CORPORATE TAX RECEIPTS AND CORPORATE TAX LIABILITIES

Scheduled for a Public Hearing
Before the
HOUSE COMMITTEE ON WAYS AND MEANS
on February 11, 2020

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JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The House Committee on Ways and Means has scheduled a hearing for February 11, 2020, entitled "The Disappearing Corporate Income Tax." This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a summary of present law and accounting rules relevant to the Federal income tax liabilities and tax receipts of corporations. This document also discusses possible behavioral responses to Federal income tax and describes a review of 50 large C corporations undertaken by the Joint Committee staff related to corporate tax receipts.

[1] This document may be cited as follows: Joint Committee on Taxation, *Corporate Tax Receipts and Corporate Tax Liabilities* (JCX-4-20), February 10, 2020. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

I. CORPORATE INCOME TAX

In general

Corporations organized under the laws of any of the 50 States or the District of Columbia generally are subject to the U.S. corporate income tax on their U.S.-source and certain foreign-source income.[2] Foreign corporations generally are subject to the U.S. corporate income tax only on income that is effectively connected with a U.S. trade or business.

Taxable income

The taxable income of a corporation generally is its gross income less allowable deductions, computed based on the corporation's methods of accounting. Large C corporations (*i.e.*, those with average annual gross receipts for the three-taxable-year period ending with the prior taxable year that exceed $26 million (for 2020[3])) are generally required to use an accrual method of accounting.[4] Under the accrual method of accounting, items of income generally accrue when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy, but no later than the taxable year in which such income is included as revenue for book purposes.[5] Items of expense generally may not be deducted prior to when all the events have occurred that fix the obligation to pay the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred.[6]

Special rules for taxable year of inclusion.–An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018,[7] often referred to as the Tax Cuts and Jobs Act ("TCJA"), revised the rules associated with the timing of income recognition under the all events test of section 451 for taxable years beginning after 2017. Specifically, TCJA modified the all events test to provide that sales, gross receipts, and other items of gross income that have been realized are included in income no later than the

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[2] Under subchapter S of the Internal Revenue Code of 1986 (the "Code"), a small business corporation may elect not to be subject to the corporate income tax (*i.e.*, may make an "S corporation election"). If an S corporation election is made, the income of the corporation flows through to the shareholders and is taxable directly to them.

[3] Rev. Proc. 2019-44, 2019-47 I.R.B. 1093.

[4] Sec. 448. Special methods of accounting that provide an exception to the all events test may apply (*e.g.*, special methods for long term contracts subject to section 460). Unless otherwise stated, all section references are to the Code.

[5] Sec. 451.

[6] Sec. 461.

[7] Pub. L. No. 115-97.

taxable year in which such income is included as revenue for book purposes.[8] In addition, certain bonds and debt instruments are now subject to the all events test,[9] and advance payments may generally only be deferred using a one-year deferral method.[10]

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, contributions to qualified retirement plans and certain other employee benefit programs, repairs, bad debts, taxes (other than Federal income taxes), contributions to charitable organizations (subject to an income limitation), advertising, interest expense (subject to limitation), certain losses, selling expenses, and other expenses. In the event these deductions exceed gross income, a net operating loss ("NOL") deduction may be allowed in other years, as described below. Deductions are also allowed for certain amounts despite the lack of a direct expenditure by the taxpayer. For example, a deduction is allowed for all or a portion of the amount of dividends received by a corporation from another corporation (provided certain ownership requirements are satisfied).

Limitation on deduction for interest.–TCJA modified the limitation on the deduction for business interest for taxable years beginning after 2017. Specifically, the deduction for business interest is limited to the sum of: (1) business interest income; (2) 30 percent of adjusted taxable income; and (3) floor plan financing interest.[11] Taxpayers with average annual gross receipts for the three-taxable-year period ending with the prior taxable year that do not exceed $26 million (for 2020[12]) and certain regulated public utilities are not subject to this limitation. Taxpayers in real property or farming trades or businesses[13] may elect not to be subject to this limitation.

NOL deduction.–TCJA changed the rules governing carrybacks and carryovers of NOLs and imposed a limitation on the deduction for NOLs. For NOLs arising in taxable years beginning after 2017, the NOL deduction is generally limited to 80 percent of taxable income and excess losses generally may be carried forward indefinitely, but not back (with certain

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[8] Sec. 451(b). The provision does not apply to taxpayers without an applicable financial statement (as defined in section 451(b)(3)).

