Key Elements of the U.S. Tax System

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 $297.0 billion in fiscal 2017, accounting for 9 percent of total federal revenue.

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 expenses, interest, nonfederal 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 do US-owned corporations.

Corporate profits can also be subject to a second layer of taxation at the individual shareholder level, both on dividends when distributed and on capital gains from the sale of shares. The maximum tax rate on both dividends and capital gains is currently 23.8 percent (including the 3.8 percent tax on net investment income).

Many US businesses are not subject to the corporate income tax; rather, they 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, and eligible corporations that elect to be taxed under subchapter S of the Internal Revenue Code (S 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 $297.0 billion in fiscal 2017, 9.0 percent of all revenue, and 1.5 percent of gross domestic product (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 revenues equal to about 2 percent of GDP (figure 1).

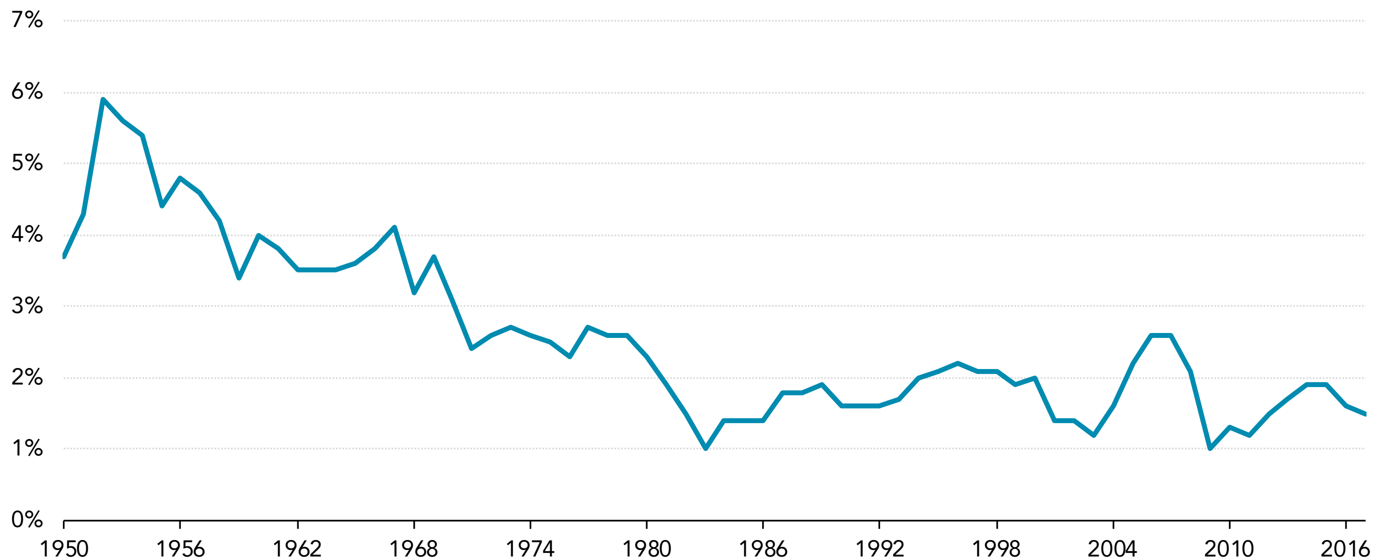
Key Elements of the U.S. Tax System

How does the corporate income tax work?

FIGURE 1

Corporate Income Tax Revenue

Share of GDP, fiscal years 1950–2017



Source: Office of Management and Budget, Fiscal Year 2019, *Historical Tables*, Table 2.3.

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. The new law also repealed the corporate alternative minimum tax.

The TCJA made fundamental changes to the treatment of multinational corporations and their foreign source income. Profits earned abroad by US resident multinationals are now exempt (a "territorial" system). In addition, it created two new minimum taxes—the tax on Global Intangible Low-Taxed Income (GILTI) and the Base Erosion and Anti-abuse tax (BEAT). Another provision of the TCJA provides a new deduction for certain foreign-derived intangible income (FDII).

Before the TCJA, US resident multinationals owed tax on their worldwide profits, but tax on their profits from controlled foreign subsidiaries was deferred until those profits were repatriated (that is, paid back as dividends) to the US parent corporation. Further, these profits were eligible for a nonrefundable credit for foreign taxes paid.

