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Issues in a Tax Reform Limited to Corporations and Businesses

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Summary

Some tax proposals have focused on broadening the tax base and lowering the rates of both individual and corporate income taxes. In some cases, these proposals have advanced a revenue-neutral tax reform. In other instances, they have proposed revenue increases. An example of a broad-based revenue-neutral income tax reform is H.R. 1 introduced in the 113th Congress by then Ways and Means Chairman Dave Camp. The bill proposed lowering both individual and corporate rates, while increasing the tax base through revising both business-related tax benefits (such as accelerated depreciation) and individual benefits (such as itemized deductions).

Given the challenges of adopting a broad income tax reform, some proposals have focused on business-only tax reform. The Obama Administration has proposed such a reform, which would be revenue neutral and include cutting the corporate rate, reducing business-related tax expenditures, reducing taxes on manufacturing, simplifying taxes for small business, and reforming the international tax system.

A challenge to confining tax reform to businesses is that provisions that expand the tax base may affect pass-through businesses, such as partnerships, proprietorships, and small business (Subchapter S) corporations. Unlike income in regular corporations, which is subject to the corporate income tax rate, income in pass-through businesses passes through to the individual owners and is taxed at the individual income tax rate. The effects on pass-throughs of broadening the tax base most likely could not be offset by generally lowering individual tax rates because the vast majority of those individual rates apply to labor or passive income. The cost of lowering the individual rates on this labor or passive income would probably be prohibitive. As a result, a revenue-neutral tax reform composed solely of corporate rate reductions and base-broadening provisions would likely increase the tax burden on pass-through businesses in the absence of other revisions.

Noncorporate business income is large relative to that of the corporate sector, but small relative to total individual income. Noncorporate business and rental income is estimated to be 45% of total business income but only 9.2% of income reported on individual income taxes. Unincorporated businesses are estimated to own around 40% of the business capital stock.

Broadening the tax base could be achieved by eliminating various tax expenditures, such as exemptions, credits, or deductions. Of the major corporate tax expenditures and other provisions that might be considered for base-broadening, the largest is the deferral of tax on foreign source income, which accounts for about 40% of corporate tax expenditures and is almost entirely corporate. This provision, however, may not be available for corporate rate reduction, based on international tax reform proposals that have been advanced. Of the other tax expenditures, some have limited overlap with unincorporated businesses whereas others significantly affect pass-through businesses. The next two largest tax corporate tax expenditures, accelerated depreciation for equipment and the production activities deduction, also benefit pass-through businesses.

Increasing the tax burden on pass-through businesses to finance corporate rate reductions could lead to efficiency gains because corporate income currently is taxed more heavily than noncorporate income. Moreover, any tax reform will produce winners and losers (for example, creditors will also experience higher effective tax rates and industries will be affected differentially). Other options for business only tax reform are to target base-broadening provisions that are primarily corporate, limit changes in provisions to corporations, introduce or expand provisions that benefit small business, allow a deduction or alternative rate structure for pass-through income, or limit corporate reform to international tax changes.

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Introduction

Some tax proposals have focused on broadening the tax base and lowering the rates of both individual and corporate income taxes. In some cases, these proposals have advanced a revenue-neutral tax reform. In other instances, they have proposed revenue increases. An example of a broad-based revenue-neutral income tax reform is H.R. 1 introduced in the 113th Congress by then Ways and Means Chairman Dave Camp. The bill proposed lowering both individual and corporate rates, while increasing the tax base through revising both business-related tax benefits (such as accelerated depreciation) and individual benefits (such as itemized deductions).

Given the challenges of adopting a broad income tax reform, some proposals have focused on business-only tax reform. The Obama Administration has proposed such a reform, which would be revenue neutral and include cutting the corporate rate, reducing business-related tax expenditures, reducing taxes on manufacturing, simplifying taxes for small business, and reforming the international tax system.[1]

A challenge to confining tax reform to businesses is that many provisions that expand the tax base may affect pass-through businesses. Unlike income in regular corporations, which is subject to the corporate income tax rate, income in pass-through businesses passes through to the individual owners and is taxed at the individual income tax rate. The effects on pass-throughs of broadening the tax base most likely could not be offset by generally lowering individual tax rates because the vast majority of those individual rates apply to labor or passive income. The cost of lowering the individual rates on this labor or passive income would probably be prohibitive. As a result, a revenue-neutral tax reform composed solely of corporate rate reductions and base-broadening provisions would likely increase the tax burden on pass-through businesses in the absence of other revisions.

Note that a narrower business reform is to limit changes to the international tax system. Major changes to the international tax rules have been included in both H.R. 1 and the Administration's proposal. These changes could be considered in a stand-alone proposal and, since their effects are largely confined to the corporate sector, pass-through businesses would be largely unaffected.

How, or whether, to offset the potential increase in tax burden on pass-through businesses arising from base broadening is an issue in a business-only tax reform. The Administration reform proposal included special provisions benefitting small business which was reported to lead to a net tax cut for small businesses (although not for all pass-through businesses).

This report discusses issues and options that might be considered in a business-only tax reform, including the approach of the Administration's reform as well as other potential options to consider. It first outlines how firms operate as incorporated or unincorporated businesses for tax purposes and discusses the share of assets and income in the unincorporated sector. The next section examines corporate tax expenditures and the extent to which those tax expenditures affect pass-through firms. The final section discusses a number of options and issues that might be considered for business-only tax reform.

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[1] In 2012, the President proposed a general outline. See *The President's Framework for Business Tax Reform, A Joint Report by The White House and the Department of the Treasury,* February 2012, at http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf. Most recently, the President has proposed a business-only tax reform in his FY2016 budget. See Treasury Green book at http://www.treasury.gov/resource-center/tax-policy/Pages/general_explanation.aspx.

