taxnotes®

Volume 157, Number 12 ■ December 18, 2017

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Reprinted from *Tax Notes*, December 18, 2017, p. 1821

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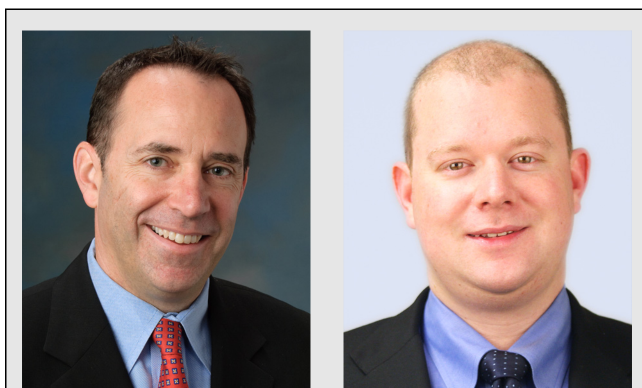

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In this article, Brannon and Gray discuss the aftermath of the 1986 tax reform process and argue that a reform intended to spur long-term growth should endeavor to lower the corporate tax rate as much as is feasible because it is unlikely that Congress will revisit the corporate rate anytime soon.

I. Introduction

In 1986 President Reagan signed into law the Tax Reform Act of 1986 (TRA 1986), which many consider the most comprehensive reform of the tax code ever undertaken by our government. It scaled back deductions, dramatically lowered rates at both the personal and corporate levels, removed millions of people from the tax rolls, and — most importantly — erased thousands of special provisions from the code.

By the end of the 1980s these momentous reforms were already becoming undone, and less than a decade after its passage the tax code was again replete with deductions, credits, and various other tax incentives, with sharply higher rates than were enacted in 1986.

While some reforms started to become undone as soon as the legislation was fully enacted, other changes remained in place for a considerable period as measured in legislative years. Comparing the nature of the 1986 tax changes that proved durable to the more ephemeral changes could inform us how to approach future attempts at comprehensive tax reform.

The one change accomplished in 1986 that has proven immune to attempts to change has been the corporate tax rate, which has changed just once — and by a single percentage point — in 1993.

We believe this point is salient to today's tax reform debate, as the House-Senate Conference Committee contemplates scaling back the corporate rate reduction in the House and Senate Bill in order to afford other tax preferences under the constraints imposed on bills passed under reconciliation. One important lesson history provides is that while Congress may very well have the opportunity — or find it necessary — to change almost every other aspect of the tax reform being debated today, it may not get another chance to reduce corporate tax rates for at least a generation. Therefore, reducing the scope of the corporate rate cut may come at a high opportunity cost, and doing that to pay for other tax provisions makes little sense.

II. Evolution of the Individual Tax Code

Since 1986, 17 tax bills that could be described as "major" have been enacted and, more narrowly, the IRC has been amended more than 15,000 times. These measures have variously raised and lowered rates, and have added numerous deductions, credits, and other tax incentives for specific activities. Taken as a whole, these changes constitute a major departure from one of the stated goals of TRA 1986: simplicity.

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Table 1. Evolution of Individual Tax Rates

Tax Rates for a Single Filer by Tax Year					
1986	1988	1991	1993	2003	Current
0%	15%	15%	15%	10%	10%
11%	28%	28%	28%	15%	15%
12%		31%	31%	25%	25%
14%			36%	28%	28%
15%			39.6%	33%	33%
16%				35%	35%
18%					39.6%

The individual tax code raises the plurality of the tax revenue collected by the federal government — 46 percent, or about $3 trillion in 2014 — while also exerting a great programmatic influence. Equally important to the consideration of the tax code's evolution since 1986 is the amount of subsidization of some activities and other forms of support exerted through the tax code. Such expenditures amounted to $1.2 trillion in 2014. Of this amount nearly $1 trillion is apportioned from the individual code. The personal side of the IRC has evolved greatly since the 1986 tax reform, and in myriad ways.

A. Tax Rates

Not including space for signatures and other administrative requirements, the current Form 1040 has 79 lines for reporting and determining individual tax liability. In 1988 there were 65. While this is by no means a comprehensive measure of the tax code's complexity, nor does it capture the degree to which it has become more cumbersome, it is illustrative of the direction of the code since TRA 1986 became law.

