contrast, the number of traditional or C corporations, which are subject to the corporate tax, declined by an average annual rate of 0.90 percent from 1980 to 2012. By 2012, there were 1,617,739 C corporations, down from 2,163,458 in 1980.

**SHARES OF BUSINESS RETURNS AS A PERCENTAGE,
1980-2012²³**

	1980	1990	2000	2010	2011	2012
S Corporations	4	8	11	13	13	13
Partnerships	11	8	8	10	10	10
Sole Proprietorships (Non-farm)	69	74	72	72	72	72
C Corporations	17	11	9	5	5	5

As would be expected, with the increasing number of S corporations and partnerships, an increasing amount of business income is being earned by pass-through entities.²⁴ In 1980, C corporations earned 75 percent of the net income earned by all businesses, with S corporations, partnerships, and sole proprietorships earning a combined 21 percent of all

21. See, e.g., National Federation of Independent Business, Submission to Senate Finance Committee Tax Reform Working Groups (Apr. 15, 2015), available at <http://www.finance.senate.gov/legislation/download/?id=6f0b655d-638a-41b7-9a78-51b5826b1d42> (accessed Aug. 16, 2015); Robert Carroll and Gerald Prante, *The Flow-Through Business Sector and Tax Reform: The Economic Footprint of the Flow-Through Sector and the Potential Impact of Tax Reform*, Prepared for the S-Corporation Association (April 2011), available at <http://s-corp.org/wp-content/uploads/2011/04/Flow-Through-Report-Final-2011-04-081.pdf> (accessed Aug. 16, 2015).

22. Internal Revenue Service, SOI Tax Stats – Table 1 – Selected Financial Data on Businesses, available at <http://www.irs.gov/uac/SOI-Tax-Stats-Integrated-Business-Data> (accessed Aug. 16, 2015).

23. *Id.*

24. *Id.*

net business income. By 1990, C corporations earned only 50 percent of the net income earned by all businesses, with S corporations, partnerships, and sole proprietorships earning 37 percent. In 2000 and 2012, C corporations earned 35 percent and 36 percent, respectively, of the net income earned by all businesses, with S corporations, partnerships, and sole proprietorships earning slightly less than half of the net income in 2000 (46 percent) and slightly more in 2012 (52 percent).

PERCENTAGE SHARE OF NET INCOME, 1980-2012²⁵

	1980	1990	2000	2010	2011	2012
All Businesses	100	100	100	100	100	100
C Corporations	75	50	35	35	32	36
Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs)	5	12	18	13	13	12
S Corporations	1	8	13	15	17	16
Partnerships	3	3	18	26	26	26
Sole Proprietorships (Non-farm)	17	26	15	12	12	10

In the last several years, there have been a couple of opportunities for enactment of corporate or business tax reform. Unfortunately, it did not happen. During the summer of 2011, Congress passed, and the President signed into law, the Budget Control Act of 2011,²⁶ which created the Joint Select Committee on Deficit Reduction, colloquially referred to as the Supercommittee. This committee was composed of twelve members of Congress, six from the House of Representatives and six from the Senate, with each delegation split evenly between Democrats and Republicans. The Supercommittee was charged with issuing a recommendation by November 23, 2011, for at least \$1.5 trillion in additional deficit reduction steps to be undertaken over a ten-year period with tax reform being one of the areas under consideration. Although the Supercommittee devoted a significant amount of time on business tax reform,²⁷ ultimately, it was unable to come to a bipartisan agreement.²⁸

In April 2014, Pfizer, Inc., a Fortune 500 U.S. pharmaceutical company, announced its intention to acquire AstraZenaca PLC, a large United Kingdom-based pharmaceutical company. The combined company would be a U.K.-domiciled company for tax purposes. Although the acquisition did not materialize, the announcement shook up the tax world.

25. *Id.*

26. Pub. L. No. 112-25 (Aug. 2, 2011).

27. See *Hearings Before the J. Select Comm. on Deficit Reduction*, 112th Cong., S. Hrg. 112-142 (Sept. 13, Sept. 22, Oct. 26, and Nov. 1, 2011).

28. See *Statement of Co-Chairs of the Joint Select Comm. on Deficit Reduction* (Nov. 21, 2011), available at <http://www.murray.senate.gov/public/index.cfm/newsreleases?ID=3ee7a9e6-a66e-4703-b8f9-2b4169b9328e> (accessed Aug. 16, 2015).

A U.S. corporation becoming either a foreign corporation or part of a foreign multinational group, commonly referred to as a “corporate inversion,” has been taking place for over 30 years. In 1983, McDermott International inverted and became a Panamanian corporation. In the late 1990s and early 2000s, a number of U.S. corporations, such as Ingersoll-Rand Inc., Tyco International, Nabors Industries Ltd., and Cooper Industries, inverted, becoming domiciled in countries such as Bermuda and the Cayman Islands. In the last few years, a new wave of corporate inversions has taken place with a number of U.S. corporations, such as Aon Corp., Eaton Corp., and Rowan Companies, Inc., inverting to foreign countries. In the new wave of inversions, however, the country of domicile is typically Ireland, Canada, Switzerland, the U.K., and other European countries.

The latest wave of inversions, led by Pfizer’s intent to acquire AstraZeneca and invert to the United Kingdom, appeared to trigger a serious interest in business tax reform. A number of members of Congress noted that the United States’ corporate and international tax systems needed to be reformed to avoid more U.S. multinationals inverting to foreign jurisdictions.²⁹ However, in September 2014, the Internal Revenue Service issued a notice eliminating much of the benefits of an inversion.³⁰ As a result, inversion activity ground almost to a halt and the perception that business tax reform needed to be accomplished quickly dissipated.

29. See, e.g., Orrin Hatch, *How to Deal With Corporate Inversions—Without the Politics*, WASH. POST (Aug. 7, 2014), available at http://www.washingtonpost.com/opinions/how-to-deal-with-corporate-inversions—without-the-politics/2014/08/07/t552b5cc-1da5-11e4-82f9-2cd6fa8da5c4_story.html; John D. McKinnon, *As Democrats Fret About Inversions, Republicans Focus on Tax Overhaul*, WALL ST. J. (Sept. 10, 2014, 5:54 PM ET), <http://blogs.wsj.com/washwire/2014/09/10/as-democrats-fret-about-inversions-republicans-focus-on-tax-overhaul/>.

30. I.R.S. Notice 2014-52, Rules Regarding Inversions and Related Transactions, 2014-42 IRB 712 (Oct. 14, 2014).

