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The Repeal of Graduated Corporate Tax Rates

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Section 11 applies a bracket system to corporations, imposing lower tax rates on lower amounts of income. Similarly, section 1 applies a bracket system to individuals, which is intended to adjust the tax rate to the taxpayer's standard of living. Modest and subsistence incomes bear little or no income tax. Higher incomes bear tax rates as high as 35 percent. By contrast, the bracket system of section 11 bears no relation to standards of living. Corporations are artificial entities that do not have variable standards of living. Moreover, the income level of a corporation bears no relation to the shareholders' standards of living. The section 11 bracket system may induce privately held businesses to incorporate because it effectively provides corporations with high-income shareholders in the top individual tax bracket access to two sets of low tax brackets, one under section 1 and a second under section 11.

This proposal would repeal the lower tax brackets in section 11 and apply the top corporate rate, currently 35 percent, to all corporations. This change would eliminate the incentive for business owners to incorporate to receive the lower corporate tax rates. More significantly, repealing the lower corporate marginal rates could increase annual tax revenue by an estimated $3 billion.

An overview of the Shelf Project is found in ''How to Raise $1 Trillion Without a VAT or a Rate Hike,'' *Tax Notes*, July 5, 2010, p. 101, *Doc 2010-13081*, or *2010 TNT 129-4*. An inventory of all prior Shelf Project proposals, by subject matter, can be found at http://www.utexas.edu/law/faculty/calvinjohnson/shelf_project_inventory_subject_matter.pdf.

Shelf Project proposals follow the format of a congressional taxwriting committee report in explaining current law, what is wrong with it, and how to fix it.

Section 11(b) should be amended to repeal the lower marginal tax rates that now apply to the first $10 million of corporate income. As a result, all corporate income would be taxed at the same rate, currently 35 percent.

Current Law

Under current law, the maximum statutory corporate tax rate is 35 percent.[1] Since 1936, tax law has applied lower tax rates to lower amounts of corporate income.[2] Lower tax rates now apply to the following thresholds of corporate income:

- up to $50,000 is taxed at 15 percent;
- $50,001-$75,000 is taxed at 25 percent; and
- $75,001-$10 million is taxed at 34 percent.[3]

Since 1986, other corporate taxes that phase out have eliminated the tax savings derived from the lower corporate tax brackets. Under current law, a 5 percent phaseout tax applies to corporate income between $100,000 and $335,000 to eliminate the tax savings derived from the lower rates applying to the first $75,000.[4] That phaseout creates a marginal tax rate bubble of 39 percent that applies until it increases the average tax rate to 34 percent on corporate incomes at or above $335,000. Also, a 3 percent phaseout tax applies to corporate income between $15 million and $18.3 million to eliminate the tax savings derived from the 34 percent rate applying to the first $10 million.[5] The 3 percent phaseout tax creates a marginal rate bubble of 38 percent that raises the average rate to 35 percent on incomes at or above $18.3 million. The bubble effects of the phaseout taxes can result in corporations with lower income paying tax at higher marginal rates than corporations with higher income.

Any business with ownership interests traded on a public market is automatically subject to the corporate tax under section 11.[6] By contrast, a privately owned business is generally taxed as a passthrough entity. The two available passthrough formats are partnerships, governed by subchapter

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[1]Section 11(b)(1)(D).

[2]On June 19, 1935, President Franklin D. Roosevelt recommended the ''substitution of a corporate income tax graduated according to the size of corporation income in place of the present uniform corporate income tax.'' *See* H.R. 74-1681 (1935). Congress embraced the president's recommendation and adopted a graduated corporate tax in 1936.

[3]Section 11(b)(1)(A)-(C).

[4]Section 11(b) (second sentence).

[5]Section 11(b) (third sentence).

[6]Section 7704.