Overview of Corporate and Noncorporate Businesses

Businesses operate in several different forms: C corporations, proprietorships, partnerships, and S corporations (sometimes referred to as subchapter S corporations following the section of the Internal Revenue Code that defines them). S corporations elect to be taxed as proprietorships or partnerships. Individuals may also hold rental property without engaging in business activity. Income from rental property may also be received through shares in real estate investment trusts (REITs).[2]

Regular (C) corporations' income is subject to the corporate income tax and to the individual income tax income when it is distributed to shareholders through dividends and capital gains taxes when stock is sold. The other business forms are called pass-throughs, because the income passes through to the individual owners and is taxed under the individual income tax (although in the case of partnerships, C corporations can be partners and are subject to corporate tax). Sole proprietorships are businesses owned by a single individual, whereas partnerships are businesses owned by multiple individuals and entities. Partners can be corporations, individuals, other partnerships, and tax exempt organizations. Therefore, partnership income may be reported multiple times in the Internal Revenue Service data on entities. S corporations are corporations with no more than 100 shareholders who elect to be taxed as pass-throughs (i.e., as either sole proprietorships or partnerships). Although Subchapter S firms are legally incorporated, for tax purposes they are treated as unincorporated businesses and will be referred to as unincorporated or noncorporate businesses in this report.

Shares of Total Business Income

Noncorporate business income is large relative to that of the corporate sector, but small relative to total individual income.[3] In 2012, the latest year data were available, individual income reported on tax returns was $9,234 billion, whereas income from sole proprietorships was $304 billion and income from partnerships and Subchapter S firms was $535 billion. Farming income was small and negligible (-$5 billion), rental income was $14 billion, and farm rental income was $6 billion. The business and rental incomes, therefore, constituted 9.2% of income reported on individual income taxes. Corporate income in that same year was $1,051 billion. Out of the total income of corporate and noncorporate businesses, corporate accounted for 55% and noncorporate for 45%.[4] Note also that some of the income from unincorporated businesses, perhaps a significant share, is from labor income, a component of pass-through income.

These relative sizes confirm the basic challenge to a corporate-only or business-only tax reform: provisions that broaden the base for business in general could have consequences for unincorporated businesses that constitute a large share of total business income earned by both sectors, but are such a small part of the individual income tax that cutting overall individual tax

[2] See CRS Report R43104, *A Brief Overview of Business Types and Their Tax Treatment*, by Mark P. Keightley.

[3] Data in this section is from IRS Statistics of income for individual and corporate tax returns, http://www.irs.gov/uac/Tax-Stats-2.

[4] Note that this ratio relies on income reported on individual tax returns and not entity level data for pass-throughs. Because partnerships can be owned by corporations or other partnerships, partnership income may be reported multiple times in the Internal Revenue Service data on entities.

rates to offset noncorporate base-broadening provisions would create revenue losses for the large share of income that is not business income.

Differences by Asset Type and Activity

The noncorporate business sector has activities, and ownership of capital, that differ substantially from the corporate sector. **Table 1** provides estimates of the types of business assets owned by the corporate and noncorporate sectors as reported in the National Income and Product Accounts and the Federal Reserve Flow of Funds Accounts.

Table 1. Distribution of Business Assets in the Economy

(percentages)

Asset Type	Share of Each Asset That is Corporate	Share of Total Business Assets in Economy by Asset Type
Equipment	69.3	13.6
Nonresidential Structures	60.9	29.0
Residential Rental Structures	5.6	7.8
Inventories	66.9	5.4
Intangibles[a]	85.6	11.8
Land	52.2	32.34
Total	60.6	**100.0**

Source: Assets other than land based on the National Income and Product Accounts (NIPA). Land is estimated from the Federal Reserve Flow of Funds Data (latest available data from either 2013 or 2014). Intangibles deriving from research and development (R&D) are also from the NIPA, but additional intangibles from advertising or worker training are based on estimates by Carol Corrado, Charles Hulten, and Daniel Sichel, Intangible Capital and U.S. Economic Growth, *Review of Income and Wealth*, vol. 55, no. 3, September 2009, pp. 661-685.

Notes: The NIPA data include Subchapter S corporations in the corporate sector; a reallocation was made to reflect the share of income as reported in the Internal Revenue Service (IRS) Statistics of Income data except for intangibles. The data exclude assets held by non-taxable entities, primarily nonprofit organizations (e.g., private universities, religious institutions, nonprofit hospitals).

a. R&D intangibles are 42% of total intangibles. Other intangibles are allocated in the same ratio as R&D intangibles.

As shown in **Table 1**, the corporate share of assets is 60.6%; this share is larger than the share of corporate income (55%) in the business sector. This difference may result from some portion of noncorporate income reflecting labor income. The share of assets held by corporations varies considerably by asset type. Corporations have a tiny share of residential rental property and a large share of equipment and intangibles. Moreover, about half of the nonresidential structures in the corporate sector are due to public utility properties (such as power plans), which are treated as equipment in the tax code but structures in the National Income and Product Accounts. Thus, a change in the cost recovery provisions for rental residential structures would largely broaden the base of the unincorporated business whereas a change in the treatment of research and development would largely affect the base of the corporate income tax.

The forms of organizations also differ in the types of industries in which business organizations earn income. **Table 2** reports the share of income by industry and business organization for any activity that is at least 10% of total net income in some sector. In these data from tax returns, of the four types of businesses, the corporate share of income is smaller, 47% rather than 55%

mentioned above, but these data involve some multiple counting (because partnerships can be held by other partners, corporations, or tax exempt organizations).

Table 2. Shares of Net Earnings in Each Industry by Organizational Form, for Industries Accounting for at Least 10% of the Share in Some Sector, 2012

(percentages)

Industry	Corporate	Partnership	Proprietorship	Subchapter S
Mining	0.7	13.6	0.8	2.8
Construction	0.2	2.1	10.7	9.0
Manufacturing	44.4	12.9	1.3	14.6
Trade	17.6	6.8	7.0	20.6
Information	6.5	11.1	1.0	1.7
Finance & Insurance	16.9	17.1	6.0	6.5
Holding Companies	11.1	0.8	0.0	3.1
Professional Services	0.2	22.7	23.1	15.3
Health Services	0.3	8.3	14.6	8.9

Source: IRS Statistics of Income, Corporation Complete Report, Table 12, http://www.irs.gov/pub/irs-soi/12coccr.pdf and Tables for Partnerships, Nonfarm Sole Proprietors, and Partnerships posted at http://www.irs.gov/uac/Tax-Stats-2.

Notes: Does not include Real Estate Investment Trusts (REITs), Regulated Investment Companies (RICs) and farm proprietorships. REITs involve passive investment in real estate and RICS (such as mutual firms) passive investments in financial assets.