Data Source

Office of Management and Budget. *Historical Tables*. 2.3. "Receipts by Source as Percentages of GDP: 1934–2023."

Q. What are pass-through businesses?

A. Most US businesses are not subject to the corporate income tax. Rather, profits flow through to owners and are taxed under the individual income tax. Pass-through businesses include sole proprietorships, partnerships, and S corporations. The share of business activity represented by pass-through entities has been rising in recent 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 include their allocated shares of profits in taxable income under the individual income tax. Pass-through businesses include sole proprietorships, partnerships, 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. 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 their individual tax returns. Under "check the box" regulations instituted by the US Department of the Treasury in 1997, limited-liability companies can elect to be taxed as partnerships. 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.

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 the shareholder's personal income tax. S corporations cannot have more than 100 shareholders, and those shareholders must be US citizens or resident individuals (although certain estates, trusts, and tax-exempt organizations are also allowed). In addition, S corporations may have only one class of stock. 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 tax (i.e., the Federal Insurance Contributions Act, or FICA).

Key Elements of the U.S. Tax System

What are pass-through businesses?

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, more than 80 percent of businesses were organized as flow-through entities in 2014—up from 47 percent in 1980 (figure 1). Pass-throughs now account for more than 50 percent of total business net income, up from about 20 percent in 1980 (figure 2).

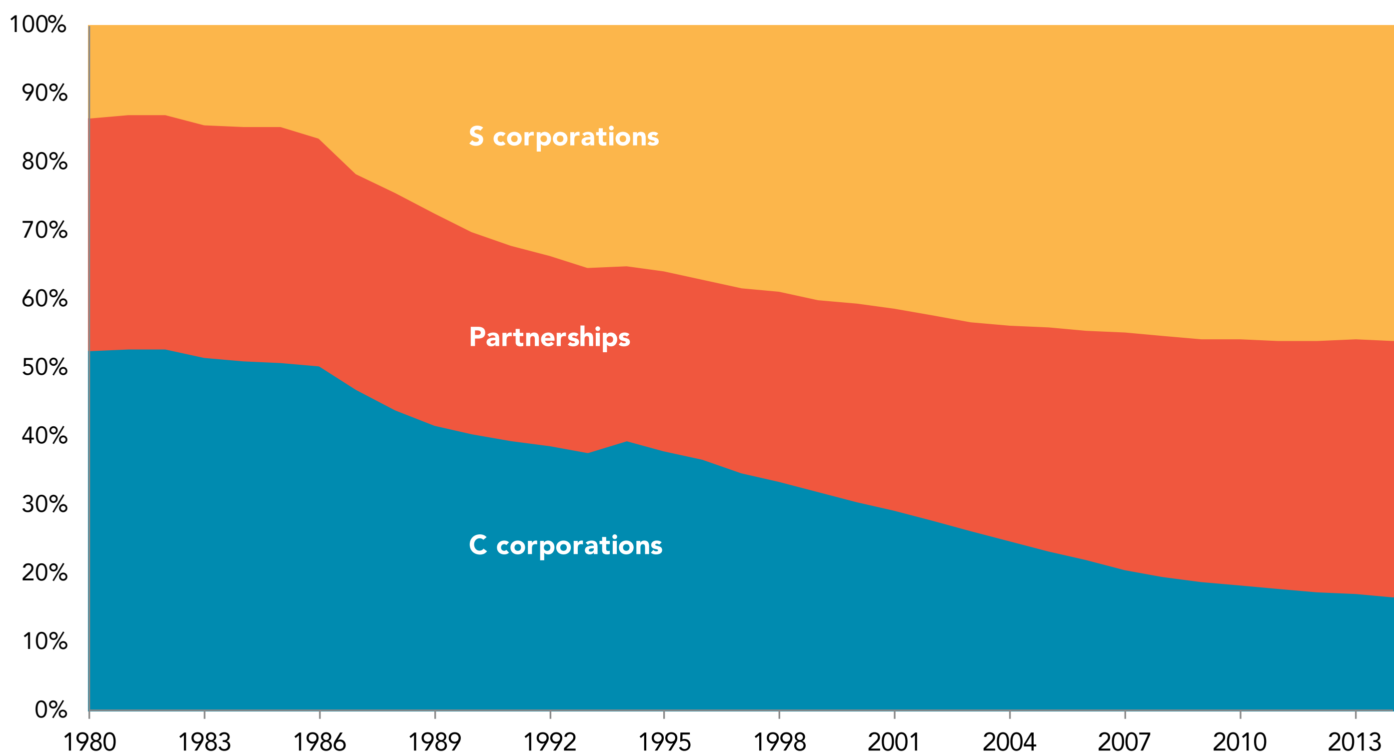
PASS-THROUGHS AND THE INDIVIDUAL INCOME TAX

