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Commentary/Viewpoints

The corporate tax conundrum*

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Commentary / Viewpoints

In conjunction with a conference on business taxation and global competitiveness, the Treasury Department on July 26, 2007, released a background paper on the taxation of business income in the United States.[1]1 The background paper describes the taxation of corporate and noncorporate businesses in the United States, compares the U.S. corporate tax system with that of its major trading partners, and describes the major economic distortions caused by the U.S. rules for taxing income from capital.

The background paper reports that the United States has the second highest combined (federal and state) statutory corporate income tax rate among the 30 member countries of the OECD.[2] At 39 percent, the U.S. combined statutory corporate tax rate is reported to be 8 percentage points higher than the OECD average. More recent data collected by the OECD show that the OECD average corporate tax rate has fallen to 28.4 percent in 2006, almost 11 percentage points below the U.S. tax rate. This gap continues to widen. Legislation has been enacted further reducing corporate tax rates in Germany (from 38.9 percent to 29.8 percent), the United Kingdom (from 30 percent to 28 percent), and Denmark (from 28 percent to 25 percent).

Although the United States has the second highest statutory corporate tax, the background paper reports that U.S. corporate income tax revenue (federal and state) as a percentage of GDP paradoxically is much lower than the OECD average — 2.2 percent in the United States versus an OECD average of 3.4 percent — over the 2000-2005 period.[3]3 In short, the OECD data present a conundrum — the United States has the second highest combined statutory corporate tax rate among OECD countries, yet is tied with Hungary in raising the fourth lowest amount of combined corporate income tax revenue relative to GDP in 2004.

There are a number of potential answers to this conundrum. First, the U.S. corporate income tax base may be relatively narrow compared with the typical OECD member country tax base. The background paper cites Institute for Fiscal Studies (IFS) data showing that federal depreciation deductions for equipment are slightly more accelerated in the United States than in the typical OECD member country. However, the benefit of accelerated depreciation deductions is not enough to offset the higher U.S. corporate tax rate, as IFS calculations show the U.S. effective marginal income tax rate on equity-financed equipment investment is 4 percentage points higher than the OECD average (24 percent in the United States versus an average of 20 percent for the OECD).[4]

A second explanation is that high statutory tax rates encourage U.S. corporations to structure their investments with an eye to tax efficiency. For example, high corporate tax rates encourage increased usage of debt finance and discourage sale of appreciated corporate assets and repatriation of foreign subsidiary profits. As a result of these types of behavioral responses, the experience in OECD countries is that corporate income tax revenue does not rise in proportion to increases in the statutory tax rate. Using data on corporate tax rates and collections over the 1980-2005 period, a recent study by Alex Brill and Kevin Hassett finds that the revenue-maximizing central government corporate tax rate in the OECD is now about 26 percent.[5] In other words, an increase in the average OECD corporate tax rate above 26 percent would be expected to reduce, rather than increase, total OECD member corporate tax revenue.

There is a third explanation that has received relatively little attention, yet may be the single-most important answer to the corporate tax conundrum. In the United States, federal and state business and tax laws provide firms with considerable flexibility in the legal form of organization. Rather than organize as regular corporations subject to two

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[1] Treasury Department, ''Treasury Conference on Business Taxation and Global Competitiveness: Background Paper,'' July 26, 2007, available at http://www.treas.gov/press/releases/ hp500.htm. The background paper was also printed in Tax Notes, July 30, 2007, p. 399.

[2] Id. at 35.

[3] Id.at42.

[4] Id.at35.

[5] Alex Brill and Kevin A. Hassett, ''Revenue-Maximizing Corporate Income Taxes: The Laffer Curve in OECD Countries,'' AEI Working Paper No. 137 (July 31, 2007).

levels of tax (at the corporation and the shareholder levels), businesses may organize as S corporations, partnerships, or limited liability companies that are not subject to entity-level tax. Since the Tax Reform Act of 1986, which lowered the top individual income tax rate below the top corporate tax rate, the share of taxable business income earned through passthrough entities (including sole proprietorships) has increased by 75 percent from 29 percent in 1987 to 52 percent in 2004 (see table).[6] There is a large body of empirical evidence that confirms that corporate income tax rates that are high relative to individual income tax rates reduce the share of U.S. business activity conducted in corporate form.[7]

Business Income Subject to Tax by Legal Entity, 1987-2004 (Dollar amounts in billions)

