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COVID-19 and US Tax Policy: What Needs to Change?

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1. Introduction

The COVID-19 Pandemic already feels like a historical turning point akin to Word Wars I and II and the Great Depression. It may signal the end of the second period of globalization (1980-2020) and a change in the relative positions of the US and China. It could also lead in the US to significant changes in tax policy designed to bolster the social safety net which was revealed as very porous during the pandemic.

In what follows I will first discuss some short-term effects of the pandemic and then some potential longer-term effects on US tax policy.

2. Short-Term Changes

The CARES act, which passed unanimously through Congress in March, enacted some significant modifications in tax policy. In particular, the CARES act relaxed limits on the use of net operating losses by individuals and corporations, permitting 2020 losses to offset 2015 to 2019 profits.[1] It also relaxed the limits on interest deductibility.[2] It remains to be seen whether these changes will become permanent. During the last time the US underwent a pandemic, the "Spanish flu" of 1918-19, it enacted major changes to the corporate tax (the first tax-free reorganization provision, percentage depletion, and the foreign tax credit) that are still with us over a century later.

In my opinion, another change is needed, which might be considered in 2021 if the Democrats win in November. That change is to enact an excess profits tax on corporations that benefit from the pandemic.

At a time when most American citizens and businesses suffer catastrophic economic damage from the Coronavirus Recession, some corporations such as Amazon, 3M, Gilead, and Zoom see their profits rise dramatically because of the pandemic.

[1] The extension of the carryback period beyond 2018 means that these losses can be deducted against a 35% rate (instead of 21%) as well as eliminate the one-time repatriation tax of 2017 (which was the price the multinationals were supposed to pay for future tax-free repatriations). This is having your cake and eating it too with a vengeance. Corporations even get to elect whether to apply the losses against the repatriation tax or the regular tax, whichever is higher.

[2] Allowing a deduction for interest and at the same time an exemption for offshore profits is a classic tax arbitrage that implies negative tax rates on amounts not subject to GILTI.

Given that most corporations are losing money but some are now earning excess profits due to the crisis, it is time to revive the wartime excess profits taxes that the US deployed in WW1 and WW2 to prevent the winners from achieving this form of opportunistic unjust enrichment.

The most recent US excess profits tax was enacted even before the US entered WW2. It was first adopted in 1940, amended in 1941, 1942, 1943, and 1945, and repealed in 1950.[3]

Excess profits taxes are designed to tax the proportion of profits that derives from some external event not of the taxpayer's making. The US excess profits tax was adopted by Congress to "syphon off war profits." It was intended both to address direct profits as well as indirect profits resulting from the war, and the tax rate was set at 95%. This made the definition of normal profits crucial, since those profits would only be taxed at the regular corporate rate (currently 21%). Any profit above normal profit was deemed to be excess profits.

The calculation of the excess profits tax base began not with gross income but with net income as shown on the corporate tax return. This number was then reduced to create "excess profits tax net income." The reduction removed certain items like long-term capital gains and losses, income from discharge of indebtedness, and income from recovering bad debts incurred before the war.

"Excess profits tax net income" was then used to calculate the "excess profits tax credit," which was designed to remove normal profits from the tax base. There were two methods used to calculate the credit: The "average earnings" method and the "invested capital" method.

The average earnings method of calculating the excess profits tax credit began by looking back at the years 1936, 1937, 1938, and 1939 (prior to the war) and determining a monthly base-period average income. The amount of the credit was 95 percent of the "average base period net income," plus 8 percent of the corporation's net capital addition (or minus 6 percent of net capital reduction). The result created a deduction from excess profits tax net income. The average base period net income was deemed to be normal peacetime profit and therefore not subject to the excess profits tax.

Alternatively, the invested capital method assumed that a fair return on invested capital is 8 percent on the first $5 million, 6 percent on the next $5 million, and 5 percent on

[3] The description of the excess profits tax is based on Nuccio, Timothy, Substance over Form: Creditability of the 1997 U.K. Windfall Tax as an Excess Profits Tax Under I.R.C. § 901 (July 1, 2012). Transnational Law & Contemporary Problems, 2013.

invested capital beyond $10 million. Calculating invested capital involved summing all of the cash and property invested in the corporation and all profits prior to the taxable year, then reducing that figure by "all the distributions that have been made to stockholders out of other than earnings and profits," plus 50 percent of current debt. This figure was then multiplied by a ratio of "inadmissible assets" to total current assets, which removes credit allowance for partially or completely tax-exempt assets (such as tax-exempt bonds and stock in corporations producing exempt dividends). The idea was that a "taxpayer should be entitled to a reasonable allowance on its invested capital before being subjected to the excess profits tax."