In 2016, individuals reported about $957 billion in net income from sole proprietorships, partnerships, and S corporations, accounting for 9.4 percent of total adjusted gross income (AGI) reported on individual income tax returns (figure 3). Nonfarm sole proprietor income (reported on Schedule C) has declined modestly as a percentage of total AGI beginning in the mid-1990s. In 2016, 25 million returns reported net income of $328 billion, or 3.2 percent of AGI. In contrast, income from partnerships and S corporations has more than tripled as a share of AGI since the late 1980s. In 2016, 8.7 million returns reported $629 billion in net income from those sources, or 6.1 percent of AGI.

FIGURE 1

Share of Business Returns by Type

1980–2014



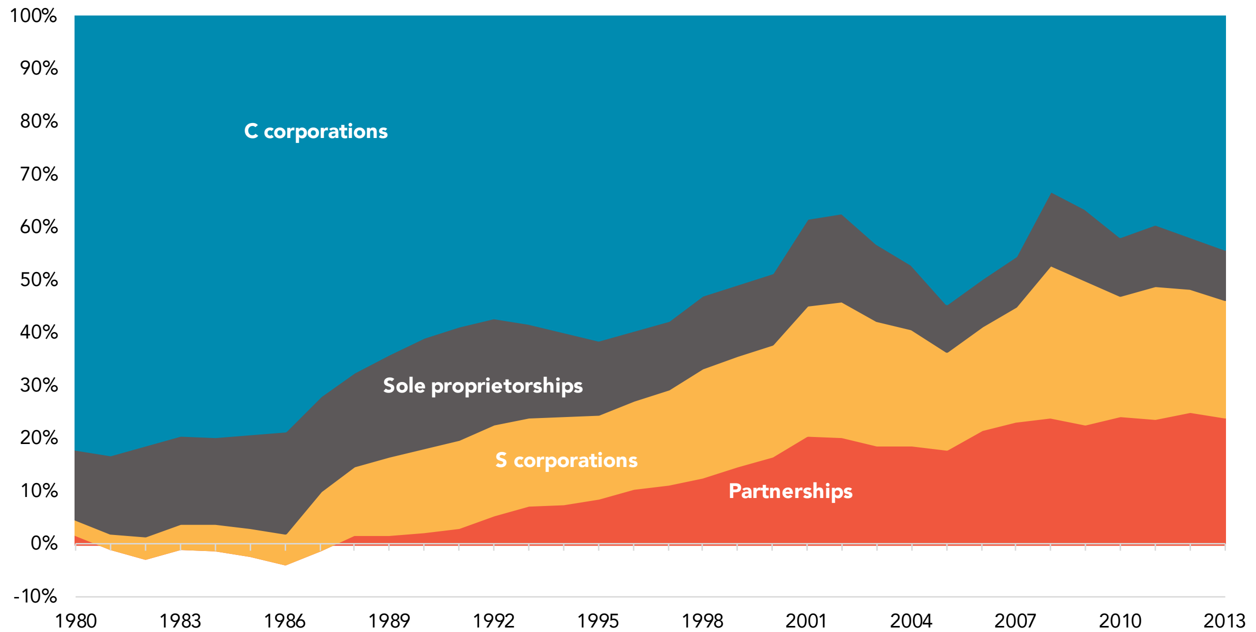
Source: Joint Committee on Taxation (2017).

Key Elements of the U.S. Tax System

What are pass-through businesses?

