BACKGROUND ON BUSINESS TAX REFORM

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INTRODUCTION

The Committee on Finance of the Senate has scheduled a public hearing on April 26, 2016, on Navigating Business Tax Reform. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a discussion of present law and data relating to the taxation of business income and business entities. In addition, this document discusses certain reform proposals, starting with those that maintain the basic structure of the income tax, then those that offer a structural change to income taxation, and finally those that move to a consumption tax.

[1] This document may be cited as follows: Joint Committee on Taxation, *Background on Business Tax Reform* (JCX-35-16), April 22, 2016. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

I. PRESENT LAW

Overview

The taxation of business income generally depends on the choice of business entity. In 2012, there were approximately 1.6 million C corporations, 3.4 million partnerships, and 4.2 million S corporations. The number of passthrough entities (partnerships and S corporations) surpassed the number of C corporations in 1987 and has nearly tripled since then, led by growth in small S corporations (those with less than $100,000 in assets) and limited liability companies ("LLCs") taxed as partnerships.

The vast majority of businesses in the United States are organized for tax purposes as sole proprietorships, however. In 2012, there were more than 23.5 million nonfarm sole proprietorships and 1.8 million sole proprietorship farms out of 34.6 million total business returns. Unlike a C corporation, partnership, or S corporation, a sole proprietorship typically is not an entity distinct from its individual owner.[2] Rather, the business owner is taxed directly on business income, and files Schedule C (sole proprietorships, generally), Schedule E (*e.g.*, rental real estate and royalties), or Schedule F (farms) with his or her individual tax return.

C corporations

A C corporation[3] is subject to Federal income tax as an entity separate from its shareholders. A C corporation's income generally is taxed when earned at the corporate level and is taxed again at the individual level when distributed as dividends[4] to its shareholders. Corporate deductions and credits reduce only corporate income (and corporate income taxes) and are not passed directly through to shareholders.

Corporate income that is not distributed to shareholders generally is subject to current tax at the corporate level only. To the extent that income retained at the corporate level is reflected in an increased share value, the shareholder may be taxed at capital gains rates upon sale or exchange (including certain redemptions) of the stock or upon liquidation of the corporation.[5]

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[2] A single-member unincorporated entity is treated as a disregarded entity for Federal tax purposes.

[3] A C corporation is so named because its Federal tax treatment is governed by subchapter C of the Internal Revenue Code of 1986, as amended (the "Code"). All section references are to the Code, unless otherwise stated.

[4] Distributions with respect to stock that exceed corporate earnings and profits are not taxed as dividend income to shareholders but are treated as a tax-free return of capital that reduces the shareholder's basis in the stock. Distributions in excess of corporate earnings and profits that exceed a shareholder's basis in the stock are treated as amounts received in exchange for the stock which, in general, are taxed to the shareholder at capital gains rates. Sec. 301(c).

[5] If stock is held until the death of the shareholder, the heirs are given a fair market value basis in the stock at death, resulting in no shareholder level income tax on appreciation prior to death if the heirs sell the stock to a third party, or receive corporate distributions in the form of a redemption (*i.e.*, a sale of their stock to the corporation). Sec. 1014(a)(1).

Foreign investors generally are exempt from U.S. income tax on capital gains, but are subject to withholding tax on dividends. Tax-exempt investors generally are not subject to tax on corporate distributions or on sales or exchanges of corporate stock.

The gain on appreciated corporate assets generally is subject to corporate level tax if the assets are distributed to the shareholders, yielding the same tax result as if the assets had been sold by the corporation and the proceeds distributed to the shareholders.

For corporations, the tax rate depends on the amount of taxable income reported by the corporation, with marginal rates rising from 15 percent to 35 percent. No separate rate structure exists for corporate capital gains.[6]

Passthrough entities

While a large portion of business income is taxed under the corporate income tax, some business income – such as that earned through sole proprietorships, partnerships, and S corporations – is taxed only at the individual level. In the case of individuals, the tax rate depends on the individual's filing status and income. For each filing status, the rate schedules are broken into several ranges of income and the marginal tax rate increases as a taxpayer's income increases (rising from 10 percent to 39.6 percent). Capital gains and certain dividends are taxed at lower rates, up to a maximum of 20 percent.[7]

Partnerships

Partnerships generally are treated for Federal income tax purposes as passthrough entities, not subject to tax at the entity level.[8] Items of income (including tax-exempt income), gain, loss, deduction, and credit of the partnership are taken into account in computing the tax of the partners (based on the partnership's method of accounting and regardless of whether the income is distributed to the partners).[9] A partner's deduction for partnership losses is limited to the amount of the partner's adjusted basis in his or her partnership interest.[10] To the extent a loss

[6] For taxable income from $15,000,000 to $18,333,333, there is a "bubble rate" of 38 percent. Sec. 11(b)(1).

[7] Investment income may be subject to additional tax or higher marginal rates by reason of the "Unearned Income Medicare Contribution" 3.8-percent tax under section 1411 and numerous phase-outs of tax benefits, such as the phase-out of the alternative minimum tax exemption (section 55(d)(3)), the overall limitation on itemized deductions (section 68), and the phase-out of personal exemptions (section 151(d)(3)).

[8] Sec. 701.

[9] Sec. 702(a). The recognition of income under this rule does not necessarily correspond with distributions from the partnership to cover the tax liabilities of individual partners.

[10] Sec. 704(d). In addition, passive loss and at-risk limitations limit the extent to which certain types of income can be offset by partnership deductions (sections 469 and 465). These limitations do not apply to corporate partners (except certain closely held corporations) and may not be important to individual partners who have partner-level passive income from other investments.

is not allowed due to a limitation, it generally is carried forward to the next year. A partner's adjusted basis in the partnership interest generally equals the sum of (1) such partner's capital contribution to the partnership, (2) the partner's distributive share of partnership income, and (3) the partner's share of partnership liabilities, less (1) such partner's distributive share of losses allowed as a deduction and nondeductible expenditures not properly chargeable to such partner's capital account and (2) any partnership distributions.[11]

Partnerships provide partners with a significant amount of flexibility to vary their respective shares of partnership income. Unlike corporations, partnerships may allocate items of income, gain, loss, deduction, and credit among the partners, provided the allocations have substantial economic effect.[12] In general, an allocation is permitted to the extent the partner to which the allocation is made receives the economic benefit or bears the economic burden of such allocation and the allocation substantially affects the dollar amounts to be received by the partners from the partnership independent of tax consequences.

S corporations

For Federal income tax purposes, an S corporation[13] generally is not subject to tax at the corporate level.[14] Items of income (including tax-exempt income), gain, loss, deduction, and credit of the S corporation are taken into account in computing the tax of the shareholders (under the S corporation's method of accounting and regardless of whether the income is distributed to the shareholders). A shareholder's deduction for corporate losses is limited to the sum of the shareholder's adjusted basis in the S corporation stock and the indebtedness of the S corporation to such shareholder. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward to the next year. The shareholder's basis in the S corporation stock (and debt) is reduced by the shareholder's share of losses and (in the case of stock) by distributions and is increased (in the case of stock) by the shareholder's share of the S corporation's income and contributions to capital.[15]

Unlike a partnership, but like a C corporation, gain realized on the distribution of built-in gain property by the S corporation to shareholders is recognized. The shareholders take their shares of such gain into account on their individual tax returns.

To be eligible to elect S corporation status, a corporation may not have more than 100 shareholders and may not have more than one class of stock.[16] Only individuals (other than

[11] Sec. 705.

[12] Sec. 704.

[13] An S corporation is so named because its Federal tax treatment is governed by subchapter S of the Code.

[14] Secs. 1363 and 1366.

[15] Sec. 1367.

[16] Sec. 1361. For this purpose, a husband and wife and all members of a family are treated as one shareholder. Sec. 1361(c)(1).

nonresident aliens), certain tax-exempt organizations, and certain trusts and estates are permitted shareholders. A corporation may elect S corporation status only with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than 50 percent of the stock.[17]

Taxable income of businesses

Taxable income of businesses generally is comprised of gross income less allowable deductions, with the specific rules depending on the choice of business entity. Gross income generally is income derived from any source, including gross profit from the sale of goods and services to customers, rents, royalties, interest (other than interest from certain indebtedness issued by State and local governments), dividends, gains from the sale of business and investment assets, and other income.

Allowable deductions include ordinary and necessary business expenditures, such as salaries, wages, incidental materials and supplies, contributions to profit-sharing and pension plans and other employee benefit programs, repairs, bad debts, taxes (other than Federal income taxes), contributions to charitable organizations (subject to an income limitation), advertising,[18] interest expense, certain losses, selling expenses, and other expenses. Expenditures that produce benefits in future taxable years to a taxpayer's business or income-producing activities (such as the purchase of plant and equipment) generally are capitalized and recovered over time through depreciation, amortization, or depletion allowances. A net operating loss incurred in one taxable year generally may be carried back two years and carried forward 20 years. A corporation may not deduct the amount of capital losses in excess of capital gains for any taxable year. Disallowed capital losses may be carried back three years and forward five years. Moreover, a deduction is allowed for a portion of the amount of income attributable to certain manufacturing activities.

Certain expenditures may not be deducted, such as dividends paid to shareholders, expenses associated with earning tax-exempt income,[19] certain entertainment expenditures, certain executive compensation in excess of $1,000,000 per year, a portion of the interest on certain high-yield debt obligations of corporations that resemble equity, as well as fines, penalties, bribes, kickbacks, and illegal payments.

Capital expenditures

Expenditures that produce benefits in future taxable years to a taxpayer's business or income-producing activities (such as the purchase of plant and equipment) generally are

[17] Sec. 1362.

[18] Advertising expenses generally are deductible as ordinary and necessary business expenses in the year in which they are paid or incurred.

[19] For example, the carrying costs of tax-exempt State and local obligations and the premiums on certain life insurance policies are not deductible.

capitalized[20] and recovered over time through depreciation, amortization or depletion allowances.[21] In addition, if the production, purchase, or sale of merchandise is an income-producing factor to a taxpayer, the taxpayer must generally account for inventories.[22]

Depreciation

A taxpayer is allowed to recover through annual depreciation deductions the cost of certain property used in a trade or business or for the production of income.[23] Under the modified accelerated cost recovery system ("MACRS"), the amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined for different types of property based on an assigned applicable depreciation method, recovery period, and convention.[24]

Bonus depreciation

An additional first-year depreciation deduction is allowed equal to 50 percent of the adjusted basis of qualified property acquired and placed in service before January 1, 2020 (January 1, 2021 for certain longer-lived and transportation property).[25] The 50-percent allowance is phased down for taxable years beginning after 2017 (after 2018 for certain longer-lived and transportation property). Special rules are provided for passenger automobiles and certain plants bearing fruits and nuts.

The additional first-year depreciation deduction is allowed for both the regular tax and the alternative minimum tax ("AMT"),[26] but is not allowed in computing earnings and profits.[27] The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction.[28] The amount of the additional first-year depreciation deduction is not affected by a short taxable year.[29] The taxpayer may elect out of additional first-year depreciation for any class of property

[20] See sec. 263(a).

[21] See secs. 167, 168, 197, and 611.

[22] See secs. 471, 472, and 263A. See also Treas. Reg. sec. 1.471-1.

[23] Sec. 167(a).

[24] Sec. 168.

[25] Sec. 168(k). The additional first-year depreciation deduction is subject to the general rules regarding whether a cost must be capitalized under section 263A.

[26] Sec. 168(k)(2)(G). See also Treas. Reg. sec. 1.168(k)-1(d).

[27] Treas. Reg. sec. 1.168(k)-1(f)(7).

[28] Sec. 168(k)(1)(B).

[29] *Ibid*.

for any taxable year.[30] In addition, a corporation otherwise eligible for additional first-year depreciation may elect to claim additional AMT credits in lieu of claiming additional depreciation with respect to "eligible qualified property."[31]

Expensing

A taxpayer may elect under section 179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions, subject to limitation. The maximum amount a taxpayer may expense is $500,000 of the cost of qualifying property placed in service for the taxable year. The $500,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $2,000,000. The $500,000 and $2,000,000 amounts are indexed for inflation for taxable years beginning after 2015. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.[32] Qualifying property also includes off-the-shelf computer software and qualified real property (qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property).

Inventory

In those circumstances in which a taxpayer is required to account for inventory, the taxpayer must maintain inventory records to determine the cost of goods sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer's inventory at the beginning of the period to the purchases made and production costs incurred during the period, and subtracting from that sum the taxpayer's inventory at the end of the period. Because of the difficulty of accounting for inventory on an item-by-item basis, taxpayers often use conventions that assume certain item or cost flows (*e.g.*, the first-in, first-out ("FIFO") method or the last-in, first-out ("LIFO") method).[33] In addition, the uniform capitalization ("UNICAP") rules require certain direct and indirect costs allocable to real or tangible personal property produced by the taxpayer to be included in either inventory or capitalized into the basis of such property, as applicable.[34] For real or personal property acquired by the taxpayer for resale, section 263A generally requires certain direct and indirect costs allocable to such property to be included in inventory.

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[30] Sec. 168(k)(2)(D)(iii). For the definition of a class of property, see Treas. Reg. sec. 1.168(k)-1(e)(2).

[31] Sec. 168(k)(4).

[32] Passenger automobiles subject to the section 280F limitation are eligible for section 179 expensing only to the extent of the dollar limitations in section 280F. For sport utility vehicles above the 6,000 pound weight rating, which are not subject to the limitation under section 280F, the maximum cost that may be expensed for any taxable year under section 179 is $25,000. Sec. 179(b)(5).

[33] See, *e.g.*, secs. 471 and 472.

[34] Sec. 263A.

Amortization of intangibles

Under section 197, when a taxpayer acquires intangible assets held in connection with a trade or business, any value properly attributable to a "section 197 intangible" is amortizable on a straight-line basis over 15 years.[35] Such intangibles include goodwill; going concern value; workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment; business books and records, operating systems, or other information base; any patent, copyright, formula, process, design, pattern, knowhow, format, or similar item; customer-based intangibles; supplier-based intangibles; and any other similar item.[36] The definition of a section 197 intangible also includes any license, permit, or other rights granted by governmental units (even if the right is granted for an indefinite period or is reasonably expected to be renewed indefinitely);[37] any covenant not to compete; and any franchise, trademark, or trade name.[38]

Research and experimental expenditures

Business expenses associated with the development or creation of an asset having a useful life extending beyond the current year generally must be capitalized and depreciated over such useful life.[39] Taxpayers, however, may elect to deduct currently the amount of certain reasonable research or experimentation expenditures paid or incurred in connection with a trade or business.[40] If taxpayers choose to forgo a current deduction, they may capitalize their research expenditures and recover them ratably over the useful life of the research, but in no case over a period of less than 60 months.[41] In the alternative, taxpayers may elect to amortize their

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[35] Sec. 197(a) and (c). A franchise is included in the definition of a section 197 intangible. Sec. 197(d)(1)(F) and (f)(4). A franchise is defined as "an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area." Sec. 1253(b)(1).

[36] Sec. 197(d)(1).

[37] Sec. 197(d)(1)(D). Examples include a liquor license, a taxi-cab medallion, an airport landing or take-off right, a regulated airline route, or a television or radio broadcasting license. Renewals of such governmental rights are treated as the acquisition of a new 15-year asset. Treas. Reg. sec. 1.197-2(b)(8). A license, permit, or other right granted by a governmental unit is a franchise if it otherwise meets the definition of a franchise. Treas. Reg. sec. 1.197-2(b)(10). Section 197 intangibles do not include certain rights granted by a government not considered part of the acquisition of a trade or business. Sec. 197(e)(4)(B) and Treas. Reg. sec. 1.197-2(c)(13).

[38] Sec. 197(d)(1)(F).

[39] Secs. 167 and 263(a).

[40] Sec. 174(a) and (e).

[41] Sec. 174(b). Taxpayers generating significant short-term losses often choose to defer the deduction for their research and experimentation expenditures under this section. Additionally, section 174 amounts are excluded from the definition of "start-up expenditures" under section 195 (section 195 generally provides that start-up expenditures in excess of $5,000 either are not deductible or are amortizable over a period of not less than 180 months once an active trade or business begins). So as not to generate significant losses before beginning their trade or business, a taxpayer may choose to defer the deduction and amortize its section 174 costs beginning with the month in which the taxpayer first realizes benefits from the expenditures.

research expenditures over a period of 10 years.[42] Generally, such deductions are reduced by the amount of the taxpayer's research credit (discussed in more detail below under "research credit").[43] Research and experimental expenditures deductible under section 174 are not subject to capitalization under either section 263(a)[44] or section 263A.[45]

Amounts defined as research or experimental expenditures under section 174 generally include all costs incurred in the experimental or laboratory sense related to the development or improvement of a product.[46] In particular, qualifying costs are those incurred for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product.[47] For purposes of section 174, the term "product" includes any pilot model, process,[48] formula, invention, technique, patent, or similar property whether used by the taxpayer in its trade or business or held for sale, lease, or license.[49] Uncertainty exists when information available to the taxpayer is not sufficient to ascertain the capability or method for developing, improving, and/or appropriately designing the product.[50] The determination of whether expenditures qualify as deductible research expenses depends on the nature of the activity to which the costs relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents. Examples of qualifying costs include salaries for those engaged in research or experimentation efforts, amounts incurred to operate and maintain research facilities (*e.g.*, utilities, depreciation, rent), and expenditures for materials and supplies used and consumed in the course of research or experimentation (including amounts incurred in conducting trials).[51] In addition, under

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[42] Secs. 174(f)(2) and 59(e). This special 10-year election is available to mitigate the effect of the alternative minimum tax adjustment for research expenditures set forth in section 56(b)(2). Taxpayers with significant losses also may elect to amortize their otherwise deductible research and experimentation expenditures to reduce amounts that could be subject to expiration under the net operating loss carryforward regime.

[43] Sec. 280C(c). Taxpayers may alternatively elect to claim a reduced research credit amount under section 41 in lieu of reducing deductions otherwise allowed. Sec. 280C(c)(3).

[44] Sec. 263(a)(1)(B).

[45] Sec. 263A(c)(2).

[46] Treas. Reg. sec. 1.174-2(a)(1) and (2).

[47] Treas. Reg. sec. 1.174-2(a)(1).

[48] Treas. Reg. sec. 1.174-2(a)(11), Example 10, provides an example of new process development costs eligible for section 174 treatment.

[49] Treas. Reg. sec. 1.174-2(a)(3).

[50] Treas. Reg. sec. 1.174-2(a)(1).

[51] See Treas. Reg. sec. 1.174-2. The definition of research and experimental expenditures also includes the costs of obtaining a patent, such as attorneys' fees incurred in making and perfecting a patent. Treas. Reg. sec. 1.174-2(a)(1).

administrative guidance, the costs of developing computer software have been accorded treatment similar to research expenditures.[52]

Research or experimental expenditures under section 174 do not include expenditures for quality control testing; efficiency surveys; management studies; consumer surveys; advertising or promotions; the acquisition of another's patent, model, production or process; or research in connection with literary, historical, or similar projects.[53] For purposes of section 174, quality control testing means testing to determine whether particular units of materials or products conform to specified parameters, but does not include testing to determine if the design of the product is appropriate.[54]

Generally, no current deduction under section 174 is allowable for expenditures for the acquisition or improvement of land or of depreciable or depletable property used in connection with any research or experimentation.[55] In addition, no current deduction is allowed for research expenses incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, including oil and gas.[56]

Credits

Research credit

For general research expenditures, a taxpayer may claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceed its base amount for that year.[57] Thus, the research credit is generally available with respect to incremental increases in qualified research. An alternative simplified credit (with a 14-percent rate and a different base amount) may be claimed in lieu of this credit.[58]

A 20-percent research tax credit also is available with respect to the excess of (1) 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving

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[52] Rev. Proc. 2000-50, 2000-2 C.B. 601.

