Key Elements of the U.S. Tax System

How does the corporate income tax work?

Q. How does the corporate income tax work?

A. The United States imposes a tax on the profits of US resident corporations at a rate of 21 percent (reduced from 35 percent by the 2017 Tax Cuts and Jobs Act). The corporate income tax raised $230.2 billion in fiscal 2019, accounting for 6.6 percent of total federal revenue, down from 9 percent in 2017.

The United States taxes the profits of US resident C-corporations (named after the relevant subchapter of the Internal Revenue Code) at 21 percent.

Taxable corporate profits are equal to a corporation's receipts less allowable deductions—including the cost of goods sold, wages and other employee compensation, interest, most other taxes, depreciation, and advertising. US-based corporations owned by foreign multinational companies generally face the same US corporate tax rules on their profits from US business activities as US-owned corporations.

The corporate income tax is the third-largest source of federal revenue, although substantially smaller than the individual income tax and payroll taxes. It raised $230.2 billion in fiscal year 2019, 6.6 percent of all federal revenue and 1.1 percent of gross domestic product (GDP). The relative importance of the corporate tax as a source of revenue declined sharply from the 1950s to the mid-1980s. Since that time, it has averaged less than two percent of GDP (figure 1).

Key Elements of the U.S. Tax System

How does the corporate income tax work?

FIGURE 1

Corporate Income Tax Revenue

Fiscal years 1934 – 2019

Source: Office of Management and Budget. Historical Tables. Table 2.3, "Receipts by Source as Percentages of GDP: 1934–2025."

RECENT CHANGES TO THE CORPORATE INCOME TAX

The Tax Cuts and Jobs Act (TCJA) reduced the top corporate income tax rate from 35 percent to 21 percent and eliminated the graduated corporate rate schedule and the corporate alternative minimum tax. Through 2022, the TCJA allows full expensing of most new investment, after which that benefit is phased out through 2026. The TCJA also limited net interest expense deductions to 30 percent of adjusted taxable income.

The TCJA made fundamental changes to the treatment of multinational corporations and their foreign-source income. Prior to the TCJA, dividends distributed by foreign subsidiaries to their US parent corporations were subject to US tax with a credit for foreign income taxes paid—a so-called "worldwide" system. Now, a ten percent return on certain qualified business asset investment is exempt from further U.S. tax—a so-called "territorial" system. However, the reduced-rate Global Intangible Low-Taxed Income (GILTI) minimum tax applies to returns above that amount regardless of whether they are repatriated as dividends. The TCJA also created a new domestic minimum tax, the Base Erosion and Anti-abuse tax (BEAT), designed to prevent cross-border profit shifting. A deduction for certain foreign-derived intangible income (FDII) serves as an incentive for corporations to locate intellectual property in the U.S.

Key Elements of the U.S. Tax System

How does the corporate income tax work?

SHAREHOLDER-LEVEL TAXES

Corporate profits can also be subject to a second layer of taxation at the individual shareholder level, both on dividends and on capital gains from the sale of shares. Dividends are separated into "qualifying dividends", comprising most ordinary dividends of U.S. corporations, and other dividends; capital gains are separated into long-term, for assets held at least one year, and short-term. Non-qualifying dividends and short-term capital gains are taxed as ordinary income at current rates of up to 40.8 percent (the top marginal individual income tax rate of 37 percent plus the 3.8 percent tax on net investment income); by contrast, the maximum tax rate on qualifying dividends and long-term capital gains is currently 23.8 percent.

Many US businesses are not subject to the corporate income tax but are taxed as "pass-through" entities. Pass-through businesses do not face an entity-level tax. But their owners must include their allocated share of the businesses' profits in their taxable income under the individual income tax. Pass-through entities include sole proprietorships, partnerships, limited liability companies (LLCs) and S-corporations.

Updated May 2020

Data Sources

Office of Management and Budget. *Historical Tables.* 2.3. "Receipts by Source as Percentages of GDP: 1934–2025."