The data in **Table 2** show the concentration of corporate activity in manufacturing (close to half). The next largest corporate activities are trade and services, which have similar shares and together account for a third of earnings. Proprietorships, which are owned by one individual, are concentrated in professional (e.g., attorneys, accountants) services, followed by health services (e.g., physicians) and construction. Subchapter S firms, which can have up to 100 owners, have about 20% of activities in trade and about 15% each in professional services and manufacturing. Partnerships range from small firms with a few (even two) partners to large firms with many partners who may be passive investors. The largest share of their business income is earned in professional services, followed by finance and insurance, with significant shares in mining, manufacturing, and information. (Note that more corporate activity is involved in the extractive industries than suggested in **Table 2** because integrated companies, such as major oil companies, are classified as manufacturing; this manufacturing sub-industry accounts for 14% of income.)

These data are suggestive of some of the sub-types of assets owned. For example, most of the earnings in agriculture (not shown in **Table 2** because it is small in every sector) and construction are in the unincorporated sector (80% and 98%, respectively), and thus unincorporated businesses probably own the preponderance of these equipment assets. The unincorporated sector, however, accounts for only 19% of manufacturing and thus equipment assets used in manufacturing are largely owned by corporations. Similarly, the unincorporated sector dominates in the service industries (earning at least 80% and in some sectors more than 95% of income) and thus presumably owns a larger share of furniture and fixtures, and service industry machinery. The ownership of categories of equipment assets can matter because the largest tax expenditure in the corporate sector (outside of deferral of foreign source income) is accelerated depreciation on equipment, and it would be a likely base-broadening candidate.

Distribution of Tax Expenditures and Other Potential Base-Broadening Provisions

The analysis continues by examining the potential base-broadening provisions that might be used to finance corporate rate reductions in a business-only tax reform. Broadening the tax base could be achieved by eliminating various tax expenditures, such as exemptions, credits, or deductions.

Tax Expenditures

Many, perhaps most, base-broadening provisions are tax expenditures. **Table 3** shows the corporate tax expenditures with costs of $1 billion or more and the amount of the corporate tax expenditure.[5] It also shows the amount allocated to individuals, and the share. In most cases, these tax expenditures for individuals are associated with business activity, but in a few cases (charitable contributions, tax exempt general obligation and private activity bonds, and treatment of investment income from life insurance) the tax expenditure relates to non-business activities. Numbers from 2014 reflect adjustments for bonus depreciation and certain "extenders": provisions that are temporary but often extended. Most extenders expired at the end of 2014.

Table 3. Allocation of the Corporate Tax Expenditures Costing $1 Billion or More, FY2014

Provision	Corporate ($billions)	Noncorporate or Individual ($billions)	Share Noncorporate or Individual (%)
Deferral of Foreign Source Income	83.4	0.0	0.0
Equipment Depreciation	24.0	6.3	20.8
Production Activities Deduction	12.2	4.6	27.4
Like-Kind Exchanges	11.7	5.2	30.8
Tax Exempt Bonds (General)	9.2	23.8	72.1
Nondealer Installment Sales	6.9	2.7	28.1
Low Income Housing Credit	6.8	0.3	3.4
R&D Tax Credit	6.6	0.1	1.5
Expensing of R&D	4.6	0.1	2.1
Reduced Corporate Rates	3.8	0.0	0.0
Charitable Contributions	3.1	38.4	92.5
Title Passage Rule	3.0	0.0	0.0
Investment Income Life Insurance	2.7	27.4	91.0
Treatment of Life Insurance Reserves	2.7	0.0	0.0
Section 179 Expensing	2.5	4.5	69.2

[5] Note that the cost of tax expenditures is not necessarily equal to the revenue gain from eliminating them. Some provisions, such as accelerated depreciation, may initially have larger revenue gains due to transition effects. Some provisions may have smaller gains because of behavioral effects. Finally, a package of provisions may have different effects from the sum of the individual provisions because of interactions.

Provision	Corporate ($billions)	Noncorporate or Individual ($billions)	Share Noncorporate or Individual (%)
Credit Union Exemption	2.1	0.0	0.0
Interest Rate Discounting Insurance	2.1	0.0	0.0
Private Activity Bonds	1.8	4.7	71.3
Electric Transmission Restructuring	1.8	0.0	0.0
Inventories	1.6	0.3	15.8
Production Tax Credit	1.4	0.1	6.7
Tax Credit for Renewable Energy	1.4	0.1	6.7
Special Deduction for Interest Charge Domestic International Sales Corporations	1.3	0.0	0.0
Excess of Percentage over Cost Depletion, Fuels	1.2	0.0	0.0
Expensing of Intangibles; Amortization of Geological and Geophysical Costs: Fuels	1.0	0.2	16.7

Source: The Congressional Research Service (CRS) calculations based on estimates by the Joint Committee on Taxation (JCT), with adjustments to separate bonus depreciation from overall accelerated depreciation. See *Tax Expenditures: A Compendium of Background Material on Individual Provisions*, Prepared by CRS for the Senate Budget Committee, December 2014, shttp://www.crs.gov/Products/CommitteePrint/CP10001.pdf?Source=search; Joint Committee on Taxation, Estimates Of Federal Tax Expenditures For Fiscal Years 2014-2018, JCX-97-14, November 7, 2014, https://www.jct.gov/publications.html?func=startdown&id=4663.

Notes: Each tax expenditure is estimated independently. The tax expenditure list captures some provisions that expired at the end of 2014, or are scheduled to expire but may be extended. A number of provisions are enacted on a temporary nature but have in the past been extended periodically. There is some uncertainty about which provisions will be extended. The list captures the R&D credit that has expired but has been extended since 1981. It does not include bonus depreciation, which was instituted as a short-term stimulus. See CRS Report R43898, *Tax Provisions that Expired in 2014 ("Tax Extenders")*, by Molly F. Sherlock for estimates of the effect of bonus depreciation. Another temporary provision that has expired, the deferral of tax on foreign income from active finance increases the cost of deferral for 2014 and is estimated at $2.5 billion. This provision, however, would disappear if deferral were ended. The tax credit for renewable energy is another temporary provision with elements that expire. The production tax credit and the special rule to implement electric transmission restructuring is also temporary. In addition, the Section 179 expensing provision has higher temporary limits that have expired.

