Obama/Romney Tax Proposals
And Economic Growth

By Samuel C. Thompson Jr.

Samuel C. Thompson Jr. is a professor of law and director of the Center for the Study of Mergers and Acquisitions at Penn State Law School. He wishes to thank his research assistants Stephen Anderson, Raymond Cywinski, Philip Farrell, and Stephanie Wilhelm for their helpful comments.

This article is based on a chapter from The Obama vs. Romney Debate on Economic Growth: A Citizen’s Guide to the Issues (Sept. 2012). It examines the positions of President Obama and Republican presidential candidate Mitt Romney on several tax policy issues.

Copyright 2012 Samuel C. Thompson Jr. All rights reserved.

Although President Obama and Republican presidential nominee Mitt Romney have each set forth many tax proposals, this article focuses on their major points of disagreement.1 It analyzes Obama’s proposal to return to the top marginal rate of 39.6 percent for high-income taxpayers, the candidates’ recommendations for the taxation of capital gains and dividend income, and their views on the appropriate tax treatment of foreign business income of U.S. controlled foreign corporations.

A. Marginal Rates
1. Background. To fully appreciate the various proposals regarding marginal rates, one must first understand the rate structure as it existed in 1999, toward the end of the Clinton administration. The marginal brackets were then 15, 28, 31, 36, and 39.6 percent. The two highest brackets resulted from tax increases enacted in 1993, during Clinton’s first term. Dividends were included in ordinary taxable income, and capital gains were subject to a maximum 20 percent rate.

The brackets changed under the Bush administration. In 2001 all taxpayers received tax relief that was phased in. And in 2003 the rate reductions scheduled for 2004 and 2006 were accelerated. So for 2003 and later years, the income tax rates were 15, 25, 28, 33, and 35 percent.2

The Bush-era tax provisions were scheduled to expire at the end of 2010 for all taxpayers, thus causing a reversion to the earlier rates, including the top marginal rate of 39.6 percent. As discussed below, those provisions have been extended through 2012.

2. Obama and Buffett proposals. Throughout his 2008 election campaign, Obama proposed that the pre-Bush rate structure be reinstated for married taxpayers with more than $250,000 of income and for single taxpayers with more than $200,000 of income.3 That would have subjected those taxpayers to a top rate of 39.6 percent rather than 35 percent.

He has sustained that position during his presidency. As described in the Treasury green book for fiscal 2013,4 Obama proposes to replace part of the 33 percent bracket and the entire 35 percent bracket with the prior-law rate brackets of 36 and 39.6 percent, respectively. The annual thresholds, to be indexed for inflation, would be $250,000 for married taxpayers filing jointly, $225,000 for head-of-household taxpayers, $200,000 for single taxpayers, and $125,000 for married taxpayers filing separately.

Although congressional Republicans have adamantly opposed an increase in the top marginal rate, there is agreement with the president that married taxpayers with less than $250,000 in taxable income (and singles earning less than $200,000)

---

1Accordingly, this report does not address Obama’s proposal to make various middle-income tax cuts permanent, because Romney agrees with that proposal.
should get the permanent benefit of the Bush-era tax provisions. To avoid a return to higher rates for low- and middle-income taxpayers, the president compromised with congressional Republicans and extended the Bush-era rate structure through 2012. Without further extension, the rates will revert for all taxpayers shortly after the November election.

In September 2011 Obama proposed the so-called Buffett rule, in response to a then-recent op-ed by Warren Buffett in The New York Times. Pointing out that his effective tax rate was lower than his secretary’s, Buffett argued that “billionaire-friendly” Congress should significantly increase the progressivity of the federal income tax by increasing the marginal rates of millionaires:

For those making more than $1 million . . . I would raise rates immediately on taxable income in excess of $1 million, including, of course, dividends and capital gains. And for those who make $10 million or more . . . I would suggest an additional increase in rate.5