			Business Entities Subject to Passthrough Tax**				Percent of Total Income	
Year	Total Business Income	C Corp.*	Subtotal	S Corps.	Partnerships	Sole Proprietors	C Corps.	Pass-throughs
1987	$442	$312	$130	$30	-$5	$105	70.6%	29.4%
1988	$567	$383	$184	$44	$14	$126	67.5%	32.5%
1989	$562	$371	$192	$45	$14	$133	65.9%	34.1%
1990	$331	$128	$203	$45	$17	$141	38.7%	61.3%
1991	$557	$350	$208	$45	$21	$142	62.7%	37.3%
1992	$633	$378	$255	$58	$43	$154	59.7%	40.3%
1993	$726	$437	$289	$66	$67	$156	60.1%	39.9%
1994	$835	$494	$341	$92	$82	$167	59.2%	40.8%
1995	$940	$565	$375	$99	$107	$169	60.1%	39.9%
1996	$1,087	$640	$447	$125	$145	$177	58.9%	41.1%
1997	$1,191	$683	$508	$153	$168	$187	57.4%	42.6%
1998	$1,233	$662	$571	$182	$187	$202	53.7%	46.3%
1999	$1,323	$693	$630	$194	$228	$208	52.4%	47.6%
2000	$1,441	$759	$682	$199	$269	$215	52.7%	47.3%
2001	$1,316	$634	$681	$188	$276	$217	48.2%	51.8%
2002	$1,275	$600	$675	$183	$271	$221	47.0%	53.0%
2003	$1,444	$698	$745	$214	$301	$230	48.4%	51.6%
2004	$1,764	$856	$908	$275	$385	$248	48.5%	51.5%

*Income subject to tax is positive income after net operating loss, dividends received, and special deductions. Includes mutual funds and real estate investment trusts.

**Income subject to tax is net income (less deficit) that flows through to individual returns of owners of passthrough entity.

Source: Internal Revenue Service, Statistics of Income Division, various sources.

The shift in the form of business organization in the United States since 1986 has substantially reduced the amount of business income subject to double taxation. Indeed, if the same share of business income were earned through regular corporations in 2004 as was the case in 1987, corporate income tax revenue would have been 45 percent higher, amounting to 3.2 percent (rather than 2.2 percent) of GDP in 2004. That would have placed the United States in the middle of OECD countries ranked by corporate tax revenue as a percent of GDP.

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[6] Business income reported in Table 1 includes some amount of double counting due to unconsolidated affiliated entities. However, the trends reported in Table 1 are unaffected provided the share of double-counted income has remained relatively constant. The passthrough share of business income is understated to the extent that net losses flowing through to individual returns cannot be used because of various limitations such as the passive loss rules.

[7] A recent contribution to this literature is by Austan Goolsbee: ''The Impact of The Corporate Income Tax: Evidence From State Organizational Form Data,'' 88(11) Journal of Public Economics 2283-2299 (2004). An early study of the effects of the Tax Reform Act of 1986 is: Roger Gordon and Jeffrey Mackie-Mason, ''Effects of the Tax Reform Act of 1986 on Corporate Financial Policy and Organizational Form,'' pp. 91-131 in Joel Slemrod, ed., Do Taxes Matter? (MIT Press, Cambridge, Mass. (1990)).

Recent research confirms that the prevalence of passthrough business entities is unusually high in the United States compared with other OECD countries. Among 15 OECD countries for which data are available, the United States had the second highest percentage of unincorporated businesses in 2004, 13 percentage points above the OECD average (82 percent in the United States compared with an OECD average of 69 percent). For businesses reporting profits of at least $1 million, the United States had the highest share of unincorporated business (66 percent) among reporting OECD countries — over twice the share of Mexico, which had the second highest share of large unincorporated business (27 percent).[8] These data suggest that if the corporate share of business income in the United States were more similar to the OECD average, U.S. corporate tax receipts as a percentage of GDP would have been among the OECD's highest.

In summary, the U.S. corporate tax conundrum of high rates combined with relatively low revenue is explained by the unusually high share of U.S. business income earned through passthrough entities, rather than the frequently alleged use of inappropriate corporate tax shelters or tax havens.

Usage of passthrough forms of business organization can be viewed as a form of ''self-help'' corporate tax integration, that is, avoiding the double tax on corporate income by choosing passthrough forms of organization. The reduction in the top individual income tax rate on corporate dividends to 15 percent in 2003 has, temporarily, reduced the incentive to avoid use of C corporations and may slow the shift away from use of corporate entities. If so, this will result in higher corporate income tax revenue.

[8] Treasury Department, supra note 1, at 16-17. The background paper notes that in at least seven OECD member countries there is no form of business organization that offers limited liability without incorporation.