[9] Sec. 451(b)(2). In the case of income from a debt instrument having original issue discount, the provision applies to taxable years beginning after 2018.

[10] Sec. 451(c).

[11] See sec. 163(j).

[12] Rev. Proc. 2019-44, 2019-47 I.R.B. 1093.

[13] As defined in sec. 163(j)(7)(B) and (C).

exceptions).[14] Prior to TCJA, an NOL incurred in one taxable year generally could be carried back two years or forward 20 years.

Deduction for income attribution to domestic production activities.–Prior to TCJA, a deduction was allowed for a portion of the amount of income attributable to certain manufacturing activities.[15] TCJA repealed the provision, effective for taxable years beginning after December 31, 2017.

Recovery of 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 capitalized and recovered over time through depreciation, amortization, or depletion allowances. In some instances, taxpayers can recover their costs more quickly than under the general rules.

Section 179 expense.–A taxpayer may elect to deduct (or "expense") up to $1,040,000 of the cost of section 179 property placed in service during the 2020 taxable year. This amount is reduced (but not below zero) by the amount by which the cost of qualifying property exceeds $2,590,000. These limits are indexed for inflation.[16] Prior to TCJA (*i.e.*, for property placed in service in taxable years beginning after 2009 and before 2018), the amount a taxpayer could expense under section 179 was generally $500,000, reduced (but not below zero) by the amount by which the cost of qualifying property exceeded $2,000,000.

Additional first-year depreciation deduction.–An additional first-year depreciation deduction is allowed equal to up to 100 percent of the adjusted basis of qualified property.[17] The portion of basis allowable as additional first-year depreciation depends on both the date the qualified property is acquired and the year the qualified property is placed in service. Used property acquired in arms-length transactions may qualify for the additional first-year depreciation deduction. Generally, property used by businesses not subject to the limitation on interest expense (*e.g.*, regulated public utilities and electric cooperatives and taxpayers in a trade or business that has had floor plan financing indebtedness) is excluded from the definition of qualified property. Prior to TCJA (*i.e.*, generally for property acquired and placed in service before September 28, 2017), the additional first-year depreciation deduction was 50 percent and used property did not qualify for the deduction.

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[14] See sec. 172.

[15] See former section 199. Deductions of income amounts can be viewed as substitutes for exemption or rate reductions for the affected income.

[16] See sec. 179 and Rev. Proc. 2019-44, 2019-47 I.R.B. 1093.

[17] See sec. 168(k).

Deduction limitations

Certain expenditures may not be deducted, such as dividends paid to shareholders, expenses associated with earning tax-exempt income,[18] certain meal and entertainment expenses, certain qualified transportation fringe and commuter benefits, certain executive compensation in excess of $1 million per year, a portion of the interest on certain high-yield debt obligations that resemble equity, as well as fines, penalties, bribes, kickbacks, illegal payments, and settlements subject to nondisclosure agreements paid in connection with sexual harassment or abuse.

Disallowance of certain meal and entertainment expenses and fringe benefits.–TCJA changed the rules governing the deductibility of meal and entertainment expenses to generally prohibit deductions for entertainment expenses, including meals and other items, activities, and facilities that constitute entertainment. A 50-percent deduction disallowance applies to expenses associated with providing meals and facilities that qualify as de minimis under section 132(e), including meals for the convenience of the employer under section 119.[19] TCJA also added rules to disallow deductions to employers for expenses associated with providing qualified transportation fringe benefits unless amounts are reported and properly included in employee compensation, and to disallow deductions for other commuter benefits generally.

Limitation on deduction for certain executive compensation in excess of $1 million per year.–TCJA substantially expanded the application of section 162(m), including striking the exceptions for performance-based compensation and commissions and changing the definitions of a covered employee and publicly held corporation.

U.S. tax rules applicable to foreign activities of U.S. persons

In general, income earned directly by a U.S. corporation from the conduct of a foreign business is taxed currently, while income earned indirectly through certain related foreign legal entities is taxed either in the year earned or not at all. In particular, the indirect earnings from certain related foreign legal entities (*i.e.*, controlled foreign corporations ("CFCs")) may constitute subpart F income to U.S. shareholders.[20] Subpart F income generally includes certain passive income and certain other related-party income that is readily movable from one jurisdiction to another. After the enactment of TCJA, U.S. shareholders of a CFC also may be subject to tax on their pro rata shares of certain other income of the CFC (referred to as global

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

[19] See sec. 274.