Finally, the sum of the excess profits tax credit, any carry-back or carry-forward of unused credits, and a de minimis exemption was deducted from excess profits tax net income. The result was "adjusted excess profits tax net income," which was taxed at 95%.

If Congress wanted to impose a modern excess profits tax, how should it go about it?

Given the diversity of the corporations that are likely to profit from the pandemic and the fact that most of them are not engaged in capital intensive activities, the tax should use the average earnings method based on 2016, 2017, 2018 and 2019.The rest of the WW2 methodology can be applied unchanged. Thus, one would for example start with the net income of Amazon for 2020, subtract a credit for average 2016-2019 earnings plus 8% of R&D (the main capital investment), and apply a 95% tax rate to the excess profits. The resulting tax can be reduced by credits for wages of additional employees hired in 2020 to encourage the winners to hire and pay well during the recession.

It is unconscionable that some corporations would profit from the current crisis while everyone else suffers. Moreover, the federal government will be spending trillions to save the economy, and much of this spending would benefit the winners since it will be spent on their services. There is no reason not to use this opportunity to revive the excess profit tax and apply it to profits that derive entirely from the pandemic.

3. Longer-Term Changes

In the longer term, significant changes to US tax policy are needed. In particular, the corporate tax needs to be significantly strengthened and made more progressive.

The basic problem is that the current US corporate tax is inadequate to deal with the increasing monopolization of the US economy, led by Big Tech (Facebook, Amazon, Apple, Netflix, and Google). Big Tech have clearly become for early 21st century America what Standard Oil, U.S. Steel, and the railroads were to early 20th century America: The embodiment of corporate power that enjoys a near monopoly on an important segment of economic activity.[4] Indeed, incumbent platforms (*i.e.*, Big Tech) can potentially abuse their monopolistic power in such manner that hinders the competitive process, stifles innovation, and harms consumer welfare.[5]

The corporate tax can limit corporate power in three ways. First, even a low rate corporate tax requires corporations to provide the government with detailed information about their activities that is hard to obtain without a corporate tax (e.g., it forces them to calculate profits per taxing jurisdiction, which they may not otherwise do). Second, potentially the corporate tax, like any tax, involves the power to destroy if the rate is high enough. The knowledge that this could happen may limit the aggressiveness of corporate management (i.e., in the case of the Big Techs, their founders). Third and most important, the corporate tax can be used as a regulatory device, with the effective rate being raised or lowered either for specific desirable or undesirable activities (e.g., maintaining or compromising privacy) or in response to an overall corporate social responsibility score.

I have previously argued that such regulatory uses are the only valid reason to have a corporate tax, since taxing shareholders is more easily accomplished by either taxing them directly (in the case of closely held corporations) or taxing them on the changes in the value of their shares (in the case of publicly traded corporations like the Big Techs).[6] We believe that corporate taxation may be a useful complement to antitrust enforcement in curbing the power of the Big Techs. Especially, corporate tax has a probability of making anti-competitive killer acquisitions less lucrative. It can also be used as a proper vehicle for regulating excessive monopolistic pricing, and might also reduce unwanted consumer data accumulation by large platforms.

Imagine a corporate tax, like the original corporate tax of 1909, that (a) does not include a dividend received deduction, (b) does not include tax-free mergers, and (c) does not permit consolidated returns. Such a tax would significantly limit the monopoly power of the Big Techs by not enabling them to acquire competitors or potential competitors (e.g., WhatsApp and Instagram for Facebook, Waze for Google) on a tax-free basis and limiting their ability to use the profits of those corporations to fund R&D at the parent level. Hence, corporate tax turns anti-competitive killer acquisitions to less lucrative.

However, such changes in the corporate tax may be too limited, too late, and would unnecessarily harm corporations with no monopolization potential (the same argument that was made against enacting a corporate tax to address the monopolization issue in

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[4] See e.g., Naomi R. Lamoreaux, *The Problem of Bigness: From Standard Oil to Google*, Journal of Economic Perspectives 33.3 (2019): 94-117.
[5] See generally, Kenneth A. Bamberger and Orly Lobel, *Platform market power*, Berkeley Tech. LJ 32 (2017): 1051.
[6] See generally Avi-Yonah, *Corporations, Society and the State: A Defense of the Corporate Tax*, 90 Va. L. Rev. 1193 (2004).

