Tax Foundation University

Session 2: The Business Tax Code

Areas of Focus

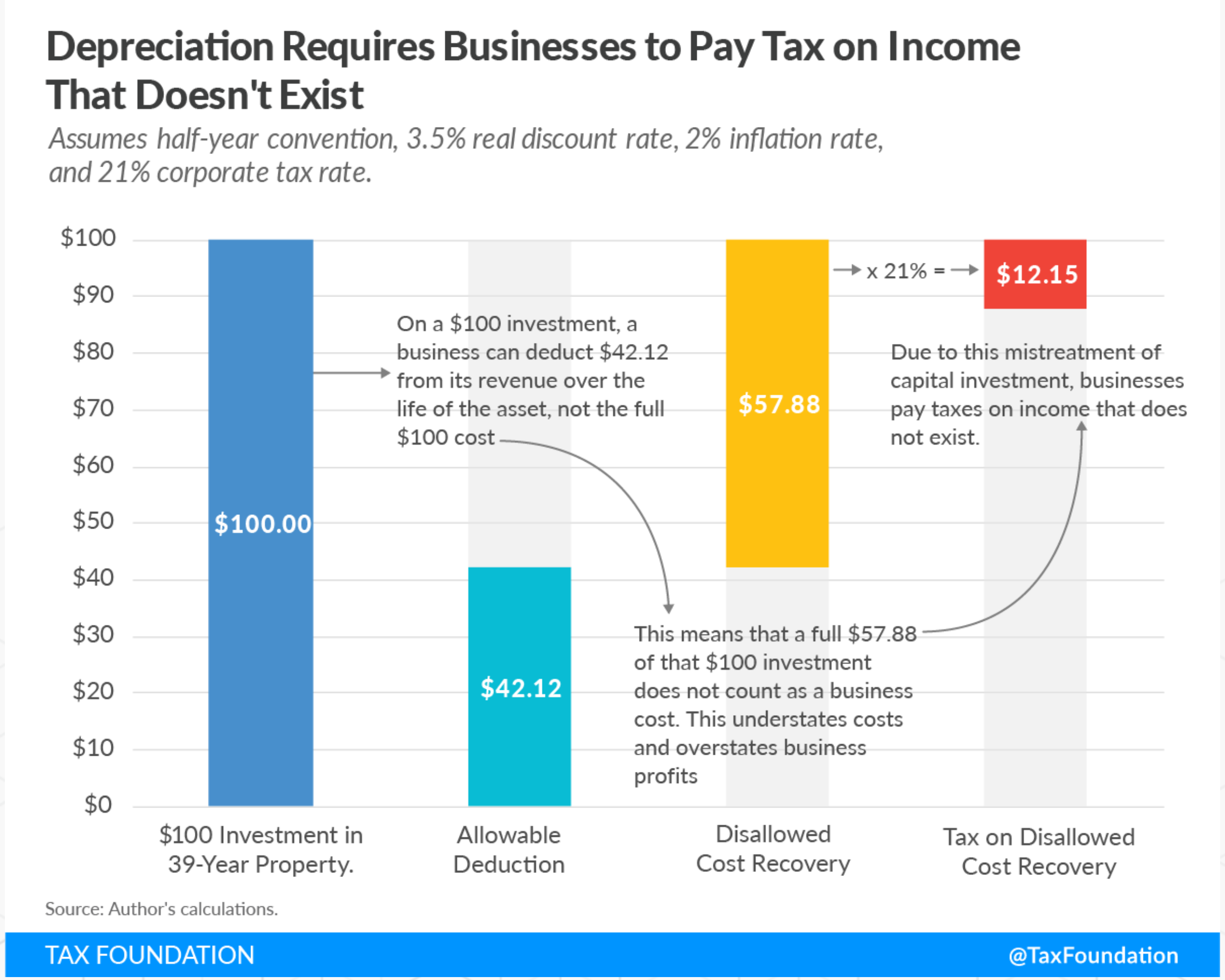
- The Basics of Corporate Income Taxes
- The Basics of Noncorporate Income Taxes
- The Impact of Corporate Taxes on Investment and Workers
- Do Corporations Pay “Zero” in Federal Taxes?
- Industrial Policy and Options for Tax Reform