As developed by Obama, the Buffett rule is based on the fair-share principle: “No household making over $1 million annually should pay a smaller share of its income in taxes than middle-class families pay.”6 The White House website assures that taxes would not go up for the “98 percent of American families who make less than $250,000.” It explains that the Buffett rule “would limit the degree to which the best-off can take advantage of loopholes and tax rates that allow them to pay less of their income in taxes than middle-class families.”7

Previously, there was uncertainty regarding the tax rates that would apply under Obama’s plan to incomes exceeding $250,000 for joint filers. For example, a New York Times article by Andrew Ross Sorkin stated: “Mr. Obama’s proposed top household income tax bracket — starting at $250,000 — would pay 39.6 percent on federal income.”8 However, Treasury’s 2012 green book9 makes it clear that if the president’s proposal applies in 2013, the tax rate on incomes between approximately $250,000 and $379,000 would increase from 33 to 36 percent, and the tax rate on incomes exceeding $379,000 would increase from 35 to 39.6 percent. For example, a family filing jointly with $300,000 of taxable income would see the tax rate on their income exceeding $250,000 increased by 3 percentage points (a tax increase of $1,500).10

3. Romney proposals. Romney wants to keep the Bush-era tax rate structure. In Believe in America, he writes: “The goals that President Bush pursued in bringing rates down to their current level — to spur economic growth, encourage savings and investment, and help struggling Americans make ends meet — are just as important today as they were a decade ago.” Those rates, he believes, “should be regarded as a directional marker on the road to more fundamental reform.”11 He has since proposed a permanent, across-the-board 20 percent cut in marginal rates.12

In the first presidential debate on October 3, when elaborating on his tax plan for high-income taxpayers, Romney said:

I’m not going to reduce the share of taxes paid by high-income people. High-income people are doing just fine in this economy. They’ll do fine whether you’re president or I am.

I cannot reduce the burden paid by high-income Americans. So . . . any language to the contrary is simply not accurate.

Thus, Romney’s position is that he would, on a revenue-neutral basis, reduce for high-income taxpayers both marginal tax rates and various tax expenditures.

Romney subsequently said on CNN13 that there would continue to be preferences for the deductions for mortgage interest and charitable contributions.

4. Obama vs. Romney. The debate between Obama and Romney over the marginal rate structure boils down to the question of how progressive the tax system should be. Should Congress reinstate the 39.6 percent rate and possibly, as Buffett has suggested, increase individual rates significantly above that level for super-high-income taxpayers? It must

For a table setting out the tax increases for various levels of income, see Thompson, “Under President Obama’s Proposal to Return to the Pre-Bush Tax Rates for High-Income Taxpayers, How Much Additional Tax Would Be Due for Various Levels of Income?” posted on my blog, available at http://obamavsmittromneydebateoneconomicgrowthblog.com/.


13Interview with Wolf Blitzer of CNN (Oct. 9, 2012). In response to a question from Blitzer, Romney said, “And I can tell you, with regards to the deductions you describe — home mortgage interest deduction and charitable contributions — there will, of course, continue to be preferences for those types of expenses.”

10For a table setting out the tax increases for various levels of income, see Thompson, “Under President Obama’s Proposal to Return to the Pre-Bush Tax Rates for High-Income Taxpayers, How Much Additional Tax Would Be Due for Various Levels of Income?” posted on my blog, available at http://obamavsmittromneydebateoneconomicgrowthblog.com/.

be emphasized that there is no dispute between Obama and Romney concerning the desirability of making permanent the rate reductions provided to lower- and middle-income taxpayers in the Bush-era tax provision. Their disagreement centers on the appropriate rate structure for high-income taxpayers.

5. Thompson proposals. In an earlier article, I argued for an increase in the progressivity of the federal income tax that would go beyond the Buffett rule. I believe the president’s and Buffett’s proposals are steps in the right direction but do not go far enough regarding taxpayers with super-high levels of income.

I propose that the 39.6 percent rate begin at $400,000 for married taxpayers filing jointly, with appropriate adjustments for other taxpayers. That bracket would end at $1 million. A 45 percent rate would apply to taxable incomes between $1 million and $5 million, and a 50 percent rate would apply to taxable incomes exceeding $5 million. The table above shows how my rate structure compares with those proposed by Obama, Romney, and Buffett.