[20] Secs. 951-964. A CFC is generally defined as any foreign corporation where U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that are within the meaning of the term "United States shareholder," which refers only to those U.S. persons who own at least 10 percent of the stock (measured by vote or value). Secs. 951(b), 957, and 958.

intangible low-taxed income ("GILTI")).[21] Subpart F income is taxed at full rates, while GILTI is taxed at preferential rates, both without regard to whether the income is distributed to shareholders. The preferential rate on GILTI is achieved by means of allowing corporations a 50-percent deduction (a "section 250 deduction") on their GILTI (and the corresponding section 78 gross up amount).[22] A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income.[23] Also after TCJA, dividends received by corporate U.S. shareholders from their CFCs are generally eligible for a 100-percent dividends received deduction.[24] Corporations meeting certain requirements are subject to a base erosion and anti-abuse tax that is in the nature of a minimum tax and payable in addition to all other tax liabilities.[25]

Corporate tax liability

In general

A corporation's income tax liability generally is determined by applying a 21-percent rate to its taxable income. Prior to 2018, the corporate income tax included a four-step graduated tax rate schedule, with a top corporate tax rate of 35 percent on taxable income in excess of $10 million, as well as an alternative minimum tax ("AMT") that was payable (in addition to all other tax liabilities) to the extent that it exceeded the corporation's regular income tax liability.[26] TCJA eliminated the graduated corporate rate structure and repealed the corporate AMT, effective for taxable years beginning after December 31, 2017. As part of the repeal of the corporate AMT, a corporation may offset its entire regular tax liability for a taxable year with its

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[21] Secs. 951-964. GILTI means, with respect to any U.S. shareholder, the excess of its pro rata share of certain CFC income over a 10-percent return (reduced by certain interest expense incurred by CFCs) on its pro rata share of the aggregate of the average quarterly adjusted bases in certain depreciable tangible property of each CFC with respect to which it is a U.S. shareholder.

[22] Sec. 250(a)(1)(B). The section 250 deduction for GILTI is only available for C corporations that are neither regulated investment companies ("RICs") nor real estate investment trusts ("REITs"). The section 250 deduction also applies with respect to foreign-derived intangible income of certain corporations, discussed in more detail below.

[23] Foreign tax credits limited in a tax year generally may be carried back one year or forward 10 years. Sec. 904(c). In contrast with the general rules allowing carrybacks and carryovers of excess foreign tax credits, no carrybacks or carryovers of excess foreign tax credits are allowed in the GILTI foreign tax credit limitation category. In addition, a 20-percent foreign tax credit disallowance applies to foreign income taxes paid with respect to GILTI. Sec. 960(d). Foreign tax credits are not available for foreign taxes paid or accrued with respect to dividends qualifying for the 100-percent dividends received deduction. Sec. 245A(d).

[24] Sec. 245A.

[25] Sec. 59A. The base erosion and anti-abuse tax is discussed in more detail below.

[26] If a corporation was subject to AMT in any taxable year, the amount of AMT was allowed as an AMT credit in any subsequent taxable year to the extent the corporation's regular tax liability exceeded its tentative minimum tax in the subsequent year. See sec. 53.

AMT credit(s) carried forward from prior taxable years. In addition, the corporate AMT credit is allowable and refundable for taxable years beginning after 2017 and before 2022.

In contrast to the treatment of capital gains in the individual income tax, no separate rate structure exists for corporate capital gains. 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 or carried forward five years.

Corporations generally are taxed at lower rates on their foreign-derived intangible income ("FDII").[27] The preferential rate is accomplished by the allowance of a 37.5-percent deduction under section 250, resulting in an effective tax rate of 13.125 percent on FDII.

Corporations may reduce their tax liability by any applicable tax credits.[28] The three largest dollar amount credits are the research credit, the low-income housing tax credit, and the renewable electricity production credit, which target intangible investment, real property investment, and electricity production, respectively.[29]

The research credit is generally available with respect to incremental increases in qualified research.[30] A research credit is also available with respect to corporate cash expenses paid for basic research conducted by universities (and certain nonprofit scientific research organizations) above a certain floor.[31] Finally, a research credit is available for a taxpayer's expenditures on research undertaken by an energy research consortium.[32]

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[27] A corporation's FDII is its deemed intangible income multiplied by the percentage of its income (computed with certain exceptions) derived from serving foreign markets. A corporation's deemed intangible income is the excess of its income (computed with certain exceptions) over a 10-percent return on the aggregate of its average quarterly adjusted bases in certain depreciable tangible property. The deduction for FDII is not available for RICs or REITs. Sec. 250.

