

Tax Policy Center
Urban Institute and Brookings Institution

THE TAX POLICY

BRIEFING BOOK

*A Citizens' Guide for the
2008 Election and Beyond*

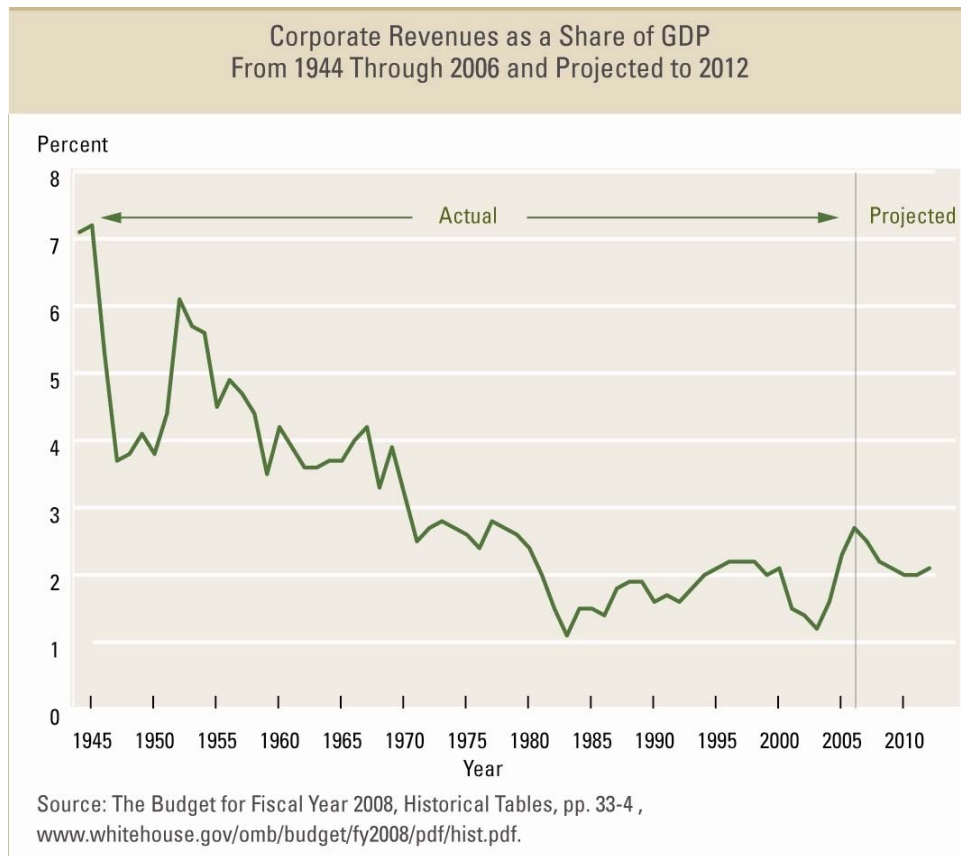
BUSINESS TAXATION

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Business Taxation: How does the corporate income tax work?

The United States imposes a tax on the profits of U.S. resident corporations at graduated rates ranging from 15 to 35 percent. Most corporate income is taxed at the maximum rate. Corporate shareholders also pay individual income tax on dividends and on capital gains from sale of their shares. The maximum tax rate on both dividends and capital gains is currently 15 percent, but both are scheduled to revert to pre-2001 levels (ordinary income rates of up to 39.6 percent on dividends, a maximum rate on capital gains of 20 percent) after 2010.

The corporate income tax is the third largest source of federal revenue, after the individual income tax and payroll taxes, and raised \$354 billion in fiscal 2006, 14.6 percent of all revenue and 2.7 percent of GDP. The relative importance of the corporate tax as a source of revenue declined sharply between the 1950s and 1980s, but over the past quarter century it has brought in around 2 percent of GDP, with some fluctuations mostly associated with the business cycle.