The reason for starting the 39.6 percent rate at $400,000 is to economically replicate in 2013 what Congress did in 1993 when it first adopted the 39.6 percent rate and applied it to taxable incomes exceeding $250,000. For post-1993 years, under the inflation adjustment provisions of section 1, the $250,000 threshold has been adjusted for inflation. If the Bush-era tax cuts are repealed at the end of 2012 and there is a reversion to the prior higher individual tax rates, under section 1, the 39.6 percent rate would not apply until married taxpayers filing jointly had approximately $400,000 in taxable income. That is because $250,000 in 1993 dollars has the same buying power as approximately $386,000 in 2011 dollars, and by 2013 that will likely be near $400,000.16

My proposal for significantly increasing the progressivity of the income tax system is based on the observation that U.S. taxes are too low when measured as a percentage of GDP. According to the 2011 edition of the OECD’s Revenue Statistics, U.S. revenues as a percentage of GDP were not only lower than the OECD average but also lower than the percentage in any of the other countries except for Mexico and Chile. That analysis leads inextricably to the conclusion that Congress should increase the federal income tax rates.

6. Studies. Significant research by economists Thomas Piketty and Emmanuel Saez supports rates even higher than what I propose for individuals with very high incomes. In a 2001 article they concluded that “the optimal top tax rate could be over 80 percent and no one but the mega rich would lose.” Piketty and Saez also disputed the assertion that cutting taxes on the wealthy leads to increased growth. Noting significant declines in the top income tax rates in many OECD countries over the past few decades — especially in the United States and the United Kingdom — the economists

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Romney Proposal: Rate of Tax</th>
<th>Obama Proposal: Rate of Tax</th>
<th>Buffett Proposal: Rate of Tax</th>
<th>Thompson Proposal: Rate of Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>More than $250,000, but not more than $400,000</td>
<td>26 percent</td>
<td>36 percent</td>
<td>?</td>
<td>36 percent</td>
</tr>
<tr>
<td>More than $400,000, but not more than $1 million</td>
<td>28 percent</td>
<td>40 percent</td>
<td>?</td>
<td>40 percent</td>
</tr>
<tr>
<td>More than $1 million, but not more than $5 million</td>
<td>28 percent</td>
<td>40 percent, with a minimum tax</td>
<td>40 percent</td>
<td>45 percent</td>
</tr>
<tr>
<td>More than $5 million, but not more than $10 million</td>
<td>28 percent</td>
<td>40 percent, with a minimum tax</td>
<td>40 percent</td>
<td>50 percent</td>
</tr>
<tr>
<td>More than $10 million</td>
<td>28 percent</td>
<td>40 percent, with a minimum tax</td>
<td>45 or 50 percent, but not specifically set out</td>
<td>50 percent</td>
</tr>
</tbody>
</table>

---

14 See Thompson, supra note 3.
15 The balance of this report focuses on the rate structure for married taxpayers filing jointly.

17 OECD, “Revenue Statistics 1965-2010” (2011). The OECD and other organizations commonly measure tax revenues as a percentage of GDP because that metric allows for an “apples to apples” cross-country comparison of taxes raised.
found “no correlation between cuts in top tax rates and average annual real GDP-per-capita growth since the 1970s.” They observed that “rich countries have all grown at roughly the same rate over the past 30 years — in spite of huge variations in tax policies.”

