NATIONAL CENTER FOR POLICY ANALYSIS

How Corporations Are Taxed[1]

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There appears to be agreement in principle that U.S. corporate tax rates are too high. The top U.S. corporate income tax rate is 35 percent — the highest in the world among developed countries. However, some small businesses face a 39.6 percent tax rate because, as sole proprietorships or partnerships, they are taxed at the highest personal income tax rate of 39.6 percent. Corporate taxes are so high largely because corporations are an easy target for raising revenue. The corporate income tax represents about 14 percent of total federal tax revenue, including taxes on profits before and after they are distributed to owners and shareholders — so-called double taxation.

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Executive Summary

A basic principle of sound tax policy is horizontal equity — that is, two taxpayers with the same income and alike in all other ways should pay the same tax. However, the legal form of a business has a substantial impact on its tax liability, clearly indicating we are not meeting that goal. In order to understand why reform is needed, it is necessary to understand the details of U.S. business taxation in general and corporate taxation in particular.

S-Corporations, C-Corporations and Other Business Entities. Businesses are either taxpaying entities or conduits that pass all their income (or losses) through to owners, for whom it is taxable income — including partnerships, S-corporations and trusts. The income of the partnership or the S-corporation flows through and is taxable to the partners or shareholders. (S-corporations have only one class of stock outstanding and no more than 100 eligible shareholders.)

Domestic C-corporations include all major U.S. corporations with publicly traded stocks. One of the unique characteristics of C-corporations is that earnings are usually subject to double taxation. The corporation pays tax on its taxable income and, if a portion of that profit is distributed as a dividend to the shareholder, it is generally taxed again through the personal income tax system.

Statutory versus Effective Corporate Tax Rates. The statutory tax rate that applies to the highest corporate income bracket is 35 percent. The average state/local marginal corporate tax rate is 6.4 percent. The combined marginal rate (after the federal rate is adjusted for deductions of the state rate) is 39 percent. Because there are several tax brackets and many differences in the ability of various legal forms of businesses to minimize their tax burden, effective tax rates vary across entities. Estimates of effective average rates for C-corporations range from about 13 percent to 28 percent, but there is general agreement that U.S. rates are the highest in the industrial world.

Corporate Income Tax Avoidance. A unique aspect of U.S. corporate tax law is that a C-corporation is taxed on worldwide income, not just the income it created in the United States. U.S. law taxes the foreign income only when it is repatriated into the United States (usually at a 35 percent rate). Therefore, one way to avoid the U.S. corporate income tax is not to repatriate the income from a foreign subsidiary — that is, if the parent corporation can avoid rules that try to prevent deferral of income in this way. Otherwise, this income can be deferred indefinitely. It is estimated that U.S. corporations have more than $2 trillion in earnings parked in other countries.

Inversions. "Inversion" is a technique where a corporation simply shifts its headquarters and residency to a country with a lower tax rate than the United States. Then, it is only taxed on income earned in the United States. The Treasury Department recently issued new regulations in an attempt to curb this behavior. They have made re-domiciling more difficult and costly, but not impossible.

Debt Financing. A tax avoidance measure used by both small and large corporations is to engage in debt, instead of equity, financing. Equity financing occurs when a corporation sells shares of stock. Interest on debt is deductible while dividends on equity are not. This feature of the tax code is largely responsible for the huge amount of debt on U.S. balance sheets and the preference for leveraged buyouts.

Compensating shareholding employees by paying salaries rather than dividends. Compensation is a deductible expense and can eliminate the corporation's tax liability. However, the salary has to be reasonable for the duties performed by the shareholder/employee.

The corporate income tax serves only to obscure and worsen the negative consequences of any tax system for economic growth and tax fairness. It serves no purpose except to exploit popular resentment toward corporations for political ends that have no bearing on any legitimate goal of tax policy.

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Introduction

It is a rare event in recent memory when there is bipartisan agreement on tax reform. Such is said to be the case with corporate tax reform. President Obama's Bipartisan Debt Commission recommended reforming the "uncompetitive" corporate tax code.[2] In a *Wall Street Journal* opinion piece, Gene Sperling, former director of the President's National Economic Council, observed that consensus remains possible in the matter of corporate tax reform. Sperling noted that Representative David Camp, chairman of the Republican-majority House Ways and Means Committee, has expressed his own aim to reform the corporate tax code. "There is no question that corporate tax reform in 2015 would be a heavy lift," Sperling observes. "But it might be a little less onerous if there were more focus on the amount of common ground that President Obama and Rep. Camp have started to unearth."[3]

One thing is certain: Corporations do not pay taxes. Only people pay taxes. The corporation itself is just a legal veil behind which the executives in charge serve at the will of its owners, in which capacity they try to minimize the corporation's tax liability. Corporations don't pay the corporate income tax. They just pass it along in the form of lower dividends to shareholders, lower wages to employees and higher prices to consumers.