[53] Treas. Reg. sec. 1.174-2(a)(6).

[54] Treas. Reg. sec. 1.174-2(a)(7).

[55] Sec. 174(c).

[56] Sec. 174(d). Special rules apply with respect to geological and geophysical costs (section 167(h)), qualified tertiary injectant expenses (section 193), intangible drilling costs (sections 263(c) and 291(b)), and mining exploration and development costs (sections 616 and 617).

[57] Sec. 41(a)(1).

[58] Sec. 41(c)(5).

during a fixed-base period, as adjusted for inflation.[59] This separate credit computation commonly is referred to as the basic research credit.

Finally, a research credit is available for a taxpayer's expenditures on research undertaken by an energy research consortium.[60] This separate credit computation commonly is referred to as the energy research credit. Unlike the other research credits, the energy research credit applies to all qualified expenditures, not just those in excess of a base amount.

Low-income housing credit

The low-income housing tax credit ("LIHTC") may be claimed over a 10-year period for the cost of building rental housing occupied by tenants having incomes below specified levels.[61] The amount of the credit for any taxable year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building. The applicable percentage is designed to produce a credit with a present value equal to a fixed percentage of the qualified basis of the building. The qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building. Eligible basis is generally adjusted basis at the close of the first taxable year of the credit period.

Other credits

Other tax credits applicable to businesses include credits for biofuels and renewable power, investment tax credits (applicable to investment in certain renewable energy property and the rehabilitation of certain real property), the empowerment zone employment credit (applicable to wages paid to certain residents of, or employees in, empowerment zones), the work opportunity credit (applicable to wages paid to individuals from certain targeted groups), and the disabled access credit (applicable to expenditures by certain small businesses to make the businesses accessible to disabled individuals). Unused credits generally may be carried back one year and carried forward twenty years.[62]

A foreign tax credit is available, subject to limitations, for certain foreign income taxes paid or accrued. Foreign income taxes limited in a tax year may be carried back one year or forward ten years.[63]

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[59] Sec. 41(a)(2) and (e). The base period for the basic research credit generally extends from 1981 through 1983.

[60] Sec. 41(a)(3).

[61] Sec. 42.

[62] Sec. 39.

[63] Sec. 904(c).

Deduction for qualified production activities (section 199)

Lower rates apply to income from certain domestic production activities. This rate reduction is effected by the allowance of a deduction equal to a percentage of qualifying domestic production activities income. Specifically, present law generally provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to nine percent of the lesser of the taxpayer's qualified production activities income or taxable income for the taxable year. For corporations subject to the 35-percent corporate income tax rate, the nine-percent deduction effectively reduces the corporate income tax rate to slightly less than 32 percent on qualified production activities income. A similar reduction applies to the graduated rates applicable to individuals with qualifying domestic production activities income.

In general, qualified production activities income is equal to domestic production gross receipts reduced by the sum of: (1) the costs of goods sold that are allocable to those receipts and (2) other expenses, losses, or deductions which are properly allocable to those receipts.

Domestic production gross receipts generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange, or other disposition, or any lease, rental, or license, of qualifying production property[64] that was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States; (2) any sale, exchange, or other disposition, or any lease, rental, or license of qualified film[65] produced by the taxpayer; (3) any lease, rental, license, sale, exchange, or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction of real property performed in the United States by a taxpayer in the ordinary course of a construction trade or business; or (5) engineering or architectural services performed in the United States for the construction of real property located in the United States.

The amount of the deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer, and properly allocable to domestic production gross receipts, during the calendar year that ends in such taxable year.[66]

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[64] Qualifying production property generally includes any tangible personal property, computer software, and sound recordings.

[65] Qualified film includes any motion picture film or videotape (including live or delayed television programming, but not including certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of the film (including compensation in the form of residuals and participations) constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers.

[66] For purposes of the provision, "wages" include the sum of the amounts of wages as defined in section 3401(a) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer's taxable year.

II. DATA ON BUSINESS ENTITIES AND TAX RATES

A. Data on the Number and Size of Business Entities in the United States

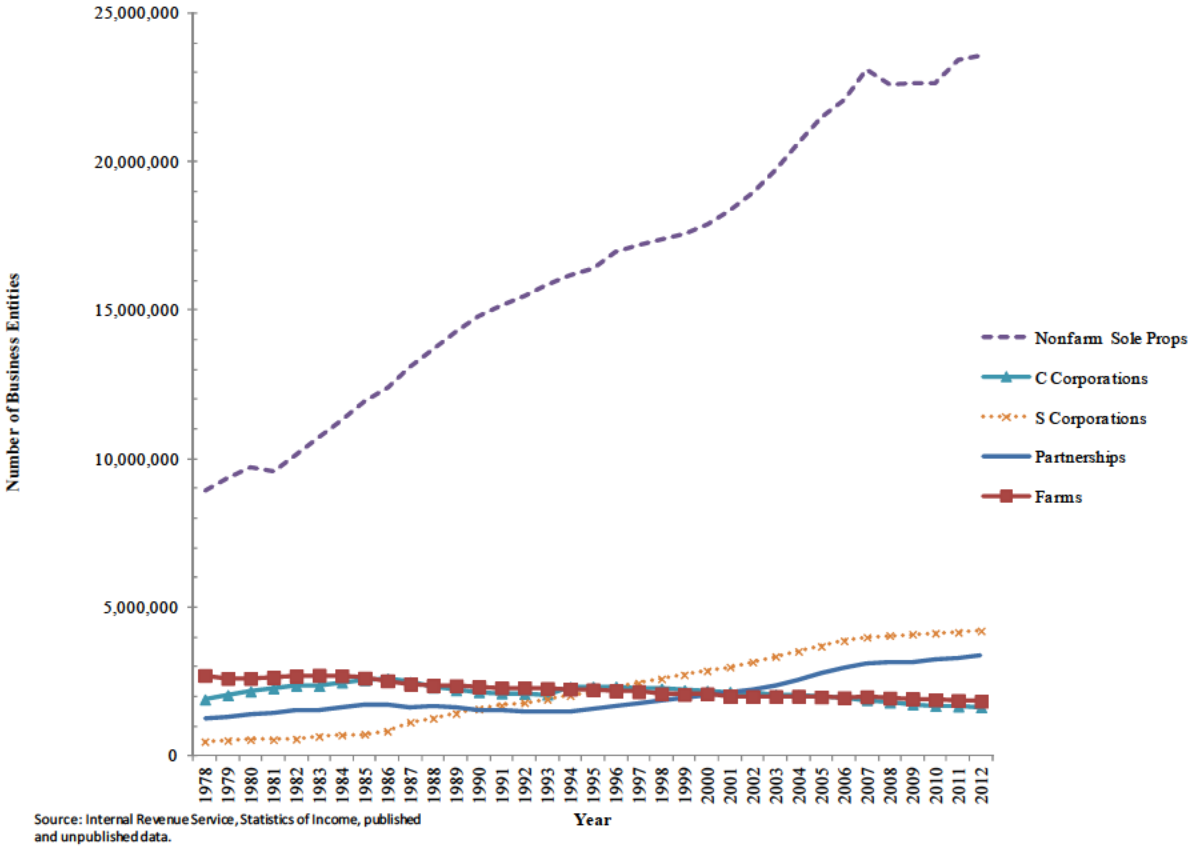
Returns filed by C corporations, S corporations, partnerships, nonfarm sole proprietors, and farming enterprises

For tax purposes, businesses may be organized as various entities including as C corporations, S corporations, partnerships, or sole proprietorships.[67] Throughout the period 1978 to 2012, nonfarm[68] sole proprietorships made up the vast majority of businesses, as shown in Figure 1 and Table 1. The S corporation is the second most prevalent business form. In 2012, S corporations constituted 12.2 percent of all business entities. By contrast, as recently as 1988, S corporations accounted for less than six percent of all business entities. The growth in the number of S corporations was most dramatic immediately following 1986, while the number of C corporations declined each year from 1987 through 1993. After an increase in the number of C corporation returns in the mid-1990s, the number of C corporation returns has again declined each year since 1998. The number of partnership returns filed reached a peak in 1985 and then generally declined until 1993. Since 1993, partnership returns filed and S corporation returns filed have grown at approximately the same rate. As described below, LLCs generally are taxed, at the election of the owners, either as partnerships or as corporations. In the great majority of cases involving U.S. businesses, LLCs are taxed as partnerships. The number of farm returns (that is, individuals operating farms as sole proprietorships and reporting their income on Schedule F of Form 1040) generally declined throughout the period.

[67] The IRS's Statistics of Income division ("SOI") tabulates the number of tax returns filed by different forms of business organizations. These data are based upon returns filed by individuals and entities. The numbers reported for nonfarm sole proprietorships and for farm returns are based upon the number of taxpayers who file a business return as a sole proprietor (Schedule C of Form 1040) and who file a farm income return (Schedule F of Form 1040). One taxpayer may report more than one business organized as a sole proprietorship; in that circumstance, the data reported here count only one sole proprietorship per taxpayer. On the other hand, the data for C corporations, S corporations, and partnerships count the number of tax returns and information returns filed by C corporations, S corporations, and partnerships. One taxpayer may own more than one corporation. When this occurs, unlike the case in sole proprietorships, the data reported here count each corporation as a separate entity. Two (or more) corporations can also form a partnership. Thus, the data are not perfectly comparable across entity classification.

[68] In these data, farms are measured solely by reference to those individuals who report income (or loss) on Schedule F of Form 1040. Other individuals engaged in agricultural enterprises may conduct their farm business through a separate legal entity. When this occurs, the data reported below report that entity among the totals of C corporations, S corporations, or partnerships.

Figure 1.–Number of Different Types of Business Returns, 1978-2012



Source: Internal Revenue Service, Statistics of Income, published and unpublished data.

Table 1.−Number of Different Types of Business Returns, 1978-2012

Year	Nonfarm Sole Props	C Corporations	S Corporations	Partnerships	Farms	Total
1978	8,908,289	1,898,100	478,679	1,234,157	2,704,794	15,224,019
1979	9,343,603	2,041,887	514,907	1,299,593	2,605,684	15,805,674
1980	9,730,019	2,165,149	545,389	1,379,654	2,608,430	16,428,641
1981	9,584,790	2,270,931	541,489	1,460,502	2,641,254	16,498,966
1982	10,105,515	2,361,714	564,219	1,514,212	2,689,237	17,234,897
1983	10,703,921	2,350,804	648,267	1,541,539	2,710,044	17,954,575
1984	11,262,390	2,469,404	701,339	1,643,581	2,694,420	18,771,134
1985	11,928,573	2,552,470	724,749	1,713,603	2,620,861	19,540,256
1986	12,393,700	2,602,301	826,214	1,702,952	2,524,331	20,049,498
1987	13,091,132	2,484,228	1,127,905	1,648,035	2,420,186	20,771,486
1988	13,679,302	2,305,598	1,257,191	1,654,245	2,367,527	21,263,863
1989	14,297,558	2,204,896	1,422,967	1,635,164	2,359,718	21,920,303
1990	14,782,738	2,141,558	1,575,092	1,553,529	2,321,153	22,374,070
1991	15,180,722	2,105,200	1,696,927	1,515,345	2,290,908	22,789,102
1992	15,495,419	2,083,652	1,785,371	1,484,752	2,288,218	23,137,412
1993	15,848,119	2,063,124	1,901,505	1,467,567	2,272,407	23,552,722
1994	16,153,871	2,318,614	2,023,754	1,493,963	2,242,324	24,232,526
1995	16,423,872	2,321,048	2,153,119	1,580,900	2,219,244	24,698,183
1996	16,955,023	2,326,954	2,304,416	1,654,256	2,188,025	25,428,674
1997	17,176,486	2,257,829	2,452,254	1,758,627	2,160,954	25,806,150
1998	17,398,440	2,260,757	2,588,081	1,855,348	2,091,845	26,194,471
1999	17,575,643	2,210,129	2,725,775	1,936,919	2,067,883	26,516,349
2000	17,902,791	2,184,795	2,860,478	2,057,500	2,086,789	27,092,353
2001	18,338,190	2,149,105	2,986,486	2,132,117	2,006,871	27,612,769
2002	18,925,517	2,112,230	3,154,377	2,242,169	1,995,072	28,429,365
2003	19,710,079	2,059,631	3,341,606	2,375,375	1,997,116	29,483,807
2004	20,590,691	2,039,631	3,518,334	2,546,877	2,004,898	30,700,431
2005	21,467,566	1,987,171	3,684,086	2,763,625	1,981,249	31,883,697
2006	22,074,953	1,968,032	3,872,766	2,947,116	1,958,273	32,821,140
2007	23,122,698	1,878,956	3,989,893	3,096,334	1,989,690	34,077,571
2008	22,614,483	1,797,278	4,049,943	3,146,006	1,948,054	33,555,764
2009	22,659,976	1,729,984	4,094,562	3,168,728	1,924,214	33,577,464
2010	22,659,976	1,686,171	4,127,554	3,248,481	1,886,058	33,608,240
2011	23,426,940	1,664,553	4,158,572	3,285,177	1,867,208	34,402,450
2012	23,553,850	1,635,369	4,205,452	3,388,561	1,835,687	34,618,919

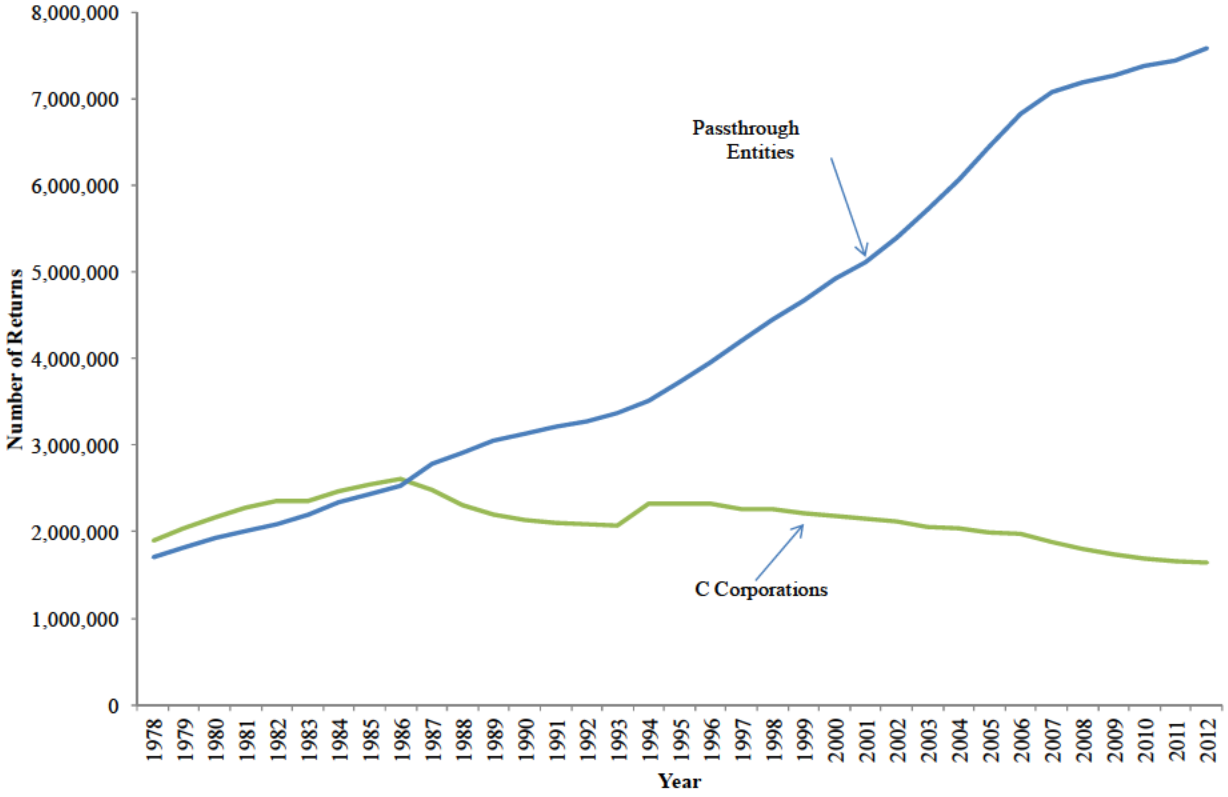
Source: Internal Revenue Service, Statistics of Income, published and unpublished data.

Business ventures organized (or reorganized) as a separate legal entity are generally taxable as a C corporation, S corporation, or partnership for Federal tax purposes. A major tax difference among them is that business ventures organized as C corporations are subject to tax at the entity level, with the owners subject to tax on subsequent distributions of income from the C corporation, while ventures organized as S corporations and partnerships are not subject to tax at the entity level. The income of S corporations and partnerships passes through to the owner or partner in whose hands it is subject to tax.

Figure 2, below, reports the trend over the past 32 years of the number of C corporation returns filed compared to the sum of S corporation and partnership returns.[69] The last year in which the number of C corporation returns exceeded the number of returns from passthrough legal entities was 1986. As Figure 2 reports, while the number of C corporations has generally declined in the United States since 1986 by a third, the number of passthrough entities has nearly tripled.

[69] The data reported in this section comparing C corporations and passthrough entities are derived from entity-level returns filed with the Internal Revenue Service. The subsequent comparisons based either on assets or gross receipts include some double counting of assets or gross receipts because these items may be passed through from passthrough entities to the returns of a C corporation partner or a partner that is itself a passthrough entity. For example, some partnerships are partnerships of C corporations, some are partnerships of other partnerships, and some are partnerships of individuals and C corporations or other partnerships.

Figure 2.–Number of C Corporation Returns Compared to the Sum of S Corporation and Partnership Returns, 1978-2012



The growth of limited liability companies

The use of the LLC as an entity is primarily a development of the past 20 years. Most LLCs elect to be taxed as partnerships for Federal reporting purposes and their numbers are counted among the partnership data reported in Table 1 and Figures 1 and 2 above. Figure 3, below, decomposes the number of partnerships for the period 1990 through 2009 into general partnerships, limited partnerships, and LLCs.[70] Figure 3 documents the rapid growth of LLCs relative to other forms of business organization that are taxed as partnerships over the past several years.[71] Since 1996, LLCs have grown at a rate of approximately 18 percent per year. In addition to reporting numbers of general partnerships, limited partnerships, and LLCs, Table 2

[70] The data in Table 2 may not sum to the total number of partnerships reported in Table 1 because of rounding. Also, this decomposition excludes those businesses that checked the "other" box on Form 1065, Schedule B, line 1. See Alan Zempel, "Partnership Returns, 1998," *SOI Bulletin*, 20, Fall 2000, and Nina Shumofsky and Lauren Lee, "Partnership Returns, 2009," *SOI Bulletin*, 31, Fall 2011.

[71] For ease of exposition, Figure 3 does not include domestic limited liability partnerships, foreign partnerships, and certain other partnerships.

provides information on the number of limited liability partnerships and foreign partnerships filing partnership returns.

