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# SPECIAL REPORT

## The Corporate Tax Burden

### *Corporate Income Tax Collections Rise Despite Proliferation of S Corporations; Compliance Burden Remains High*

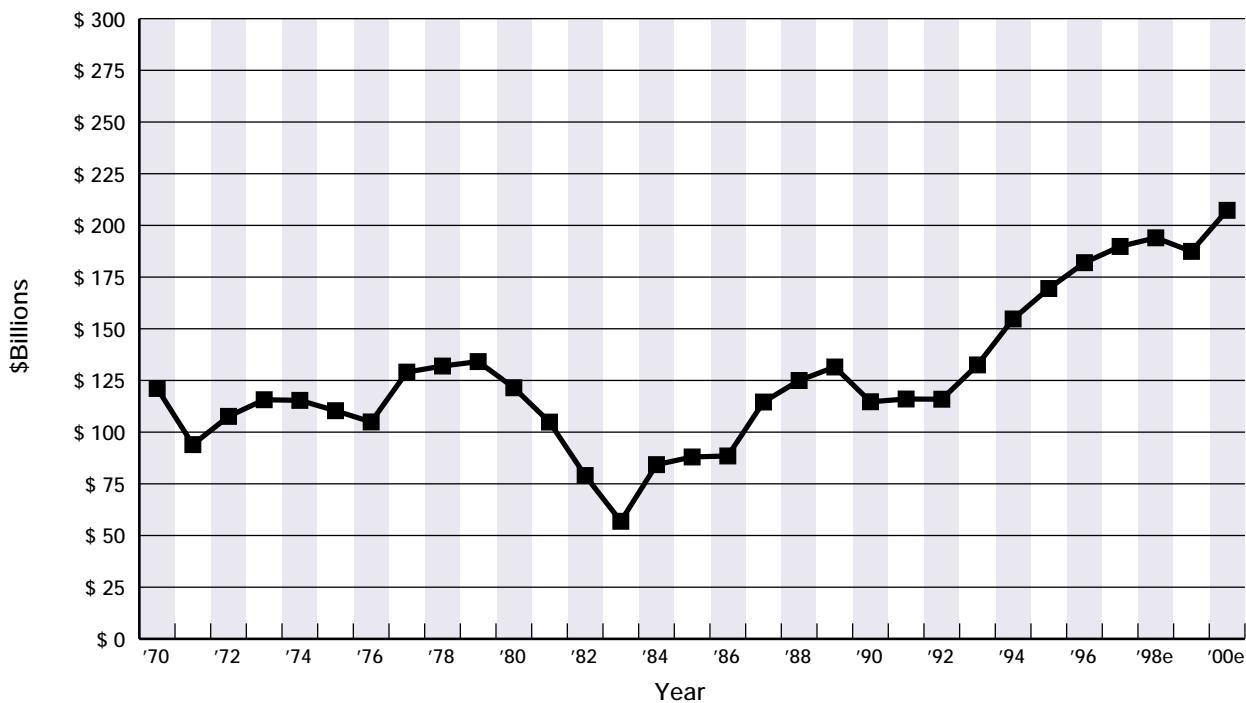
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#### Introduction

Several members of the Bush Administration, including Treasury Secretary Paul O'Neill and Council of Economic Advisors Chairman R. Glenn Hubbard, have mentioned their interest in corporate income tax reform. During an interview with the *Financial Times* in late May 2001, Secretary O'Neill stated, "So, it's not

just the direct amount of the [corporate income] tax, but the administrative cost of running the tax process through the businesses and corporations that we could effectively eliminate." Politically, reform, reduction, or elimination of the corporate income tax will be very difficult. Economically, however, O'Neill is exactly right, the corporate income

Figure 1  
Federal Corporate Income Tax Receipts  
Fiscal Years 1970-2000



Source: *Survey of Current Business*, Department of Commerce, and Tax Foundation calculations.

tax is one of the most burdensome and economically inefficient taxes in the code.

Fundamental reform of the corporate income tax deserves heightened attention given

## *Simplifying, lowering, or eliminating the corporate income tax would provide immediate relief for all Americans, remove one very significant source of inefficiency from the capital markets, and promote economic growth.*

the current economic downturn. Simplifying, lowering, or eliminating this burdensome tax would provide immediate relief for all Americans, remove one very significant source of

**Table 1**  
*Federal Corporate Income Tax Receipts  
Fiscal Years 1970–2000  
(\$Millions)*

Year	Federal Corporate Income Tax Receipts (Current \$)	Total Federal Receipts (Current \$)	Receipts as a Percentage of Total Federal Receipts (Current \$)	Federal Corporate Income Tax Receipts (Constant Year 2000 \$)
1970	\$ 32,829	\$ 192,807	17.0%	\$ 121,136
1971	26,785	187,139	14.3	93,956
1972	32,166	207,309	15.5	107,627
1973	36,153	230,799	15.7	115,668
1974	38,620	263,224	14.7	115,370
1975	\$ 40,621	\$ 279,090	14.6%	\$ 110,358
1976	41,409	298,060	13.9	104,935
1977	54,892	355,559	15.4	129,036
1978	59,952	399,561	15.0	131,967
1979	65,677	463,302	14.2	134,115
1980	\$ 64,600	\$ 517,112	12.5%	\$ 121,469
1981	61,137	599,272	10.2	104,866
1982	49,207	617,766	8.0	79,003
1983	37,022	600,562	6.2	56,887
1984	56,893	666,486	8.5	84,265
1985	\$ 61,331	\$ 734,088	8.4%	\$ 87,984
1986	63,143	769,215	8.2	88,474
1987	83,926	854,353	9.8	114,563
1988	94,508	909,303	10.4	124,980
1989	103,291	991,190	10.4	131,504
1990	\$ 93,507	\$ 1,031,969	9.1%	\$ 114,691
1991	98,086	1,055,041	9.3	116,020
1992	100,270	1,091,279	9.2	115,924
1993	117,520	1,154,401	10.2	132,510
1994	140,385	1,258,627	11.2	154,733
1995	\$ 157,004	\$ 1,351,830	11.6%	\$ 169,470
1996	171,824	1,453,062	11.8	181,962
1997	182,293	1,579,292	11.5	189,821
1998	188,677	1,721,798	11.0	193,989
1999e	184,680	1,827,454	10.1	187,441
2000e	\$ 207,289	\$ 2,025,218	10.2%	\$ 207,289

Source: Office of Management and Budget, 2001.

inefficiency from the capital markets, and promote economic growth.