There appears to be agreement in principle that U.S. corporate tax rates have become too high largely because corporations have come to be seen as an easy target for raising tax revenue. However, agreement in principle is a far cry from agreement on details. In order to understand why reform is needed it is necessary to understand the details relating to U.S. business taxation in general and corporate taxation in particular.

Business Taxation in the United States

Businesses in the United States may be operated as sole proprietorships, partnerships or corporations. The choice is dependent upon nontax as well as tax factors. Examples of nontax factors that can influence the form of business are the number of owners, the desire for limited liability and maintenance costs.

S-Corporations. S-corporations are regular corporations whose shareholders have elected, within the first 75 days, to be taxed under Subchapter S of the Internal Revenue Code. An S-corporation can have

Table I
C-Corporation Percentage of Total Receipts - 2012

	Tax Collected (thousands)
C - Corporations	$267,505,564
Qualified Dividends and 15% Capital Gains	96,725,388
Net Short term Capital Gains	0
Non-Qualified Dividends	27,281,520
Total	391,512,472
Total Receipts	$2,730,900,000
Percentage of Total Receipts	14%

*Dividends, Long-term Capital Gains and Short-term Capital Gains are subject to the personal income tax.

Source: Internal Revenue Service, Statistics of Income, 2012.

only one class of stock outstanding and no more than 100 eligible shareholders. Despite these limitations, about 72 percent of all active corporate tax returns are S-corporations.[4] The income of the partnership or the S-corporation flows through and is taxable to the partners or shareholders *regardless* of how much they have taken out as a predetermined amount of money (partnership), or dividends (S-corporation) during the year. The income (profits) is taxable to the owners whether or not they actually get it. This treatment can create cash flow problems for minority shareholders or partners, who have to pay tax on income they may not receive. If an S-corporation's taxable income is $100,000, the shareholders will be taxed on $100,000 on their personal returns, even if they did not receive a penny from the S-corporation in dividends. They are also taxed on only $100,000 even if they received a dividend of $150,000. The same is true for partnerships. Therefore, it is a flow of income, not cash. The cash paid out by an S-corporation as a dividend is usually not taxable and is ignored. This is not true for trusts or C-corporations. Dividends from a C-corporation are usually taxable.[5]

C-Corporations. The income of domestic C-corporations are subject to tax under Chapter 11 of the Internal Revenue Code.[6] One of the unique characteristics of C-corporations is that earnings are usually subject to double taxation. The corporation pays tax on its taxable income and, if a portion of that profit is distributed as a dividend, the distribution to the shareholders generally are taxed again. A C-corporation that receives a dividend from another C-corporation generally only pays tax on 30 percent of the amount received, preventing some triple taxation.[7] The corporate income tax represents about 14 percent of total federal tax revenue, including double taxation [see Table I].

To illustrate double taxation, assume that John owns 100 percent of the stock of Widgets, Inc. (a C-corporation) with taxable income for the current year of $100,000 and paid dividends to John totaling $100,000. Widgets, Inc. would pay a corporate tax of $22,250. If Widgets pays a dividend of $100,000 to John, he will pay a tax of as much as 23.8 percent, or $23,800, on the $100,000 of dividends.[8] Therefore, the $100,000 is taxed twice for a total corporate and individual tax of $46,050 or 46.05 percent.[9] If the corporation had made a timely "S" election, or formed a partnership, the corporate tax of $22,250 would have been avoided. However, in an S-corporation, the $100,000 of flow-through income would be taxed as *ordinary* income up to the highest individual rate (39.6 percent), not the lower dividend rate (in this case 23.8 percent). Any S-corporation dividends paid would not be normally taxable.[10]

C-corporations also pay twice on liquidation. When they liquidate they pay tax at the corporate level on the capital gain on any appreciated assets, and then the shareholders pay tax again when they receive the liquidating dividend. It is usually not advisable for a C-corporation to acquire real estate, since real estate tends to appreciate.

