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A Closer Look at the Business Tax Burden: C-Corps, S-Corps, and the Impact of the Federal Budget's 2011 Tax Proposals

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Executive Summary

The “Great Recession” and the election of Barack Obama as President have fundamentally changed the calculus of tax policy debate relative to just a few years ago. The prospect of gaping budget deficits as far as the eye can see, combined with a large increase in federal spending commitments with regard to health care and a wide array of other domestic initiatives, means that tax policy has become more focused on ways to raise revenue at the expense of the adverse effects those tax increases are likely to have on the profitability and competitiveness of U.S. businesses.

The purpose of this report is to help bring tax policy debate back to its moorings by examining in detail some of the major provisions in the President's 2011 proposed budget that will affect the taxes paid by American businesses. The corporate tax rate is unchanged in this proposal (remaining the second-highest among OECD nations) but proposals to broaden the base will increase the aggregate business tax bill by more than \$350 billion over the next 10 years. This amounts to a 6 percent tax increase relative to the pre-budget baseline.

The paper also examines the incidence of the 2011 budget's tax provisions on pass-through businesses, which include almost four million S corporations and more than three million partnerships. These firms have quietly become an important economic pillar, accounting for one-third of total U.S. business activity. They will not only be affected by corporate base broadeners (which will increase the taxable income that is passed through to owners and shareholders), but personal tax increases for high-income filers will directly cut into their bottom line as well, decreasing resources available for new investment and hiring. This direct interplay between personal tax rates and after-tax business

profits is underappreciated in the tax policy debate, but has become critically important, since fully 80 percent of businesses today are organized as pass-through entities.

The tax provisions of the 2011 budget will affect S corporations and other pass-through manufacturing firms much more heavily than both firms outside of manufacturing and C corporations within manufacturing. Pass-through businesses in the manufacturing sector will see their tax bills increase by an average of 14 percent. Given the growing importance of S corporations and partnerships to economic growth and job creation over the past 25 years, it is important to understand that tax increases intended to help contain deficits will exact a high price in terms of the competitive posture of U.S. manufacturing and the growth of the economy as a whole.

In terms of macroeconomic effects, the tax proposals in the 2011 budget are forecast to shave an average of 0.2 percent from annual GDP growth through the middle of the decade, resulting in \$200 billion of foregone output and a net job loss of almost 500,000 relative to the baseline. Because taxable business revenues are highly concentrated in manufacturing firms, they are likely to account for a disproportionate share of these output and employment gaps.

But the most surprising and ominous result of the simulations is the forecast effect on the federal deficit. The tax provisions in the President's budget slightly improve the fiscal outlook in 2011, but as tax increases begin to bite into corporate profits and reduce economic activity, the forecast deficit actually gets larger than the baseline deficit, and by 2019 the budget deficit under this “deficit-reduction” scenario is in fact \$100 billion *larger* than under the baseline.

A smarter approach to business taxation can be found in the Bipartisan Tax Fairness and Simplification Act of 2010 (S. 3018) co-sponsored by Senator Ron Wyden (D-OR) and Senator Judd Gregg (R-NH), which would simplify the personal income tax system and reduce the corporate tax rate from 35 percent to 24 percent. Simulations undertaken for this report indicate that it would create nearly two million jobs on a net basis and add an extra \$500 billion to GDP by 2015. More significantly, the dramatic increase in business profits and personal income that result would

¹ *Acknowledgments:* The author gratefully acknowledges the assistance of Estelle Dauchy, formerly of Ernst & Young, for assistance in interpreting the tax incidence data presented in this report, and Ronald D. Bullock, Chairman of Bison Gear and Engineering Corporation, who funded this project and provided invaluable insights.

reduce the deficit relative to both the 2011 budget and the pre-budget baseline, illustrating how smart tax policy can advance the twin goals of sustaining the competitive edge of American businesses and help keep the government's fiscal house in some state of order.

Introduction

The "Great Recession" and the election of Barack Obama as President have fundamentally changed the calculus of tax policy debate relative to just a few years ago. The prospect of gaping budget deficits as far as the eye can see, combined with a large increase in federal spending commitments with regard to health care and a wide array of other domestic initiatives, means that tax policy has become more focused on ways to raise revenue at the expense of the adverse effects those tax increases are likely to have on the profitability and competitiveness of U.S. businesses. A key tenet of tax policy is that there are good and bad ways to raise revenue in terms of their effect on business incentives, and tax changes must be carefully assessed to ensure that adverse impacts on competitiveness are minimized.

The purpose of this report is to help bring tax policy debate back to its moorings by examining in detail the effects of some of the major provisions in the President's 2011 budget proposal that will affect the taxes paid by American businesses. Some observers note that the corporate tax rate will not increase and erroneously conclude that businesses will not be adversely affected. But aside from the fact that the statutory—and effective—U.S. corporate tax rates are currently among the highest in the world, the conclusion sidesteps the inconvenient truth that the base of taxable corporate income will be significantly broadened, increasing the aggregate business tax bill to the tune of \$350 billion over the next 10 years.²

Another important aspect of current tax proposals that has not received wide attention to date is the impact of personal tax increases on "pass-through" businesses, so called because their earnings are passed through to their owners and taxed at personal income tax rates rather than being subject to the corporate tax. These

firms have become much more numerous in the past quarter century and now account for more than one-third of all business activity in the United States. Unlike standard corporations, their bottom line is directly affected by changes in personal income tax rates, particularly at higher income levels. The expiration of the 2001 personal income tax cuts will thus have a substantial impact on the business tax burden, and a central goal of this report is to document the evolution of pass-through businesses and assess the impact of proposed tax changes on them. The report will also analyze the impact of proposed tax changes on the federal deficit as well as aggregate employment and output.

A Short History of Tax Policy and Business Organization

Tax policy is an important factor in understanding business organization in the United States. Up until about 50 years ago, entrepreneurs and business owners were faced with a stark choice with regard to tax treatment and personal liability. They could, on one hand, choose to run their business as corporations (which exist as legal and taxable entities separate from owners and shareholders) in order to benefit from limited personal liability in the event that the corporation encounters financial difficulties. But the "price" of this limited personal liability is the fact that the income generated by the corporation is subject to the corporate income tax and, if distributed to shareholders, is taxed a second time as personal dividend income. The only way to avoid the double taxation of business income was to organize a company as a partnership that had no legal and tax status separate from its owners. But the "price" of this tax relief was the loss of the liability protection that incorporation offered, so that creditors could lay a legal claim on the owners' personal assets in the event that the business was unable to meet its financial obligations.

