Eric Solomon: Good morning everyone. My job this morning is to set the stage. Clearly, there's widespread agreement that the United States needs to reform our method of taxing businesses including corporations and various multinational corporations, the academics, the policy makers have been calling for reform of the US method of taxing international operations as well.

Until recently, the debate about tax reform has focused mostly on the corporate side and mostly on the international side, but in the negotiations about the fiscal cliff, the debate has moved into a discussion about individual taxation. Of course as Senator Hatch said, one of the 800 pound gorillas in the room is the fiscal cliff.

I'm not going to take the time now to talk about all the things that are scheduled to happen at the end of this year, but this slide shows you the many things that are scheduled to happen at the end of this year unless Congress and the president take action to address these issues. I do want to spend a minute just talking about some of the potential consequences if Congress fails to take action before year-end.

If Congress and the president fail to reach a resolution. First, income tax withholding will increase at the beginning of 2013. Payroll tax withholding will increase at the beginning of 2013. Also, because of uncertainty in the tax code, the filing season is likely to be delayed delaying refunds.

The question that I ask is what effect would this possibility and the spending cuts that result from sequestration have on the economy and the reason I asked that question of course is concern for the economy, but also as an issue that could affect the topic for our discussion today which is tax reform.

The question before us is is Congress and the president going to take action at the end of this year to extend various provisions and create a framework for solving our country's financial issues including spending and tax reform. One basic question that has been somewhat ambiguous in the public discussion at this point is is Congress going to enact a short-term solution?

If it enacts a solution? Will it be a short-term solution, perhaps a one year solution or a long-term solution? And again the answer to that question as well could affect our topic today which is tax reform. The outcome of the fiscal cliff events could have ramifications for tax reform including business tax reform.

As many have said, 2013 is perhaps the best opportunity for tax reform because once again in 2014 we move into an election cycle. Now as I mentioned, failure to address the fiscal
cliff could cause a downturn in the economy at least in the short term which could affect the chances for tax reform. If there's a downturn in economy, the concern of Congress may turn to stimulus as opposed to reforming our tax system.

In addition, if the fiscal cliff negotiations are not resolved in 2012, but continue into 2013; that could impact the timing of tax reform. If a fiscal cliff negotiation result in a longer term solution about important aspects of individual taxation. For example, the rates and deductions. A longer term solution that's more than a yearlong that could diminish the interest.

That could change the momentum around tax reform and for some that could diminish the interest in further reforming our tax system. Finally, the fiscal cliff events will set the tone for the next four years between the administration and Congress and between Democrats and Republicans.

There could be cooperation, there could be antagonism, there could be something in between. The fiscal cliff events that are immediately before us could very well have an impact on the possibility of tax reform in the future. Now before focusing specifically on business tax reform, I just want to take a minute and talk about some principles of tax system design because these principles are true not only for business taxation, but also for taxation in general.

First, what's the purpose of our tax system? I think we should start at the very beginning. What is the purpose of our tax system? The purpose of our tax system is to raise revenue to fund the government. Our tax code does a whole lot more things than just raising revenue for the government as we all know.

It serves many social policy purposes. One of the basic questions we have to ask ourselves about task reform is, okay, granted our tax code does serve various social policy purposes, but to what extent should it do so? That's going to be an important question in the debate about tax reform, generally in business tax reform.

What social policy purposes should be supported through our tax system? Many say our current system does too much in that regard. Let's talk for a moment about principles to consider in reforming our tax system. First of course, economic growth. Our tax system should encourage investments in highly productive activities.

But one question that I think we need to ask ourselves is how much can tax reform by itself increase economic growth. There are many other factors the government can affect that can increase economic growth. How much can tax reform by itself increase economic growth. Another thing we would want our tax system to do is minimize economic distortions not to favor one activity over another unless perhaps there are certain activities that are highly productive that we want to encourage.

We want to minimize economic distortions that encourage investments in less productive activities. As Senator Hatch said, we want our tax system to be simple and administrable and it's anything but that. Ask tax payers and ask the Internal Revenue Service. We want a system that's stable. Right now, we have many expiring provisions.