The federal government currently collects around \$200 billion a year from C corporations through the corporate income tax. State and local governments tap corporate America for an additional \$40 billion in income taxes annually. Federal corporate tax rates and bases have been on a roller coaster ride over the past thirty years as rates have gone up and down and the corporate tax base has expanded and contracted. Under current law, corporate taxable income above \$75,000 is subject to an income tax of 34 percent and corporate income above \$10 million is subject to a tax of 35 percent.

Several other federal tax policies affect corporate tax collections. The corporate alternative minimum tax applied to 25,047 companies in 1997, the most recent year for which official data are available. These companies paid \$3.9 billion in alternative minimum taxes that year. Despite meeting the stated goal of increasing revenues from corporations, several issues, including equity and complexity, are raised by the presence of this tax.

Although the vast majority of business activity in the United States occurs in C corporations, alternative legal constructs such as S corporations and sole proprietorships are increasingly popular. In 1998, there were 2.6 million S corporations and 17.4 million sole proprietorships in the United States. None of these businesses pay any corporate income tax. Instead, the owners of S corporations and sole proprietors report all income on their individual income tax returns.

This is important for two reasons. First, income earned through an S corporation or sole proprietorship is taxed only once, whereas income earned through a C corporation is taxed twice: once through the corporate income tax, and again when investors pay individual income taxes on dividends. Second, as the percentage of business activity conducted through S corporations and sole proprietorships increases, an increasing amount of taxes will be collected through the personal income tax compared to the corporate income tax.

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. Other proposals,

dating back to at least 1992, call for the integration of the corporate and personal income taxes to simplify overall tax compliance and eliminate the double taxation that currently exists on savings.

**Table 2**  
**Federal Corporate Income Tax Rates**  
**1950 – Present**

1950	First \$25,000 (Normal Rate)	23%	1982	First \$25,000 \$25,000 to \$50,000 \$50,000 to \$75,000 \$75,000 to \$100,000 Over \$100,000	16% 19% 30% 40% 46%
1951	Over \$25,000 (Add Surtax of 19%)	42%			
	Excess Profits Tax	30%			
1952	First \$25,000 (Normal Rate)	28.75%	1983–1984	First \$25,000 \$25,000 to \$50,000 \$50,000 to \$75,000 \$75,000 to \$100,000 Over \$100,000	15% 18% 30% 40% 46%
	Over \$25,000 (Add Surtax of 22%)	50.75%			
	Excess Profits Tax	30%			
1953–1963	First \$25,000 (Normal Rate)	30%	1985–1986	First \$25,000 \$25,000 to \$50,000 \$50,000 to \$75,000 \$75,000 to \$100,000 \$100,000 to \$1,000,000 \$1,000,000 to \$1,405,000 <sup>c</sup>	15% 18% 30% 40% 46% 51%
	Over \$25,000 (Add Surtax of 22%)	52%			
1964	First \$25,000 (Normal Rate)	22%	1987 <sup>d</sup> –1993	First \$50,000 \$50,000 to \$75,000 \$75,000 to \$100,000 \$100,000 to \$335,000 <sup>e</sup>	15% 25% 34% 39%
	Over \$25,000 (Add Surtax of 28%)	50%			
1965–1967	First \$25,000 (Normal Rate)	22%	1994–Present	Over \$335,000 First \$50,000 \$50,000 to \$75,000 \$75,000 to \$100,000	34% 15% 25%
	Over \$25,000 (Add Surtax of 26%)	48%			
1968–1969	First \$25,000 (Normal Rate)	22%		\$100,000 to \$335,000 <sup>e</sup> \$335,000 to \$10,000,000 \$10,000,000 to \$15,000,000 \$15,000,000 to \$18,333,333 <sup>f</sup>	39% 34% 35% 38%
	Over \$25,000 (Add Surtax of 26%)	48%			
1970	With 10% Surcharge First \$25,000 (Normal Rate)	24.20%		Over \$18,333,333	35%
	Over \$25,000 (Add Surtax of 26%)	52.80%			
1971–1974	First \$25,000 (Normal Rate)	22%	<sup>a</sup>		
	Over \$25,000 (Add Surtax of 26%)	48%			
1975–1978	With 2.5% Surcharge <sup>a</sup> First \$25,000 (Normal Rate)	22.55%	<sup>b</sup>		
	Over \$25,000 (Add Surtax of 26%)	49.20%			
1979–1981 <sup>b</sup>	First \$25,000 \$25,000 to \$50,000 \$50,000 to \$75,000 \$75,000 to \$100,000 Over \$100,000	17% 20% 30% 40% 46%	<sup>c</sup>		

Source: *Facts and Figures on Government Finance*, 35th Edition, Tax Foundation.

## Trends in Corporate Income Taxes

Because corporate profits are volatile, rising in booms and falling in recessions, so, too, are government receipts from the corporate income tax. Figure 1 and Table 1 show that federal receipts dipped during the recessions of both the early 1980s and early 1990s. However, the long-term trend of federal corporate tax receipts is upward, from \$121.1 billion collected during 1970 to \$207.3 billion collected during 2000 (both expressed in terms of constant year 2000 dollars).

