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BACKGROUNDER

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American Business Competitiveness Act: Good Steps Toward Business Tax Reform

Curtis S. Dubay and David R. Burton

Abstract

The U.S. has the highest corporate tax rate in the developed world. House Ways and Means Committee Member Representative Devin Nunes (R–CA) has introduced new legislation for business tax reform, called the American Business Competitiveness Act (H.R. 4377). The legislation would reduce business tax rates, move to a territorial system, allow full expensing for business investment, and eliminate many economically unjustified deductions. Two Heritage Foundation tax policy analysts explain how the legislation works—and how it could be changed to work even better.

On January 13, 2016, Representative Devin Nunes (R–CA) introduced the American Business Competitiveness Act (ABC Act) to reform business taxation provisions of the U.S. Internal Revenue Code.[1] The legislation would be a large step in the right direction for the business side of the tax code, as it makes the major changes that are necessary to fix the current broken system. As a result, the legislation would have a substantial positive impact on the economy.

Why Business Tax Reform Is Necessary

There are many problems with the business tax system, but business tax reform is badly needed principally because: (1) the business tax rate is too high; (2) it uses a worldwide system; and (3) it has a poor cost-recovery system. These areas of concern have the largest negative impact on the economy. They are slowing investment, which depresses economic growth, slows job creation, and suppresses wages.

Key Points

- The U.S. has the highest corporate tax rate in the developed world, is essentially the only major country in the OECD that taxes the foreign incomes of its businesses through its worldwide tax system, and has a poor capital-cost-recovery system.
- Representative Devin Nunes (R–CA) has introduced legislation (H.R. 4377) to make the major changes necessary to fix the current broken system.
- The legislation is designed to make essential pro-growth changes immediately: It reduces the top rate for all businesses to 25 percent, establishes a territorial system, allows full expensing, and eliminates many unjustified credits and deductions.
- As a result of improvements contained in the legislation, the economy would grow.

This paper, in its entirety, can be found at **http://report.heritage.org/bg3100**

The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

The U.S. has the highest corporate tax rate in the developed world as defined by the 30 countries in the Organization for Economic Cooperation and Development (OECD). The combined federal and average state rate in the U.S. is 39.1 percent. The average of other OECD countries is 25 percent, so the U.S. is far from being competitive with other industrialized nations.[2] The rate on pass-through businesses, which pay tax on their owners' tax returns instead of at the business level, is also too high, at 43.4 percent.

The U.S. is the only major country in the OECD that taxes the foreign incomes of its businesses through its worldwide tax system. Most of the other countries use a modern territorial system that only taxes businesses on the income they earn within a country's borders. The U.S. uses an outdated and cumbersome cost-recovery method for when businesses purchase capital, such as machines, equipment, and other property used to make products and provide services. That method forces businesses to depreciate the costs of those assets slowly over many years instead of deducting the full costs when the businesses purchase them.

The spate of inversions that started in 2014 and continues today is one of the harmful economic results of these poor policy choices. Inversions occur when a U.S. business merges with a foreign business and the new company locates its headquarters abroad to escape the burdensome U.S. tax code on its international operations. Inversions are troubling because they lead to lost high-level jobs domestically and because they often leave economic holes in communities that the formerly U.S.-headquartered businesses leave behind.[3] Business tax reform that addresses each of the three major problems will greatly boost the economy and largely remove the tax impetus for inversions.

Business-Only Reform Acceptable Place to Start Tax Reform. The individual side of the tax code is a drag on the economy, too. But the business side is the bigger, and more immediate, problem for the economy today because it is badly reducing the global competitiveness of U.S.-based businesses. By addressing this business side of the tax code, the ABC Act is a step in the right direction.

In 2015, Heritage Foundation scholars proposed a plan for business-only tax reform.[4] That plan calls for a three-stage approach to fixing the three major problems with the business system. It would reduce the top rate to 20 percent on all businesses, make the system territorial, and allow full expensing of capital investments.

ABC Act Makes Essential Pro-Growth Changes Immediately. The ABC Act institutes much-needed and long-overdue policies immediately. The ABC Act would:

- **Reduce the top rate for all businesses to 25 percent.** That rate, when combined with the average state rate, leaves the combined rate over 29 percent. That is still too high, but much more competitive than the current rate. It also applies to C-corporations and pass-through businesses. This is a much-needed step since pass-through businesses are an important and large portion of the business community. It would be unfair and economically damaging to lower rates only for large C-corporations while leaving the rate for pass-throughs at almost 44 percent.