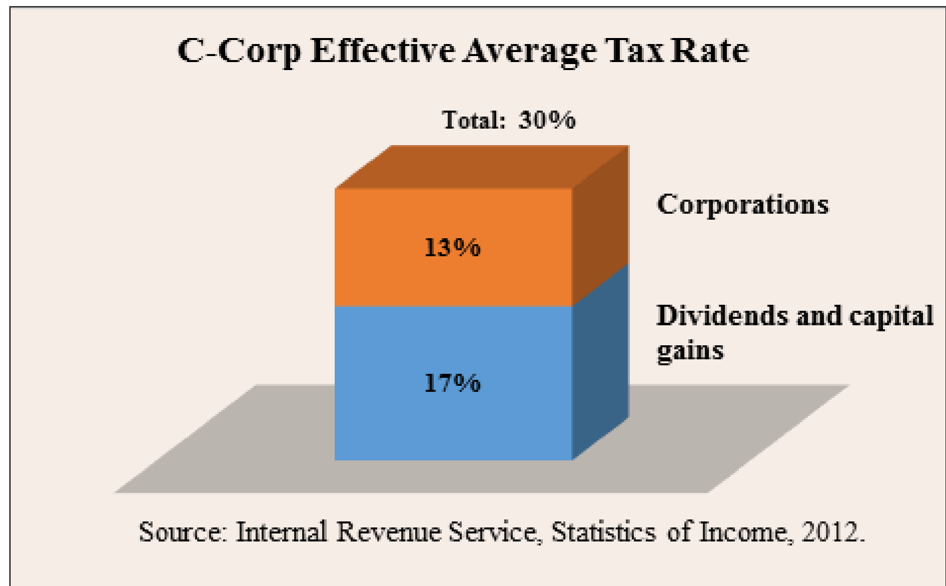
The losses of a partnership or S-corporation flow through and are potentially deductible. Again, these losses flow through to owners regardless of how much cash they have taken during the year as partner or employee compensation. Losses do not flow through to shareholders of a C-corporation. They are simply carried forward.

Table II
Percentage of Total Business Receipts by Entity Type - 2012

	Total Receipts (thousands)	%	# of Returns	%
C-corporations	$22,830,809,333	64	1,635,369	4
S-corporations	6,572,866,128	19	4,205,452	11
Partnerships	4,763,737,266	13	3,388,561	9
Sole Proprietors (Sch. C)	1,279,684,288	4	26,202,494	70
Farming (Sch. F)	36,862,274	0	1,907,750	5
Total Business Receipts	$35,483,959,289	100	37,339,626	100

Source: Internal Revenue Service, Statistics, 2012, Corporation, Individual and Partnership Tax Returns.

Entities. Businesses are either taxpaying entities or conduit entities. A conduit entity is one that passes all its income (or losses) through to owners. The entity itself does not usually pay the tax. There are only three types of business entities subject to tax under the federal income tax: Individuals operating as sole proprietors, C-corporations, and estates and trusts (fiduciaries). Each has its own tax rate schedules and rules.



Source: Internal Revenue Service, Statistics of Income, 2012.

Conduit entities include partnerships, S-corporations and trusts. For partnerships and S-corporations the income or loss is passed through to the partners or shareholders and is taxable to them. A partnership never pays any tax. The S-corporation usually does not pay tax, unless it was once a C-corporation and converted to "S" status after the first year of its life.[11] Trusts are both taxpaying and conduit entities. A trust's income is taxable if it is distributed to the beneficiaries. If it is retained by the trust, the trust pays the tax. Losses do not flow through to beneficiaries, but are carried forward by the trust to offset income in future years. Retaining income at the trust level is expensive because of very progressive trust rates.

- A trust hits the top tax rate of 39.6 percent at only $12,300 for 2015.
- A single individual would not hit that rate until he had $413,200 of taxable income.[12]

Table II presents all U.S. business forms with their total receipts and number of taxpayers. Notably:

- C-corporations represent 64 percent of total receipts yet only 4 percent of the total returns filed.
- Sole proprietors represent 70 percent of the returns filed yet only 4 percent of total receipts.

Corporations and Social Security Taxes. Social Security taxes are imposed differently for S-corporations and partnerships. For an S-corporation the flow-through of income or payment of dividends is not subject to self-employment tax. For a partnership the flow-through of income is subject to the tax. This is a 15.3 percent difference on the first $118,500 of income and a 2.9 percent Medicare tax after that (plus an extra 0.9 percent tax on higher income taxpayers starting in 2013). Dividends from, and earnings of, C-corporations are not subject to Social Security taxes.[13]

A basic principle of sound tax policy is horizontal equity; that is, two taxpayers with the same income, and alike in all other ways, should pay the same tax. Clearly, the variability in the taxation of different legal business forms indicates we are not meeting that goal. This is especially true for those businesses which must, or choose to, operate as C-corporations. Even within the C-corporation area the goal of horizontal equity is not met. C-corporations with multinational operations have much lower effective tax rates than corporations with only domestic operations.

Statutory versus Effective Corporate Tax Rates

There is no more obvious reason to reform corporate taxes than the disparity between statutory and effective corporate tax rates. The statutory tax rate that applies to the highest corporate income bracket is 35 percent. The average state/local marginal corporate tax rate is 6.4 percent. The combined marginal rate (after the federal rate is adjusted for deductions of the state rate) is 39 percent. A corporation's *effective* rate is its tax liability divided by the sum of its taxable and nontaxable income. Its marginal rate equals the rate applicable to its tax bracket.

Because there are several brackets and many differences between taxpaying entities in their ability to minimize taxes, effective rates vary across entities. The effective average tax rate (EATR) equals total tax liability across all entities, divided by taxable and non-taxable income. The effective marginal tax rate (EMTR) equals the

change in tax liability across all entities that results from a one-dollar change in taxable and nontaxable income. Estimates range from about 13 percent to 28 percent, but there is general agreement that U.S. rates are the highest in the industrial world.[14] The wide variation is due to how the rates are calculated, what income is included and whether the corporation is multinational.