We have more than 50 expiring provisions. I don't want any more expiring provisions including the business provisions. As many companies are aware their provisions have
expired at the end of 2012. That affect businesses including in the international area. And finally, we want a tax code that's fair.

Now it challenges us to ask what exactly does that mean? What does fairness mean? Surely the press is playing a significant role in defining this term and in shaping public opinion, portraying large business is failing to pay their fair share of tax. Another question I want to ask at the beginning is why do we tax corporations in the first place?

In fiscal year 2012, corporate taxes were about $242 billion representing about 10% of federal revenues which are about $2.45 trillion. We're talking about 10% of the federal revenues when we talk about corporate taxation. It's interesting to note that how much emphasis is placed upon this portion of federal revenues, 10%.

Corporate taxation as we all know is distorted because of the double tax, the tax on profits at the corporate level and the second tax on dividends paid to shareholders. Why do we tax corporations? One reason we may tax corporations is they're a good source of collection of revenues. Another question we need to ask in considering tax reforms is who bears the corporate tax and in what proportion?

This question is important if you're going to reform the tax code and if you're going to reform corporate taxation, who actually is going to get the benefit of it? Who bears the corporate tax? Is it the owners of capital, is it labor or is it customers? As I said, this is an important question because if you change it, you affect who gets the benefit of improving our corporate tax system.

Recent research suggests that labor bears a larger share than before. Traditionally, the view has been that capital, the owners of capital bear most or of all the corporate tax but recent study seems to suggest that labor is paying a larger share than before. Let's talk about the drivers for business tax reform.

First, competitiveness. Again, I challenge us to ask what exactly does this mean? We use various terms in the tax reform debate but what do we mean when we use these terms? We talked about fairness, what exactly fairness means. Let's talk about the word competitiveness, what exactly does it mean?

There's an interesting paper this year that Eric Toter wrote about what competitiveness is. Some folks define competitiveness and I think it's a pretty good definition. It's something that increases the living standard of Americans. I think that's a pretty good definition of competitiveness but in terms of our tax system, how can a tax system have anything to do with it?

Eric Toter in his paper talks about competition at a more granular level. Perhaps when we're talking about competition, we talk about competition for inputs. We talk about competition over labor supply or capital or intangible capital or tax revenue or natural resources in an attempt to provide some context for what exactly competitiveness means.

Another driver for tax reform is certainty. As we all understand, standing here today how uncertain our tax system is, how uncertain our economy is. Uncertainty makes planning difficult and it affects decisions and one example of the effects of uncertainty is the amount of cash that companies are holding at the present time.
Because of the economic uncertainty, how do you invest? How do you make plans for the future if everything is uncertain? Finally, another driver for business tax reform of course is economic growth. Let’s just take a moment and talk about some of the proposals for business tax reform. First, President Obama issued a framework for business tax reform earlier this year.

Proposing a 28% corporate rate with a lower rate for manufacturing and then minimum tax on foreign profits. President Obama’s framework seem to suggest that the president would continue to support a worldwide system of taxing international earnings though it’s not absolutely clear from the framework.

What the framework does say is that the administration opposes a pure territorial tax system. Chairman Camp has issued an international tax reform discussion draft with a 25% corporate rate, a territorial system. In addition, very important to understanding Chairman Camp’s tax reform discussion draft is that there are various revenue raisers to make it revenue neutral, to make the proposal revenue neutral including an offshore earnings transition tax so all the money sitting offshore will be immediately taxed.

Various base erosion provisions and a limitation on interest deductions on US over leveraging. Chairman Camp’s international tax reform discussion draft has a 25% corporate rate, a territorial system, but is intended to be revenue neutral overall and we’ll come back to this concept of revenue neutrality and the important implications this has for business tax reform.

In addition, Senator Enzi has introduced a bill with the territorial system and Senator Portman previously indicated that he might introduce a bill and we look forward to the possibility of further discussions arising from particular bills. But as you can see, the discussions so far with regards to tax reform have focused mostly on the international side, on the business side.