In 1958, Congress created a "third way" between the option of corporate taxation and personal liability. Because the risks of personal liability are considerable, most large businesses are organized as corporations. However, to offer some of the protections of limited liability to small, closely held businesses that might not be financially viable when subject to the corporate tax, Subchapter S was added to the Internal Revenue Code. In exchange for enjoying limited liability and exemption from the corporate tax (whose top statutory rate at the time was 52

² For a more detailed discussion of the interplay between statutory corporate tax rates and the base of taxable income, see Jeremy A. Leonard, "A Closer Look at the U.S. Corporate Tax Burden," *Tax Notes*, November 17, 2008, pp. 849-860.

percent), businesses electing the so-called “S corporation” status agreed to the following limitations:

- They must be domestic corporations.
- They may have a single class of stock and a limited number of shareholders, all of whom must be U.S. citizens or residents.

Since their creation, S corporations have become increasingly popular and are now the most common form of business organization in the United States. By offering small businesses the possibility of limited personal liability without the burden of corporate taxation, they have spurred business creation and allowed entrepreneurs to bring their new products and services to the marketplace more quickly and securely.

The success of subchapter S has led to other business forms that share the twin benefits of limited liability and exemption from the corporate tax, the most important of which is the Limited Liability Company (LLC).³ LLCs are created under state law: Wyoming was the first to enact such a statute in 1977 and by the mid-1990s LLC laws had been enacted in all 50 states. State LLC statutes are designed to allow a business entity to be as similar to a C corporation as possible in terms of liability protection and flexibility of management without being considered as such for corporate tax purposes. The Internal Revenue Service issued a series of rulings culminating in the 1997 “check the box” regulations, which essentially allowed LLCs to elect whether to be treated as a pass-through entity or a standard C corporation for tax purposes.

Because all of their income (rather than just dividends, as in the case of standard C corporations) is “passed through” to owners and shareholders, changes in individual tax rates have a more pronounced effect on pass-through entities in terms of their profits and ability to grow. This effect is typically overlooked in analyses of the business tax burden, and one of the goals of this study is to understand the direct effects that changes in *personal* tax rates have on business activity.

The rise of S corporations and LLCs also means that the interplay between corporate and individual tax rates has a measurable effect on the structure of business organization. As shown in the next section, when the top personal tax rate falls relative to the corporate rate, it becomes more attractive to declare business income via a pass-through company rather than a C corporation.

The 1986 Tax Act and the Rise of “Pass-Through” Business Entities

The most striking example of how changes in tax policy affect the choice of business organization is the Tax Reform Act of 1986. This landmark legislation sought to create a less distortionary tax system by broadening the tax base and lowering statutory rates.⁴ The Act “leveled the playing field” in the sense that the effective taxation of labor and capital were brought closer together. On the corporate tax side, the top marginal rate declined from 46 percent to 34 percent (with lower tax brackets for income less than \$100,000). At the same time, the base was broadened primarily by repealing the 10 percent investment tax credit in place for most of the previous 25 years and lengthening the tax writedown periods for business assets to more closely reflect actual economic depreciation. In addition, a number of accounting changes regarding inventory valuation significantly broadened the definition of corporate income.

On the personal tax side, the Act reduced the number of tax brackets, lowered the top rate from 50 percent to 28 percent (the then-existing rate for dividends and capital gains), and significantly increased the standard deduction and personal exemption. To compensate for the revenue reduction that such changes implied, rules governing limitations on passive investment losses and interest deductibility were tightened in order to curb the use of tax shelters by high-income households.

More importantly from a business organization standpoint, the 60 percent exclusion for long-term capital gains was repealed, raising the effective capital gains rate from 20 percent to 28 percent.

³ For a detailed survey of the origins and development of S corporations, LLCs, and other business pass-through entities, see Jack H. Taylor, “Passthrough Organizations Not Taxed as Corporations,” *Report for Congress*, Congressional Research Service, August 2002.

⁴ For a more detailed description of the Act and its economic consequences, see Alan J. Auerbach and Joel Slemrod, “The Economic Effects of the Tax Reform Act of 1986,” *Journal of Economic Literature*, Volume 35, No. 2, June 1997.

Table 1
**Schematic Illustration of After-Tax Profits and Total Taxes Paid on
 Business Income, by Type of Business Organization**
 (\$ millions)

	Before 1981		After 1986		Current Law	
	C Corp	S Corp	C Corp	S Corp	C Corp	S Corp
Taxable income	100	100	100	100	100	100
Income tax	46	70	34	28	35	36
After-tax profits	54	30	66	72	65	64
Distributed dividends	32	N/A	40	N/A	40	N/A
Personal income tax on dividends	22	N/A	11	N/A	6	N/A
Total tax paid on business income	68	70	45	28	41	36

Source: Author's calculations

Note: To simplify the illustration, the calculations here do not account for lower marginal tax rates for incomes below that subject to the maximum rate.

Similarly, the \$200 dividend exclusion was repealed. Both of these provisions increased the personal tax burden on corporate income.

The fact that the maximum statutory personal tax rate fell substantially below the corporate rate in the wake of the Act, coupled with increases on the taxation of corporate income at the individual level, provided strong incentives for businesses to organize as S corporations. Analysis done at the time showed that, while the estimated long-term after-tax rates of return were nearly identical for C corporations and S corporations prior to the Act, after-tax rates of return were more than twice as high for S corporations in its aftermath.⁵

To illustrate how relative movements in personal and corporate tax rates affect different types of businesses, Table 1 shows a simplified comparison of the total tax burdens on \$100 million of taxable business income for a stylized C corporation and S corporation at three points in time: pre-1981 (top rates of 70 percent for personal income and 46 percent for corporate income); immediately following the Tax Reform Act of 1986 (top rates of 28 percent for personal income and 34 percent for corporate income); and current law (top rates of 35 percent for both personal and corporate income).⁶

Prior to 1981, it was far more advantageous from a tax perspective to be organized as a C corporation because the corporate rate was significantly lower than the personal rate. After-

tax profits were significantly higher than for S corporations, and even after factoring in the double taxation of dividends, the total tax burden was slightly less as well. The Tax Reform Act of 1986, as noted earlier, lowered both corporate and individual rates such that the latter was less than the former for the first time in history. As a result, the prototypical S corporation in Table 1 saw after-tax profits exceed those of an equivalent C corporation, and the exemption from double taxation of dividend income gave it an even larger advantage in terms of total taxes paid.