Principles of Sound Tax Policy

Simplicity	Tax codes should be easy for taxpayers to comply with and for governments to administer and enforce.
Neutrality	Taxes should neither encourage nor discourage personal or business decisions. The purpose of taxes is to raise needed revenue, not to favor or punish specific industries, activities, and products.
Transparency	Tax policies should clearly and plainly define what taxpayers must pay and when they must pay it. Hiding tax burdens in complex structures should be avoided.
Stability	Taxpayers deserve consistency and predictability in the tax code. Governments should avoid enacting temporary tax laws, including tax holidays, amnesties, and retroactive changes, and strive to establish stable revenue sources.

Corporate Income Taxes – The Tax Base

- Profits = revenue minus expenses, except for capital investments
  - Capital investments must be depreciated over time
  - Depreciation artificially increases taxable income and the cost of capital
  - Depreciation is counted as a “tax expenditure” but is a normal part of a tax code that is neutral toward investment
- Net operating losses (NOLs) smooth profits over time
- Interest payments
- Current issues – TCJA Phaseouts
  - Phase out of Section 168(k) bonus depreciation
  - Section 174 R&D amortization
  - Section 163(j) interest limitation
  - International tightening



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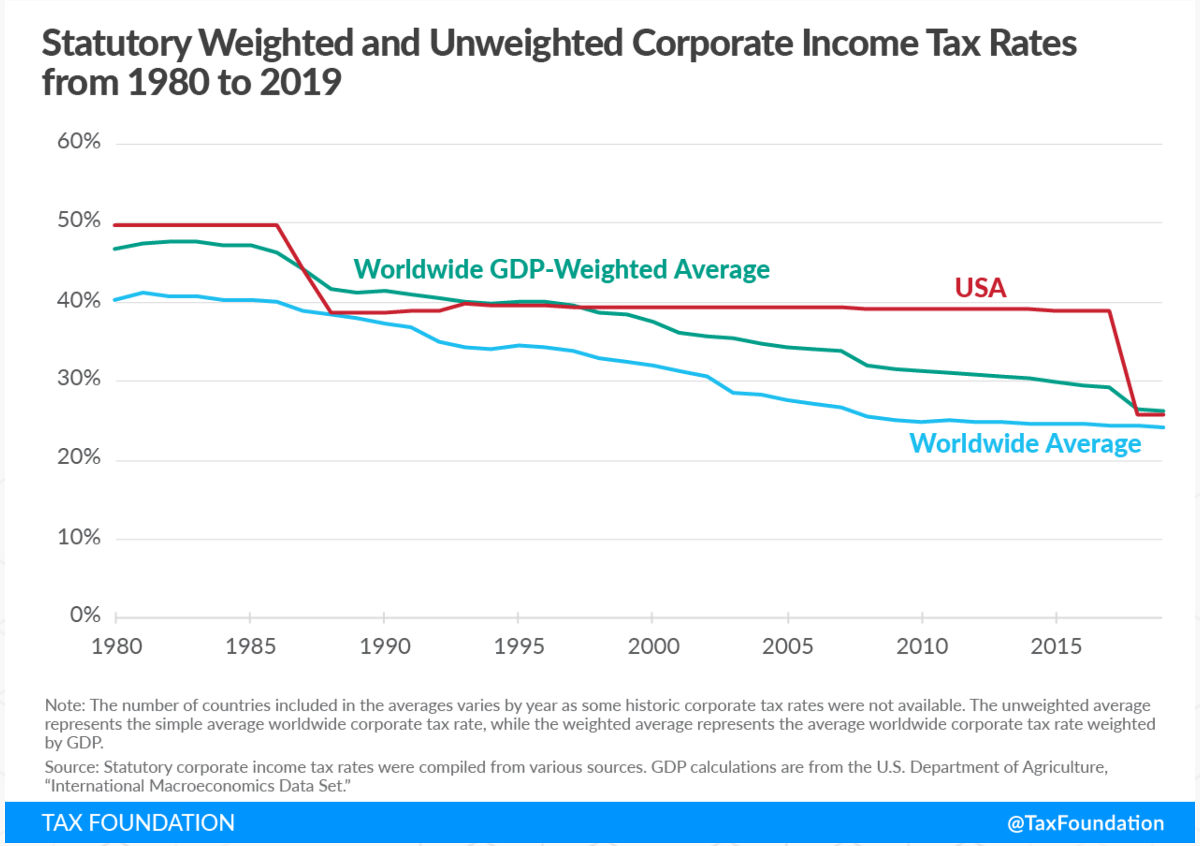
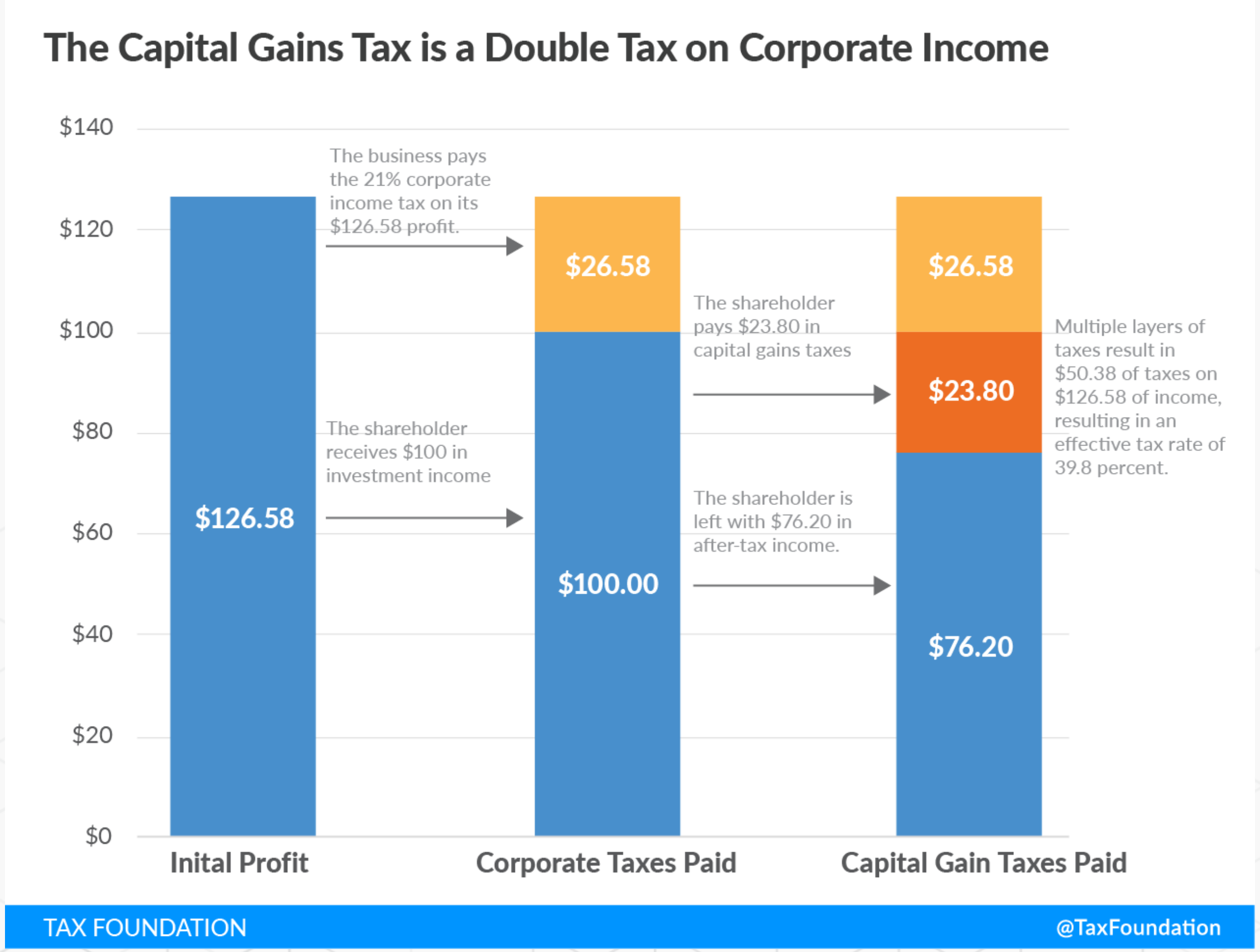
Corporate Income Taxes – The Tax Rate

