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Options for Reforming the U.S. Corporate Income Tax

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Economists generally agree that economic rather than tax considerations should guide companies' decisions about how to organize and expand. Unfortunately, the corporate income tax often distorts these organizational decisions, making the economy less efficient as a result.

Tax-Induced Distortions

In the United States, businesses have been traditionally structured in three ways: sole proprietorships, partnerships or corporations. In recent years, however, hybrid forms such as S corporations and limited liability proprietorships and partnerships have also become common (See related "Fiscal Fact" at http://www.taxfoundation.org/publications/show/1477.html.)

With the exception of traditional C corporations, the income earned by these businesses is reported on the tax returns of the firms' owners—where it is subject to the individual income tax. Income earned by traditional C corporations is subject to tax by both the corporate and individual systems.

This double taxation results in corporate income generally being more heavily taxed than non-corporate income. This creates a situation where firm structure is sometimes chosen for tax reasons rather than because it makes the most sense economically. Moreover, under current law, corporations can deduct interest payments when calculating taxable income, but cannot deduct dividend payments. This creates an incentive for firms to finance projects using debt rather than equity.

The economic costs of these tax-induced distortions is estimated to be quite high. In 1996 the Congressional Budget Office reviewed a number of studies examining the efficiency losses associated with the corporate income tax and found that they probably exceed half of corporate receipts.

At first glance the solution to the problems created by the corporate income tax appears fairly straightforward: simply eliminate the corporate income tax and tax all income at the individual level. A major problem with this fix involves retained earnings, or income that is held by the firm rather than paid out to shareholders.

Because funds can be invested and earn interest, a tax paid this year is effectively more than the same nominal amount paid next year. Consequently, taxpayers have an incentive to delay payment of taxes. If the corporate income tax system were eliminated without any adjustment to the individual system, income could be sheltered from taxation as retained earnings in corporations. Such a system would also distort choices about firm structure since some firms, which would otherwise organize as sole proprietorships or partnerships, would organize as corporations so that they would have the ability to shelter income.

What Should Be Done

In order to move toward a system which treats all business income equally, tax experts have suggested that the individual and corporate tax systems be integrated. Under the most pure form, known as *full integration* or the *partnership method*, retained earnings would be attributed to shareholders, who would be required to pay taxes on this income. Such a system would help to ensure that both business form and decisions about corporate finance were made for economic rather than for tax reasons. It would also help to mitigate the problem of differences in effective tax rates across corporations.

Recent Proposals to Reform the Corporate Income Tax

The economic inefficiencies and high cost of the corporate income tax have not gone unrecognized by policy makers. Numerous proposals to reform or modify the corporate income tax have been discussed since the last major change in 1993 when the top corporate income tax rate was increased from 34 percent to 35 percent. Most significantly, talk of fundamental tax reform in 1996 led to several proposals to replace the corporate income tax with a value-added tax or other consumption-based tax.

Current tax reform proposals offer less, in terms of major corporate tax changes. However, some older proposals, dating back to at least 1992, call for the integration of the corporate and personal income.

Integration Proposal

A 1992 Department of the Treasury Report, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once*, has received renewed attention as one possible way to reform the existing corporate income tax. One of the report’s principal co-authors, Professor R. Glenn Hubbard, subsequently became the Chairman of President Bush’s Council of Economic Advisers. The general idea behind this proposal is to integrate the corporate income tax into the individual income tax structure. The report highlights three “prototypes” of integration of the corporate and individual income tax systems.[1]

Dividend Exclusion Prototype

Under the dividend exclusion prototype, dividends paid to corporate shareholders would be taxed only once, at the corporate level. Thus, individual shareholders would exclude their dividend income from their taxable income base. Capital gains attributable to retained earnings also would be excluded from taxation at the individual level.

Shareholder Allocation Prototype
The shareholder allocation prototype directly attributes a company's retained earnings to its shareholders, who receive a credit for corporate taxes paid on their portion of retained earnings. Dividends are excluded from the individual's income tax base, just as under the dividend exclusion prototype. Thus, the shareholder allocation prototype treats retained earnings and dividends the same. The shareholder allocation prototype suffers from extremely high administrative costs as each corporation must allocate its income, earnings, and expenses to each shareholder. The 1992 Treasury report estimates that these costs outweigh the benefits associated with the proposal.[2]