Other Base-Broadening Provisions

Depreciation of structures, because of its small cost to corporations, is not included in **Table 3** although reform proposals that slow depreciation generally cover all depreciable assets. The cost for nonresidential structures is small ($0.2 billion each) because the depreciation allowed for these assets is close to the alternative system that forms the baseline for the tax expenditure. Rental housing would be more affected but is held largely by individuals: it gains $0.5 billion from corporations but $4.3 billion from individuals (either as part of an active business or as rental property).

In addition to these provisions, a number of other provisions have appeared in some tax reform proposals that are not in the tax expenditure list. Among those are

- disallowing the portion of interest deductions that reflect the inflation premiums;
- limiting excess interest deductions of firms in general;

- capitalizing and depreciating advertising expenses;
- extending the period used to recover certain acquired assets, such as good will and intangibles; and
- disallowing the deduction for entertainment expenses.

A number of potential base-broadening provisions are associated with foreign source income or with multinationals.[6] Some of these provisions would limit the amount of deferral of tax on foreign income by focusing on profit shifting, a minimum tax rate, or other such approaches, which would not have as large of an effect as eliminating deferral, but would raise some revenue. Some would restrict benefits for multinationals while retaining deferral, such as disallowing a share of parent office expenses, such as interest and other costs, to the extent income is deferred. Others would restrict the foreign tax credit allowed to offset foreign taxes on income subject to U.S. taxation to avoid double taxation. For example, one proposal that has been made is to limit the crediting of taxes that can be viewed in the nature as royalties paid by extractive industries. Other provisions might focus on limiting profit shifting by foreign parents of U.S. subsidiaries by limiting the deductibility of interest. Still others may address corporate *inversions*, or the shifting of headquarters by U.S. firms, generally through merger with a foreign firm. A characteristic of these types of base-broadening provisions is they are concentrated almost entirely in the corporate sector.

Examining Potential Base-Broadening Provisions

Turning to the tax expenditure list in **Table 3**, it is helpful to divide these tax expenditures into four categories: (1) provisions that use businesses as a conduit for other recipients; (2) provisions that are solely or virtually all corporate and thus would have little or no spillovers to unincorporated businesses; (3) provisions that have spillover effects, making it difficult or complicated to differentiate organizational form; and (4) provisions that accommodate different rules by organizational form.

Provisions Whose Benefits Flow Through to Other Entities

Two provisions in the list are technically affecting corporate taxes but are intended to flow benefits through largely to other recipients and thus may not be appropriate to consider for corporate rate reduction. In addition, if these benefits were disallowed for corporations, unincorporated businesses would likely increase their activities and offset much of the potential revenue gain. These provisions include general obligation tax exempt bonds, which are aimed at benefitting state and local governments by providing lower interest rates, and the low-income housing credit whose objective is to reduce housing costs for low-income tenants. The credit requires the setting aside of housing that is rented at below market rates. These provisions amount to about $16 billion and account for 8% of the total corporate tax expenditures in **Table 3**.

Other provisions that might fall into this category include private activity bonds and charitable contributions. Private activity bonds allow reductions of interest on borrowing by private entities to finance assets used in certain types of activities, such as hospitals, mass transit facilities, wharves and docks, and other items. Although corporations may capture some of the benefits,

[6] For more details on international proposals, see CRS Report RL34115, *Reform of U.S. International Taxation: Alternatives*, by Jane G. Gravelle, CRS Report R40623, *Tax Havens: International Tax Avoidance and Evasion*, by Jane G. Gravelle, and CRS Report R43568, *Corporate Expatriation, Inversions, and Mergers: Tax Issues*, by Donald J. Marples and Jane G. Gravelle.

these provisions lower the cost of construction that may be viewed by some as desirable to subsidize. The revenue gain from disallowing the tax expenditure for corporations might also be largely offset as individuals replace corporations as bond holders. Similarly, the beneficiary of charitable contributions is, in part, the recipient of the charity.

Provisions That are Primarily or Solely Corporate

Some provisions are almost entirely corporate. The largest of these is the provision that allows deferral of U.S. tax on foreign source income until the income is repatriated (i.e., paid as a dividend by a foreign subsidiary to the U.S. parent). The deferral provision alone accounts for 42% of corporate tax expenditures in **Table 3**. If this provision is not a potential source of revenue for corporate rate reduction, as may be the case (see the "Limit Reform to International Tax Changes" section), the tax expenditures that might be considered for base broadening that do not also spill significantly over into the noncorporate sector are limited. (The expenditures include research provisions, insurance and finance, graduated corporate rates, and some other small provisions relating to energy or international issues.) Note that the title passage rule that treats part of export income as eligible for foreign tax credits would no longer provide benefits if the United States moves to some type of territorial system.

Tax Expenditures That Spill Over When Conformity Is Important

In general, the availability of tax benefits is not restricted by organizational form, although some benefits are limited in dollar amounts or in other ways. For example, Section 179 expensing allows businesses to immediately deduct the full purchase price of equipment with a dollar limit and phase out. Certain benefits for oil and gas are limited based on production or whether the company is a major company with manufacturing and distribution operations.

It is possible that, in considering corporate- or business-only tax reform, proposals could suggest repealing certain provisions for corporations only. Any provision that is differentiated by organizational form would create incentives to change form that would vary depending on the provision. Such induced changes may be undesirable for efficiency reasons and lead to additional revenue loss. In some cases, it might be especially difficult to differentiate by organizational form for administrative and compliance reasons as well.

The second largest tax expenditure, accelerated depreciation for equipment, is a provision in which conformity would be helpful for tax administration and compliance and to limit incentives to choose organizational form. Maintaining two different depreciation systems that apply depending on corporate versus noncorporate form would be confusing and would encourage firms that use a lot of equipment (such as construction) to choose noncorporate status. In addition, slowing equipment depreciation would affect (if Section 179 expensing is retained) only a small share of larger unincorporated businesses in specific industries.

The third largest tax expenditure, the production activities deduction, might also fall into this category. The production activity deduction was initially aimed at the corporate sector as an offset to repealing an export subsidy and was extended to unincorporated businesses during legislative consideration. It is a complicated provision and a main benefit of eliminating it is to reduce the complexity in allocating income to domestic activities of particular types. To maintain the provision for unincorporated firms as a way of shielding them from tax increases would continue that complexity for a provision covering a small segment of businesses that were not the original intended beneficiary.