Under current law, the identical top corporate and personal tax rates mean that after-tax profits for the example firm types are essentially the same, and the only difference between taxes paid is due to the double taxation of dividend income, which itself declined from 35 percent to 15 percent in 2003 for most dividends paid by U.S. companies. Thus, in terms of tax burden, the playing field between C corporations and S corporations (and other pass-through entities) has never been more level than it is now.

The effect of the Tax Reform Act of 1986 is clearly visible in Figure 1, which shows that the number of S corporations grew dramatically in relative terms at the expense of C corporations immediately following passage of the Act, after having held a fairly steady share in previous years.

The increasing numbers of S corporations had perceptible effects on corporate tax payments, which were far lower than expected in 1987 and subsequent years. Prior to the Act's passage, corporate tax revenues were projected to increase by a cumulative \$112 billion from 1987 to 1991 relative to the status quo policy baseline. In fact, actual receipts were not only less than projected,

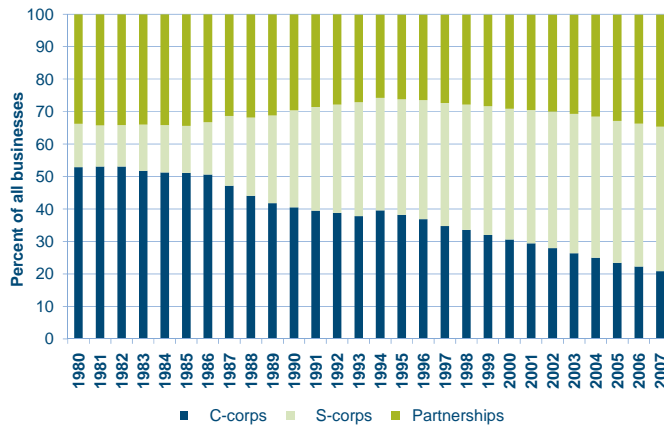
⁵ Patrick J. Wilkie, James C. Young, and Sarah E. Nutter, "Corporate Business Activity Before and After the Tax Reform Act of 1986," *Statistics of Income Bulletin*, Internal Revenue Service, 1996.

⁶ To simplify the illustration, the calculations here do not account for lower marginal tax rates for incomes below that subject to the maximum rate.

they were also \$50 billion less in cumulative terms than the baseline. Part of the reason was an

ay to raise government revenue as is popularly believed. This effect is one of the reasons that “taxing the rich” can have unintended consequences in terms of restraining economic activity.⁸

Figure 1: Distribution of U.S. Business Organizations by Type



Source(s): Department of the Treasury, Internal Revenue Service

Statistical Portrait of Pass-Through Entities

As shown earlier, pass-through business entities are now the most common form of business organization. C corporations last accounted for more than 50 percent of businesses in 1986, and their share has fallen steadily to 20 percent in 2007, the latest year for which information is available. S corporations and partnerships have significant differences with C corporations with regard to size and industry distribution that need to be understood.

In terms of size, pass-through entities tend to be smaller and more closely held than C corporations, a fact which stems from the restrictions placed on them regarding number of shareholders and scope of operations. For instance, for the 2007 tax year, just under four million S corporations filed returns representing 6.8 million shareholders, less than two per firm on average. As shown in Figure 2, average revenue for C corporations reached nearly \$100 million in 2007, compared to just \$15 million for S corporations and \$12 million for partnerships. But in terms of contribution to overall economic activity, their smaller average size documented in Figure 2 is more than offset by their sheer numbers. Pass-through entities now account for more than one-third of all business receipts in the United States, up from just 8 percent in 1980.

This revenue gap does not mean that large pass-through entities do not exist. If we look at

overestimate of pretax profits (which had been above historical norms in the years leading up to the Act) as well as increasing corporate leverage (which increased tax-deductible interest payments), but the shift from C corporations to S corporations reduced corporate tax payments by more than 10 percent.⁷

This dynamic illustrates how changes in the *personal* tax rate affects rates of return facing pass-through firms, a fact not always taken into account when assessing the impact of tax policy changes on business costs. In the popular consciousness, the top marginal rate applies to a very small number of well-to-do households who are assumed to be able to easily afford to shoulder an additional financial burden. It is true that only 4.7 percent of income tax returns in 2007 had declared adjusted gross income of \$200,000 or more. But a significant proportion of these returns are filed by owners and shareholders of S corporations and other pass-through entities, and personal tax increases are distinctly less affordable when viewed through this lens. Because they cut into business profits, such increases have the same adverse effects on investment, hiring and profitability that corporate tax increases have on C corporations, and should rightly be regarded as impediments to competitiveness rather than a relatively painless w

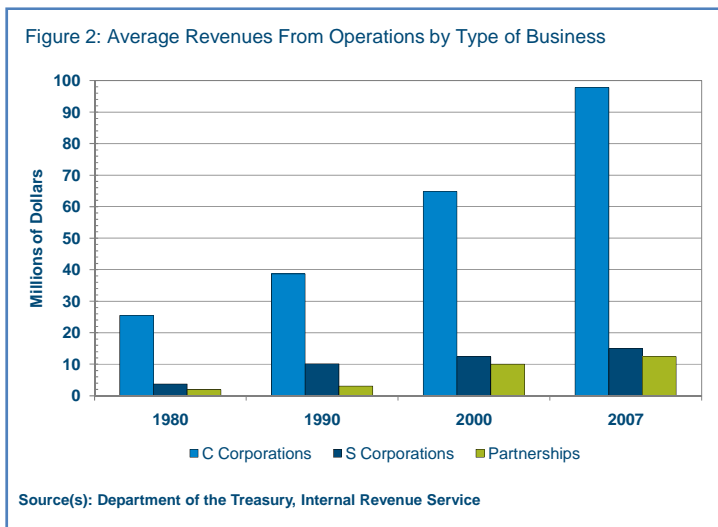
⁷ James M. Poterba, “Why Didn’t the Tax Reform Act of 1986 Raise Corporate Taxes?” *Tax Policy and the Economy*, Volume 6, 1992, pp. 43-58.

⁸ Another potential unintended consequence is the effect of high tax rates on labor supply. While there is consensus on the theory (imposing higher taxes on income will induce people to work less, since the after-tax payoff to working has declined), and that tax rates above 40 percent are harmful, there is considerable disagreement about the magnitude of this effect if tax rates are reduced below the 40 percent threshold. See James D. McGwartyne, “Supply Side Economics,” *The Concise Encyclopedia of Economics* and references therein (<http://www.econlib.org/library/Enc/SupplySideEconomics.html>).

