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WHAT ARE THE LARGEST BUSINESS TAX EXPENDITURES?

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In this brief, we list the 10 major business tax expenditures with the largest revenue losses, as defined by the Office of Tax Analysis (OTA) of the US Treasury Department and the Congressional Joint Committee on Taxation (JCT). We provide a brief description of each provision and briefly summarize the rationale for the provision and its effects.

We define business tax expenditures as those provisions that affect the measurement of business income, such as special deductions or deferrals of income recognition, or credits that businesses or their owners may claim against business tax liability. Business tax expenditures affect both corporate and individual tax liability. They affect individual liabilities because most of the businesses in the United States, accounting for over half of business profits, are taxed as "pass-through" enterprises. These businesses include sole proprietorships, corporations organized under subchapter S of the Individual income tax (S corporations), partnerships, and limited liability companies. They do not pay tax directly; they instead allocate their net profits to their owners or shareholders, who add them to the income on which they pay individual income tax. Special tax preferences for these businesses pass through to their owners in the form of lower reported income on their individual income tax returns or tax credits.

We also do not count all corporate revenue losses from tax expenditures as business tax expenditures. For example, we count the exemption of interest from public-purpose bonds as an individual tax expenditure provision, even though some of that exempt interest is received by corporate financial institutions. We do, however, include both the individual and corporate revenue losses from exemption of interest on private-purpose tax exempt bonds as business provisions because they are designed to subsidize investments in selected business activities.

THE 10 LARGEST BUSINESS TAX EXPENDITURES

Based on data from the JCT, the 10 largest tax expenditures over fiscal years 2019 to 2022, and their revenue losses over that period (table 1) are:

- the reduced tax rate on active income of controlled foreign corporations ($309.2 billion);

- depreciation of equipment in excess of the alternative depreciation system ($253.2 billion);
- the 20 percent deduction individual taxpayers may claim for qualified business income ($225.8 billion);
- the deduction for foreign-derived intangible income from a trade or business within the United States ($85.1 billion);
- the tax credit for increasing research activities ($49.4 billion);
- expensing under section 179 (small business expensing) of depreciable property ($46.0 billion);
- the tax credit for low-income housing investments ($40.5 billion);
- tax credits for electricity production from renewable resources ($20.6 billion);
- cash accounting for businesses other than agriculture ($16.0 billion); and
- the 2-year carryback for net operating losses for insurance companies ($13.8 billion).

TABLE 1

Top 10 Business Income Tax Expenditures

Billions of dollars, fiscal years 2019–22

Tax Provision	JCT		OTA	
	Rank	Amount	Rank	Amount
Reduced tax rate on active income of controlled foreign corporations	1	$309.2	3	$158.8
Depreciation of equipment in excess of alternative depreciation system	2	$253.2	1	$261.6
20 percent deduction for qualified business income	3	$225.8	2	$236.8
Deduction for foreign-derived intangible income from trade or business within the United States	4	$85.1	6	$36.1
Credit for increasing research activities	5	$49.4	4	$66.4
Expensing under section 179 of depreciable property	6	$46.0	-	$9.6
Credit for low-income housing	7	$40.5	5	$36.8
Credits for electricity production from renewable resources	8	$20.6	10	$13.8
Cash accounting other than agriculture	9	$16.0	-	N/A
Insurance companies 2-year NOL carryback	10	$13.8	-	N/A
Exception from passive loss rules for $25,000 of rental loss	-	N/A	7	$26.3
Energy Investment Credit	-	$10.7	8	$19.3
Accelerated depreciation on rental housing	-	$9.1	9	$15.2

Sources: Joint Committee on Taxation (JCT), "Estimates Of Federal Tax Expenditures For Fiscal Years 2018-2022", October 2018; U.S. Department of the Treasury, Office of Tax Analysis (OTA), "Tax Expenditures", October 2018; Authors' analysis.
Note: Tax provisions marked "N/A" are not counted as tax expenditures by respective sources.