- Current combined statutory tax rate is 25.8%, near worldwide average
- Prior to the 2017 tax reform, it was 38.9%, an international outlier
- Applying the tax rate to the tax base results in a corporation's tax liability
- Tax liability may be offset by tax credits
    - R&D tax credit
    - Green energy tax credits
    - Semiconductor investment tax credit
    - LIHTC



Corporate Income Taxes – Shareholder Level

- Corporate profits are **taxed at the entity level** – that's the tax we just reviewed
- And corporate profits are **taxed at the shareholder level** when distributed as dividends or realized as capital gains
- Remember the two layers of tax whenever you hear about corporate taxes or capital gains taxes, together they make up the **integrated rate on corporate income**



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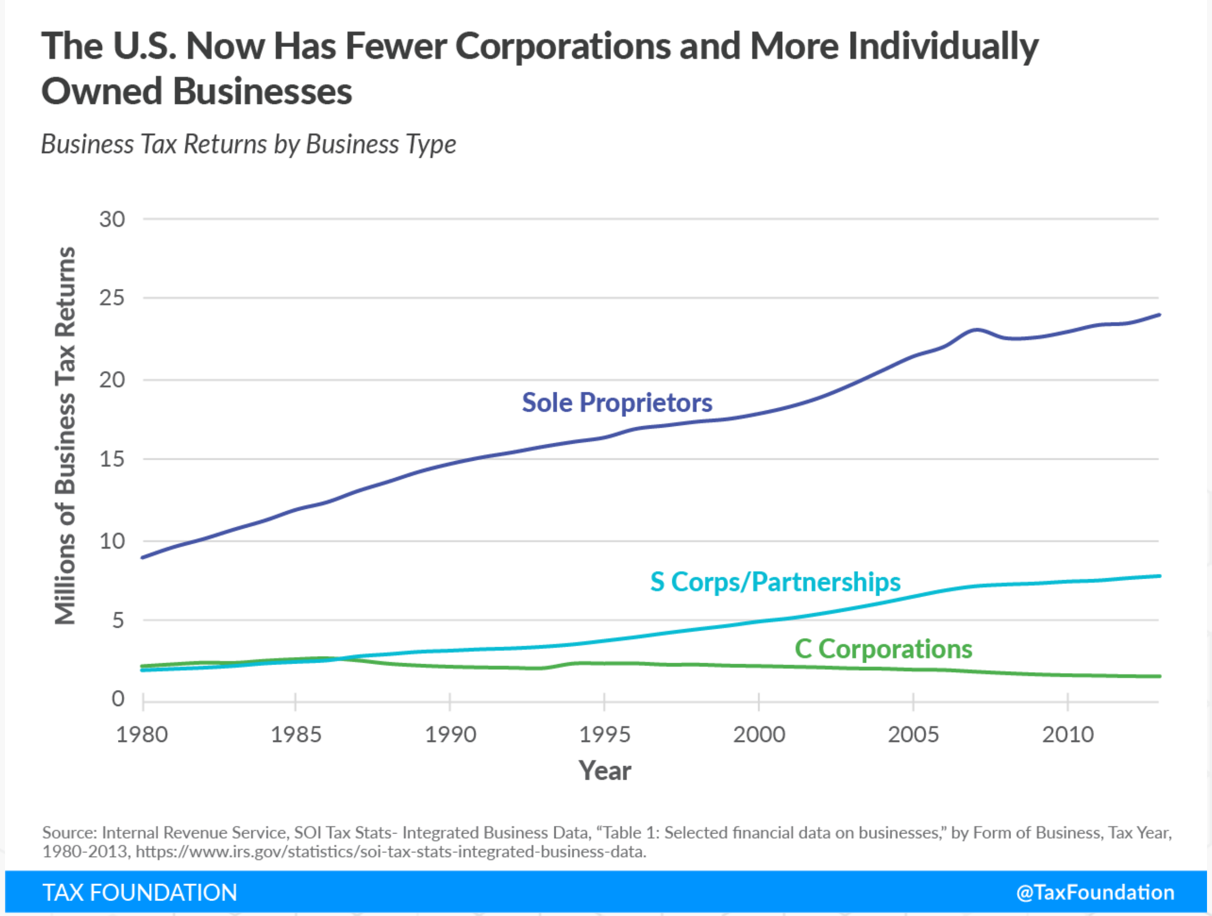
Noncorporate Income Taxes