Key Elements of the U.S. Tax System

What are pass-through businesses?

Q. What are pass-through businesses?

A. Most US businesses are not subject to the corporate income tax; rather, their profits flow through to owners or members and are taxed under the individual income tax. Pass-through businesses include sole proprietorships, partnerships, limited liability companies, and S-corporations. The share of business activity represented by pass-through entities has been rising for several decades.

Most US businesses are taxed as pass-through (or flow-through) entities that, unlike C-corporations, are not subject to the corporate income tax or any other entity-level tax. Instead, their owners or members include their allocated shares of profits in taxable income under the individual income tax. Pass-through businesses include sole proprietorships, partnerships, limited liability companies and S-corporations.

TYPES OF PASS-THROUGH ENTITIES

Sole Proprietorships: A business with a single owner does not file a separate tax return, but rather reports its net income on Schedule C of the owner's individual tax return (Form 1040). Generally, all net income from sole proprietorships is also subject to payroll taxes under the Self-Employed Contributions Act (SECA).

Partnerships: Partnerships file an entity-level tax return (Form 1065), but profits are allocated to owners who report their share of net income on Schedule E of Form 1040. General partners are subject to SECA tax on all their net income, while limited partners are only subject to SECA tax on "guaranteed payments" that represent compensation for labor services.

Limited Liability Companies (LLCs): LLCs are companies authorized under state laws. LLC owners, who are called members, may include individuals, corporations, other LLCs and foreign entities; there is no maximum number of members and most states also allow single ownership. Certain activities, such as banking and insurance, are usually disallowed. LLCs may elect to be taxed as a corporation, partnership, or as part of their members' tax return (a "disregarded entity"). Members of disregarded entities are subject to SECA tax on their earnings.

S-Corporations: Eligible domestic corporations that elect S-corporation status file a corporate tax return (Form 1120S), but profits flow through to shareholders and are reported on Schedule E of Form 1040. S-corporations can have only one class of stock and cannot have more than 100 shareholders, who must be US citizens or resident individuals. (However, certain estates, trusts, and tax-exempt organizations are also allowed.) S-corporation owners do not pay SECA tax on their profits but are required to pay themselves "reasonable compensation," which is subject to the regular Social Security or "FICA" (Federal Insurance Contributions Act) tax.