The number of individual tax rates has nothing to do per se with the complexity of the tax code, but it is a key determinant of how it influences labor and investment activity, and the increase in the number of tax brackets mirrors the overall increased complexity in the code. Before enactment of TRA 1986 there were 16 taxable income brackets and tax rates, including a zero bracket. TRA 1986 collapsed these brackets to just five brackets at first — 11 percent, 15 percent, 28 percent, 35 percent, and 38.5 percent — and then just two by 1988 — 15 percent and 28 percent. The Joint Committee on Taxation promoted this collapsing of rates as a signal of simplification in 1986, stating, "The Act reduces the complexity of the tax code for many Americans. The Act provides just two brackets."

However, this rate structure lasted for only three years, until passage of the Omnibus Budget Reconciliation Act of 1990 (the result of the Andrews Air Force Base budget summit), which created a new 31 percent income bracket. The Omnibus Budget Reconciliation Act of 1993 saw the addition of two new brackets — 36 percent and 39.6 percent — that remained in place until enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), which passed a phased-in reduction of prevailing rates and the creation of a new 10 percent bracket. The passage of the Jobs and Growth Tax Relief and Reconciliation Act of 2003 (JGTRRA) accelerated those tax rate reductions. Tax rates were untouched for a decade, despite their prominence in the election debate of 2008, until the passage of the American Taxpayer Relief Act of 2012 reinstated the 39.6 percent bracket for incomes exceeding $450,000.

The tax treatment of capital gains and dividend income has similarly evolved. Before 1986 the tax code treated dividend income as ordinary income, while long-term capital gains historically received a tax preference in the form of exclusion. Dividends could also be taxed at the maximum 50 percent rate (with a $100 exclusion), while long-term capital gains were effectively taxed at 20 percent because of a 60 percent exclusion. While TRA 1986 reduced overall

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income tax rates, it also eliminated the exclusions for dividend income and long-term capital gains. In effect, this raised the effective tax rate on capital gains to 28 percent.

The rate structure on individual capital income put in place in 1986 also proved to be ephemeral. The addition of the 31 percent bracket in the 1990 tax legislation subjected dividend income to a maximum 31 percent rate. However, the law capped the maximum capital gains rate on long-term gains at 28 percent and taxed gains on assets held for less than one year as ordinary income. This regime prevailed only until 1993, when Congress added the 36 percent and 39.6 percent tax brackets. Both dividend income and gains on assets held for less than one year were subject to these new rates, and gains on assets held for one year or longer remained taxable at the 28 percent rate.

With a change in party control of Congress after the 1994 elections came a push to reduce capital taxes that was realized in the Taxpayer Relief Act of 1997, which phased in a reduction in capital gains taxes for assets held over one year. The rate eventually fell to 20 percent for the latter part of tax year 1998, but dividend income remained taxable at ordinary income rates. The 2001 enactment of the EGTRRA partially addressed this discrepancy by phasing in a reduction of ordinary income rates, and JGTRRA in 2003 returned parity to the tax treatment of dividends and gains on assets held longer than one year. JGTRRA reduced rates on qualified dividends to 15 percent for the highest three brackets and 5 percent for the lowest two brackets, with a further reduction to zero in 2008.

Two subsequent laws changed these rates again beginning in 2013. The American Taxpayer Relief Act made permanent most of the provisions enacted as part of EGTRRA and JGTRRA while also increasing the tax rate on qualified dividends and long-term capital gains to 20 percent for those in the then-newly reinstated 39.6 percent bracket. The Affordable Care Act further increased individual capital taxes by imposing a surtax of 3.9 percent, ostensibly credited to the Medicare Hospital Insurance Trust Fund, on dividend and capital gain income for single filers with incomes more than $200,000 and joint filers with incomes at or exceeding $250,000.

Table 2. Dividend Rates for a Single Filer by Tax Year

1986	1988	1991	1993	2003	2008	Current
0%	15%	15%	15%	5%	0%	10%
11%	28%	28%	28%	15%	15%	15%
12%		31%	31%			20%
14%			36%			
15%			39.6%			

Source: Tax Foundation and Tax Policy Center. This does not include the additional 3.8 percent surtax imposed by the ACA.

Table 3. Rates on Long-Term Capital Gains

Capital Gains Rates for a Single Filer by Tax Year (Percent)					
1986	**1988**	**1993**	**2003**	**2008**	**Current**
0%	15%	15%	5%	0%	10%
11%	28%	20%	15%	15%	15%
12%					20%

Source: Tax Foundation and Tax Policy Center. Note that capital gains received a 60 percent exclusion in 1986, effectively reducing the rate by 60 percent. This does not include the additional 3.8 percent surtax imposed by the ACA.

