The Washington Post

Why Companies Pay Less; [FINAL Edition]

Steven Rattner. **The Washington Post**. Washington, D.C.: May 18, 2004. pg. A.19

Full Text (988 words)

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The corporate tax bill winding its way through Congress has been widely criticized for its mountain of special-interest loopholes and other provisions. But the bill is just the latest example of why we need to have the same debate about the fairness of corporate taxes that we have been having about individual income taxes.

Over the past 50 years, the share of tax revenue coming to the federal government from business has collapsed, causing Warren Buffett to declare that "if class warfare is being waged in America, my class is clearly winning." In fiscal 2003 corporate taxes represented just 7.4 percent of federal revenue, down from 32 percent in 1952. The 2003 figure was especially low because of depressed corporate profits, but other measures paint a similar picture of a declining contribution. Corporate taxes as a percentage of our gross domestic product dropped to 1.2 percent in 2003, compared with as high as 6 percent in the early 1950s.

The question of whether American business is paying its fair share is particularly relevant at the moment. Corporate profits are booming -- in part because of lower tax rates -- and a higher share of the benefits of this recovery has gone to business (as opposed to workers) than in any recovery since World War II, according to a recent Northeastern University study.

Like anything that has to do with taxes, the reasons for this dramatic decline are complex and multifaceted. At the top of the list: the increasing sophistication of large multinational corporations in managing their tax obligations, particularly by shifting profits to countries with lower tax rates. Companies employ mechanisms for moving these profits, particularly within the murky zone of "transfer prices," the rates at which the various subsidiaries of a company exchange goods and services around the world. By keeping these transfer prices high in low-tax countries and low in high-tax countries, companies can generate more of their profit in places with lower taxes.

One recent study by Tax Notes found that subsidiaries of U.S. corporations operating in the top four tax havens (the Netherlands, Ireland, Bermuda and Luxembourg) had 46.3 percent of their profits in those countries in 2001, but only 9 percent of their employees and 12.6 percent of their plant and equipment.

As globalization mushrooms, the proportion of business being conducted internationally also grows, and with it comes more opportunity to manage taxes.

Complex rules attempt to limit this shifting of profits, but even the Bush administration has conceded that attention is needed. In 2002, Pamela Olson, then assistant secretary of the Treasury for tax policy, told a House committee during testimony about transfer pricing that "the inappropriate income shifting that results can significantly erode the U.S. tax base."

Companies have become emboldened to push the edges of the tax system in part because enforcement has become lax. According to a recent study by a Syracuse University research organization, the audit rate for the 11,200 largest corporations has fallen by nearly half over the past decade.

And while most companies are operating within the boundaries of the tax code -- at least as they interpret it -- abuses certainly occur. In a September 2002 report, then-IRS Commissioner Charles

Rossotti identified corporate tax shelters as "one of the most serious and current compliance problem areas."

Finally -- but by no means least -- the Bush tax cuts have also contributed to this drop, particularly the dramatic acceleration of depreciation schedules that now allow businesses to immediately deduct from their taxes 50 percent of their investments in plant and equipment, which previously had to be written off over a much longer period.

Some argue that the United States taxes business more heavily than do other nations, creating a different competitive disadvantage: a global one. But apart from the tax havens, with their exceptionally low rates, those statistics are at best ambiguous. What seems clear is that multinational companies that have worked hard to game the system have garnered a special edge. Thus, fixing the U.S. corporate tax system would be particularly helpful for domestic and other corporations that pay closer to the sticker rate of 35 percent. Those businesses are competing in the U.S. market at a disadvantage against companies paying much lower rates. The playing field needs leveling.

So what to do about corporate taxes? A conventional approach would focus on better enforcement and closing loopholes. Both are a part of the budget that President Bush proposed this year, but progress on either has yet to be visible.

Then there are less conventional ideas that recognize that a globalized world requires a more globalized approach to tax policy. Martin Lobel, a Washington tax lawyer and chairman of Tax Analysts, favors solving the transfer pricing problem by taxing multinational corporations on the basis of where their operations are rather than where they declare their profits.

Another creative approach would be to tax corporations according to the income they report to their shareholders rather than the lower taxable income that they calculate after including the extra deductions, such as accelerated depreciation, that are available to them. Finally, for American companies to be treated fairly, reforms are needed to World Trade Organization rules on global taxation, such as those regarding value-added taxes.

Raising the question of corporate taxes is not populist or anti- business or redistributionist. No one can want to put American business at a competitive disadvantage. We all should be rooting for American business to produce strong profits and, when necessary, tax policy should help.

But the goal of any tax system should be to distribute the burden fairly. That could well mean lower taxes for small business and domestic corporations that are penalized by the current rules. At a moment when corporate profits and the federal budget deficit are soaring, a constructive reexamination of corporate taxation can't be a bad idea.

The writer is managing principal of Quadrangle Group LLC, a private investment firm.

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Section: *EDITORIAL*
ISSN/ISBN: 01908286
Text Word Count 988

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