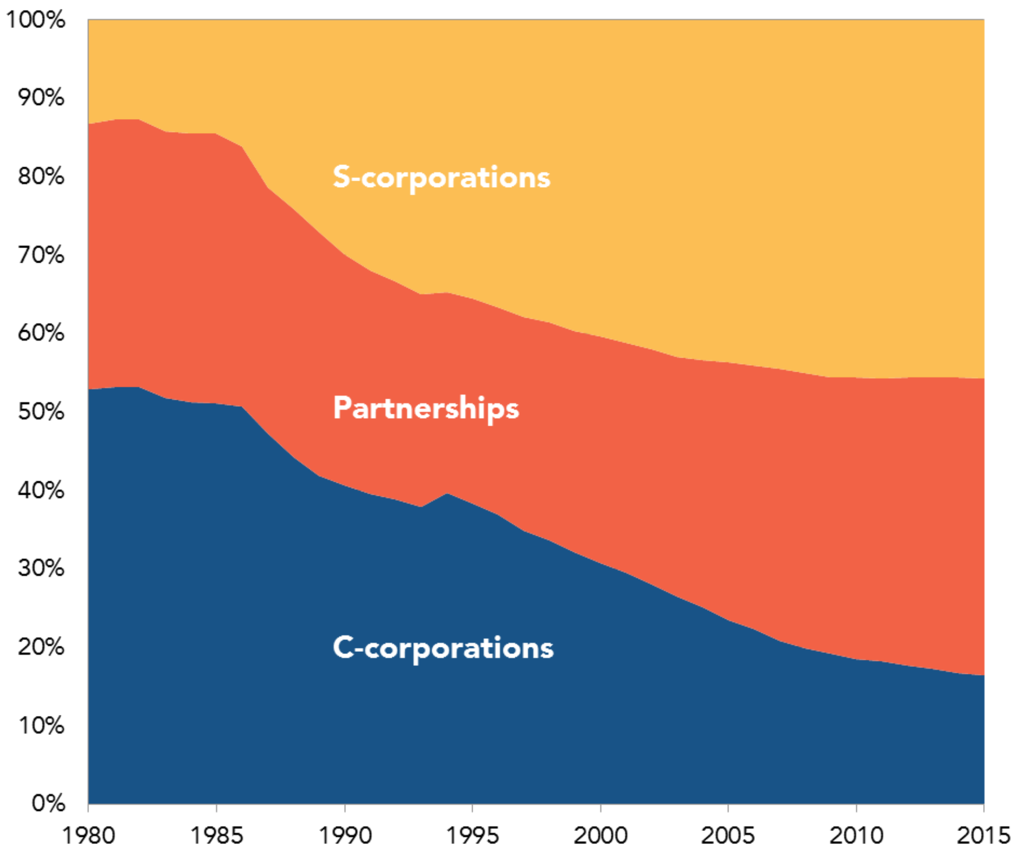
GROWTH IN PASS-THROUGHS

The share of business activity represented by pass-through entities has been rising, particularly since passage of the Tax Reform Act of 1986 (Plesko and Toder, 2013). Excluding sole proprietorships (which comprise a majority of business tax returns), more than 80 percent of businesses were organized as flow-through entities in 2015—up from 47 percent in 1980 (figure 1). Including sole proprietorships, pass-throughs account for more than 50 percent of total business net income, up from about 22 percent in 1980 (figure 2).

FIGURE 1

Number of Business Tax Returns by Type

Share of total, tax years 1980–2015



Source: Internal Revenue Service. SOI Tax Stats - Integrated Business Database (IBD). Table 1: Selected financial data on businesses, tax year 2015. February 2020.
Notes: Excludes nonfarm sole proprietorships, regulated investment companies (RICs), and real estate investment trusts (REITs).