OTA lists the same top 10 business expenditures with three exceptions (table 1). OTA does not include cash accounting or the two-year carryback of net operating losses for insurance companies as tax expenditure provisions. And OTA only reports a four-year revenue loss of $9.6 billion for expensing of depreciable property under section 179. Three other provisions are included in the OTA top 10 list:

- the exception from passive loss rules for $25,000 of losses on rental housing ($26.3 billion, not included as a tax expenditure by JCT);
- the energy investment credit ($19.3 billion, scored as $10.7 billion by JCT); and
- accelerated depreciation of rental housing ($15.2 billion, scored as $9.1 billion by JCT).

DESCRIPTION AND BRIEF ASSESSMENT OF PROPOSALS ON BOTH LISTS

Reduced Tax Rate on Active Income of Controlled Foreign Corporations

Under the baseline tax system, US corporations are taxable on their worldwide income, with a credit for the foreign income taxes they pay. The current US international taxation rules differ from this system in two major ways. First, the new tax law exempts from US tax any profits of foreign subsidiaries (controlled foreign corporations or CFCs) of US multinational corporations that are less than 10 percent of a company's net value of foreign tangible assets (such as equipment, machinery, and structures).[1] Second, the tax law allows CFCs to deduct 50 percent of profits greater than 10 percent of net asset value so defined, which, at the 21 percent corporate rate, makes the effective rate on this income (called global intangible low-tax income) equal to 10.5 percent. Firms may claim credits for 80 percent of foreign taxes attributable to global intangible low-tax income, which means that US corporations pay a residual tax on any foreign profits taxed at rates of 13.125 percent (10.5 divided by 0.8) or less.

Both JCT and OTA define the difference between the US taxes CFCs pay on their foreign-source income and the taxes they would pay if all this income were taxed annually at the 21 percent corporate tax, with a credit for foreign income taxes, as a tax expenditure. JCT scores this tax expenditure as costing $309 billion between fiscal years 2019 and 2022, while OTA scores the cost at $159 billion over the same period. One possible reason for this difference in estimates is that OTA counts as an offset to this revenue loss the revenue raised by a transition tax that the Tax Cuts and Jobs Act of 2017 (TCJA) imposed on profits US companies accrued in their CFCs between the end of 1986 and 2017, while the JCT does not count this offset.

The reduced tax rate on active foreign income of CFCs is the largest business tax expenditure on the JCT list and the third-largest business tax expenditure on the OTA list. By providing a lower rate on foreign-source income than on domestic-source income, it encourages US corporations to invest more overseas than at home than would a system that taxed both US and foreign-source profits of US multinationals at the same rate. However, the current 21 percent corporate rate (26 percent on average including state corporate income taxes) is roughly equal to the average corporate tax rate among the world's largest economies. As a result, US corporations pay a roughly equivalent tax rate on domestic income and their foreign-source income in most countries where they have production facilities. The lower corporate rate makes the subsidy to foreign investment much less than it would have been at the 35 percent US corporate tax rate in effect prior to the TCJA. The preferential US tax rate on foreign-source income, however, still favors investment in some low-tax foreign jurisdictions with real economic activity (notably Ireland and the United Kingdom) and provides a benefit (reduced from prior law) for US corporations to engage in transactions that shift reported profits to low-tax jurisdictions, thereby eroding the corporate tax base.

The existence of any positive tax rate on active income of US CFCs, however, may place US-resident multinational corporations at a competitive disadvantage relative to multinationals resident in our major trading partners, most of whom pay no domestic tax on their active foreign-source income. The tax expenditure, therefore, may be seen as reducing the penalty for companies establishing or maintaining a US corporate residence.

In summary, the reduced rate on foreign-source income is not a targeted incentive intended to promote a favored activity. Instead, it can be thought of as an imperfect rule seeking a balance between the competing goals of achieving

[1] The value of net foreign tangible assets equals the initial investment outlays minus the sum of past depreciation deductions.

neutral treatment between domestic and foreign investments and providing a level playing field between US and foreign-resident multinational corporations. The tax expenditure measures the difference between the US corporate taxes US-resident multinational corporations pay (net of foreign corporate taxes) on their foreign-source income and the taxes they would pay (net of foreign corporate taxes) if they were taxable on their foreign source income at the US tax rate applied to domestic income.

