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Ending the One-Two Corporate Tax Punch

Jason Furman is right about the 'stupid' policy on overseas income. Domestic policy also isn't so bright.

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We don't often agree with President Obama's chief economist, Jason Furman, but he got it exactly right when he noted earlier this month that the U.S. treatment of international business income is a "stupid territorial tax system."

His point is simple. On paper, the U.S. has a world-wide tax system that imposes two layers of tax on overseas business income—an initial foreign tax when the money is earned and a second U.S. tax when the money is repatriated. In practice, however, companies actively avoid the U.S. tax by various means, including inversions (moving their headquarters abroad by merging with foreign corporations), shifting profits to foreign subsidiaries, and hoarding the cash overseas. The result is, in effect, a territorial system, but one that produces less revenue for the U.S. Treasury and less growth for the U.S. economy.

But what about Washington's system of taxing domestic business income? It is "stupid" too: On paper, the U.S. also imposes two layers of tax on domestic corporate income—one layer when the corporation earns the income and another on shareholders when they receive the income as a dividend or a capital gain.

As with the U.S. world-wide tax system, however, business owners have voted for a single-layer tax here as well. Those that are able become pass-through entities—sole proprietorships, partnerships and S corporations—where their business income is taxed only once, on their personal returns. Those that remain C corporations avoid the double corporate tax by retaining their earnings rather than distributing them, paying their executives excess salaries and bonuses, engaging in share buybacks rather than paying dividends, and borrowing rather than raising capital through the equity markets. The result is less investment, fewer jobs and more debt. It also means that very little corporate income is subject to a second layer of tax.

To fix both counterproductive tax systems, why not tax all business income only once and at the same reasonable top rate? To do this, Congress could couple Sen. Orrin Hatch's idea to "integrate" the corporate code by giving C corporations a deduction for the dividends they pay to shareholders, together with a cap on pass-through business taxes—as proposed by Sen. Marco Rubio and others—at the top rate imposed on C corporations.

The benefits of pairing corporate integration with lower marginal rates are multifold. First, it would reduce the cost of capital, which means more business investment, more employment and higher wages. Analysis by the Tax Foundation consistently finds that tax-reforms that eliminate the double corporate tax would boost economic growth significantly.

Second, it would help balance out the tax treatment of debt versus equity. The current code imposes a very high tax on equity investment, but a much lower tax on debt-financed investments. The dangers of too much debt were exposed during the 2008 financial crisis. The crisis is over, but the incentive to over-leverage remains. It is time to stop penalizing equity by eliminating the double corporate tax.

Third, a single layer of tax coupled with a lower rate would help to discourage inversions, mergers and profit-shifting. Eliminating the double tax means there would be no double tax on foreign earnings repatriated and paid out to shareholders, which means less incentive for corporations to invert. The lower marginal rate would mean less incentive to shift profits overseas. More headquarters and business investment would stay in the U.S.

Finally, since the U.S. already has de facto pass-through and territorial tax systems, there isn't much revenue to lose by making this change. You aren't forgoing revenues if they presently go uncollected—a big economic bang can be had at little cost.

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