1909). This may be why the FDR administration, which believed in the regulatory power of the corporate tax, did not undo the 1920s changes in the 1930s.[7]

However, there may be another way of using the corporate tax to address the problem of abusing monopoly power and exploiting consumers. The current corporate tax is flat: "The amount of the tax imposed by subsection (a) shall be 21 percent of taxable income."[8] Before 2017, there was some progressivity in the corporate tax, but it only applied to small corporations (most of whom were not subject to the tax): A flat rate of 35% applied from taxable income of corporations over $10 million, and a surtax eliminated the progressive rate structure for taxable income above $15 million.[9]

The rationale for the flat corporate tax was that corporations do not bear the burden of the tax, people do, and therefore it was an inappropriate vehicle for redistribution because the incidence of the tax was not clear (it could fall on shareholders, on all capital providers, on employees or on consumers, depending on the economic model used).[10]

But if the corporate tax is conceived as primarily an antitrust device, then a sharply progressive corporate tax makes sense. The purpose of monopolization is to increase corporate profits. The more monopolistic a corporation is, the higher its profits are likely to be, and the purpose of anti-competitive mergers is to eliminate competitors that would decrease profits. Therefore, a highly progressive corporate tax (e.g., with top rates of 70% or 80% above a high threshold of e.g., $10 billion in annual profit) would tend to apply at the top only to monopolies. The more competition there is in an

[7] Steven A. Bank and Ajay K. Mehrotra, *Corporate Taxation and the Regulation of Early Twentieth-Century American Business* (2015).

[8] IRC section 11(b).

[9] IRC section 11(b), 2017: The amount of the tax imposed by subsection (a) shall be the sum of--

(A) 15 percent of so much of the taxable income as does not exceed $50,000,

(B) 25 percent of so much of the taxable income as exceeds $50,000 but does not exceed $75,000,

(C) 34 percent of so much of the taxable income as exceeds $75,000 but does not exceed $10,000,000, and

(D) 35 percent of so much of the taxable income as exceeds $10,000,000.

In the case of a corporation which has taxable income in excess of $100,000 for any taxable year, the amount of tax determined under the preceding sentence for such taxable year shall be increased by the lesser of (i) 5 percent of such excess, or (ii) $11,750. In the case of a corporation which has taxable income in excess of $15,000,000, the amount of the tax determined under the foregoing provisions of this paragraph shall be increased by an additional amount equal to the lesser of (i) 3 percent of such excess, or (ii) $100,000.

[10] For a recent discussion of the incidence issue and an argument that the corporate tax falls mostly on economic rents and is therefore born by capital see Edward Fox, "Does Capital Bear the U.S. Corporate Tax After All? New Evidence from Corporate Tax Returns." *J. Empirical Legal Stud.* 17, no. 1 (2020): 71-115; see also Power, Laura, and Austin Frerick. 2016. "Have Excess Returns to Corporations Been Increasing Over Time?" *National Tax Journal* 69 (4): 831–46. Given today's environment (expensing for equipment, some interest deductibility), this is probably even more the case under current law.

industry, the lower the likelihood of very high profits because the competition drives down profits. In 2018, all of the Big Tech had profits above $10 billion.[11]

In general, Amazon, Apple, Facebook, Google and Netflix all have high profit margins, especially if we disallow expensing R&D, which tends to reduce their taxable income and should not be expensed because it generates future profits, and tax them on worldwide profits so they cannot avoid tax by shifting profits offshore.[12]

Importantly, none of the Big Techs can easily escape such a progressive US corporate tax by "inverting" (i.e., expatriating to another, more friendly jurisdiction) because under existing law inversions are subject to an exit tax that would be prohibitively expensive for the controlling founders. As long as Messrs. Zuckerberg, Bezos, Brin and Page control the Big Techs, and as long as they do not want to pay 23.8% of their unrealized gains (i.e., tens of billions in tax each) to the IRS, the Big Techs are trapped. And if they were willing to pay the 23.8%, IRC section 7874 should be revised to treat an inverted corporation as a US corporation if it is managed and controlled from the US or if it merges with a smaller foreign corporation, as the Obama administration had proposed.