- Taxable corporate profits are equal to a corporation's receipts less its current expenses (including wages and interest), deductions for the cost of inventory when goods are sold, and depreciation of capital investments. U.S. resident multinational corporations pay tax on their worldwide profits, but tax on the profits of their controlled foreign subsidiaries is deferred until those profits are repatriated (that is, paid back as dividends) to the U.S. parent corporation. U.S. companies receive a tax credit, subject to various limitations, for foreign income taxes associated with their foreign-source income. U.S.-based corporations that are owned by foreign multinational compa-

nies face the same U.S. corporate tax rules on their profits from U.S. business activities as do U.S.-owned corporations.

- Some form of corporate taxation is needed under an income tax system to prevent individuals from accumulating tax-free income within corporations. But the current U.S. corporate income tax discourages the use of the corporate form of enterprise relative to noncorporate forms by imposing tax on corporate profits twice, when earned by the corporation and again when paid out to shareholders. The earnings of "flow-through" businesses (described below) are taxable only at the individual or partner level.
- The corporate tax also encourages debt finance relative to equity finance, because the interest payments of corporations are deductible whereas dividends are not, and it encourages corporations to retain earnings instead of paying dividends. The 15 percent tax rate on dividends through 2010 is below the marginal income tax rate paid by most individual shareholders, and so provides partial relief from double taxation of dividends. Even with the lower dividend tax rate, however, retained earnings are more favorably treated than dividends because tax on them at the shareholder level is deferred until capital gains are realized.
- Many U.S. businesses are taxed as "flow-through" enterprises and are not subject to the corporate income tax. These include U.S. corporations organized under subchapter S of the Internal Revenue Code (S corporations), partnerships, and sole proprietorships. Instead their shareholders or partners include their allocated share of the businesses' profits in their taxable income under the individual income tax.
- The tax law includes a number of preferences, in the form of accelerated depreciation deductions, immediate expensing of some capital costs, and tax credits, that make economic profits less than fully taxable for some businesses. In addition, corporations can reduce their tax liability through sophisticated financial transactions (called tax shelters) that take advantage of inconsistencies in the tax law, while incurring zero or negligible potential for pretax economic gain or loss. Multinational corporations can also shift some net reported income to low-tax foreign jurisdictions in which they operate. Although the Internal Revenue Service has disallowed some of these transactions, and its assessments are often (but not always) upheld by the courts upon challenge, it is difficult to monitor and control all such activities. Both tax shelters and intentional preferences reduce the tax revenue collected from corporate profits.

See Also

International Taxation: How does the U.S. international tax system work?

Data Sources

The Budget for Fiscal year 2008, Historical Tables, pp 33-4.

Author: Eric Toder

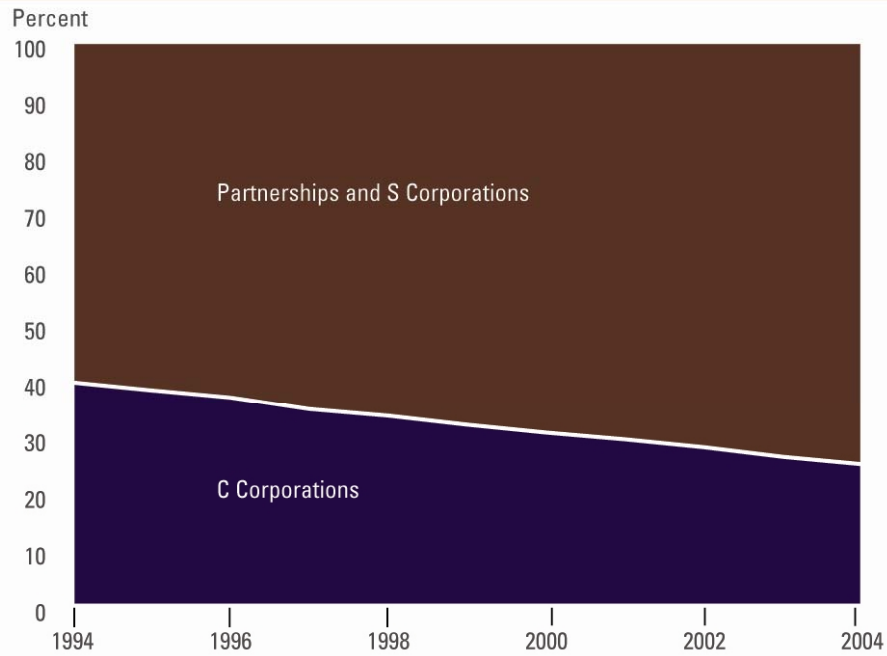
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Business Taxation: What are flow-through enterprises and how are they taxed?