Limiting inventory accounting methods is another provision in which conformity across organizational forms would be desirable for compliance and administration, although, as noted below allowing expensing for inventories is a simpler matter that might be considered as an offset to other base-broadening provisions.

Section 179 expensing may also be considered a provision in which uniformity is desired because it allows a dollar amount of equipment investment to be expensed.

Tax Expenditures That Spill Over When Conformity Is Less Important

As noted earlier, any differentiation of a tax benefit by organizational form creates incentives to operate in the favored form. Nevertheless, from an administrative standpoint, it might be feasible to limit provisions such as like-kind exchanges (in which individuals are able to exchange properties without incurring a capital gains tax)[7] and nondealer installment sales (in which individuals can delay the recognition of income received in installments) to the noncorporate sector. These are simple rules (either a benefit is allowed or disallowed) and differentiating them by organizational form does not require the maintenance of dual complex systems such as depreciation lives and rates or inventory accounting methods.

Paths to a Business-Only Tax Reform

This section discusses a variety of options that might be considered for a tax reform confined to businesses. A combination of approaches might also be considered.

Accept Higher Taxes for Pass-Throughs

One approach to the issue of business-only tax reform is to accept the potential spillovers from base broadening for unincorporated businesses and pursue the goal of overall revenue neutrality for business investment. An argument for this view is that increasing overall taxes on pass-through and decreasing taxes on corporations might be desirable for efficiency reasons.

In the case of efficiency, the current tax system favors the noncorporate sector overall. The corporate statutory tax rate of 35% tends to be higher than the average marginal statutory rate for noncorporate business, estimated to average around 27%.[8] Although effective tax rates are lower than statutory rates, and this reduction is more pronounced for corporations (because they have a larger share of tax-favored investments), corporate effective tax rates are still higher in most cases and for most assets. **Table 4** shows the effective tax rates for a range of assets (excluding land and inventories). In addition, these rates reflect firm-level taxes and do not account for taxes on stockholders. Tax rates including stockholder taxes are estimated at an additional 2.3 percentage points.[9] These effects reflect tax rates on capital gains and dividends and the fraction that is excluded because the assets are held in pension and retirement accounts and by nonprofits.

[7] For corporations, the majority of deferred gain in like-kind exchanges is the exchange of vehicles (e.g., car rental companies exchanging their used vehicles with auto dealers. This effect was enhanced by bonus depreciation which allows half of equipment to be deducted immediately. For individuals, the most important source is real estate. See Gerald Auten, David Joulfaian, and Romen Mookerje, Recent Trends in Like-kind Exchanges, presented at the 2014 meetings of the National Tax Association.

[8] The 27% estimate is based on calculations from the Internal Revenue Service's (IRS's) public use file. It measures the ratio of the change in taxes that occurs with a small change in income, divided by the change in income.

[9] These effects are small for several reasons: the tax rates applied are small (rates range from zero to 20% but average around 15%); a large fraction of income is held in pension funds, retirement accounts, and nonprofits; a large share of capital gains is never realized but passed on at death; and the tax is applied net of the corporate tax. Estimates of taxes on stockholders are sensitive to assumptions about the proportion of capital gains and dividends subject to the tax. A (continued...)

Table 4. Weighted Average Effective Firm-Level Tax Rates (Assuming No Debt)

Asset Type	Corporate (%)	Noncorporate (%)
Equipment	23.6	17.9
Public Utility Structures	24.9	18.9
Other Nonresidential Structures	30.8	23.9
Residential Structures	28.2	21.6
Intangibles		
R&D Intangibles	0	0
Advertising Intangibles	0	0
Other Intangibles	0	0
Total	**22.3**	**20.8**

Source: CRS. See **Appendix** for method of computations and assumptions.

Notes: Excludes land that is fixed in quantity and inventories, which are relatively unresponsive to tax rates on carrying costs. These assets are taxed at close to the statutory rate, and thus higher for corporate rather than noncorporate investment.

For equipment and structures, in which a choice between corporate investment and noncorporate investment is likely more important, the effective tax rates also differ substantially. Thus, at least up to a point, a business-neutral tax reform that lowered taxes on corporate investment and raised them on noncorporate investment would appear to increase efficiency by bringing effective tax rates closer together.

In addition, a corporate rate reduction, because the corporate statutory rate is higher, would reduce the more favorable treatment of debt finance, which is taxed at a low or negative rate because nominal interest is deducted at the statutory rate, but only the real return is taxed (and at a lower rate). As a result, the estimate of effective tax rate for debt-financed corporate investment is -7% compared with 22.3% for equity.

Moreover, it is difficult to make a fairness argument for making noncorporate equity investors whole since there will be numerous winners and losers in any tax reform. As noted above, creditors may see higher effective tax rates as well. Similarly, depending on the type of reform, some industries will be affected differently than others. For example, if accelerated depreciation for equipment is eliminated, manufacturing and construction firms would be affected more than firms engaged in trade and services. Noncorporate business investors may also have passive assets in corporate stock that could benefit from a business tax reform. Moreover, in the longer run, any flows of capital into the corporate sector would drive down the pre-tax return in that sector and increase it in the noncorporate sector, just as changes in the treatment of investments in

(...continued)

recent CBO study assuming a smaller share of capital gain and dividend income received by nontaxable entities found higher corporate shareholder level taxes than calculated in this report. That study also considered a different mix of assets, but reached the same conclusion, that corporate returns on investment are taxed at a higher rate than individual returns. See Congressional Budget Office, *Taxing Capital Income: Effective Marginal Tax Rates Under 2014 Law and Selected Policy Options*, December 18, 2014, https://www.cbo.gov/publication/49817. Note also that these shareholder level taxes do not include the additional 3.8% tax on capital gains and dividends received at higher income levels, enacted to finance health reform because the tax is also imposed on passive income of unincorporated business and the differential effect overall is uncertain.

different industries would lead to a reallocation and adjustment of pre-tax returns that brings after-tax returns, for distributional purposes, back together.

Administrative and compliance costs would also be smaller when tax provisions, such as depreciation and inventory accounts, are conformed across organizational form.