A recent article by the Center on Budget and Policy Priorities reached a similar conclusion based on a review of empirical studies. It found a lack of compelling evidence to support the assumption that raising taxes on high-income households would seriously harm the economy: “The literature suggests that if the alternative to raising taxes is larger deficits, then modest tax increases on high-income households would likely be more beneficial for the economy over the long run.” Further, in a September analysis of the relationship between tax rates and economic growth, the independent and nonpartisan Congressional Research Service found the opposite of the low-tax, high-growth proposition. Instead, it found that “higher tax rates are associated with slightly higher real per capita GDP growth rates,” elaborating as follows:

The top marginal tax rate in the 1950s was over 90%, and the real GDP growth rate averaged 4.2% and real per capita GDP increased annually by 2.4% in the 1950s. In the 2000s, the top marginal tax rate was 35% while the average real GDP growth rate was 1.7% and real per capita GDP increased annually by less than 1%. The bottom line is that the evidence does not support — and to an extent is contrary to — the proposition that lowering marginal rates will lead to an increase in economic growth.

One way to analyze this issue in economic terms is to consider a tax cut’s two potential effects on demands for labor: the substitution effect and the income effect. The substitution effect predicts that individuals will work more because they will have higher after-tax incomes. The income effect predicts that as after-tax income increases, individuals will work less and take more leisure time. In their leading text on economics, William Baumol and Alan Blinder summarize the empirical economic evidence on these two effects:

- the response of labor supply to wage changes is not very strong for most workers;
- for low-wage workers, the substitution effect seems clearly dominant, so they work more when wages rise; and
- for high-wage workers, the income effect just about offsets the substitution effect, so these individuals do not work more when wages rise.

A graph accompanying those conclusions depicts a supply curve for labor that is (1) upward sloping for low-income workers (that is, the more income these workers have, the more they substitute work for leisure); (2) vertical for most workers, meaning the income effects and substitution effects offset each other; and (3) downward sloping for high-income workers, meaning that higher wages are accompanied by lower work effort — that is, the income effect predominates. To maximize work effort and thereby promote economic growth, the policy prescription one can draw from this curve is clear: Federal income tax rates should be cut for low-income taxpayers (thereby causing them to put forth more work effort) and raised for high-income taxpayers (thereby causing them to put forth more work effort).

Indeed, it could be expected that my proposed 40, 45, and 50 percent rate structure for high-income earners would stimulate more work by these taxpayers and therefore promote both economic growth and deficit reduction. The rates I have proposed are far below the 83 percent maximum rate that Piketty and Saez conclude would cause the substitution effect to overpower the income effect.

7. Implementation of the Obama proposal. There was a significant increase in economic activity after 1993, when the top marginal rate was raised from 35 percent to 39.6 percent. I believe our economy would similarly benefit from an increase in the progressivity of the system along the lines the president has proposed.

However, to address the Republican-voiced concern that the last thing Americans need right now is increased taxes, Congress could avoid raising the total amount of taxes collected in the short term, while still increasing the progressivity of the system. That could be accomplished, temporarily, by giving low- and middle-income taxpayers a tax cut that in the aggregate would equal the total amount of the increase in taxes generated by reinstating the 39.6 percent rate for high-income taxpayers. Through the substitution effect, this policy would encourage more work by the recipients of the tax

---

19Piketty et al., supra note 18.
cut. At the same time, through the income effect, it would not decrease work efforts of those subject to the tax increases, and it would possibly increase them. This policy would also boost the consumption spending component of GDP because low-income taxpayers are more likely than high-income taxpayers to spend any tax savings they receive.\textsuperscript{23}

\section*{B. Capital Gains Rate}

\subsection*{1. Background.} As with the ordinary income tax rates, a historic perspective is necessary to fully understand Obama’s and Romney’s positions on capital gains. In 1999 capital gains were taxed at a top rate of 20 percent. So a taxpayer in the top marginal rate of 39.6 percent for ordinary income would also be subject to a 20 percent tax on capital gains. The top rate on capital gains was reduced to 15 percent under 2003 legislation.\textsuperscript{24} It was scheduled to revert to 20 percent in 2008; however, the 15 percent rate has been extended through 2012.