Many businesses are taxed as flow-through enterprises, which are not subject to the corporate income tax as are corporations taxed under subchapter C of the Internal Revenue Code (C corporations). Instead their shareholders or partners include their allocated share of profits in taxable income under the individual income tax. These include corporations organized under subchapter S of the Internal Revenue Code (S corporations), partnerships, and sole proprietorships.

- Domestic companies with no more than 100 shareholders may elect S corporation status. Shareholders must be U.S. citizens or residents and generally may not be corporations or partnerships. In addition, S corporations may have only one class of stock.
- Partnerships have always been taxed as flow-through enterprises, but in the past they were not afforded the benefits of limited liability that the corporate form provides. State laws allowed partnerships to organize themselves as limited-liability companies beginning in the late 1970s, and "check the box" regulations instituted by the Treasury Department in the 1990s made it easy for any business to elect limited liability status.
- C corporations and flow-through businesses generally have the same rules for inventory accounting, depreciation, and other provisions affecting the measurement of business profits. But profits of C corporations are first subject to the corporate income tax (at rates up to 35 percent) and then taxed again when paid out as dividends to shareholders or when shareholders realize capital gains arising from retained earnings. (The maximum tax rate on dividends and capital gains is 15 percent through the end of 2010.) In contrast, profits of flow-through businesses are taxed just once, at the shareholder's individual tax rate for ordinary income, for which the top rate is currently 35 percent.
- Another benefit of flow-through status is that individuals may deduct business losses against income from other sources, subject to some limitations for "passive losses" from partnership income. In contrast, corporations may not use losses on their return for the current tax year to reduce current-year tax liability; instead losses may be carried back (up to two years) or carried forward (up to twenty years) and deducted against profits in previous or future years. To the extent corporations are unable to claim loss carrybacks, the tax offsets from these losses are delayed and reduced in present value.
- The share of businesses organized as flow-through businesses and the share of business receipts in flow-through enterprises have been rising over time (see figure). Excluding sole proprietorships, 75 percent of businesses were organized as flow-through enterprises in 2004, up from 60 percent in 1994; during that same period flow-through enterprises increased their share of business receipts from 23 percent to 33 percent. Most large businesses, however, are still corporate taxpayers. In 2004, S corporations accounted for 64 percent of all corporations with assets less than \$10 million and received 56 percent of gross business revenues of those companies, but for only 37 percent of corporations with assets greater than \$10 million and only 12 percent of business receipts in that category.

Figure 1. Business Returns Filed by Type of Return
As a Share of All Returns

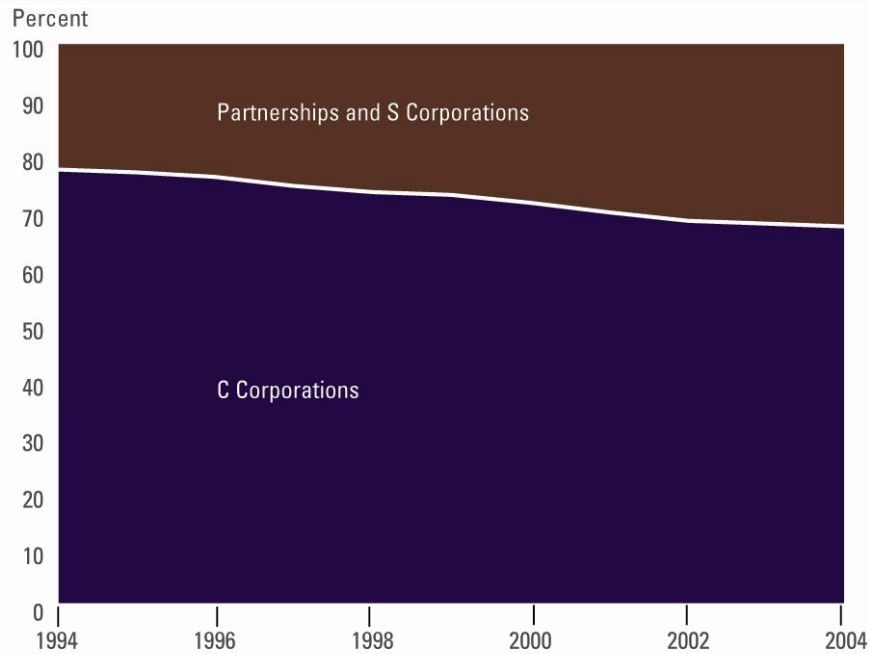


Notes:

