Tax Reform Should Promote Competition, Fairness, Equity, and Growth

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Americans for Tax Reform Foundation (ATR) is a nonprofit, 501(c)(3) research and educational organization opposed to all tax increases as a matter of principle.

ATR was founded in 1985 by Grover Norquist at the request of President Reagan. We believe in a system in which taxes are simpler, flatter, more visible, and lower than they are today. The government's power to control one's life derives from its power to tax. We believe that power should be minimized.

Introduction

While there is consensus that the existing tax code is unacceptable, there remains disagreement about what the new product should look like.

ATR believes tax reform should promote three principles:

- Make America Competitive Again
- Promote fairness and simplicity
- Promote economic growth

First, tax reform must ensure that businesses of all sizes can compete. As the rest of the world aggressively updates their tax codes to compete in the global economy, the U.S. code remains unchanged, forcing American businesses to invert or be acquired by foreign competitors. Tax reform must fix this competitiveness problem and stop needlessly punishing American business to the benefit of our foreign competitors.

Second, tax reform ought to create a code that is equitable and simple. In its current form, the tax code is too complex for families and small businesses and unfairly places burdensome compliance costs on those least equipped to deal with it.

Third, tax reform must promote economic growth and encourage innovation. The status quo of stagnant growth is unacceptable, and tax reform should ensure that anti-growth provisions are swept away and replaced with a system that drives job creation and higher wages.

Beyond these three principles, there are specific provisions in the code that tax reform should change or remove, and others that must not be added. Priorities should include:

- Reduce business tax rates
- Move to a territorial system of taxation
- Tax all businesses equitably
- No carbon tax
- Full business expensing
- Repeal or reduce the capital gains tax
- Encourage tax-preferred savings accounts
- Repeal the Death Tax
- No government run tax preparation
- Repeal the Alternative Minimum Tax
- No VAT
- Repeal Obamacare Tax Hikes

Principles of Tax Reform

Tax Reform Must Promote American Competitiveness

The U.S. tax code remains mostly unchanged since the cold war, when President Reagan signed the Tax Reform Act of 1986. Three decades later, the world is a very different place, yet our tax code is the same.

As a result of our archaic system, countless American businesses have or are actively pursuing an inversion – a merger with a foreign business with the intent of headquartering the new entity overseas. Concurrently, American businesses are being acquired by foreign competitors in greater numbers than ever before because our tax code is constraining business activity.

While inversions and to a lesser extent acquisitions are subject to negative media coverage, both are mere indicators of America's competitiveness problem. The solution to this problem should be simple: reduce the rate and update the code from the outdated worldwide taxation system to a more modern territorial system.

Even as the U.S. fails to act, other countries have shown they understand the necessity of tax competition. Many of our competitors are aggressively implementing policies that take aim at America's tax base by implementing pro-growth, pro-business policies that accelerating the exodus of U.S. capital. For instance, the U.K. has announced plans to reduce its corporate tax rate from 20 percent to 18 percent by 2020, while China recently modified its business tax system with the effect of lowering its the rate from 25 percent to 17 percent.

Competing countries are also implementing tax provisions preferential to innovation in a bid to steal high paying U.S. jobs and IP. The provisions, known as an Innovation Box offer a lower tax rate, typically between 5 and 15 percent on income derived from intellectual property intensive business activity. Currently 15 countries, mostly located in the EU have Innovation Boxes.

The EU led OECD Base Erosion and Profit Shifting (BEPS) project imposes a requirement that businesses must locate their IP in a country in order to take advantage of the preferential tax treatment, forcing the hand of U.S. businesses. Clearly, the spread of Innovation Boxes across the world is only further exacerbating the gap between American businesses and the rest of the world and encouraging the flight of IP and jobs from the U.S. to our competitors.

For the past eight years, the Obama administration has refused to act, instead deriding tax competition as a "race to the bottom." They narrow-mindedly see the problem as inversions and the solution as new regulations on businesses. For instance, the Treasury Department announced two regulations purportedly aimed at businesses that are inverting last month. The first regulation modified thresholds at which a newly inverted company is counted as foreign or domestic under the U.S. tax code, in an effort to halt pending inversions.

The second regulation, proposed under section 385 of the tax code, is so broad it gives Treasury leeway to define whether interest held by a corporation is treated as debt or equity for federal tax purposes. Although this was proposed as an effort to clamp down on earnings stripping utilized by inverted businesses, the regulation will broadly impact American businesses with international operations and have a chilling effect on investment.

This is not the first time that regulations have been proposed as the solution to the so-called inversion problem. Each time, they have failed to fix the underlying problem. Paradoxically, new regulations will only increase compliance costs and further perpetuate a tax system that is too complex and too burdensome for businesses.