Comprehensive Business Income Tax (CBIT) Prototype
The CBIT prototype is a long-term plan to equalize the treatment of corporate debt and equity. In general, the CBIT prototype calls for a uniform tax, levied at the business level, and exemption from taxation of interest and equity income at the individual level. Corporations and non-corporate businesses would be taxed at the same, uniform rate. "In theory, CBIT would apply to all businesses, without regard to size or legal form of organization." As with the other prototypes included in the 1992 Treasury report, the CBIT would effectively eliminate the double taxation of investment income. A 2005 study by the Joint Economic Committee suggested the resulting economic gains from the elimination of double taxation could be substantial.[3]

Fundamental Tax Reform Proposals
Initial talk of integration plans in the early 1990s was one factor that led to discussion of additional tax reform proposals during the mid 1990s. Steve Forbes' campaign for President in 1996 put fundamental tax reform on the front burner of the public policy debate. Most proposals of this period included two primary goals: overall simplification of the U.S. tax code and the elimination of at least one—if not both—taxes on investment. As such, integration of the corporate and individual income tax was an inherent part of most fundamental tax reform proposals.

In January of 2005, President George W. Bush established an advisory panel to reform the Federal Internal Revenue Code. After conducting numerous hearings and generating considerable media attention, the commission's final policy recommendations were released in November of 2005.[4] However, there has been negligible interest in legislatively adopting the panel's two recommendations in the current legislative session of Congress. Nonetheless, optimism remains that the next Congress will address the recommendations from the President's Advisory Panel on Federal Tax Reform.

While these fundamental tax reform proposals put forth are not under active consideration by the Congress, the principles that underlie these plans continue to drive discussion of tax cuts and tax code complexity. Therefore, understanding the impact these proposals would have on businesses and investment income is helpful in analyzing potential changes to the corporate income tax. The President's Advisory Panel on Federal

Tax Reform proposed two reform options for the current tax code. These plans generally sought to broaden the corporate tax base, while lowering the rates and simplifying the system.

The Simplified Income Tax Plan (Plan A) would reduce the corporate income tax rate from 35 percent to 33 percent for small and medium-size businesses and 31.5 percent for large businesses with more than $10 million in receipts. The Panel further recommended allowing small businesses to deduct most purchases of assets in the current year, a provision commonly referred to as "immediate expensing."

While recommending lower rates, the Panel's Simplified Income Tax Plan would expand the tax base by eliminating all business tax preferences except for accelerated depreciation. Large businesses and business entities with less than $10 million in receipts that choose to report income as corporations would get a 100 percent exclusion for domestic dividends. Investors would also receive an exclusion of 75 percent for capital gains on the sale of corporate stock.

The Panel's Growth and Investment Tax Plan (Plan B) proposed a blended tax structure that included elements of a progressive consumption tax, while retaining some elements of capital income taxation. The Panel suggested a flat 30 percent tax rate on all business cash flow. It also recommended lowering the top individual tax rate for sole proprietorships to 30 percent. The Growth and Investment Tax Plan would allow all businesses to expense the cost of new investments immediately, instead of depreciating the assets over time.

Conclusion

The specifics of the corporate income tax have changed significantly over the past thirty years. Statutory and effective rates have increased and decreased. The tax base has narrowed and expanded. Collections have fallen and risen (see related "Fiscal Fact" at http://www.taxfoundation.org/publications/show/1478.html). And tangential statutes such as the creation of the S corporation structure and the imposition of an alternative minimum tax have complicated overall compliance and created additional economic inefficiencies. What has not changed is that the corporate income tax remains one of the most economically inefficient and burdensome taxes on the books. As the Joint Economic Committee noted, "The U.S. corporate tax system is a patchwork of overly complex, inefficient and unfair provisions that impose large costs on corporate business."[5]

Moreover, individual workers, consumers, and owners bear the economic cost of the corporate income tax, not corporations, which are merely legal entities. So, while corporations are responsible for physically complying with and paying the corporate income tax, individuals ultimately pay the price. The President's Advisory Panel on Federal Tax Reform once again raised the prospect of fundamentally changing our tax system. Fundamental reform of the corporate income tax would remove a major source of inefficiency from the federal tax code and support increased economic growth.

Footnotes

1. Department of the Treasury, Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once (Washington, D.C.: January 1992, p. 1).
2. Also see R. Glenn Hubbard in "Corporate Tax Integration: A View From the Treasury Department." *The* Journal of Economic Perspectives. Vol. 7, No. 1. Winter 1993.
3. United States Congress, Joint Economic Committee. "Reforming the US Corporate Tax System to Increase Tax Competitiveness," Washington, DC: May, 2005.
4. The final report of the President's Advisory Panel on Federal Tax Reform is available at: http://www.taxreformpanel.gov/.
5. United States Congress, Joint Economic Committee. "Reforming the US Corporate Tax System to Increase Tax Competitiveness," Washington , DC : May, 2005.

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