Figure 3.–Domestic Partnership Returns by Type of Partnership, 1990-2012

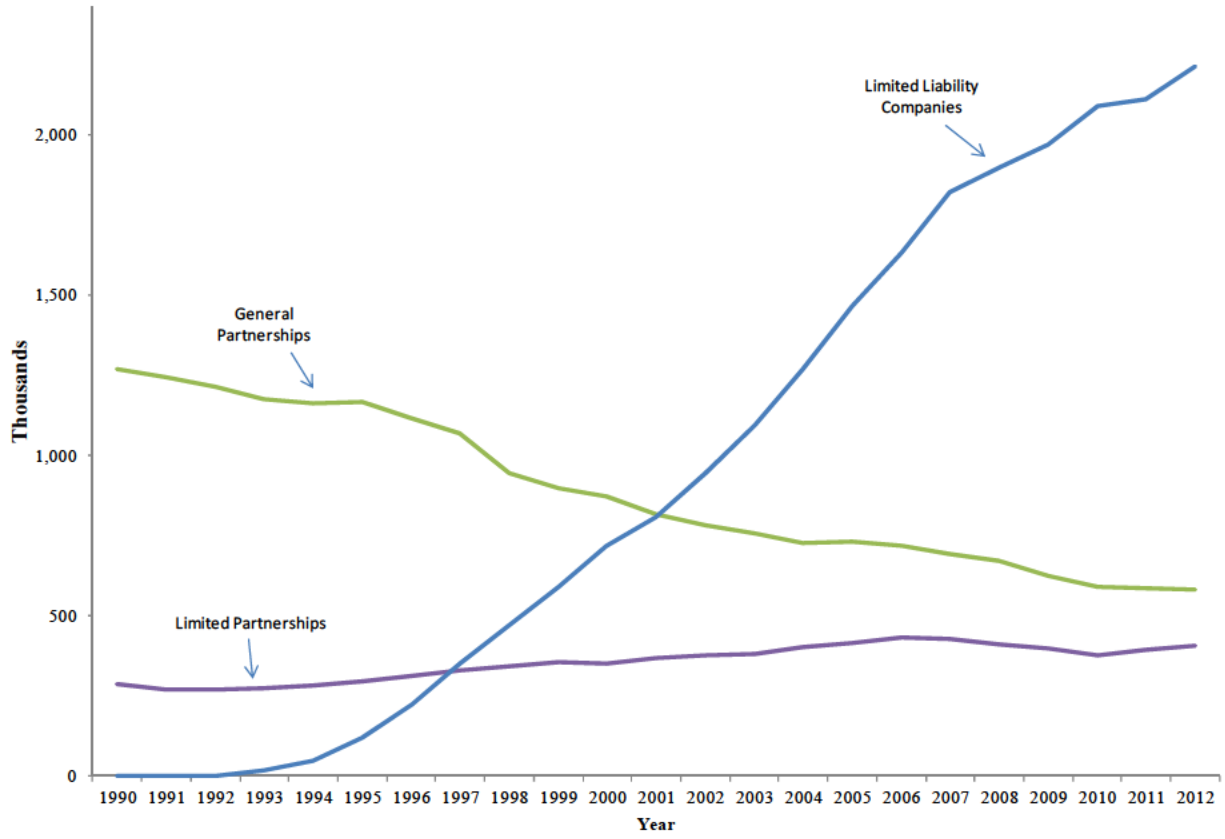


Table 2.–Number of Partnership Returns by Type, 1990-2009

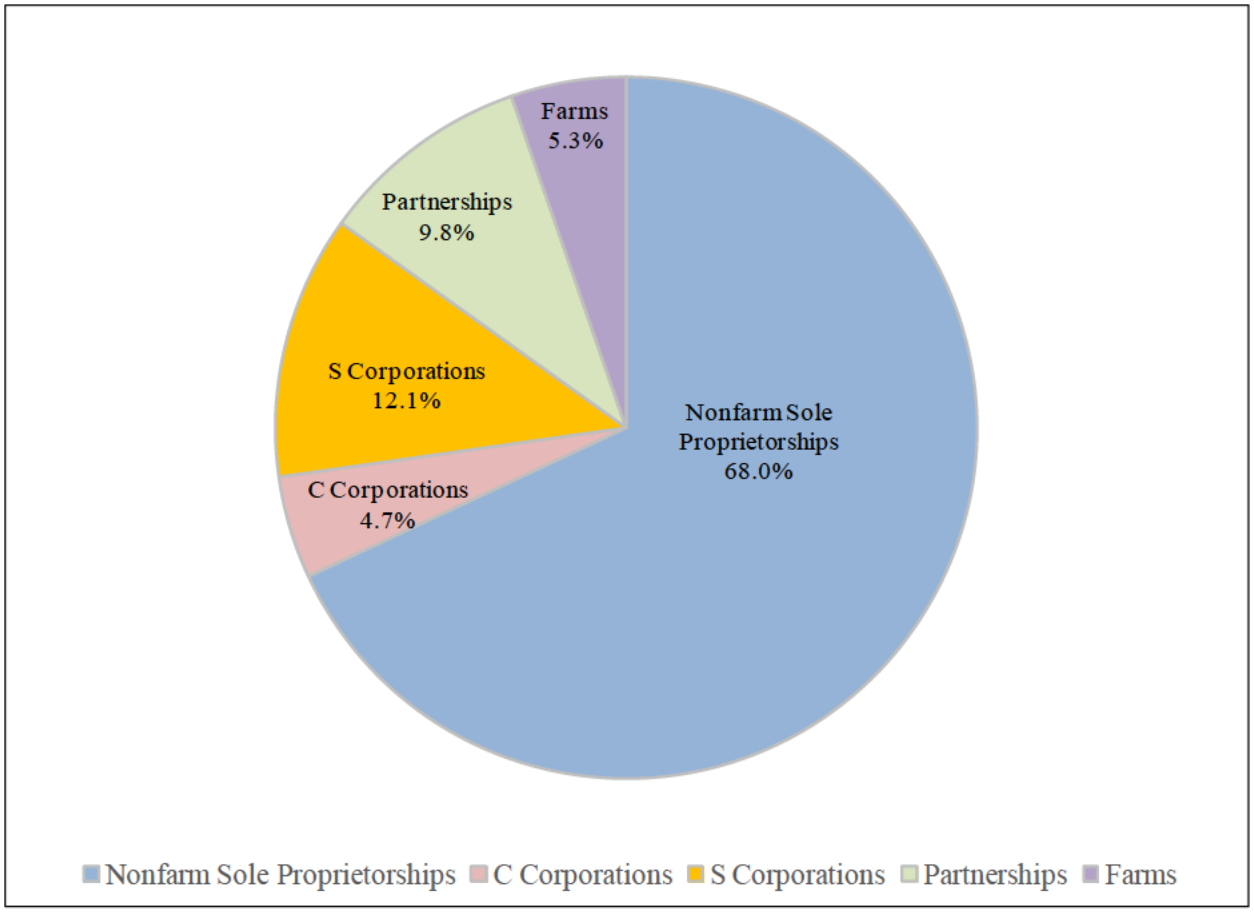
Year	Type of Partnership					
	Domestic General Partnerships (thousands)	Domestic Limited Partnerships (thousands)	Domestic Limited Liability Companies (thousands)	Domestic Limited Liability Partnerships (thousands)	Foreign Partnerships (thousands)	Other Partnerships (thousands)
1990	1,267	285	n.a.	n.a.	n.a.	n.a.
1991	1,245	271	n.a.	n.a.	n.a.	n.a.
1992	1,214	271	n.a.	n.a.	n.a.	n.a.
1993	1,176	275	17	n.a.	n.a.	n.a.
1994	1,163	283	48	n.a.	n.a.	n.a.
1995	1,167	295	119	n.a.	n.a.	n.a.
1996	1,116	311	221	n.a.	n.a.	5
1997	1,069	329	349	n.a.	n.a.	13
1998	945	343	470	26	n.a.	71
1999	898	354	589	42	n.a.	52
2000	872	349	719	53	3	61
2001	815	369	809	69	5	65
2002	780	377	946	78	3	58
2003	757	379	1,092	88	3	55
2004	725	403	1,270	89	4	56
2005	729	414	1,465	100	5	50
2006	718	433	1,630	109	7	50
2007	694	426	1,819	110	8	40
2008	670	412	1,898	122	11	33
2009	624	397	1,969	118	12	48
2010	590	375	2,090	142	13	38
2011	586	394	2,111	148	14	32
2012	583	407	2,211	129	16	43

n.a. - not available

Sources: Bill Pratt, "Partnership Returns, 2000," *SOI Bulletin*, 22, Fall 2002; Nina Shumofsky and Lauren Lee, "Partnership Returns, 2009," *SOI Bulletin*, 31, Fall 2011; and Ron DeCarlo and NinaShumofsky, "Partnership Returns, 2012," *SOI Bulletin*, 34, Winter 2015.

Figure 4 shows the fraction of business returns by type of entity for 2012. More than two-thirds of all business returns were nonfarm sole proprietorships, 12.1 percent of business returns were S corporations. Partnerships represented an all-time high of 9.8 percent of business returns. Farms and C corporations represented approximately 5 percent of returns each.

Figure 4.–Business Returns by Type of Entity, 2012



Source: JCT staff calculations on IRS Statistics of Income data.

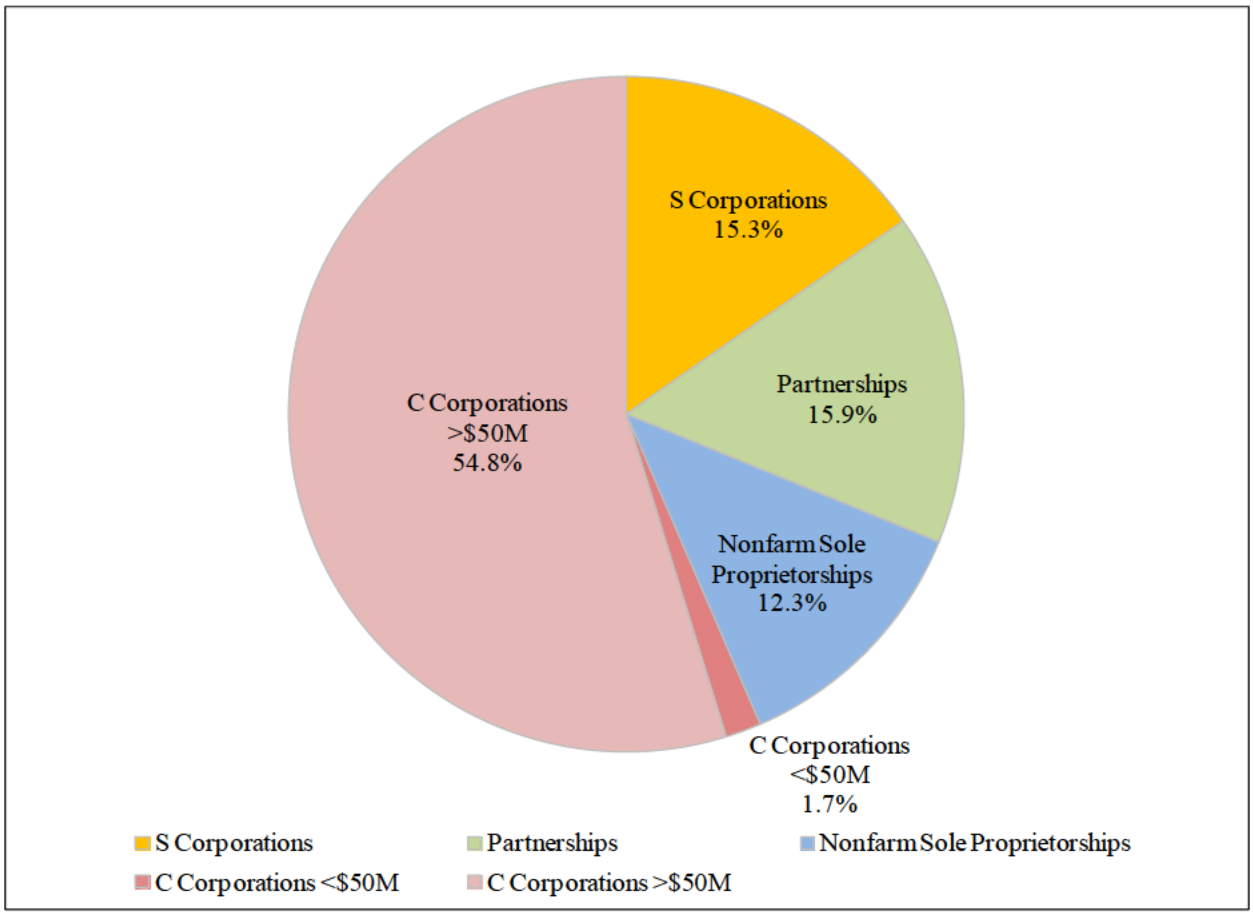
Business income by entity type

Figure 5 reports the share of business net income by entity type for 2012.[72] While the majority of business returns are filed by nonfarm sole proprietorships, such businesses represent only 12.3 percent of business net income. C corporations, though they file 4.7 percent of business returns, represent more than half of all business net income. The 1.19 percent of C corporations with gross receipts in excess of $50 million report 54.8 percent of all business net income for 2012, while the remaining 98.81 percent report 1.7 percent of all business net income. S corporations and partnerships are responsible for roughly the same share of overall

[72] The data reported in this section comparing C corporations and passthrough entities are derived from entity-level returns filed with the Internal Revenue Service. The subsequent comparisons based either on assets or gross receipts include some double counting of assets or gross receipts because these items may be passed through from passthrough entities to the returns of a C corporation partner or a partner that is itself a passthrough entity. For example, some partnerships are partnerships of C corporations, some are partnerships of other partnerships, and some are partnerships of individuals and C corporations or other partnerships.

business net income. Farm proprietorships, which represent 5.3 percent of all returns, are not shown in Figure 5 because they collectively report an overall net loss for 2012.[73]

Figure 5.–Distribution of Net Income by Business Entity Type



Source: JCT staff calculations on IRS Statistics of Income data.

Size distribution of C corporations, S corporations, partnerships, and nonfarm sole proprietorships

Present law does not impose a limit on the size of a business that is conducted in the form of a sole proprietorship, a partnership, an S corporation, or a C corporation, and there is no legal requirement of any correspondence between the size of the business and he form of business organization. While many small businesses are organized as a sole proprietorship, a partnership, or an S corporation, not all businesses organized in those forms are small, and not all businesses organized as C corporations are large. One can use SOI data on assets and total receipts to measure the size of businesses to sort out how small businesses are arrayed across the different forms of organization.

[73] Farms have collectively reported an overall net loss on Schedule F for every year since 1980.

Tables 3 through 6 display 2012 SOI data on C corporations, S corporations, entities taxed as partnerships (which category includes most LLCs), and nonfarm sole proprietorships. For the first three forms of organization, the tables classify all taxpayers using that form of organization both by the size of assets and total receipts.[74] For sole proprietorships (Table 6), there is no tax data on assets, so the table uses only total receipts as a classifier. When businesses are classified by asset size, one can see that there are a significant number of C corporations of small size. More than 750,000 C corporations have assets under $50,000, approximately 45 percent of the total number of C corporations. For S corporations, approximately one-half have assets under $50,000.

The concentration of assets differs among the three entity forms. C corporations have the largest disparity in asset holdings. Firms with over $100 million in assets, which represent approximately 1.35 percent of all C corporations, hold more than 97 percent of all assets owned by C corporations. By comparison, partnerships with $100 million or more in assets constitute 0.65 percent of all entities classified for tax purposes as partnerships; these businesses own nearly 75 percent of all assets owned by partnerships. S corporations with $100 million or more in assets constitute only 0.09 percent of all S corporations and account for less than 40 percent of all assets owned by S corporations.

When businesses are classified by total receipts, a picture emerges that is similar to that seen in the asset data. There are a substantial number of relatively small C corporations: more than 410,000 corporations report total receipts of $25,000 or less, approximately 25 percent of the total number of C corporations. About one-quarter of S corporations also report total receipts of $25,000 or less. However, across the other forms of organization there are higher percentages of businesses with small amounts of total receipts. For partnerships and nonfarm sole proprietorships, the percentage of businesses with total receipts of $25,000 or less are 72 percent and 70 percent, respectively.

As with assets, the dispersion of total receipts across the classifications is more skewed for C corporations and partnerships than for S corporations. C corporations with over $50 million in receipts, which represent approximately 1.2 percent of all C corporations, collect 90 percent of total receipts of all C corporations. For partnerships, the approximately 0.25 percent of partnerships with total receipts over $50 million report 72 percent of all partnership receipts. For S corporations, 0.37 percent of S corporations with total receipts in excess of $50 million report almost 40 percent of S corporation total receipts. For nonfarm sole proprietorships, less than 0.002 percent of such businesses report total receipts in excess of $50 million, and these businesses report less than 5 percent of all nonfarm sole proprietorship total receipts.

[74] Total receipts are used in lieu of business receipts to classify statistics for finance and insurance and management of companies (holding companies) sectors. Total receipts may be negative due to the addition of negative items (*e.g.*, net capital losses) to business receipts. Total assets may also be negative if, for example, balance sheet assets reflect depreciation of assets held in a lower tier partnership. This could occur if the balance sheet were prepared using tax accounting rather than generally accepted accounting principles. For example, a partnership may hold an interest in a lower tier partnership that in turn holds leveraged assets that have been depreciated for Federal tax purposes. The depreciated basis of the assets may be less than debt encumbering the assets. In some cases this could be reflected as a negative asset value for the underlying partnership interest.

Table 3.–Distribution of C Corporations, 2012

Firms Classified by Assets	Number of Returns	Total Assets (millions)	Cumulative Percent Returns	Cumulative Percent Total Assets
$0 or less	344,612	$0	21.07%	0.00%
$1 to $25,000	279,930	2,039	38.19%	0.00%
$25,001 to $50,000	119,774	4,064	45.51%	0.01%
$50,001 to $100,000	151,991	10,515	54.81%	0.02%
$100,001 to $250,000	215,199	34,566	67.97%	0.06%
$250,001 to $500,000	158,589	56,533	77.66%	0.13%
$500,001 to $1,000,000	126,128	89,440	85.38%	0.24%
$1,000,001 to $10,000,000	178,396	514,908	96.29%	0.88%
$10,000,001 to $50,000,000	31,301	691,202	98.20%	1.72%
$50,000,001 to $100,000,000	7,434	529,526	98.65%	2.38%
More than $100,000,000	22,016	79,425,962	100.00%	100.00%
All Assets	1,635,369	$81,358,757		

Firms Classified by Receipts	Number of Returns	Total Receipts (millions)	Cumulative Percent Returns	Cumulative Percent Total Receipts
$0 or less	209,901	-$1,169	12.84%	-0.01%
$1 to $2,500	42,551	45	15.44%	-0.01%
$2,501 to $5,000	23,201	86	16.86%	0.00%
$5,001 to $10,000	41,376	299	19.39%	0.00%
$10,001 to $25,000	94,136	1,594	25.14%	0.00%
$25,001 to $50,000	111,694	4,061	31.97%	0.02%
$50,001 to $100,000	140,882	10,310	40.59%	0.07%
$100,001 to $250,000	236,684	39,495	55.06%	0.25%
$250,001 to $500,000	185,414	66,890	66.40%	0.56%
$500,001 to $1,000,000	185,719	132,170	77.75%	1.17%
$1,000,001 to $10,000,000	294,274	886,398	95.75%	5.27%
$10,000,001 to $50,000,000	50,033	1,033,403	98.81%	10.04%
More than $50,000,000	19,504	19,469,284	100.00%	100.00%
All Receipts	1,635,369	$21,642,866		

* Details may not add to totals due to rounding.