Table 2
Characteristics of Firms With Annual Sales in Excess of \$50 Million by Type, 2003

	Characteristic				
	Number of Firms	Total Business Receipts (\$ billions)	Average Business Receipts (\$ millions)	Net Income (\$ billions)	Profit Rate (Cents per dollar)
C Corporations	16,516	11,748	695	819	7.0
All Pass-Through Entities	15,360	2,946	188	259	8.7
S Corporations	9,757	1,253	128	55	4.4
Partnerships	5,603	1,693	302	204	12.0

Source: U.S. Department of the Treasury, Internal Revenue Service



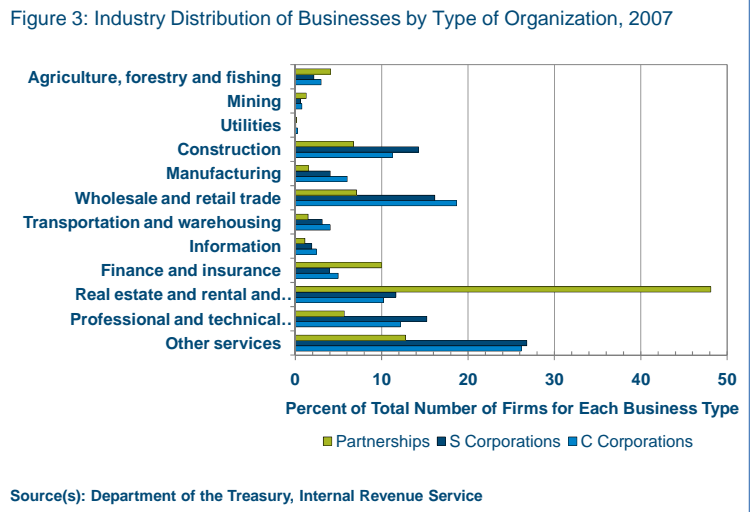
the number of businesses with revenues in excess of \$50 million, in 2003 there were just under 17,000 C corporations, almost 10,000 S corporations, and more than 5,000 partnerships (Table 2). Even in this sub-group of firms, however, C corporations are considerably larger on average in terms of sales.

Broadly similar patterns are evident in the manufacturing sector. In 2003, 60 percent of the 300,000 manufacturing businesses filing tax returns were pass-through entities (primarily S corporations), and larger firms with more than \$10 million in annual sales are split evenly between pass-through entities and C corporations. But C corporations account for almost 95 percent of total business receipts generated by firms with more than \$10 million in sales, underscoring their significantly greater average size.

Despite their minuscule share of business receipts, pass-through

manufacturers must not be overlooked when assessing the effects of personal tax increases. In addition to their sheer numbers, they are particularly vulnerable because of their relatively precarious financial position. While their gross profit rate is similar to larger firms, they tend to have significantly higher debt levels in proportional terms, which often swings their net income less accumulated deficits to a negative position. In such instances, even small increases in income taxes can have large effects on the viability of the business.

The sectoral distribution of pass-through entities is, with a few notable exceptions, similar to C corporations (Figure 3). S corporations essentially mirror that of C corporations; i.e., the percent of C corporations in any given industry is roughly the same as the share of S corporations. The chart confirms that three broad sectors—wholesale and retail trade, professional services and other services—account for just under 60 percent of



both C and S corporations in terms of number of businesses.

Partnerships are disproportionately concentrated in real estate and leasing. This sector accounts for 40 percent of all partnerships but only 8 percent of C corporations and 9 percent of S corporations. This anomaly is primarily due to the large number of condominium and homeowners' associations (of which there are over 250,000, according to the Community Associations Institute) that are organized as general partnerships. In addition, Real Estate Limited Partnerships, which are responsible for the lion's share of new residential construction, fall into this category.

the past 20 years, rates in the United States are virtually unchanged from their 1986 levels. As a result, the United States, with a combined federal-state rate of 40 percent, now shares only with Japan the dubious honor of having the highest statutory rate among the 30 members of the Organization for Economic Co-operation and Development (OECD).

Some have argued that international differences in depreciation rules, exemptions and other provisions that affect the breadth of the corporate tax base imply that comparisons of statutory rates overstate the U.S. disadvantage, but several recent studies of effective marginal tax rates (which correct for international differences in

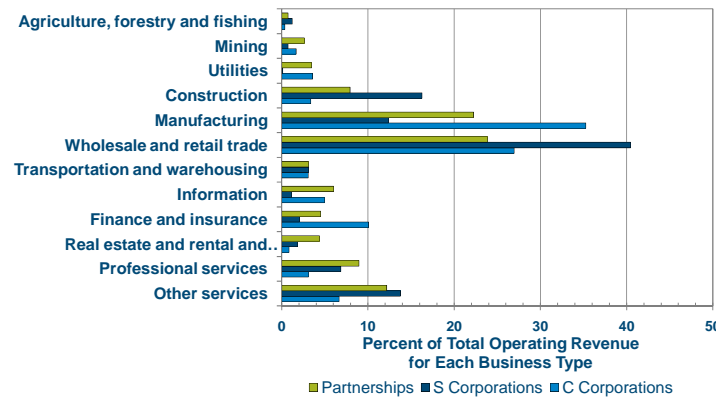
the taxable income base) disprove this contention.⁹ A major tax bill introduced by Representative Charles Rangel (D-NY) in late 2007 proposed to significantly broaden the corporate tax base and use the anticipated increase in revenues to lower the statutory rate to 30.5 percent, closer to the OECD average. It also proposed to impose a surtax of more than 4 percent or more on incomes above \$200,000. Corporate tax rates were also a key issue in the 2008 presidential race, as Senator John McCain (R-AZ) had campaigned for a five percentage point reduction in the statutory rate.

However, the financial crisis, the "Great Recession," and the election of President Obama on a platform of

large-scale domestic policy initiatives have profoundly changed the parameters of tax policy debate by opening up U.S. federal budget deficits of a magnitude never before seen in peacetime. The debate has shifted from thinking about ways to improve the competitive posture of American business towards novel (and in most cases economically harmful) ways to raise revenue.

An example of the latter is the 3.8 percent surtax applied to investment income of high-income individuals in order to raise money for the health care reform signed into law by the

Figure 4: Industry Distribution of Operating Revenue by Type of Business, 2007



Source(s): Department of the Treasury, Internal Revenue Service

Measured in terms of business receipts, the construction, manufacturing and wholesale and retail trade sectors are more prominent, collectively accounting for two-thirds of the total business receipts of both C and S corporations (Figure 4). Within these sectors, sales of S corporations are more concentrated in wholesale and retail trade and construction, while those of C corporations are more concentrated in manufacturing. Within manufacturing, pass-through entities represent about 20 percent of total business receipts.