\subsection*{2. Proposals.} As explained in Treasury’s green book, Obama would restore the maximum capital gains rate to the pre-Bush maximum 20 percent.\textsuperscript{25} Romney would retain the Bush-era tax rate structure for capital gains. He proposes making the lower rates for investment income permanent and exempting investment income from tax for taxpayers with less than $200,000 of income.\textsuperscript{26}

\subsection*{3. Analysis.} In my view, the president is correct that the 20 percent rate should be reinstated after 2012.\textsuperscript{27} First, corporations do not get the benefit of a lower rate on capital gains; therefore, when corporations are making real investment decisions (such as decisions to buy a new plant or equipment), the individual capital gains rate has absolutely no impact. For that reason, it is highly unlikely that returning the capital gains rate to its level during the great boom of the 1990s would have an adverse effect on corporate investment, which is a big contributor to economic growth.

\textsuperscript{23}See for example, Policymic, “Tax Cuts for the Wealthy Will Not Stimulate the Economy, Government Spending on Infrastructure Will” (“Generally speaking, the lower a person’s income, the greater the percentage of that income they will spend quickly”). \textit{See also} Wikipedia, “Marginal Propensity to Consume” (“The greater a person’s income, the more of her or his basic human needs will have already been met, and the greater his or her tendency to save in order to provide for future will be”).

\textsuperscript{24}Although in his 2003 tax proposals Bush did not propose a reduction in the capital gains rate, in considering Bush’s proposal to eliminate the tax on dividends, the House decided to reduce the tax on both dividends and capital gains to 15 percent.\textsuperscript{26} Treasury, \textsuperscript{supra} note 4, at 72.

\textsuperscript{25}Romney, \textsuperscript{supra} note 8, at 41.

\textsuperscript{26}The following discussion comes from Thompson, \textsuperscript{supra} note 3.

Second, because a reinstatement of the 20 percent rate would reduce the deficit, it would likely help keep interest rates down, thereby promoting investment through a lower cost of capital for corporations. Finally, reinstatement of the 20 percent rate would not deter individuals from making financial investments in the stock market, which they did with a passion when the rate was at 20 percent during the late 1990s. Buffett said he has never seen anyone avoid an investment because of the tax rate on any potential gain.\textsuperscript{28}

\section*{C. Carried Interest}

Owners of private equity and similar companies receive part of their compensation as carried interest, which is taxed as capital gain. Buffett argues that carried interest should be taxed as ordinary income, not as capital gain.\textsuperscript{29} Obama is of the same view.\textsuperscript{30}

As an investor and manager of Bain Capital, a private equity firm, Romney has benefited greatly from carried interest. It has helped make him a very wealthy man with an effective tax rate of less than 15 percent. Before his 2012 presidential campaign, Romney opposed increasing taxes on carried interest; however, his position has since become unclear.\textsuperscript{31}

In my view, the case for taxing carried interest as ordinary income is beyond compelling because it is, in substance, compensation for services. Even Bill Kristol, head of the conservative \textit{Weekly Standard}, has said that the rate on carried interest should go up.\textsuperscript{32}

\section*{D. Dividends}

\subsection*{1. Background.} In 1999 dividends were taxed like any other type of ordinary income, and the maximum individual tax rate was 39.6 percent. The maximum corporate tax rate was 35 percent, as it is today. Consequently, if a shareholder was in the top 39.6 percent bracket for ordinary income, the combined tax rate on dividends would be 60.74 percent.

For example, assume that a corporation has $100 of taxable income. With a tax rate of 35 percent, the tax is $35, leaving $65 after tax. If all the $65 of after-tax income is distributed to an individual shareholder who is subject to the 39.6 percent maximum rate, the tax will be $25.74. Thus the combined corporate and individual taxes would be $60.74, which is 60.74 percent.

\textsuperscript{28}Buffett, \textit{supra} note 5.

\textsuperscript{29}Id.

\textsuperscript{30}Treasury, \textit{supra} note 4, at 134-135.

\textsuperscript{31}Charles Riley, “Romney’s Confounding Position on Carried Interest,” CNN Money (June 18, 2012).

COMMENTARY / VIEWPOINTS

Although this 60.74 percent rate is a theoretical possibility, as a practical matter it is rarely applicable, particularly for closely held businesses. Those businesses are usually organized as partnerships, S corporations, or limited liability companies, which are not subject to the corporate-level tax. So the maximum rate on the owners of those entities is generally the top marginal individual rate.