Source: JCT staff calculations on SOI data.

Table 4.–Distribution of S Corporations, 2012

Firms Classified by Assets	Number of Returns	Total Assets (millions)	Cumulative Percent Returns	Cumulative Percent Total Assets
$0 or less	747,657	$0	17.78%	0.00%
$1 to $25,000	1,060,992	7,921	43.01%	0.22%
$25,001 to $50,000	420,370	13,896	53.00%	0.61%
$50,001 to $100,000	441,335	30,460	63.50%	1.45%
$100,001 to $250,000	585,588	92,233	77.42%	4.02%
$250,001 to $500,000	364,237	127,743	86.08%	7.58%
$500,001 to $1,000,000	244,965	171,784	91.91%	12.36%
$1,000,001 to $10,000,000	299,196	835,207	99.02%	35.60%
$10,000,001 to $50,000,000	33,504	658,977	99.82%	53.94%
$50,000,001 to $100,000,000	3,872	269,332	99.91%	61.44%
More than $100,000,000	3,737	1,385,725	100.00%	100.00%
All Assets	4,205,452	$3,593,278		

Firms Classified by Receipts	Number of Returns	Total Receipts (millions)	Cumulative Percent Returns	Cumulative Percent Total Receipts
$0 or less	563,894	-$3,420	13.41%	-0.05%
$1 to $2,500	96,155	102	15.70%	-0.05%
$2,501 to $5,000	54,793	199	17.00%	-0.05%
$5,001 to $10,000	80,031	576	18.90%	-0.04%
$10,001 to $25,000	202,996	3,431	23.73%	0.01%
$25,001 to $50,000	284,347	10,469	30.49%	0.18%
$50,001 to $100,000	415,507	30,363	40.37%	0.65%
$100,001 to $250,000	769,034	126,769	58.66%	2.61%
$250,001 to $500,000	569,970	205,296	72.21%	5.78%
$500,001 to $1,000,000	459,997	323,755	83.15%	10.79%
$1,000,001 to $10,000,000	616,617	1,710,611	97.81%	37.24%
$10,000,001 to $50,000,000	76,420	1,531,082	99.63%	60.92%
More than $50,000,000	15,690	2,527,471	100.00%	100.00%
All Receipts	4,205,452	$6,466,705		

* Details may not add to totals due to rounding.

Source: JCT staff calculations on SOI data.

Table 5.–Distribution of Partnerships, 2012

Firms Classified by Assets	Number of Returns	Total Assets (millions)	Cumulative Percent Returns	Cumulative Percent Total Assets
$0 or less	908,432	-$81,865	26.81%	-0.37%
$1 to $25,000	343,424	2,779	36.94%	-0.36%
$25,001 to $50,000	127,417	4,717	40.70%	-0.34%
$50,001 to $100,000	207,533	15,282	46.83%	-0.27%
$100,001 to $250,000	317,448	52,986	56.20%	-0.03%
$250,001 to $500,000	350,630	127,855	66.54%	0.55%
$500,001 to $1,000,000	306,011	217,800	75.57%	1.54%
$1,000,001 to $10,000,000	684,026	2,068,158	95.76%	11.48%
$10,000,001 to $50,000,000	105,756	2,178,199	98.88%	21.37%
$50,000,001 to $100,000,000	15,709	1,106,634	99.35%	26.40%
More than $100,000,000	22,174	16,322,386	100.00%	100.00%
All Assets	3,388,561	$22,014,929		

Firms Classified by Receipts	Number of Returns	Total Receipts (millions)	Cumulative Percent Returns	Cumulative Percent Total Receipts
$0 or less	2,143,161	$0	63.25%	0.00%
$1 to $2,500	63,031	65	65.11%	0.00%
$2,501 to $5,000	39,260	142	66.27%	0.00%
$5,001 to $10,000	56,283	415	67.93%	0.01%
$10,001 to $25,000	130,944	2,205	71.79%	0.06%
$25,001 to $50,000	100,183	3,665	74.75%	0.14%
$50,001 to $100,000	141,807	10,212	78.93%	0.35%
$100,001 to $250,000	210,177	34,305	85.13%	1.07%
$250,001 to $500,000	140,004	50,915	89.27%	2.14%
$500,001 to $1,000,000	126,895	90,707	93.01%	4.04%
$1,000,001 to $10,000,000	198,992	584,107	98.88%	16.31%
$10,000,001 to $50,000,000	28,789	597,322	99.73%	28.84%
More than $50,000,000	9,036	3,389,677	100.00%	100.00%
All Receipts	3,388,561	$4,763,737		

* Details may not add to totals due to rounding.
Source: JCT staff calculations on SOI data.

Table 6.–Distribution of Nonfarm Sole Proprietorships, 2012

Firms Classified by Receipts	Number of Returns	Total Receipts (millions)	Returns	Total Receipts
$0 or less	1,200,399	$0	5.10%	0.00%
$1 to $2,500	4,508,328	5,262	24.24%	0.41%
$2,501 to $5,000	2,429,305	8,792	34.55%	1.09%
$5,001 to $10,000	3,187,588	23,308	48.08%	2.90%
$10,001 to $25,000	5,213,449	83,411	70.22%	9.38%
$25,001 to $50,000	2,800,354	99,110	82.11%	17.07%
$50,001 to $100,000	1,872,758	132,510	90.06%	27.36%
$100,001 to $250,000	1,477,496	229,532	96.33%	45.18%
$250,001 to $500,000	499,008	173,326	98.45%	58.63%
$500,001 to $1,000,000	232,476	156,960	99.44%	70.82%
$1,000,001 to $10,000,000	129,114	273,420	99.98%	92.04%
$10,000,001 to $50,000,000	3,259	58,119	100.00%[1]	96.56%
More than $50,000,000	316	44,355	100.00%	100.00%
All Receipts	23,553,850	$1,288,105		

* Details may not add to totals due to rounding.

[1] The actual figure is 99.9987 percent which rounds to 100.00 percent.

Distribution of C corporations, S corporations, and partnerships by primary business activity

Taxpayers filing returns as C corporations, S corporations, and partnerships are asked to self-report the primary industry in which the business operates. Table 7, below, reports the distribution of entities by number of returns and by assets across various industry classifications. Distributing by number of returns, for C corporations, the three most prevalent industries are services, retail trade, and construction. These three industries account for approximately 33 percent of all C corporations. For S corporations, the three most prevalent industries are services, construction, and real estate. These three industries account for approximately 41 percent of all S corporations. For entities taxed as partnerships, the three most prevalent industries are real estate, finance and insurance, and services. These three industries account for approximately 64 percent of all partnerships.

Distributing by assets, for C corporations, the three largest industries are finance and insurance, holding companies, and manufacturing. These three industries account for more than 83 percent of all assets reported by all C corporations. For S corporations, the three largest industries are holding companies, construction, and manufacturing. These three industries account for 37 percent of all assets reported by all S corporations. For partnerships, the two largest industries by far are finance and insurance and real estate, followed by manufacturing at a distant third. These three industries account for more than 81 percent of all assets reported on all partnership returns.

Table 7.–Distribution of Certain Business Entities and Assets by Industry, 2009

Industry	C Corporations		S Corporations		Partnerships	
	Percent of Returns	Percent of Total Assets	Percent of Returns	Percent of Total Assets	Percent of Returns	Percent of Total Assets
Agriculture	3.00	0.08	2.10	2.31	4.46	0.94
Mining	0.82	1.35	0.61	1.80	0.95	2.27
Utilities	0.19	2.10	0.08	0.15	0.09	1.37
Construction	9.20	0.35	12.76	9.54	4.74	0.84
Manufacturing	5.48	14.22	3.75	11.62	1.98	3.48
Wholesale Trade	8.62	2.64	5.86	10.98	1.89	1.04
Retail Trade	9.91	1.68	9.71	10.32	4.68	0.76
Wholesale and Retail Trade Not Allocable						
Transportation and Warehousing	4.20	0.78	3.39	2.60	1.23	1.98
Information	2.74	3.09	1.77	1.72	1.13	3.01
Finance and Insurance	5.26	51.42	3.78	10.97	9.04	55.20
Real Estate and Rental and Leasing	10.82	1.71	11.06	9.89	49.11	22.50
Professional, Scientific, and Technical Services	12.20	1.02	16.48	4.29	6.89	1.03
Holding Companies	1.60	18.15	0.63	14.29	0.83	2.89
Administrative and Support and Waste Management and Remediation Services	4.39	0.33	4.64	1.91	2.07	0.35
Educational Services	0.91	0.05	0.99	0.33	0.42	0.02
Health Care and Social Services	6.73	0.36	8.13	2.16	2.47	0.65
Arts, Entertainment, and Recreation	2.02	0.09	2.15	1.00	1.95	0.49
Accommodation and Food Services	4.54	0.46	5.43	2.93	3.65	1.09
Other Services	7.32	0.10	6.38	1.19	2.41	0.09
Not Allocable	0.03	0.00	0.00	0.00	0.00	0.00
Total[1]	1,635,369	$72,724,918	4,205,452	$3,240,101	3,388,561	$22,014,929

[1] The totals show the actual numbers of returns in the 'Percent of Returns' columns and the total assets in millions of dollars for the 'Percent of Total Assets' columns.

* Details may not add to 100 percent due to rounding.

Distribution of income by entity type and entity size

On average, in any given year, relatively smaller businesses are more likely to operate at a loss. Tables 8 and 9, below, classify businesses by size of their reported total receipts. The tables report the aggregate income, or loss, reported within a class by entity type. Tables 8a and 8b report results for S corporations, partnerships, and sole proprietorships, while Tables 9a and 9b report results for C corporations. Tables 8 and 9 are not directly comparable because the net income of C corporations may include investment income (*e.g.*, interest income) while S corporations and partnership returns generally provide that investment income be reported separately on the owner's or partner's individual income tax return. Similarly, investment income of the owner of a sole proprietorship is not reported as part of schedule C of Form 1040.

Table 8a reports that in 2012, on average, S corporations and partnerships reporting $50,000 or fewer in total receipts operated at a loss. Consistent with these data, Table 8b reports that among S corporations and partnerships reporting $25,000 or fewer in total receipts, more than 50 percent of such entities operated at a loss in 2012. Nonfarm sole proprietorships more consistently reported profits at all size classes but the very smallest, those with $5,000 or fewer in total receipts.

Tables 9a and 9b report similar results for C corporations. Overall, 45 percent of all C corporations reported net operating losses in 2012. For C corporations reporting $25,000 or fewer in total receipts, 50 percent or more reported net operating losses in 2012. In contrast to comparably sized S corporations and partnerships, 29 to 41 percent of C corporations reporting total receipts between $100,000 and $10 million reported net operating losses, and the losses were of sufficient magnitude that aggregate C corporate income in those size categories was a loss. Less than one quarter of the largest C corporations reported losses.

Table 8a.–Distribution of Net Income by Gross Receipts and Entity Type, 2012

	Net Income (millions of dollars)		
Firms Classified by Receipts	**S Corporations**	**Partnerships**	**Nonfarm Sole Proprietorships**
$0 or less	-$2,066	$36,588	-$4,038
$1 to $2,500	-812	-825	-6,644
$2,501 to $5,000	-296	-436	-202
$5,001 to $10,000	-390	-726	7,766
$10,001 to $25,000	-710	-2,053	39,969
$25,001 to $50,000	15	-1,787	39,926
$50,001 to $100,000	4,280	-543	49,228
$100,001 to $250,000	16,610	630	68,945
$250,001 to $500,000	20,300	3,125	42,819
$500,001 to $1,000,000	27,617	3,249	30,843
$1,000,001 to $10,000,000	117,477	45,222	31,338
$10,000,001 to $50,000,000	85,217	42,337	3,264
More than $50,000,000	111,114	267,448	1,682
All Receipts	$378,357	$392,228	$304,896

Table 8b.–Percent of Firms with a Net Operating Loss by Gross Receipts and Entity Type, 2012

Firms Classified by Receipts	**S Corporations**	**Partnerships**	**Nonfarm Sole Proprietorships**
$0 or less	54	25	81
$1 to $2,500	79	66	40
$2,501 to $5,000	69	64	30
$5,001 to $10,000	51	62	21
$10,001 to $25,000	47	46	12
$25,001 to $50,000	35	37	10
$50,001 to $100,000	26	39	9
$100,001 to $250,000	23	35	10
$250,001 to $500,000	19	31	10
$500,001 to $1,000,000	19	35	9
$1,000,001 to $10,000,000	15	25	14
$10,000,001 to $50,000,000	12	23	23
More than $50,000,000	31	21	37
All Receipts	31	30	23

* Details may not add to totals due to rounding.
Source: JCT staff calculations on SOI data.

Table 9a.–Distribution of Net Income by Gross Receipts of C Corporations, 2012

Firms Classified by Receipts	Net Income (millions of dollars)
$0 or less	$13,525
$1 to $2,500	-2,147
$2,501 to $5,000	-649
$5,001 to $10,000	-1,129
$10,001 to $25,000	-1,619
$25,001 to $50,000	-1,452
$50,001 to $100,000	-1,849
$100,001 to $250,000	-2,472
$250,001 to $500,000	-2,991
$500,001 to $1,000,000	-1,952
$1,000,001 to $10,000,000	4,318
$10,000,001 to $50,000,000	40,540
More than $50,000,000	1,353,793
All Receipts	$1,395,916

Table 9b.–Percent of C Corporations with a Net Operating Loss by Gross Receipts, 2012

Firms Classified by Receipts	C Corporations
$0 or less	74
$1 to $2,500	66
$2,501 to $5,000	55
$5,001 to $10,000	63
$10,001 to $25,000	52
$25,001 to $50,000	47
$50,001 to $100,000	48
$100,001 to $250,000	41
$250,001 to $500,000	40
$500,001 to $1,000,000	34
$1,000,001 to $10,000,000	29
$10,000,001 to $50,000,000	24
More than $50,000,000	24
All Receipts	45

* Details may not add to totals due to rounding.
Source: JCT staff calculations on SOI data.

B. Comparison of U.S. and International Tax Rates

The gradual decline in statutory corporate income tax rates throughout the OECD is illustrated in Table 10, below, which details the top combined statutory corporate income tax rates in the OECD from 2005 to 2015 and reflects tax rates set by central governments as well as sub-central governments and accounts for some (but not always all) surtaxes and deductions.[75]

For each year, the cell corresponding to the country with the highest tax rate is shaded pink, while the cell associated with the country with the lowest tax rate is shaded blue. There has been a steady, downward trend in statutory corporate tax rates in OECD countries besides the United States. From 2005 to 2015, the median combined statutory corporate income tax rate fell from 30 percent to 25 percent. Moreover, in 2015, the United States currently had the highest combined statutory corporate income tax rate (39.0 percent) among OECD countries, while Ireland had the lowest (12.5 percent).

[75] See OECD, *OECD Tax Database Explanatory Annex Part II: Taxation of Corporate and Capital Income*, September 2015, available at http://www.oecd.org/ctp/tax-policy/Corporate-and-Capital-Income-Tax-Rates-Explanatory-Annex-Sept-2015.pdf. For the United States, the combined statutory corporate tax rate of 39.0 percent equals the (top) federal corporate income tax rate of 35.0 percent minus 2.15 percent (to account for the section 199 and the deductibility of state corporate income taxes) plus a weighted average state corporate income tax rate of 6.15 percent. The weighted average rate equals the sum of the top corporate income tax rate for each state multiplied by the state's share in personal income. The OECD weighting methodology is not consistent across countries.

Table 10.−Top Combined Statutory Corporate Income Tax Rates in the OECD (Central and Sub-Central Governments): 2005-2015

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Australia	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0
Austria	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0
Belgium	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0	34.0
Canada	34.2	33.9	34.0	31.4	31.0	29.4	27.6	26.1	26.3	26.3	26.3
Chile	17.0	17.0	17.0	17.0	17.0	17.0	20.0	20.0	20.0	20.0	22.5
Czech Republic	26.0	24.0	24.0	21.0	20.0	19.0	19.0	19.0	19.0	19.0	19.0
Denmark	28.0	28.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	24.5	23.5
Estonia	24.0	23.0	22.0	21.0	21.0	21.0	21.0	21.0	21.0	21.0	20.0
Finland	26.0	26.0	26.0	26.0	26.0	26.0	26.0	24.5	24.5	20.0	20.0
France	35.0	34.4	34.4	34.4	34.4	34.4	34.4	34.4	34.4	34.4	34.4
Germany	38.9	38.9	38.9	30.2	30.2	30.2	30.2	30.2	30.2	30.2	30.2
Greece	32.0	29.0	25.0	25.0	25.0	24.0	20.0	20.0	26.0	26.0	26.0
Hungary	16.0	17.3	20.0	20.0	20.0	19.0	19.0	19.0	19.0	19.0	19.0
Iceland	18.0	18.0	18.0	15.0	15.0	18.0	20.0	20.0	20.0	20.0	20.0
Ireland	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5
Israel	34.0	31.0	29.0	27.0	26.0	25.0	24.0	25.0	25.0	26.5	26.5
Italy	33.0	33.0	33.0	27.5	27.5	27.5	27.5	27.5	27.5	27.5	27.5
Japan	39.5	39.5	39.5	39.5	39.5	39.5	39.5	39.5	37.0	37.0	32.1
Korea	27.5	27.5	27.5	27.5	24.2	24.2	24.2	24.2	24.2	24.2	24.2
Luxembourg	30.4	29.6	29.6	29.6	28.6	28.6	28.8	28.8	29.2	29.2	29.2
Mexico	30.0	29.0	28.0	28.0	28.0	30.0	30.0	30.0	30.0	30.0	30.0
Netherlands	31.5	29.6	25.5	25.5	25.5	25.5	25.0	25.0	25.0	25.0	25.0
New Zealand	33.0	33.0	33.0	30.0	30.0	30.0	28.0	28.0	28.0	28.0	28.0
Norway	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0	27.0	27.0
Poland	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0
Portugal	27.5	27.5	26.5	26.5	26.5	26.5	28.5	31.5	31.5	31.5	29.5
Slovak Republic	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0	23.0	22.0	22.0
Slovenia	25.0	25.0	23.0	22.0	21.0	20.0	20.0	20.0	17.0	17.0	17.0
Spain	35.0	35.0	32.5	30.0	30.0	30.0	30.0	30.0	30.0	30.0	28.0
Sweden	28.0	28.0	28.0	28.0	26.3	26.3	26.3	26.3	22.0	22.0	22.0
Switzerland	21.3	21.3	21.3	21.2	21.2	21.2	21.2	21.2	21.1	21.1	21.2
Turkey	30.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
United Kingdom	30.0	30.0	30.0	28.0	28.0	28.0	26.0	24.0	23.0	21.0	20.0
United States	39.3	39.3	39.3	39.3	39.1	39.2	39.2	39.1	39.1	39.1	39.0
OECD Median	29.0	28.0	27.0	26.8	26.0	25.8	25.5	25.0	25.0	25.0	25.0

Source: OECD Tax Database.