In sum, there are efficiency and administrative arguments to be made for allowing a business-only tax reform that does not reduce individual tax rates but uses base-broadening provisions associated with unincorporated businesses to finance corporate rate cuts. There is not a clear fairness argument against this approach.

Note also that if the corporate tax rate cut were generous enough, many pass-through businesses might recoup some of the loss by incorporating.

Target Base-Broadening Provisions That Are Primarily Corporate

Another approach is to target base-broadening provisions that are primarily corporate. For example, one base-broadening provision is to slow the depreciation for buildings and equipment to correspond with the alternative depreciation schedule. Referring to the rates in **Table 4**, this change would increase the tax rate from 22.3% to 26.7% for corporate investment and from 20.8% to 23.7% for noncorporate businesses. The rate change of 4.4 percentage points for corporations is larger than the 2.9 percentage points change for the noncorporate sector. However, if buildings were excluded from the depreciation change and only equipment (including public utility structures treated as equipment) had the change in depreciation, the corporate rate would increase to 26.5% (4.2 percentage points) while the rate for structures would increase to 22.5% (or 1.7 percentage points). Thus, while both tax rates go up, the effective tax rate change for noncorporate firms would be just over a third of the size of the change for corporations.

Other provisions might exhibit similar or more pronounced effects. For example, estimates suggest that eliminating the production activities deduction would increase the overall statutory corporate tax rate from 0.3414 to 0.35 (or -0.85 percentage points); it is estimated to increase the noncorporate rate from 0.2683 to 0.27 (or 0.17 percentage points).[10] Although a larger share of the production activities deduction than implied by these rate changes accrues to unincorporated businesses in the tax expenditures, some of that benefit presumably falls on labor rather than capital income.

Other provisions that are largely corporate include provisions associated with international taxes, research, advertising, and LIFO (last in, first out inventories). However, one of the problems with focusing on base broadening provisions that are primarily corporate is such an approach may interfere with other objectives of tax reform. For example, implementing the depreciation choices discussed above may minimize the effects on unincorporated businesses, but will leave rental housing favored relative to other business assets (although not as favored as owner-occupied housing). International provisions may be subsumed into an overall international tax reform. Moreover, tax benefits for R&D may be desirable due to the positive externalities research creates for the economy.

Limit Changes to Corporations

This approach would limit base broadening to the corporate sector by restricting provisions only for corporations.

[10] These estimates are based on data on the production activities deduction from the IRS Statistics of Income.

As noted above, excluding deferral leaves only a few relatively small provisions that are predominantly or completely corporate. Predominantly or completely corporate provisions include, for example, include research subsidies, insurance provisions, energy provisions and lower tax rates for small corporations. Some of the provisions, such as expensing research and development expenditures, may be desirable provisions.

A reform, however, could also implement corporate-only changes for provisions that affect pass-through businesses. For example, the existing depreciation system could be preserved for unincorporated businesses. Similarly, provisions such as the production activities deduction, like-kind exchanges, nondealer installment sales, and interest deductions could be disallowed only for corporations. As noted earlier, there are two objections to this approach: first, it adds to complexity to the tax code and second, it will create incentives to shift out of the corporate form for certain businesses.[11]

Business tax expenditures that are used by corporations only to a limited degree, such as accelerated depreciation on rental housing, could be avoided entirely, although such a choice would lead to their continued favorable treatment.

Expand or Introduce Provisions That Are Beneficial to Smaller Businesses

Because unincorporated businesses are smaller on average than incorporated business, provisions that allow benefits based on dollar amounts can target these businesses and offset other base-broadening changes. This approach was used in the Administration's business-only tax reform proposal.[12]

Perhaps the most important example is the Section 179 expensing provision, which has been part of the extenders (i.e., provisions that have been enacted on a temporary basis).[13] Section 179 allows firms to expense (deduct immediately), with dollar limits, the cost of investment in equipment. In 2014, this amount was $500,000.[14] Once a firm's investment reached at least $2 million, the amount eligible is reduced one dollar for each dollar of investment in excess of $2 million. Thus once a firm's investment reached $2.5 million, no deduction is allowed. While unincorporated firms own about 30% of equipment according to **Table 1**, **Table 3** indicates that they receive almost 70% of the benefit of the Section 179 expensing provision.

[11] These points were also made by Robert Carroll and Gerald Prante, *The Flow-Through Business Sector and Tax Reform*. Prepared for the S Corporation Association by Ernst & Young LLP, April 2011, http://www.s-corp.org/wp-content/uploads/2011/04/Flow-Through-Report-Final-2011-04-08.pdf.

[12] See *The President's Framework for Business Tax Reform, A Joint Report by The White House and the Department of the Treasury*, February 2012, at http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf. The President has proposed a business-only tax reform in his FY2016 budget. See Treasury Green book at http://www.treasury.gov/resource-center/tax-policy/Pages/general_explanation.aspx.

[13] See CRS Report RL32254, *Small Business Tax Benefits: Current Law and Main Arguments For and Against Them*, by Gary Guenther for further details.

[14] Without an extension, the exemption will revert to its permanent level of $25,000, with a phase-out beginning at $200,000. No deduction would be allowed when investment is $225,000. For example, off-the-shelf computer software will also no longer be eligible, and a $250,000 expensing provision for leasehold property, which was eligible for expensing in 2014, will no longer be allowed.

The Obama Administration has proposed a permanent increase in the limit to $1 million.[15] This treatment would not only provide an additional benefit but would make most smaller businesses unaffected by changes in accelerated depreciation of equipment, the second largest corporate tax expenditure, and the largest one that affects pass-throughs.

Smaller businesses would also benefit from another set of provisions to expand eligibility for cash accounting (in which costs are deducted when paid and revenues included when received). Most business accounting is on an accrual basis in which revenues and expenses are recorded when incurred (rather than when paid) and inventory costs not deducted until sold. Uniform capitalization rules require indirect overhead costs to be capitalized. Current tax law contains exemptions from requirements of accrual accounting and capitalization rules for small firms and for firms participating in certain activities. Firms with inventory have smaller size limits.[16] The Administration has proposed to expand some of the limits and requirements for eligibility for cash accounting for small business and this approach may be considered to compensate for the loss of tax benefits in a business-only tax reform.[17]

Provide Lower Statutory Rates or a Revenue Neutral Deduction for Unincorporated Businesses

An alternative approach is to lower the individual rates only for business income. Precedents exist in current tax law. Separate tax rates are applied to dividends and capital gains. Alternatively, the production activities deduction, because it is a deduction from taxable income, also reduces the statutory tax rate.