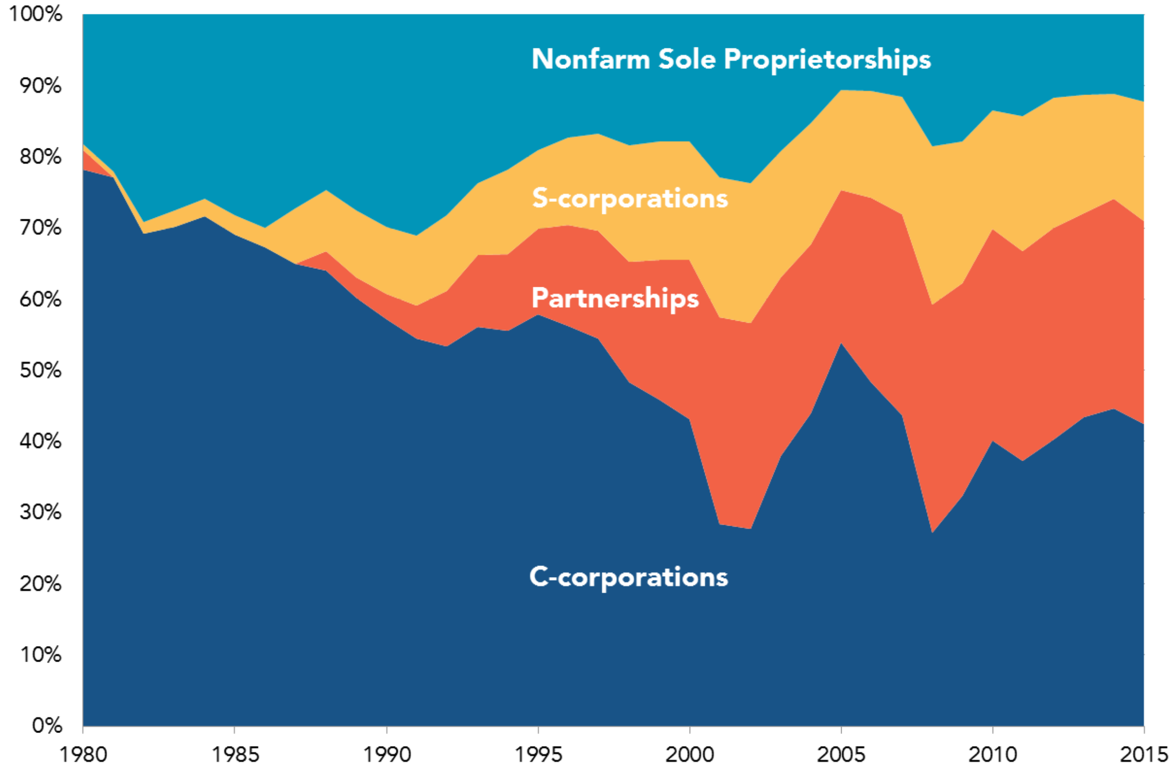
Key Elements of the U.S. Tax System

What are pass-through businesses?

FIGURE 2

Net Income (Less Deficit) of Business Tax Returns by Type

Share of total, tax years 1980–2015



Source: Internal Revenue Service. SOI Tax Stats - Integrated Business Database (IBD). Table 1: Selected financial data on businesses, tax year 2015. February 2020.

Notes: Excludes regulated investment companies (RICs) and real estate investment trusts (REITs). Partnerships reported a net loss overall in tax years 1981 through 1987.

PASS-THROUGHS AND THE INDIVIDUAL INCOME TAX

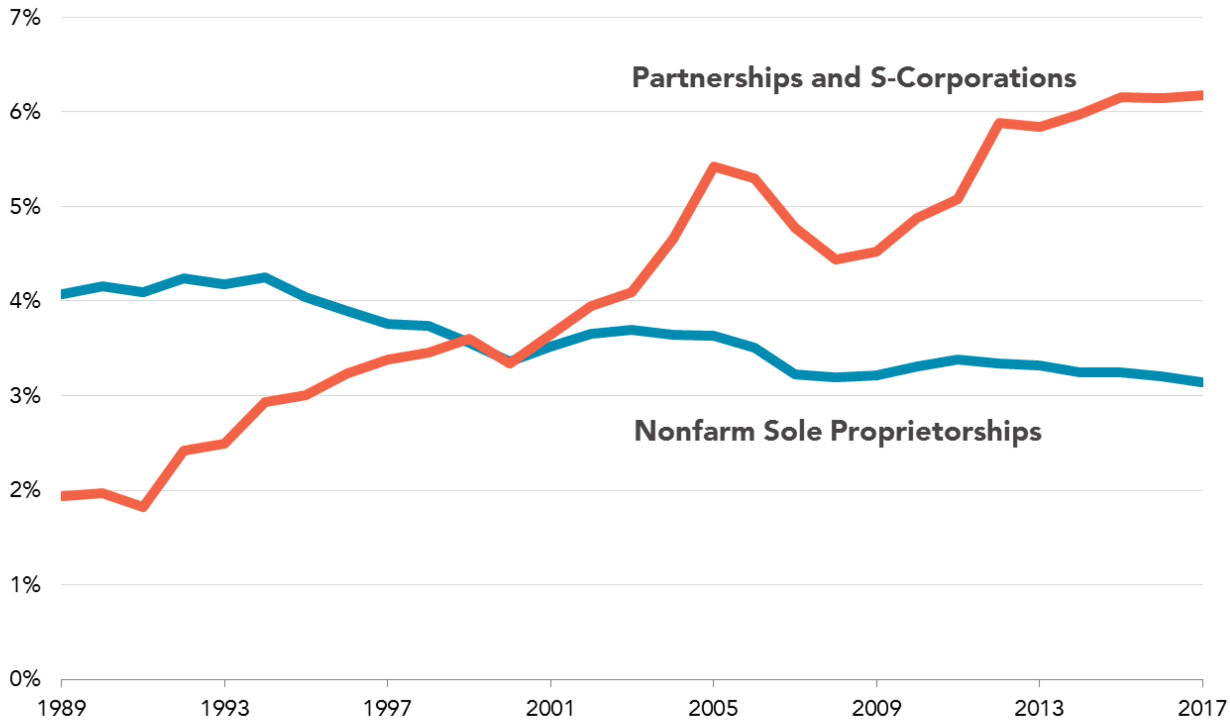
Income from partnerships and S-corporations has been rising as a share of adjusted gross income (AGI), while sole proprietorship income has been declining. In 2017, individuals reported about $1.03 trillion in net income from all types of pass-throughs accounting for 9.3 percent of total AGI reported on individual income tax returns (figure 3). Nonfarm sole proprietor income has declined modestly as a percentage of total AGI beginning in the 1990s; in 2017, about 26 million returns reported net income of $346 billion, or 3.1 percent of AGI. In contrast, income from partnerships and S corporations has more than tripled as a share of AGI over the same period; in 2017, 9.1 million returns reported $680 billion in net income, or 6.2 percent of AGI.