FIGURE 2

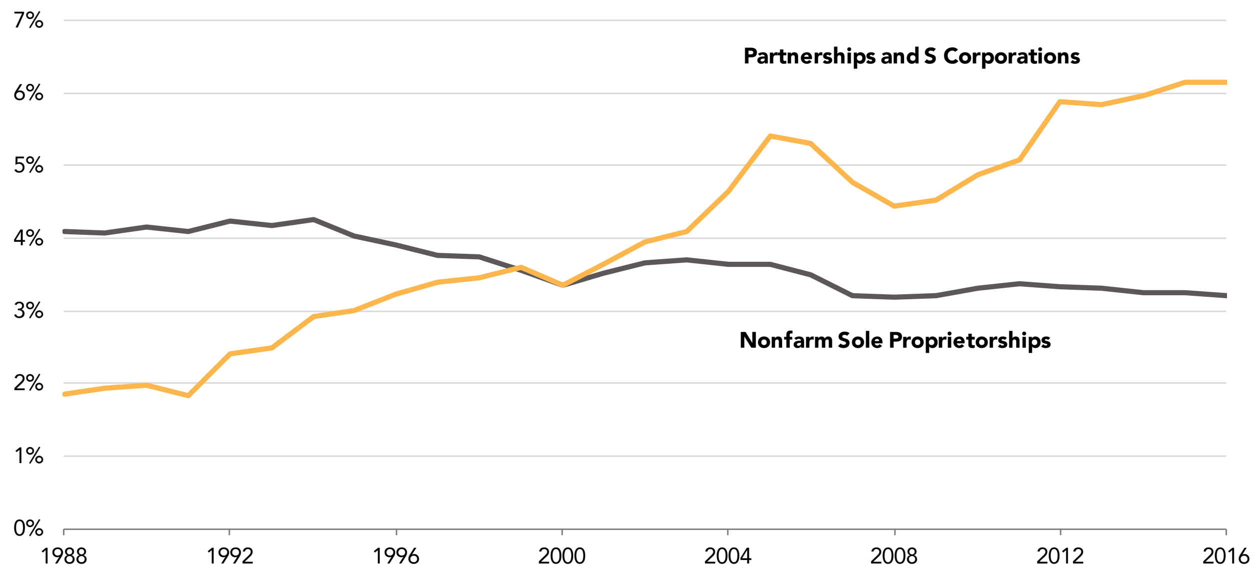
Share of Business Net Income (Less Deficit) by Type
1980–2013



Source: Nelson (2016).
Note: Shares do not include regulated investment corporations and real estate investment trusts. C and S corporation income includes officer compensation.

FIGURE 3

Net Income from Pass-through Businesses as a Percentage of AGI
1988–2016



Source: Internal Revenue Service, *SOI Tax Stats—Individual Income Tax Returns Publication 1304 (Complete Report)*, Table 1.4 (1988–2016).

Key Elements of the U.S. Tax System

What are pass-through businesses?

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).

Data Sources

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

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

Further Reading

Cooper, Michael, John McClelland, James Pearce, Richard Prisinzano, Joseph Sullivan, Danny Yagan, Owen Zidar, and Eric Zwick. 2016. "Business in the United States: Who Owns It and How Much Tax They Pay." *Tax Policy and the Economy* 30 (1): 91–128.

Joint Committee on Taxation. 2017. "Present Law and Data Related to the Taxation of Business." JCX-42-17. Washington, DC: Joint Committee on Taxation.

Nelson, Susan C. 2016. "Paying Themselves: S Corporation Owners and Trends in S Corporation Income, 1980–2013." Working Paper 107. Washington, DC: Office of Tax Analysis, US Department of the Treasury.

Plesko, George A., and Eric J. Toder. 2013. "Changes in the Organization of Business Activity and Implications for Tax Reform." *National Tax Journal* 66 (4): 855–70.

Key Elements of the U.S. Tax System

Q. How are pass-through businesses taxed?

A. Pass-through businesses are not subject to the corporate income tax. Rather, profits flow through to owners and are taxed under the individual income tax. Some pass-through income may be eligible for a 20 percent deduction beginning in 2018.

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 may be eligible for a 20 percent deduction, which reduces the top tax rate to as low as 29.6 percent. 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 forms of pass-through income beginning in 2018. The TCJA will reduce federal revenues by between $50 billion and $60 billion a year according to the Joint Committee on Taxation. The pass-through deduction is scheduled to expire at the end of 2025.

The so-called 199A (named for the relevant IRS code section the law created) or "qualified business income" deduction reduces the marginal tax rate for qualifying pass-through income. The 20 percent deduction effectively reduces the top marginal tax rate on qualifying pass-through income from the top ordinary rate of 37 percent to 29.6 percent (10 percentage points below the pre-TCJA top marginal rate of 39.6).
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 1 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 the associated business paid and/or its depreciable assets. 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.