The broader discussion of a tax reform about individuals again as I said is starting now on the individual side in the context of the fiscal cliff discussion. I would ask a question, can business tax reform move on its own? Can it move without individual tax reform? The American people support tax reform just for business.

They understand the importance, the economic importance of tax, business tax reform by itself. Certainly, discussions in the press portraying American corporations is not paying their fair share. I’m not sure that creates an atmosphere in which business tax reform can move on its own. Perhaps individual tax reform can provide the momentum for business tax reform.

Let’s talk about our current system and everybody knows our US statutory corporate income tax rate is high by international standards. There’s a lot of discussion about the effects of the high statutory rate and its effect on US investment. One of the questions as well as the statutory rate is as important as the effective rate.

We have a system that has a high rate. A high headline rate but there are many deductions and credits. Is the statutory rate really the most important thing or is it the effective rate? Certainly, if there are many deductions and credits, it affects different industries in a
different way. Another point is again we have a distorted system because we have two-tier taxation.

Dividends bear a second level of tax. Certainly, corporate tax reform would present an opportunity to address various biases on our tax system. For example, our current system encourages corporations to use debt because interest on debt is deductible. Some have suggested that the financial crisis in 2008 was in part encouraged because there was too much leverage in the systems because companies are encouraged to use debt by a system that gives deductions for interest.

In addition, our corporate tax system affects the choice of entity. Since 1986 reform, most companies don’t want to be in corporate form. Most companies want to be as tax as pass-throughs. Pass through entities, partnerships, LLCs and as corporations and sole proprietors are clearly a more favored choice for entity.

Certainly, much more favorable from a tax point of view than a double tax C corporation and that’s why we see so much business in the United States done through these kinds of entities. That raises a very important issue if we’re going to reform our tax system not that more than half of business income is earned through pass through entities and sole proprietorships.

If we’re going to consider corporate tax reforms, we have to consider the taxation of these flow-through entities. The final bias of the corporate tax reforms might be able to address is the fact that one of the current system with the double tax, corporations are encouraged to retain earnings rather than to pay dividends.

Let’s talk about global issues. Senator Hatch just talked about global issues at the end of his remarks. Global issues are very important. We know our economy has changes since 1962. Since much of the framework of our international tax system was put in place. Our current system is a modified worldwide system.

A deferral system in which US tax of active earnings of foreign subsidiaries is deferred until earnings are repatriated to the United States. If you have an active operation in a subsidiary in France, the income is taxed in France but it’s not taxed in the United States until it’s brought back.

The current system encourages companies to keep their money offshore. It’s a dis-incentive to repatriate foreign earnings. It’s the lockout effect that Senator Hatch mentioned. Now upon repatriation the US corporation can claim credits for foreign taxes previously paid on those earnings which helps prevent double taxation but what it results in companies keeping their money offshore unless they can do planning to maximize use of foreign tax credits then they bring the money back to avoid the 35% rate in the United States.

That’s our current system. Most of our trading partners have adopted the territorial system that exempts their corporation’s foreign earnings from home country tax. Now the UK and Japan recently adopted territorial system but it’s too early to know what the consequence is and the ramifications of the actions by the UK and Japan so they’re not yet good case studies for us.
As you know under a territorial system there’s little or no residual tax on the repatriation of dividends. There is concern in the United States by both Democrats and Republicans that a territorial system could further encourage you as companies to move their activities and income overseas where it wouldn’t be subject to tax when it’s repatriated.

Particularly, an incentive to move income and activities to lower tax countries and that’s why the Obama administration opposes a pure territorial tax system and that’s why Chairman Camp’s proposal includes basic rules and provisions. There is a concern that if we move to a territorial system that there’ll be greater incentive for activities and income to move offshore.

The need to create protections against that and democrats and republicans appear to agree. One of the most significant things in corporate tax reforms is lowering the US corporate tax rate. Perhaps in my view, that’s the most important thing. If we’re going to reform our corporate tax system to lower the rate because lowering the rate would increase incentives for US and foreign companies to invest in the United States and it would make United States a more attractive location for inbound investment as well as more attractive as a headquarters location for multinational corporations.