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B. Additional Provisions

Essential to the goal of the 1986 tax reform was not only simplicity but also efficiency. The JCT noted that the "Act's most important measures in promoting the efficiency in the economy . . . are the dramatic reductions in personal and corporate tax rates." However, Congress enacted TRA 1986 to be revenue-neutral, which necessitated the repeal of a host of other tax preferences to finance rate reduction. The politically-imposed constraint served to enhance economic efficiency insofar as most of those preferences represented distortions that reduced economic growth. For instance, the JCT noted that some of these discarded tax incentives led to excessive office construction and wasteful agricultural tax shelters, among other inefficiencies.

While TRA 1986 managed to reduce tax preferences to concomitantly reduce rates, it did nothing to preclude the return of discarded tax expenditures — or new ones, for that matter. (To be fair, Congress has no recourse by which it can effectively tie the hands of a future Congress.) According to the Congressional Research Service, tax expenditures did decline sharply as a share of GDP following the passage of TRA 1986, but they began increasing again soon thereafter.[1]

However, TRA 1986 did not address many of the largest tax expenditures that prevailed at the time and remain in the tax code, such as the exclusion for employer-sponsored health insurance, the deduction for mortgage interest, and the deduction for state and local taxes. According to the OMB, these three policies are responsible for about one third of the estimated $7.3 trillion in forgone revenue attributable to tax expenditures over the coming decade. Each was in the code before 1986 and has survived since with little political threat.

The single largest tax expenditure in the tax code is the exclusion for employer-sponsored health insurance. Its origin is an artifact of World War II-era wage controls that induced the growth in unrestricted fringe benefits such as healthcare. The tax code codified this exclusion in 1954 and it has persisted to this day.

While TRA 1986 did not touch this policy, two other "sacred cows" — the deductions for mortgage interest and state and local taxes — are in some ways reflections of the attempt to limit some of these policy elements from the code. The mortgage interest deduction is a vestigial policy that reflects pre-1986 tax policy when *all* consumer interest was deductible, including credit card and auto loan debt. TRA 1986 limited the deduction to home mortgage interest. While current law allows for the deduction of state and local income, property, and sales taxes, TRA 1986 repealed the deduction for state and local sales taxes. This provision was restored with the American Job Creation Act of 2004 on a temporary basis and remains available today.

Since TRA 1986 Congress has added additional tax preferences to the individual code. The restoration of the deduction for state and local taxes is one key example, but there are many others, including savings incentives for college tuition, new varieties of retirement savings accounts, and an above-the-line deduction for classroom expenditures by teachers. These new tax expenditures include the expansion of existing preferences such as the earned income tax credit, which has been amended and made more generous at least five times since 1986, as well as the creation of new provisions such as the child tax credit and the HOPE scholarship credit and Lifetime Learning credit.

Ultimately, TRA 1986 did not change the political environment in a way that would allow the largest and most durable elements to be stricken from the code for perpetuity. However, the persistence of many of these large tax expenditures is not a failure of the 1986 reform as much as it reflects the difficulty in fully eliminated, broadly enjoyed tax preferences.

C. Business Taxation and the Individual Code

According to IRS Statistics of Income data, legal passthrough entities filed 30.9 million tax returns in 2011. These returns were filed by 23.4 million sole proprietorships, 4.6 million S corporations, and 3.3 million partnerships such as LLCs. These reflect the growth in the preference for legal forms of organization other than C corporations. Indeed, since 1986 there has been a

[1] Donald J. Marples, "Tax Expenditures: Overview and Analysis," CRS Report 7-5700 (Apr. 30, 2015).

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relative decline in the number of C corporations as a share of businesses.

The JCT data show that 1986 was the last year in which the number of C corporation returns exceeded the number of returns from passthrough legal entities. While the number of C corporations has declined by a third since 1986, the number of passthrough entities has tripled — a trend that can be largely attributed to TRA 1986 itself. While the act reduced both individual and corporate rates, it reduced individual rates below the prevailing corporate rate — 28 percent versus 34 percent (and since 1993, 35 percent). The proliferation of businesses that decided to avail themselves of the individual code is a reasonable consequence of this disparity, combined with the fact that passthrough businesses have only a single layer of taxation.

Other features of the business tax code reflect the growth in passthrough entities, specifically business expensing. The most significant expensing provision available under the individual tax code is section 179, which allows companies to deduct the cost of some investments up to an allowance, which phases out above a specific amount of aggregate company expenditure on property. This phaseout limitation broadly confines the use of this provision to small to medium-sized companies.

