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Corporate Tax

Ike Brannon of Capital Policy Analytics and the Cato Institute discusses the benefits and drawbacks of replacing corporate taxation with shareholder taxation similar to the current S corporation approach. Brannon says the goal should be to tax all business income once and only once so that the tax system no longer distorts the choice of organizational form or discriminates among types of businesses.

The Benefits of Integrating the Personal and Corporate Tax Codes

BY IKE BRANNON

There are a lot of contentious issues related to business taxation: Should we try to tax the foreign income of multinationals and, if so, how? Should we allow immediate deductions for business investments or make companies write them off over time? Should business income be taxed at a lower rate than other income? Views on these issues tend to follow a fairly predictable partisan divide.

But there's one issue on which economists from across the political spectrum tend to agree: the current system of business taxation is needlessly complex, inefficient, and often unfair.

The U.S.—like most of our major trading partners—has a ''classical income tax'' that taxes U.S. shareholders twice: once at the corporation level and again when shareholders realize income via dividends or capital gains. The consequence is that corporate income taxed at wildly different rates depending on who holds the corporate stock, whether investments are financed by debt or equity, and—because of our porous income tax— the kinds of investments that the company makes and where those investments are located.

In contrast, closely-held businesses that organize as S-corporations are taxed only once at the individual level. Profits and losses flow through to the shareholders as current income subject to ordinary income tax rates. Whether these pass-through businesses pay more or less tax than their corporate cousins is open to debate, but the S corporation approach to taxing business income is clearly less complex and less distortionary than the double corporate tax.

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Public finance economists have long agreed that a straightforward solution to this hodgepodge of inefficient and inequitable taxation would be to tax corporation income the same way we tax closely held businesses and partnerships. Although there are significant practical complexities, the goal should be to tax all business income once and only once so that the tax system no longer distorts the choice of organizational form or discriminates among types of business income.

The potential benefits from such a reform could be significant: a less-distortionary tax code would reduce the role of taxation in determining where capital is invested, increasing the odds that it would flow to the most productive investments. Ending the tax penalty on C-corporations would mean that more companies would have access to the stock market as a relatively efficient source of investment capital. (Only C corporations can have more than 100 shareholders or gain access to stock markets.) The bottom line is that this reform could be designed to boost the economy without adding to the deficit.

The current debate on tax reform has thus far skirted the issue of corporate integration, no doubt because its benefits are non-intuitive. However, there is no reason that corporate integration could not be a part of a fundamental tax reform, and done in a way so as to maintain the progressivity of current law.

Improving the Tax Code

Economists have been debating the merits of integrating the personal and corporate tax systems for more than half a century—at least back to the publication of Arnold Harberger's seminal article on the incidence of the corporate income tax in 1962. In 1992 the U.S. Treasury released a report entitled ''Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once,'' under the direction of Glenn Hubbard, then the Deputy Assistant Secretary for Tax Analysis and later Chair of the Council of Economic Advisers. The study helped bring the notion to the attention of the broader policy community.

More recently, Eric Toder of the Tax Policy Center and Alan Viard of the American Enterprise Institute published a particular approach to corporate tax integration that has generated a great deal of interest amongst the tax economists.

The broader public, however, is less easily swayed. They see corporations as giant, highly profitable enterprises, many of which don't pay their fair share of the tax bill. Economists counter that corporations might remit taxes, but the burden is ultimately borne by people: shareholders, other investors (because the shift of capital away from corporations to other investments pushes down their rates of return), consumers (via higher prices), and workers (because companies invest less in machines that could make them more productive).

Determining who ultimately bears what portion of the corporate income tax is a point of some debate, but there is widespread agreement that the workers bear part of the burden—the Tax Policy Center concluded that workers bore 20 percent of the corporate tax, close to the figure reached by the U.S. Treasury's Office of Tax Analysis. A study published by the Congressional Budget Office estimated that workers bear as much as 75 percent of the burden. Because capital is increasingly mobile and can move across borders at little cost, there's reason to believe that ratio is increasing over time.

The fact that working Americans bear a sizable fraction of its burden suggests that it might not be a great way to alleviate income disparity.

Some have proposed to abolish the corporate income tax altogether, but that is neither politically feasible nor desirable. The problem is that there is not necessarily a bright line that distinguishes corporate income from labor income. Absent a tax on corporate profits, corporations would become the ideal tax shelter. Sole proprietors will have an enormous incentive to incorporate and forgo wage income in favor of tax-free corporate profits, and others who are currently wage earners would have a strong incentive to incorporate and become provide services under contract with their former employers. (Something like this occurred in Kansas when it exempted S-corporations from the state income tax.)

Even absent such tax shenanigans, it's not clear the federal government could replace the hundreds of billions of dollars the corporate income tax raises each year.

Open-Economy Advantages of Shareholder Taxation

The most contentious issue with the current corporate tax code is the implicit incentive it gives for U.S. companies to be taken over by a foreign entity and move its domicile outside of the U.S., thereby allowing it to avoid paying U.S. taxes on any of its income earned in another country. Dozens of companies have undergone this maneuver in recent years and, despite regulatory changes made by the Treasury, more are contemplating doing so.

Corporate integration sidesteps the dilemma posed by the choice between corporate residence-based and source-based taxation. U.S. shareholders pay U.S. tax on foreign corporate income and foreign shareholders do not pay U.S. tax on corporate income, regardless of where the corporation resides or where the corporate income is earned; neither the corporate residence nor the source of corporate income needs to be defined. The U.S. tax system would no longer put U.S.-resident corporations at a disadvantage relative to foreign-resident corporations. No corporation, regardless of its residence, would be penalized for investing or locating profits in the U.S. rather than abroad, and corporate inversions would end.