III. PROPOSALS FOR BUSINESS TAX REFORM

Over the past several years, the Administration, members of Congress, commissions, and others have presented to policymakers a number of proposals to reform the Federal tax system. Some proposals maintain the basic structure of income taxation, while others offer a structural change in income taxation (*e.g.*, corporate integration), and some are more accurately characterized as consumption-based taxes. Below are brief summaries of several selected proposals, proceeding from income-based proposals to consumption-based proposals.

A. President's Framework for Business Tax Reform

The President's fiscal year 2017 budget proposal, as submitted to the Congress on February 9, 2016 (the "President's proposal"),[76] includes a framework for business tax reform, with provisions expanding tax benefits for small business, as well as provisions relating to tax rules in the areas of manufacturing, research, energy, bonds, financial and insurance businesses, tax accounting, among many others. The President's proposal also includes additional revenue raising and simplification provisions.

Specific provisions of the President's proposal include reducing the maximum corporate tax rate from 35 percent to 28 percent, and repealing the corporate AMT.

The President's proposal includes provisions that broaden the Federal tax base by repealing a number of corporate tax expenditures such as the credit for enhanced oil recovery costs, the credit for producing oil and gas from marginal wells, the expensing of exploration and developments for oil, gas and other fuels, the percentage of depletion method of accounting for hard mineral fossil fuels, the deduction for income attributable to domestic production activities related to the production of coal and other hard mineral fossil fuels, and the exceptions for publicly traded partnerships with qualified income from certain energy-related activities, just to name a few. Additional base-broadening provisions include repealing various methods of accounting for inventories such as the LIFO, lower-of-cost-or-market ("LCM"), and subnormal goods[77] methods; and modifying other provisions such as limiting the amount of capital gain deferred on the exchange of like-kind property to $1,000,000 (indexed for inflation) per taxpayer per taxable year,[78] and increasing the recovery period for general aviation passenger aircraft from

[76] See Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2017: Analytical Perspectives* (H. Doc. 114-86, Vol. III), February 9, 2016. For estimated revenue effects of the various provisions, see Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2017 Budget Proposal* (JCX-15-16), March 24, 2016.

[77] Under the LCM method, the value of ending inventory is written down if its market value is less than its cost. Additionally, subnormal goods, defined as goods that are unusable at normal prices or in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or similar causes, may be written down to bona fide net selling price, under either the cost or LCM method.

[78] In addition, art and collectibles would no longer be eligible for like-kind exchange treatment under section 1031.

five to seven years under MACRS (from six to twelve years under the alternative depreciation system).

With respect to small business, the President's proposal (among other things) increases the section 179 expensing limitation from $500,000 to $1,000,000 (indexed for inflation),[79] expands the universe of taxpayers that may use the cash method of accounting,[80] and expands the exception for small taxpayers from the uniform capitalization rules.[81]

With respect to research, the President's proposal repeals the traditional 20 percent research credit calculation method. In addition, the proposal increases the rate of the alternative simplified credit from 14 percent to 18 percent (*i.e.*, the research credit is equal to 18 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years), but does not reduce such rate if a taxpayer has no qualified research expenses in any one of the three preceding taxable years. The proposal also allows the research credit to offset AMT liability, and changes the special rules in the research credit to allow, in certain cases, for contract research expenses to include 75 (instead of 65) percent of payments to qualified nonprofit organizations (*e.g.*, educations institutions).

[79] The President's proposal does not change the present law $2,000,000 limitation on the cost of qualifying property that may be placed in service during the year. See section 179(b)(2).

[80] Under the President's proposal, the cash method of accounting may be used by taxpayers other than tax shelters that satisfy an increased $25 million (indexed for inflation) average annual gross receipts test (the "$25 million gross receipts test"), regardless of whether the purchase, production, or sale of merchandise is an income-producing factor. The proposal also eliminates the exceptions from the required use of the accrual method for farming C corporations such that farming C corporations will be precluded from using the cash method unless they meet the $25 million gross receipts test.

[81] Under the President's proposal, a taxpayer that meets the $25 million gross receipts test is exempted from the application of section 263A.

B. Reform that Maintains the Basic Structure of Income Taxation

Some proposals undertake comprehensive tax reform by broadening the base, lowering tax rates, and maintaining parity between corporate and passthrough entities.

1. Base broadening to lower rates

Various business tax reform options have been proposed with the intent of broadening the base and lowering tax rates. One of the issues that is often addressed in this context is the treatment of cost recovery. Cost recovery refers to the process by which a taxpayer recoups the cost of its investment in business or other income-producing property. Examples of cost recovery methods include straight-line depreciation, accelerated depreciation, and expensing, the latter two of which may be used as a tax policy tool to encourage investment. As discussed below, the repeal or modification of accelerated depreciation provisions is common to many recent proposals that include the lowering of corporate tax rates, as are changes to expensing provisions (*e.g.*, research and advertising).

The Senate Committee on Finance Chairman's Staff Discussion Draft to Reform Certain Business Options - Pooled Asset Cost Recovery System and Depreciation of Real Property

On November 21, 2013, Ambassador Baucus (the then Senate Finance Committee Chairman) released a discussion draft to reform certain business provisions (the "Baucus Plan").[82] The Baucus Plan repeals present-law depreciation rules under section 168 and replaces such rules with a pooling cost recovery system for "pooled property" (*i.e.*, most tangible property and computer software) and a straight-line cost recovery system for "straight-line property" (*i.e.*, real property and personal-use passenger automobiles) (collectively, "section 168 property").[83]

Pooled property

In the case of pooled property, costs are recovered by multiplying the applicable recovery rate for each pool by the associated pool balance at year-end. "Pooled property" is defined as any tangible property (other than any personal-use passenger automobile) and any computer software[84] assigned to any one of the four pools.[85] The applicable recovery rates for the four

[82] MCG13833, available at http://www.finance.senate.gov/imo/media/doc/Chairman's Staff Discussion Draft on Cost Recovery and Accounting Language.pdf. See also, Joint Committee on Taxation, *Technical Explanation of the Senate Committee on Finance Chairman's Staff Discussion Draft to Reform Certain Business Options* (JCX-19-13), November 21, 2013.

[83] The term "section 168 property" does not include motion picture films, video tapes, or sound recordings. "Sound recordings" are any works resulting from the fixation of a series of musical, spoken, or other sounds, regardless of the nature of the material (*e.g.*, discs, tapes, or other phonorecordings) in which such sounds are embodied.

[84] As defined in section 197(e)(3)(B) that is not an amortizable section 197 intangible.

[85] For a description of pooled property by pool, see Joint Committee on Taxation, *Technical Explanation of the Senate Committee on Finance Chairman's Staff Discussion Draft to Reform Certain Business Options*

pools are 38 percent for pool one, 18 percent for pool two, 12 percent for pool three, and five percent for pool four.

To determine an asset pool balance as of the close of the taxable year, a taxpayer generally must take into account additions to and subtractions from the pool as well as any depreciation deduction or negative pool balance adjustment. In general, pool balances that are less than zero at year-end ("negative pool balances") give rise to section 1245 gain.[86] The amount of section 1245 gain recognized is added to the pool balance to restore such pool balance to zero. Similarly, if there are no assets remaining in a pool at year-end, any positive year-end balance in the pool may be deducted as a terminal loss with respect to that pool. Additionally, a taxpayer may deduct any pool balance at year-end of $1,000 or less ("*de minimis* balance"). Any amount deducted as a terminal loss or *de minimis* balance with respect to a pool is an ordinary loss and is subtracted from the pool balance to restore the taxpayer's pool balance to zero for the subsequent year's calculation.

Special rules are provided for pooled property disposed of or transferred to a related person or to a tax shelter, as well as for sale-lease-back transactions (*i.e.*, transactions where the taxpayer continues to use pooled property after its disposition).

Straight-line property

In the case of straight-line property, costs are recovered ratably (without regard to salvage value) over the applicable recovery period, beginning with the midpoint of the month in which the asset is placed in service. "Straight-line property" is comprised of tangible property classified as real property[87] and any personal-use automobile.[88] The applicable recovery period

(JCX-19-13), November 21, 2013. In general, the classification is based on the asset class categorization provided in Rev. Proc. 87-56, 1987-2 C.B. 674, as amended. The assignment of asset classes based on the categorization provided in Rev. Proc. 87-56 is not intended to disrupt IRS guidance (*e.g.*, Rev. Proc. 2011-22, 2011 I.R.B. 737). Assets used predominantly outside the United States ("foreign assets") must be pooled separately from assets used predominantly inside the United States ("domestic assets") (*e.g.*, a trade or business with both foreign assets and domestic assets may have two of each pool). The Baucus Plan grants the Secretary authority to issue guidance to: (1) reclassify assets (or categories of assets) as real property or as pooled property; (2) reclassify assets (or categories of assets) to different pools; and (3) modify asset classes described in Rev. Proc. 87-56 or create new categories of assets.

[86] For a discussion of section 1245 gain, see Section 12 of the Baucus Plan, Rules related to treatment of gains from depreciable property.

[87] "Real property" is defined as (1) any residential rental property (as defined in section 168(e)(2)(A) prior to the enactment of the Baucus Plan); (2) any nonresidential real property (as defined in section 168(e)(2)(B) prior to the enactment of the Baucus Plan); (3) any qualified second generation biofuel plant property (as defined in section 168(l) prior to enactment of the Baucus Plan); and any asset treated under Rev. Proc. 87-56 as belonging to one of the real property asset classes delineated in the Baucus Plan.

[88] A "personal-use passenger automobile" is defined as any passenger automobile that is used for business less than 100 percent of the time. A passenger automobile for this purpose is any four-wheeled vehicle that is (1) manufactured primarily for use on public streets, roads, and highways and (2) rated at 6,000 pounds unloaded gross vehicle weight or less. In the case of a truck or van, "gross vehicle weight" is replaced with "unloaded gross vehicle

is 43 years for real property and five years for personal-use passenger automobiles. The amount of depreciation with respect to any personal-use passenger automobile may not exceed $45,000 in total.[89] A transition rule is provided for straight-line property placed in service prior to the effective date of the Baucus Plan.

Tax Reform Act of 2014

On December 10, 2014, Mr. Camp (the then House Ways and Means Committee Chairman) introduced the "Tax Reform Act of 2014" (the "Camp Plan").[90]

Reform of Accelerated Cost Recovery System

Under the Camp Plan, the depreciation method for tangible property is the straight line method and the applicable recovery period generally is the class life of the property.[91] A recovery period is specifically assigned for certain property.[92] Under the Camp Plan, the Secretary is required to develop a schedule of class lives for all tangible property, except for property with a recovery period that was specifically assigned. One year following the delivery of the schedule of class lives, the revised class lives will take effect, replacing Rev. Proc. 87-56.

The Camp Plan provides an election for taxpayers to increase their depreciation deductions to take into account inflation. The election is made annually and applies to all property (except for specified property used outside the United States, real property, water treatment and utility property, and any clearing and grading land improvements or tunnel bore)

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weight." Excluded from the definition of a passenger automobile is (1) any ambulance, hearse, or combination ambulance-hearse used by the taxpayer directly in their trade or business and (2) any vehicle used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire.

[89] The $45,000 limitation is provided in section 13 of the Baucus Plan, Limitation on depreciation of personal use passenger automobiles, modifying section 280F.

[90] See section 3104 of H.R. 1 (113th Cong.), introduced December 10, 2014. See also, Joint Committee on Taxation, *Technical Explanation, Estimated Revenue Effects, Distribution Analysis, And Macroeconomic Analysis Of The Tax Reform Act Of 2014, A Discussion Draft Of The Chairman Of The House Committee On Ways And Means To Reform The Internal Revenue Code* (JCS-1-14), November 18, 2014.

[91] See, *e.g.*, Rev. Proc. 87-56, 1987-2 C.B. 674, for class lives of certain property.

[92] Specifically, the Camp Plan assigns recovery periods for the following property: property with no class life (12 years); any race horse, and any horse other than a race horse that is more than 12 years old at the time it is placed in service (3 years); semi-conductor manufacturing equipment (5 years); qualified technological equipment (5 years); automobile or light general purpose truck (5 years); qualified rent-to-own property (9 years); certain telephone switching equipment (9.5 years); railroad track (10 years); smart electric distribution property (10 years); airplanes (12 years) (while the Camp Plan increases the recovery period for fixed wing aircraft from six years to 12 years, the recovery period for helicopters remains unchanged from present law (*i.e.*, remains the 6-year class life)); natural gas gathering line (14 years); tree or vine bearing fruit or nuts (20 years); telephone distribution plant (24 years); real property, including nonresidential real property and residential rental property (40 years); water treatment and utility property (50 years); clearing and grading improvements, and tunnel bore (50 years); and tax-exempt use property subject to lease (recovery period shall be no less than 125 percent of the lease term).

placed in service during such taxable year.[93] With respect to property for which an election has been made, the taxpayer increases the depreciation deductions associated with such property by applying an inflation adjustment percentage to the modified adjusted basis of such property.[94] The term "modified adjusted basis" means the taxpayer's adjusted basis in such property determined as if the inflation adjustment[95] had not been applied. The overall depreciation allowance (including the inflation adjustment) for a taxable year with respect to any property may not exceed such property's adjusted basis as of the beginning of such taxable year.[96]

The Camp Plan also provides normalization rules for public utility property and excess deferred tax reserves resulting from the reduction of corporate income tax rates[97] (with respect to prior depreciation or recovery allowances taken on assets placed in service before the date of enactment).

Amortization of research and experimental expenditures[98]

Under the Camp Plan, amounts defined as specified research or experimental expenditures (including expenditures for software development) are required to be capitalized and amortized over a five-year period, beginning with the midpoint of the taxable year in which the specified research or experimental expenditures were paid or incurred. Specified research or experimental expenditures which are attributable to research that is conducted outside of the United States[99] are required to be capitalized and amortized over a period of 15 years, beginning with the midpoint of the taxable year in which such expenditures were paid or incurred. A

[93] Once elected, the taxpayer is required to apply the inflation adjustment percentage to such property for all subsequent taxable years.

[94] The increase for the first taxable year is reduced to take into account the placed in service convention applicable to the property (*i.e.*, reduced by one-eighth for property subject to the mid-quarter convention, and reduced by one-half for all other property).

[95] The term "inflation adjustment percentage" means the cost-of-living adjustment for such calendar year, which is the percentage (if any) by which the Chained Consumer Price Index for all Urban Consumers ("C-CPI-U") for the preceding calendar year exceeds the C-CPI-U for the second preceding calendar year. For the indexing tax provisions for inflation, see section 1001 of the Camp Plan, Simplification of individual income tax rates.

[96] For a table illustrating the depreciation for an asset with and without the election to apply the inflation adjustment, see Joint Committee on Taxation, *Technical Explanation, Estimated Revenue Effects, Distribution Analysis, And Macroeconomic Analysis Of The Tax Reform Act Of 2014, A Discussion Draft Of The Chairman Of The House Committee On Ways And Means To Reform The Internal Revenue Code* (JCS-1-14), November 18, 2014.

[97] The Camp Plan reduces the maximum corporate income tax rate from 35 percent to 25 percent.

[98] See section 3108 of H.R. 1 (113th Cong.), introduced December 10, 2014, by then Chairman Dave Camp. See also, Joint Committee on Taxation, *Technical Explanation, Estimated Revenue Effects, Distribution Analysis, And Macroeconomic Analysis Of The Tax Reform Act Of 2014, A Discussion Draft Of The Chairman Of The House Committee On Ways And Means To Reform The Internal Revenue Code* (JCS-1-14), November 18, 2014.

[99] For this purposes, the term "United States" includes the United States, the Commonwealth of Puerto Rico, and any possession of the United States.

transition rule is provided for domestic research or experimental expenditures[100] paid or incurred during any taxable year beginning before 2021.

In the case of retired, abandoned, or disposed property with respect to which specified research or experimental expenditures are paid or incurred, the remaining basis may not be recovered in the year of retirement, abandonment, or disposal, but instead must continue to be amortized over the remaining amortization period.

As a conforming amendment to the repeal of the alternative minimum tax,[101] taxpayers may no longer elect to amortize their research expenditures over a period of 10 years.

Amortization of certain advertising expenses[102]

Under the Camp Plan, a taxpayer must capitalize and amortize 50 percent of its specified advertising expenses over a 10-year period, beginning with the midpoint of the tax year in which the expenses are paid or incurred. The remaining 50 percent of a taxpayer's specified advertising expenses may continue to be deducted in the year paid or incurred (as under present law). A transition rule is provided for specified advertising expenses paid or incurred during any taxable year beginning before 2018.

The Camp Plan provides an exemption from the capitalization requirement for taxpayers with advertising expenses for the taxable year of $1 million or less. However, if the taxpayer's otherwise deductible advertising expenses for any taxable year exceed $1.5 million, the $1 million amount is reduced (but not below zero) by twice such excess amount. The $1 million and $1.5 million amounts are adjusted for inflation in taxable years beginning after 2015.

A "specified advertising expense" is defined as any amount paid or incurred for the development, production, or placement (including any form of transmission, broadcast, publication, display, or distribution) of any communication to the general public (or portions thereof) which is intended to promote the taxpayer or a trade of business of the taxpayer, including any service, facility, or product provided as part of such trade or business. Specified advertising expense includes only deductions that would (but for this section) be deductible by the taxpayer for the taxable year under other provisions of the Code. Thus, the determination of amounts that are capitalizable under section 263 or other Code sections is not affected by the Camp Plan.

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[100] Domestic research or experimental expenditures are specified research or experimental expenditures which are attributable to research that is not conducted outside of the United States.

[101] See section 2001 of the Camp Plan, Repeal of alternative minimum tax.

[102] See section 3110 of H.R. 1 (113th Cong.), introduced December 10, 2014, by then Chairman Dave Camp. See also, Joint Committee on Taxation, *Technical Explanation, Estimated Revenue Effects, Distribution Analysis, And Macroeconomic Analysis Of The Tax Reform Act Of 2014, A Discussion Draft Of The Chairman Of The House Committee On Ways And Means To Reform The Internal Revenue Code* (JCS-1-14), November 18, 2014.

The Camp Plan provides certain exclusions from the definition of a specified advertising expense: (1) wages paid to the taxpayer's employees unless the employee's services are primarily related to specified advertising activities (including supervision of such employees); (2) depreciation expense allowed under section 167 for tangible property; (3) amortization deductions allowable under section 197;[103] (4) any discount, coupon, rebate, slotting allowance, sample, prize, loyalty reward point, or any other item determined by the Secretary to be similar; (5) amounts paid or incurred with respect to any communications appearing on the taxpayer's tangible property subject to depreciation or treated as inventory;[104] (6) amounts paid or incurred for the creation of any logo, trademark, or trade name; (7) amounts paid or incurred for package design;[105] (8) amounts paid or incurred for marketing research; (9) amounts paid or incurred for business meals; and (10) amounts paid or incurred as qualified sponsorship payments (as defined in section 513(i)(2)) with respect to an organization subject to the tax imposed by section 511.

In the case of retired, abandoned, or disposed property with respect to which specified advertising expenses are paid or incurred, the remaining basis may not be recovered in the year of retirement, abandonment, or disposal, but instead must continue to be amortized over the remaining amortization period.