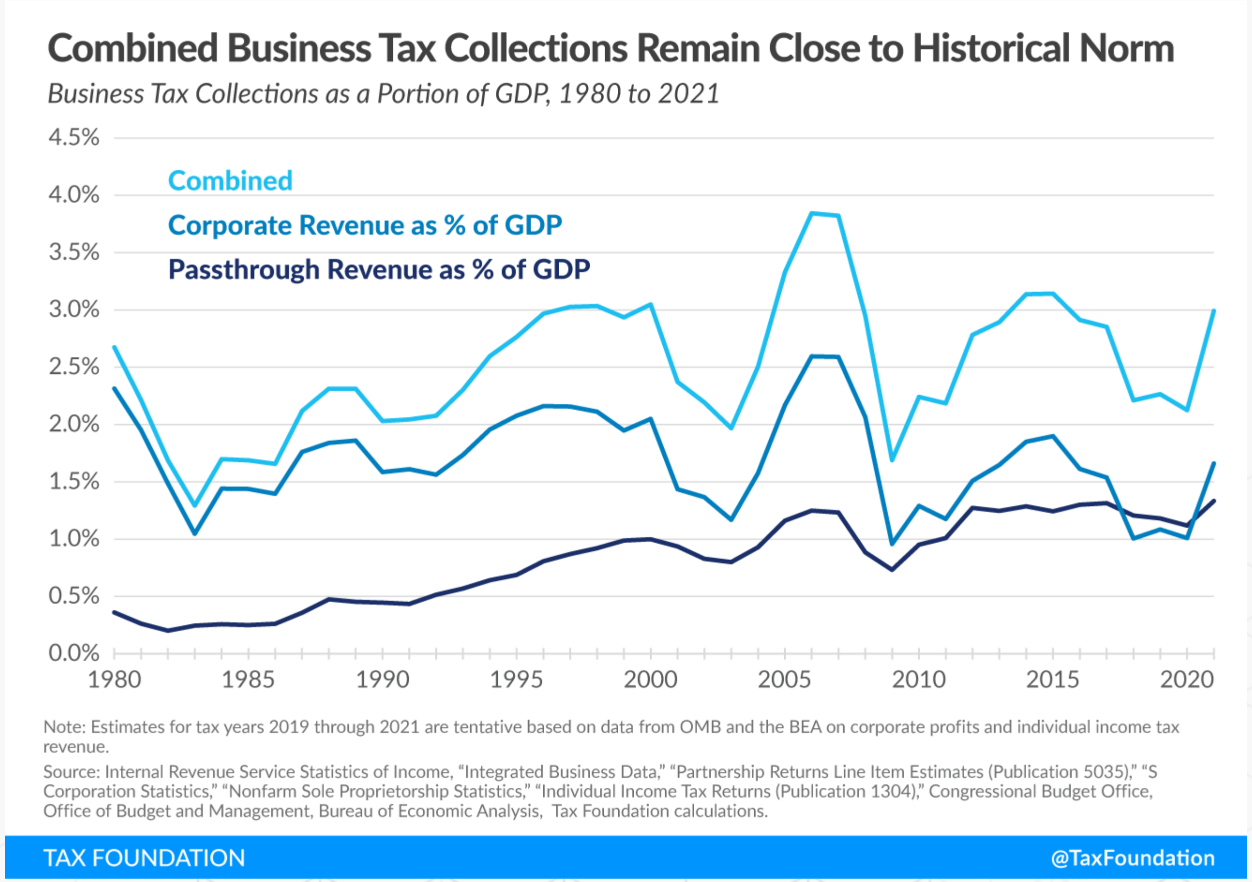
The U.S. Now Has Fewer Corporations and More Individually Owned Businesses