Glaringly absent from these estimates is any consideration of the double taxation inherent in the code — the tax paid by shareholders on dividends and on capital gains. We estimate that taxes paid on dividends add 17 percent to the effective C-corporation tax rate. If we assume a 13 percent C-corporation effective average rate, the effective average tax rate including taxes on dividends and capital gains is 30 percent [see the figure].[15] It is a political sleight of hand to claim the average effective corporate tax rate is low, in order to justify raising the rate or expanding the tax base, without considering the taxes paid on dividends or on capital gains through stock sales. The entire corporate tax burden is at issue, not just part of it.

Furthermore, any reform of corporate tax law should also include businesses operated as S-corporations. Although they are not usually subject to double taxation, the income that passes through to shareholders is subject to high individual tax rates.[16] C-corporations organized in the United States are subject to the highest statutory corporate tax rate in the industrialized world, at 35 percent.[17] In addition, their earnings and appreciated assets are subject to double taxation. This double taxation is fairly unique and puts the United States at a competitive disadvantage versus most other countries.

Table III presents corporate tax rates for Organization for Economic Cooperation and Development countries.[18] The central rate is the top national or federal statutory rate, net of tax savings due to deductions for local government (sub-central) taxes. The U.S. has the highest combined rate of 39 percent. Almost 99 percent of C-corporations are in the 35 percent-or-above tax bracket.

Corporate Income Tax Avoidance

There are ways to avoid the double taxation of C-corporations. The tax avoidance schemes employed by these corporations create massive economic distortions in the allocation of capital and labor in the United States and account for the large disparity between the statutory corporate tax rate and the effective rate.

Techniques that C-corporations use to avoid double taxation of their earnings can be divided into two groups: those used by large businesses and those used by small businesses.

Large Business Tax Avoidance. Large multinational corporations can avoid corporate taxes by using a variety of international tax schemes. Most countries employ a "water's edge" rule that taxes only income earned in the country of residence. A unique aspect of U.S. corporate tax law is that a C-corporation is taxed on worldwide income, not just the income it created in the United States. U.S. law taxes the foreign income only when it is repatriated into the United States (usually at a 35 percent rate). Therefore, one way to avoid the U.S. corporate income tax is not to repatriate the income from a foreign subsidiary — that is if the parent corporation can avoid rules that try to prevent deferral of income in this way.[19] Otherwise, this income can be deferred indefinitely. It is estimated that U.S. corporations have almost $2 trillion of earnings parked in other countries, which is an increase of 12 percent over 2013.[20]

Because the United States has such a high corporate tax rate, multinationals use a variety of tax avoidance techniques to shift income from the United States to countries with lower rates. Although U.S. tax law permits a foreign tax credit to help alleviate double (really triple) taxation of foreign income, the credit can't be larger than the U.S. tax. Since the U.S. tax rate is so high, the overall corporate tax burden is reduced by reducing the amount of income subject to the U.S. tax as much as possible.

Corporate "inversion" is a technique that has received a great deal of recent scrutiny. In this technique a corporation simply shifts its headquarters and country of residency to a country with a lower tax rate than the United States, akin to an individual giving up U.S. citizenship.[21] Since the corporation is not domiciled in the United States it is not subject to tax on its worldwide income, but only on the income earned in the United States. The corporation thus creates its own "water's edge" system of taxation. The Treasury Department recently issued new regulations in an attempt to curb this behavior. These rules have slowed down the number of inversions. They have made re-domiciling more difficult and costly, but not impossible.[22]

Most other tax avoidance techniques for multinational corporations involve shifting income from the high U.S. tax rate to a lower rate in another country. For example, it is common to transfer intellectual property, such as trademarks or patents, to a related corporation in a low or