What are pass-through businesses?

FIGURE 3

Net Income of Pass-Through Business Tax Returns by Type

Share of adjusted gross income (AGI), tax years 1989–2017



Source: Internal Revenue Service. SOI Tax Stats Individual Income Tax Returns. Table 1.4: All Returns: Sources of Income, Adjustments, and Tax Items, tax year 2017. September 2019.

Pass-through income is concentrated among higher-income taxpayers. About 85 percent of all pass-through income is reported by taxpayers in the top 20 percent of the income distribution, and more than 50 percent is reported by the top 1 percent of taxpayers. Net income from partnerships and S corporations is even more concentrated—with more than 70 percent reported by the top 1 percent of taxpayers—and accounts for a large fraction of the increased share of income the top 1 percent earns (Cooper et al. 2016).

Updated May 2020

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———. *SOI Tax Stats—Individual Income Tax Returns Publication 1304 (Complete Report)*. Table 1.4. "All Returns: Sources of Income, Adjustments, and Tax Items." September 2019.

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Key Elements of the U.S. Tax System

How are pass-through businesses taxed?

Q. How are pass-through businesses taxed?

A. Pass-through businesses are not subject to an entity-level tax; instead, profits flow through to owners and are taxed under the individual income tax. Some pass-through income is eligible for a 20 percent deduction through 2025.

Pass-through income is only subject to a single layer of income tax and is generally taxed as ordinary income up to the maximum 37 percent rate. However, certain pass-through income is eligible for a 20 percent deduction, which reduces the top tax rate to a maximum of 29.6 percent. (Payroll and/or net investment income taxes may also apply.) Pass-through businesses generally face the same tax rules as C-corporations for inventory accounting, depreciation, and other provisions affecting the measurement of business profits.

20 PERCENT PASS-THROUGH DEDUCTION

The 2017 Tax Cuts and Jobs Act (TCJA) created a new 20 percent deduction for certain pass-through income through 2025, after which the measure is scheduled to expire. The so-called 199A (named for the relevant IRS code section) or "qualified business income" deduction effectively reduces the top marginal tax rate on qualifying pass-through income from the top ordinary rate of 37 percent to 29.6. This tax expenditure will reduce federal revenues by between $50 billion and $60 billion a year, according to the Joint Committee on Taxation.

The 199A deduction is subject to several restrictions and exceptions (Gale and Krupkin, 2018). For single filers with taxable income above $157,500 and joint filers with taxable income above $315,000, the pass-through deduction is potentially subject to two limitations:

Specified service limitation. Income earned by certain "specified service" businesses is excluded from the definition of qualified business income and therefore receives a reduced deduction or no deduction. Specified service activities include "any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade of business is the reputation or skill of one or more of its employers or owners." The qualifying income is phased out for singles with taxable income between $157,500 and $207,500 (between $315,000 and $415,000 for joint filers).