Federal legislation during the 1980s first cut then raised corporate taxes. The Economic Recovery Tax Act of 1981 (ERTA) represented a significant cut in corporate taxes, both through lower rates and various provisions designed to spur capital formation which effectively reduced the corporate income tax base. However, subsequent legislation largely reversed the impact of the 1981 Act and led to increases in corporate taxes.

The Tax Equity and Fiscal Responsibility Act of 1982 was a straightforward attempt to recapture some of the revenues returned to the private sector by ERTA in 1981. The Tax Reform Act of 1986, on the other hand, represented a major reshuffling of tax liability.

While the 1986 Act lowered the marginal corporate tax rate from 46 percent to 34 percent, it significantly broadened the tax base and, on balance, increased corporate income tax collections. Table 1 shows this impact as federal corporate tax receipts rose significantly from 1987 to 1989, then stabilized after 1989 as the economy slipped into recession.

President Clinton and Congress passed an increase in the corporate income tax in 1993, raising the top marginal rate from 34 to 35 percent (see Table 2). The rate increase, coupled with a strong economy, led to an inflation-adjusted increase of 78.8 percent in corporate income tax collections between 1992 and 2000.

Total collections tell only part of the story of the impact corporate taxes have on the economy. Effective marginal tax rates, which have a large impact on the level and consumption of corporate investment, have varied widely since 1970. Table 3 and Figure 2 show effective federal, state, and local corporate income tax rates for the years 1970 to 2000.

All told, the average effective federal tax rate on corporate income in 2000 was lower than it was in 1970, down from 38 to 26 per-

cent. In fact, the effective rate in 2000 was below the average for the 30-year period, 29.2 percent. The same is true of state and local taxes on corporate income. The average effective state rate has decreased slightly since

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1970, down from 4.6 percent to 4.3 percent, and is significantly lower than the average effective rate over the period, 5.6 percent. Effective state and local tax rates peaked at 9.3 percent in 1986 before dropping back to their current level.

## **Other Factors Affecting Corporate Tax Receipts**

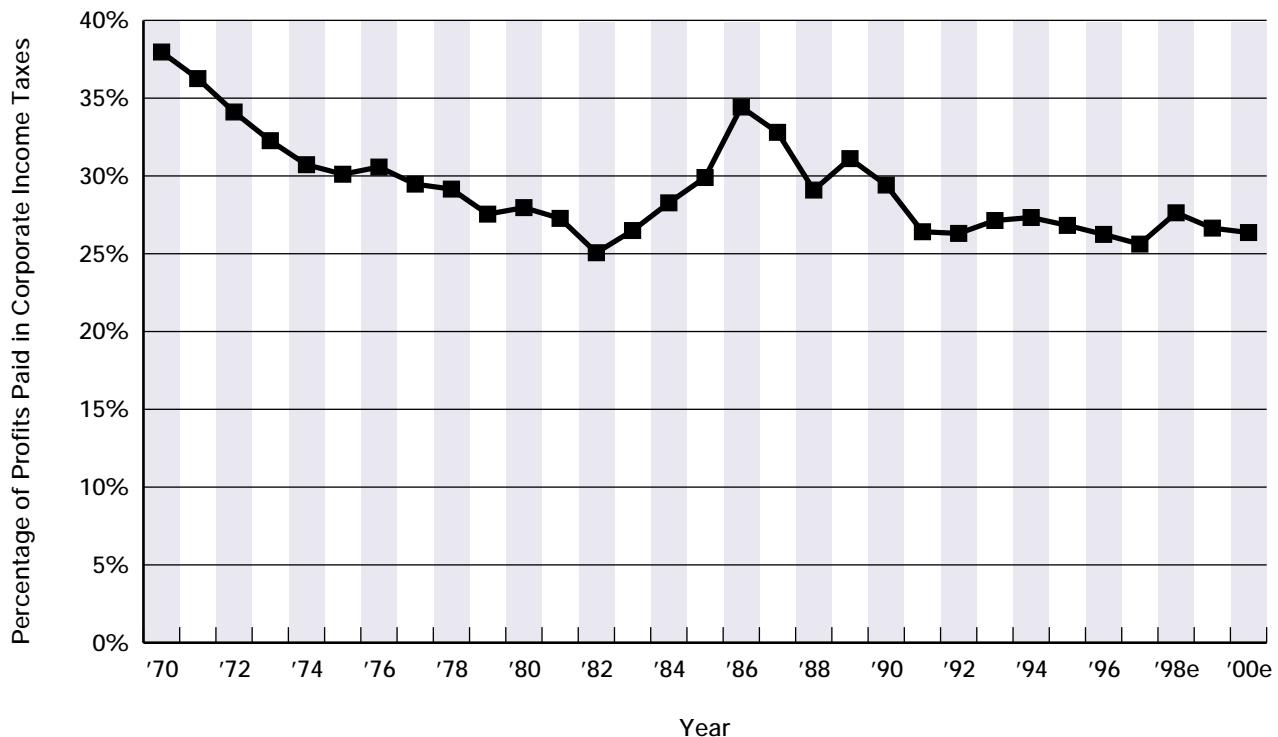
Several additional factors and trends have affected the impact of the corporate income tax on businesses and federal tax collections over the past thirty years. For example, corporate profits as a percentage of national income have fluctuated over the past thirty years, reaching a peak of over 13.2 percent in 1978 before falling to a low of 6.9 percent in 1986, only to rise to their current level of about 11.6 percent (see Table 4).

This has affected federal corporate taxes measured as a percentage of total federal receipts. Corporate tax receipts averaged 15.0 percent of total receipts annually during the 1970s. The average during the 1980s dropped to 9.3 percent annually, only to rise again during the 1990s to 10.5 percent of total receipts.