[28] Business credits also apply to the business income of individuals.

[29] See Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2019-2023* (JCX-55-19), December 18, 2019.

[30] 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. Sec. 41(a)(1). An alternative simplified research credit (with a 14-percent rate and a different base amount) may be claimed in lieu of this credit. Sec. 41(c)(5).

[31] This 20-percent credit is available with respect to the excess of (1) 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 during a fixed-base period adjusted for inflation. Sec. 41(a)(2) and (e).

[32] 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. Sec. 41(1)(3).

The low-income housing tax credit may be claimed over a 10-year period by owners of certain residential rental property for the cost of rental housing occupied by tenants having incomes below specified levels.[33] 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 qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building.

An income tax credit may be claimed during a 10-year period beginning after a qualified facility is originally placed in service for the production of electricity from qualified energy resources at qualified facilities (the "renewable electricity production credit"). Qualified energy resources comprise wind, closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, qualified hydropower production, and marine and hydrokinetic renewable energy. Qualified facilities are, generally, facilities that generate electricity using qualified energy resources. To be eligible for the credit, electricity produced from qualified energy resources at qualified facilities must be sold by the taxpayer to an unrelated person.[34]

In addition, there are credits applicable to businesses including investment tax credits (applicable to investment in certain renewable energy property and the rehabilitation of certain real property), the work opportunity credit (applicable to wages paid to individuals from certain targeted groups), the employer-provided child care credit (applicable to certain expenditures to provide child care for employees), the employer credit for paid family and medical leave (applicable to wages paid to employees on family and medical leave), and the disabled access credit (applicable to expenditures by certain small businesses to make the businesses accessible to disabled individuals), among others.[35] Unused credits generally may be carried back one year and carried forward 20 years.

The base erosion and anti-abuse tax ("BEAT")

The BEAT applies to a corporation (1) that is not a RIC or REIT, (2) that has average annual gross receipts of at least $500 million over the prior three taxable years, and (3) whose

[33] Sec. 42.

[34] Sec. 45. In lieu of this credit, taxpayers may claim a 30 percent investment credit for property placed in service at facilities that would otherwise qualify for the renewable electricity production credit. Sec. 48(a)(5). For both the production credit and the investment credit in lieu of the production credit, a phaseout applies for wind facilities the construction of which begins after December 31, 2016. Under this phaseout rule, for wind power facilities the construction of which begins in calendar year 2020, the credit is reduced by 40 percent. Generally, no credit is allowed for renewable power facilities the construction of which begins after December 31, 2020.

[35] Certain of these credits are scheduled to expire in 2020 or later. For more information on expiring provisions of the Code, see Joint Committee on Taxation, *List of Expiring Federal Tax Provisions 2020-2029* (JCX-1-20), January 16, 2020.

base erosion tax benefits, as a share of certain outlays made by the corporation, exceed three percent.[36]

A corporation's BEAT liability is generally the excess, if any, of 10 percent (five percent in the case of taxable years beginning in calendar year 2018) of its modified taxable income over an amount equal to its regular tax liability reduced (but not below zero) by certain credits under chapter 1 of the Code.[37] Special rules for computing the base erosion minimum tax apply to banks and securities dealers.

A corporation's modified taxable income is its taxable income determined without regard to a certain portion of any NOL deduction allowed for the taxable year and without regard to any base erosion tax benefit with respect to certain items (*i.e.*, "base erosion payments"), including (1) certain deductible payments made to foreign related parties, (2) deductions allowed for depreciation (or amortization in lieu of deprecation) with respect to property acquired from foreign related parties, and (3) reinsurance premiums paid to foreign related parties.[38]

<u>Transition tax on U.S. shareholders of certain controlled foreign corporations</u>

TCJA made many changes to the taxation of the foreign activities of U.S. persons, which had the effect of moving the United States from a worldwide system with limited deferral toward a participation exemption system with current inclusion of certain additional income. As part of the transition to this new participation exemption system, TCJA enacted a one-time tax (the "transition tax") on undistributed foreign earnings that accrued before the effective date of the new system. The transition tax allowed for the uniform applicability of the participation exemption with respect to post-enactment foreign earnings of foreign subsidiaries.