Given the graduated individual rate structure, following the model of a separate rate structure (as for capital gains and dividends) would be complex. The rate imposed for capital gains and dividends is determined with reference to the rate structure, and applies three different rates, which requires two rounds of calculation. If a lower business income structure were to have a different business tax rate for each ordinary tax rate, six rounds of calculations would be required.

A simpler approach would be to reduce effective statutory rates for unincorporated businesses by allowing a deduction from taxable income for pass-through businesses following the model of the production activities deduction. This approach would result in the same percentage reduction for all ordinary tax rates but would apply at the marginal tax rate. An analysis by Sullivan points out, however, that an across-the-board deduction would not necessarily benefit small businesses primarily, because a large share of earnings of partnerships and S corporations is from larger entities.[18]

It might also be possible to direct the deduction to certain industries to more closely target firms affected by the tax revision. For example, if equipment depreciation and the production activities

[15] U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals*, February 2015, http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf.

[16] See CRS Report R44002, *Cash Versus Accrual Accounting: Tax Policy Considerations*, by Raj Gnanarajah and Mark P. Keightley.

[17] U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals*, February 2015, http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf.

[18] Martin A. Sullivan, "Relief for Passthrough Business Under Corporate Tax Reform," *Tax Notes*, April 27, 2015, pp. 463-468.

deduction were the principal base-broadening provisions, a deduction aimed at manufacturing and construction business incomes might be more appropriate. A proposal of this nature was included in the tax reform bill introduced by then-Chairman of the Ways and Means Committee Dave Camp (H.R. 1, 113th Congress).

Limit Reform to International Tax Changes

A narrower reform might concentrate on the international sector. Recently, tax reform has been motivated by interest in revising the current international tax system, in which income of subsidiaries incorporated abroad is taxed, but not until repatriated (i.e., paid by the foreign subsidiary to the U.S. parent). This deferral of tax on foreign source income is the single largest corporate tax expenditure. (When tax is paid, the firm can take a credit against the U.S tax paid for foreign income taxes.) The current system creates a number of distortions, one of them being an incentive to retain earnings abroad. This incentive could be removed by eliminating deferral (and freeing up revenue that could be used for rate reduction) or simply not taxing foreign source income at all (which would lose revenue). This latter approach would move to what is termed a *territorial tax*. There are middle roads between these positions, which include adopting a territorial tax but enacting strong anti-abuse provisions, or imposing a minimum tax on foreign source income that would be due immediately. The details of potential international tax reforms are beyond the scope of this report.[19]

A reform confined to international changes would have negligible effects on pass-through businesses because almost all multinational business income is in the corporate sector. Such a reform, however, might not produce adequate revenue to cut the corporate rate and remain revenue-neutral.

[19] CRS Report RL34115, *Reform of U.S. International Taxation: Alternatives*, by Jane G. Gravelle contains a discussion of these international proposals.

Appendix. How to Calculate Effective Tax Rates

This appendix provides the methodology and data for calculating the effective tax rates in **Table 4** and the changes of base-broadening provisions that affect savings and investment.

The basic formula for calculating the effective firm-level tax rate is (r-R)/r, where *r* is the pre-tax return, or internal discount rate for an investment with no taxes, and *R* is the after-tax discount rate that discounts all flows to the cost of the investment with taxes.

For a corporate depreciable investment, the relationship between r and R, with R the firm's real discount rate, derived from an investment with geometric depreciation and continuous time, is from the standard user cost formula:

(1) r = (R+d)(1-uz)/(1-u)-d

where u is the corporate tax rate, d is the economic depreciation rate, and z is the present discounted value of tax depreciation deductions (discounted at the nominal rate, that is, the real rate plus the inflation rate).

For an unincorporated business taxed at an effective statutory tax rate t, the pre-tax return is:

(2) r = (R(1-v) +d)(1-tz)/(1-t)-d

In this formula, v is the effective tax rate on capital gains and dividends in the corporate sector. The discount rates differ between corporate and noncorporate firms given the assumption that the noncorporate investor's opportunity cost is investment in the corporate sector, net of shareholder taxes. Thus the R for the noncorporate sector is the corporate discount rate reduced by the taxes on capital gains and dividends. These shares are subject to special tax rates and are adjusted for the extent of earnings that are not subject to tax in an overall economy-wide portfolio because some capital gains are not realized and some earnings on corporate stock are exempt because they are held in pension funds and retirement accounts and by nonprofits.

The effective tax rate is determined in part by the effective statutory rate and in part by how quickly costs are recovered (the value of z) and any credits. Without the production activities deduction, the tax rate is equal to the statutory rate when z equals the present value of economic depreciation (d/(R+d)). More rapid depreciation decreases the effective tax rate.

The formula is applied to obtain firm-level tax rates in **Table 4** and subsequent calculations in the text. To calculate the effect on debt-financed investment, including creditor taxes paid, the firm's discount rate used in equation (1) is adjusted to include debt finance:

(3) R_d = (i(1-u)-p)

with R_d the after-tax real interest rate (i(1-u)-p) where i is the nominal interest rate and p is the inflation rate.

The tax rate is calculated using that r as (r-R_i)/r, where R_i is the final after-tax return to creditors:

(4) R_i = (i(1-ati)-p)

where t_i is the tax rate of creditors, a is the share subject to tax, and v is the effective tax rate on corporate equity.

Data on Assets and Depreciation

To provide overall effective tax rates that cover a broad category of investments, the pre-tax returns estimated for each of 32 different types of assets are weighted by asset share to provide an overall pre-tax return. The estimates reflect equipment, structures, and intangible assets used in business. They exclude land (which is relatively fixed in quantity and where taxes tend to be capitalized in prices) and inventories, which are small and relatively unresponsive to taxes on the return. Assets are assigned to the corporate or the noncorporate sector.

Table A-1 lists the asset values and economic depreciation rates for the assets, including 22 types of equipment assets, 7 types of structures, and 3 types of intangibles.