### **The Alternative Minimum Tax**

The Corporate Alternative Minimum Tax (CAMT) as it exists today first appeared in 1987 after passage of the Tax Reform Act of 1986. Congress enacted the CAMT in response

**Figure 2**  
*Average Effective Tax Rate on Corporate Profits*  
Calendar Years 1970-2000



to claims that some companies were able to avoid the corporate income tax altogether using exclusions, deductions, and credits. The CAMT operates as a parallel, or alternative, tax structure to the corporate income tax. All corporations with annual revenues greater than \$7.5 million are required to go through CAMT calculations each year to determine whether they owe taxes through the standard corporate income tax or the CAMT.

The CAMT has achieved its stated objective of increasing tax revenues collected from the corporate sector. Since 1987, the federal government has collected roughly \$60 billion through the CAMT. The IRS reports that in 1998, the most recent year for which definitive data are available, collections from the CAMT were \$3.3 billion. Yet, as a previous Tax Foundation report noted, "... the effect of the CAMT goes beyond simply increasing taxes on corporations. The CAMT is a disincentive to investment, hits companies particularly hard during

economic slowdowns when they can least afford it, and adds substantial complexity to the tax system."<sup>1</sup>

### *Disincentive to Invest*

As does the conventional corporate income tax, the CAMT causes double taxation of capital. This places a heavy burden on savings and is a strong disincentive to invest in capital. Moreover, the CAMT is a particularly onerous tax on capital because it requires longer depreciation and amortization schedules than required under the regular corporate income tax. Also, the CAMT is not indexed to keep pace with inflation.<sup>2</sup> This means that firms investing in capital receive less favorable treatment under the CAMT than under the regular corporate income tax.

Another strong disincentive to invest inherent in the current CAMT structure is the disallowance of the Research and Development (R&D) tax credit applicable in the regular corporate income tax calculation. Firms facing the CAMT therefore have less incentive to invest in research and development efforts that have the potential to increase long-run productivity than do firms facing the regular corporate income tax.<sup>3</sup>

### *Countercyclical Effect*

Because of the structure of the CAMT, the tax hits corporations particularly hard during economic downturns, when these businesses can least afford large tax burdens. This counter-cyclical effect comes about because the CAMT essentially disallows corporations to take certain deductions, credits, and exclusions against their taxable income in calculating their CAMT tax liability. Some of the primary deductions disallowed by the CAMT come about from economic events associated with downturns in the market.<sup>4</sup> Therefore, just as corporations are fighting through a tough economic time the CAMT hits them with a relatively large tax burden on the basis of minimal income and few deductions, credits, and exclusions.

For example, under the CAMT tax calculation, a firm may report net operating losses of no more than 90 percent of its tentative minimum tax. This prevents firms from smoothing out their tax liability over several years as is allowed under the regular corporate income tax. This limitation is complicated further by the CAMT's limitation on a corporation's use of foreign tax credits that are intended to eliminate a double tax on U.S. firms operating abroad. Limiting use of this credit prevents firms from adequately protecting themselves

**Table 3**  
*Average Effective Tax Rate on Corporate Profits*  
*Fiscal Year 1970-2000*

Year	Corporate Profits Before Tax	Federal Corporate Income Tax Accruals	State/Local Corporate Income Tax Accruals	Effective Rate of Federal Tax	Effective Rate of State/Local Tax	Effective Rate of Federal and State/Local Tax
1970	\$ 80.6	\$ 30.6	\$ 3.7	38.0%	4.6%	42.6%
1971	92.4	33.5	4.3	36.3	4.7	40.9
1972	107.3	36.6	5.3	34.1	4.9	39.0
1973	134.2	43.3	6.0	32.3	4.5	36.7
1974	146.8	45.1	6.7	30.7	4.6	35.3
1975	\$ 144.8	\$ 43.6	\$ 7.3	30.1%	5.0%	35.2%
1976	178.6	54.6	9.6	30.6	5.4	35.9
1977	209.0	61.6	11.4	29.5	5.5	34.9
1978	244.9	71.4	12.1	29.2	4.9	34.1
1979	270.1	74.4	13.6	27.5	5.0	32.6
1980	\$ 251.4	\$ 70.3	\$ 14.5	28.0%	5.8%	33.7%
1981	240.9	65.7	15.4	27.3	6.4	33.7
1982	195.5	49.0	14.0	25.1	7.2	32.2
1983	231.4	61.3	15.9	26.5	6.9	33.4
1984	266.0	75.2	18.8	28.3	7.1	35.3
1985	\$ 255.2	\$ 76.3	\$ 20.2	29.9%	7.9%	37.8%
1986	243.4	83.8	22.7	34.4	9.3	43.8
1987	314.6	103.2	23.9	32.8	7.6	40.4
1988	381.9	111.1	26.0	29.1	6.8	35.9
1989	376.7	117.2	24.2	31.1	6.4	37.5
1990	\$ 401.5	\$ 118.1	\$ 22.5	29.4%	5.6%	35.0%
1991	416.1	109.9	23.6	26.4	5.7	32.1
1992	451.6	118.8	24.4	26.3	5.4	31.7
1993	510.4	138.5	26.9	27.1	5.3	32.4
1994	573.4	156.7	30.0	27.3	5.2	32.6
1995	\$ 668.5	\$ 179.3	\$ 31.7	26.8%	4.7%	31.6%
1996	726.3	190.6	33.0	26.2	4.5	30.8
1997	792.4	203.0	34.2	25.6	4.3	29.9
1998	758.2	209.5	35.1	27.6	4.6	32.3
1999	823.0	219.3	36.6	26.6	4.4	31.1
2000	\$ 925.6	\$ 244.0	\$ 40.2	26.4%	4.3%	30.7%

Source: *Survey of Current Business*, Department of Commerce; and Tax Foundation computations.

from regional downturns by diversifying into international markets.

