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Double-Taxing Capital Income: How Bad Is the Problem?

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Introduction

"Double taxation" is a common and often misused expression in tax policy discussions. It is not the number of tax layers that matters, but the total effective tax rate—that is, the percentage of each income stream taken as tax.

One of the best-known cases, and one of the most critical problems in public finance, is the double tax on capital income. Corporations pay the federal corporate income tax, and then with their remaining after-tax income, they pay dividends to their shareholders. Those individuals then must pay an additional, individual-level tax on those amounts.

The essential question is whether the resulting total tax rate on capital income from corporations is substantially higher than the rate on other types of income. There are several types of income that it should be compared to: income from sole proprietorships, partnerships, S corporations and other business entities that are by law exempt from the corporate income tax, and finally, wage income. Under an ideal income tax, all income would be taxed at the same rate.

In current law, the statutory federal rate on corporate income is 35 percent. In the simplest type of comparison, then, this corporate rate is added to the statutory rate on individuals' capital income, currently 15 percent, for a total tax rate of approximately 50 percent in the U.S., while it is significantly lower in many other nations (see Table 1).

Table 1. Overall Effective Statutory Tax Rate on Dividend Income by Rank in 2005

OECD Nations	Top Rate on Corporate Income Plus Individual Tax Rate on Dividends				Percentage Point Change 2000 to 2005
	2005		2000		
	Rate	Rank	Rate	Rank	
Japan	63.7%	1	64.5%	3	-0.8
Denmark	59.0%	2	59.2%	7	-0.2
Canada	56.1%	3	62.5%	5	-6.4
France (d)	55.9%	4	63.2%	4	-7.2
Switzerland (g)	54.7%	5	56.5%	10	-1.8
Germany	52.4%	6	60.9%	6	-8.5
Netherlands	52.1%	7	74.0%	1	-22.0
United States	50.8%	8	58.9%	8	-8.1
Spain	50.0%	9	52.7%	12	-2.7
Sweden	49.6%	10	49.6%	16	0.0
Ireland	49.3%	11	57.4%	9	-8.2
Korea	48.7%	12	44.6%	21	4.1
Australia (a)	48.5%	13	48.5%	18	0.0
United Kingdom (a)	47.5%	14	47.5%	19	0.0
Hungary (e)	45.4%	15	55.7%	11	-10.3
Italy	44.8%	16	45.9%	20	-1.1
Turkey	44.0%	17	65.0%	2	-21.0
Luxembourg	44.0%	18	52.2%	13	-8.3
Belgium (b)	43.9%	19	49.1%	17	-5.3
Austria	43.8%	20	50.5%	15	-6.8
Portugal	42.0%	21	51.4%	14	-9.4
New Zealand (a)	39.0%	22	39.0%	26	0.0
Finland (c)	37.8%	23	29.0%	29	8.8
Czech Republic	37.1%	24	41.4%	23	-4.3
Poland (f)	34.4%	25	44.0%	22	-9.6
Greece	32.0%	26	40.0%	24	-8.0
Mexico	30.0%	27	35.0%	28	-5.0
Norway	28.0%	28	28.0%	30	0.0
Iceland	26.2%	29	37.0%	27	-10.8
Slovak Republic	19.0%	30	39.7%	25	-20.7
Average	44.3%		50.1%		-5.8

(a) For Australia, New Zealand and the UK, all with a non-calendar tax year, the rates shown are those in effect as of July 1, April 1 and April 5, respectively.
(b) For shares issued before January 1, 1994, the (withholding) personal income tax rate is 25 per cent. The withholding tax is final, if the shareholder so chooses.
(c) Part of the dividends from non-listed companies is taxed as earned income. Since the highest marginal tax rate is higher for earned income than for capital income, the net personal tax in this table would not be zero for such companies.
(d) For companies not paying the CSB (Contribution Sociale sur les Bénéficies), the corporate income tax rates are 1.1 percentage points lower. Included in the rate in column 6 is the prélèvements sociaux (CSG,CRDS) of 11%, which is levied on distributed profits

(100). As shown in column 10, taxpayers only have to declare 50 per cent of the dividends that are grossed-up with the prélèvements sociaux that have been withheld at source. The tax base is further reduced by a part of the prélèvements sociaux (up to 5.8 per cent of the grossed-up dividends).
(e) Distributed dividends that exceed a threshold equal to 30 percent of the value of the share are taxed at the shareholder level at a personal income tax rate of 35%. For dividends below this threshold, the rate is 20 percent.
(f) Source for the information: KPMG's Corporate Tax Rate Survey and the IBFD European Tax Handbook.
(g) The corporate income tax rate includes the church tax, while the personal income tax rates excludes it.

Source: Organization for Economic Cooperation and Development

Firm Structure
To ensure that their businesses produce goods and services as efficiently as possible, managers are always seeking the ideal firm structure. Writers of tax law often interfere with this process to the great detriment of the nation's economic performance. A tax-minimizing structure is not necessarily an efficient business structure.

A significant transformation of firm structure has indeed taken place in the U.S. Businesses had traditionally been structured in three ways: sole proprietorships, partnerships or corporations. But in the past two decades, hybrid forms such as S corporations and limited liability partnerships--so-called pass-through entities exempt from the corporate income tax--have multiplied at a phenomenal pace (see Table 2).