The tax code is clearly the reason businesses cannot compete with the rest of the world, and tax reform that updates outdated rules and lowers the rate is therefore the only way to ensure that American businesses become competitive again. The longer tax reform that fixes this competitive problem is delayed, the longer American companies will lose out to foreign competitors and the tax base will remain vulnerable to inversions and acquisitions.

Tax Reform Should Promote Fairness and Simplicity

The 75,000 page tax code is simply too complex and confusing for the majority of American families. Each year, taxpayers waste $378 billion complying with the code. Low and moderate-income families with children bear the worst aspects of this complexity. Ideally, tax reform should lower the rates for families, reduce the number of brackets, tax income once – at the point of consumption, and make the system easier to comply with.

While the existing tax code is already pro-family in some ways, it is difficult or impossible to take advantage of all the credits and deductions. For instance, a family with children can take a personal exemption, a child tax credit, and a childcare credit. But they all have different, and confusing rules. Low-income families also have the Earned Income Tax Credit, but this provision is so confusing to everyone involved and is rife with fraud.

Not only is the code complex, it is also unfair. One would think that tax brackets double for married couples, but this is not the case. Instead, there are arbitrary penalties that punish married couples to the tune of hundreds or thousands of dollars. Needless to say, tax reform should remove this inequity.

Making the tax code simpler and fairer also has the added benefit of taking power from the IRS. With the existing, byzantine code, the IRS or a similar agency is necessary, but making the code simpler can make the agency obsolete.

Tax Reform Should Promote Growth

For years, economic growth has remained stagnant. Strong growth requires the right rules in place, and that means taxing workers and businesses in the least burdensome way. When considering tax reform, lawmakers should prioritize growth over revenue neutrality and repeal as many anti-growth taxes as possible. The fact is, reducing taxes means you are stealing less money from the American people.

The Congressional Budget Office (CBO) estimates that every 0.1 percentage points in higher GDP growth equates to roughly $59 billion in revenue over ten years. Extrapolating, tax reform that can achieve four percent growth – as opposed to the current anemic two percent – equates to roughly $1.1 trillion more in revenue over ten years.

For decades the Joint Committee on Taxation (JCT), the Congressional in-house scorekeeper, did not incorporate the Laffer Curve in their methodology, which simply states that moving from very high to very low marginal income tax rates increase the incentive of taxpayers to work, save, and invest. Doing the opposite – moving from a very low to a very high marginal income tax rate – has the opposite effect.

Only recently has Congress begun accurately analyzing tax reform through dynamic scoring. Contrary to what some argue, this does not mean that tax cuts somehow pay for themselves, it simply means that commonsense economic effects are taken into account. Given this constraint, Congress should not allow itself to be bound by out-of-date tax analysis and should prioritize strong economic growth.

Specific Recommendations

Reduce the Corporate Income Tax Rate

With a combined state/federal average of 39.1 percent, the U.S. has the highest corporate income tax rate in the developed world. By comparison, the average rate in the 34 member Organisation for Economic Co-operation and Development (OECD) is just 25 percent.

The last time the U.S. rate changed was in 1986 when the rate was reduced from almost 50 percent to 38.6 percent over a two-year period. At the time, the average rate in the developed world was just 44 percent and the U.S. was ahead of the times.

Since then, other countries have cut their rates aggressively. The United Kingdom went from 35 percent in 1988 to 20 percent today with plans to go down to 18 percent by 2020. In that same three decades period, Germany has reduced its rate from 60 percent to just 30.2 percent, Canada from 41 percent to 26 percent, and Ireland from 47 percent down to just 12.5 percent.

This high rate puts a severe burden on American businesses competing with foreign companies, but it impacts American families just as strongly. As much as 75 percent of the cost of the corporate income tax is passed onto labor and so reducing the rate will result in higher wages and more jobs for American families.

Move from a Worldwide System to a Territorial System

Not only is the U.S. code one of the most complex, the U.S. treats outbound taxation – tax rules as they apply to the foreign activities of U.S. taxpayers – different than almost all other developed countries in the world. America has a worldwide tax system which double taxes income earned abroad by a U.S. company.

This means a business that wants to bring income to its U.S. parent company to invest in the economy or pay out to shareholders is required to pay the difference between what was paid in the country where the income was earned and the U.S. rate. Because the U.S. has the highest rate in the world, companies frequently pay a rate in the double digits.

In contrast, 28 of the 34 OECD countries have a system of territorial taxation, meaning that income earned abroad by a business is exempt from taxation. Countries generally exempt between 95 percent and 100 percent of foreign income from taxation.

In practice, this means a company headquartered in one of the many countries with a territorial system of taxation enjoys a substantial advantage over U.S. business, as they face little or no double taxation on profits earned abroad. Tax reform should address this discrepancy and update the code to a system that treats our businesses the way the rest of the world treats theirs.