- **Establish a territorial system.** The ABC Act would create a territorial system that would no longer tax businesses on their foreign income. A territorial system would increase the returns to investment, which would increase efficiency and jobs and wages domestically.[5]

1. The American Business Competitiveness Act of 2015, H. R. 4377, 114th Cong., 1st Sess., http://nunes.house.gov/uploadedfiles/updated_abc_act_bill_text.pdf (accessed March 2, 2016). The bill had 26 co-sponsoring Members of the House at the time of its introduction.
2. Michael Schuyler, "Updated: Details and Analysis of the ABC Act to Reform Business Taxation," Tax Foundation *Fiscal Fact* No. 494, January 14, 2016, http://taxfoundation.org/article/updated-details-and-analysis-nunes-plan-reform-business-taxation (accessed January 28, 2016).
3. Curtis S. Dubay, "Business Inversions: Tax Reform Is the Only Way to Curb Them," Heritage Foundation *Issue Brief* No. 2950, September 4, 2014, http://www.heritage.org/research/reports/2014/09/business-inversions-tax-reform-is-the-only-way-to-curb-them.
4. Curtis S. Dubay and David R. Burton, "How Congress Should Reform Business Taxes," Heritage Foundation *Backgrounder* No. 3022, June 4, 2015, http://www.heritage.org/research/reports/2015/06/how-congress-should-reform-business-taxes.
5. Curtis S. Dubay, "A Territorial Tax System Would Create Jobs and Raise Wages for U.S. Workers," Heritage Foundation *Backgrounder* No. 2843, September 12, 2013, http://www.heritage.org/research/reports/2013/09/a-territorial-tax-system-would-create-jobs-and-raise-wages-for-us-workers.

For foreign income that has not yet been repatriated, and therefore not taxed, since tax payments are deferred until the money is returned to the U.S., the ABC Act would apply a 5 percent toll tax. This is a sensible step. Businesses already accrued the tax on their books and therefore anticipated paying it. To absolve them of responsibility completely would give those businesses an unwarranted windfall. A lower rate than under current law is fair, too, because some businesses planned never to bring those funds back to the U.S. and therefore did not anticipate ever paying tax on them.

- **Allow full expensing.** The ABC Act allows businesses to fully deduct the cost of capital at the time they make such purchases. This is an important step to lower the cost of capital and increase investment. More investment would boost job creation and wage growth for American workers. Congress has recently made strides in the direction of expensing with the permanent expansion of the Internal Revenue Code's Section 179 expensing for small businesses, and the five-year extension of 50 percent expensing for most businesses. But full expensing is needed to completely remove the tax-imposed impediment to capital formation.

- **Eliminate many credits and deductions.** There are some unjustified loopholes in the business tax system.[6] Congress should eliminate them to help offset the cost of pro-growth business reforms. Nunes follows this approach by eliminating many such policies.

The ABC Act Strongly Pro-Growth

The ABC Act fixes the biggest problems in the business tax system that are plaguing the economy. As a result, the plan has strong positive economic effects. According to an analysis conducted by the Tax Foundation, after 10 years of being in effect, the ABC Act would:[7]

- **Expand** the economy by 7.3 percent;
- **Increase** the level of investment by 22.1 percent;
- **Lift** wages by 6.0 percent; and
- **Create** 1.4 million full-time-equivalent jobs.

These are substantial and impressive gains for the economy.

On a dynamic basis, which is now the standard for all tax policy analysis, the Tax Foundation shows that the plan would *increase* federal revenue by $631 billion over 10 years. That means that Nunes has ample room to make his plan even more pro-growth, for instance, by lowering the rate further. The Tax Foundation finds that "the two main drivers of economic growth in the plan are the full expensing of capital investment and the lower tax rate on business income."

The ABC Act would also undoubtedly slow down the rush of U.S. businesses to invert. Inversions may still occur for other reasons, but the reforms in the ABC Act would eliminate the tax motivations for them.

