Corporate Tax Reform, Finally, After 100 Years

By George K. Yin

Individual income tax rates will soon rise, with the rates for top-bracket individuals perhaps increasing significantly to finance the cost of healthcare reform, climate change mitigation, or other government initiatives, or to reduce the national deficit and debt. Many policy analysts have also recommended a reduction in the corporate tax rate, principally as a means to encourage cross-border investment and reduce revenue losses from transfer pricing manipulation.

These two changes to the income tax landscape are incompatible with one another because they invite the widespread use of C corporations as tax shelter vehicles. Top-bracket individuals will have a strong incentive to incorporate their affairs and subject their income to the lower corporate tax rate. Even if the graduated corporate tax brackets are eliminated (already the rule for personal service corporations and a justifiable change apart from any other reforms) and the tax on corporate distributions and gains from stock sales is increased, the changes would not offset the advantage of accumulating income year after year at the more favorable corporate rate. The problem may be even more severe once the effects of employment taxes and state and local income taxes are taken into account.

Although the problem is not new, it has never been addressed successfully. If policymakers are not careful, their changes may resurrect the need for the collapsible-corporation provision (section 341), which is now repealed only through 2010. That
provision was “characterized by a pathological degree of complexity, vagueness and uncertainty”\(^1\) and famously contained a single sentence (section 341(e)) that was twice the length of the Gettysburg Address.

A straightforward way to avoid the tax shelter problem is to restrict the corporate tax to public corporations and their subsidiaries. All nonpublic firms, including corporations, would have to be taxed as passthrough entities.\(^2\) If the firm is ineligible for, or fails to elect, subchapter S, it would be taxed as a partnership under subchapter K (or be treated as a disregarded entity). Top-bracket individuals would therefore not have the option of sheltering their income under the corporate tax. The corporate tax rate could be reduced, if appropriate, with the tax on corporate distributions and stock sales adjusted to help meet revenue needs.

This change would continue trends that have occurred over the last two decades. Between 1985 and 2005, there was an over fivefold increase in the number of S corporations, from 725,000 to almost 3.7 million. Between 1993 and 2005, the number of limited liability companies taxed like partnerships grew from 17,000 to almost 1.5 million. Thus, increasing numbers of closely held firms are now taxed under a form of passthrough taxation. Passthrough taxation allows income to be taxed just once when it arises, at the tax bracket applicable to the person allocated the income. And unlike shareholders of C corporations, owners of passthrough entities may offset their income with entity-level losses, subject to limitations imposed by the passthrough system. The proposed change would improve equity and efficiency by taxing all owners of closely held firms alike.

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The proposal would also eliminate a key structural difficulty with the corporate tax — its need to adapt to two completely different groups of taxpayers. According to IRS data, more than 90 percent of the roughly 2 million C corporations reported income of $50,000 or less in 2006, which allowed that income potentially to be taxed at no more than the lowest (15 percent) corporate tax rate. Meanwhile, a mere 3,801 C corporations, representing just 0.2 percent of all such corporations, reported income of more than $18.33 million — taxed at a flat 35 percent rate — and paid almost 90 percent of the corporate income tax.

Although many closely held firms have few assets and little or no income, their organization as C corporations has necessitated many corporate tax rules generally designed to prevent avoidance of individual income taxes by the shareholders of the firms. By removing those firms from the corporate tax, the rules could be simplified and tailored to public firms, with little loss of corporate tax revenue and potential increases in overall tax revenue.

Transitioning to the new system would be the most challenging task. Although closely held C corporations may not pay much corporate tax, some of them own appreciated property that is potentially subject to two levels of future tax. A tax-free transition of a C corporation into a passthrough entity

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3The data, from a special tabulation compiled by the IRS Statistics of Income Division, is based on “income subject to tax,” which is generally corporate net income after taking into account the net operating loss deduction for prior-year losses and the dividends received deduction. About 65 percent of the corporations reported zero income or less, and another 25 percent (about 500,000 corporations) reported positive income of $50,000 or less. Personal service corporations, which are not separately identified in the data, are ineligible for the lower corporate tax rates. Section 11(b)(2). Under current law, the tax shelter advantage of using a C corporation is modest and is fully realized once the corporation has $100,000 of income. Taxpayers in the 35 percent bracket save $12,750 in income taxes if they shelter that amount of income in a C corporation.

4In addition to permitting repeal of the collapsible-corporation provision and the taxes on accumulated earnings (section 531 et seq.) and personal holding companies (section 541 et seq.), many other rules, such as section 302 regarding the taxation of stock redemptions, could be greatly simplified or eliminated. The corporate tax also could be tailored to public corporations by, for example, having the base of the tax conformed more closely to income reported for financial purposes or measured by changes in the market capitalization value of the firm. See Joe Bankman, “A Market-Value Based Corporate Income Tax,” Tax Notes, Sept. 11, 1995, p. 1347; Michael Knoll, “An Accretion Corporate Income Tax,” 49 Stan. L. Rev. 1 (1996).
would allow at least one of those levels to escape taxation. On the other hand, a taxable transition may be inappropriate from a policy standpoint and, in any event, would not be politically feasible.

The transition should be carried out through some combination of carrots and sticks. The principal stick would be elimination of all of the graduated corporate tax brackets and an increase in the corporate tax rate for nonpublic firms equal to the top tax rate for individuals. This stick would be accompanied, however, by rules permitting a tax-free transition of the firm into subchapter K (or disregarded entity status) along the same lines as current-law transition of a C corporation into an S corporation. A subchapter K firm or disregarded entity with a prior C history might, for example, be subject to a section 1374-type tax for a period of years.

Alternatively, the usual owner-level basis adjustment might be denied when a passthrough entity recognizes and passes through built-in C gain to its owners. Another possibility would be to preserve in the surviving firm the lower of the inside and outside bases of the former subchapter C firm.5

The proposed change would reverse a policy decision made exactly 100 years ago. The first federal income taxes in the United States, enacted during the Civil War and in 1894, taxed corporations in two different ways. Some corporations were treated as passthrough entities. Others were taxed directly but primarily as a way to collect an income tax from the investors in those companies.

It was not until 1909, during the period before ratification of the 16th Amendment when income taxation of the owners of corporations was impermissible, that Congress passed the first truly separate income tax on corporations. Although the tax was termed an excise tax, it was measured by the net income of the corporation. When the individual income tax was enacted in 1913, Congress carefully integrated the existing corporate tax

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5The rules may need to prohibit public firms from going private and then converting into passthrough entity status under the liberal transition rules.
with the new tax on individuals to avoid double taxation, but changes in both taxes over the years gradually eroded that arrangement.

It is time to modernize the tax system to better serve the fiscal needs of the nation. Although Congress may soon be forced to adopt income tax rates reminiscent of years before 1986, it need not and should not bring with that change the same impenetrable problems and failed solutions of that bygone era. The income of all closely held firms should be taxed just once, under a passthrough system. The corporate tax should be limited and tailored to public firms.