2. Relief for certain types of income

Intellectual property or "patent box" regimes

Outside of the United States, a number of countries have established intellectual property regimes (or "patent boxes"), which offer preferential tax treatment on income attributable to intellectual property.[106] Policymakers have adopted patent boxes to (1) increase domestic investment in research and development and (2) encourage companies to locate intellectual

[103] It is intended that amortization expenses allowable under other provisions of the Code (*e.g.*, section 167) are not part of this exception. For example, a taxpayer who acquires stadium naming rights and capitalizes such amount paid pursuant to section 263(a), includes the current year amortization of such amount as a specified advertising expense for purposes of this proposal. Likewise, a taxpayer who incurs costs in connection with entering into a three-year contract to receive advertising services and capitalizes such amounts pursuant to section 263(a) includes the current year amortization of such amounts as a specified advertising expense for purposes of this proposal.

[104] Items such as signage on the taxpayer's business premises or logo(s) appearing on the taxpayer's product(s) are intended to be covered under this exception.

[105] "Package design" is any amount to which new section 263A(i) of the Camp Plan applies (see section 3110 of the Camp Plan). While package design expenses are excluded from capitalization under new section 177, the Camp Plan requires such costs to be treated as allocable indirect costs for purposes of section 263A with respect to packages which utilize such design. For a discussion of section 263A, see section 3312 of the Camp Plan, Modification of rules for capitalization and inclusion in inventory costs of certain expenses.

[106] These countries include Belgium, Cyprus, France, Hungary, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Spain, and the United Kingdom.

property in their countries, among other goals.[107]

Federal income tax rules provide incentives for research activities by providing (i) a deduction that allows research expenditures to be expensed instead of amortized over time and (ii) a credit for certain qualified research expenditures.[108] There is no present law Federal income tax provision that provides for preferential rates, deductions or credits specifically for profits attributable to the sale or license of intellectual property (or products using or incorporating intellectual property).

Deduction for innovation box profits

On July 29, 2015, Representatives Boustany and Neal introduced the "Innovation Promotion Act of 2015" (the "Boustany-Neal Plan").[109] The Boustany-Neal Plan establishes a deduction for innovation box profits.[110] The deduction has the effect of lowering the income tax rate on profits that qualify for the deduction. The deduction is equal to 71 percent of the lesser of the (1) "innovation box profit" of the taxpayer for the taxable year or (2) taxable income (determined without the 71 percent deduction) for the taxable year.[111] This results in an effective tax rate of approximately 10 percent on innovation box profits. The deduction for innovation box profit is not taken into account in computing any net operating loss or the amount of any operating loss carryback or carryover. Thus, the deduction cannot create, or increase, the amount of a net operating loss deduction.

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[107] For more detail on key design features of the intellectual property regimes enacted or contemplated by other countries, see Joint Committee on Taxation, *Present Law and Selected Policy Issues in the U.S. Taxation of Cross-Border Income* (JCX-51-15), March 16, 2015. For detail on the Base Erosion and Profit Shifting Project conducted by the Organization for Economic Cooperation and Development at the request of the Group of Twenty ("OECD/G20 BEPS Project") and its substantial activity requirement (*i.e.*, "nexus approach") for preferential intellectual property regimes, see Joint Committee on Taxation, *Background, Summary, and Implications of the OECD/G20 Base Erosion and Profit Shifting Project* (JCX-139-15). November 30, 2015.

[108] For more detail on federal tax benefits for research activities, see Joint Committee on Taxation, *Background and Present Law Relating to Manufacturing Activities Within the United States* (JCX-61-12), July 17, 2012.

[109] See the "Innovation Promotion Act of 2015" Discussion Draft (July 28, 2015). This document can be found on the House Committee on Ways and Means website at http://waysandmeans.house.gov/wp-content/uploads/2015/07/Innovation-Box-2015-Bill-Text.pdf.

[110] The Boustany-Neal Plan also provides special rules for transfers of intangible property from controlled foreign corporations to United States shareholders. More detail about this aspect of the Plan can be found on the House Committee on Ways and Means website at http://waysandmeans.house.gov/wp-content/uploads/2015/07/Boustany-Neal-IP-box-section-by-section-FINAL.pdf.

[111] This deduction does not affect the ability of the taxpayer to claim the deduction for domestic production activities under section 199, the current deduction for research and experimental expenditures under section 174, or the research and experimentation credit under section 41. For purposes of computing innovation box profit, all members of an expanded affiliated group (as defined in section 1504(a), determined by substituting "more than 50 percent" for "at least 80 percent" each place it appears) are treated as a single corporation. The deduction is allocated among the members of the expanded affiliated group in proportion to each member's respective amount (if any) of innovation box profit.

To determine innovation box profit, a taxpayer must first determine its qualified gross receipts. Qualified gross receipts are the gross receipts of the taxpayer derived from the sale, lease, license, or other disposition of qualified property in the ordinary course of a U.S. trade or business of the taxpayer. Qualified property is any (1) patent, invention, formula, process, design, pattern, or know-how, (2) motion picture film or video tape, (3) computer software, and (4) any product produced using any property described in (1) above. Additionally, any compensation for infringement of the taxpayer's intellectual property rights to qualified property is included in qualified gross receipts to the extent the compensation is included in the gross income of the taxpayer. With one exception, qualified gross receipts do not include gross receipts from the sale of qualified property to a related person. If products produced using qualified property are sold to a related person outside of the United States, gross receipts from the sale are qualified gross receipts only if the products are resold to an unrelated person.

Once the taxpayer determines its qualified gross receipts, the taxpayer must determine the amount of tentative innovation profit by subtracting from qualified gross receipts the sum of (1) the taxpayer's costs of goods sold for the taxable year that are properly allocable to qualified gross receipts [112] and (2) other expenses, losses, or deductions (other than the 71 percent deduction) that are properly allocable to qualified gross receipts.[113]

Innovation box profit for the taxable year is a taxpayer's tentative innovation profit multiplied by a fraction, the numerator of which is the taxpayer's five-year research and development expenditures for the taxable year[114] for research and development performed in the United States.[115] The denominator is the taxpayer's five-year total costs for the taxable year.[116]

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[112] For purposes of the provision, costs of goods sold is determined using the same inventory methods that the taxpayer uses to compute taxable income in accordance with the principles of sections 263A, 471, and 472. In the case of non-inventory property, such as motion picture films, costs of goods sold includes the adjusted basis of the property. Special rules apply to items brought into the United States and to property exported by the taxpayer for further manufacture.

[113] The provision grants the Secretary authority to prescribe rules for the proper allocation of items for purposes of determining innovation box profit, including promulgating rules for the proper allocation of items whether or not such items are directly allocable to qualified gross receipts.

[114] A taxpayer's five-year research and development expenditures is the amount paid or incurred by the taxpayer for the performance of research and development for which a deduction is allowed under section (a) or (b) of section 174 (determined without regard to sections 41 and 280(c)) for the five-taxable-year period ending with the taxable year.

[115] For purposes of determining whether the research and development was performed in the United States, the United States includes the District of Columbia, Puerto Rico, the Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands.

[116] A taxpayer's five-year total costs is the excess of all costs paid or incurred by the taxpayer for the five-taxable year period ending with the taxable year over the sum of (1) the taxpayer's cost of goods sold for the five-taxable year period, (2) interest paid or accrued for the five-taxable year period, and (3) taxes paid or accrued for the five-taxable year period. A taxpayer's five-year total costs do not include any research and development expenditures for any testing conducted outside the United States if such testing is conducted outside the United States because there is an insufficient testing population in the United States, or because testing is required by law to

The taxpayer's costs paid or incurred is intended to include all costs paid or incurred by a taxpayer in the ordinary course of its trade or business. Such costs include cost of goods sold, research and development, distribution, marketing, other costs of operations, taxes and financing costs of the taxpayer. For these purposes, costs paid or incurred by the taxpayer do not include section 165 losses or losses from the sale or exchange of capital assets. A taxpayer subtracts its cost of goods sold, interest and taxes, from the total costs paid or incurred by the taxpayer, to arrive at the five-year total costs included as the denominator for purposes of computing the innovation box profit of the taxpayer. The intent is to determine the tentative innovation profit that results from the taxpayer's research and development activities in the United States.

If a taxpayer was not in existence for the entire taxable-year period, the provision is applied on the basis of the period during which the taxpayer was in existence. Additionally, the term "taxpayer" includes any predecessor of the taxpayer.

Deduction for patent box profits

On August 2, 2012, Representatives Schwartz and Boustany introduced the "Manufacturing American Innovation Act of 2012" (the "Schwartz-Boustany Plan").[117] The Schwartz-Boustany Plan allows a deduction for patent box profits. The deduction is equal to 71 percent of the lesser of the (1) "patent box profit" of the taxpayer for the taxable year or (2) taxable income (determined without the 71 percent deduction) for the taxable year.[118] For a corporation otherwise paying tax at the statutory 35-percent rate, the 71-percent deduction creates a tax rate of approximately 10 percent on patent box profits. The deduction for patent box profit is not taken into account in computing any net operating loss or the amount of any net operating loss carryback or carryover. Thus, the deduction cannot create, or increase, the amount of a net operating loss deduction.

To determine patent box profit, a taxpayer must first determine its patent gross receipts. Patent gross receipts are the gross receipts of the taxpayer derived from the sale, lease, license, or other disposition of qualified property in the ordinary course of a U.S. trade or business of the taxpayer in which qualified patent property is used directly or indirectly if more than a substantial percentage of the value of such property is derived from the use of one or more

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be conducted outside the United States.

[117] See H.R. 6353 (112th Cong.).

[118] This deduction does not affect the ability of the taxpayer to claim the deduction for domestic production activities under section 199, the current deduction for research and experimental expenditures under section 174, or the research and experimentation credit under section 41. For purposes of computing patent box profit, all members of an expanded affiliated group (as defined in section 1504(a), determined by substituting "more than 50 percent" for "at least 80 percent" each place it appears) are treated as a single corporation. The deduction is allocated among the members of the expanded affiliated group in proportion to each member's respective amount (if any) of patent box profit. Special rules are provided for the application of the patent box profit deduction to partnerships, S corporations, trusts, estates, agricultural and horticultural cooperatives, and individuals.

qualified patents. Qualified patent property is a (1) qualified patent[119] or (2) product which incorporates a qualified patent or patents if more than a substantial percentage of the value of the product is derived from the use of one or more qualified patents. Additionally, any compensation for infringement of a qualified patent is included in qualified gross receipts to the extent the compensation is included in the gross income of the taxpayer. Qualified gross receipts do not include gross receipts from the sale of qualified property to a related person.

Once the taxpayer determines its patent gross receipts, the taxpayer must determine the amount of "IP profit" by subtracting from patent gross receipts the sum of (1) the taxpayer's costs of goods sold for the taxable year that are properly allocable to qualified gross receipts,[120] (2) other expenses, losses, or deductions (other than the 71 percent deduction) that are properly allocable to patent gross receipts,[121] and (3) routine profit. Routine profit is the taxpayer's costs of goods sold for the taxable year properly allocable to patent gross receipts less the sum of the cost of raw materials, cost of items purchased for resale, and costs of intangible property rights (including royalties and amortization) multiplied by 15 percent.

Patent box profit for the taxable year is a taxpayer's IP profit multiplied by a fraction, the numerator of which is the taxpayer's five-year research and development expenditures for the taxable year[122] and the denominator of which is the taxpayer's five-year total costs for the taxable year.[123]

Alternatively, a taxpayer may elect to determine patent box profit as the amount equal to the net income derived from patent gross receipts related to the exploitation of the qualified patent that would be received for the taxable year if all transactions of the taxpayer for the taxable year were conducted at arm's length under the principles of section 482 (the "elective

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[119] A "qualified patent" is a patent issued or extended by, or for which an application is pending before, the U.S. Patent and Trademark Office if (1) the taxpayer is the patent owner or exclusive licensor, (2) the taxpayer is actively involved with exploiting the patent, and (3) the taxpayer performed substantial activity to develop the patented invention, its application, or a product incorporating the patented invention. The Schwartz-Boustany Plan provides special recapture rules relating to patent claims denied or ruled invalid.

[120] For purposes of the provision, costs of goods sold is determined in accordance with the principles of sections 263A and 471, as provided for by the Secretary under regulations or other guidance. Special rules apply to items brought into the United States and to property exported by the taxpayer for further manufacture.

[121] The provision grants the Secretary authority to prescribe rules for the proper allocation of items for purposes of determining patent box profit, including promulgating rules for the proper allocation of items whether or not such items are directly allocable to patent gross receipts.

[122] A taxpayer's five-year research and development expenditures is the amount paid or incurred by the taxpayer for the performance of research and development in the United States for which a deduction is allowed under section (a) or (b) of section 174 (determined without regard to section 41) for the five-taxable-year period ending with the taxable year.

[123] A taxpayer's five-year total costs is the excess of all costs paid or incurred by the taxpayer for the five-taxable year period ending with the taxable year over the sum of (1) the taxpayer's cost of goods sold for the five-taxable year period, (2) interest paid or accrued for the five-taxable year period, (3) taxes paid or accrued for the five-taxable year period, and (4) the net gain or loss for the five-taxable year period.

method").[124] Additionally, in the case of a taxpayer which meets the $5,000,000 gross receipts test of section 448(c) for the taxable year, patent box profit equals the greater of the amount determined under the elective method or 50 percent of IP profit.

If a taxpayer was not in existence for the entire taxable-year period, the provision is applied on the basis of the period during which the taxpayer was in existence. Additionally, the term taxpayer includes any predecessor of the taxpayer.

3. Relief for passthroughs and small businesses

Other business tax reform options have been proposed with the intent of maintaining parity between corporate and passthrough entities (*e.g.*, by attempting to equalize the top corporate tax rate with the top individual tax rate).

Tax Reform Act of 2014 - Qualified domestic manufacturing income of individuals[125]

Under the Camp Plan, Mr. Camp phases out and repeals section 199 as part of his plan to lower the corporate tax rate to 25 percent.[126] However, under the Camp Plan, qualified domestic manufacturing income of individuals is subject to a maximum tax rate of 25 percent.[127] For these purposes, qualified domestic manufacturing income is equal to domestic manufacturing gross receipts reduced by the sum of: (1) the costs of goods sold that are allocable to those receipts and (2) other expenses, losses, or deductions which are properly allocable to those receipts.

Domestic manufacturing gross receipts generally are gross receipts of a taxpayer that are derived from: (1) any lease, rental, license, sale, exchange, or other disposition of tangible personal property[128] that was manufactured, produced, grown, or extracted by the taxpayer in

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[124] If made for a taxable year, such election applies to all qualified patents and may only be revoked with the consent of the Secretary.

[125] See sections 1001 and 1003 of H.R. 1 (113th Cong.), introduced December 10, 2014, by then Chairman Dave Camp. See also, Joint Committee on Taxation, *Technical Explanation, Estimated Revenue Effects, Distribution Analysis, And Macroeconomic Analysis Of The Tax Reform Act Of 2014, A Discussion Draft Of The Chairman Of The House Committee On Ways And Means To Reform The Internal Revenue Code* (JCS-1-14), November 18, 2014.

[126] See section 3122 of the Camp Plan.

[127] The Camp Plan generally replaces the individual income tax rate structure with a three-rate structure of 10 percent, 25 percent, and 35 percent. See sections 1001 and 1003 of the Camp Plan.

[128] Under the Camp Plan, tangible personal property does not include computer software or any motion picture films, video tapes, or sound recordings. It is intended that any lease, rental, license, sale, exchange, or other disposition of computer software, regardless of the method (*e.g.*, provided via a tangible medium, downloaded from the internet, accessed on the cloud, or any similar transaction) is excluded from the definition of "domestic manufacturing gross receipts."

whole or in significant part within the United States[129] or (2) in the case of a taxpayer engaged in the active conduct of a construction trade or business, construction of real property performed in the United States by a taxpayer in the ordinary course of such trade or business if such real property is placed in service after December 31, 2014.

However, domestic manufacturing gross receipts do not include any gross receipts of the taxpayer derived from property that is leased, licensed, or rented by the taxpayer for use by any related person. Further, domestic manufacturing gross receipts do not include any gross receipts of the taxpayer that are derived from the sale of food or beverages prepared by the taxpayer at a retail establishment; that are derived from the transmission or distribution of electricity, natural gas, or potable water; and that are derived from the lease, rental, license, sale, exchange, or other disposition of land. Domestic manufacturing gross receipts also do not include any gross receipts which are properly allocable to the taxpayer's net earnings from self-employment,[130] or any amount attributable to a qualified change in method of accounting,[131] and/or any other change in method of accounting required by the Camp Plan.[132]

With respect to the domestic manufacturing income of a partnership or S corporation, each partner or shareholder generally will take into account such person's allocable share of the components of the calculation (including domestic manufacturing gross receipts; the cost of goods sold allocable to such receipts; and other expenses, losses, or deductions properly allocable to such receipts) from the partnership or S corporation. For a trust or estate, the components of the calculation are apportioned between (and among) the beneficiaries and the fiduciary under regulations prescribed by the Secretary. However, in the case of a publicly traded partnership described in section 7704(c), each partner shall not take into account any allocable share of the aforementioned components of the calculation.

Passthrough entity business deduction

On March 21, 2012, Mr. Cantor introduced (with additional cosponsors) the "Small Business Tax Cut Act" (the "Cantor Plan").[133] The Cantor Plan effectively lowers the tax rate for a qualified small business by generally allowing a deduction for 20 percent of the lesser of

[129] A special rule for government contracts provides that property that is manufactured or produced by the taxpayer pursuant to a contract with the Federal Government is considered to be domestic manufacturing gross receipts even if title or risk of loss is transferred to the Federal Government before the manufacture or production of such property is complete to the extent required by the Federal Acquisition Regulation.

[130] See section 3621 of the Camp Plan, Ordinary income treatment in the case of partnership interests held in connection with performance of services.

[131] See, *e.g.*, section 3301 of the Camp Plan, Limitation on use of cash method of accounting.

[132] See, *e.g.*, section 3310 of the Camp Plan, Repeal of last-in, first-out method of inventory.

[133] H.R. 9 (March 21, 2012). H.R. 9 referred to the Committee on Ways and Means. It was reported (as amended) by the Committee on Ways and Means on April 10, 2012 (H. Rep. 112-425, the Small Business Tax Cut Act, 112th Cong., 2d Sess., April 10, 2012), and was passed by the House of Representatives on April 19, 2012. The bill was received in the Senate April 23, 2012, and referred to the Committee on Finance.

qualified domestic business income or taxable income for the taxable year.[134] However, a taxpayer's deduction for any taxable year may not exceed 50 percent of certain W-2 wages of the qualified small business.[135] The deduction for qualified domestic business income is also allowed for purposes of computing alternative minimum taxable income (including adjusted current earnings).[136]

Under the Cantor Plan, a qualified small business means an employer engaged in a trade or business if the employer had fewer than 500 full-time equivalent employees ("FTEs")[137] for either calendar year 2010 or 2011.[138] For example, a C corporation, S corporation, partnership, or sole proprietorship with fewer than 500 FTEs in either calendar year 2010 or 2011 may be a qualified small business. In general, an employer's FTEs are calculated by dividing the total hours of service for which wages were paid by the employer to employees during the taxable year by 2,080 hours.[139]

Under the Cantor Plan, rules similar to the rules under section 199 (described above) apply with respect to partnerships, S corporations, trusts or estates, or agricultural and horticultural cooperatives.[140] Rules similar to the rules under section 199 also apply with respect to individuals.[141] In addition, all members of an expanded affiliated group are treated as a single

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[134] The provision applies only with respect to the first taxable year of the taxpayer beginning after December 31, 2011.

