Corporate tax reform proposals, and how they may affect your business
May 16, 2011

Congressional Research Service's report *"Tax Reform: An Overview of Proposals in the 112th Congress"*

The U.S. has one of the highest corporate income tax rates in the world, which arguably encourages companies to take their businesses overseas—or, at least, their profits. In addition, the highly publicized tax planning techniques of some major corporations that manage to pay little or no corporate income tax have come under recent scrutiny, elevating both the public's awareness of the issue and its prominence in the overall tax debate. This article examines the current corporate tax system, perceived loopholes within the system, and a number of proposals for reform.

The current tax system. The income of a C corporation is subject to double taxation since it is taxed once at the corporate level, then again at the shareholder level. "Pass-through entities," such as partnerships and S corporations, are only taxed at the partner level. A partnership files an information return on which it reports gross income and deductions for the tax year, but these amounts are passed down to the partners (or shareholders) and taxed to them.

The general procedure for computing corporate tax is basically the same as the procedure for computing the tax of any other taxpayer. It involves computation of taxable income, application of rates, and subtraction of credits. But, specific rates are provided for corporations, special rules apply to certain special corporations, and special deductions are also authorized.

Corporations are subject to graduated tax rates similar to individuals, with a nominal top rate of 35%. Corporations are also subject to alternative minimum tax (AMT), similar to individuals, but it is calculated in a different way.

Deductions and tax expenditures. There are many deductions and credits available to corporate taxpayers. Some of these provisions can be categorized as intending to encourage taxpayer spending and revive the economy, such as the accelerated write-off of business equipment and machinery. Others are more policy-driven, such as Code Sec. 174 's deduction for research and experimental expenditures, or various deductions and credits designed to promote "green" technology. Some claim that other provisions are simply a result of lobbying efforts by influential industries. The cumulative result of these provisions is a complex Code that allows certain corporate taxpayers to pay an effective tax far below the nominal 35% top rate.

For instance, according to a 2008 study by the Government Accountability Office (GAO), during the 8-year period of '98 through 2005, 55% of U.S.-controlled corporations reported a zero tax liability during at least one year. 42% of those corporations reported a zero liability for two years, and 24% for four or more years.

The various deductions, credits, and incentives also result in significantly disparate treatment among corporations by industry. For instance, it is widely known that technology companies often pay a lower effective tax rate than other types of industries. There are a number of reasons for this, including that technology companies can often deduct, rather than capitalize, the costs of developing software and other products, and that the underlying product (often patents and other types of intangible property) is readily transferrable to low-tax countries. By way of comparison, traditional retailers of tangible goods generally can't take advantage of these provisions (or, at least, not to the same extent) and thus typically pay higher rates overall than their high-tech counterparts.

Foreign income issues. Another way that U.S. corporations reduce the amount of, or postpone the payment of, their U.S. taxes is by offshore tax deferral, which has been identified by the Congressional Research Service (CRS) as the third largest corporate tax expenditure in 2010. (The largest is bonus depreciation, which was expanded and extended by the 2010 Tax Relief Act, and the second largest corporate tax expenditure results from a temporary provision allowing deferral of discharge of indebtedness income occurring in 2009 and 2010;) Although U.S. corporations are generally taxable under Code Sec. 862 on income from outside the U.S. just as they are on income from inside the U.S., and thus shouldn't have any tax advantage by virtue of another country's low rates, there nonetheless exist a number of potential tax advantages to foreign-source income.

In general, subject to certain limitations, foreign-source income is insulated from U.S. tax until it is actually brought back to the U.S., at which point it is taxable income to the U.S. owners. So, under current law, U.S. corporations can defer income—by, for example, forming a wholly-owned foreign subsidiary in a low-tax country. The profits that the foreign subsidiary earns are subject to the foreign country's lower tax, but generally are not subject to U.S. tax, and the U.S. corporation won't pay any U.S. tax on the subsidiary's profits unless and until they are repatriated to the U.S. The U.S. corporation will also receive a foreign tax credit for the amount of tax that it paid to the foreign country.

Corporate tax as a source of revenue. According to a CRS report, in FY2010, the $191 billion in corporate tax reflected 8.9% of total tax collections, and 1.3% of the gross domestic product (GDP. In light of the “great recession” and the corresponding focus on the national deficit, it is worth noting that the U.S.'s 1.3%-of-GDP share for 2010 is significantly lower than it has been historically—it was 2.7% in 2007, and averaged closer to 5% in the '50s. (See Office of Management and Budget (OMB) tables, Receipts by Source as Percentages of GDP: 1934–2016, at http://www.whitehouse.gov/omb/budget/Historicals/) The 1.3% share is also significantly lower than that most OECD (Organization for Economic Cooperation and Development) countries.

Tax reform proposals. The most common proposal, in general terms, is to broaden the corporate tax base (i.e., by doing away with or modifying certain deductions and credits) and lower the rate. By broadening the corporate tax base, a corporation's taxable income would presumably be a clearer reflection of its income, and corporations that have tax planning departments would have less advantage over smaller businesses that do not. The reduction in deductions, credits, and expenditures would presumably simplify the system and cover lost revenue associated with lowering the rate.

