Revisiting the Corporate Income Tax in the United States: Philosophical and Structural Issues

Anthony Pappas*

ABSTRACT

As corporate profits soar and cash reserves increase, while the government that facilitates the business environment that these businesses operate in, there is increasing discussion concerning the corporate tax burden and whether it is sufficient or "fair."

DISCUSSION

Recently, as many Americans debate ways the federal government can raise revenue, a closer look has been given to corporations and the taxes they pay. In these debates, attention is turned towards the 35% statutory tax rate that the United States levies on taxable corporate income of corporations whose revenues exceed $18,333,333 for the tax year (IRS); other times attention is given to various loopholes that corporations exploit to lessen their tax burden. There have been many studies trying to tease out where the burden of corporate income taxes fall, but it seems that shareholders bear the greater part. The Citizens for Tax Justice cynically point out that corporations do not lobby for a reduction in payroll taxes as they are borne by workers (2003). Thus, the prominence of their lobbying for corporate tax reductions seems to bolster studies that show that shareholders are most affected by changes in the corporate tax.

However, in the United States, effectively taxing corporations is hampered by the very nature of the corporate entity and also by the structural problems associated with the peculiarities of federalism. To address corporate tax reform, one has to wrestle with these underlying problems.

To begin with, there is no single corpus of federal law that handles the corporate entity; rather, corporate law is governed by each of the 50 states that comprise the Union. In taxing corporations, the Internal Revenue Service (IRS) attempts to reconcile the need to tax corporate entities on the federal level without any unifying legal structure to underpin the recognition and classification of corporations. Preeminent among the various frameworks available in America are the American Bar Association's Model Business Corporation Act (MDCA) and Delaware's General Corporation Law. The prominence of the State of Delaware may seem strange to the layman. Indeed, to the layman, when Facebook made its Iinitial Public Offering (IPO) there was great fanfare and video from Facebook's Menlo Park, California, headquarters.

* Department of Economics and Finance, Tobin College of Business, St. John's University, Jamaica, NY 11439, Email: anthonypappas1988@gmail.com

The fact that Facebook launched its IPO as a legal entity of the State of Delaware is the kind of fact that many would, perhaps, find odd. But Facebook is far from odd. The 2012 Annual Report From the Delaware Division of Corporations states that 90% of all U.S. IPOs were incorporated in Delaware and, out of the 50 U.S. states, 64% of the Fortune 500 were incorporated in Delaware (2012).

As a single legal entity it seems that a corporation is unique in its ability to be in many places at once. The statement from the MDCA that, once incorporated,

> "every corporation has perpetual duration and succession in its corporate name and has the same powers as an individual to do all things necessary or convenient to carry out its business and affairs."

is somewhat laughable for equating a corporation to anything like an "individual". To wit, with the advent of globalization, corporations can be in many countries at once; they chose where they want to be incorporated, whose laws they want to be subject too, and, most importantly, have many ways of choosing where they declare income.

The super-individual powers of corporations also extend to lifetimes: corporations have a theoretical unlimited lifetime. As such, they have avenues to tax deferral not available to individual persons. This "immortality" is one of the main reasons to have a corporate income tax. Many critics would seek to abolish the corporate income tax, arguing that corporate profits are taxed twice: first under the corporate income tax and, when corporate profits are distributed as dividends to individuals, under the individual income tax. But, without a corporate income tax, the owners of a corporation could defer their tax liability and reinvest the profits indefinitely; theoretically, a corporation could go ten or twenty years without paying the government any taxes. This is obviously unsatisfactory. It would constitute an enormous tax loophole for corporate owners and would deny the government compensation for the various services it provides that makes the carrying out of the business in the first place.

As individuals, corporations are enormous beneficiaries to an environment composed of strong, stable governments. However, the ability of the government to provide such services is underwritten by tax receipts; thus, it is well within the prerogatives of the government to tax corporations. Since the 1980s, the GAO reports corporate tax receipts accounted for 6 to 15 percent of U.S. federal revenues (2013). It is my guess that, as it currently stands, if one could put a dollar amount to the benefit that U.S. corporations receive from the government, the 6 to 15 percent companies pay is vastly disproportionate compared to the resources of the federal government that they utilize to their benefit.