Wage/asset limitation. The 20 percent deduction may also be limited based on the wages and/or depreciable asset of the associated business. Specifically, the deduction is limited to the greater of 50 percent of W-2 wages paid or 25 percent of W-2 wages paid plus 2.5 percent of the acquisition cost of qualifying depreciable property. That limitation is phased-in over the same income range as the specified service limitation.

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Further Reading

Gale, William, and Aaron Krupkin. 2018. "Navigating the New Pass-Through Provisions: A Technical Explanation." Washington, DC: Urban-Brookings Tax Policy Center.

Q. Is corporate income double-taxed?

A. C-corporations pay entity-level tax on their income, and their shareholders pay tax again when the income is distributed. But in practice, not all corporate income is taxed at the entity level, and many corporate shareholders are exempt from income tax.

Income earned by C-corporations (named after the relevant subchapter of the Internal Revenue Code) is subject to the corporate income tax at a 21 percent rate. This income may also be subject to a second layer of taxation at the individual shareholder level, whether on dividends or on capital gains from the sale of shares.

Suppose a corporation earns $1 million in profits this year and pays $210,000 in federal taxes. If the corporation distributes the remaining $790,000 to its shareholders as dividends, the distribution would be taxable to shareholders. Qualifying dividends are taxed at a top rate of 20 percent, plus a 3.8 percent tax on net investment income. As a result, if the shares were held by high-income individuals only $601,980 would be left, and the combined tax rate on the income would be 39.8 percent = 0.21 + (1-0.21) * 0.238.

To alleviate double taxation of corporate income, other countries have “integrated” their corporate and shareholder taxes. Some countries permit corporations to deduct the dividends they pay to shareholders. Other countries give shareholders full or partial credit for taxes paid at the corporate level, or they permit shareholders to exclude dividends from their taxable income.

IMPACT ON BUSINESS BEHAVIOR

Businesses have devised several ways to reduce the burden of double-taxation:

Choice of Organizational Form: Double taxation can encourage businesses to organize as pass-through businesses (S-corporations, partnerships, limited liability companies, or sole proprietorships) instead of C-corporations. Pass-through profits are taxed only once at a top rate of 37 percent (or 29.6 percent if eligible for the 20 percent Section 199A deduction). By no coincidence, the share of business activity represented by pass-through entities has been rising (figure 1). However, businesses that wish to list their shares for public trading generally need to organize as C-corporations.

