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Recommended Citation
Hoogstra, Eric; Dimkoff, Gregg; and Sundaram, Sridhar (2014) "Corporate Taxes: Too High, Too Low, or Just Right? That is the Question," *Seidman Business Review*: Vol. 20: Iss. 1, Article 8.
Available at: [http://scholarworks.gvsu.edu/sbr/vol20/iss1/8](http://scholarworks.gvsu.edu/sbr/vol20/iss1/8)
Corporate Taxes: Too High, Too Low, or Just Right? That is the Question.

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There are many today who believe corporate taxes are just too high and it would be best to eliminate them. Others believe corporations are not paying their fair share. Yet, others believe the rates currently paid are fair and just. Because of these divergent opinions, the fairness of corporate taxes once again has moved into the political spotlight. Both political parties present facts, figures, and rationale to support their individual positions. The arguments presented by politicians, economists, the media, and corporate executives, however, often conflict depending on the point each group is trying to make. Often their arguments are not based on economic theory, but instead merely reflect their emotions or their philosophical values. This article reviews trends in the corporate tax environment and concludes with an outlook for change.

Discussion about the fairness of corporate taxes has been debated since the income tax on corporations was established by the Corporate Income Tax Act of 1909 (The 16th amendment to the U.S. Constitution created the individual income tax in 1913). The corporate income tax rate is a graduated tax topping out at 35% for taxable income above $18.3 million. That official U.S. corporate income tax rate is the world’s highest. For example, rates in China and Brazil are 25%, Russia is 20%, and India is 33.9%. Yet, the average effective tax rate paid by U.S. corporations was 12.6 percent in 2010 as reported by the Government Accounting Office earlier this year. In addition, corporate income tax receipts have become smaller relative to total federal tax revenue over the years. They accounted for 32.1% of tax revenue in 1952 (the post-WWII peak), entered a long downward trend, and by 2010 amounted to 8.9% of federal tax revenue. The decrease is due to the explosion in other organizational forms of business such as LLCs and partnerships, where profits pass through to owners who then pay individual income taxes, the decline in profitability of corporations over the years, and the practice of U.S. global corporations holding profits they’ve earned overseas in foreign banks to delay or avoid paying corporate income taxes when those profits are brought back into the U.S.

Considering these facts and figures, what are some aspects that must be considered when determining if corporate tax rates are currently too high, too low, or just right? First, note that income of most corporations is taxed twice: first at the corporate level through the corporate income tax, and second, at the individual level through personal income taxes on dividends paid to owners. Does this double taxation matter to you? Most likely. The majority of us are corporate owners through shares of stock we own directly or in our defined contribution retirement plans, our pension funds, and maybe even in our annuities and life insurance policies. Stock ownership is not just the domain of the filthy rich. About 52% of households own stock, and a slight majority of owners are women.

Here is an example showing how double taxation can affect a stockholder. Say a corporation earns $100 of taxable income. At a corporate tax rate of 30%, taxes will be $30. That leaves $70 after taxes. If the entire $70 is paid to the shareholders who have an average 33% individual federal and state tax rate, owners would pay another $23 in taxes. The $100 of corporate income is taxed a total of $53. Although the corporate tax rate is 30%, the investor/owner paid an overall effective rate of 53%. Double taxation is an important reason why many U.S. corporations have moved their headquarters to countries where tax laws are less onerous.

C-Corporations are the only business organization form having its own income tax—the corporate income tax. Pass-through entities (LLCs, partnerships, and S-Corporations) pay no income taxes. Instead, their taxable income passes through to their owners' individual income tax forms. Along with sole proprietorships, these pass through entities account for 71% of tax returns filed, a number that is increasing. A major reason for this growth is the avoidance of double taxation.

The top tax rates on corporate income taxes have been much higher in the past. When Kennedy was president in the early 1960s, for example, the top corporate rate was 90%. From 1970–1986, top rates were in the mid- to high-40% range. Only since 1993 have top rates been at 35%.

Corporations rarely pay the current statutory federal rate. Although the average rate is 12.6%, many companies pay little or no taxes because of the numerous tax preferences,
distributions, and the benefits of offshore operations. Large corporations unable to take advantage of these tax breaks pay much higher rates than average. Accordingly, lowering the corporate income tax from 35% to even 25%—a substantial cut in the official rate—will have a muted effect on overall tax revenue, but would give the perception that the U.S. corporate tax structure is more globally competitive.