The value of z depends on how quickly costs are recovered for tax purposes, which is a function of the tax life and whether the recovery is straight-line (equal amounts in each year) or accelerated (larger amounts in earlier years). For tax lives, depreciation methods and depreciation formulas, see Jane G. Gravelle, *The Economic Effects of Taxing Capital Income*, Cambridge, MA, MIT Press, 1994. The alternative lives simulated in the report are available on request. For mining structures, largely oil and gas, based on data from the Independent Petroleum Association of America,[20] 57.7% of costs are expensed either through intangible drilling costs of dry holes, 16.7% recovered through depletion, 1.9% over seven years, and the remainder over five years.

Values Used

In addition to the data used above, data are needed for the rates of return (R and i), the inflation rate, and the tax rates. The equity rate of return based on historical trends is after corporate tax but before individual tax is set at 7%. The nominal interest rate is set at 7.5%, and the inflation rate at 2%, reflecting recent experience with the Baa bond rate and the gross domestic product (GDP) deflator prior to the recession (for a real interest rate of 5.5%).[21] Note that while effective tax rates are sensitive to the inflation rate, they are not very sensitive to the assumed real rate of return.

The statutory corporate tax rate is 35%, but it is reduced slightly by the production activities deduction. Based on claims as a percentage of taxable income by manufacturing and non-manufacturing on corporate income tax returns and the distribution of equipment, structures, and assets between those categories in the National Income and Product Accounts, the estimated rate for the three categories of assets, respectively, is 34.12%, 34.29%, and 33.83%, with an overall rate of 34.14%. That is, the production activities deduction appears to reduce statutory tax rates by slightly under 1 percentage point.

The estimated statutory tax rate for unincorporated business income, using the public use file data, is 27%. Using the aggregate for individual returns and distributing it in the same proportions, the estimated tax rates for the three categories, including the production activities deduction, are 26.74%, 26.87%, and 26.56%, for an overall rate of 26.83%, a reduction of less than 0.2 percentage points. This estimate is based on the production activities deduction compared to business income reported in individual tax return.

[20] Independent Petroleum Association of America (IPAA), United States Petroleum Statistics, 2011 data, August 2012, available at http://www.ipaa.org/wp-content/uploads/downloads/2012/09/USPS-2012.pdf.

[21] See data in *Economic Report of the President*, Council of Economic Advisers, February 2015, https://www.whitehouse.gov/sites/default/files/docs/2015_erp_appendix_b.pdf.

Table A-1. Asset Values and Depreciation Rates for Equipment, Structures, and Intangibles

Asset Type	Stock of Assets ($billions)	Economic Depreciation Rates (%)
Autos	183.5	33.33
Office/Computing Equipment	179.6	28.00
Trucks/Buses/Trailers	417.9	17.25
Aircraft	352.8	6.60
Construction Machinery	174.4	15.50
Mining/Oilfield Equipment	103.0	15.00
Service Industry Equipment	166.8	16.50
Tractors	121.5	15.00
Instruments	554.0	13.50
Other Equipment	325.8	14.73
General Industrial Equipment	591.3	10.72
Metalworking Machinery	259.5	12.25
Electric Transmission Equipment	464.7	5.00
Communications Equipment	601.0	11.00
Other Electrical Equipment	325.8	18.34
Furniture and Fixtures	316.9	13.75
Special Industrial Equipment	333.8	10.31
Agricultural Equipment	122.3	11.79
Fabricated Metal	160.6	9.17
Engines and Turbines	112.5	5.16
Ships and Boats	76.2	6.11
Railroad Equipment	139.1	5.89
Mining Structures	1,346.0	4.50
Other Structures	1,451.9	2.25
Industrial Structures	1,411.2	3.14
Public Utility Structures	2,419.8	2.24
Commercial Structures	3,680.1	2.50
Farm Structures	320.2	2.39
Residential Structures	3,338.6	1.40
Intangibles, R&D	1,786.7	17.00
Intangibles, Advertising	271.8	60.00
Intangibles. Other	1,577.5	38.00

Source: Data on assets other than advertising and other intangibles from U.S. Commerce Department, Bureau of Economic Analysis, National Income and Product Accounts, Table 2.1. Stocks of advertising and other intangibles imputed based on relative proportions in Carol Corrado, Charles Hulten, and Daniel Sichel, "Intangible Capital and U.S. Economic Growth," *Review of Income and Wealth*, vol. 55, no. 3, September 2009, pp. 661-685, http://econweb.umd.edu/~hulten/WebPageFiles/Intangible%20Capital%20and%20U.S%20Economic%20Growth.pdf. Depreciation rates on assets other than intangibles from Bureau of Economic Analysis, BEA Depreciation Rates, http://bea.gov/national/FA2004/Tablecandtext.pdf. Depreciation rates on R&D intangibles from *R&D Depreciation Rates in the 2007 R&D Satellite Account*, Bureau of Economic Analysis/National Science Foundation, 2007 R&D Satellite Account Background Paper, by Charles Ian Mead, http://faq.bea.gov/papers/pdf/Mead_RD_Paper_wp.pdf. Depreciation rates on advertising and other intangibles from Corrado, Hulten, and Sichel.

The marginal rates for interest, dividends, and capital gains, respectively, are 22%, 14.6% and 15.4%. A large fraction of interest and dividends paid do not appear on individual income tax returns, according to Tables 7.1 and 7.2 of the National Income and Product Accounts and IRS Statistics of Income. In previous years a direct reconciliation had been prepared, and the current amounts included, 19% and 25%, are slightly lower than in the past, but similar.[22] This same share for dividends is used for capital gains. The small share reported is largely due to the large share of assets in pension, retirement, and insurance plans. In addition, half of capital gains held privately is assumed to be untaxed because it is held until death.[23]

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[22] The most recent reconciliation study was Mark Ledbetter, "Comparison of BEA Estimates of Personal Income and IRS Estimates of Adjusted Gross Income, New Estimates for 2005, Revised Estimates for 2004," *Survey of Current Business*, November 2007, https://www.bea.gov/scb/pdf/2007/11%20November/1107_pi_agi.pdf.

[23] Based on historical comparisons of realizations and accumulations. See CRS Report 91-250, *Limits to Capital Gains Feedback Effects,* by Jane G. Gravelle.