K of the Internal Revenue Code,[7] and S corporations, governed by subchapter S of the code.[8] There are important technical differences between the K and the S regimes, but under both, the entity calculates accounting income that is then attributed to the individual owners and reported on their personal tax returns.[9] The income of C corporations, however, bears a double tax — a tax on the entity when income is earned[10] and a second tax when profits are distributed or ownership interests are sold (albeit at capital gains rates at the shareholder level).[11] The K and S regimes impose only a single tax at the individual (owner) level.[12]

Individuals also are subject to a tax bracket system of graduated rates. The standard deduction and personal exemptions create a zero tax rate for married couples on the first $19,000 of income,[13] followed by tax rates of 10, 15, 25, 28, 33, and 35 percent on income exceeding $19,000. For 2011, the 35 percent bracket applies to taxable income in excess of $379,150.[14]

Graduated rates for individuals are adjusted to the standard of living. People have a diminishing marginal utility for money[15]; as a taxpayer's income increases, a higher percentage can be spent on discretionary items that can be seen as justifying the imposition of higher tax rates on higher incomes.[16] That rationale does not apply to corporate brackets because corporations are not consuming entities and do not value dollars at varying utilities.

An individual subject to the 35 percent rate can save as much as $12,750 annually if he incorporates a business that earns $100,000 of taxable income each year and retains all corporate profits indefinitely.[17] In light of legal and practical constraints on achieving those goals,[18] few individuals are likely to incorporate for the sole reason of exploiting the lower marginal rates.[19] Nevertheless, the lower marginal rates are indefensible as a policy matter and result in forgone tax revenue of $3 billion to $3.2 billion per year.[20]

Reasons for Change

The section 11 graduated corporate rates are inequitable — that is, the size of a corporation bears no necessary relation to the income levels of the owners. Indeed, low-income corporations may be owned by individuals with high incomes, and high-income corporations may be owned by individuals with low incomes. Moreover, as the Congressional Budget Office recently observed:

> Many of the companies that benefit from the current rate structure are not small or medium-sized. Under current law, large corporations can reduce their taxable income for certain years by sheltering some of it or by controlling when they earn income and incur expenses.[21]

Since the addition of the graduated tax rate structure in 1936, little effort has been made to

[7]Sections 701-776.

[8]Sections 1361-1378.

[9]Sections 702, 703, 1363, and 1366.

[10]Section 11.

[11]Sections 1(h)(11), 301, 1001, and 1221.

[12]Sections 701, 702, 1363(a), and 1366.

[13]Rev. Proc. 2011-12, 2011-2 IRB 297, *Doc 2010-27298*, *2010 TNT 247-8*, section 2.05 ($11,600 standard deduction), section 2.07 ($3,700 personal exempt for two).

[14]*Id.* section 2.01.

[15]The underlying intuition behind diminishing marginal utility is that people spend money for most critical needs first (food and shelter for survival) and then less critical needs only thereafter. *See, e.g.*, Walter J. Blum and Harry Kalven Jr., "The Uneasy Case for Progressive Taxation," 19 *U. Chi. L. Rev.* 417, 477 (1952). Diminishing marginal utility is displayed by people saving for a rainy day, buying insurance even in the face of transaction costs, and risk aversion. *See* William Vickrey, "Measuring Marginal Utility by Reactions to Risk," 13 *Econometrica* 319, 324-333 (1945) (translating between utility and risk aversion).

[16]The Report of the Royal Commission on Taxation (Canada) 20-22 (1966) translated increasing discretionary fractions of income into brackets.

[17]A savings of $10,000 on the first $50,000 of corporate income (taxed at 15 percent corporate rate rather than 35 percent individual rate), $2,500 of savings on the next $25,000 of corporate income (taxed at 25 percent corporate rate rather than 35 percent individual rate), and $250 of savings on the next $25,000 of corporate income (taxed at 34 percent corporate rate rather than 35 percent individual rate).

[18]Fine-tuning a C corporation in this way will trigger professional fees that eat away at the tax savings. Also, retaining all profits could subject the corporation to corporate penalty taxes. *See* sections 531-537, 541-547. Even if the strategy is successful, a future sale of assets will trigger a corporate tax as high as 35 percent on self-created intangible value (and a stock sale will normally result in a comparable discount to the purchase price) that can be avoided if a passthrough entity is used. Hence, if the business is successful, the additional tax cost at the time of sale could eliminate or exceed any savings achieved during the life of the business.