Table III
2014 International Tax Competitiveness Index Rankings

Country	Overall Score	Overall Rank	Corporate Tax Rank	Consumption Taxes Rank	Property Taxes Rank	Individual Taxes Rank	International Tax Rules Rank
Estonia	100	1	1	8	1	2	11
New Zealand	87.9	2	22	6	3	1	21
Switzerland	82.4	3	7	1	32	5	9
Sweden	79.7	4	3	12	6	21	7
Australia	78.4	5	24	7	4	8	22
Luxembourg	77.2	6	31	5	17	16	2
Netherlands	76.6	7	18	11	21	6	1
Slovak Republic	74.3	8	16	32	2	7	6
Turkey	70.4	9	10	26	8	4	19
Slovenia	69.8	10	4	25	16	11	13
Finland	67.3	11	9	15	9	23	18
Austria	67.2	12	17	22	18	22	4
Korea	66.7	13	13	3	24	10	30
Norway	66.7	14	20	23	14	13	12
Ireland	65.7	15	2	24	7	20	26
Czech Republic	64.4	16	6	28	10	12	24
Denmark	63.7	17	14	14	11	28	20
Hungary	63.5	18	11	33	20	17	3
Mexico	63.3	19	32	21	5	3	32
Germany	62.8	20	25	13	15	32	10
United Kingdom	62.2	21	21	19	29	18	5
Belgium	59.6	22	28	29	22	9	8
Iceland	57.1	23	12	16	28	29	16
Canada	56.1	24	19	10	23	24	27
Japan	54.8	25	34	2	26	25	25
Poland	53.8	26	8	34	27	15	23
Greece	53.3	27	15	27	25	14	28
Israel	53.2	28	26	9	12	27	31
Chile	51.1	29	5	30	13	19	33
Spain	50.8	30	27	18	30	31	14
Italy	47.2	31	23	20	33	33	15
United States	44.6	32	33	4	31	26	34
Portugal	42.9	33	29	31	19	30	29
France	38.9	34	30	17	34	34	17

Source: Tax Foundation, 2014 International Tax Competitiveness Index. Available at http:/taxfoundation.org/article/2014-international-tax-competitiveness-index.

zero-tax rate country. The U.S. company pays deductible royalty fees for the use of the property, thus lowering its U.S. tax. The royalty income is either not taxable in the foreign country or taxed at a lower rate.

The same goal is seen in transfer pricing schemes whereby income and deductions are allocated between related companies in different countries. For example, the U.S. parent corporation buys inventory at over-inflated prices from a foreign subsidiary, thus increasing its cost of goods sold deduction, or sells inventory at lower than normal prices. Interest charged on intercompany loans can be artificially low or high to shift income. The IRS and the tax authorities of other countries have the right to adjust income and deductions to an "arm's length" standard to properly reflect income. In other words, the transactions should reflect prices that would occur if the parties were not related.[23] Transfer pricing abuse has been on the radar of the IRS for some time and corporations are routinely audited.

A final tax avoidance measure that is used by both small and large corporations is to engage in debt instead of equity financing. Interest on debt is deductible while dividends on equity are not. The economic distortion caused by this simple distinction cannot be overstated. It is largely responsible for the huge amount of debt on U.S. balance sheets and the preference for leveraged buyouts. An additional advantage of receiving interest on the debt is that that interest income is not subject to payroll taxes, except for the 3.8 percent net investment income tax for some taxpayers. Also, repayment of the principal is tax free, whereas redemptions of stock are usually taxable. However, if appreciated assets are transferred into the corporation, the receipt of debt will trigger a gain to the shareholder.

Small Business Tax Avoidance. Consider some of the advice tax accountants give their small-business clients.

Elect "S" status. An S-election must be made within the first 75 days (2.5 months) of the corporation's tax year for it to be applicable for that year. If that deadline is missed, the corporation is a C-corporation for that year. The corporation can ask the IRS for a late election, but there is no guarantee that the agency will grant it. If there is appreciated property in the corporation, the shareholders will have to wait five years to liquidate the corporation to avoid a corporate-level tax, even though it is an S-corporation. This is called a "built in gains tax," and it prevents C-corporations that want to liquidate from electing S status just before the liquidation to avoid the corporate-level tax.[24] Another benefit of electing S status in the first year of the corporation's life is that losses, which are likely in the first year, will flow through and could potentially be deductible by the shareholders. If the S-election is missed and made in the second year, the first year losses will be stuck in the C-corporation until the corporation is liquidated, which may not be for many years. The shareholders will not get the tax benefit of those first year losses. Due to the restriction on the number of shareholders allowed in an S-corporation (100), this is a viable option only for small business.

Don't pay dividends, since they are taxed twice. The IRS has a weapon against this form of tax avoidance called the Accumulated Earnings Tax.[25] The Accumulated Earnings Tax is an extra tax at a 20 percent rate, assessed on corporations that accumulate their income and never pay dividends. There are ways to avoid it.

Compensate shareholding employees by paying salaries rather than dividends. Compensation is deductible and can eliminate the corporation's tax liability. However, all deductions have to be a reasonable amount, so the salary has to be reasonable in amount for the duties performed by the shareholder/employee. If the shareholder is not an employee this will not work; the IRS will attack "unreasonable" compensation and claim that part of it is disguised dividends.

Pay deductible rent to shareholder/lessors, instead of dividends. If the shareholder leases property to the corporation, it lowers the corporate tax liability. This is another reason C-corporations should not own real estate. There is no requirement that shareholders transfer all their assets to the corporation. The other big advantage of extracting rents from the corporation is that rental payments for real estate are not subject to payroll taxes. The shareholder/employee could accept less salary and take out the difference as rent and save the 15.3 percent FICA & Medicare taxes (some high income taxpayers may be subject to a 3.8 percent Net Investment Income Tax on the rent). In addition, the real estate will generate non-cash depreciation deductions for the shareholders, which are not subject to payroll taxes.

