

Business Tax Legislation

Prepared by Edward Dumoulin



**Harvard Model
Congress Asia**

INTRODUCTION

The current economic crisis has proven to be one of the most severe in recent history. The situation has affected businesses especially severely, with many large national companies declaring bankruptcy and many others **laying off** massive numbers of workers. Particularly, workers in the American car industry have been hurt, and many skilled professionals in the legal and financial industries have been laid off as well. Although these problems are not the cause of the economic crisis, they are some important and serious effects of it.

Congress's strongest reaction to the financial crisis has come in the form of the **stimulus** legislation it has passed. Stimulus bills are those that give out extra money to groups of people in order to encourage economic activity. According to some economic theorists, this strategy works to make businesses operate better in the short run, and will help individuals have jobs and get paid. Since Congress has the power to disburse money, it is the sole source of federal **fiscal** stimulus for the current crisis. Many stimulus bills have passed recently, and two of them have been quite significant. Nevertheless, the crisis drags on and many workers and businesses are still suffering its effects.

Much of the stimulus funding that has been distributed so far has been directed either toward private individuals or toward large national financial companies. Many smaller businesses, however, are feeling the crunch of the crisis and have received no direct stimulus funding that might help them stay afloat. Additionally, there are serious questions about whether some larger companies have received enough funding to ensure their stability in the next few years, and whether they can remain stable without laying off even more workers. Long-standing taxes on businesses also discourage certain types of investment that might help businesses raise **capital**, which is very important for companies that may have lost significant sums of money in investments that went sour.

In determining what forms of tax relief, if any, would be appropriate for businesses right now, many factors must be considered. To be sure, many will ask whether more stimulus money should be spent, as it will lead to increased **deficit spending** that will raise the national debt. This could cause different sorts of problems in the long run. Also, if the government lowers taxes for businesses or provides them with stimulus funding, it might have less money to spend on welfare projects or relief



funding, both of which are needed more than usual given the circumstances. Issues also exist concerning the proper relationship of the government to businesses, and there are real questions about how it might affect the economic system in the long run if the government makes a large-scale relief effort right now.

These questions must be addressed to determine the sort of stimulus funding that would be most appropriate, given the current problems and the underlying ideological tensions that always go along with changes to the tax code involving businesses. It should not be forgotten, also, that this crisis is a good “excuse” to review long-standing problems with the business tax code or to implement theoretical positions concerning what the taxes should be.

BUSINESS TAXATION

Taxation of businesses is much like taxation of anything else: it allows the government to collect revenue, and has some (perhaps) undesirable side effects. This is the case with any activity that is taxed: if the government requires citizens to pay money to perform a certain activity, that activity will be discouraged. On the other hand, if the government reduces taxes on some activity, or gives citizens money for that activity, it will provide an **incentive** for them to perform that activity.

For this reason, it is important to understand what parts of doing business are taxed, because these are the things businessmen are discouraged from doing. Let us examine some of the major items that the government taxes.

Taxes on Profit

There are two types of corporations in American law: an **S Corporation** and a **C Corporation**. An S corporation is usually a smaller business (it must have fewer than 100 **shareholders**), and it cannot be part of a complex corporate holding pattern: its shareholders must be humans instead of companies (or **artificial persons**, as they are sometimes called in related materials). There are other requirements, but the S corporation structure is designed to simplify many of the taxation processes normally associated with corporations.

This is especially true for taxation on corporate profit, which is called “**corporate income tax**” by the IRS. Calling the profit tax an “income tax” is misleading, because corporations do not pay taxes on revenue, but only on profit, which is defined as the corporation’s revenue minus its expenses. S corporations simply pass all of their profits to the shareholders, allowing them to pay tax on the profit as though it were their own income (because, in fact, it is).

C corporations are different, however. They pay taxes ranging



from 15% to 35% on profits, which are then distributed to the shareholders. The shareholders then pay dividend taxes on the income they have received.