#### *Complexity and Compliance Costs*

The Joint Economic Committee estimated in 1999 that CAMT compliance costs can run

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as high as 16.9 percent of a company's total personnel and nonpersonnel costs of filing federal income taxes.

The IRS's Office of the Inspector General found that over 2,100 small corporations,

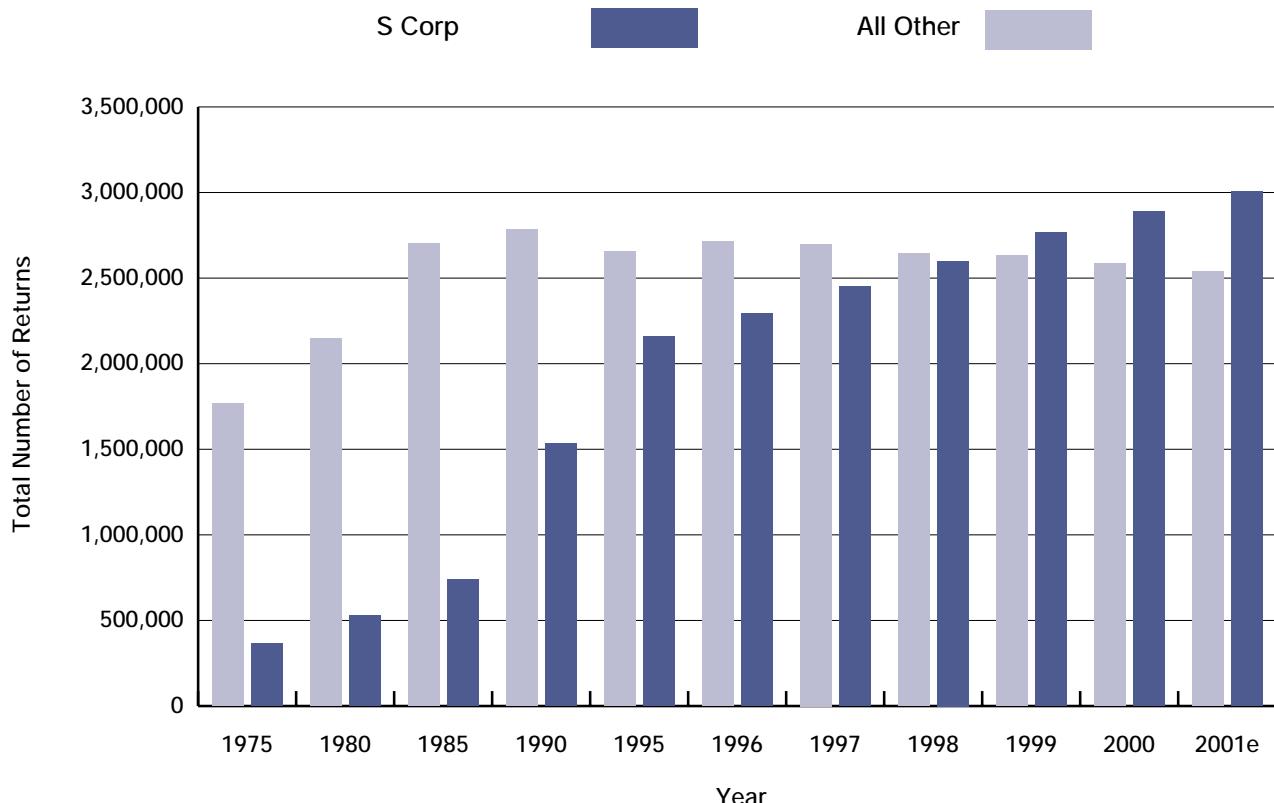
those with annual gross receipts of less than \$7.5 million, paid the CAMT although a change in law in 1997 specifically exempted them from paying the tax.<sup>5</sup> These corporations paid over \$25 million in CAMT despite being legally exempt.<sup>6</sup> Such costly mistakes highlight the complexity and the attendant economic burden created by the CAMT.

#### **S Corporations**

S corporations are similar to regular C corporations in that they provide owners with such benefits as limited liability and freely transferable ownership rights. However, unlike C corporations, S corporations are allowed to pass income through the corporate structure tax-free. Thus, the double taxation of earnings is eliminated; all earnings are taxed once at the individual owner's level as reported on their individual tax returns. S corporations agree to certain limitations in exchange for this benefit, including limiting their number of shareholders to 75 or fewer and limiting ownership to U.S. citizens and resident aliens.

The benefits of this legal organizational

**Figure 3**  
*S Corporation Returns vs. Other Corporate Returns*  
Selected Calendar Years 1975–2001



Source: Statistics of Income, Internal Revenue Service.

structure have led to a steady increase in the number of businesses filing as S corporations. According to the IRS's Statistics of Income Division, "The average annual growth since 1986, the year in which the first of four major tax reform acts affected S corporations, is 10.3 percent. Over the same period, all other corporations have experienced an average annual decline of 1.1 percent."<sup>7</sup> In 1999, for the first time, the number of corporations filing as S

corporations outnumbered all other corporate structures (see Figure 3.)

The existence of a dual corporate structure creates inequalities between companies in similar economic situations but of different legal structures. This inequality creates inefficiency and has an impact on corporate income tax collections.

