Is corporate income double taxed?

**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
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

![Graph showing share of business net income by type from 1980 to 2013.](source)

**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).
Is corporate income double taxed?

**FIGURE 2**
Direct and indirect holdings

<table>
<thead>
<tr>
<th>Percent of US corporate equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreigners</td>
</tr>
<tr>
<td>Defined contribution plans</td>
</tr>
<tr>
<td>Defined benefit plans</td>
</tr>
<tr>
<td>Insurance companies(^1)</td>
</tr>
<tr>
<td>Nonprofits(^2)</td>
</tr>
<tr>
<td>Other(^3)</td>
</tr>
<tr>
<td>Retirement Plans</td>
</tr>
<tr>
<td>IRAs</td>
</tr>
<tr>
<td>Taxable accounts</td>
</tr>
</tbody>
</table>


(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**


**Further Reading**