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. Yes, as a general rule. A corporation pays tax on its income, and its shareholders pay tax again when the income is distributed. But in practice, not all corporate income is taxed 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 and taxed at a 21 percent rate. This income may also be subject to a second layer of taxation at the individual shareholder level, both on dividends when distributed and 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, the distribution would be taxable to shareholders. Dividends are taxed at a top rate of 23.8 percent. As a result, only $601,980 would be left (assuming the dividends went to high-income individuals), and the combined tax rate on the income would be 39.8 percent.

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

Choice of organization form: Double taxation may discourage businesses from organizing as C corporations (which are subject to the corporate tax), encouraging them to organize as pass-through businesses (S corporations, partnerships, or sole proprietorships). Profits of an S corporation, partnership, or sole proprietorship are taxed only once, at a top rate of 37 percent (or 29.6 percent if eligible for the additional 20 percent pass-through deduction). By no coincidence, the share of business activity represented by pass-through entities has been rising (figure 1).

Source of financing (debt versus equity): Corporations can reduce the double-taxation of their income by issuing debt instead of stock to finance an investment, because interest payments are deductible in the calculation of taxable income.

Payout policy (dividends versus retained earnings): Corporations can also choose to retain its earnings and not 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 the corporation distributed the earnings or the

Key Elements of the U.S. Tax System

Is corporate income double taxed?

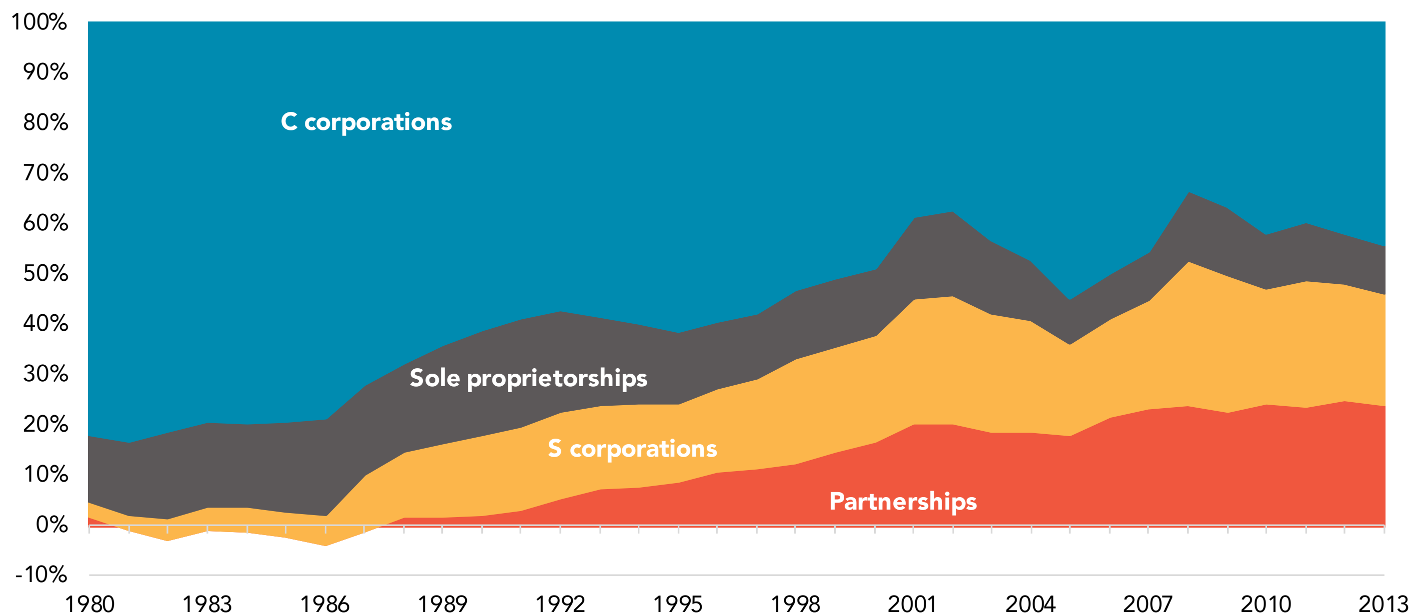
shareholders sold their stock at a price that reflected the value of the retained earnings.

But these choices distort business behavior. They encourage debt financing over equity, which creates a riskier capital structure for the corporation. And they encourage a corporation to retain earnings that might better be used by its shareholders.