[19]*But see* John W. Lee, "A Populist Political Perspective of the Business Tax," 78 *Tex. L. Rev.* 985 (1999) (arguing that most corporations, counting by number rather than by amount of income, are formed to create a new set of low brackets, after the shareholders have exhausted their individual tax bracket of 25 percent and lower).

[20]Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014," JCS-3-10 (Dec. 15, 2010), *Doc 2010-27177*, *2010 TNT 245-12*, at 40 ($3.2 billion for 2010); Office of Management and Budget, "Estimates of Total Income Tax Expenditures for Fiscal Years 2010-2016," Table 17-1, line 79 ($3 billion in 2010), in excerpts of the Analytical Perspectives volume of the Obama administration's fiscal 2012 budget proposal, *Doc 2011-3135*, *2011 TNT 31-36*.

[21]CBO, "Reducing the Deficit: Spending and Revenue Options," Option 19 at 175 (Mar. 2011), *Doc 2011-5145*, *2011 TNT 48-18*.

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justify its existence. As part of the tax reform debate in 1985, Treasury recommended restoring a flat corporate tax.[22] Treasury's 1985 proposal highlighted the lack of an equitable justification for the lower marginal corporate rates, stating, ''A system of graduated rates must be based on the ability to pay concept and that ability has no application to corporations.''[23]

In addition to being inequitable, the lower corporate tax rates are associated with antiabuse rules that complicate the tax system. For example, individuals have tried to access multiple sets of low section 11 brackets by creating multiple corporate entities. When President Roosevelt first proposed a system of graduated corporate tax rates, he acknowledged that ''provision should . . . be made to prevent evasion of such graduated tax on corporate incomes through the device of numerous subsidiaries or affiliates, each of which might technically qualify as a small concern even though all were in fact operated as a single organization.''[24] In response to that concern, Congress enacted legislation that precludes individuals from availing themselves of multiple sets of lower marginal corporate tax rates when specified relationships exist among the owners of multiple corporations.[25] The provision is complex and its contours are not always clear.[26]

Even a single set of low corporate brackets creates an incentive to deflect income to, and accumulate profits in, a C corporation to take advantage of the low rates. As part of the 1985 tax reform debate, Treasury highlighted that ''the existence of corporate rates that are significantly lower than individual rates creates sheltering opportunities that can be reduced only by the imposition of complicated personal holding company rules and similar restrictions.''[27] Specifically, the existence of lower marginal corporate rates is one of the few remaining justifications for the antiquated and cumbersome accumulated earnings tax and personal holding company tax provisions.[28] Under current law, which has identical maximum rates for both individuals and corporations, there is little incentive for an individual to deflect income to a C corporation other than to exploit the lower marginal corporate rates. Commentators have long called for repeal of those archaic penalty tax provisions, but the continued existence of lower marginal corporate tax rates diminishes the likelihood of achieving that simplification goal.[29]

The increased availability of passthrough tax regimes in recent decades further reduces any possible justification for making the corporate tax regime friendlier to small businesses by perpetuating the lower marginal corporate rates. Graduated corporate rates were adopted at a time when incorporated small businesses could rarely avoid C corporation status and were justified as an aid to small business.[30] Since that time, passthrough tax regimes have been attached to business forms that insulate owners of non-publicly-traded enterprises from liability, thereby eliminating most of the business reasons for owners of small businesses to use the C corporation regime.[31] Since 1958, the option of operating as an S corporation has dramatically reduced the need for small businesses to subject themselves to the corporate tax.[32] The S corporation eligibility rules have been significantly liberalized over the past half century.[33] Not surprisingly, the

[22]The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity at 128-129 (1985) (Treasury II).

[23]*Id.* This point was apparently overlooked when President Roosevelt originally proposed a graduated corporate tax. *See* H.R. 74-1681, *supra* note 2 (quoting Roosevelt as saying: ''We have established the principle of graduated taxation in respect of personal incomes, gifts and estates. We should apply the same principle to corporations'').