Depreciation of Equipment in Excess of the Alternative Depreciation System

Under the baseline income tax, the costs of acquiring machinery and equipment are capitalized instead of being deducted immediately because they represent a change in the composition of business assets from cash to equipment instead of a decline in the value of the business. To measure net income of the business correctly, the costs of acquiring equipment would be recovered over time through depreciation deductions that reflect the decline in the economic value of the assets caused by wear and tear and obsolescence.

Current law allows companies to deduct the costs of equipment much faster than they would under economic depreciation. The TCJA greatly increased this incentive by allowing companies to deduct immediately 100 percent of the costs (called expensing) of qualifying assets purchased between 2018 and 2022.[2] JCT and OTA estimate the revenue cost of allowing expensing instead of economic depreciation between fiscal years 2019 and 2022 at $253 billion (per JCT) and $262 billion (per OTA).

The tax expenditure for accelerated depreciation in the years 2019 through 2022 overstates the net value of the tax preference to businesses because it represents a change in the timing of deductions instead of an increase in total deductions available. Deductions claimed earlier because of accelerated depreciation come at the expense of deductions that would have been claimed in later years. The tax savings that firms receive is equivalent to a zero-interest loan from the government instead of a direct grant, but the revenue loss in the first four years is close to the revenue loss from a direct grant.

Accelerated depreciation encourages firms to invest more in machinery and equipment used in domestic manufacturing. By reducing the cost of capital, this preference does increase domestic investment in qualifying assets. It may, however, reduce the efficiency of allocation of the US capital stock by favoring some types of investment (qualifying machinery and equipment) over others (business structures and inventory). Expensing, however, does create a more level playing field between equipment and other tax-favored assets, notably research and other intangible capital that benefits from immediate expensing (and in the case of research, from the research and experimentation credit discussed below). As the share of intangible assets in the economy has increased, it is no longer clear that the distortion accelerated depreciation of equipment creates between equipment and structures outweighs the reduction in the distortion between equipment and intangible assets. And by increasing the overall US capital stock, the preference should increase domestic output and real wages over time.

The main drawback of expensing is that when combined with deductibility of interest, it could create negative effective tax rates on new investments. If the last dollar of investment is funded by borrowing from overseas, a marginally profitable domestic investment (e.g., an investment that would not be profitable without the interest deduction) induced by the preference would provide a net return to the US economy that is less than interest rate paid to the overseas lender. The result would be a reduction in the net income of Americans caused by overly generous tax treatment of debt-financed investment.

[2] After 2022, bonus depreciation phases out at a rate of 20 percent per year, so that firms can deduct immediately 80 percent of qualifying investment in 2023, 60 percent in 2024, 40 percent in 2025, and 20 percent in 2026.

Twenty Percent Deduction for Qualified Business Income

The TCJA allows individual taxpayers to claim a deduction of 20 percent of their qualified income from domestic pass-through businesses (partnerships, limited liability companies, S corporations, and sole proprietorships), where the definition of qualified business income (QBI) reflects a number of complex limitations based on the total income and occupation of the taxpayer and investments and wages paid by the businesses he or she owns. The deduction is a tax expenditure because it reduces marginal tax rates by 20 percent relative to the marginal rates on earnings of employees. The deduction reduces revenue between 2019 and 2022 by $226 billion according to JCT and by $237 billion according to OTA.

By providing a benefit to business income relative to wages, the provision encourages taxpayers and firms to purchase labor services from independent contractors instead of employees and to alter their form of internal organization. For example, the provision would encourage a retail chain to set up its individual stores as separate franchised businesses instead of making store managers employees within the larger firm. It also encourages certain types of firm combinations. For example, highly paid physicians who would not otherwise be eligible for the deduction might become eligible if their medical group combines with a firm supplying medical equipment. It also increases the incentive for companies organized as S corporations to reduce wages paid to their owner-managers and increase profits, which may then qualify for the lower rate.