Corporations go to great lengths to avoid corporate income taxes. For example, many companies hold money outside the U.S. instead of repatriating it back home and subjecting it to U.S. tax rates. These actions are increasingly frustrating to the political establishment. For example, General Electric holds only $30.7 of its $85.5 billion in cash reserves in the United States; Microsoft holds only $8.6 of its $58 billion of cash in the United States; Whirlpool keeps 85% offshore; and Johnson and Johnson has all of its $24.5 billion offshore (Spaeth, 2012). Apple was criticized last summer for issuing bonds to pay dividends rather than move its cash from offshore accounts back to the United States. In fact, Citizens for Tax Justice reports that 253 corporations hold $1.3 trillion in profits overseas to avoid high U.S. income tax rates.

Many people believe that cutting corporate taxes would lower the Federal Government's tax revenue. Some economists estimate that cutting the tax rate from 35% to 25% would reduce revenues by $1.2 trillion—about $120 billion a year—over a 10 year period (Pozen, 2013). That number seems preposterous given that U.S. corporations pay about $160 billion in corporate income taxes per year. Others argue a tax cut would spur business growth with the resulting higher income leading to increased corporate tax receipts. Because the average corporate tax rate is 12.6%, a reduction in the official rate would have to be enormous to have the effect proponent of either position contend. In addition, over the past century, there have been periods when lowered corporate tax rates increased economic growth, while at other times growth did not increase. Clearly, economic factors can swamp the effect of changes in tax rates.

The populist opinion holds that businesses and industries earning huge profits can afford to pay additional taxes. Petroleum companies are criticized for making exorbitant profits, and many of the complainers feel oil companies should be taxed at higher rates. For example, Exxon Mobil’s annual report shows $44.9 billion of profit from sales of $453.1 billion and an overall profit margin of 10%. In contrast, Apple Inc. reported profits of $25.9 billion on $108.2 billion on sales equivalent to a profit margin of 23.9%. In other words, Exxon Mobil had over four times the sales of Apple, but only 40% of Apple’s profit margin. What’s fair then? It’s rare to hear someone railing against Apple’s profit gouging, while it’s common to hear such complaints about Exxon Mobil. In comparison, General Electric earned $14.2 billion in profit, yet when it came tax time, it reported a $3.2 billion credit. According to Kocieniewski (2011), that was due to “an aggressive strategy that mixes fierce lobbying for tax breaks and innovative accounting that enables it to concentrate its profits offshore.” Any change to corporate income tax law must address the difference between total profit, profit margin, the size of the company relative to the size of its profits, and the fairness of the lobbying leverage enjoyed by the largest firms. That is an exceedingly complex issue, and any agreement will face a steep battle.

Today, corporations are increasingly moving offshore to take advantage of lower tax rates in other countries. That trend extends to West Michigan. For example, Perrigo Co. announced this past summer it would buy Dublin, Ireland-based Elan Pharmaceuticals in a $8.6 billion deal. The decision to move the holding company headquarters to Dublin was driven mostly by Ireland’s 12% income tax rate. Perrigo executives expect the move will reduce expenses by $150 million per year, with most of the savings coming from Ireland’s lower income tax. CEO Joseph Papa estimated that Perrigo’s income tax rate will drop from about 30% to the high teens. The good news is that Perrigo’s executive headquarters will remain in Allegan, MI. During the past decade, over 300 U.S. corporations moved their headquarters to countries with more favorable tax laws. In a global environment, one would expect these shifts and transitions to continue as the world becomes more competitive.

So, what conclusions can be made about corporation taxation? First, it is a complex topic that not only affects the national landscape but plays out in the global environment. Corporations will continue to push for lower rates and are not fearful of moving their global headquarters to gain them. The U.S. also has to be sensitive to its ranking within the world marketplace and must push to remain a competitive environment for businesses. Lowering the statutory rate would help satisfy those who argue corporate tax rates are too high, but the effect on corporations would be uneven, and unless the decrease is substantial, would have little effect on overall revenue raised. While there is general agreement within Congress to reform the corporate tax code to make it more efficient and effective, there are still major disagreements about how to do so fairly. In short, the answer to whether taxes are too high, too low, or just right cannot be answered easily, if at all. And that’s why the status quo is likely to be the norm for the immediate future.

References