Areas that Need Improvement

Although the ABC Act is very strong, it does contain areas of concern. For instance, it keeps in place the double taxation of business income by retaining capital gains and dividends taxes on individuals. It would be better to eliminate double taxation to further reduce the disincentive that the tax code creates for investment. That would further increase economic growth, jobs, and wages. The plan also suffers from an incoherent treatment of interest. If a system taxes interest income to lenders, it should provide a deduction for borrowers. If it does not tax interest income to lenders, it should deny a deduction to borrowers.[8]

The Nunes business tax excludes interest and other financial receipts from the tax base and does not allow a deduction for interest or other financial payments. This is an acceptable approach. But by

6. Dubay and Burton, "How Congress Should Reform Business Taxes."
7. Schuyler, "Updated: Details and Analysis of the ABC Act to Reform Business Taxation."
8. Curtis S. Dubay, "The Proper Tax Treatment of Interest," Heritage Foundation *Backgrounder* No. 2868, February 19, 2014, http://www.heritage.org/research/reports/2014/02/the-proper-tax-treatment-of-interest, and Curtis S. Dubay, "An Alternative Way to Treat Interest Properly in Tax Reform," Heritage Foundation *Issue Brief* No. 4465, September 30, 2015, http://www.heritage.org/research/reports/2015/09/an-alternative-way-to-treat-interest-properly-in-tax-reform.

taxing the interest and other financial income of individuals, it introduces an inconsistent asymmetry into the tax system that will distort economic decisions considerably. The treatment of interest in the plan should be revised to treat all interest income consistently using either acceptable method.

Furthermore, the Nunes draft is missing stronger anti-base erosion and profit-shifting policies to go along with the territorial system. These are important and necessary when instituting a territorial system. Without them, the U.S. business tax base may erode quickly and could necessitate higher tax rates, which would be antithetical to tax reform. The tax base could erode because businesses might move income that is U.S.-source income, and therefore income that should be taxed in the U.S., to other, lower-taxed countries. Amendments correcting these shortcomings would strengthen the legislation.

Financial Institutions and Financial Intermediation Services. The bill contains a section titled "Real-Plus-Financial Treatment of Certain Transactions Involving Financial Institutions."[9] The laudable aim of this provision is to ensure that financial intermediation services provided by financial institutions are taxed as other services provided by businesses. But the provision, as drafted, is inadequate.

First, the provision does not provide rules for taxing financial institutions. Instead, it delegates the job of writing the rules to the Treasury Department. For purposes of determining net business income, receipts and deductible amounts from "covered financial transactions" by financial institutions are to be included. In general, a covered financial transaction is a transaction between a financial institution and a consumer. Business-to-business financial transactions are left out of the tax base. Figuring out what all of this means is left to Treasury regulators.

The ABC Act is a substantial move to a consumption tax, and consumption tax rules are the proper rules to apply. There are two appropriate ways to tax financial intermediation services in a consumption tax. The first way is to define financial intermediation services and tax both the explicit charges for the services and the implicit charges, such as lower-than-benchmark interest rates on checking accounts or higher-than-benchmark interest rates on loans. This approach has been adopted in two previous sales tax and business transfer tax proposals offered in Congress.[10] The second approach is the "real plus financial" or cash-flow approach that the Nunes legislation appears to be trying to adopt. The language in the bill does not properly set forth either approach.

Finally, the legislation contains a "transition rule" that imposes a 25 percent tax on financial institutions' "net claims against parties that are not business entities." Once again, it leaves it to the Treasury Department to define what this means. It is exceedingly unclear what this provision is meant to accomplish or why it would be desirable. Assuming, however, that it means financial institution loans to consumers minus loans from consumers, it is an unwarranted confiscation of the assets of financial institutions and has the potential to render insolvent financial institutions that provide services primarily to consumers.

Amendments to the ABC Act could strengthen its financial provisions and eliminate the express delegation of authority to the Treasury Department.

An Excellent Place to Start

The plan that Representative Nunes has put together is economically strong and an excellent place to start the process of reforming business taxes. There are areas where it can be improved, including lowering the rate even further.

*—**Curtis S. Dubay** is Research Fellow in Tax and Economic Policy, and **David R. Burton** is Senior Fellow in Economic Policy, in the Thomas A. Roe Institute for Economic Policy Studies, of the Institute for Economic Freedom and Opportunity, at The Heritage Foundation.*

9. Proposed Internal Revenue Code §1424.
10. See, for example, proposed Chapter 8 in the Fair Tax Act, H. R. 25, 114th Congress (2015); proposed chapter 6 in subtitle C in S. 1921, 109th Congress (2005); and proposed subchapter G of Chapter 2 in the USA Tax Act, S. 722, 104th Congress (1995).