One possible justification for the deduction under current law is that it reduces the incentive for small pass-through firms owned by high-income individuals to convert to C corporations to take advantage of the reduced corporate tax rate under the TCJA (21 percent, compared with the top individual rate of 37 percent). That incentive is reduced because the 20 percent deduction lowers the top rate on pass-through income to 29.6 percent. Overall, however, the creation of a distinction between tax rates on business income and earnings, combined with the complex rules for qualifying for the QBI deduction, creates large incentives for business reorganizations that would otherwise be inefficient absent tax considerations.

The QBI deduction is scheduled to expire at the end of 2025, along with most of the other individual income tax provisions in the TCJA. The pending expiration of the deduction could limit tax planning responses that would otherwise occur if the future of the provision was less uncertain.

Deduction for Foreign-Derived Intangible Income from a Trade or Business Within the United States

In general, income from US domestic production pays the 21 percent corporate rate whether the output is used for domestic sales or exports. The TCJA created a new deduction of 37.5 percent for a certain category of income called foreign-derived intangible income (FDII), reducing the top tax rate on that income to 13.125 percent. FDII is defined as profits from export sales that exceed 10 percent of the adjusted basis (investment costs less depreciation) of assets used in export production. It provides an incentive for US multinational companies that produce for export to source their intangible assets in the US. JCT scores the FDII deduction as reducing federal receipts by $85 billion between 2019 and 2022, while OTA scores it as reducing receipts by $36 billion over the same period.

The FDII deduction offsets to some degree the subsidy provided by the global intangible low-tax income deduction, under which US companies pay no more than a 13.125 percent tax rate on profits attributable to intangible assets they hold in low-tax foreign countries. However, because the FDII deduction only applies to those intangible assets used for export sales, it can be viewed as an export subsidy and may be subject to challenge by the World Trade Organization.

Credit for Increasing Research Activities

The federal income tax provides a research credit of up to 20 percent of qualified research expenditures above a base amount. In general, the base amount is calculated by multiplying a "fixed base percentage" by the average amount of a

company's gross receipts for the four prior years. The base amount is the ratio of the company's research expenditures to its gross receipts for the years 1984 through 1988. This calculation intends to make the credit available only for research outlays above what a company would otherwise undertake, given its size as measured by its total receipts. Taxpayers may elect an alternative simplified method, in which the credit equals 14 percent of qualified research expenses that exceed 50 percent of average qualified research expenses for the three preceding taxable years. The JCT estimates the research credit will cost $49 billion between fiscal years 2019 and 2022; OTA estimates its cost at $66 billion over the same period.

The research credit was first enacted as a temporary measure in the Economic Recovery Tax Act of 1981 and was subsequently modified and extended numerous times, often retroactively after it had expired. Congress made the credit permanent in 2015, providing more predictability for firms and a more honest accounting of its budgetary costs, because the credit almost always ended up being extended, so the savings from its expiration never materialized. It is uncertain how much additional predictability the new permanent status provided, however, because businesses based on their past experience may have expected that the credit would never expire.

The main justification for the credit is that research outlays by firms create spillover benefits that the firms performing the research do not fully capture through patents or through the market advantage they gain from introducing new products and services before their competitors do. The spread of knowhow from company-funded research generates wider benefits for households and other firms. Absent some government subsidy, firms would spend too little on research, and socially beneficial investments that fail to meet a private-market test would not be undertaken.

Governments can encourage research through direct grants to projects that government agencies select. The research credit, in contrast, gives firms more discretion in choosing how to use public research dollars, within the limits that the legislation and regulations provide to determine what is a qualifying expenditure. The credit thereby encourages a broader array of research outlays that public officials may not have thought of and encourages research that is more directed to applications than to basic science. It also may, however, support some outlays that do not produce much spillover effect.

It is unclear to what extent the credit increases the amount of research firms undertake. Some early research did find that the credit increased research outlays, but the overall evidence and views of its effectiveness are mixed. Even if the credit does not change decision within firms, however, it does reduce private research costs and thereby may expand the activities of research-intensive companies.