Business Tax Returns by Business Type

Source: Internal Revenue Service, SOI Tax Stats- Integrated Business Data, "Table 1: Selected financial data on businesses," by Form of Business, Tax Year, 1980-2013, https://www.irs.gov/statistics/soi-tax-stats-integrated-business-data.

- Pass-through entities pass profits (or losses) directly to individual owners, no double taxation
- Taxed at personal tax rates
- Owners take deductions, such as Section 199A and Section 179
- Vast majority of U.S. companies are pass-throughs

Business Tax Revenue



- Decline in number of corporations has led to a decline in corporate tax revenue as share of GDP
- FY2023 corporate tax revenues totaled $420 billion out of $4.4 trillion in total taxes
- Combining corporate and noncorporate tax revenues, total business tax revenue in the U.S. is near historical norms

Impact of Corporate Taxes on Investment

- Three rates to pay attention to
- **Statutory tax rates** affect location of profits; at the margin, a higher statutory tax rate encourages profit shifting to jurisdictions with lower statutory tax rates (impact location of profits)
- **Marginal effective tax rates** are an indicator of marginal investment incentives within a jurisdiction (impact the level of investment)
- **Average effective tax rates** are an indicator of asset-location incentives (impact location of investment)

	METR	AETR
United States, maintain TCJA biz policies	11.2%	21.5%
United States, current law	18.3%	23.4%
OECD average	15.5%	22.9%

Note: Estimates do not account for R&D tax credits.
Source: Kyle Pomerleau, "The tax burden on corporations: A comparison of Organisation for Economic Co-operation and Development countries and proposals to reform the US tax system," American Enterprise Institute, Oct. 13, 2021, https://www.aei.org/research-products/report/the-tax-burden-on-corporations-a-comparison-of-organisation-for-economic-co-operation-and-development-countries-and-proposals-to-reform-the-us-tax-system/.

Impact of Corporate Taxes on Workers

- Legal incidence says, “Corporations pay the taxes!”
- Economic incidence asks, “But who bears the burden?”
  - JCT: 75% of the burden falls on capital, 25% of the burden falls on labor
  - Tax Foundation: 50% on capital and 50% on labor
  - Range in literature suggests in some cases, labor bears 70% to 100%
- Fuest et al find corporate taxes reduce wages more for young workers, the low-skilled, and women
- Most economists, including at the OECD, find the corporate income tax is the most harmful and least efficient way to fund priorities