[135] The deduction is limited to 50 percent of the greater of (1) W-2 wages paid by the taxpayer to non-owner employees, or (2) the sum of W-2 wages paid by the taxpayer to (a) employees who are non-owner family members of direct owners and (b) employees who are 10-percent-or-less direct owners. Certain partners' distributive shares of partnership items may be treated as W-2 wages solely for purposes of the provision.

[136] The deduction in computing alternative minimum taxable income is determined by reference to the lesser of the qualified domestic business income (as determined for the regular tax) or the alternative minimum taxable income (in the case of an individual, adjusted gross income as determined for the regular tax) without regard to this deduction.

[137] The term full-time equivalent employees for this purpose has the meaning given under section 45R(d)(2), without regard to section 45R(d)(5) and (e)(1) and by applying that subsection on a calendar year rather than a taxable year basis. Thus, for this purpose, seasonal employees and self-employed individuals, including partners and sole proprietors, two percent shareholders of an S corporation and five percent owners of the employer are included in the calculation of an employer's FTEs.

[138] In the case of an employer not in existence on January 1, 2012, the determination is made with respect to calendar year 2012 rather than 2010 or 2011.

[139] This number is rounded down to the nearest whole number if not otherwise a whole number. Employers in existence for a partial calendar year annualize the number of FTEs calculated based on the number of calendar days the taxpayer was in existence during 2012.

[140] See sec. 199(d)(1) and (3).

[141] See sec. 199(d)(2).

corporation for purposes of the provision.[142] Rules similar to the rules under section 199 apply to allocate the deduction among the members of the expanded affiliated group.[143]

If a taxpayer is allowed a deduction under the Cantor Plan for a taxable year, gross receipts of the taxpayer taken into account in determining the deduction cannot be taken into account under section 199 for the taxable year. Similarly, W-2 wages taken into account in determining the deduction cannot be taken into account under section 199 (which also has a limitation related to W-2 wages) for the taxable year. As a result, the taxpayer may not benefit under the Cantor Plan and under section 199 with respect to the same gross receipts or W-2 wages. However, a taxpayer may elect not to take into account under the Cantor Plan any item of domestic business gross receipts. Under this election, for example, the taxpayer may treat an item of domestic business gross receipts as not taken into account in determining the deduction so that the item may be taken into account for purposes of section 199.

[142] Members of an expanded affiliated group for purposes of this provision generally include those corporations which would be members of an affiliated group if such membership were determined based on an ownership threshold of "more than 50 percent" rather than "at least 80 percent."

[143] See sec. 199(d)(4).

C. Reform that Offers Structural Changes in Income Taxation

1. Incentives related to firm capital structure

In the absence of taxes and bankruptcy costs, the market value of any firm is independent of its capital structure.[144] Leveraged companies cannot command a premium over unleveraged companies because investors can replicate the borrowing of the firm by putting the equivalent leverage into their portfolio directly by borrowing on their own account. The combination of the unleveraged company and the individual borrowing replicates the risk and return of holding a leveraged company. Arbitrage opportunities between these two equivalent portfolios prevent a leveraged firm from being valued more highly than an unleveraged firm. Similarly, leveraged companies cannot sell at a discount to unleveraged companies because investors have the opportunity of undoing the leverage by holding the bonds of the leveraged company in their portfolio in proportion to the debt of the levered company. The combination of the leveraged company and its bonds is equivalent to an unleveraged company. Arbitrage opportunities between these two equivalent portfolios prevent an unleveraged firm from being valued more highly than a leveraged firm. Thus, under these assumptions, the value of a firm does not depend on whether or to what extent it is leveraged.

In the presence of a tax system in which interest is deductible, a firm can increase its value by taking on debt. The value of the leveraged firm is equal to the value of the unleveraged firm plus the present value of the tax savings associated with the interest deductions on the debt.[145] The deductibility of interest means that a firm can reduce its tax bill by the amount of interest it pays multiplied by the tax rate. In valuing the benefit of these reduced tax payments to the firm, the stream of tax savings is discounted at the interest rate on the debt, such that the increase in the value of the leveraged firm is equal to the tax rate multiplied by the amount of debt outstanding.[146] This implies that the optimal capital structure of the firm might be all debt.

This analysis does not, however, consider the numerous additional factors that influence a firm's choice of capital structure. These additional factors include both economic considerations, features of Federal income tax law, and interactions with nontax laws and rules.

<u>Economic considerations</u>

Equity and debt capitalization of a business each involves a cost of capital, and the required rate of return to the equity of a leveraged firm may be higher than that of the unleveraged firm due to the additional risk associated with leverage. A business (the issuer of

[144] Franco Modigliani and Merton H. Miller, "The Cost of Capital, Corporation Finance, and the Theory of Investment," *American Economic Review*, vol. 48, no. 3, June 1958, pp. 261-297.

[145] Franco Modigliani and Merton Miller, "Corporate Income Taxes and the Cost of Capital: A Correction," *American Economic Review*, vol. 53, no. 3, June 1963, pp. 433-443.

[146] For a review of recent empirical evidence on taxes and firm capital structure, see John Graham, "Do Taxes Affect Corporate Decisions? A Review," in George M. Constantinides, Milton Harris, and Rene M. Stulz (eds.), *Handbook of the Economics of Finance*, vol. 2A, North-Holland Publishing Col., 2013, pp. 123-210.

debt or equity) typically wishes to obtain capital at the lowest cost. Generally, an investor seeks a higher rate of return (and thus may impose a higher cost of capital) on riskier investments. Debt might commonly be thought of as more secure than equity, and thus perhaps less costly to the issuer, due to rights the debt may have in bankruptcy and various protective covenants required by a creditor in connection with a loan. However, it has been observed that a portion of the expected equity return of a stable company could be considered as secure as any debt instrument the same company might issue. Similarly, in certain highly leveraged situations, debt may be considered as risky as equity and may command a high cost of capital.

To the extent the holders of common equity capital (that is, equity capital that has full participation in the future profits of the business) also capitalize their business with other interests that have a limited participation, the rate of return on investment to the common equity holders increases if the investment is successful. At the same time, because of the need to pay the other capital returns prior to obtaining the common equity return, the risk that the common equity holder will not obtain any significant return is also higher. The desire to enhance the potential rate of return on investment may be a nontax factor in choosing to leverage a business. However, this financial result also can be obtained through the use of a preferred equity instrument that is limited in its participation in future profits, but the preferred equity would carry no tax advantage.

Given that debt typically gives creditors rights to force a debtor into bankruptcy, the relative risk of bankruptcy given a specified debt level may serve to limit the amount of debt in a firm's capital structure. Even short of bankruptcy, other costs of financial distress imposed on a business by debt covenants may influence a firm's financing. These costs include not only the direct costs of legal and accounting fees but also the indirect costs of financial distress. Suppliers or employees may demand less favorable payment terms, putting further strain on the cash flow of a highly-leveraged company. Customers may switch to competitors rather than face the risk of diminished quality or customer service. Companies without sufficient cash from current operations may need to sell assets at fire-sale prices to service their debt. In addition, even absent bankruptcy, the requirements of debt covenants may limit a firm's flexibility in its operations. These factors, among others, affect the optimal level of debt for a firm.

The extent to which business owners choose to incur debt also depends in part on the availability of equity capital on acceptable terms. None may be available or the level of participation or control required by the investor may be unattractive.

Features of Federal income tax law

Numerous features of Federal income tax law create potentially conflicting incentives for businesses to structure capital investments as debt or equity because the tax treatment of these investments may differ for both issuers and holders. In addition, if one form of investment provides an advantage to either the issuer or the holder (or to both), the tax savings can potentially be shared between the parties. Such sharing can result in an increase in an investor's after-tax return and thus lower the cost of capital to the business.

A principal difference in the Federal income tax treatment of debt and equity is that interest and dividends are treated differently for both issuers and holders. For C corporations, the deductibility of interest on debt can reduce or eliminate corporate-level income tax.

The tax treatment of holders of debt or equity depends on the status of a particular holder. For example, certain holders, such as U.S. tax-exempt organizations, may be indifferent as to holding debt or equity of a C corporation issuer because income in either case is exempt from tax. However, a tax-exempt organization may not be indifferent as between debt and equity in a partnership as a result of the unrelated business income tax rules. In the case of U.S. individuals, preferential income tax rates apply to dividends paid with respect to qualifying equity interests, but not on payments of interest with respect to debt. Individual taxpayers may also benefit from preferential tax rates on capital gains that may accrue to retained corporate earnings.

Combinations of features of the Federal income tax can further influence the choice between debt and equity. For example, the deduction for interest on debt can be combined with other tax benefits to produce a negative tax rate greater than produced if the other benefits were equity financed.[147] This can occur if debt giving rise to deductible interest payments is used to finance an investment that produces income taxed at preferential rates, that is eligible for special tax credits, or that is not taxed at all. In such cases, the otherwise unused interest deduction can be deducted against other taxable income of the issuer, while the debt-financed asset produces low-tax or tax-exempt income.

Rules governing the recognition of income enable a business owner to obtain funds for use in his business, or may allow an owner to extract value from the business, in either case without the recognition of gain that would result from a sale of assets.

Federal income tax law treats different business entities differently in various circumstances that can create incentives for debt or equity financing. For example, the partnership rules that increase a partner's basis in his partnership interest by his allocable share of partnership debt may encourage partners to incur debt at the entity level because such debt can increase the amount of partnership losses a partner can deduct, and the amount of cash distributions that a partner can receive without tax. In contrast, the S corporation rules do not contain a similar incentive for entity-level debt.

Interaction with nontax laws and rules

Whether a particular instrument is classified as debt or equity has significance in a number of nontax contexts, including financial accounting, the regulation of banks, insurance companies and other financial institutions, securities law, and the credit determinations of rating agencies. In addition, the rules for determining what constitutes debt or equity for these different purposes are not always consistent with the Federal income tax rules.

[147] If the same investment were equity financed, the special credits or accelerated deductions would be available to shelter other income, but the interest deduction for debt finance magnifies the effect.

Proposals to equalize treatment between debt and equity

With shareholders in different income tax brackets, high bracket taxpayers will tend to concentrate their wealth in the form of equity and low bracket taxpayers will tend to concentrate their wealth in the form of debt. The distribution of wealth among investors with different marginal tax rates affects the demand for investments in the form of debt or equity. The interaction between the demand of investors, and the supply provided by corporations, determines the aggregate amount of corporate debt and equity in the economy.

At some aggregate mix between debt and equity, the difference in the investor-level tax on income from equity and debt may be sufficient to offset completely, at the margin, the apparent advantage of debt at the corporate level. Even if the difference in investor tax treatment of debt and equity is not sufficient to offset completely the corporate tax advantage, the advantage to debt may be less than the corporate-level tax treatment alone would provide.

The analysis above suggests that any policy change designed to reduce the tax incentive for debt must consider the interaction of corporate and shareholder taxes. For example, proposals to change the income tax rates for individuals or corporations will change the incentive for corporate debt. Likewise, proposals to change the tax treatment of tax-exempt entities may alter the aggregate mix and distribution of debt and equity.

Various options could be adopted which lessen the distinction between the tax treatment of debt and equity to reduce the tax bias toward the issuance of debt. The double taxation of dividends could be lessened by allowing corporations to deduct dividends or by providing a shareholder credit for corporate tax paid with respect to such dividends. In addition, the tax treatment of debt could be made less favorable by, for example, limiting the deduction for interest on indebtedness. Possible limitations include the following: disallowing a flat percentage of all interest deductions; limiting the deduction for interest on debt in excess of a specific rate of return; limiting interest deductions based on inflation (interest indexing); disallowing interest deductions in excess of a specified percentage of income; disallowing corporate interest deductions in transactions that reduce corporate equity; and denying interest deductions in specified situations, such as acquisitions involving high risk, acquisitions involving borrowing against untaxed appreciation, or hostile acquisitions.

Any proposal to reduce the double taxation of dividends would more nearly conform the tax treatment of debt and equity and reduce the bias toward the issuance of debt. Previous attempts to provide dividend tax relief have met resistance because of the revenue costs and because of lack of support from the business community. In addition, dividend relief proposals raise numerous complex issues including, for example, the treatment of corporate tax preferences, the treatment of tax-exempt and foreign shareholders, and transition issues and effective dates. Proposals to more nearly conform the tax treatment of debt and equity by limiting interest deductions have been based on the notion that certain types of debt with high interest rates or equity features should be treated, in whole or in part, as equity. Other proposals have been based on the concept that debt issued for certain purposes (such as certain takeovers) does not serve a worthy public purpose and should be discouraged by disallowing an interest deduction. Others, such as indexing, have been based on the idea of more properly measuring economic income. Many of the proposals to limit interest deductions are subject to criticism as

resulting in an improper measurement of income. Also, proposals to limit interest deductions have been criticized as causing a bias in favor of foreign persons who may deduct interest in computing income in their home country. Proposals to limit interest deductions also involve difficult issues relating to transitional rules and effective dates.

2. Corporate integration

There are two broad categories of integration: (1) complete integration and (2) dividend relief. Complete integration eliminates double taxation of both dividends and retained corporate earnings. S corporations are taxed under a regime of complete integration since earnings of an S corporation, whether retained or distributed, are treated as income of the shareholders for tax purposes. Dividend relief, unlike complete integration, reduces the double taxation on distributed earnings, with no change in the taxation of retained earnings. Dividend relief may be accomplished by reducing tax at either the corporate or shareholder level. At the corporate level, the tax burden on distributed earnings can be alleviated by means of a dividends paid deduction or a lower corporate income tax on distributed versus retained income (*i.e.*, a split-rate corporate income tax). At the shareholder level, the tax burden on dividends may be reduced by exemption or by crediting shareholders with tax paid by the corporate distributee (*i.e.*, the imputation method).

Complete integration

Relief from the two-tier tax can be achieved by eliminating the corporate tax and including undistributed, as well as distributed, earnings in shareholders' gross income. Under this approach, a corporation's undistributed earnings would be deemed to have been distributed to and reinvested by the shareholders each year. Tax could be collected at the corporate level (in effect using the corporation as a withholding agent for shareholders), or tax could be collected solely at the shareholder level without withholding. Shareholders would be subject to income tax on their allocated earnings and would adjust basis in their shares accordingly.

In one form of this mechanism, all corporations would be treated in a manner similar to either partnerships or S corporations; this treatment would include the passing through of credits and losses as well as the character (ordinary or capital gain) and source (domestic or foreign) of income. Other versions would provide for the pass through of net income but not losses in excess of income, as is the case with real estate investment trusts.

Full integration generally is considered to be the most theoretically desirable method of providing relief from the two-tier tax, since all income earned at the corporate level would be taxed directly and currently to the shareholders, leaving none of the possible distortions between corporate and noncorporate investment, debt and equity finance, or retention and distribution of corporate income. However, such a system is also considered to be difficult to implement. One traditional objection to this form of relief is the concern that imposition of tax at individual rates on allocated corporate income (that is not actually distributed) may result in liquidity problems, particularly for shareholders whose marginal rates exceed the rate of tax collected at the corporate level. Considerable administrative difficulties are inherent in a system of full integration. For example, the need to allocate a corporation's tax attributes among all its shareholders (where share ownership changes and tax attribute adjustments are common), as well

as the resulting need for individuals to account for potentially complex items (such as foreign tax credits, intangible drilling costs and the like), pose what many consider to be insurmountable obstacles to the general implementation of this system.

Reducing corporate or shareholder tax rates

The burden on both distributed and retained corporate earnings also could be relieved, in part, by reducing the corporate income tax rate. This method of providing relief from the two-tier tax could reduce concerns about incentives for debt financing and inadequate investment in the corporate sector. However, such concerns would not be eliminated so long as the corporate tax rate exceeds zero. Reducing the corporate tax rate to zero, however, would turn corporations into the equivalent of nondeductible individual retirement accounts, since retained earnings and reinvestment income would accumulate tax free within the corporation. Moreover, the lower the corporate effective tax rate relative to the individual effective tax rate, the greater the incentive is for a corporation to retain rather than distribute earnings.

Individual holders of corporate equity are eligible for a maximum tax rate on qualified dividend income generally below the rate on ordinary income. The legislative history for the provision establishing the reduced rate suggests that Congress was at least in part motivated by concerns about economic distortions related to "corporate financial decisions" favoring debt over equity, "financial engineering to achieve interest deductions from financial instruments with substantial equity characteristics[,]" and incentives "to retain earnings rather than to distribute them as taxable dividends…even if the shareholder might have an alternative use for the funds that could offer a higher rate of return than that earned on the retained earnings."[148]

Deduction for dividends paid

The double taxation of dividends could be alleviated at the corporate level by allowing a deduction for dividends paid to shareholders. A portion of the double tax on dividends could be eliminated by means of a partial dividends paid deduction, which reduces the corporate tax on distributed, as compared to retained, corporate income. In 1985, the Administration proposed a deduction of 10 percent of the dividends paid from the earnings of a domestic corporation that have borne the regular corporate tax. A similar proposal was included in the House-passed version of the 1986 Act.[149]

Under those proposals, dividends are eligible for the dividends paid deduction only to the extent that such dividends do not exceed the amount of a Qualified Dividend Account ("QDA"). Generally, the QDA consists of the amount of corporate earnings that have been subject to the corporate tax for taxable years after the effective date. Accordingly, each year a corporation

[148] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05), May 2005, p. 24.

[149] For a more detailed description of the Administration proposal, and a comparison with the House-passed version, see Joint Committee on Taxation, *Federal Income Tax Aspects of Corporate Financial Structures* (JCS-1-89), January 18, 1989, pp. 90-93, and Committee Report to accompany H.R. 3838, Tax Reform Act of 1985, H.R. Rep. No. 99-426 Part 1, December 7, 1985, pp.237-242.

adds to its QDA its taxable income (*i.e.*, gross income less deductible expenses), subject to certain adjustments.[150] For this purpose, taxable income does not include amounts on which no corporate tax was paid as a result of any available credit (including the foreign tax credit). The amount of dividends paid in a taxable year is deductible from the balance of the QDA as of the end of the taxable year, except to the extent that the balance in the QDA would be reduced below zero. Dividends in excess of the QDA as of the end of the taxable year in which the dividends were paid are not deductible. Such "excess dividends" may not be carried forward and deducted in subsequent years.

Exclusion for dividends paid

One method for relieving the tax burden on dividends at the shareholder level would be to exclude a portion of dividends from gross income. This alternative has been criticized as reducing the progressivity of the income tax, since the tax benefit of exemption is greatest for shareholders in the highest tax bracket. Shareholders might be required to reduce stock basis, to the extent of tax exempt dividends, to prevent the deduction of capital losses associated with untaxed dividends.

In 2003, the President's budget proposal for fiscal year 2004 contained a provision that would have exempted from shareholder tax dividends on which corporate tax had been paid. A substantially identical proposal was set forth in S. 2 (introduced by Senators Nickles and Miller) and in H.R. 2 (introduced by Chairman Thomas), on February 27, 2003.[151] Under the proposal, the excludable portion of any dividend received by a shareholder is not included in gross income. The excludable portion of any dividend is the portion of the dividend which bears the same ratio to the dividend as the amount of the corporation's excludable dividend amount ("EDA") for a calendar year bears to all dividends paid by the corporation during the calendar year. The EDA generally measures the corporation's fully taxed income reduced by taxes paid. In addition, shareholders may be allowed to increase the basis in their corporate stock to the extent the EDA exceeds the dividends paid by the corporation during the calendar year. These rules apply to both individual and corporate shareholders.