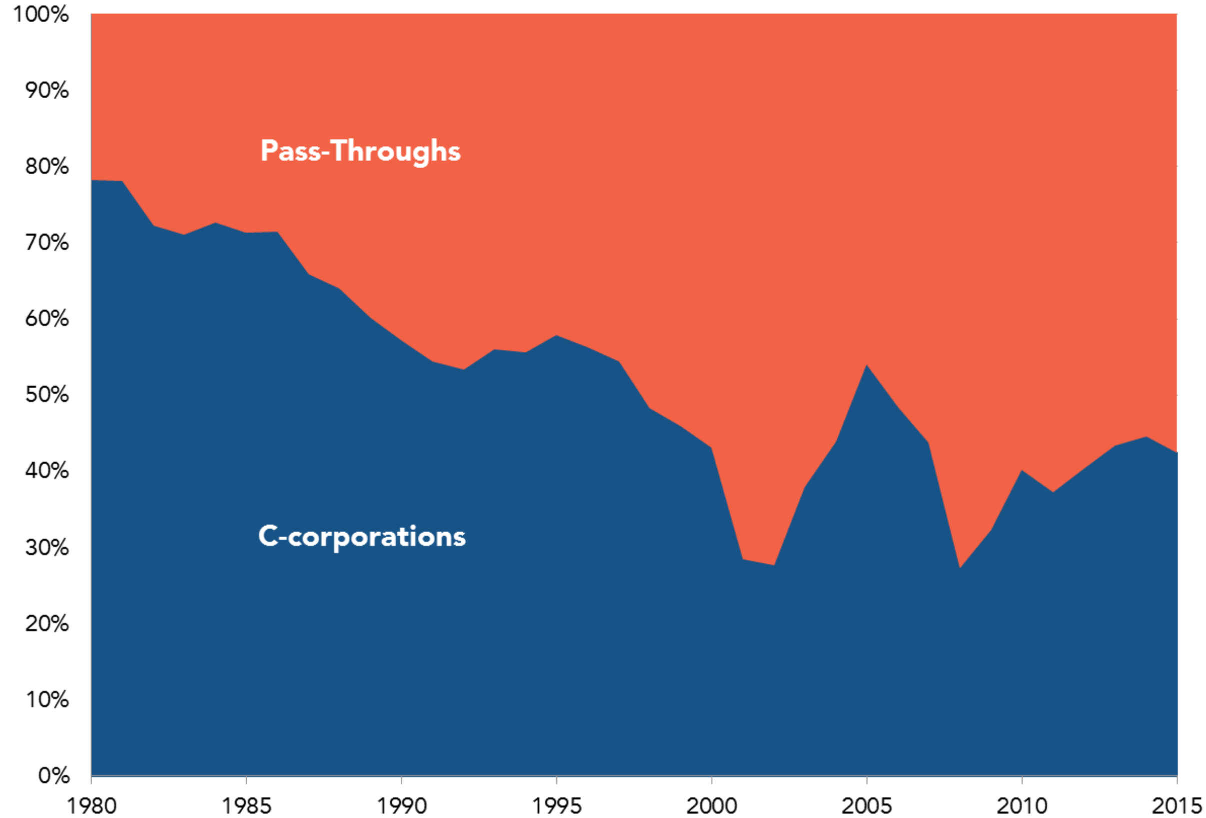
BUSINESS TAXES

How are pass-through businesses taxed?

FIGURE 1

Net Income (Less Deficit) of Business Tax Returns by Type

Share of total, tax years 1980–2015



Source: Internal Revenue Service. SOI Tax Stats - Integrated Business Database (IBD). Table 1: Selected financial data on businesses, tax year 2015. February 2020.
Notes: Excludes regulated investment companies (RICs) and real estate investment trusts (REITs).

Source of Financing (Debt versus Equity): Unlike dividends, which are paid out of after corporate tax income, interest is deductible. C-corporations can thus reduce the total tax paid on their income by issuing debt instead of stock to finance investment.

Payout Policy (Dividends versus Retained Earnings): C-corporations can also choose to retain their earnings rather than pay dividends. The corporation would still pay the corporate income tax on its earnings, but the shareholders would defer the second round of taxation until either the corporation distributed the earnings sometime in the future or the shareholders sold their stock at a price that reflected the value of the retained earnings. Deferral of taxation reduces the present value of its burden. The incentive to retain earnings created by shareholder-level taxation is known as “corporate lock-in.”

These tax-induced behavioral distortions have costs. Increased debt (leverage) elevates bankruptcy risk, especially during economic downturns. And corporate lock-in usually results in inefficient use of funds that could earn a higher real return if distributed to shareholders.

Key Elements of the U.S. Tax System

BUSINESS TAXES

How are pass-through businesses taxed?

