CTJ Citizens for Tax Justice

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Why We Need the Corporate Income Tax

Some observers have asked why we need a corporate income tax in addition to a personal income tax. The argument often made is that corporate profits eventually make their way into the hands of individuals (in the form of stock dividends and capital gains on sales of stock) where they are subject to the personal income tax, so there is no reason to also subject these profits to the corporate income tax. Some even suggest that the $4.8 trillion[1] that the corporate income tax is projected to raise over the next decade could be replaced by simply raising personal income tax rates or enacting some other tax. This is a deceptively simple argument that ignores the massive windfalls that wealthy individuals would receive if there was no corporate income tax.

Here are three of the biggest problems with repealing the corporate income tax:

First, a business that is structured as a corporation can hold onto its profits for years before paying them out to its shareholders, who only then (if ever) will pay personal income tax on the income. With no corporate income tax, high-income people could create shell corporations to indefinitely defer paying individual income taxes on much of their income.

Second, even when corporate profits are paid out (as stock dividends), only a fraction are paid to individuals rather than to tax-exempt entities not subject to the personal income tax.

Third, the corporate income tax is ultimately borne by shareholders and therefore is a very progressive tax, which means any attempt to replace it with another tax would likely result in a less progressive tax system.

1. Without a Corporate Income Tax, Retained Profits Would Not Be Taxed. As a Result, High-Income People Could Defer Paying Personal Income Taxes on Much of Their Income Indefinitely.

The first problem is that corporations can retain their profits and reinvest them rather than paying out dividends. If a corporation does this for years before paying out dividends, then, without a corporate income tax, the business's profits would not be taxed at all over that period. (In contrast, the interest that accrues on an ordinary savings account owned by a typical middle-income person is taxed each year, which reduces the rate at which the savings grow.)

If Congress simply repealed the corporate income tax and did nothing else, this would create an enormous *personal* income tax loophole. High-income individuals would no longer want to be employed directly by businesses or make their investments directly. Instead they would set up shell corporations that sell the individuals' services or make investments for them. The result would be that income could go untaxed indefinitely, until it is taken out of the shell companies to be spent. Even extremely complex rules and heavy enforcement by the IRS might be unable to prevent this type of tax avoidance. Thus, without a corporate income tax, the individual income tax on high-income people could be undermined.

2. Two-Thirds of Corporate Profits Are Never Subject to the Personal Income Tax.

Some people may believe that Congress can repeal the corporate income tax and address the retained profits problem described above by requiring corporations to follow the rules for "pass-through" businesses, which, under the existing rules, cannot avoid taxes by retaining profits. ("Pass-through" businesses are the companies that are not subject to the corporate income tax, and their profits are allowed to "pass through" to the individuals who own them, meaning the profits are subject to only the personal income tax.) Some people may believe that if all businesses were pass-through businesses, then everything would be fine because corporate profits would eventually be subject to the personal income tax.

But this is wrong. Two-thirds of the profits that corporations pay out today (as stock dividends) go to tax-exempt entities like retirement plans and university endowments.[2] In other words, if the personal income tax was the only tax applied to the profits of large, currently taxable corporations, then two-thirds of those profits would *never* be taxed.[3]

3. The Corporate Income Tax Is Borne by Shareholders and Thus Very Progressive.

Taken as a whole, America's tax system is just barely progressive.[4] It would be considerably less progressive if the corporate income tax was repealed. Most, if not all, of the corporate income tax is borne by shareholders in the form of reduced stock dividends, and high-income Americans receive the lion's share of these dividends. Corporate leaders sometimes assert that corporate income taxes are really borne by workers or consumers. But virtually all tax experts, including those at the Congressional Budget Office, the Congressional Research Service and the Treasury Department, have concluded that the owners of stock and other capital ultimately pay most corporate taxes.[5] Further, corporate leaders would not lobby Congress to lower these taxes if they did not believe their shareholders (the owners of corporations) ultimately paid them. (In contrast, corporations do not lobby for lower payroll taxes, which are borne by workers).

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[1] Congressional Budget Office, "Updated Budget Projections: Fiscal Years 2013 to 2023," May 14, 2013. http://www.cbo.gov/publication/44172

[2] According to data from the Bureau of Economic Analysis and our calculations, $1.9 trillion in corporate stock dividends were paid, excluding inter-corporate dividend payments, over the 2004-2008 period (and excluding dividends from non-taxable, "pass-through" S corporations). But the IRS reports that only $0.6 trillion in such corporate stock dividends were reported on individual tax returns (as "qualified" dividends). The remaining corporate stock dividends were not subject to personal income tax, because they were paid to individuals' accounts with tax-exempt pension plans, other retirement plans, and certain life insurance arrangements. That means that two-thirds of personal dividends from corporate stock are not subject to personal income tax. (See BEA National Income and Product Account Tables 1.16 and 7.10 and the related (albeit somewhat confusing) table accompanying BEA FAQ #318, all at www.bea.gov. See also annual data on Individual Income Tax Returns for 2004–08 from the Internal Revenue Service at www.irs.gov.)

[3] Contributions to retirement funds (pensions, 401k's, etc.) are not taxable as earnings when the contributions are made, thus avoiding both income and payroll taxes. Distributions during retirement are taxable. But, assuming a constant tax rate, this is the mathematical equivalent of taxing the contributions when made and exempting the distributions from tax. (This is why analysts treat tax-deductible IRA contributions as the equivalent of "Roth IRAs," where the contributions are not deductible, but the distributions are tax-exempt.) In fact, since tax rates on retirement distributions from pensions, 401k's, etc. are likely to be taxed at a lower tax rate than the tax rate avoided by the tax exemption for contributions, the actual tax rate on retirement income is likely to be negative.

[4] Citizens for Tax Justice, "Who Pays Taxes in America in 2013?" April 1, 2013, http://ctj.org/ctjreports/2013/04/who_pays_taxes_in_america_in_2013.php

[5] Jennifer C. Gravelle, "Corporate Tax Incidence: Review of General Equilibrium Estimates and Analysis," Congressional Budget Office, May 2010, http://www.cbo.gov/ftpdocs/115xx/doc11519/05-2010-Working_Paper-Corp_Tax_Incidence-Review_of_Gen_Eq_Estimates.pdf; Gravelle, Jane G. and Kent A. Smetters. 2006. "Does the Open Economy Assumption Really Mean That Labor Bears the Burden of a Capital Income Tax." Advances in Economic Analysis & Policy vol. 6:1.