The Current Tax Policy Environment

Prior to the "Great Recession" of 2008-2009, the main concern about tax policy was the high corporate tax rates faced by U.S. businesses. While many of the United States' major trading partners have been reducing corporate rates over

⁹ Two recent studies using independent methodologies conclude that international rankings of effective marginal tax rates essentially mirror those for statutory rates, with the U.S. at or near the top relative to its major trading partners. See Jeremy A. Leonard, "A Closer Look at the U.S. Corporate Tax Burden," *Tax Notes*, November 17, 2008, pp. 849-860.

President in March 2010.¹⁰ This new investment tax will substantially reduce capital spending. It will affect pass-through entities equally hard since it will impose the tax on the income of limited partners in LLCs and S corporation principals not actively engaged in the business, and thus raise their marginal tax rates by nearly 10 percent over current levels. Dynamic analysis by the Institute for Research on the Economics of Taxation suggests that the surtax would result in a 3.4 percent decline in private capital formation and a 1.2 percent decline in GDP.¹¹ This decline would have negative repercussions for all American families in the form of fewer jobs and less robust wage growth, not just those households who pay the tax directly.

The Impact of Budget 2011 Tax Proposals on Corporate and Noncorporate Business

President Obama's 2011 budget includes a number of large tax increases on both businesses and individuals. On the corporate side, the net revenue effect is estimated to be \$346 billion over the next 10 years, with \$443 billion in tax increases being partially offset by \$97 billion in corporate tax cuts. The statutory rate is unchanged at 35 percent, but there are numerous provisions that affect the base of taxable income. This study examines three of them in detail:

1. **Repeal of last in, first out (LIFO) inventory valuation methods.**—The tax code currently allows firms to value their inventories on the assumption that the last goods produced or purchased are the first ones sold. By doing

so, the effective tax burden on carried inventories is similar to that on capital equipment, so repeal of LIFO would overtax inventory relative to other forms of investment. Furthermore, in the context of rising prices, LIFO corrects for the effects of inflation on inventory valuation and assures that businesses are taxed only on real economic profits, much in the same way indexing of personal tax rates avoids paying higher taxes due to inflation.¹² Manufacturers account for 35 percent of total inventories declared for tax purposes (with most of the remainder in the wholesale and retail trade sectors), and many large manufacturing firms use LIFO inventory accounting extensively, particularly in the petroleum and coal products, chemicals, metals, and machinery industries.

2. **Tighten foreign tax credit pooling and splitting rules.**—President Obama's 2011 budget proposes several changes to the international tax system. Two of the larger ones in terms of revenue increases relate to the calculation of the foreign tax credit. Current law allows U.S. multinational corporations to claim a credit based on foreign taxes paid against their U.S. taxes, to avoid the double taxation of foreign income. If the foreign tax rate for a subsidiary exceeds the U.S. tax rate, the parent firm accrues excess credits, which can sometimes be used to offset U.S. tax payments on income from another subsidiary, a procedure called "cross-crediting." The 2011 budget would require firms to pool all foreign income and foreign taxes paid when calculating the value of the credit. This would effectively eliminate the ability to cross-credit. In addition, it would require firms to account for the foreign tax they pay on foreign earnings in calculating their foreign tax credits. Now they only account for the U.S. tax they pay on foreign earnings. A second related change would prohibit firms from claiming a foreign tax credit on income that is not repatriated to the United States. Current law allows firms to "split" the credit for foreign taxes paid from that income and apply it to domestic taxable income.
3. **Make the Research and Experimentation (R&E) tax credit permanent.**—While the R&E credit has been in existence since 1981, it has always been temporary, requiring periodic extension by Congress (the credit

¹⁰ While often referred to as a "Medicare payroll" tax, it is in fact neither. The final version of the health care legislation passed by Congress eliminated any link of the tax to the Medicare system—all the revenue simply goes into the general fund, not one of the Medicare trust funds—while the tax itself is applied to investment rather than labor income. The bill did, however, retain the term "Medicare" in the title, which has been the source of much confusion. See U.S. Department of Health & Human Services, Centers for Medicare & Medicaid Services, Office of the Actuary, *Estimated Financial Effects of the Patient Protection and Affordable Care Act, as Amended*, by Richard S. Foster, Baltimore: Centers for Medicare & Medicaid Services, April 22, 2010.

¹¹ Stephen J. Entin, Gary Robbins, and Michael Schuyler, "The Obama Administration's Proposed 2.9% 'HI' Surtax Would Harm the Economy and Lose Revenue," *IRET Congressional Advisory*, March 2010.

¹² Alan Viard, "Why LIFO Repeal is Not the Way to Go," *Tax Notes*, November 6, 2006.

was not re-authorized and expired at the end of 2009). Because research and development (R&D) is a long-term and risky proposition, a permanent credit would provide a much stronger incentive for firms to undertake the research that underlies innovation, profitability and competitiveness. This provision, unlike all the others analyzed here, will reduce rather than increase the business tax burden for those firms qualifying for the credit. But since the credit has expired, its reinstatement will merely return the tax burden back to where it was in 2009, rather than reduce the long-run overall R&D tax burden.

There are more than two dozen other provisions that affect business tax payments, which are aggregated together as a residual subtotal for the purposes of the analysis here. The large majority of them are small in terms of revenue effects. The significant measures in terms of revenue are generally targeted at a particular industry (such as the proposed fee levied on the liabilities of financial institutions and elimination of tax preferences for oil and gas extraction) and, for this reason, they are not included in the present analysis.¹³

It is important to emphasize that these provisions affect the taxable base of income for all businesses, not just the C corporations subject to the corporate tax. Even though S corporations and partnerships are exempt from the corporate tax, the taxable income that they pass through to owners and shareholders is calculated subject to the deductions and credits stipulated in the corporate tax code. Thus, as an example, S corporations currently using the LIFO inventory accounting framework would see their taxable income (which would be subject to the personal income tax) increase.

On the individual side, the most important change in terms of revenue is to allow most of the tax cuts enacted by then-President George W. Bush in the 2001 budget to expire in 2011 as stipulated in the original legislation. More specifically, the top statutory rates for high-income taxpayers will increase from 33 percent and 35 percent to 36 percent and 39.6 percent. This is expected to raise \$364 billion in revenue over the

next 10 years.¹⁴ But as explained earlier, this rate increase has a direct effect on the tax burden faced by S corporations and partnerships.