Conclusion

The elimination of the double taxation of C-corporations and their shareholders is gaining ground as a serious

policy goal. A July 26, 2007, Department of the Treasury conference on *Global Competitiveness and Business Tax Reform* highlighted the need for reform. The Treasury Department has stated:

"The multiple taxation of corporate profits distorts a number of economic decisions important to a healthy economy. It distorts corporate financing choices by taxing interest earned on corporate bonds less heavily than corporate profits. As a result, corporations are induced to use more debt than they otherwise would. It distorts corporate distribution policy by taxing dividends more heavily than corporate earnings that are retained and later realized as capital gains (primarily due to the deferral of gains until sale and the opportunity for step-up of stock basis at death). As a result, it confounds market signals of a company's financial health and may have important implications for corporate governance. It also penalizes investment in the corporate form by taxing corporate income more heavily than other capital income. Consequently, it discourages investment in and through corporations in favor of investment in other less heavily taxed business forms (such as partnerships) or in non-business assets (such as owner-occupied housing). The double tax on corporate profits was reduced in 2003 with the enactment of lower tax rates on dividends and capital gains, although this relief, which focused primarily on equity-financed investment, did not completely remove the double tax."[26]

Not surprisingly, corporations expend an enormous amount of time and money navigating the tax avoidance minefield. The resources spent on the tax avoidance industry constitute a deadweight loss to the economy.

Attempts by the Obama administration to stop inversions are not working.[27] Other countries are lowering their rates, and we need to compete. Permanently eliminating or lowering the U.S. corporate tax rate would reverse the tax calculus and establish the United States as a tax haven. These moves would result in a huge infusion of capital and labor, especially given our other advantages, such as access to capital, rule of law, infrastructure and so forth. Multinational corporations would reverse course and try to shift the sourcing of income into the United States, instead of away from it.

Notes

1. Adapted from David G. Tuerck and James P. Angelini, "The U.S. Corporate Income Tax: A Primer for Policymakers," Beacon Hill Institute/National Center for Policy Analysis, July 2015. Available at http://www.ncpa.org/pdfs/sp_The%20U.S.%20Corporate%20Income%20Tax.pdf.
2. *The Moment of Truth* (Washington, D.C.: National Commission on Fiscal Responsibility and Reform, 2010). Available at http://www fiscalcommission.gov/.
3. Gene Sperling, "Believe It or Not, Corporate Tax Reform is Doable in 2015," *Wall Street Journal*, October 8, 2014.
4. "Corporate Income Tax Returns, Tax Year 2012," U.S. Internal Revenue Service. Available at http://www.irs.gov/pub/irs soi/12CorporateReturnsOneSheet.pdf.
5. Distributions from a C-corporation are taxable as dividends to the extent of the corporation's "earnings and profits," per Section 312 and Section 316. (All references to section numbers refer to the Internal Revenue Code, per Title 26 of the U.S. Code.) If the corporation does not have any earnings and profits the distributions are tax free up to the shareholder's stock basis and capital gain for the excess.
6. Tax-exempt organizations, such as certain schools, hospitals, churches and similar charities are organized as corporations, but they are not subject to income tax, except on their unrelated business income. We are also not including other businesses formed as C-corporations, but that receive special conduit tax treatment, similar to S-corporations. These include Regulated Investment Companies (mutual funds), Real Estate Investment Trusts and others.
7. See U.S. Code, Title 26, Sections 243-246, "Dividends received by corporations." Available at https://www.law.cornell.edu/uscode/text/26/243.
8. Tax rates on qualified dividends and long term capital gains can be 0 percent, 15 percent, 18.8 percent and 23.8 percent, depending upon income level. We assume the highest rate.
9. In "The Economic Effects of Corporate Taxation," forthcoming, we show how this double taxation enters into the determination of the "cost of capital."
10. Dividends from an S-corporation can be taxable if they are so large that they exceed the shareholder's stock basis.
11. C-corporations, on the other hand, pay taxes at the corporate level and personal level if income is paid to business owners as dividends.
12. Limited Liability Companies (LLCs) can elect to be taxed as almost any type of entity. The law does not recognize LLCs. Under "Check-the-box" regulations that became effective in 1997, an LLC will be taxed as a partnership unless it affirmatively elects to be taxed as a C or S-corporation via Form 8832. If it has only one member it will be considered a disregarded entity and taxed as a sole proprietorship, unless it elects to be taxed as a C or S-corporation.
13. High income taxpayers pay a 3.8 percent Net Investment Income Tax, which is essentially the Medicare Health Tax.
14. Martin A. Sullivan "Behind the GAO's 12.6 Percent Effective Corporate Tax Rate," *Tax Notes*, 2013, pages 197-200, available at http://taxprof typepad.com/files/140tn0197.pdf; and Jack Mintz and Duanjie Chen, "The U.S. Corporate Effective Tax Rate: Myth and the Fact," Tax Foundation, February 6, 2014, available at http://taxfoundation.org/article/us-corporate-effective-tax-rate-myth-and-fact.
15. "Statistics of Income 2012, Individual Income Tax Returns, Line Item Estimates, Internal Revenue Service," U.S. Internal Revenue Service. Seventy-eight percent of all dividends were "qualified" dividends, which are taxed at rates ranging from 0 percent to 23.8 percent.
16. Up to 39.6 percent and perhaps 43.4 percent if the 3.8 percent Net Investment Income Tax applies. Additional increases in the marginal rate can occur due to phase-out of deductions and credits. S-corporation taxable income can be taxed to the corporation also, if the S-corporation was once a C-corporation and certain conditions are met.
17. U.S. corporate tax rates start at 15 percent on the first $50,000 of taxable income and range as high as 39 percent, before stabilizing at 35 percent on taxable income above $18.3 million.
18. "Corporate Income Tax Rates," Organization for Economic Cooperation and Development (OECD), 2015. Available at http://stats.oecd.org//Index aspx?QueryId=58204.
19. Foreign earned income (Subpart F income) can be taxed immediately to U.S. shareholders if a foreign corporation is deemed to be a controlled foreign corporation (CFC). A CFC is a foreign corporation that meets a control test per Section 951(b), 957(a), 958(a) and (b). U.S. shareholders who own at least 10 percent of the CFC are taxed immediately on their share of Subpart F income, even if it is not distributed.
20. Richard Rubin, "Cash Abroad Rises $206 Billion as Apple to IBM Avoid Tax," *Bloomberg News*, March 12, 2014. Available at http://www bloomberg.com/news/articles/2014-03-12/cash-abroad-rises-206-billion-as-apple-to-ibm-avoid-tax.
21. U.S. citizens are also taxed on their worldwide income. In 2014, the number of citizens renouncing their citizenship increased dramatically.
22. Notice 2014-52, 2014-42 IRB 712.
23. In the United States, U.S. Code, Title 26, Section 482 gives the IRS the rather broad authority to reallocate income and deductions between related companies.
24. U.S. Code, Title 26, Section 1374, "Tax imposed on certain built-in gains." Available at https://www.law.cornell.edu/uscode/text/26/1374.
25. U.S. Code, Title 26, Section 531, "Imposition of accumulated earnings tax." Available at https://www.law.cornell.edu/uscode/text/26/531.
26. *Approaches to Improving the Competitiveness of the U.S. Business Tax System for the 21st Century* (Washington, D.C.: U.S. Department of the Treasury, 2007).
27. Amanda Athanasioue, "Is the Anti-Inversion Notice Doing Its Job?" *Tax Notes,* March 3, 2015.