In his 2003 tax proposals, Bush recommended eliminating the tax on dividends. Congress responded in the 2003 tax act by temporarily reducing the maximum rate on both capital gains and dividends to 15 percent. Although the 15 percent rate on dividends was scheduled to revert to the maximum marginal rate on ordinary income in 2008, the 15 percent rate has been extended through 2012.

The House report to the 2003 act explains why Congress initially adopted the 15 percent rate for dividends: “Reducing the individual tax on dividends lowers the cost of capital and will lead to economic growth and the creation of jobs. Economic growth is impeded by tax-induced distortions in the capital markets. Mitigating these distortions will improve the efficiency of the capital markets.”

2. Proposals. Obama proposes to restore the ordinary income tax treatment of dividends for upper-income taxpayers by allowing the current reduced tax rates on qualified dividends to expire in 2012 for income that would be taxable in the 36 percent or 39.6 percent brackets. Romney would retain the current 15 percent maximum rate on dividends. He would also exempt dividend income of taxpayers with less than $200,000 of income.

3. Analysis. In a 2003 article, I showed that while low-bracket taxpayers are overtaxed on corporate dividends and therefore should be given relief on dividend taxation, high-income taxpayers are generally not overtaxed on dividends. This may seem counterintuitive; however, there are many twists and turns in analyzing the taxation of dividends. For example, the effective corporate tax rate is generally less than 35 percent because corporations may receive specific tax preferences, such as accelerated depreciation. Also, dividends are not taxed until paid; thus, there is the possibility of deferring the shareholder tax between the time the corporation earns income and the time the shareholder receives the dividend. Moreover, if the shareholder holds appreciated stock until death, there is a step-up in the basis of the stock to its fair market value at death; therefore, the shareholder’s beneficiary can sell the stock and avoid both the capital gains tax and the tax on dividends.

My 2003 analysis shows that on average, after taking into account those factors and others, taxpayers in the 35 percent or higher brackets are not overtaxed on dividends. However, taxpayers in the lower brackets are overtaxed on average, which means there is a case for giving them dividend relief. I therefore agree with Obama in urging Congress to reinstate the taxation of dividends as ordinary income for taxpayers in the 35 percent and higher brackets.

E. Assessment of Romney’s Individual Proposals

On August 1 the Tax Policy Center published a paper analyzing the distributional effects of base-broadening income tax reform. Using the tax policy reflected in Romney’s individual income tax proposals as an example, the authors considered revenue-neutral reform’s competing goals of maintaining tax revenues, ensuring a progressive tax system, and lowering marginal tax rates. They found as follows:

Our major conclusion is that a revenue-neutral individual income tax change that incorporates the features Governor Romney has proposed — including reducing marginal tax rates substantially, eliminating the individual alternative minimum tax (AMT) and maintaining all tax breaks for saving and investment — would provide large tax cuts to high-income households, and increase the tax burdens on middle- and/or lower-income taxpayers. This is true even when we bias our assumptions about which and whose tax expenditures are reduced to make the resulting tax system as progressive as possible. For instance, even when we assume that tax breaks — like the charitable deduction, mortgage interest deduction, and the exclusion for health insurance — are completely eliminated for higher-income households first, and only then reduced as necessary for other households to achieve overall revenue-neutrality — the net effect of the plan would be a tax cut for high-income households coupled with a tax increase for middle-income households.

[^34]: Treasury, supra note 4, at 71.
[^35]: Romney, supra note 11, at 41.
In addition, we also assess whether these results hold if we assume that revenue reductions are partially offset by higher economic growth. Although reasonable models would show that these tax changes would have little effect on growth, we show that even with implausibly large growth effects, revenue neutrality would still require large reductions in tax expenditures and would likely result in a net tax increase for lower- and middle-income households and tax cuts for high-income households.38

Obama quickly used the report to claim that Romney’s tax policies were like “Robin Hood in reverse,” taking from the poor to give to the rich. The president referred to this as “Romney Hood.” Romney described the president’s charge as a bunch of “Obamaloney.”