Effect on Business Tax Burdens by Sector and Type of Organization

These tax measures will clearly raise the tax burden on U.S. businesses, but the effect will vary considerably by sector and type of business organization. Using data provided by Ernst & Young, this section outlines the estimated revenue effects. Table 3 shows the aggregate effects of all business tax measures in the 2011 budget (as well as the reinstatement of the 33 percent and 39.6 percent top rates for individual income tax) in dollar terms. The economy-wide increase is estimated to be just over \$440 billion, of which about 60 percent (\$263.2 billion) will be borne by C corporations and 40 percent (\$177.6 billion) by pass-through entities such as S corporations and LLCs. In terms of sectoral distribution, the large majority of additional taxes (\$339.6 billion) will be paid by nonmanufacturers, which is not surprising given that nonmanufacturing accounts for more than 80 percent of U.S. economic output. Within manufacturing, the additional burden is heavily tilted toward nondurable manufacturers. As explained below, this is primarily due to the incidence of the R&E tax credit on selected durable goods industries and the impact of several industry-specific measures.

To get a better picture of how the 2011 budget will change businesses' tax bills in relative terms (which is more important when considering their effect of profitability and competitiveness), Table 4 shows the same information as Table 3 expressed as the percent difference from estimated tax payments under current law. The \$440 billion tax increase over the next 10 years translates into a 5.9 percent increase relative to baseline cumulative tax payments.

The first thing to note is that the seemingly small \$97 billion tax increase on nondurable manufacturers is in fact large in relative terms. At a sectoral level, nondurable manufacturers face a 9.4 percent tax increase over the next 10 years,

¹³ For a more complete analysis of the revenue effects of these other provisions, see Estelle Dauchy and Tom Neubig, "Industry effects of President's FY2011 business tax proposals," *Tax Insights*, Ernst & Young, April 2010.

¹⁴ There are other significant increases in personal income taxes proposed in the 2011 budget, most notably an increase in the rate imposed on dividends and capital gains and reductions in the effective value of itemized deductions for high-income taxpayers, but they are not analyzed in this report.

significantly higher than other sectors. Pass-through nondurable manufacturers are particularly hard hit, with a tax increase nearly double that for the sectoral total.

C corporations taken together face a slightly higher tax increase than pass-through entities (6.9 percent compared to 4.9 percent). This is primarily due to the proposed changes to the foreign tax credit, which will have a pronounced effect on multinational corporations.

A Closer Look at the Manufacturing Sector

Table 5 illustrates the dynamics of the four major tax changes analyzed in this report in the manufacturing sector. The expiration of income tax rate reduction for high-income filers has no direct effect on C corporations, but does have a considerable effect on pass-through entities for the reasons described earlier in the paper. More than one-quarter of the \$364 billion expected to be raised by these rate hikes will be paid by pass-

through entities, raising their total tax bill considerably relative to baseline payments. The hike will amount to an average of 3.2 percent for durable goods producers and 3.6 percent for nondurable goods producers.

The repeal of LIFO inventory valuation would also have a larger relative effect on pass-through entities. This is largely due to the fact that manufacturing pass-through entities account for a relatively small proportion of total pass-through income but hold over 20 percent of pass-through inventory stocks. This illustrates how business tax provisions that seem small in absolute terms have disproportionate adverse effects on pass-through entities.

Table 5 also reveals the degree to which the benefits of making the R&E tax credit permanent accrue to durable manufacturers. Of the \$169 billion spent on research by manufacturers in 2007, two-thirds was done by durable goods producers, and the vast majority of it was concentrated in just three industry groups: computer and electronic products, automotive,

Table 3
Impact of FY2011 Budget Tax Proposals on Tax Payments
by Broad Sector, 2010-2020
(\$ billions)

	Sector			Total
	Durable Manufacturing	Nondurable Manufacturing	Rest of the Economy	
C Corporations	-2.2	70.5	194.9	263.2
Multinational	3.6	64.5	144.7	212.8
Domestic	-5.7	6.0	50.2	50.5
Pass-Through Firms	6.1	26.9	144.6	177.6
All Businesses	3.4	97.4	339.6	440.4

Source: Ernst & Young

Table 4
Impact of FY2011 Budget Tax Proposals on Tax Payments
by Broad Sector, 2010-2020
(Percent change from baseline)

	Sector			Total
	Durable Manufacturing	Nondurable Manufacturing	Rest of the Economy	
C Corporations	-0.5	7.9	7.8	6.9
Multinational	1.2	9.3	11.7	9.5
Domestic	-4.2	2.9	4.0	3.1
Pass-Through Firms	9.4	18.7	4.2	4.9
All Businesses	0.8	9.4	5.7	5.9

Source: Ernst & Young

Table 5
**Impact of FY2011 Budget Tax Proposals on Manufacturers’
 Tax Payments, 2010-2020**
 (Percent change from baseline)

	C Corporations		Pass-Through Firms	
	Durable Goods	Nondurable Goods	Durable Goods	Nondurable Goods
Expiration of Income Tax Reductions	N/A	N/A	3.2	3.6
Repeal of LICO/LCM	2.5	2.2	4.1	4.0
Tighten Foreign Tax Credit	4.1	3.0	N/A	N/A
Make R&E Tax Credit Permanent	-10.0	-3.1	-0.7	-0.5
All Other Permanent Tax Provisions	2.9	5.8	2.8	11.6
Total Impact	-0.5	7.9	9.4	18.7

Source: Ernst & Young

and aerospace. As a result, for C corporations the estimated 10 percent decrease in tax payments due to this provision more than offsets other tax increases for the sector as a whole. But since the R&D expenditures that qualify for the credit are highly concentrated in just a handful of industries, this means most durable manufacturers outside of computers and transportation equipment will see net tax increases from the 2011 budget.¹⁵

Pass-through entities are expected to garner only a marginal benefit from making the R&E tax credit permanent, and this is mainly due to differences in firm size. As noted earlier, pass-through firms are much smaller on average than C corporations, whereas most R&D is performed in larger firms. Three-quarters of all business R&D is performed in firms with 1,000 or more employees, and there are relatively few pass-through businesses of this size.

Aside from the four tax proposals examined in detail here, there are several provisions in the residual subtotal that have particularly pronounced effects on nondurable manufacturers that merit discussion. The most important in terms of dollars is to rescind eligibility of pulp and paper companies for the cellulosic biofuel credit. As a by-product of primary production, many pulp and paper companies produce a fuel called “black liquor” that currently qualifies for the credit. The 2011 budget would eliminate eligibility for such “secondary” production, increasing the tax bill for

pulp and paper companies by an estimated \$9.2 billion over the next 10 years. This accounts for about half of the 11.6 percent tax increase for nondurable manufacturing pass-through firms due to “other” provisions.