Solutions for Americans from America's Think Tank

Established in 1983, the National Center for Policy Analysis (NCPA) is a nonprofit, nonpartisan public policy research organization. We seek to unleash the power of ideas for positive change by identifying, encouraging and aggressively marketing the best scholarly research and innovative solutions to public policy problems.

As America's Think Tank we develop and promote private alternatives to government regulation and control, solving public policy problems by relying on the strength of the competitive, entrepreneurial private sector.

Health Care Policy

NCPA's Health Policy Research Center seeks to reform the health care system in ways that reduce cost, increase access to care and improve the quality of care with solutions that rely on the power of individual choice. With over 30 years of leadership in solving some of the nation's most intractable health policy challenges, the NCPA, through its Health Policy Center Research Center, continues to research, develop and educate Americans about our reform solutions.

The NCPA is probably best known for developing the concept of Health Savings Accounts. NCPA's research, efforts to educate the public and briefings for members of Congress and the White House staff helped motivate Congress to approve a pilot Medical Savings Accounts program for small businesses and the self-employed in 1996 and to vote in 1997 to allow Medicare beneficiaries to have MSAs. In 2003, as part of Medicare reform, Congress and the President made HSAs available to all nonseniors, revolutionizing the health care industry.

As a result, more than 30 million Americans are managing some of their own health care dollars today in HSAs.

Taxes & Economic Growth.

NCPA research demonstrates the benefits of shifting the tax burden on work and productive investment to consumption. The NCPA helped shape the pro-growth approach to tax policy during the 1990s. A package of six tax cuts designed by the NCPA and the U.S. Chamber of Commerce in 1991 became the core of the Contract with America in 1994. Three of the five proposals (capital gains tax cut, Roth IRA and eliminating the Social Security earnings penalty) became law. A fourth proposal - rolling back the tax on Social Security benefits - passed the House of Representatives in the summer of 2002.

Because of the NCPA idea of Roth IRAs, $310 billion in savings has been taxed once and will never be taxed again.