Our worldwide tax system has meant that American businesses have more than $2 trillion in after tax earnings locked outside of the country, unable to be brought back and reinvested. Ahead of moving the U.S. code to a territorial system, one option is to have optional repatriation for business income trapped overseas.

Bringing this money back through repatriation would provide a boost to the economy, create jobs, and increase income. In fact, there is already a model to follow, when repatriation last occurred in 2005. That year, businesses could bring back income at a rate of 5.25 percent. However, repatriation must be one part of tax reform, not a stand-alone proposal. Implemented alone it would be nothing more than a Band-Aid solution that temporarily addressing the underlying lockout effect.

Tax All Businesses Equitably

Under the tax code, businesses are categorized into two basic categories – corporations and pass-through businesses. Based on how they choose to organize, they face drastically different tax, legal, and employment consequences.

If a business is organized as a corporation, it typically calculates profits by subtracting expenses from revenue and then pays federal and state corporate income taxes. Businesses that are structured as pass-through firms are different – they don't pay taxes themselves. Instead, the profits of the business "pass through" to the owners who pay individual taxes on their 1040 form. This means that typically smaller pass-through businesses pay a higher rate than corporations, exceeding 50 percent in some states.

While it is important to reduce corporate tax rates to promote American competitiveness, it is also important that businesses on Main Street are not left behind. For many small businesses and startups such a change would result in a significant disadvantage that would make it harder for them to compete with businesses organized as corporations. Tax Reform must ensure businesses are treated equitably regardless of their size.

No Carbon Tax

Lawmakers should make the code simpler, not more complex, and this means taxing businesses and families once, not two, three, or four times. While some have suggested a revenue neutral carbon tax, this would be a mistake. The claim here is that a carbon tax could take the place of ineffective EPA regulations and would be a more efficient, more effective, and less harmful way to regulate carbon emissions. These arguments are divorced from reality.

A carbon tax would impact every sector of the economy, would increase energy prices, and would cause the cost of consumer goods to rise. Further, it would disproportionately hit low-income households who expend a greater share of their income on energy and consumer goods. While it may start small (like the AMT and the income tax), a carbon tax would inevitably increase in size once created.

Full Business Expensing

Currently, there is a bias in the tax code that discourages business owners from making investments. Some business investments can be written off immediately, while others are subject to a bizarre patchwork of rules under the depreciation system.

For instance, if a business purchases a box of paper clips, it can be written off the first year. But if a business purchases a computer, it takes five years to recover the cost. A desk takes seven years and a building as much as 39 years. This distorts business decisions by needlessly and arbitrarily treating purchases differently under the tax code.

To correct this, tax reform should implement full business expensing, which would allow a business owner to reduce their taxable income dollar-for-dollar by the amount purchased when they invest in business expenses. Encouraging investment back into the business in turn encourages more jobs and stronger economic growth.

Repeal or Reduce the Capital Gains Tax

A key policy goal should be incremental progress toward a consumption base of taxation and therefore cutting the tax rate on capital gains (and dividends, distributed after-tax corporate earnings) to zero.

The capital gains tax hits income that has already been subjected to income taxes and has been reinvested to help create jobs, grow wages, and increase economic growth. This double taxation makes no sense from the perspective of encouraging investment and stronger growth.

At present, the code taxes a dividend or capital gain (a profit derived from the sale of a stock, bond or other asset) at a lower rate, with a top rate of 23.8 percent for assets held longer than a year. This is an okay start, but ideally the tax code should be based on consumption and income derived from investments (as well as income saved) and would be not be taxed at all.

Certainly, reform should not involve going in the other direction and taxing capital gains as ordinary income either.

One frequent proposal from those that want to hike the capital gains tax starts with taxing carried interest as ordinary income. Carried interest is simply the expert investor's share of the profits from a partnership and is no different from any other type of capital gain. Taxing one type of capital gain as ordinary income opens the door to taxing all capital gains at the higher rate.

Another proposal that should be rejected is limiting or repealing like-kind exchanges. A like-kind exchange allows an investor to sell one asset and uses the earnings to purchase a similar asset. If this meets certain conditions, the investor can defer paying capital gains tax until they cash out. This is a common sense provision from an economic perspective -- because there is a continuity of investment there is no reason to arbitrarily punish reallocation of resources. In a perfect world, all capital gains would be treated the same as like-kind exchanges.

Encourage and Simplify the Use of Tax-preferred Savings Accounts

Currently, there are about 15 tax-advantaged savings accounts that taxpayers can use to save for things like retirement, health care, and education. Unfortunately, this system can be so confusing and complex that it is difficult for most Americans to take advantage of and it causes households to under-save.

When used correctly these saving accounts drastically reduce the tax burden on families, so tax reform should promote and simplify the use of savings accounts.