In the first presidential debate, Romney said there are six studies that disagree with the Tax Policy Center study.39 Although his claim that he can reduce rates by 20 percent for high-income taxpayers and make up for the resulting revenue loss by eliminating tax expenditures has been challenged,40 he has stood by the claim. To get a better understanding of the competing claims, I have analyzed41 Romney’s claim, focusing only on the taxation of ordinary income.

The analysis shows, for example, that with a $50,000 cap on itemized deductions, the average joint filer with AGI between $1 million and $1.5 million would have a savings of 9.5 percent of the taxes otherwise due under the Bush tax cuts. The analysis also shows that with a $50,000 cap together with no limitation on mortgage interest or charitable deductions, there would have been a tax savings of 15.4 percent. The analysis further shows that under both limitations, taxpayers with more than $10 million of taxable income also get a significant tax cut relative to what would otherwise be due under the Bush tax cuts.

In the analysis, I conclude that “Romney cannot both (1) cut taxes on high-income taxpayers by 20%, and (2) make the cuts revenue neutral by limiting itemized deductions by either (a) $50,000, or (b) $50,000, but without any limit on mortgage interest or charitable deductions.”

F. Taxation of CFCs

1. The current system and two alternatives. To understand how the current deferral system operates, assume a U.S. corporation headquartered in Pennsylvania, State Oil Corp., sets up a subsidiary in China, China Oil Sub. Under our current deferral system and CFC regime, China Oil Sub’s active business income is not taxed when China Oil Sub earns the income, but it is taxed when China Oil Sub pays dividends to State Oil Corp. On receipt of the dividends, State Oil Corp. receives, within limits, a foreign tax credit against its U.S. tax liability for Chinese taxes paid by China Oil Sub. Some tax haven income earned by China Oil Corp., including passive income (subpart F income), is subject to immediate taxation in the United States.

A principal problem with the deferral system is that there is a tax incentive for a U.S. company to invest through a foreign subsidiary in a foreign country that has a low tax rate. As long as the income stays overseas, the higher U.S. tax is deferred. The reluctance of U.S. parent companies to repatriate earnings of foreign subs because of the U.S. tax that would be imposed on the repatriated earnings has been called the “lockout” or “trapped income” problem, which curtails investment in the United States.

Under a territorial system, State Oil Corp. would not be taxed on the business income earned by China Oil Sub either when the income was earned or when it was brought back to the United States in the form of dividends paid by China Oil Sub to State Oil Corp. This is the case regardless of the Chinese tax rate applicable to China Oil Sub.

A territorial system has an even greater tax incentive for a U.S. company to invest through a subsidiary in a foreign country that has a low tax rate, because the income earned will never be subject to U.S. tax, including when it is repatriated.

Under an imputation system, State Oil Corp. would be taxed in the United States on all the income earned by China Oil Sub, and within limits, State Oil Corp. would receive a credit against its U.S. tax liability for taxes China Oil Sub pays to China.

2. Arguments for a territorial system. In 2005 the President’s Advisory Panel on Federal Tax Reform suggested that the United States move to a
territorial regime. Many other groups (including the Republican-controlled House Ways and Means Committee) and individuals have made similar recommendations. The principal cited reason is to ensure that the United States remains competitive within the global marketplace. The argument is that a territorial system would make U.S. companies competitive with other companies doing business in, for example, China by subjecting the U.S. company’s Chinese operations to the same tax rate that applies to other companies doing business in China that are either Chinese-owned companies or subsidiaries of companies located in countries with territorial systems. I refer to that as the “horizontal” competitiveness claim, because it supports similar tax treatment for companies investing in a particular country.

The horizontal competitiveness claim is, at a minimum, overstated. For example, in his testimony before the Senate Finance Committee at the September 8, 2011, hearing on international tax issues, professor Reuven Avi-Yonah made it clear that the facts do not support this competitiveness claim: “There is no good data indicating that the effective tax rate faced by U.S.-based [multinational enterprises] is significantly higher than that faced by MNEs based in other OECD countries.”