Lowering the rate would encourage investment by US corporations, would encourage investment by foreign corporations into the United States and it will encourage more multinational headquarters to be placed in the United States. There appears to be a consensus forming around reform of business taxation.

I see six elements in the consensus that it appears to be forming around business taxation. First, as I said, I think there’s a consensus about lowering the corporate tax rate. It will increase the investment in the United States and would have other benefits as well. It would reduce the incentive to move the activities and income offshore and it would also reduce the incentive to use debt financing.

The first item is lowering the corporate tax rate which I believe to be perhaps the most important. Second, there appears to be a consensus about broadening the tax base. As I mentioned, because so much business in the United States has done through pass through entities and sole proprietorships, if we were to lower the rate and broaden the base, does that mean we would lower the rate and broaden the base with regard to business income earned by pass-through entities and sole proprietorships?

If we’re going to lower the rate and take away corporate tax preferences, we will lower the rate on income earned by pass-through entities and we would broaden the base because again you don’t want to create a distortion if you’re going to reform corporate taxation. You don’t want to create distortions with regard to the taxation of income earned through pass-through entities and sole proprietorships so that’s an important issue.

Third, and this is extremely important as well. I think there’s a consensus forming about revenue neutrality. You know exactly what revenue neutrality means. I’m not going to take the time now and the brief time I have to have a discussion about baselines and figuring out what revenue neutrality exactly means.

I will ask the question though, can the federal statutory corporate income tax rate be reduced on a revenue neutral basis low enough to be comparable to the rates in other
countries if we're competing with other countries? If the statutory tax rate is important in that competition, can we lower our rate low enough on a revenue neutral basis to be competitive to be comparable to the rates in other countries?

Roughly, revenue estimators have said a 1% reduction in the federal corporate tax rate costs about $100 billion over 10 years. If we eliminate all corporate tax expenditures, including accelerated depreciation, which many believe is extremely helpful, how low can we lower the corporate tax rate maybe to 28% and is that enough?

The 2007 Treasury study suggested that if you take away all corporate tax expenditures you can get the rate down to about 28% or 27%, is that low enough? Would it be necessary to consider and acting additional corporate revenue raisers? Some have suggested limitations on interest deductibility. You have to take into consideration well which preferences, which corporate preferences are really worthwhile to take away?

For example, take away accelerated depreciation, that can have a countervailing negative economic effect. Can we get the rate down enough on a revenue neutral basis? The point that it maybe revenue neutral is a very important constraint. I'm not going to take the time to try to define revenue neutrality.

There is some discussion even about how is revenue neutrality defined in terms of international tax reform, should that be revenue neutral? Should corporate tax reform be revenue neutral? Should individual tax reform be revenue neutral? All of these separate baskets and each one has to be revenue neutral?

Initially there was a debate about how revenue should be measured. Static scoring versus dynamic scoring. Our current system which is a static system takes the forecast underlying the CBL baseline including nominal GDP and certain other aggregate figures as given. Whereas dynamic scoring would take these factors into account.

Now certain behavioral effects are taken into account in static scoring but as I said, certain aggregate figures are taken as given so there's a debate even about how to do scoring. The fourth area in which there appears to be consensus is to include base erosion provisions. There are concerns about the movement of activities, income and jobs offshore.

There’s concern about transfer pricing. The transfer of pricing provides an opportunity to move income offshore. There’s large concerns about intangibles. Under any tax system there are significant difficulties in taxing the income from intangibles. How do you source the income? That’s a basic question.

One example of where we see this issue becoming increasingly important is cloud computing. The issues surrounding cloud computing, how do you source it? What country has first rights to that income? Are there risks of double taxation where more than one country claims rights to tax intangible income?

The fourth area of consensus is to include base erosion provisions. The fifth area of consensus is to deal within the current tax system. As of present, the debate has not moved to other kinds of taxes to say oh, perhaps we can bring tax rates down. We can achieve economic growth by considering other revenue sources like VAT.
As of now there’s a self-imposed constraint that we should not consider a consumption tax or VAT. The final point which I put a question mark by, the final point is moving to a territorial tax system. I put a question mark by that because I think there is going interest in moving towards a territorial system as Senator Hatch said with certain safeguards.