There are several equally good options here. One solution is to roll these fifteen choices into a streamlined system with a few flexible, but defined savings accounts. For instance, back in the mid-2000s, the Treasury Department came up with a proposed three-account program to replace the existing system. Another option is to create an additional account (not displacing what's already there), but which allows saving in the most simple way possible. These types of accounts already exist in Canada and the United Kingdom, and they are doing very well.

Repeal the Death Tax

One of the most intrusive and unfair taxes is the Death Tax, which requires your loved ones to tell the IRS about everything you own at the moment of death – your bank accounts, investments, the value of your home and business, and more.

Right now, the tax sits at 40 percent with an exemption threshold of $5.43 million, meaning the tax burden for families is significant. Those who are hit hardest generally are first and second generation families with a small business, because the truly wealthy can avoid the tax through an army of accountants, attorneys, and charitable planners.

The Death Tax is counterproductive to growth – it is a tax you pay on savings you have already paid taxes on at least once. As a result, the Tax Foundation predicts repeal would add 150,000 jobs and raise $8 billion in annual revenue over the long term.

No Government Run Tax Preparation

One annual suggestion for simplifying the tax code is have the IRS prepare and file your taxes for you. The argument here is that it makes things simple for confused taxpayers and the IRS already has most or all of this information anyway. All you would have to do each year is sign off on your government-processed refund.

While this may sound appealing, it is a giant conflict of interest for the IRS to determine your tax liability, and then seize your wages and assets in order to collect that tax liability. Taxpayers have little understanding of the tax code and would be left to trust the notoriously inefficient IRS. A mistake means hundreds or thousands dollars less on your tax refund.

In reality, this proposal is driven more by a desire to increase the scope and size of government than it is to help confused taxpayers. Advocates of government tax preparation ignore or dismiss the fact there is already a system that mitigates tax complexity with none of the conflict of interest. The Free File program, a public-private partnership that grants 70 percent of taxpayer's access to electronic tax preparation software eases this complexity problem for many Americans. It's even endorsed by the IRS, who has said repeatedly that it has no desire to get into the tax preparation business.

Repeal the Alternative Minimum Tax

First imposed in 1969, the Alternative Minimum Tax (AMT) was established to prevent certain taxpayers from using otherwise available deductions to reduce (and in some cases eliminate) their income tax liability. Any taxpayer whose income exceeds the AMT threshold is required to calculate their regular tax burden and the AMT, then pay the higher amount.

Over time, the AMT has expanded in scope to hit a far larger percentage of Americans than was ever intended. In 1970, the tax hit just 20,000 taxpayers. As of 2011, it had grown to hit 4.3 million including many upper-middle class taxpayers. Because wages are continuously increasing, the AMT will only continue to impact more taxpayers over time. It should be repealed.

No Value Added Tax

Whenever a Value-Added Tax has been implemented, it is promised as a solution to other taxes being too high. Inevitably, taxes increase in size after a VAT is imposed. It is simply too easy for politicians to raise a tax that is hidden from citizens.

In Europe, a small VAT was first enacted in 1967. At that time, Europe and the United States both confiscated about $0.27 out of every dollar of national income. Since the introduction of the VAT in Europe, its average tax take has gone from 27% to 41%, nearly a 50% increase in just four decades. There is currently a minimum VAT requirement of 15% to be a member of the European Union, and an average VAT rate of 20%. Meanwhile, the VAT-less United States still taxes at about the same level as it did in 1967.

A VAT is not like a national retail sales tax. A sales tax is a line-item on a cash register receipt, and is easily known by the consumer: a very effective check on raising the sales tax rate. A VAT, on the other hand, is embedded in the final cost of the goods sold, and is hidden to the consumer. The VAT is applied at every stage of consumption, from wholesale to retail. It is passed along until it literally becomes as much an inherent and cloaked component in the price as transportation or raw materials. As a result, countries that have adopted a VAT have been sorely tempted to raise the rate over time.

Repeal Obamacare Tax Hikes

This administration used passage of Obamacare to pass a series of 20 tax hikes on the American people, many of which were directly aimed at the middle class. Many of these taxes were delayed to shield the true cost of Obamacare from the public.

When CBO provided its ten-year scoring estimate shortly after the bill was passed, it said Obamacare would cost taxpayers a little over $500 million. Fast forward to 2012, and CBO updated this score to $1 trillion because this second window saw more of the tax increases coming into effect and it was no longer necessary to hide the ball.

These taxes take aim at the sick with the chronic care tax, the healthy with the individual mandate tax, and at users of savings accounts with several taxes such as a tax on FSAs, a tax on HSAs, and the Cadillac tax. Obamacare also taxes medical devices, taxes prescription medicine, taxes employers, taxes health insurers, taxes investors, and taxes small businesses.

The goals of healthcare reform should be lower costs, increased efficiency and empowering patients and doctors. As part of any reform, the many Obamacare taxes should be repealed.