The 2011 budget also proposes to eliminate a number of tax preferences that encourage investment in exploration for, and extraction of, fossil fuels as well as reinstatement of the Superfund tax, both of which will have a marked effect on firms in the petroleum and coal products industry. These proposed tax modifications account for almost 40 percent of the 11.6 percent tax increase for nondurable manufacturing pass-through firms due to “other” provisions.

The tax provisions of the 2011 budget will thus affect S corporations and other pass-through manufacturing firms much more heavily than both firms outside of manufacturing and C corporations within manufacturing. Given the growing importance of these businesses to economic growth and job creation over the past 25 years, it is important to understand that tax increases may help fill government coffers in the eventual hope of containing deficits, but the increases as they are currently structured are likely to have a high price in terms of the competitive posture of U.S. manufacturing and the growth of the economy as a whole.

Macroeconomic Effects of Business Tax Provisions in the 2011 Budget and Alternative Proposals

To examine the question of how the business tax provisions in the 2011 federal budget affect

¹⁵ The tax benefits on the nondurables side will accrue almost exclusively to pharmaceutical manufacturers, which accounted for almost 90 percent of total nondurable-goods R&D in 2007.

overall economic performance, I have incorporated the estimates furnished by Ernst & Young into the IHS Global Insight model of the U.S. economy to examine their likely effects. The baseline scenario consists of IHS Global Insight's midrange forecast as of early February 2010, the most current that precedes the release of the President's 2011 budget proposals. Its assumptions thus provide a reasonably accurate representation of the status quo with regard to tax policy.¹⁶

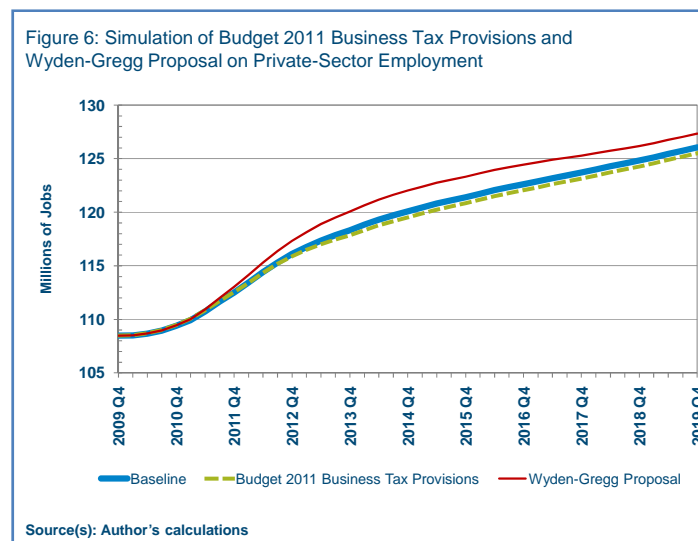
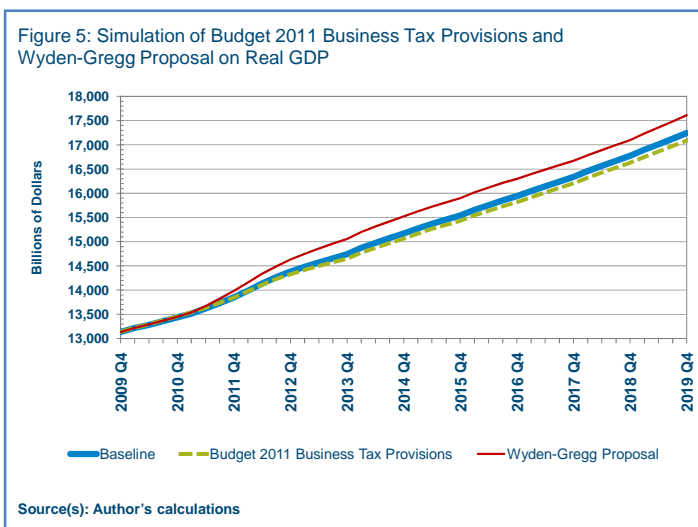
Estimating the aggregate economic effects of the changes to corporate taxes is straightforward, because the data from Ernst & Young allow us to determine how effective corporate tax rates will change, and this parameter can be modified accordingly. But the model is limited for the purposes of this paper, because it makes no distinction between the corporate and noncorporate business sector. It does make a distinction between personal income taxes (which affect after-tax income, consumption, and work incentives) and corporate income taxes (which affect business profits and investment). But it presumes no explicit relationship between personal income tax rates and after-tax business profits, even though this paper has shown that such a relationship indeed exists for the millions of firms which are organized as S corporations and partnerships.

To get around this limitation, the simulation presented here allocates the portion of the personal income tax increase borne by pass-through entities as equivalent to an increase in corporate taxes, since it is likely to have similar impact in terms of its effect on profits and investment.

As a point of comparison, a second simulation was undertaken to approximate recent legislation sponsored by Senator Ron Wyden (D-OR) and Senator Judd Gregg (R-NH) that seeks to simplify both corporate and personal income taxes. On the personal side, the most important changes are replacement of the existing rate structure with three brackets taxed at 15 percent, 25 percent, and 35 percent. To compensate for the abolition of the 10 percent bracket for lower incomes, the standard deduction would be tripled. In addition, capital gains would be taxed as

ordinary income, but 35 percent of those gains would be excluded from taxation, resulting in an effective capital gains tax rate of about 23 percent. On the corporate side, the centerpiece is a cut in the statutory tax rate from 35 percent to 24 percent.

Figures 5 and 6 show the estimated effects on real GDP and employment of the business tax proposals put forth in the 2011 federal budget as well as by Senator Wyden and Senator Gregg.



They each depart substantially from the baseline scenario. With regard to GDP, the President's budget proposals have a slight negative effect, opening a gap in real GDP relative to the baseline that reaches almost \$200 billion by the middle of the decade and which persist through at least 2019. This would shave 0.2 percentage points from annual GDP growth over the 2011-2015 period. A similar pattern prevails with regard to

¹⁶ It is important to recognize that assumptions about tax rates are based on current legislation, meaning that that the 2001 reductions in personal tax rates are assumed to expire at the end of 2010 as current legislation stipulates. This tax increase is thus built into the baseline.