Administration's proposals. In President Obama's State of the Union address on Jan. 25, 2011, he called on Congress to reform the corporate tax system. Noting that "[t]hose with accountants or lawyers to work the system can end up paying no taxes at all," he specifically emphasized the need to simply the system, eliminate loopholes, and "level the playing field". He reiterated the need to reform the Code on April 11, in a budget proposal titled "The America We Believe In" (see Federal Taxes Weekly Alert 04/21/2011).

The President's Fiscal Year 2012 budget proposal, released on Feb. 1, 2011, called for a good deal of tax-related reform. Among other things, the President sought to increase the research credit and make it permanent, make the Code Sec. 179 rule allowing up to $125,00 to be expensed permanent (under current law, the maximum expensing amount is $500,000 for tax years beginning in 2010 or 2011, dropping down to $125,000 for tax years beginning in 2012, and then falling to $25,000 for tax years beginning after 2012), and eliminate tax preferences for oil, gas, and goal companies.

The 2012 budget proposal also contained a number of U.S.-international tax reform proposals that target transfer pricing tax strategies. These proposals, if enacted, would, among other things, (i) preclude a corporation from receiving a current benefit from an interest expense deduction while deferring the associated tax burden; (ii) change the way that a corporation's "deemed paid" credit is calculated (iii) increase the amount of income that U.S. shareholders would have to include and pay U.S. tax on, regardless of whether or not it was actually distributed to them; and (iv) subject certain intangible assets (workforce in place, goodwill, and going concern value) to the restrictions imposed by Code Sec. 482.

Another reform proposal that the Administration is reported to be considering is taxing as corporations pass-through entities with gross receipts of $50 million or more. According to various reports, this provision is part of a tax reform package that could be unveiled later this month. Treasury Secretary Timothy Geithner had hinted at this issue in his testimony before the Senate Finance Committee on Feb. 15, 2011, stating that "Congress has to revisit this basic question about whether it makes sense for us as a country to allow certain businesses to choose whether they're treated as corporations for tax purposes or not."

Other unconfirmed reports indicate that a top corporate rate of 26% could be included as part of the soon-to-be-released reform package.

Rep. Ryan's House-approved budget proposal. Representative Paul Ryan (R-WI), chairman of the House Budget Committee, introduced his budget plan on Apr. 5, 2011. His plan, dubbed "The Path to Prosperity," would set the highest tax rate for businesses at 25%. According to Ryan, this reduction would result in increased wages, bring the U.S. corporate tax rate closer to the rates of other developed nations and help U.S. businesses compete on an international level, and lessen incentives for U.S.-based multinational corporations to keep their profits offshore. His budget resolution was passed by the House on Apr. 15, 2011.

Although the GOP's and Obama's budget proposals are drastically different in many respects, they both reflect a desire for corporate tax reform.

Other proposals. On Jan. 5, 2011, Representative David Dreier (R-CA) introduced H.R. 99, the "Fair and Simple Tax Act of 2011." This proposal would reduce the maximum corporate tax rate to 25% and reduce the 15% rate on dividends and capital gains of individuals to 10%.

On Apr. 5, 2011, Senator Ron Wyden (D-OR) introduced S. 727, the "Bipartisan Tax Fairness and Simplification Act of 2011." This proposal would reduce the corporate tax to 24%, repeal the corporate alternative minimum tax (AMT), and eliminate numerous tax credits, deductions and income exclusions. Further, it would make permanent, for small businesses with annual receipts of $1 million or less, Code Sec. 168 's provision allowing all equipment and inventory costs to be expensed in a single year.

Although not formally proposed, a number of prominent multinational corporations have also lobbied in favor of a repatriation tax holiday. This would allow businesses to repatriate funds that corporations have earned and accumulated outside of the U.S. without subjecting those funds to the taxes that would normally apply. These efforts were rebuffed by Treasury Assistant Secretary for Tax Policy Michael Mundaca, who questioned the efficacy of a repatriation tax holiday as a means of increasing U.S. investment or jobs, but conceded that the tax treatment of overseas earnings could potentially be considered in connection with broader corporate tax reform.

Effect on businesses. It is difficult to determine the exact effect that any of these proposals would have on businesses since they are relatively unspecific in terms on how the corporate tax base would be broadened. There is, however, a good degree of consensus regarding lowering the corporate tax rate.

The general commentary underlying these proposals, and the debate in general, suggests that any reform should reduce the incentive to park profits overseas, provide incentives for companies to do business with and in the U.S., and optimally also contribute to reducing the deficit. The overall effect of many of these proposals may make little difference in the amount of taxes paid by many corporations, since reduced or eliminated deductions and credits may in some cases simply offset the reduced rate. For other corporations however, particularly those that take advantage of many of the

tax-saving opportunities available under current law, it may bring the amount of taxes that they pay closer to the effective rate paid by other businesses.

The effect of any particular base-broadening provision would likely vary from one industry to the next. For example, if depreciation schedules were slowed down, this would have a greater effect on industries that rely heavily on machinery and equipment, such as manufacturing or agriculture. Similarly, the repeal of any research-related provisions would have a large effect on pharmaceutical and computer technology firms, but would have a lesser impact on less technologically innovative industries.

If the proposal to tax large passthrough entities as corporations were to pass, this would constitute a significant change and would have a dramatic effect on many businesses and tax planners. Such a drastic change, however, would likely take a good deal of time to implement.