This provision has its origins in the Small Business Tax Revision Act of 1958 and went largely unchanged until the early 1980s. The Economic Recovery Tax Act of 1981 increased the prevailing expense allowance to $5,000, but the provision was underutilized. Enactment of TRA 1986 eliminated the investment tax credit, and thus more companies availed themselves of these capital cost recovery provisions. Since 1986 Congress has expanded section 179 dramatically — in 2013 the maximum deduction was $500,000, with a phaseout threshold of $2 million. This remains an essential element of the post-TRA 1986 individual code and, to the extent Congress continues it, will continue to affect investment decisions among companies.

Table 4. Section 179 Allowance 2003-2013

Year	Maximum Deduction	Phaseout Threshold
2003	$100,000	$400,000
2004	$102,000	$410,000
2005	$105,000	$420,000
2006	$108,000	$430,000
2007	$125,000	$500,000
2008	$250,000	$800,000
2009	$250,000	$800,000
2010	$500,000	$2,000,000
2011	$500,000	$2,000,000
2012	$500,000	$2,000,000
2013	$500,000	$2,000,000

III. Evolution of the Corporate Code

A. Tax Rates

The one feature of TRA 1986 that has remained stable is the corporate tax rate. Before TRA 1986 the federal corporate tax rate was 46 percent, which was above the rate imposed by most developed nations at the time. Tax reform reduced that rate to 34 percent by 1988. At the time this rate placed the United States in the bottom third of developed nations; however, the U.S. corporate income tax rate has been largely unchanged since, with one exception — an increase of 1 percentage point as part of OBRA 1993. In 2005 the Crane-Rangel bill reduced the corporate tax rate for manufacturers — defined loosely enough that the creation of movies and software qualified as "manufacturing" — by 3 percentage points.

In the ensuing decades since the 1986 tax reform the United States has come to reclaim its position as a high-tax corporate jurisdiction. According to OECD data from 1988-2013, only the U.S. rate has increased over time, while almost all other nations have lowered their rates significantly. A 2013 study reported that since 2000 there have been nearly 100 separate corporate tax rate reductions in the OECD, with few of those rate reductions "paid for" by an

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offsetting spending reduction or revenue gain elsewhere.

A key goal of the 1986 reform was to lower tax rates to enhance economic efficiency. However, in a modern world with ever more mobile capital and when the importance of the United States to the global economy continues to lessen, lowering corporate tax rates was prescient but ultimately insufficient. Today there is a bipartisan belief — which is also held by the White House — that our corporate tax rate is too high, but the "pay as you go" straitjacket and congressional gridlock make further reductions politically intractable.

B. Capital Cost Recovery

The 1981 tax legislation instituted the accelerated cost recovery system. Before 1981 a corporation could deduct only the proportion of a capital investment deemed to have depreciated in that year; for a $100,000 truck deemed to have a useful life of ten years, that would mean the company could deduct $10,000 each year.

The tax code at the time also provided an investment tax credit for qualified property to the extent that the combined effect of these incentives provided a greater tax benefit for some assets than if the asset were expensed. In some instances the effective tax rate on capital could be negative, which meant the tax code delivered a subsidy to the investor.

The combined impact of these tax provisions created a significant disparity between investments in assets qualifying for the investment tax credit and those not eligible for it. Eliminating these distortions was a key goal of the politicians crafting the 1986 reform, who addressed it with the modified accelerated cost recovery system, which lengthened the effective asset lives on depreciation schedules. However, to compensate for the repeal of the investment tax credit, TRA 1986 also provided greater acceleration of cost recovery. Taken together, tax reform reduced the disparity of the after-tax returns to capital investment across the economy, but it did so by reducing the tax investment incentives overall. Many economists — most notably Stephen Entin, who was with Treasury at the time — believe this was a fatal flaw of the 1986 reform, and that it led to lower rates of economic growth than had we done nothing.

The modified accelerated cost recovery system remains the primary cost recovery system in the tax code. Over time, recovery periods for some assets have variously been altered (notably for racetracks and restaurant property), but in general the post-TRA 1986 depreciation regime has been durable, for better or worse.

Congress has attempted to provide short-term boosts in capital investment during economic downturns in the form of "bonus depreciation," which is temporary partial expensing. This policy can trace its recent history to 2002, when Congress and the administration sought to incentivize business investment during a recession and granted companies the ability to immediately expense 30 percent of a qualified investment. This incentive has remained a fixture of the tax code over the last decade, and it at one point rose as high as 100 percent — what amounts to full expensing.