Further, adoption of a territorial regime would create an unlevel playing field between business conducted in the United States and business conducted overseas. I refer to this as the “vertical” competitiveness problem, because it is a disparity between U.S. and foreign investment destinations. Bush’s tax reform panel and other proponents of territoriality do not address the vertical competitiveness problem.

3. Romney’s and Obama’s proposals. Romney supports the adoption of a territorial regime like the one proposed in 2011 by the Republican-controlled Ways and Means Committee.

Obama proposes modifying the current deferral system. To cut back on the benefits of deferral, he suggests the establishment of a “new minimum tax on foreign earnings — while repealing deductions for shipping jobs overseas and providing new incentives for bringing jobs back home.” Obama thus calls for “goodbye” tax penalties on U.S. companies moving abroad and “welcome back” tax benefits for U.S. companies returning their foreign operations to the United States.

4. Analysis. Congress should completely reject a territorial system and adopt a full imputation system. While the president’s minimum tax on deferral goes in the right direction, an imputation system would more completely eliminate the tax benefits realized from moving a U.S. business abroad. Also, with an imputation system, there would be no need for the “goodbye” tax penalties and “welcome back” tax benefits. From a tax perspective, there would be a level playing field between U.S. and foreign investment, which is all the tax system should be concerned with.

President Kennedy proposed the adoption of a full imputation system in 1962, but the proposal was rejected. Instead, Congress continued the deferral system for active income and enacted the CFC provisions, which provide for imputation of tax-haven-type income. An imputation system has been recently proposed by, among others, Stephen E. Shay, who served as Treasury international tax counsel for the first President Bush and deputy assistant Treasury secretary (international tax affairs) in Obama’s administration.

The lockout effect of the current deferral system would be eliminated with an imputation system because the earnings of a foreign subsidiary would be taxed when earned and not when distributed. Thus, it could be expected that foreign earnings would be deployed in the United States or a foreign country without regard to the federal income tax treatment of the investment, because foreign earnings would not be locked out of the United States.

Although some argue that a territorial regime would also address the lockout problem, a territorial regime creates a tax incentive for foreign over domestic investment, and that incentive will work against any repatriation. And while an imputation

---

45Romney, supra note 11, at 45-46.
system would reduce transfer pricing abuse, adoption of a territorial regime would increase that abuse because any allocation of income to a foreign subsidiary would eliminate forever any tax on the income.

Another benefit of an imputation system is the additional revenue it would generate. The Joint Committee on Taxation’s October 2008 tax expenditure report shows that only the allowance for accelerated depreciation for equipment produces a larger corporate tax expenditure (that is, reduction in tax liability) than the deferral provision.48 Thus, of the nearly 150 corporate tax expenditures covered in the report, only one produces a greater revenue loss than the deferral provision.

There is much debate over the number of U.S. jobs that would be shipped overseas if a territorial system were adopted.49 The bottom line is that the current deferral system acts as a significant subsidy for foreign investment, and the adoption of a territorial system would increase that subsidy. However, the adoption of an imputation system with a reduction in the corporate tax in the amount of the revenues gained from the adoption of the imputation system would clearly increase the attractiveness of U.S. investment to both domestic and foreign companies, and that increased investment would increase U.S. employment.

G. Conclusion

This article has summarized and analyzed the following tax policy issues in the ongoing debate between Obama and Romney: the structure of the individual tax rates, the taxation of capital gains and dividends, and the taxation of foreign business income. The article argues that the individual rate structure should be more progressive than the rate structure before the Bush tax cuts; the tax rates on capital gains and dividends should be returned to their pre-Bush rates; and an imputation system should be adopted for taxing foreign income, the revenue savings from which should be used to significantly lower the corporate tax rate. All those policy options would require Romney and his running mate, House Budget Committee Chair Paul Ryan, to violate their “no new tax” pledge to Grover Norquist’s organization.50