This “double tax” provides a strong **disincentive** for investors to purchase stock in companies. It is easy to see why. Suppose, for example, that an unmarried person held 5% of the **stock** in a C corporation, and that the corporation’s total profit was just over \$10,000,000 in a given year. This would mean that the corporation would have to pay 35% tax on the profit for that year, coming to a total of \$3.5 million in money owed to the government. So while his share without the corporate tax would have been \$500,000, it is reduced to \$325,000 after the tax. But after this first tax, he must still pay dividend taxes on the money he has received. For most taxpayers, the rate of dividend taxation is 15%, which would bring his final receipt to \$276,250, or a little more than half of his share of the company’s profit. Because of these taxes on dividends, potential shareholders might be moved to invest elsewhere.

This disincentive is important because corporations can use stock as a way to raise capital when they are in need of it. This is especially true of new corporations, which can issue some of their ownership to investors in the form of stock. It is also true of corporations that have previously issued some of their stock, but hold some of it and wish to issue more. It should be noted, however, that the exchange of already issued stock between investors is of no use whatsoever to the corporation. Money is only exchanged between investors; the company has no role in the transaction and receives no benefit from it.

Employment Taxes

In addition to personal **income taxes**, employees in the United States are required to pay a portion of their income to **Social Security** and **Medicare**, two government programs. Employees pay 6.2% of their first \$102,000 of income each year to Social Security. Given that most Americans make less than \$102,000 each year, this means that most people pay 6.2% on all of their income. Additionally, they must pay 1.45% of their entire income to Medicare. The corporations that employ them must match these taxes, thus making the total tax 15.3% of an employee’s wages.

These taxes are controversial for several reasons. First of all, since the largest portion of the tax is on income below \$102,000, the taxes lie much more heavily on poor people than on rich people. Additionally, many economists believe that the effect of the tax does not depend on whether the company pays it or the employee pays it, and that the division of payment between the company and employees just creates unnecessary and wasteful paperwork. Most of all for our purposes, the taxes discourage companies from employing people because they



increase the costs of employment. If it were less expensive to hire employees, it is likely that fewer people would be unemployed, which would have serious and important effects on the crisis.

It is argued by many that these taxes are important because the programs that they go to fund are important. There is no good reason, however, that the funding for Social Security and Medicare could not come from other taxes. It may be that the government could tax other practices less harmfully, and that the employment taxes that are currently in place are not the best way to fund the programs.

Deductions

In defining “profit,” I said that it consisted of counting a corporation’s revenue and subtracting its expenses. The things that a corporation is allowed to count as expenses are called **tax deductions**. In addition, the government can specify tax deductions for things that might not appear to be business expenses. For example, certain types of charitable giving are tax-deductible, and thus count against revenue earned when paying taxes.

Businesses are, in some cases, also allowed to count losses from one year against revenue from previous years. One part of the recent stimulus legislation has increased the time frame for this practice, allowing some corporations to count losses against up to five years of revenue for tax purposes, thereby lowering their taxable income in those past years and entitling them to refunds.

The government might help stimulate businesses by expanding the list of things that can be considered tax-deductible. Additionally, the activities of businesses can be directed if the government provides tax deductions for those activities in which it would like businesses to engage—perhaps, for example, an expanded tax deduction for hiring new workers.

Subsidies

A **subsidy** is simply the direct appropriation of government funds to some person or entity. This is probably the least complicated and most immediate way to provide stimulus funding.

Traditional Issues

Although there are many issues involved with the timing of this crisis—for example, the already-large national debt and costly problems in other areas—some issues arise with any contemplation of changing the corporate tax code. Most of these have to do with ideas about the relationship of businesses to the government, and how this relationship is manifested in tax policy. Also, however, there are issues involved with where tax revenue should come from.