Table 5. Temporary Partial Expensing

Name of Legislation	Enacted Date	Deduction
Job Creation and Worker Assistance Act of 2002	Mar. 9, 2001	30%
Jobs and Growth Tax Relief Reconciliation Act of 2003	May 28, 2003	50%
Economic Stimulus Act of 2008	Feb. 12, 2008	50%
American Reinvestment and Recovery Act	Feb. 17, 2009	50%
Small Business Jobs Act of 2010	Sept. 27, 2010	50%
Tax Relief Act of 2010	Dec. 17, 2010	100%
American Taxpayer Relief Act of 2012	Jan. 2, 2013	50%

Investment incentives such as expensing and accelerated depreciation lower the user cost of capital and ultimately enhance economic growth over the long run. However, combined with other elements of the tax code left unaddressed by TRA 1986 and subsequent acts, these elements can introduce the types of investment distortions that TRA 1986 sought to mitigate. For instance, corporate interest expenses are a deductible

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expense, while dividends and returns to equity are not. This introduces a significant disparity between the tax treatment of debt and equity financing. Indeed, debt financing creates a marginal effective tax rate of -2.2 percent for companies, compared with 39.7 percent on equity financing. This disparity considerably distorts corporate finance decisions and company capital structure, while providing a subsidy to debt-financed investment.

C. Temporary Tax Provisions

The 2001-2003 tax code changes were done via reconciliation, which cannot be filibustered in the Senate and thus only requires 50 votes for passage. However, reconciliation does not allow a tax bill to have any budgetary impact outside of a 10-year budget window. To conform to the reconciliation rules, much of the 2001-2003 tax bills expired after a few years — including the personal tax rate reductions. Other business tax breaks expired before the 10-year budget window, and Congress responded by annually passing one-year extensions of these bills while concomitantly attempting to forge a legislative solution to permanently resolve this tax code transience.

President Obama and Congress reached a deal to make the 2001-2003 rate reductions permanent for all but those who earn over $450,000. Later that year then-House Ways and Means Committee Chair Dave Camp crafted a bill that made many of the business and energy provisions permanent as well.

IV. An Oft-Changing Tax Code

The notion that the tax changes achieved in the 1986 tax reform could have been etched in stone and left as the law of the land in perpetuity is silly. No law, however hard won, is safe from future congresses. Across several areas of the tax code much of the act has been undone, with the changes most notable on the individual side, where a two-bracket rate structure has expanded threefold. The various changes have resulted in rates on upper-income taxpayers and passthrough entities becoming more than one-third higher than in the late 1980s.

What's more, myriad tax expenditures have re-entered the code in the ensuing three decades. While some of these represent little more than a congressional attempt to micromanage the economy or provide favors for some industries and businesses, others were done in an earnest attempt to boost the economy and provide economic growth. Eliminating a tax break that was perceived — rightly or wrongly — to create jobs in a specific industry in the name of simplification was difficult to achieve in 1986, and doing so again may be beyond the abilities of future congresses.

But it's a mistake to treat the tax code that resulted from the 1986 act as approaching nirvana, or as something that a future tax reform should try to replicate. The 1986 tax reform left in place the largest and most economically deleterious tax expenditures in the code — namely, the mortgage interest deduction and the exclusion of employer-paid health insurance — and reintroduced the ability of individuals to deduct taxes paid at the state and local level, which essentially results in the federal government subsidizing the spending done by states and localities.

The one important facet of the 1986 reform that did achieve some level of permanence — the corporate tax rate — has remained the same, while literally every other developed country has reduced rates in the meantime, leaving us today with the highest corporate tax rate in the OECD.

Whoever first coined the line that nothing is certain in life except death and taxes wasn't familiar with the IRC. What the changes in the post-1986 tax code teach us is that even if Congress manages to work together to craft a broad-based reform of the tax code, keeping the code protected from future attempts to undo its reforms is impossible. In some respects, tax code stasis may not even be a worthy goal: As the world changes and our knowledge of how people react to the levers contained in the tax code changes, it's only natural that we would want to update the tax code. However, changing the corporate tax code has proven to be all but impossible. The political dangers of doing such a thing — which opponents eagerly label as nothing but a gift to evil corporations — make corporate rate reductions as much of a third rail as entitlement reform. ■

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