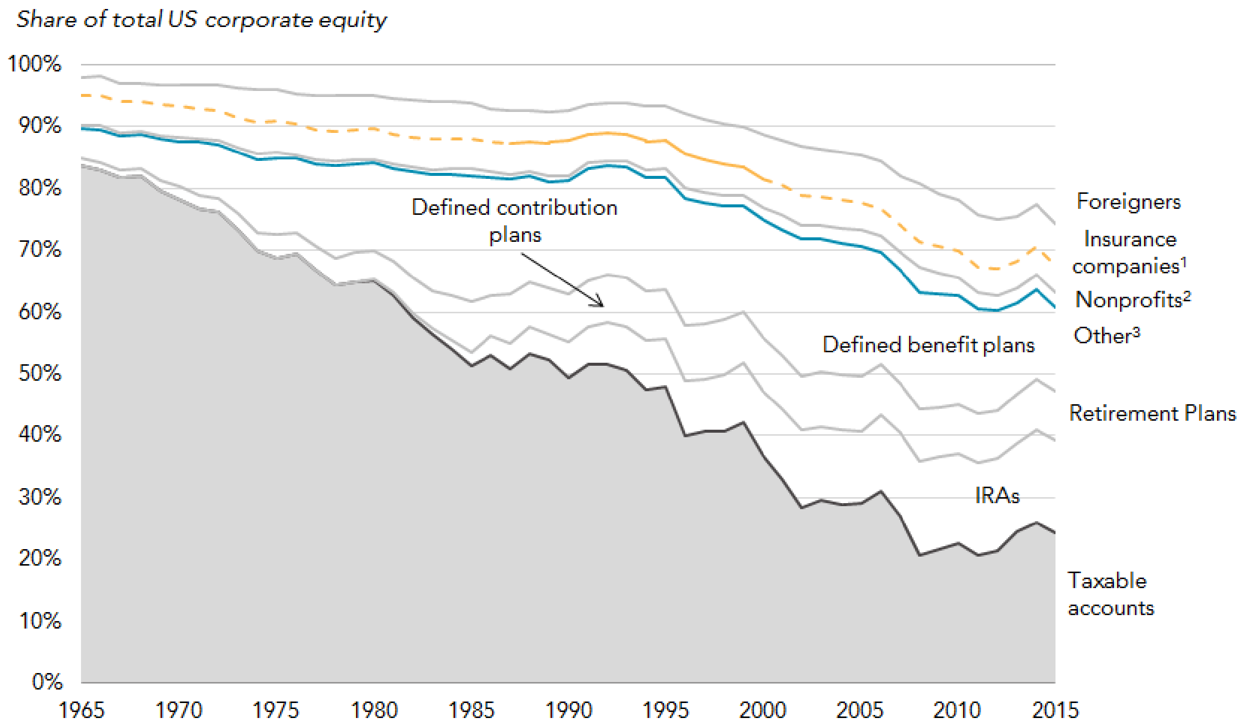
MOST SHAREHOLDERS ARE NOT SUBJECT TO A SECOND LAYER OF TAX

Often, however, there is not a second level of tax. Many shareholders of corporate stock, such as retirement accounts, educational institutions, and religious organizations, are exempt from income tax. US domestic law imposes a 30 percent withholding tax on dividends distributed to foreign shareholders, but many are exempted from this tax under bilateral tax treaties. The earnings distributed to these shareholders are therefore not double-taxed. By some recent estimates, the share of U.S. corporate stock held in taxable accounts has fallen from more than 80 percent in 1965 to about 25 percent today (Rosenthal and Austin, 2016).

FIGURE 2

Ownership of US Corporate Stock

Direct and indirect holdings, fiscal years 1965–2015



Sources: Board of Governors of the Federal Reserve System, "Financial Accounts of the United States;" Investment Company Institute. 2016, "The U.S. Retirement Market, Fourth Quarter 2015;" Barclay Hedge; Preqin; Tax Policy Center calculations.
Notes: (1) Stock held in non-taxable segregated reserves to fund annuity contracts and whole life insurance. (2) Dashed lines indicate TPC estimates. (3) Primarily government holdings, but includes equities in 529 savings plans.

Updated May 2020

Data Source

Internal Revenue Service, Statistics of Income Division. *SOI Tax Stats—Integrated Business Data*. Table 1. "Selected Financial Data on Businesses." February 2020.

Key Elements of the U.S. Tax System

How are pass-through businesses taxed?

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