To begin, one of the most classic questions in taxation is how much the tax system should support two virtues: **efficiency** and **equity**. It is theorized, for example, that America's economic output would be much higher if the wealthiest citizens were taxed far less, or not taxed at all. This change, however, would not seem to be equitable: many wealthy people would become much wealthier, and none of their new-found wealth would be able to help poor citizens receive social services.

This question leads to many theoretical divisions about the best way to divide up the tax burden in the United States. Some people have advocated, for example, that tax be divided up based on who receives the most benefits from the government. This would have the perverse affect, however, of suggesting that those who are the neediest ought to pay the most in taxes. Others have suggested that the wealthy should pay more. It is objected, however, that it might be unfair to penalize the rich for their hard work and success. Still others argue that everyone should pay the same proportion of his or her income in taxes. This plan receives criticism because it is objected that the poor should not have to pay as high a percentage as the wealthy.

These issues become more difficult when dealing with businesses. It becomes complicated, for example, to isolate who really benefits from business profits, and how those profits should be taxed. Businesses that make a substantial amount of profit pay much more in corporate income tax than those that make small profits. But the people who receive these profits as dividends are frequently working-class families that have their **pensions** invested in **mutual funds** or other funds that invest in stocks. The people who ultimately bear the corporate tax and the dividend tax, then, might be low or middle-income families that will have less money upon the retirement of their wage-earners. It is thus perverse to make a law on corporate tax with only the intent of taxing the wealthy, as there are many people who are not wealthy who depend on corporate income for their livelihoods.

Also, there are questions about how far the government should go to **bail out** businesses in the current economic crisis. It is a feature of **capitalism**, America's economic system, that businesses and individuals must assume some responsibility for their own economic situations. This is especially true when the businesses or individuals in question are badly off because of their own actions. If the government gives too much relief, then, to businesses that can be blamed for their involvement in the crisis, it could pose a long-term threat to the capitalistic order. Businessmen would not have an incentive to avoid making risky investments—they would feel safe that the government would bail them out if they failed!

On the other hand, Congress must be aware that if the crisis drags on, it will hurt many more people than it already has. Many of the people who will be hurt will probably not be responsible for their in-



volvement in the crisis. Even though Congressmen might think significant stimulus packages are bad for capitalism in America, they might provide stimulus and relief because they are unwilling to let innocent people bear the burden of a crisis for which they are not responsible.

These are the most central theoretical issues involved with changing the business tax code. There are also several issues related to the constraints supplied by the current crisis.

Issues Involved with Current Policy Change

Possible Necessity of Increased Government Revenue

The current crisis has caused the collapse of several large investment houses and the devaluation of housing assets. This has hurt older Americans quite severely, as many pensions were invested in the now-defunct investment companies, and people who were planning to sell their houses have found themselves with much less valuable assets. In addition, many companies are laying off expensive executives, which has left some middle-aged or older people jobless after years of working.

It is unclear what the best solution is for aging people who have recently lost their jobs and the value in their homes, especially. The only thing that is clear is that almost any solution to the problem would involve significant expenditures. This might be a good reason not to cut taxes too much, as the national debt is already climbing significantly.

Deficit Spending and the National Debt

America's national debt is quite large, and there are many concerns about the rising interest that the government has to pay on the debt. Additionally, there are questions about what might happen if the countries lending America money decide they would like repayment on their loans. As unlikely as this is to happen, many individuals are nervous about accumulating massive debt over a long period of time.

There are other arguments about deficit spending, but many of them are related to these two ideas.

Focus of Debate

Liberal View

Since Democrats are in control of Congress and the White House at present, they are looking for ways to ease the burden of the financial crisis. They have thus shepherded through a number of large spending bills with the aim of supplying relief and stimulus, and would be likely to favor further stimulus if the methods already at-



tempted are not effective.

At the same time, Democrats have historically been opposed to tax cuts for the wealthiest citizens. Many people see tax breaks given to businesses as a tool for distributing money to the wealthy. Nevertheless, there is some division within the party about stances on business taxation. These issues would be better explored on a case-by-case basis.