Because of another NCPA idea, 78 million baby boomers will be able to work beyond age 65 without losing Social Security benefits.

The NCPA continues to research free market tax reform ideas. Using dynamic software, NCPA's Tax Analysis Center (TAC) is able to analyze proposed federal tax reform.

The TAC can identify the effects of proposed tax changes on representative individuals and families at various income levels and at various ages.

Past NCPA research confirms that long-term economic growth depends on economic freedom, the degree to which government policies protect property rights, and allows workers and employers to keep what they earn. The NCPA continues to work to identify job-creating economic growth policies while addressing fiscal and regulatory issues.

Retirement Reform.

With a grant from the NCPA, economists at Texas A&M University developed a model to evaluate the future of Social Security and Medicare, working under the direction of Thomas R. Saving, who for years was one of two private-sector trustees of Social Security and Medicare.

NCPA's research shows that as baby boomers begin to retire, the nation's institutions are totally unprepared. Promises made under Social Security, Medicare and Medicaid are inadequately funded. State and local institutions are not doing any better - millions of government workers are discovering that their pensions are under-funded and local governments are reneging on post-retirement health care promises.

The NCPA continues to work to find practical and workable solutions for retirement security. Pension reform signed into law includes ideas to improve 401(k)s.

Because of an NCPA/Brookings Institution plan, half of all future 401(k) enrollees will be automatically enrolled in a diversified portfolio enjoying higher and safer returns.

Energy and Natural Resources.

The NCPA has been a leader in researching and developing innovative ways to reform outdated environmental regulations and energy policies that raise costs and do not benefit American workers or consumers.

The NCPA analyzes markets for, and the production and use of, Rare Earth elements (REs) that are essential to modern technology, the economy

and national security.

The NCPA examines the potential of natural gas, oil, coal and other fossil fuels for clean, secure and sustainable energy supplies, in addition to the potential of alternative energy sources, including wind, solar and nuclear power.

The NCPA educates the public by distributing our popular Global Warming Primer, second edition, and by producing videos and posts to our blog by experts and in-house analysts.

Education Reform.

The cost and quality of education from pre-kindergarten through college are growing concerns. American college students now have $1.3 trillion in debt due to rising education costs. To compete internationally, the United States requires an educated workforce, particularly in the growing fields of Science, Technology, Engineering and Mathematics (STEM). To compete in the labor market, individual students must have access to appropriate education according to their abilities and interests. Of paramount importance in education is the freedom to choose schools and curricula that engage the student in learning.

We study models of school curricula, teaching and educational finance reform, including examining the potential impact of Education Savings Accounts (ESAs) on the supply of education and student achievement, based on data from existing state ESA programs, and proposed tax-advantaged ESAs. The NCPA also analyzes ways to lower the cost of higher education so that students are not burdened with increasing amounts of debt and compares the features and outcomes of innovative teaching methods entrepreneurs have developed to utilize technology in classroom and home-based learning.

We then educate the public and inform consumers about educational reform efforts through posts by experts and in-house staff on our education blog.

Reaching the Next Generation.

NCPA equips the next generation of leaders through the following youth outreach programs.

Debate Central. Since 1996, our Debate Central has provided low-income and geographically isolated high school debate students and coaches with free-to-access web-based information on the yearly topics of each the popular forms of high school debate. Through this effort, the NCPA has reached more than 800,000 aspiring debate students and coaches across the nation.

Young Patriots Essay Contest. The NCPA launched the Young Patriots Essay Contest in 2011 to acquaint hundreds of high school students with free-market solutions to public policy problems and spur thought about the responsibility that comes with citizenship. Since its inception, the contest has grown in both prestige and the number of applicants. Top essay winners receive scholarship funds for college.

Internships, Junior Fellows & Graduate Student Fellows. Through its Internship, Junior Fellow and Graduate Student Fellow programs, the NCPA exposes undergraduate and graduate students to the world of ideas and provides them with hands-on, professional experience in public policy. Every student that completes an internship at the NCPA leaves as a published author of an NCPA publication.

Promoting NCPA Ideas.

NCPA's Washington D.C. staff monitors developments in public policy, legislation, Congressional hearings, regulatory rule-making, and other governmental affairs. We work to educate members of Congress, Administration officials, and other policy makers about NCPA free-market ideas.

NCPA aggressively markets our ideas and scholars by employing an integrated strategy which includes outreach to traditional and social media, placement of NCPA- authored commentary, distribution of fact sheets, and appearances on TV and radio.

What Others Say About the NCPA

"The battle for ideas is far from over. That's why the work of the NCPA is so important and why your support of the NCPA is necessary."

Ronald Reagan

Former President of the United States

"I commend the NCPA for your strong commitment to the ideals of liberty and limited government."

George W. Bush

Former President of the United States

From Our President and CEO

"It will be policy, not politics that secures a sound economic future for Americans."

Allen B. West

NCPA President and CEO

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