FIGURE 1

Share of Business Net Income (Less Deficit) by Type

1980–2013



Source: Nelson (2016).
Note: Shares do not include regulated investment corporations (RICs) and real estate investment trusts (REITS). C and S corporation income includes officer compensation.

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; the earnings distributed to these shareholders are not double-taxed. By some recent estimates, the share of U.S. corporate stock held in taxable accounts has fallen from over 80 percent in 1965 to about 25 percent today (Rosenthal and Austin 2016).

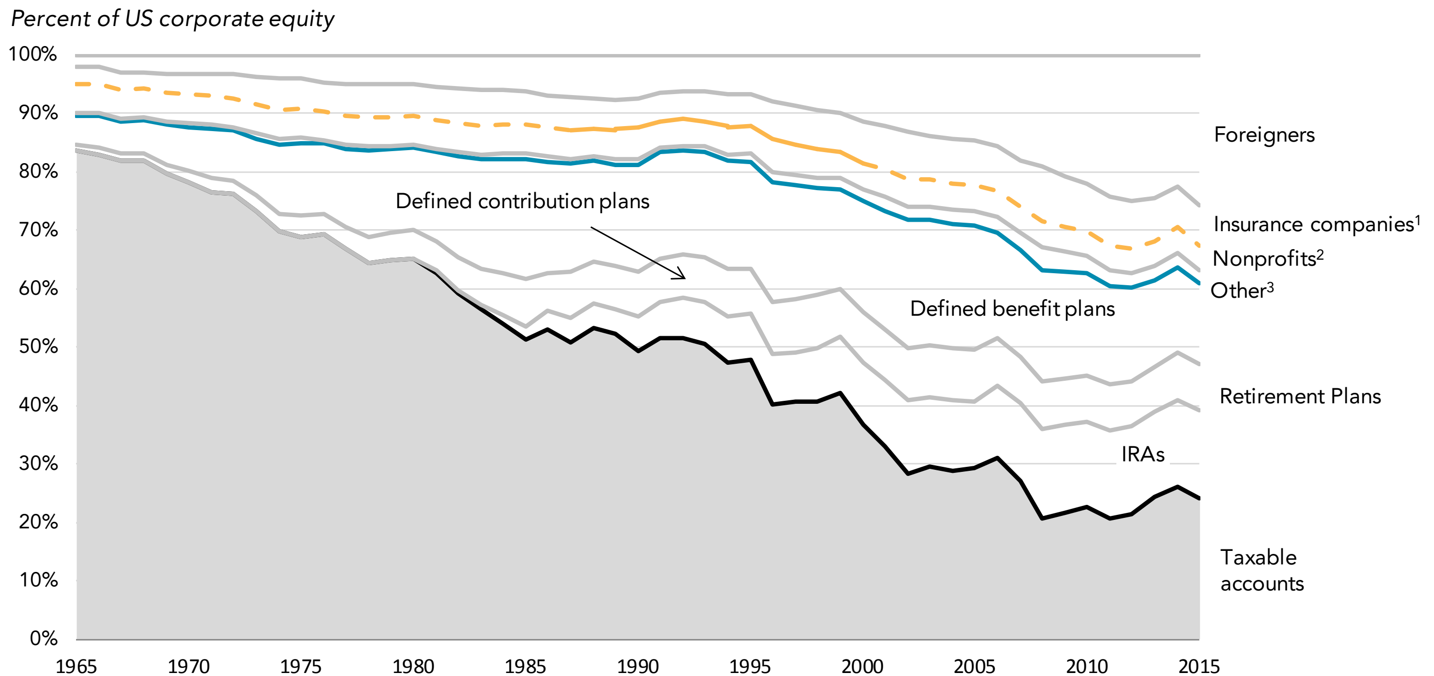
Key Elements of the U.S. Tax System

Is corporate income double taxed?

FIGURE 2

Ownership of US Corporate Stock, 1965–2015

Direct and indirect holdings



Source: 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.
(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.

Data Sources

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

Further Reading

Rosenthal, Steven M. and Lydia S. Austin. 2016. "The Dwindling Taxable Share of U.S. Corporate Stock." *Tax Notes*. May 16, 2016, p. 923-934.

US Department of the Treasury. 1992. *Report of the Treasury on Integration of the Individual and Corporate Tax Systems*. Washington, DC: US Department of the Treasury.

White House and the Department of the Treasury. 2012. "The President's Framework for Business Tax Reform." Washington, DC: White House and the Department of the Treasury.