But I’m not sure the consensus is complete at the present time. I think the debate still continues as to whether we should move to a territorial system particularly because of the concern about the movement of activities income and jobs offshore and whether moving to a territorial tax system would encourage that.

When I look at the elements of the consensus that appears to be forming about reforming business taxation, a lower corporate tax rate, broadening the tax base, revenue neutrality, inclusion of base erosion provisions, dealing within the current income tax system and then a question mark by moving to a territorial system.

Now let’s spend the last few minutes just talking about possible tradeoffs in business tax reform. With the constraints that appear to be imposed with regards to business tax reforms, it appears that winners or losers will occur. There will be winners and losers especially if a forum is revenue neutral.

I think the business community is starting to realize that there may be winners and losers if we move forward on business tax reform. That doesn't mean we shouldn't but I do believe that there is an increasing realization that there will be winners and losers. In addition to possible tradeoff is corporations versus pass-throughs.

Again, approximately half of the business income in the United States is earned by pass-throughs and sole proprietorships and therefore if we’re going to consider reforming taxation of corporations, we need to consider reforming taxation of pass-throughs. I don’t think you can do one without the other.

Third, tradeoffs between multinationals versus domestics. Only corporations, multinational corporations. In addition to desiring a lower rate may desire moving to a territorial system whereas domestic only corporation may be more interested in lowering the rate.

Outbound versus inbound companies. Outbound companies may have a big interest in moving to a territorial system. Inbound companies may have an interest in the taxation of US subsidiaries and they may have differing views. Capital intensive versus labor intensive versus financial services companies, this goes to the point that we’re going to take away various tax expenditures like depreciation.

That would harm capital intensive companies, but lowering the rate would have benefits for labor intensive versus financial services companies. So in choosing how to broaden the base; one has to decide what differential impact it will have on various industries and if we are concerned about manufacturing in the United States, if you’re going to take away various incentives to lower the rate, what effect will that have on capital intensive industries?

Also different effects within the same industry, new businesses, old businesses. Specific incentives versus rate reduction. Again, this is a theme I’ve been talking about. Rate reduction is highly desirable, but various companies perhaps would be fine with the current
system that provides specific incentives. And then, being optimistic as I generally am, when we get there to tax reform, are transition rules.

What will the transition rules be? Are we going to have an immediate effective date which will bring us more quickly the economic benefits or will there be a gradual transition? One example of an area you’d have to consider transition is for example, in depreciation, if the property is placed in service before the effective date, what rules are you going to apply to that property previously placed in service after the effective date of the provision?

Transition is a huge issue. Of course the debate at this point has not gotten through transition. Finally, although the current debate isn’t talking about alternative tax systems, perhaps we should be considering it. To allow lower rates or to raise revenue should another revenue source be considered?

Now both of that or another kind of consumption tax or carbon tax have been suggested as candidates for additional revenue base. I’m going to use this as a segue to the later discussions, but I just put on the table should a consumption tax or some alternative tax be considered either as an additional tax to help lower rates or as a substitute for the corporate income tax?

At least a couple of proposals will be discussed today. A business activities tax might be raised. That was discussed in a 2007 Treasury study. Perhaps JD perhaps may talk about an X tax and there are various other proposals. I put the question on the table whether we need to consider alternative tax systems either as an add-on or perhaps even as a substitute for the corporate tax.

An alternative tax system that might help us lower rates and achieve economic growth. With that, setting the stage, I will conclude my remarks and I thank you very much.

C. Fred Bergsten: ... Can you take a few questions?

Eric Solomon: Sure. I’m running up on time though. I don’t want to take Alan’s time.

C. Fred Bergsten: No. Are there other questions from the audience? …

Eric Solomon: Oh, from Clay Lowry.