It can be also be claimed, that higher corporate tax rates solve the problem of the transfer of entire consumer surplus (or large portions of it) to the monopolistic platform itself. When tax rates are higher, larger portion of the surplus is transferred to the state and not entirely to the platform. In such case, the state can spend more on infrastructure, which in turn, benefits the public. Hence, in such case, the monopolistic

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[11] Apple's profit for 2019 was $59.5 billion, Amazon's $10.1 billion, Alphabet $30.7 billion, Microsoft $16.6 billion, Facebook $22.1 billion.
Infographic: How the Tech Giants Make Their Billions (2019). The other corporations that had profits over $10 billion in 2019 include other Big Tech (Intel, Micron), Big Banks (Chase, Bank of America, Wells Fargo, Citi, Goldman Sachs, Visa), Big Pharma (Pfizer), Big Oil (Exxon, Chevron), Big Telecomm (AT&T, Verizon, Broadcom), United Health, Boeing, and some major consumer brands (Johnson & Johnson, Home Depot, Disney, Pepsi). All of those enjoy some degree of quasi-monopolistic status. See
https://fortune.com/fortune500/2019/search/?profits=desc.

[12] On why we should not allow expensing for either physical or human capital see Calvin Johnson, *The Effective Tax Ratio and the Undertaxation of Intangibles,* 121 TAX NOTES 1289 (December 15, 2008) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1315477. On eliminating the exemption or lower rate for foreign profits see Avi-Yonah, "Hanging Together: A Multilateral Approach to Taxing Multinationals," in Thomas Pogge and Krishen Mehta (eds.), Global Tax Fairness, 113 (2016). Note also that 70% of US equities are held by tax exempt institutions or individuals (e.g., through retirement accounts), so that dividends are not taxed and increasing the corporate tax rate is the only way to effectively tax capital income (unless we abolish all these tax preferences). Leonard E. Burman, Kimberly A. Clausing, and Lydia Austin, ***IS U.S. CORPORATE INCOME DOUBLE-TAXED?,*** *National Tax Journal, September 2017, 70 (3), 675–706.*

platform is not the only party that benefits from the profits of the transaction, but rather the public at large.

Last but not least, higher tax rate can also deter large platforms from accumulating vast amounts of consumer personal data and exploiting it for their own profits.[13] Especially, a higher corporate tax rate on the resale of data, can render it less profitable and lucrative. In such way, the tax can potentially minimize unwanted consumer data accumulation by large firms and can reduce the probability of privacy loss.

Hence, Corporate tax can also reduce monopolistic behavior that exploits consumers directly.

The corporate tax was enacted in 1909 to regulate the trusts. Changes in the 1920s took away some of its original power. It may be too late to reverse these changes, but if we make the corporate tax sharply progressive, it can be used to regulate the Big Techs and punish anti-competitive behavior. In this way, we can recapture the original intent of the corporate tax.

4. Conclusion

The US government, like other governments around the world, is currently spending trillions of dollars to contain the immediate effects of the pandemic. In the longer term, much more spending will be needed to strengthen the US social safety net, which was revealed as uniquely porous among OECD countries and has led to many unnecessary deaths. Politicians are discussing universal health insurance as well as free public college education and a massive investment in infrastructure.

Al of this will require a lot of money. Some more revenue can be extracted from current taxes like the individual and corporate income taxes, as well as the payroll tax (there is no good reason to cap the payroll tax at the first $100,000 of income). But there are limits. We can have a very high corporate tax rate because that falls on rents, but the corporate tax is only 10% of total revenues, and the individual tax and the payroll tax (the remaining 90%) cannot be raised too high because that will discourage work.[14]

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[13] See also, Francis Bloch and Gabrielle Demange, *Taxation and privacy protection on Internet platforms*, Journal of Public Economic Theory 20.1 (2018): 52-66.

[14] The US used to have very high individual income tax rates (up to 94%) but nobody paid them in practice (the capital gains rate was always much lower) and expecting such rates to be effective now is a fallacy. In general the existing US social safety programs are more effective than the tax system in reducing inequality. See Avi-Yonah, Reuven S., The Parallel March of the Ginis: How Does Taxation Relate to Inequality and What Can Be Done About it? (February 9, 2014). U of Michigan Public Law Research Paper No. 385; U of Michigan Law & Econ Research Paper No. 14-003. Available at SSRN: https://ssrn.com/abstract=2392971 or http://dx.doi.org/10.2139/ssrn.2392971

Thus, in my opinion there is no escape: The US will have to join the rest of the world and enact a federal VAT.[15]

[15] For a recent report endorsing this proposal see William G. Gale, **Raising revenue with a progressive-value added tax (The Brookings Institution,** Tuesday, January 28, 2020); for my previous recommendations see Avi-Yonah, *Designing a Federal VAT: Summary and Recommendations*, 63 Tax L. Rev. 285 (2010).