Imputation credit

An alternative to a shareholder exemption is to give shareholders an income tax credit to reflect all or a portion of the corporate level tax paid with respect to dividends. The amount of the credit could be adjusted based on the degree to which partial relief from the two-tier tax is desired. Under such a system, shareholders who receive dividends would be required to "gross up" the dividend by the amount of the credit for corporate taxes paid, and include the grossed-up amount in income, while using the credit as an offset to their tax liability. The gross-up and

[150] For this purpose, corporate income added to the QDA would be computed without regard to the dividends paid deduction in order to reflect the earnings available for distribution.

[151] For a more complete description and analysis of the proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2004 Budget Proposal* (JCS-7-03), March 2003, pp. 18-33.

credit mechanism is analogous to the credit for taxes withheld on wages under present law. Gross-up and credit systems, also known as "imputation" systems, are used by several foreign countries, including Australia, Canada, and Mexico. A number of these countries grant the shareholder credit only to the extent that the corporation actually has paid tax on dividends (this is accomplished by a corporate minimum tax on distributions). In part to comply with European Union rules forbidding countries from discriminating against residents of other European Union countries, some European countries such as Germany have abandoned their imputation systems because, for instance, the systems had been available only to resident shareholders.

3. Limits on the deductibility of corporate interest

Another alternative to lessen the distinction between the tax treatment of debt and equity to reduce any tax bias toward the issuance of debt is to make the tax treatment of debt less favorable by, for example, limiting the deductibility of corporate interest. Possible broad limitations that do not depend on particular types of corporate transactions include the following: disallowing a flat percentage of all interest deductions; limiting the deduction for interest on debt in excess of a specific rate of return; limiting interest deductions based on inflation (interest indexing); and disallowing interest deductions in excess of a specified percentage of income. Interest disallowance proposals could be evaluated with reference to various policy issues including: potential erosion of the business tax base; the proper measurement of economic income; or the nontax economic impact of business leverage.

Disallow a flat percentage of all interest deductions

Under this approach, the amount of nondeductible interest would be a percentage of total interest expense. This approach principally addresses concerns about erosion of the revenue base and about the role of debt in facilitating tax arbitrage. It does not address issues of the proper measurement of income (either by trying to distinguish debt from equity or by trying to limit interest deductions where the debt supports activities that do not produce income taxable to the entity incurring the debt). It also is not limited to any particular types of transactions that might be considered undesirable for nontax reasons.

While revenue concerns are the main basis for this particular approach, issues arise regarding its effectiveness. For example, if the deduction denial is related only to a percentage of total interest expense, it might be possible for taxpayers in some circumstances to increase the stated interest amount beyond the amount they might have stated absent this provision, thus continuing to reap the benefit of the deduction. Present law provides certain bright-line rules designed to prevent the interest component of an obligation from being understated, and in the case of applicable high yield discount obligations, rules designed to prevent the overstatement of interest. Issues related to the design of such rules are addressed below in connection with other proposals.

The impact of this proposal will vary dramatically from industry to industry. For example, financial intermediaries, such as banks, may see enormous increases in taxable income, even though their loans may bear low interest rates. Likewise, this proposal will disproportionately affect activities which support high degrees of leverage, such as real estate, even though the debt involved may not be particularly risky.

Disallow interest deductions in excess of a specified rate of return to investors

This approach would disallow interest deductions in excess of a specified rate of return to investors. Deductions not in excess of that rate still would be permitted. The rate could be determined by reference to a rate deemed to represent that of a relatively risk-free investment (for example, the rate on comparable-term Treasury obligations issued at the time of the borrowing, or a few points above that rate). The rate could fluctuate as the reference rate fluctuates.

As with the approach described above, this approach addresses concerns about erosion of the tax base, but to the extent the rate selected reflects a measurement of "risk" this approach also might be described as an attempt to measure economic income properly. If one accepts the premise that all interest on debt is properly deductible without regard to whether the debt supports an asset that produces taxable income, and the further premise that the most fundamental basis for distinguishing debt from equity is the degree of investor risk, this approach seeks to deny a deduction for the "risk" element of stated interest on the theory it more nearly resembles a dividend distribution, while continuing to permit the non-risk portion to be fully deductible.

A primary issue with respect to this type of approach is the selection of the permitted deductible interest rate. To the extent the rate is selected in an attempt to identify excessive risk, questions may be raised regarding the accuracy of a risk analysis based solely on interest rate. On the other hand, to the extent the proposal is viewed as one of administrative convenience designed to address revenue concerns and avoid the need to distinguish between debt and equity, the accuracy of any risk analysis may be considered less important.

Nontax policy issues also may arise. For example, even though it is arguable that a high degree of risk suggests an equity investment, and that a high interest rate suggests a high degree of risk, the practical result of such an approach may be that certain start-up firms, or firms involved in inherently risky ventures may be more restricted in their ability to deduct all of the interest demanded by investors than other more established or stable firms. Variations in the permitted rate might be adopted for such situations; however, arguments then may be raised that whichever taxpayers are permitted the higher deductions may obtain a competitive advantage over other ventures also involving risk, which may have implications for neutrality of the tax system in this respect.

Disallow interest deductions based on inflation: interest indexing

This approach would disallow a portion of interest deductions based on inflation. A corresponding portion of the recipient's interest income would be treated as nontaxable.

1984 Treasury proposal

The Treasury proposal in 1984 suggested a plan which generally would have rendered the same specified fraction of interest nondeductible and nonincludable.[152] Home mortgage interest and a *de minimis* amount of other individual interest were exempt from these provisions. The Treasury proposal assumed a specified real pre-tax interest rate and would have calculated a percentage each year based on this assumed real rate relative to the sum of inflation and the assumed real interest rate. The allowable interest deduction (and inclusion) each year would have been calculated by multiplying nominal interest payments (and receipts) by this percentage, which would be published periodically by the tax authorities.

As a method for indexing debt, the proposal was relatively simple. Even so, it still had numerous difficulties. Because it applied a single fraction to all interest it did a poor job of coping with debt of differing risk characteristics; in particular, it made too large a percentage of interest on risky debt nondeductible (and nonincludable). Also, if the fraction were applied to financial intermediaries (*e.g.*, banks), their income could be very lightly taxed. As pointed out by Treasury at the time, even with its problems, the method was likely to provide a more appropriate measure of income than the current method of deducting and including all nominal interest.

Other methods

Other methods of indexing may better measure real interest deductions but at the cost of increased complexity. One method would require the restatement of interest paid by subtracting out the inflationary component of the interest rate. For example, if one paid $100 of interest at a 10 percent nominal rate and the rate of inflation were 7 percent, then one would calculate the inflationary component of the interest paid at a 7 percent rate ($70) and subtract that amount from the interest actually paid. The difference ($30) would be the allowed amount of deductible interest. Similar calculations would be necessary for purposes of income inclusion. This method, while having fewer distortions than the Treasury proposal, is significantly more complex and administratively difficult. In general, proposals designed to measure the appropriate amount of interest make a trade-off between simplicity and accuracy.

Issues generally applicable to indexing

A number of issues arise with respect to interest indexing. A principal concern is determining the amount of correction to interest expense or income that accurately reflects inflation. It may be necessary to determine a "real" interest rate prior to risk considerations. Even assuming a correct adjustment is identified, it may be necessary for administrative convenience to apply that adjustment in a relatively rough manner that does not fully account for different real interest rates over different periods of a year. It may be difficult to provide an administrable adjustment that does not involve windfalls to some taxpayers.

[152] Department of the Treasury, *Tax Reform for Fairness, Simplicity and Economic Growth*, November 1984.

Indexing only interest, but not other long-term arrangements, may put additional pressure on the determination as to whether an instrument is properly characterized as debt. For example, depending on the relative tax situations of the parties, indexing only interest may make it more desirable for a taxpayer with a relatively high effective tax rate to hold an instrument characterized as debt rather than equity. Similarly, it may be more desirable for an arrangement to be characterized as a lending arrangement rather than a lease. To the extent parties in different tax situations recharacterized their arrangements to take advantage of tax arbitrage potential in this additional new disparity between the treatment of debt and other arrangements, there could be a corresponding revenue concern. On the other hand, it can be argued that failure to index may perpetuate a far greater revenue loss if the holders of debt instruments tend to be entities with a low effective tax rate and borrowers tend to be taxpayers with a higher effective rate who are obtaining an excessive interest deduction.

Exempting certain classes of debt, such as home mortgages, from indexing proposals may cause large tax-induced distortions of asset portfolios. Thus, excluding home mortgages would increase further the tax incentives for owner-occupied housing. Any proposal that reduces interest inclusions and deductions to the same degree will generally reduce nominal interest rates. Because of the fall in nominal interest, the value of tax exemption to pension funds and other tax-exempt institutions will be less than it would be under a system without indexing.

Disallow interest deductions in excess of a specified percentage of taxable income (or earnings and profits) as computed before the deductions

This approach would limit the interest deduction by reference to taxable income (or alternatively, earnings and profits) determined prior to the deduction. For example, one version of this approach would limit the deduction to no more than 50 percent (or some other specified percentage) of the taxable income of the corporation computed without regard to the interest deduction.[153] One variation would limit the deduction to no more than 50 percent (or some other specified percentage) of the earnings and profits of the corporation computed without regard to the deduction. Another variation would apply the limitation only for minimum tax purposes.

This approach is principally addressed to revenue concerns and attempts to provide a rough but practical alternative to complex rules for distinguishing equity from debt, which assures that interest alone does not shelter taxable income to an unacceptable degree.

The limitation to a specified percentage of taxable income (or earnings and profits) might arguably be viewed as reflecting concerns about proper measurement of income, on the theory that when interest deductions alone consume a significant proportion of otherwise taxable income, this may suggest excessive risk to the lender implying an equity interest. However, this particular approach is not a targeted method of identifying situations of risk. This is because the ability to pay back indebtedness depends largely on the capacity of the debtor to generate cash

[153] Such an approach was adopted in the 1986 Senate version of H.R. 3838 (the Tax Reform Act of 1986) but was limited to situations where the lender was related to the payor corporation by at least 50-percent ownership and was a tax-exempt or foreign entity that would not pay U.S. tax on interest received from the payor corporation (Senate amendment to H.R. 3838, sec. 984 (1986)).

flow, either from current operations or from sales of appreciated assets. Neither taxable income nor earnings and profits is an adequate measure of such capacity. For example, an entity with significant cash flow potential may have low taxable income because of other tax deductions that do not reflect economic losses (for example, accelerated depreciation) or because assets are currently held for appreciation and not for current income. The use of earnings and profits as a limitation similarly does not take account of items such as unrealized appreciation, which may be sufficient to avoid undue risk to the debtholder.

This approach also raises an issue whether it is desirable to limit interest deductions, thus increasing the effective tax rate, in times of recession or when taxable income is otherwise small due to real economic losses.

D. Reform that Moves to a Consumption Tax

As policymakers deliberate business tax reform, a number of proposals have been introduced which would move the business tax system, in whole or in part, in the direction of a consumption tax. The key distinction between an income tax and a consumption tax is the treatment of capital income, which is taxed under an income tax but not under a pure consumption tax. The tax base for a pure consumption tax is expenditures by individuals on goods and services and is equivalent to a tax on business cash flow (since consumer spending equals business receipts), with business cash flow equal to the value of output sold by a business minus the value of inputs purchased from other businesses. If tax rates are constant, the ability of businesses to expense investment effectively exempts from tax the required return to investment, since the value of the immediate tax deduction to the business offsets, in present value, the tax liability on the required return to the investment. In contrast, an income tax taxes the required return to investment and thereby discourages investment relative to a consumption tax, which is one reason that some policymakers favor a consumption tax over an income tax. The U.S. Federal tax system has features of both an income tax and a consumption tax.

The most common form of consumption tax in the world is the value-added tax ("VAT"). Countries have differed in their implementation of a VAT, but under the basic structure of a pure VAT, a business's tax liability is the VAT rate multiplied by the difference between the value of output sold and the value of inputs the business has purchased from other businesses.[154] Countries with VATs have generally maintained an income tax as a source of revenue (*i.e.*, have not enacted a pure consumption tax). Some U.S. policymakers have proposed instituting a VAT to reduce reliance on the income tax as a source of Federal tax revenue (*i.e.*, establishing a VAT while lowering income tax burdens on individuals and corporations), while others have supported taxing businesses on a cash-flow basis to promote business investment. An example of each of these types of proposals is described below.

1. Senator Cardin's "Progressive Consumption Tax Act of 2014"[155]

In 2014, Senator Cardin introduced the "Progressive Consumption Tax Act of 2014," which establishes a progressive consumption tax ("PCT"), similar to a VAT, on most goods and services. Although it does not replace the income tax with a consumption tax, the bill aims to reduce reliance on the income tax as a source of Federal tax revenue by lowering the top statutory individual and corporate income tax rates (among other Code changes).

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[154] This description aligns most closely to how a subtraction-method VAT operates. Countries have typically implemented their VATs through a credit-invoice method. For a discussion of these two methods, see Joint Committee on Taxation, *Background on Cash-Flow and Consumption-Based Approaches to Taxation* (JCX-14-16), March 18, 2016.

[155] "Progressive Consumption Tax Act of 2014," S. 3005 (113th Congress 2nd Sess. December 11, 2014), introduced by Senator Ben Cardin.

Value-added tax

The proposal establishes a 10-percent credit-invoice PCT on the taxable amount of a taxable supply, to be paid by the provider of the supply. (The term "PCT" is used for expositional convenience and is not defined in the bill.) In general, the person providing a supply is liable for the PCT. For eligible filers, a tax refund based on the amount of net PCT revenue collected in excess of 10 percent of GDP is available.

Taxable supply

The definition of supply is broad and includes: the sale or provision (including through renting, leasing, or licensing) of property; the performance of services; and the grant, assignment, or surrender of real property or of any right.[156] All imported supplies (except those treated as exempt) are taxable. A zero-rate PCT applies to the supply of any tangible personal property that is exported from the United States within 90 days after the provider gives an invoice for the supply, and for supplies, other than a supply of tangible personal property, which are provided to a recipient that is not in the United States when the supply is performed or otherwise done, and the use of which takes place outside the United States.

Supplies that have been neither imported nor exported (*i.e.*, domestically produced and sold to U.S. consumers) are taxable (1) if consideration is provided in return for the supply, (2) if it is made in connection with the United States,[157] and (3) to the extent that they are provided in the course of carrying on a trade or business. Special rules apply to taxable supplies provided by taxpayers exempt under section 501(a); a State, an Indian tribal government, or a possession of the United States (or any political subdivision of any of these foregoing entities); or the United States or the District of Columbia. Exempt supplies include the rental or leasing of residential property, any sale of qualified residential real property, any financial supply, and any taxable supply for which the amount of tax is *de minimis* or for which the revenue raised by taxing the supply is insufficient to justify the administrative and other costs involved in the payment and collection of the tax.

Taxable amount

The taxable amount for any taxable supply is generally the price charged by the provider of the supply and (1) includes all invoiced charges for transportation and other items payable to the provider with respect to the supply but (2) excludes any previously imposed PCT or State, local, or use tax. If money was not paid in consideration for the taxable supply, the taxable

[156] See Sec. 3911 of the bill for a more complete description of what constitutes a supply. An employee's services for his employer are not treated as a supply.

[157] In the case of tangible property, the supply of tangible property is made in connection with the United States if (1) the property is delivered or made available to the recipient in the United States or (2) the property is assembled in or removed from any location in the United States. The supply of real property is made in connection with the United States if the real property is located in the United States. The supply of anything other than tangible property and real property is made in connection with the United States if (1) the supply is used, performed, or otherwise done in the United States or (2) the supply is provided through a trade or business in the United States.

amount is equal to the fair market value of whatever consideration was paid (including any money paid in consideration).

For imports, the taxable amount equals the customs value of the taxable supply plus customs duties and any other import duties which may be imposed, or the fair market value of the taxable supply if there is no customs value. The customs value includes all invoiced charges for transportation and other items payable to the importer with respect to that supply.

Credit

Providers who make taxable supplies are generally permitted to reduce the amount of PCT for which they are liable by inputs credits for PCT paid on creditable acquisitions. Creditable acquisitions means the acquisition or receipt of any supply which was subject to the PCT and was used by the taxpayer in the course of carrying on a trade or business and was not used by the taxpayer to make an exempt supply. Special rules apply to taxable supplies acquired by taxpayers exempt under section 501(a); a State, an Indian tribal government, or a possession of the United States (or any political subdivision of any of the foregoing); or the United States or the District of Columbia.

Individual and corporate income tax

The bill makes a number of reforms to the individual and corporate income tax systems. The corporate income tax rate is reduced to 17 percent. For individual income taxes, the bill establishes three income tax brackets (the values of which depend on filing status) with rising marginal tax rates set at 15 percent, 25 percent, and 28 percent; capital gains are taxed at ordinary rates. Taxpayers are permitted a family allowance, similar to the present-law standard deduction and personal exemptions.

The bill includes, among other provisions, provisions to (1) repeal the personal exemption phaseout and the limitation on itemized deductions (*i.e.*, Pease limitation); (2) repeal the AMT; (3) eliminate the mortgage interest deduction, charitable deduction, and the deduction for State and local taxes; and (4) establish a progressive tax rebate that is meant to consolidate present-law child tax benefits and the earned income tax credit.

2. Senators Rubio and Lee's "Economic Growth and Family Fairness Tax Reform Plan"[158]

In March 2015, Senators Rubio and Lee released the "Economic Growth and Family Fairness Tax Reform Plan." The proposal moves the current tax system in the direction of a consumption tax by establishing a cash-flow tax on business income and exempting dividends and capital gains from individual-level taxation. The discussion below describes some, but not all, of the components of the proposal.

[158] A description of the proposal can be found at http://www rubio.senate.gov/public/index.cfm/files/serve/?File_id=2d839ff1-f995-427a-86e9-267365609942.

Business income tax

Under the proposal, business income is taxed largely at the entity level. Business income earned by C corporations is taxed at a 25 percent rate, with dividends and capital gains on stock exempt from tax at the individual level. Business income earned by passthrough entities and sole proprietorships is taxed at a maximum rate of 25 percent, which is to be linked by statute to the tax rate on income earned by C corporations. The proposal allows all businesses to expense any investments in equipment, structures, inventories, and land within the year the investments were made, thereby promoting cash-flow tax treatment of business income. For non-financial institutions, interest expense incurred on new debt is not deductible, while most interest income is not taxable. For financial institutions, the present-law tax treatment of interest expense and receipts is retained. The proposal eliminates "extraneous" business tax provisions and does not maintain business tax provisions that expired at the end of 2014.

The proposal establishes a dividend-exemption system for the taxation of cross-border income and creates unspecified rules to address profit shifting and decrease erosion of the U.S. tax base. As part of the transition to this system, the proposal taxes accumulated deferred foreign income at a six percent rate, payable over ten years.

Individual income tax

The proposal also includes various measures to reform individual income taxation. The changes include (1) consolidating the existing individual income tax brackets and lowering the top marginal tax rate to 35 percent; (2) creating a new, partially-refundable child tax credit based on payroll taxes; (3) replacing the standard deduction and personal exemptions with a personal credit; (4) consolidating education tax benefits; and (5) reforming the Earned Income Tax Credit. The proposal also repeals the AMT, estate tax, and the tax provisions of the Affordable Care Act. The proposal eliminates all itemized deductions except the deductions for home mortgage interest and charitable giving.