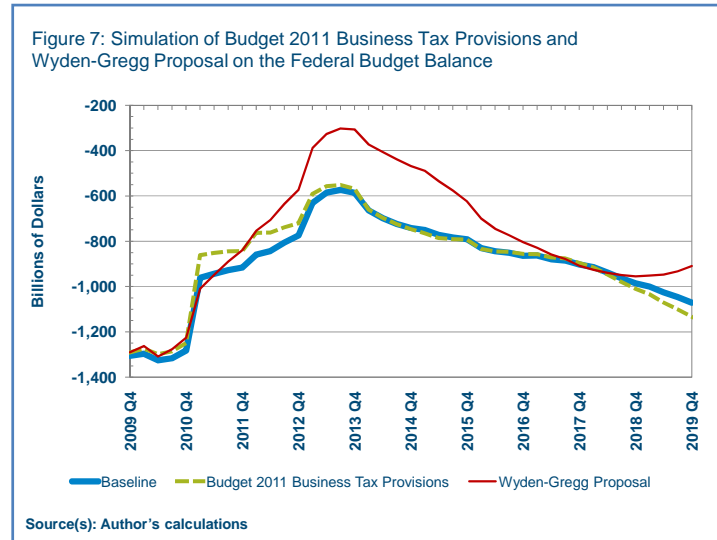
jobs. Budget 2011's proposals are projected to cost almost 500,000 jobs by 2015.

In sharp contrast, the aggressive corporate tax cut proposed by Senator Wyden and Senator Gregg would significantly increase aggregate U.S. output and employment. The main driver of these positive changes is the corporate tax cut, which significantly boosts after-tax profits and drives output growth and job creation. In addition, the reduction in effective personal income tax rates provides almost \$500 billion in extra disposable income relative to the 2011 budget's tax proposals, giving a significant boost to consumer spending. The proposals are forecast to boost average annual GDP growth from 3.4 percent to 3.8 percent over the next five years, adding an extra \$500 billion annually to GDP by 2015. They are also forecast to create nearly two million additional jobs by mid-decade.

The results of these simulations are not surprising in the sense that they are completely consistent with both Keynesian and neoclassical theory: tax cuts tend to stimulate economic activity and tax increases tend to stifle it. But the results of this simulation indicate that the effects of deficit reduction—which was one of the motivations for including business tax increases in the 2011 federal budget—runs counter to conventional wisdom, as shown in Figure 7. We can see that through the end of 2010 the deficit under all three scenarios shrinks substantially, due to the cyclical effect of the nascent recovery. From 2011 to 2012, the tax provisions in the 2011 budget appear to accomplish their goal of reducing the deficit relative to the baseline: in 2011, the deficit is \$100 billion smaller than under the baseline scenario. However, as the negative effects of the tax increases begin to bite into corporate profits and reduce economic activity, the forecast deficit actually gets larger than the baseline deficit, and by 2019 the budget deficit under the “deficit-reduction” scenario is in fact \$100 billion **larger** than under the baseline. This is a vivid illustration of the law of unintended consequences and confirms the well-documented principle that business taxes are an extremely inefficient (and in this case completely ineffective) way to raise government revenue.

In sharp contrast, the main provisions of the Wyden-Gregg tax proposal would have a salutary effect on the deficit starting in 2012. In 2011, we can briefly see the static effect of a corporate tax

cut: for a given level of corporate income, a lower tax rate will perforce reduce revenues and



increase the deficit. For this reason, the forecast deficit under the Wyden-Gregg tax proposal is larger than that assuming the President's business tax increases through most of 2011. But corporate income is not static over time, and reductions in corporate tax rates, to a point, are strongly associated with increasing aggregate profits and, hence, increasing government revenues.¹⁷ This dynamic effect is evident in the simulation. By the end of 2013, the stronger economic growth generated by the Wyden-Gregg proposal is forecast to reduce the deficit to just \$300 billion, significantly lower than both the baseline scenario and the scenario assuming the Budget 2011 business tax provisions are enacted. After that time, other factors (most notably the rapid growth in Social Security and Medicare expenditures associated with the retirement of large numbers of Baby Boomers) will conspire to worsen the deficit outlook, but the Wyden-Gregg scenario results in a better long-term fiscal outcome.

Conclusion

In their quest to find the revenue deemed necessary to fund the major new domestic

¹⁷ Empirical analysis of international data shows a strong relationship between statutory corporate rates and corporate tax revenues, and suggests that the revenue-maximizing rate is approximately 25 percent. See Alex Brill and Kevin A. Hassett, "Revenue-Maximizing Corporate Income Taxes: The Laffer Curve in OECD Countries," American Enterprise Institute Working Paper No. 137, July 2007.

initiatives envisioned by the Obama Administration, policy makers have lost sight of the fundamental principles of sound tax policy and risk further undermining the competitiveness of American businesses. The sheer size of projected deficits has seemingly blinded public debate to the fact that tax increases on the scale envisioned in the 2011 federal budget can have unintended consequences on economic activity that raise U.S. business costs and result in federal receipts that are not as large as anticipated, thereby defeating the goal of the tax changes.

This paper has clearly shown that pass-through business entities will be most adversely affected by the proposed changes: their total tax bill will increase by 5 percent over the next 10 years, but by almost 15 percent for manufacturing pass-through entities. They will not only bear their share of the business tax increases (from base broadening and elimination of preferences) that will affect all firms, but they will take a direct hit from the proposed increase in top personal income tax rates to pre-2001 levels (as well as the ill-conceived Medicare surtax on personal investment income) starting in 2011. Pass-through entities, which make up 80 percent of U.S. businesses and account for one-third of total U.S. business sales, have become a central pillar of U.S. economic strength and it would be

ill-advised to inadvertently shoulder them with a disproportionate share of the increased tax burden.

Macroeconomic analysis of the business tax proposals in the 2011 budget confirms what academic studies of business tax policy have long pointed out: firms are very sensitive to changes in their tax burden and tend to modify their behavior rapidly and significantly to compensate for those changes. The President's proposals are forecast to reduce GDP by about \$100 billion and total private employment by about 500,000 jobs, largely by reducing after-tax profits and capital spending. These amounts may seem modest, but they are large enough to offset any hoped-for reduction in the deficit – confirmation that business tax increases more often than not end up defeating their original goal.

A more principled approach to tax policy would strive to encourage U.S. businesses to grow and prosper, thereby increasing their profits and the additional federal revenues that would result. The Wyden-Gregg tax reform proposal is a step in this direction (particularly the provision that reduces the corporate tax rate to a level that is closer to that which is likely to maximize corporate tax revenues) and the analysis in this report strongly suggests that such a move would not only significantly boost GDP and employment, but reduce the projected federal deficit as well.