Toder and Viard argue that it would actually engender an influx of foreign capital into the U.S., stating that

''The policy would result in a diversion of capital from other countries to the U.S. because investment in other countries would be subject to their corporate income taxes while investment in the U.S. would not result in corporate income tax. The movement of capital to the U.S. will make the American people better off.''

Instead of abolishing the corporate income tax, Messrs. Toder and Viard propose a method of keeping the corporate tax but eliminating the double taxation of corporate profits. Essentially, they describe—consistent with the 1992 Treasury report—how the government could ascribe every dollar of profit to the shareholder so that it's taxed at the personal level as ordinary income.

Of course, for certain businesses we already do this. Certain partnerships receive this tax treatment, and so-called S-corporations—which are limited to 100 shareholders and whose shares don't actively trade on a stock market—already impose the tax liability for corporate profits directly onto the shareholder. In essence, corporate integration would expand the S corporation tax structure so that it encompasses C corporations as well.

This is, unfortunately, much easier said than done. The tax code places various restrictions on S corporation shareholders—they can't be foreign nationals, or be held in a tax-preferred account, and must be allocated income and loss in proportion to their ownership share, to name just three—that simply wouldn't work for large corporations.

These restrictions do shed light on some of the issues that confront moving to corporate integration. The personal income tax code has various ''leaks'' in it: For instance, foreigners do not have to pay taxes to the U.S. on investment income, and the investment income of charitable foundations does not get taxed at all. Also, dividends and capital gains accrued in tax-preferred accounts are not taxed until the money is withdrawn. If we imposed a tax on corporate profits solely on the owner of capital, each of these would get off scot-free,

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and the revenue loss would be significant—an estimated three-fourths of all stock in American companies are held in a foundation, retirement account or other tax-preferred entity, according to the Joint Committee on Taxation.

The most practical way to handle this would be to impose a credit imputation system on corporate income. In essence, the government continues to impose some tax on corporate profits on the corporate level, but individual shareholders would receive a credit for this tax on the taxes that would be due on their share of the corporate profits.

For example, a shareholder facing a 25 percent personal tax rate who owned 1 percent of the stock of a company that earned a profit of $10,000 would be liable to pay income taxes on his share of the profits, which adds up to 1 percent of $10,000, or $100. In this example that's an even $25. However, he would get a credit for the 20 percent already imposed at the firm level, leaving him with a tax liability remaining of just $5, which would presumably be less than the dividend for most companies. The government taxed his share of the profits at 25 percent, but collected most of it at the firm level, in this case.

There are other complications that aren't as easy to navigate. For instance, how do we treat foreign dividends and capital gains? An EU Court ruling that countries would have to give credits for foreign taxes paid under a corporate integration tax system would likely be an insurmountable barrier to doing this there if that applied to the U.S. as well.

What's more, there are various classes of stock in most U.S. corporations. Should preferred shares be treated the same as common stock? What about convertible bonds? This may seem like a trivial question but it is one that has no good answer at present.

One final question is whether we would need to change the current pass-through structure: the answer is no, but it would be likely that more than a few would choose to change their corporate structure under the new corporate integration regime.

Objections to Replacing Corporate Taxation with Shareholder Taxation

There are some downsides to moving to corporate integration. For starters, corporations would have a stronger incentive than today to reinvest earnings rather than pay dividends. Toder and Viard warn that corporations "could be used as tax shelters if the corporation reinvests the earnings and the shareholders delay realizing the gains."

This leads to a related problem, namely that the higher tax rate on realized capital gains would worsen the lock-in effect, slowing the flow of capital from poorly-performing investments to new and potentially more productive assets, thus reducing some of the potential growth gains from such a system. Such a drawback could be ameliorated if we assessed investments each year and required people to pay capital gains on unrealized gains (and also deducted unrealized losses as well), but it is a notion that Toder and Viard view as politically unrealistic.

One complaint with the current corporate tax system is that it is biased in favor of debt, since companies can deduct interest payments. The direct shareholder taxation in corporate integration would essentially replace that bias with a bias—albeit smaller—in favor of equity, given that capital gains are taxed only at realization while interest income would be immediately taxed.

Finally, such a tax could render it more difficult to pursue policy objectives—like providing companies a tax incentive for research and development. For some, however, this is not all bad: some judge the Research and Experimentation tax credit to be ineffective at actually incentivizing new investment, and likewise see a paucity of gains from various bonus depreciation schemes, which do more to shift the timing of investment than anything else. Others eschew all such tax incentives and welcome a purer tax system dedicated to raising money so that, in the words of Jean-Baptiste Colbert, it extracts more feathers with less hissing.

Conclusion

Today's tax code has two broad, often-competing goals: generate revenue while having a minimal impact on economic growth, and do so in a way so that the burden falls primarily on the wealthier households.

A tax code that integrated the personal and corporate income tax would be more amenable to economic growth: by taxing the returns to capital precisely once we would boost investment by U.S. residents and potentially attract much more capital from foreign investors. Together, this should boost productivity and, in turn, wages as well.

However, such a reform should not be viewed merely as a tax break for investors. We could achieve the same level of progressivity in a tax code that integrates personal and corporate taxes.

By itself, corporate integration will not make the tax code any simpler: there will still be a need for a corporate tax code, and the personal income tax code could be whatever Congress wants it to be under such a system. However, such a system would be a boon for economic growth by dint of removing the pernicious double taxation of corporate profits.