Shares are calculated as the ratios of numbers of returns filed and business receipts for flow-through businesses (computed as the sum of partnerships and corporations other than sub-S corporations, real estate investment trusts, and regulated investment companies) to all businesses (computed as the sum of partnerships and all corporations). Sole proprietorships are not included in the calculations.

Source: Internal Revenue Service, Statistics of Income Division, and authors' calculations.

Figure 2. Business Receipts by Type of Business
As a Share of All Business Receipts



Notes:

Shares are calculated as the ratios of numbers of returns filed and business receipts for flow-through businesses (computed as the sum of partnerships and corporations other than sub-S corporations, real estate investment trusts, and regulated investment companies) to all businesses (computed as the sum of partnerships and all corporations). Sole proprietorships are not included in the calculations.

Source: Internal Revenue Service, Statistics of Income Division, and authors' calculations.

See Also

Business Taxation: How does the corporate income tax work?

Data Sources

Internal Revenue Service, Statistics of Income Division, SOI Tax Stats - Corporation Tax Statistics.

Further Reading

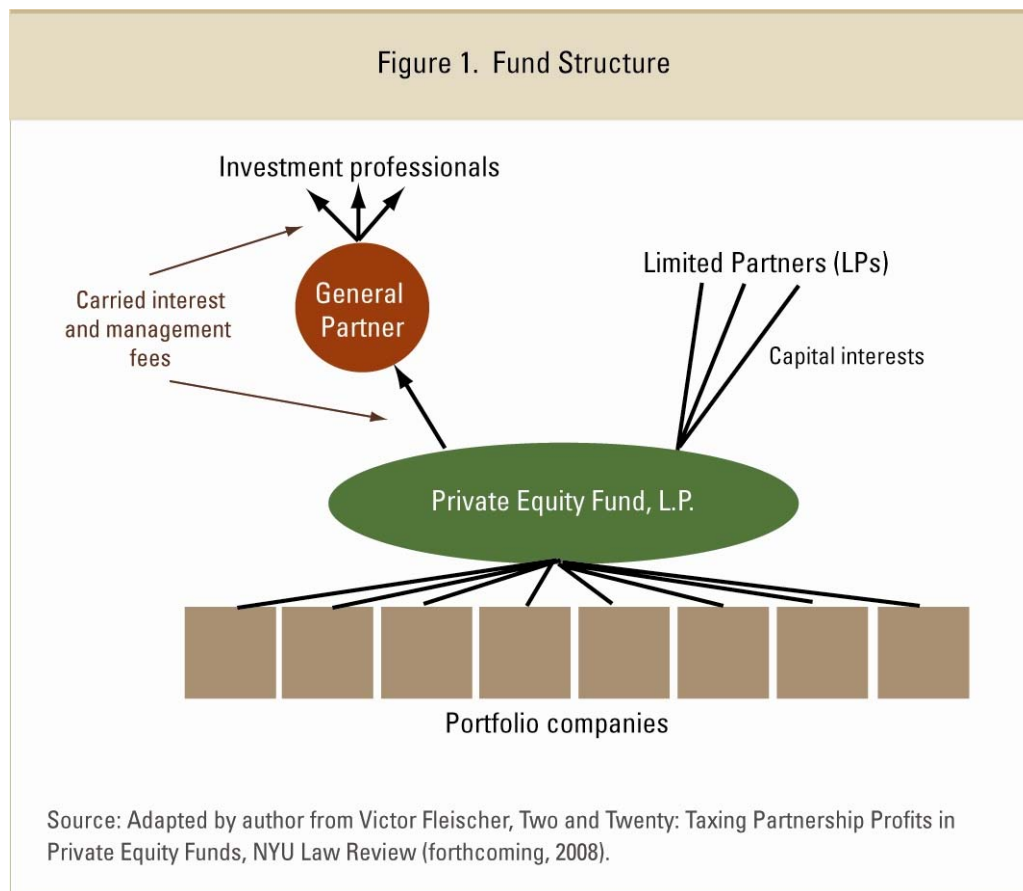
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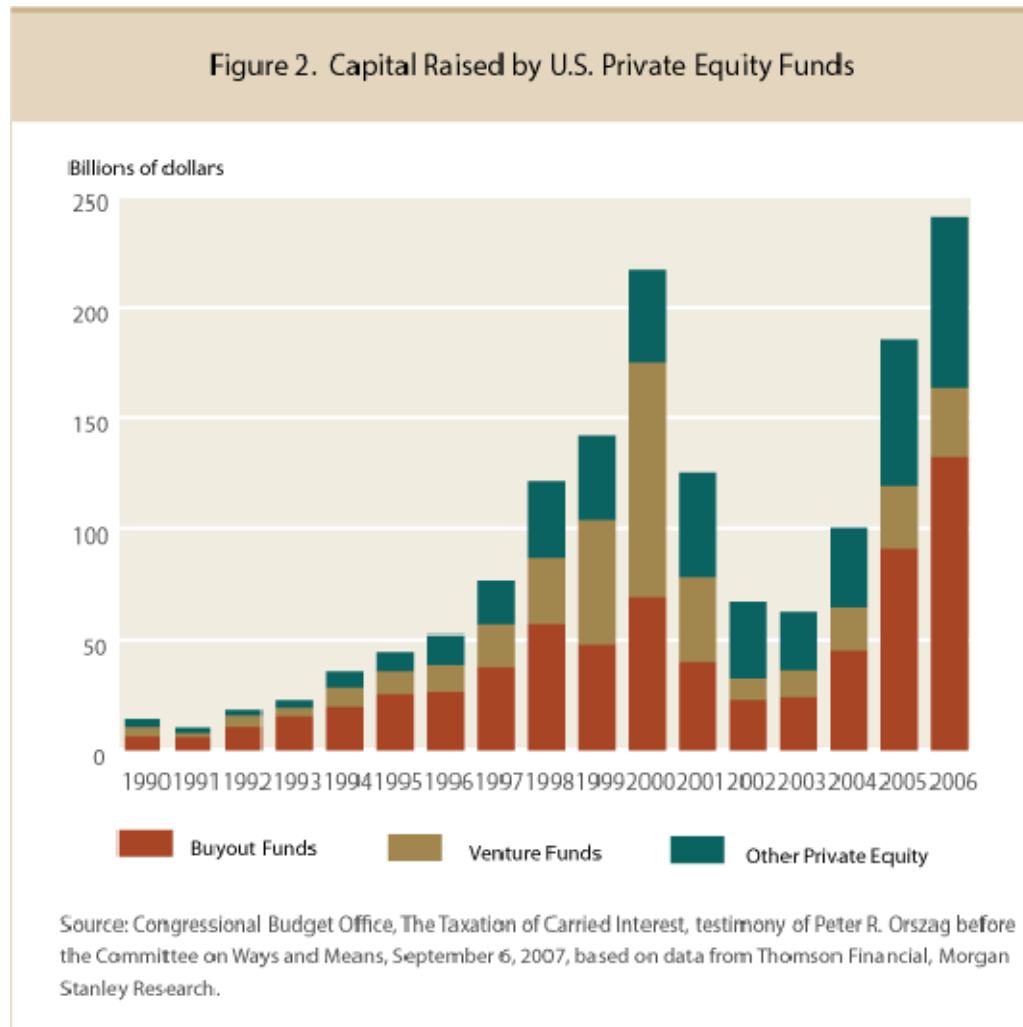
Business Taxation: What is carried interest and how should it be taxed?

Carried interest is a right that entitles the general partner (GP) of a private investment fund to a share of the fund's profits (see figure 1). Typically, the GP contributes 1 to 5 percent of the fund's initial capital and commits to managing the fund's assets. In exchange, the GP receives an annual management fee of 2 percent of the fund's assets plus a "carried interest" of 20 percent of the fund's profits that exceed a certain "hurdle" rate of return. The individual partners of the GP, not the GP itself, are taxed on these payments.