Conservative View

Conservatives have historically been in favor of lower taxes, but many Republicans voted against the recent stimulus bill passed by the Democrats. There have been objections about the vast amounts of deficit spending that the nation is incurring for these stimulus packages. Nevertheless, some Republicans might seize on the present crisis to argue for lower business taxes that might become institutionalized and outlive the crisis situation.

LOBBYING GROUP PERSPECTIVES

Cato Institute

As a libertarian group, the Cato Institute is firmly opposed to government taxes of almost any kind. This includes taxes on businesses. They have made this clear with publications over the years, and it would thus please such an institution if there were any reason to reduce corporate taxes.

United States Chamber of Commerce

As a business lobbying group, the Chamber of Commerce is very interested in the reduction of corporate taxes. Any reductions would help businesses run better and give their owners more funds and control.

Labor Unions

Since many employees are being laid off, labor unions would likely be in favor of a reduction of employment taxes—as long as the reduction did not come with the cutting of the Medicare and Social Security programs funded by the taxes. These programs are important to many citizens, especially those who would likely be in labor unions.



CONCLUSION

Despite the difficulties and complexities of business taxation, including many not outlined here, stimulating businesses might be one of the best ways to bring the country out of the financial crisis. There are also many policy results that make sense in the short run which might be equally good changes to make in the long run.

REFERENCES

“What Is Taxable and Non-Taxable Income?” found at the Internal Revenue Service Website, at <http://www.irs.gov/businesses/small/article/0,,id=117613,00.html>

“S Corporations,” found at the Internal Revenue Service Website, at <http://www.irs.gov/businesses/small/article/0,,id=98263,00.html>

N. Gregory Mankiw, *Principles of Economics*, Fourth Edition.

The Cato Institute Website, at Cato.org

Milton Friedman, *Capitalism and Freedom*

.

GLOSSARY

Laying off—terminating an employee, usually for economic reasons.

Stimulus—changes made by the government in order to encourage economic activity.

Fiscal—relating to the disbursement of money instead of the manipulation of interest rates. The other kind of stimulus, a “monetary” stimulus, involves changing interest rates to affect economic activity.

Capital—money or equipment that is used in the operation of a business or the production of other goods.

Deficit Spending—spending more money than is taken in.

Incentive— Something that motivates someone to act. In economics, this usually refers to financial incentives, or money that a person receives for acting in a certain way.



Profit—A corporation's income minus its expenses.

S Corporation—a corporation that fulfills the IRS's requirements for an S Corporation, and thus returns all profits to its shareholders who declare it as ordinary income.

C Corporation—a corporation that does not qualify as an S corporation, which has different rules for the taxation of its profits (issued through dividends).

Shareholders—individuals who own stock in a company.

Artificial Person—a corporation, which is treated as a legal entity.

Corporate Income Tax—a tax on corporate profit.

Disincentive—the opposite of an incentive, something that would discourage a certain action.

Stock—a share of ownership in a corporation. Those who hold a company's stock are its owners.

Income Tax—tax that individual persons have to pay on their salaries and other kinds of income.

Social Security—a government program that collects money from those who are working and then provides payments once they retire.

Medicare—a government program that provides medical care to the elderly.

Tax deduction—an expense that a person or corporation can use to offset its income when paying taxes.

Subsidy—a direct payment from the government to a person or company.

Economic Efficiency—economic efficiency is achieved when the economy operates in such a way that it produces the most wealth that it can.

Equity—how fairly the goods of economic production are distributed.

Pensions—retirement investment plans.

Mutual Funds—funds that invest in a wide variety of sources, usually



including the stock market.

Bailout—government expenditures that allow companies to stay in business if they are doing poorly.

Capitalism—America’s economic system, chiefly characterized by individual (rather than government) ownership of companies, and individual responsibility for investment and financial decisions.