Table 2. Growth of Non-Corporate Forms of Business, Selected Years 1980 - 2004
Millions of Tax Returns

Year	S Corporations	Partnerships	Business Schedules (C or F)
1980	0.5	1.4	11.4
1985	0.7	1.8	14.1
1990	1.5	1.8	16.2
1995	2.2	1.6	18.1
2000	2.9	2.1	19.4
2004	3.5	2.5	21.5

Sources: IRS, Tax Foundation Individual Tax Model

The taxable income (or loss) from these firms is reported directly on the tax returns of their owners; that is, it is "passed through" the business entity to the individual. There it is subject to the individual income tax. To see how this process works, consider the case of the sole proprietorship illustrated on the left side of Table 3.[1]

Table 3. Comparison of Corporate and Non-Corporate Taxation

Tax Calculation on Non-Corporate Income		Tax Calculation on Corporate Income	
Revenue	$ 10,000,000	Revenue	$ 100,000,000
Adjustments	$ 9,000,000	Adjustments	$ 90,000,000
Income	$ 1,000,000	Taxable Income	$ 10,000,000
Here, the business profit “passes through” untaxed to the individual		Corporate Income Tax	$ 3,500,000
		Tax Credits	$ 0
		Corporate Income Tax After Credits	$ 3,500,000
		Retained Earnings	$ 0
		Distributions to Shareholder	$ 6,500,000
Adjusted Gross Income	$ 1,000,000	Adjusted Gross Income	$ 650,000
Itemized Deductions	$ 20,000	Itemized Deductions	$ 20,000
Exemptions	$ 4,400	Exemptions	$ 4,400
Taxable Income	$ 975,600	Taxable Income	$ 625,600
Individual Income Tax	$ 314,711	Individual Income Tax	$ 93,840
Tax Credits	$ 0	Tax Credits	$ 0
Individual Income Tax After Credits	$ 314,711	Individual Income Tax After Credits	$ 93,840
Effective Tax Rate on Capital Income to the Individual	**31.5%**	**Effective Tax Rate on Capital Income to the Individual**	**44.4%**

Source: Tax Foundation

Taxation of Non-Corporate Income

First the individual reports the gross revenues that she has received from her business activities on Schedules C, E or F. In this simplified example it is $10 million. Then allowable expenses are subtracted, labeled here as “adjustments,” which amount to $9 million. Adjusted gross income, then, is $1 million.

The taxpayer is then allowed to exclude a portion of her taxable income through the use of deductions and exemptions. Here we will assume that the $1 million from the sole proprietorship was the individual’s only source of income and that she filed a joint return which claimed $20,000 in itemized deductions and four personal exemptions worth $4,400.[2]

This subtraction leaves the taxpayer with $975,600 in taxable income. This is then subjected to the individual tax rate schedule for a tax bill of $314,711. The effective tax rate on this type of income is therefore 31.5 percent. That is, the final payment divided by income before deductions and exemptions is 31.5 percent.

Taxation of Corporate Income
Now consider the case where income is produced by a business organized as a corporation (see the right side of Table 3). The income would be subject to two levels of federal tax. First the corporate income tax would be levied at rates ranging from 15 percent (income less than $50,000) to 35 percent (incomes over $18,333,333). Next, when the corporation disburses its after-tax profits to shareholders in the form of dividends, the income is taxed again at the individual level. Since 2003, income from qualified dividends has been taxed at 15 percent.

In the same way as the non-corporate business, the corporation subtracts its expenses from its revenues to arrive at income. This time, however, the calculation is performed on a corporate income tax return. In this case we will assume that the firm subtracts $90 million in expenses from $100 million in revenue to arrive at $10 million in income. This income is then subject to the corporate income tax for a tax bill of $3.5 million.

The firm can do two things with its after-tax income: it can hold onto it as retained earnings, or it can distribute it to shareholders in the form of dividend payments. To make the results comparable to the non-corporate case, we will assume that all income is distributed to 10 shareholders who are identical in all respects to the sole proprietor described above.

As before, each individual is allowed to deduct the $20,000 in itemized deductions and $4,400 in personal exemptions from his adjusted gross income. This leaves each of them with a taxable income of $625,600. This is then taxed at the 15 percent dividend tax rate for a total individual income tax bill of $93,840. When we sum the individual and corporate income tax bills, we find that this corporate-derived income faces an effective tax rate of 44.4 percent, nearly 13 percentage points higher than what similar income derived from a sole proprietorship faced.

Conclusion
The disparate treatment of income causes firms to organize or re-organize for tax reasons, usually in ways that make less sense economically. In the case described above, for example, it is easy to see why firms would organize as non-corporate entities rather than as corporations.

The economic cost 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.

If congressional tax-writers find corporate income tax collections to be too low, they should not conclude that the tax rate on capital income is too low, either at the corporate or individual level. Rather, they should observe that corporate collections will almost certainly never rise to their previous levels if new businesses continue to choose the tax advantages of organizing as non-corporate pass-through entities.

Footnotes:
[1] Similar results could be produced for the other forms of non-corporate businesses.
[2] The interaction of the Personal Exemption Phase-Out (PEP) and the phase-out of PEP itself results in a lower-than-expected amount of personal exemption.

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