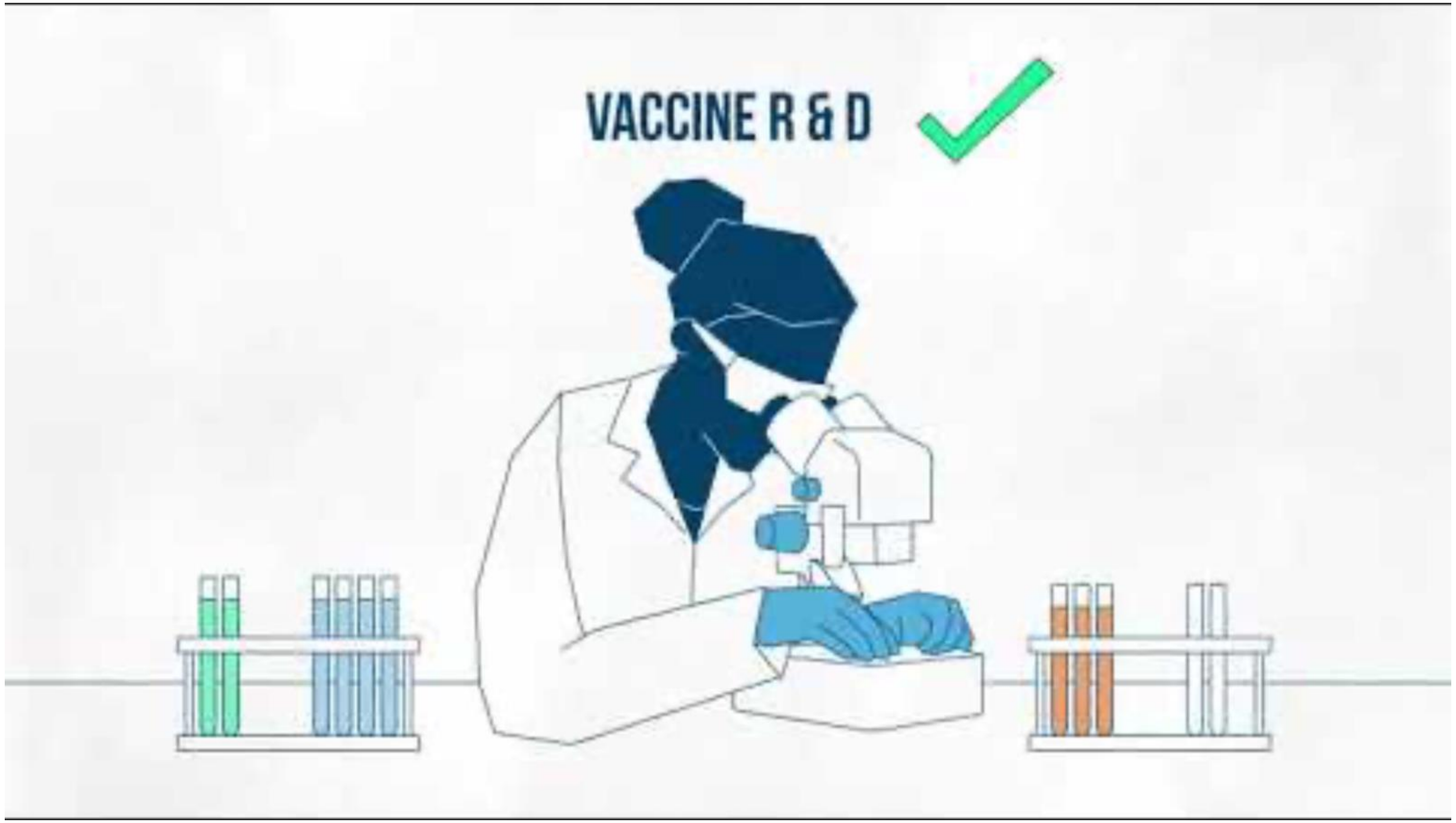
Tax Model

- https://www.taxmodel.org/userspecified


CORPORATE INCOME TAX
YOUNG
LOW SKILLED
WOMEN

Do Corporations Pay $0 in Federal Taxes?

- Taxable profits and losses are determined by tax laws
- Book profits and losses are determined by accounting standards
- Real, legitimate reasons explain why tax laws differ from accounting standards