Credit for Low-Income Housing

Taxpayers can receive a credit for investment in rental housing for low-income residents. The composition of tenants and rents charged must meet certain requirements for a project to be eligible for the credit. The credit rates are approximately 70 percent (in present value terms) for new construction and 30 percent (in present value terms) for substantially rehabilitating existing housing and for projects that receive other federal benefits (such as tax-exempt bond financing). The credit is paid out in equal amounts over 10 years. Low-income housing credits are subject to a state-by-state volume cap that limits their costs and are allocated among competing projects by State housing agencies. JCT estimates the 2019 through 2022 cost of the credit at $41 billion, while OTA estimates the cost at $37 billion over the same period.

The credit promotes the goal of increasing the supply of affordable housing for low-income families. It has widespread bipartisan political support, but issues have been raised as to whether it effectively increases the total availability of housing to low-income families and how its benefits are divided between renters and investors in the subsidized projects.

Credits for Electricity Production from Renewable Resources

The federal income tax provides credits for electricity produced from renewable resources and sold to an unrelated party. This includes electricity produced from wind energy, biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, and qualified hydropower. JCT estimates the credits will amount to $21 billion between fiscal years 2019 and 2022 while OTA estimates they will cost $14 billion over the same period.

The credits intend to reduce fossil fuel use by encouraging utilities to generate power from renewable energy sources. The carbon emissions from burning fossil fuels, especially coal, contribute to global climate change, which is becoming an increasingly serious and potentially catastrophic problem throughout the world. Power plants are a major, but by no means the only, source of carbon emissions. The tax incentives have contributed to increases in the share of power generation from renewable sources, but have only a minor overall effect on the climate problem. They also may lead to inefficiency by favoring some forms of fossil fuel reduction over others. A broader and more systemic approach would be to impose a carbon tax or enact a cap on fossil fuels emissions combined with tradable permits, both of which would cause firms and households to confront the social cost of carbon emissions and represent more cost-effective ways of combating climate change.

OVERALL ASSESSMENT

The largest business tax expenditures cost much less than the largest individual income tax expenditures. Although all of them merit review and could be improved, most of them are defensible either as necessary compromises among competing ways of designing general tax provisions or as incentives for activities that the government should encourage. The more narrowly targeted subsidies in the tax law that provide unwarranted benefits to selected taxpayers and activities have lower budgetary costs than these major provisions.

All but one of these tax expenditure provisions fall into two broad categories. One group of these large business tax expenditures represents general rules for taxing income of global corporations and domestic investment that depart from an idealized concept of a comprehensive income tax. These provisions are attempts to balance competing considerations in how best to design rules for taxing domestic investment and global capital flows. While aspects of these provisions are imperfect and some reforms of them would promote economic efficiency by reducing distortions of business decisions, there are no clear alternative policies that would achieve neutral tax treatment across all decision margins.

The second category of tax expenditures explicitly subsidizes activities that promote widely shared policy objectives, including encouraging more research and development, increasing the availability of housing to low-income families, and reducing global warming by encouraging utilities to generate power with renewable energy sources. These goals are desirable and represent appropriate activities for government to subsidize. But they certainly merit the same review that would be provided to any spending program to determine whether their level of spending is too large and whether there are more cost-effective ways of achieving the objectives they promote.

The one large tax expenditure that fits into neither of these categories is the 20 percent deduction for individuals who receive QBI from ownership of pass-through enterprises. The determination of what component of an active business owner's income represents compensation for labor services and what portion represents profits is arbitrary and subject to manipulation, and rules in the TCJA to prevent this introduce additional arbitrary distinctions among similar activities and taxpayers. The provision encourages businesses to organize themselves in ways that may be less efficient in order to generate the tax benefit its owners receive from the deduction. And it provides an unfair benefit to people who receive income classified as QBI eligible for the deduction compared with those with an equal income from fully taxable earnings. Finally, this subsidy disproportionately benefits the highest-income taxpayers because income from pass-through businesses accounts for a larger share of income for these individuals than for other taxpayers.

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