Policy Memorandum

FISCAL RESEARCH CENTER

GEORGIA STATE UNIVERSITY
ANDREW YOUNG SCHOOL OF POLICY STUDIES
FISCAL RESEARCH PROGRAM

SUBJECT: Double Taxation of Corporate Net Income

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Unless subject to the alternative minimum tax, corporate net income is taxed initially at a 35% top rate. If the earnings are then distributed to shareholders in the form of dividends, they are taxed again at the personal income tax rate of the individual shareholders. If earnings are retained or distributed in the form of a share repurchase, shareholders are remunerated in the form of capital gains, which are taxed as personal income only when realized (and at a maximum rate of 20% if held for more than one year). Regardless of the form in which profits are distributed to shareholders, *corporate net income is taxed twice,*[1] and thus shareholders face a higher tax rate than would be the case if they were in a partnership (or an s-corporation, limited liability corporation, or other form of pass-through entity). In the case of dividends and short-term capital gains, *the effective federal tax rate on corporate income may be as high as 60.1%* (35% corporate income tax rate plus 38.6% of the remaining 65%). Effective tax rates are even higher when state corporate and personal income taxes, which generally are structured after the federal tax, are factored in. The existence of separate corporate and personal income taxes is rather unique among developed countries.

The double-taxation of corporate net income leads to three primary distortions in economic activity:

- Because interest payments are deductible, *debt-financing is encouraged and equity financing is discouraged*. With interest deductions, identical debt-financed investments are taxed uniformly across the corporate and noncorporate sectors. The preference for debt finance leads to greater leverage in corporations than would be the case in the absence of double taxation, and thus increases financial risk, including the risk of bankruptcy.

- Because corporations face a higher (total) tax rate than do unincorporated firms, *noncorporate investments are favored over corporate investments*. Consider, for example, a corporation and an unincorporated firm that each have a required after-tax rate of return of 10%. Suppose further that the relevant effective personal income tax rate is 20% and that the corporate tax rate is 35%. An investment must then yield at least a 12.5% return in order to be undertaken in the noncorporate sector [12.5(1-0.20) = 10.0], but must earn at least a 19.2% return in order to be undertaken in the corporate sector [19.2(1-0.65)(1-0.20) = 10.0]. Given liquidity constraints (that is, a ceiling for noncorporate investment), not only are noncorporate investments preferred in this environment, but *the higher cost of capital associated with the double taxation of*

corporations leads to an overall lower level of investment than would be the case with an integrated tax system (or single tax).

- Because capital gains receive preferential tax treatment relative to dividend income (capital gains are not taxed until realized, and then likely at a preferential rate), *corporations have an incentive to retain earnings or distribute earnings in the form of capital gains (rather than to distribute earnings as dividends)* in an effort to avoid double taxation. The compliance burden is much higher with retained earnings due to IRS oversight.

Efforts to eliminate the double taxation of corporate net income generally represent efforts to integrate the personal and corporate income tax system. This can be accomplished in several ways:

- *Shareholder credit for corporate taxes paid.* Most likely this type of integration would be accomplished through a withholding tax on dividends with a credit for corporate income tax paid. The Treasury, in its 1992 study on tax integration, did not recommend this method of integration because of its complexity. Based on the 1992 Treasury estimates, we expect that the associated revenue loss in 2001 would have been $59.6 billion.

- *Corporate deduction for dividends paid.* Corporations would deduct dividend payments to its shareholders, which would largely equalize the treatment of equity and debt. While no direct revenue estimate is available for this prototype, we expect the revenue loss would be similar to that of the shareholder credit, approximately $60 billion annually.

- *Shareholder exclusion of dividends received.* Shareholders would exclude from gross income the dividends received from corporations. Due to its simplicity and ease of implementation, this was the method recommended in the 1992 Treasury report. Based on the 1992 Treasury estimates, we expect that the associated revenue loss in 2001 would have been $21.2 billion.

- *Comprehensive business income tax.* Would eliminate the deduction for interest payments at the corporate level, but would allow both interest payments and dividends to be excluded from gross income at the investor level. Based on the 1992 Treasury estimates, we expect that the associated revenue loss in 2001 would have been $67.2 billion, assuming current treatment of capital gains.

- *Repeal of the corporate income tax.* Corporate income tax collections generally hover around $200 billion annually.

In its 1992 study of the integration of the corporate and personal income tax, the Office of Tax Policy at the U.S. Treasury estimated that integration would increase the capital stock in the corporate sector by $125 billion to $500 billion (1992 dollars), would decrease the debt-asset ratio in the corporate sector by 1 – 7 percentage points, and would produce an annual gain to the U.S. economy as a whole from $2.5 billion to $25 billion.

Note

1. There are exceptions. If dividends are distributed to a tax-exempt shareholder, earnings are taxed only at the corporate level. Interest payments are deductible and therefore are taxed only at the investor level. Interest payments to tax-exempt shareholders are not taxed at all.

References

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