To get some sort of idea of the nature of a corporation and its dependence on government, one could imagine a society without a government. In such a society, corporations would emerge to do some functions of government, but many functions are best done by governments in that, without a government, corporations would have to band together into groups of corporations to hash out the liability of each corporation for such things as roads, airports, bridges, security, etc. It is my assumption that governments are a necessarily self-organized entity among human species. In order for disparate groups to coexist, some kind of bureaucracy will form to fill the need of organizer. If in some alternate universe a government does not form as a result of individual living organisms coexisting and corporations somehow existed without a government, one could easily see how a government of some kind would eventually form; various trade organizations would not be as efficient as a centralized government in charge of dealing with facilitating individual interactions of either individual people or individual corporations.

In considering the details of corporate tax policy and the corporate tax burden, Peter Harris nicely sums up the situation in his book *Corporate Tax Law: Structure, Policy and Practice*:

> The artificial nature of the corporation is the overpowering consideration in formulating corporate tax policy. That nature often means that there is no clear policy path, only points in a spectrum. The distinction (or lack thereof) between widely held and closely held corporations and between debt and equity capital are examples of the spectrum problem. There are many others. Tax laws draw lines in these spectrums, and every time they do, corporations are structured to manipulate the line drawing.

Many critics focus on the statutory 35% top tax rate that the most profitable companies are subject to. But, to properly measure the corporate tax burden one must look at the average effective tax rates (AETR) that corporations pay. The average effective tax rate can be defined as:

> the ratio of taxes paid or tax liabilities accrued in a given year over the net income the corporation earned that year.

While not the subject of this general discussion, it should be noted that defining and calculating the components of this general formula for AETRs is not black and white and subject to wide interpretation. Additionally, obtaining the information can prove to be equally difficult. However, in May 2013 the Government Accountability Office (GAO) calculated an AETR for profitable U.S. corporations that filed a Schedule M-3 for Form 1120 as about 13 percent. Adding state, local, and foreign income taxes, the GAO found an AETR of 17 percent. This is far below the statutory rate. Including unprofitable companies, which decrease the denominator while not affecting or decreasing the numerator (as negative taxes paid), the GAO calculated an AETR of 22.7 percent. Again, far below the statutory rate trumpeted by critics of current tax rates.

While the AETR calculations are not directly comparable to those of the GAO, according to a Congressional Research Service (CRS) Report for Congress by Steven Maguire, from 1959 to 2005, taking into account that the highest federal statutory corporate tax rate has changed over this period, the AETR paid by domestic non-financial corporations has always been less than the AETR. While some of this discrepancy can be attributed to various factors such that one would never expect the statutory rate to ever be equal to the AETR, the average discrepancy over all years was about 13% with a standard deviation of about 5.5%. The year for the maximum difference between the statutory rates and AETRs was 1985 (25.8%) and the minimum difference occurred in 2000 (1.2%). The statistics regarding the discrepancies were calculated based on Maguire's data. The following table summarizes Maguire's calculations of the AETR paid by domestic non-financial corporations by decade calculations of statistics of the discrepancy between the federal AETR and the statutory federal corporate tax rate by decade based on Maguire's data:

Table 1: Federal Average Effective Tax Rate (AETR) Analysis

Decade	**Federal AETR**	**Mean difference between Federal Statutory Rates**	**Standard Deviation**
1960s	35.57% 2.67%	12.43%	2.67%
1970s	33.93% 3.73%	13.60%	3.73%
1980s	23.61% 7.01%	18.58%	7.01%
1990s	24.45% 1.04%	9.44%	1.04%
2000 to 2005	25.48%	8.27%	4.51%

Thus, it is difficult to draw conclusions between economic performance and a specific statutory tax rate because the difference between the statutory tax rate and the AETR of corporations has always been significant.

However, one can certainly conclude that the current tax brackets are in need of reconsideration. For income in the United States, the rates on taxable income for 2012 are listed in the instruction to IRS Form 1120, line 30 can be consulted to see the absurdity of the brackets.

As previously reported in this paper, the statutory tax rate is hardly ever paid and one can surmise that the corporations with profits over $18,333,333 are the ones with the greatest means to lower their effective tax rate, not least of which is the fact that these large corporations are more likely to be the multinational corporations that can take advantage of transfer pricing among the different countries they “operate” in. The rate structure above has been in place without major changes since 1993, twenty years.

As it stands, while appearing to be progressive, time has rendered the progressive tax rates for the tax brackets as meaningless or regressive. Using the Consumer Price Index (CPI) inflation calculator provided by the Bureau of Labor Statistics (BLS), in today’s dollar terms the brackets would be.