## Who Collects the Corporate Income Tax?

The federal government, through the Internal Revenue Service, collects the corporate income tax from businesses of all sizes and in all industries. In 1998, the latest year for which official data are available, there were a total of 4.8 million corporate income tax returns filed. Of these, 2.8 million recorded a net income. Total corporate income tax collected, after credits, amounted to \$188.7 billion, or 11.0 percent of total federal revenues collected.<sup>8</sup>

The bulk of corporate income taxes are collected from relatively large corporations. In 1998, the IRS collected \$172.9 billion from 472,600 corporations with assets of more than one million dollars. This represents 98.0 percent of total corporate income taxes collected during that year. In contrast, 4,376,400 relatively small corporations (those with assets of less than \$1 million) filed 90.3 percent of all corporate income tax returns in 1998 but collections from this group of small corporations accounted for only 2.0 percent of total corporate income tax collections (see Figure 4).

## Who Bears the Burden of Corporate Income Taxes?

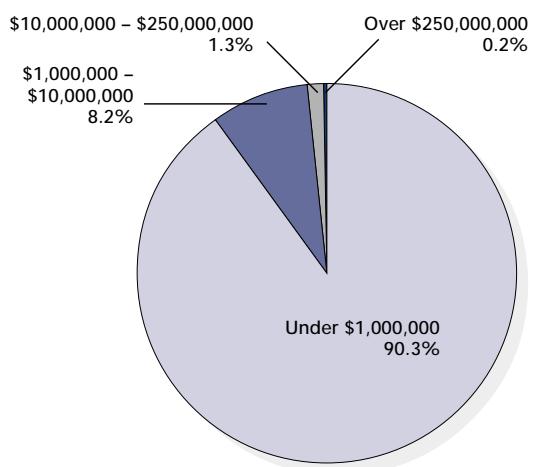
Corporations collect and subsequently pay the corporate income tax. However, the question remains, "Who ultimately bears the burden of this tax?"

Every dollar a corporation spends, whether on taxes or anything else, eventually comes out of the pockets of individuals, specifically three groups of individuals: the corporation's workers, its customers, and its owners (shareholders). It is usually a combination of these groups that ultimately bears the brunt of corporate income taxes.

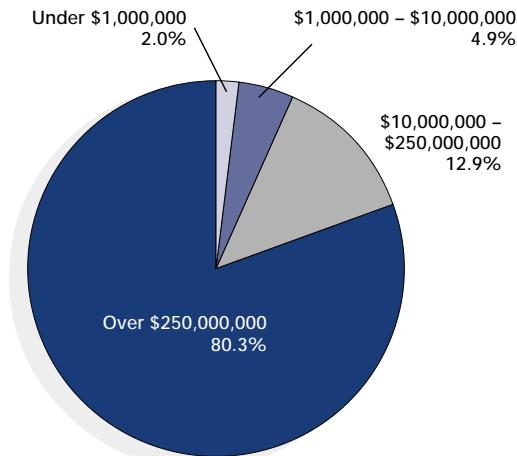
To make matters more complex, the distribution of the tax burden varies from industry to industry, and even within each industry it changes with the flow of the economy at any point in time. Recent research even indicates that the burden of the corporate income tax may be exported to foreign consumers and investors, raising prices abroad for our exported goods.<sup>9</sup>

**Figure 4**  
*Corporate Income Tax Returns and Collections by Asset Size  
Calendar Year 1998*

**Corporate Tax Returns by Asset Size**



**Tax Collections by Asset Size**



Source: *Statistics of Income*, Internal Revenue Service.

The debate over which group of individuals — workers, shareholders, or consumers — ends up paying the bulk of corporate taxes will

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go on forever, but the undisputed and most important point is that individuals pay taxes, not corporations.

**Table 4**  
*Corporate Profits as a Percentage of National Income before Tax*  
*Fiscal Years 1970–2000*

Year	Corporate Profits	
	Total (\$Billions)	As a Percentage of National Income
1970	\$ 80.6	9.6%
1971	92.4	10.2
1972	107.3	10.7
1973	134.2	11.9
1974	146.8	12.1
1975	\$ 144.8	11.1%
1976	178.6	12.3
1977	209.0	12.8
1978	244.9	13.2
1979	270.1	13.0
1980	\$ 251.4	11.2%
1981	240.9	9.6
1982	195.5	7.5
1983	231.4	8.3
1984	266.0	8.4
1985	\$ 255.2	7.5%
1986	243.4	6.9
1987	314.6	8.3
1988	381.9	9.2
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1991	416.1	8.7
1992	451.6	9.0
1993	510.4	9.7
1994	573.4	10.3
1995	\$ 668.5	11.4%
1996	726.3	11.7
1997	792.4	12.0
1998	758.2	10.8
1999	823.0	11.0
2000	\$ 925.6	11.6%

Source: Bureau of Economic Analysis.

## The True Cost of the Corporate Income Tax

In addition to the direct costs imposed by the corporate income tax, workers, owners, and customers also bear the indirect costs of complying with the code. A recent Tax Foundation study reported that compliance with the corporate income tax accounts for 32 percent of total compliance costs each year.<sup>10</sup> American corporations spend roughly 1.2 billion hours, equivalent to nearly 582,000 full-time employees, filling out IRS forms and schedules annually. Assuming an average hourly wage of \$34.66, total corporate income tax compliance costs run nearly \$40.3 billion annually.

There are other compliance costs that are not included in this figure but nevertheless add significantly to the overall burden imposed by the federal corporate income tax. Corporate executives spend tremendous amounts of money and effort planning their business activities to minimize taxes or take advantage of special tax provisions or changes in the law. Firms typically hire outside tax attorneys and consultants to help in this process. Most large and even medium size firms spend some time and money lobbying Congress and state lawmakers for more favorable tax treatment. Large firms have entire teams of IRS agents on site at all times, yet many corporations still find themselves in the unenviable position of having to hire defense attorneys to represent the company in tax court.