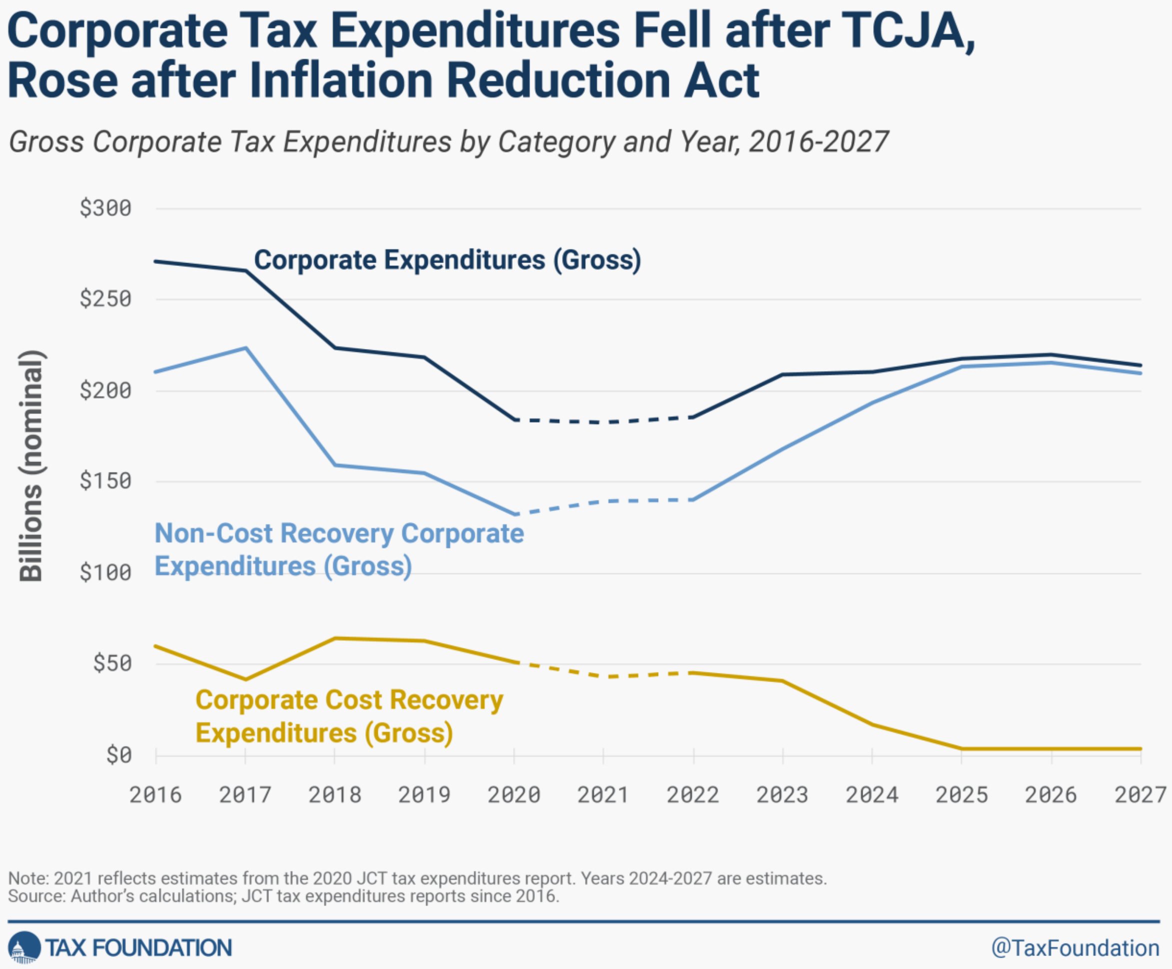

VACCINE R & D

Do Corporations Pay $0 in Federal Taxes?

- Misunderstanding the differences between book income and taxable income leads to bad policy
- Corporate Alternative Minimum Tax enacted in IRA, not as simple as it sounds
- Applies to AFSI for corporations with profits over $1 billion, effective for tax years beginning after December 31, 2022
  - Adjustments include using tax depreciation instead of book depreciation, allowing tax credits, adjustments for ambiguities between book and tax rules, etc.
- But… CAMT payments have been deferred until 2024 as the IRS needed more time to finalize guidance and regulations

Industrial Policy Versus Sound Policy

- Temptation exists to create a tax credit for anything and everything
- Trend is apparent
- Corporate tax breaks have shifted away from deductions for general investment toward subsidies for specific types of investment
- Represents a shift toward suboptimal tax policy



Wrapping Up

Rate The 21% corporate tax rate brings the U.S. in line with the worldwide average

Base Any policy short of full expensing discourages capital investment

Burden The burden of the corporate tax falls on workers and shareholders

Tax versus Book Taxable income differs from book income for good reasons

Big Issues Broad investment provisions are expiring thus raising the cost of capital, while narrowly targeted subsidies are growing thus distorting investment incentives

Questions?

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