[24]*See* H.R. 74-1681, *supra* note 2.

[25]*See* section 1561(a)(1).

[26]*See, e.g.*, *United States v. Vogel Fertilizer Co.*, 102 S. Ct. 821 (1982). The code has since been amended to eliminate the *Vogel Fertilizer* issue. *See* section 1563(a).

[27]Treasury II, *supra* note 22, at 128-129.

[28]*See* sections 531-537, 541-547.

[29]*See generally* Jeffrey L. Kwall, ''Subchapter G of the Internal Revenue Code: Crusade Without a Cause?'' 5 *Va. Tax Rev.* 223 (1985). Even if corporate income is taxed at a flat rate, the evil at which the penalty taxes were directed would still exist if legislative proposals to reduce the maximum corporate tax rate significantly below the maximum individual tax rate were enacted.

[30]*See, e.g.*, 131 *Cong. Rec.* S4415 (1985) (''Our graduated corporate rates are partly based on the fact that we want to give small businesses a break. [W]e've long believed that small businesses provide special benefits to our society and deserve reasonable incentives that help them thrive. A system of graduated corporate tax rates is a straight-forward way to provide such incentives''); CBO, *supra* note 21, at 175, Option 19 (''It lessens the 'double taxation' of profits of small and medium-sized companies'').

[31]One nontax motivation for using a C corporation is to allow a growing business to retain and reinvest all its profits without adversely affecting those owners who would need cash distributions to pay taxes on the income of a passthrough entity. Another reason for operating as a C corporation without regard to the lower graduated corporate tax rates is that a profitable C corporation that is ineligible for S corporation status cannot convert to a passthrough regime without incurring a hefty double tax. *See, e.g.*, LTR 9701029, *Doc 97-429*, *97 TNT 3-66* (demonstrating the double tax that results when a C corporation converts to a limited liability company that does not elect to be taxed as a C corporation). Even if the lower marginal corporate rates are eliminated, a business in either of the foregoing situations could continue to operate as a C corporation.

[32]Technical Amendments Act of 1958, section 64 (P.L. 85-866).

[33]*See* James S. Eustice and Joel D. Kuntz, *Federal Income Taxation of S Corporations*, ch. 3 (4th ed. 2001 and Supp. 2010).

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use of subchapter S has exploded to the point that more than two-thirds of the corporations filing federal tax returns now operate as S corporations.[34]

In addition to the S corporation, the limited liability company has been sanctioned by all 50 states during the past 25 years.[35] An LLC offers owners the same insulation from business liabilities as the corporate form, but is generally taxed as a partnership, passing through the entity income to its owners. Small businesses that cannot or will not operate under the confines of subchapter S now have the option of avoiding corporate taxation while their owners continue to enjoy limited liability under state law. Not surprisingly, the number of LLCs has grown dramatically in recent years.[36] In light of the passthrough entity options that now exist for small businesses, it becomes increasingly difficult to justify perpetuating any tax incentives for those small businesses that continue to use the C corporation tax regime.[37]

The CBO recently issued a list of spending and revenue options to reduce the deficit. That list includes the adoption of a flat corporate tax rate of 35 percent.[38] In light of the immense revenue needs that this country now faces and the weak case for perpetuating lower marginal corporate tax rates, it would be prudent to repeal the lower marginal rates that now apply to corporate income.

[34]IRS, *Statistics of Income Bulletin* (Spring 2011), Table 21 (reporting 2 million C corporations and 4.4 million S corporations).

[35]*See* Larry E. Ribstein and Robert R. Keatinge, *Ribstein & Keatinge on Limited Liability Companies* (2d ed. 2005 and Supp. 2010).

[36]IRS, *SOI Bulletin*, *supra* note 34, Table 11 (reporting 1.9 million LLCs filed partnership tax returns in 2008).

[37]*See generally* Kwall, ''Taxing Small Business in the New Millennium,'' 51 *Tax Lawyer* 229 (1998) (arguing for the imposition of a single layer of tax on all non-publicly traded enterprises).

[38]CBO, *supra* note 21, at 175, Option 19.

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