All of these additional expenditures are what economists refer to as “deadweight” costs because they are not economically productive investments. Contrary to conventional wisdom, these costs are not all unavoidable costs of doing business in a complex world. Many could be mitigated or eliminated, allowing the resources now being devoted to the tax code to be directed toward increasing productivity, which would benefit consumers, workers and shareholders through lower prices, higher wages, and/or greater profits.

The total cost of the corporate income tax is difficult to measure. However, at least another \$140 billion in indirect costs and deadweight losses are borne by consumers, workers, and owners in addition to the more than \$200 billion paid directly in taxes. Most likely, the indirect costs are even higher.<sup>11</sup> It is important to remember, therefore, that official estimates of corporate income tax collections measure only a small part of the total economic cost imposed by the tax.

## 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. Several proposals have been made over the past decade that would address the double taxation of corporate income, simplify the process of compliance, or eliminate the tax completely. Some of these proposals have received more legislative attention than others, but they are all important to discuss since each addresses a different aspect of the existing system.

### Integration Proposal

A 1992 Department of the Treasury Report entitled "Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once" has received renewed attention recently as one possible way to reform the existing corporate income tax. One of the report's principal co-authors, R. Glenn Hubbard, is now

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Chairman of the President's Council of Economic Advisors.

The general idea behind this proposal is to integrate the corporate income tax into the individual income tax structure. This would eliminate the double taxation that currently exists on most earnings from investment in corporate equity. As the 1992 Treasury report states, "Under [the current] system of corporate income taxation, two levels of income tax are generally imposed on earnings from investments in corporate equity. First, corporate earnings are taxed at the corporate level. Second, if the corporation distributes earnings to shareholders, the earnings are taxed again at the shareholder level."<sup>12</sup> Even if the earnings are retained by the firm as reserves for development of the company, to increase wages or decrease prices a second tax incidence occurs

through the capital gains tax or the regular individual income tax.

The 1992 Treasury report highlights three "prototypes" of integration of the corporate and individual income tax systems.

### 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.

### 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."<sup>13</sup> As with the other prototypes included in the 1992 Treasury report, the CBIT would effectively eliminate the double taxation of investment income.

### Fundamental Tax Reform Proposals

Initial talk of integration plans in the early 1990s was one factor that led to discussion of more comprehensive, or fundamental, tax reform proposals during the mid 1990s. The candidacy of Steve Forbes for president in 1996 put fundamental tax reform on the front burner of 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.

While most of the fundamental tax reform proposals put forth during the mid 1990s are

***While the stated goal of many policy makers remains fundamental tax reform or the integration of corporate and individual income taxes, there is a parallel effort to expand the legal definition of the S corporation as a step toward this goal.***

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 that are under active consideration.

#### *Flat Tax Proposal*

The flat tax, as outlined by economists Robert E. Hall and Alvin Rabushka, would replace the current federal tax code with a single 19 percent tax on all forms of income.<sup>14</sup> Individuals would be taxed on their wages or salary and any amounts received from employer-provided pension plans. All businesses, without regard to their legal structure, would pay the flat 19 percent tax on revenue net the purchases of goods, services, materials, capital equipment, structures and land and the amount paid to employees in the form of wages, salaries, and pensions.

The flat tax would replace all depreciation and amortization schedules with immediate expensing. All investment income would be taxed only once and levied at the corporate level. Thus, similar to the three prototypes presented in the 1992 Treasury report, interest income, capital gains, and dividends derived from equity investments would be taxed only once, at the corporate level.

#### *Value Added Tax (VAT) Proposal*

The VAT Proposal calls for a tax to be

levied on the increase in value of goods and services as they pass from one stage of production to another. In theory, the VAT would replace the existing corporate and individual income tax regimes but this would not be automatic, as would be the case with the flat tax or the integration of the individual and corporate income taxes. In fact, the experience of most European countries is that the VAT is added onto existing income tax regimes thus creating an overall more burdensome and economically depressing environment.

Companies, without regard to their legal structure, would be responsible for paying the VAT depending upon the value they add to goods and services. However, consumers would probably end up bearing the cost of the VAT in the form of higher retail sales prices. Some policy makers maintain that the VAT would increase the competitiveness of American companies because border tax adjustments could be used to level the playing field between imports and exports.

#### *National Sales Tax Proposal*

The National Sales Tax is similar to the VAT in that it is levied only on consumption goods and, in theory, could replace the existing system of corporate and individual income taxes. Unlike the VAT, however, the entire tax is collected at the point of retail sale. The National Sales Tax would reduce compliance costs because collection could be "piggy-backed" on the current system used to collect state-level sales taxes. The National Sales Tax, like all the other fundamental tax proposals described in this section would eliminate the double taxation of investment income.

#### **S Corporation Expansion**

While the stated goal of many policy makers remains fundamental tax reform or the integration of corporate and individual income taxes, there is a parallel effort to expand the legal definition of the S corporation as a step toward this goal. Proposals such as that put forward by Representatives Clay Shaw (R-FL), Robert Matsui (D-CA), Rob Portman (R-OH), and Scott McInnis (R-CO) would change the definition of the S corporation in several ways.

#### *Broaden the Shareholder Base*

Ownership of S corporations is limited to a maximum of seventy-five shareholders. Proposals now under consideration would increase this number to at least 150 shareholders. This would allow S corporations to raise additional capital or explore alternate financial arrangements.

## *Issue Preferred Stock*

Currently, S corporations are able to issue only one class of equity to shareholders. This limitation prevents some company's from raising the necessary funds to expand operations, hire more employees, or make additional investments in productivity-enhancing capital. The ability to issue preferred stock also would give S corporations the option to diversify their financial structure.