Carried interest constitutes on average about one-third of the payments that GPs receive, and the management fee the remainder. Under current law, the management fee is taxed like wage and salary income, with a top tax rate of 35 percent, whereas the carried interest is taxed as investment profit, which often faces a lower tax rate. In particular, any portion of the carried interest that represents long-term capital gains of the fund is taxed at a top rate of 15 percent. Many commentators believe it would be fairer and more efficient for carried interest to be taxed like wage and salary income, but others disagree.

- The amount of assets under management in private investment funds has increased substantially over the past two decades. Private equity funds and hedge funds currently manage roughly \$1 trillion in assets each. Private equity funds raised capital totaling about \$240 billion in 2006 (see figure 2).



- Few if any analysts believe that carried interest represents entirely a return to capital rather than labor. Instead, carried interest has two components: the return on the GP's financial investment in the fund (the "investment share"), and a return (the "compensatory share") on an amount invested by the limited partners that is implicitly lent to the GP (the "compensatory loan"). The investment share is clearly a return to capital for the GP. Because the GP does not contribute any other capital, the compensatory share appears to be a return to labor.
- How best to tax carried interest depends on one's views on several issues. One is the value of the GP's compensatory share. The compensatory value of a carried interest in 20 percent of a fund's profits should not be zero. If a GP typically contributes at most 5 percent of the initial assets of a fund, the compensatory share should at least be 15 percent of the fund's profits. Nevertheless, some believe that the compensatory share of carried interest is relatively small because of the hurdle rate. This seems unlikely given the amount of carried interest payments.
- A second issue is what other types of managers or forms of business organization are most similar to, and thus the closest substitutes for, the GP in a private investment fund. Generally, the tax system is more efficient if income earned in two ways that are close substitutes is taxed the same. Observers differ about whether entrepreneurs or investment banks are the closer substitute for GPs. Some view entrepreneurs as closer, because GPs typically start new investment funds on their own initiative and can obtain the same tax treatment as private equity by issuing debt.

Others view investment banks as more similar to GPs. Both are business entities, not individuals, and, like GPs, investment banks engage in entrepreneurial activities by starting investment funds. In addition, GPs typically hire from investment banks, not start-ups. Which is the closer substitute matters because not all returns to labor are taxed as wage and salary income. An investment banker's salary, bonus, and stock options are all taxed as wage and salary income, but an entrepreneur who starts a new business and contributes both capital and labor may, under current law, treat part of the return to labor- "sweat equity"- as a return to capital and not as wage and salary income. This is the case regardless of whether the entrepreneur raises funds for the business by issuing equity or debt.

- A third issue is the administrability of any potential reform of the taxation of carried interest. If the law were changed to tax the compensatory share as wage and salary income, GPs could still pursue strategies to dilute the tax effects of the reform. As a result, some observers argue that such a change in the law would raise no revenue or would be inadministrable. If these observers are correct, it is unclear why GPs continue to bargain with limited partners to receive carried interest and lobby for retention of its preferential tax treatment. The Joint Committee on Taxation has estimated that taxing the compensatory share like wage and salary income would raise about \$15 billion in revenue over five years.
- A final issue concerns the impact of any future reform on the effective corporate tax rate. Some observers think the current tax treatment of carried interest helps mitigate the unfair double taxation of corporate income. Currently, income earned within a partnership is subject only to the individual income tax, whereas income earned within a C corporation is subject to the corporate tax when earned and the individual income tax when realized or distributed. Some view the corporate tax as necessary to prevent individuals from using corporations as tax shelters; others view it as an unfair and inefficient "double tax." The latter may support taxing carried interest at lower tax rates as a way of reducing the degree of double taxation on a fund's profits that are from businesses that pay the corporate tax. However, the current tax treatment of carried interest is a very rough solution that only applies in the aggregate, not for individual investments. After all, most C corporations are not owned by private investment funds, and it is unclear what share of private investment fund assets are held in C corporations.

Data Sources

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Further Reading

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