Clay Lowry: Thank you Eric. I’m Clay Lowry. [Inaudible 0:33:10.5]. I’m actually very interested in the corporate side, but since this[Inaudible 0:33:18.5] two implementation questions. One is you double up with the IRS, with all the changes that can potentially be happening in a very short period of time, how hard or difficult is it for the IRS to actually do the implementation?

With [Inaudible 0:33:40.1] rates the AMT is actually 2012 tax [Inaudible 0:33:43.7] tax. Second, more Machiavellian, but you would know that this Secretary Geithner from my understanding is actually allowed to basically—if there’s no deal done by December 31st, he is actually allowed to talk to the IRS don’t implement it.

I guess the question comes out of there. How long would you do that and if there’s—maybe there’s no limit and then secondly, is there some sort of a hurdle maybe it’s an in-
Eric Solomon: I'll briefly address both questions. The first question is the administration question. It's extremely difficult for the IRS to adjust in a situation where it's uncertain what the law will be. The IRS has had this situation. In fact, at the time that we were at Treasury in 2007 with regard to the AMT, not knowing as the year closed whether or not there would be an AMT patch for that year.

The IRS has to make a very difficult decision how it's going to program its computers. At the present time, the IRS is, as I understand, it is programming its computers for the tax return filing season beginning in January of 2013 for 2012. The IRS has to make a decision how it's going to program its computers whether there's going to be an AMT patch or not an AMT patch and it has to choose one or the other.

In addition, there are various of other provisions. There's interaction with various other provisions that the IRS needs to deal with so it's extremely difficult for the IRS and what happens is if they don't make the right guess, then what happens is that the filing season gets delayed and it may be delayed in any event as this moves forward. The difficulties for the IRS are enormous and the IRS has, in the past, done a great job in being flexible so that's point number one.

The second you asked is regarding withholding tables. What makes the withholding tables difficult, and again, I'm not an expert in this area of but what makes it difficult, as I understand it, there is some flexibility for the Treasury Department to change withholding tables and I believe maybe 20 years ago there was a change of withholding tables, but I believe 20 years ago the change of withholding tables was to actually to better reflect what was going to be the tax rate on individuals.

This situation is a little bit different this situation is trying to guess what the law is going to be. Even if the Treasury Department has the power to change withholding tables, I think it would be a very difficult decision to make because you would be guessing with regard to what the law is going to be and of course if you guess wrong what happens is there's perhaps too little withholding and then tax payers are going to be subject to more taxes later.

I think whether they have the power, I do believe there may be some power, but again it would be a very difficult decision whether or not to use that authority to do so.

C. Fred Bergsten: Let's take one more question. Is there anyone? Scott.

Scott Miller: Thank you. I'm Scott Miller of CSIS. Very helpful overview presentation. The one thing that from both of your comments and Senator Hatch's comments is there seems a little awareness of the political economy of the United States versus other countries' taxation system. We know that governors like the governor of Michigan is very attuned to the right to work laws passed in Indiana recently and it was part of the political calculation in Michigan's actions yesterday.

Yet, nobody in Washington seems to understand that Canada as an example has a 15% corporate tax rate and territorial system and you have CEOs like John Chambers of Cisco
Systems saying the best place in the world to locate a business is Canada and that used to be something that people here or take as maybe an insult, but it seems to be totally ignored.

Can you comment on how that atmosphere will hinder or help corporate tax reform?

Eric Solomon: I think it would help corporate tax reform because over time we will learn. We may be slow learners, but we will learn. I also think that—and this may take longer than we would like as the younger people who were more used to in my view of understanding that the global world, they’ll become more appreciative of the interactions we have with other countries but I think we’re learning in a maybe slow education process.

Just to add to your point, the fiscal cliff is not just about the United States. There are many countries around the world including for example Canada, Europe, everyone is looking to us because how we deal with the fiscal cliff is going to affect the economies of countries around the world. Not only do we have to learn from them, but we have an effect on them as well.

There are really two points, but I’m optimistic that by continuing to see other countries, how they’re dealing with their international taxes and including lowering the rates that we will be forced in some ways to really comprehend that and address our corporate tax system.