## *Increase the Diversity of Shareholders*

S corporation ownership is limited under current law to individuals resident in the United States. Many of the current proposals under consideration would expand possible S corporation ownership to include non-resident aliens, special investment funds such as bank-managed IRA's, and family trusts. This diversification would allow S corporations to broaden their financial base and thereby raise additional capital and hedge against economic downturns.

All of these reform proposals would more closely align the permitted activities of S cor-

***Reform may take one of various forms, as part of more fundamental tax reform, integration of the corporate and individual income tax, or expansion of existing tax-free structures such as the S corporation.***

porations with regular C corporations without sacrificing the S corporation's primary advantage, single tax treatment. S corporations, even with these additional legal freedoms, would still be able to pass profits through to owners tax free. Income is taxed only once, at the individual level when owners file their individual income tax forms. Because the S corporation structure eliminates the double taxation on earnings, many policy makers view this as a step toward fundamental tax reform or integration. More and more companies would organize under the S corporation definition as it is expanded. An increasing percentage of income produced in the economy would be taxed only once and the inherent benefits of a single tax system would begin to materialize.

However, it should be recognized that there are limitations to S corporation expansion. First, single taxation is economically more efficient than double taxation and typically results in

greater after-tax income for the owners and workers, and better value for consumers. In this respect, S corporations enjoy a substantial competitive advantage over C corporations. The existence of a dual corporate structure creates inequalities between companies in similar economic situations, and this inequality creates inefficiencies in the marketplace.

Second, no matter how greatly the definition of S corporation is expanded, it will be difficult for many large corporations to re-organize themselves to take advantage of the S corporation tax benefits. Corporations like GE, Microsoft, IBM, and many others have hundreds of thousands of shareholders and various levels of stock. These large organizations will always be at a tax disadvantage compared to their S corporation competitors. Therefore, policy makers intent on fundamental reform or true integration need to reform the existing C corporation structure in parallel with expanding the S corporation definition.

## **Conclusions**

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 risen and fallen. 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. 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.

Several members of the current Administration and Congress have recently raised the prospect of significantly reforming the corporate income tax. Such attention deserves credit given the current economic downturn. Fundamental reform of the corporate income tax would remove a major source of inefficiency from the federal tax code and support increased economic growth. Reform may take one of various forms, as part of more fundamental tax reform, integration of the corporate and individual income tax, or expansion of existing tax-free structures such as the S corporation. In any case, the key is that the double taxation imposed by the corporate income tax

and the accompanying compliance burdens are eliminated.

## Notes

<sup>1</sup> Chris R. Edwards, "A Primer on the Corporate Alternative Minimum Tax," *Tax Foundation Special Report*, Number 30, (Washington, DC:

ence Number: 2001-30-019.

<sup>7</sup> Susan Wittman, "S Corporation Returns, 1998," *SOI Bulletin* (Washington, DC: Internal Revenue Service, Summer 2000), pp. 46-101.

<sup>8</sup> Internal Revenue Service, "Statistics of Income," *SOI Bulletin*, (Washington, DC: Internal Revenue Service, Winter 2000-2001, Table

***Statutory and effective rates have increased and decreased. The tax base has narrowed and expanded. Collections have risen and fallen. What has not changed is that the corporate income tax remains one of the most economically inefficient and burdensome taxes on the books.***

Tax Foundation, March 1994).

<sup>2</sup> Andrew B. Lyon, *Cracking the Code: Making Sense of the Corporate Alternative Minimum Tax* (Washington, DC: Brookings Institution Press, 1997).

<sup>3</sup> In general, it is desirable to eliminate as many credits and deductions as possible and concurrently lower rates. What is troubling in the current tax code is that the R&D credit exists under one corporate tax regime (the regular corporate income tax) and not the other (the CAMT). This creates horizontal inequity between firms in otherwise similar economic positions.

<sup>4</sup> Gary and Aldona Robbins, "Complicating the Federal Tax Code: A Look At the Alternative Minimum Tax (AMT)," *Policy Report*, Number 145 (Lewisville, TX: Institute for Policy Innovation, 1998).

<sup>5</sup> A small corporation is defined as a corporation that meets the "gross receipts criteria as established in Section 448(c) of the Internal Revenue Code. Specifically, an eligible small corporation "meets the ... gross receipts test of this subsection for any prior taxable year if the average annual gross receipts of such entity for the 3-taxable-year period ending with such prior taxable year does not exceed

\$5,000,000." For purposes of the CAMT calculation, the maximum allowable gross receipts is now set at \$7,500,000.

<sup>6</sup> Office of the Department of Treasury's Deputy Inspector General for Audit, "Letter Report: More Small Corporate Taxpayers Can Benefit from the Alternative Minimum Tax Exemption Provision," November 2000, Refer-

13), pp. 183-184.

<sup>9</sup> Jane G. Gravelle and Kent Smetters, "Who Bears the Burden of the Corporate Tax in The Open Economy?" *NBER Working Paper No. 8280*, (Cambridge: National Bureau of Economic Research, May 2001).

<sup>10</sup> J. Scott Moody, "The Cost of Complying with the U.S. Federal Income Tax," *Tax Foundation Background Paper*, Number 35 (Washington, DC: Tax Foundation, November 2000).

<sup>11</sup> See especially Jane G. Gravelle, *The Economic Effects of Taxing Capital Income* (Cambridge: MIT Press, 1994), p. 81 and Austan Goolsbee, "Taxes, Organizational Form, and the Deadweight Loss of the Corporate Income Tax," *Journal of Public Economics* Vol. 69, July 1998, pp. 143-152.

<sup>12</sup> Department of the Treasury, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (Washington, D.C.: January 1992, p. 1).

<sup>13</sup> *Ibid.*, p 41.

<sup>14</sup> Robert E. Hall and Alvin Rabushka, *The Flat Tax* (Stanford, CA: Hoover Institution Press, second edition, 1995). 



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