The transition tax requires certain foreign corporations to include as subpart F income the untaxed and undistributed foreign earnings that were accumulated by those corporations in taxable years since 1986. The U.S. shareholders of those corporations are subject to the transition tax with respect to the shareholders' pro rata shares of such subpart F income.

The transition tax generally applies for the last taxable year beginning before January 1, 2018, requiring that any U.S. shareholder of a specified foreign corporation must include in income its pro rata share of the accumulated post-1986 deferred foreign income of the corporation. However, a portion of that pro rata share of foreign earnings is deductible, depending on the proportion of the deferred earnings that are held in cash or other assets. The

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[36] Sec. 59A(e).

[37] Credits that reduce regular tax liability (*i.e.*, increase the base erosion minimum tax amount, if any) are all section 38 credits except for (1) the research credit and (2) applicable section 38 credits. Applicable section 38 credits are the low-income housing credit, the renewable electricity production credit, and the energy investment credit. The exception for applicable section 38 credits generally may not reduce the base erosion minimum tax amount by more than 80 percent (determined without regard to the exception for applicable section 38 credits). Sec. 59A(b).

[38] Sec. 59A(c).

structure of the allowable deduction results in a bifurcated rate of tax on amounts required to be included in income: the rate is 15.5 percent for cash assets and eight percent for noncash assets. A corresponding portion of the credit for foreign taxes paid with respect to such income is disallowed, thus limiting the credit to the taxable portion of the included income.[39] A U.S. shareholder may elect to forgo the use of an NOL deduction to offset the amount included under the transition tax, and if the U.S. shareholder so elects, neither the section 951 inclusion nor any related deemed paid foreign tax credits may be taken into account in computing the NOL deduction for that year.[40]

A taxpayer may elect to pay the transition tax over an eight-year period without accruing underpayment interest. Special rules are provided for S corporations and REITs.

Affiliated group

Domestic corporations that are affiliated through 80-percent or more corporate ownership may elect to file a consolidated return in lieu of filing separate returns. Corporations filing a consolidated return generally are treated as a single corporation; thus, the losses of one corporation can offset the income (and thus reduce the otherwise applicable tax) of other affiliated corporations.

Treatment of corporate distributions

The taxation of a corporation generally is separate and distinct from the taxation of its shareholders. A distribution by a corporation to one of its shareholders generally is taxable as a dividend to the shareholder to the extent of the corporation's current or accumulated earnings and profits.[41] Thus, the amount of a corporate dividend generally is taxed twice: once when the income is earned by the corporation and again when the dividend is distributed to the shareholder.[42] Conversely, some amounts paid as interest to the debtholders of a corporation may be subject to only one level of tax (at the recipient level) since the corporation is allowed a deduction for part or all of the amount of interest expense paid or accrued.

Amounts received by a shareholder in complete liquidation of a corporation generally are treated as full payment in exchange for the shareholder's stock. A liquidating corporation recognizes gain or loss on the distributed property as if such property were sold to the distributee

[39] The separate foreign tax credit limitation rules of section 904 continue to apply, with coordinating rules.

[40] Sec. 965(n).

[41] A distribution in excess of the earnings and profits of a corporation generally is a tax-free return of capital to the shareholder to the extent of the shareholder's adjusted basis (generally, cost) in the stock of the corporation; such distribution is a capital gain if in excess of basis. A distribution of property other than cash generally is treated as a taxable sale of such property by the corporation and is taken into account by the shareholder at the property's fair market value. A distribution of stock of the corporation generally is not a taxable event to either the corporation or the shareholder.

[42] This double taxation is mitigated by a reduced tax rate generally applicable to the qualified dividend income of individuals.

for its fair market value. However, if a corporation liquidates a subsidiary corporation of which it has 80-percent or more control, no gain or loss generally is recognized by either the parent corporation or the subsidiary corporation.

Accumulated earnings and personal holding company taxes

Taxes at a rate of 20 percent (the top rate generally applicable to dividend income of individuals) may be imposed on the accumulated earnings or personal holding company income of a corporation. The accumulated earnings tax may be imposed if a corporation retains earnings in excess of reasonable business needs. The personal holding company tax may be imposed on the excessive passive income of a closely held corporation. The accumulated earnings tax and the personal holding company tax, when they apply, in effect impose the shareholder-level tax in addition to the corporate-level tax on accumulated earnings or undistributed personal holding company income.