As can be seen, twenty years has totally distorted whatever reasoning was used when the brackets were created in 1993. The upper limit for the 1st bracket value adjusted with the CPI is $80,926 in 2013 and, thus, effectively places businesses in the 1st bracket in 1993 into the 3rd bracket in 2013. Some corporation who was in the 6th bracket in 1993 now finds itself paying the top tax rate.

Table 2: Statutory Tax Rates Established in 1993 in 2013 Dollars Using CPI Inflation Calculator

Bracket	Over	But not over	Difference between brackets	Over	But not over	Difference between brackets
1	$0	$50,000	$50,000	$0	$80,926	$80,926
2	$50,000	$75.000	$25,000	$80,926	$121,389	$40,463
3	$75,000	$100,000	$25,000	$121,389	$161,853	$40,464
4	$100,000	$335,000	$25,000	$161,853	$542,206	$380,353
5	$335,000	$10,000,000	$235,000	$542,206	$16,185,260	$15,643,054
6	$10,000,000	$15,000,000	$9,665,000	$16,185,260	$24,277,890	$8,092,630
7	$15,000,000	$18,333,333	$5,000,000	$24,277,890	$29,672,976	$5,395,086
Top	$18,333,333	-----------------	$3,333,333	$29,672,976	---------------	

Historically, the tax code has been updated on a more frequent basis. While the current tax brackets were effected twenty years ago, there is no hint that Congress would be able to reach an agreement on revising the tax code in the near future. Again, Steve Maguire's short report for the CRS furnishes instructive information. According to Maguire, the corporate tax highest rate brackets were:

Table 3: Highest Tax Rate Brackets

Period	Effective on taxable income above	Years in effect
1959 to 1974	$25,000	15
1975 to 1978	$50,000	3
1979 to 1986	$100,000	7
1987	1987 averaged the 1986 and 1988 brackets	------------------
1988 to 1992	$335,000	4
1993 to 2013	$10,00,00	20

The explicit calculation of years between an adjustment in the top bracket for the top rate of corporate taxable income is my addition and not in Maguire's table.

It is clear from examining the tax brackets and changes to them that as the years pass the tax code becomes more and more anomalous in its total indifference to inflation.

Furthermore, something must be done with regard to multinational corporations. Purely domestic corporations do not have the same opportunities for profit shifting and access to markets that multinational corporations have. Historically, foreign-controlled domestic corporations have reported less tax liability to the U.S. than U.S.-controlled corporations. One can only hypothesize as to the reasons for such differences and whether transfer pricing is an explanation. The tax regime should recognize the distinction between a company's operating area(s) so that purely domestic corporations are not compared to large multinationals and so that the different revenue streams from different countries of multinational corporations are more fairly taxed. Ideally multinational corporations would function under some international framework for taxation agreed upon through treaties. Having each country trying to solve the problem of taxing multinational corporations creates opportunities for corporations to manipulate corrupt nations and also to exploit the different regimes countries adopt if they advantage the corporation. As it stands, no major developed country has adopted either a fully “worldwide” approach, where all of a corporations income worldwide is taxable and the company receives foreign tax credits against domestic taxes, or a “territorial” approach, where only the income earned within a country’s borders are taxed (CBO, 2013)

In conclusion, transparent and fair taxes are to everybody’s benefit, the corporations themselves. For example, Dupont and Monsanto are in the same industry; however, over the 2008-2010 period Monsanto paid 22 percent of its profits in U.S. corporate taxes while DuPont paid a rate of -3.4 percent (McIntyre, et al, 2011). It behooves Monsanto and economists to support fair and transparent tax policies, rather than try to join DuPont in a race to exploit tax loopholes to mitigate its advantage. There are many other examples of such disparity among companies in equal industries. A corporation benefits society when it innovates in producing goods and services; however, innovation in exploiting tax loopholes is nothing other than corporations and accountants collecting “rents.” Both political parties in the U.S. Congress should strive to make the tax law relatively impervious to companies exploiting loopholes. Additionally, there are many reasons to push for an international agreement on handling multinational corporations; while anathema to many people, it is actually a more economically sound approach; like the example of DuPont and Monsanto, a company can then allocate resources according to economically productive endeavors without directing resources towards tax avoidance.

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