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The US corporate income tax system: is it in need of reform?

Andrew House, Balasundram Maniam [*], Hadley Leavell

Sam Houston State University, Department of Finance, Sam Houston, USA

Abstract: Corporate taxes play an increasingly prominent role in financial decisions made by businesses both domestically and abroad. Recent global changes have created increased pressure toward reform of the US income tax system. Recent attempts at reform have added complexity rather than much needed simplification. Future reforms need to focus on both statutory and effective corporate tax rates. The current system and its complexities favors the resource rich multinational corporation. Reforms would need to address that inequity by balancing the impact to all sizes of business. Any effort to reform also must address the need to both reduce the government budget deficit and as spur economic growth simultaneously. Finally the reform will need to overcome the current challenges of repatriating foreign funds and likely favor a more territorial tax structure over the worldwide tax structure currently dominating the US tax code.

Key words: Corporate income tax; Small business; Transfer pricing; Tax reform; Territorial tax structure; Worldwide tax structure

1. Introduction

Since 1970, the US government has lacked sufficient receipts to cover outlays in all but four fiscal years (Executive Office of the President, The Office of Management and Budget, 2015). In spite of this average 16.4% shortfall, significant tax revenue is collected each year. Of this revenue, personal and corporate income tax payments account for more than 90 percent of total US federal receipts (Mertens and Ravn, 2013). The recurring deficits indicate that this revenue is less than required; however, the debate over the proper long run balance between government spending, personal and corporate tax rates continues.

Central to this debate is the claim that the US corporate income tax rate is the highest in the developed world (McKinnon, 2013). While the top combined federal and state legally established or "statutory" income tax rate for US businesses is high (40%), a savvy global business can take advantage of differences in international tax structure through favorable transfer pricing (Hampshire, 2008). The large multinational corporation's careful planning and recordkeeping to reduce their tax burden effectively transfers the tax burden to small businesses (Rotella and Van Roekel, 2012).

These small businesses may not have the resource available or even the foreign income available to capitalize on these lucrative measures used by large corporations. Recent data from the US Government Accountability Office, indicates that profitable large (M-3 filing) corporations average 18% income tax (USGAO, 2013). Further analysis of this data indicates that small businesses average a much higher 31% effective tax rate (Quantria Strategies, LLC, 2013). Neither of these rates is particularly close to the 40% statutory tax rate.

This paper will explore the statutory tax structure for select countries and examine how the US compares to the global marketplace and current trends. It will then compare the effective tax rate paid by different types of corporations. This comparison will examine small business versus large business with respect to tax burden. These topics will lead into the final discussion of the impact of changes to the US tax structure.

2. Literature review

McClure (2008) examines the current statutory corporate tax rates within the European Union (EU) and how much each of country's GPD this tax represents. He then continues with a discussion of how multinational corporations use transfer pricing to maximize profits and minimize tax paid. Holtzman and Nagel (2014) help to introduce the key role that transfer pricing plays in reducing tax burden for multinational corporations. Hampshire (2008) explains how a corporation can benefit greatly from leveraging global advantage in the US marketplace. By positioning itself well in terms of transfer pricing and international losses, it can reduce the impact of higher US income taxes. Homburg (2008) reviews the relatively recent German reduction in statutory corporate tax rate. He compares the changed rate with other major global economies and examines the possible impacts.

[*] Corresponding Author.

Djankov et al. (2010) seek to understand the adverse impact that corporate taxes have on investment and by proximity entrepreneurship. Hanlon, Lester, and Verdi (2015) use quantitative tools to determine if repatriation costs of foreign business funds hinder domestic economic development. Mertens and Ravn (2013) apply statistical analysis to understand the economic effects of changing average personal income tax rates (APITRs) and average corporate income tax rates (ACITRs).

Huizinga et al. (2014) examine the effect of international differences in tax rates as they apply specifically to banking operations. They call out the negative impact of a higher local corporate tax rate. Rixen (2011) presents arguments to support global tax governance that strikes a balance between allowing each country to maintain sovereignty to support domestic needs, but also be fair in a global marketplace. Rush and Mincieli (2010) make a strong case for reforming US corporate taxes in an effort to correct a current disadvantage from sixty-year-old policies. Knoll (2008) cautions against using an obsession with competitiveness to drive tax policy decisions.

Brodwin (2012) shares his analysis that small businesses pay a disproportionate amount of US corporate taxes. He also suggests that lowering tax rates will not actually impact economic growth in the US. Rotella and Van Roekel (2012) further caution that reducing taxes more severely burdens small businesses. Matthews and Driver (2013) make recommendations for changing US fiscal policy. Donohoe et al. (2013) examine the impact of possible changes to the US tax system. Wagaman and Duquette (2013) also make suggestions for reforming the US international tax system.

The United States General Accountability Office (2013) and Quantria Strategies (2013) both provide valuable analysis of tax data from 2010. The former provides the initial information regarding tax burden inequity between small and large businesses. The latter further quantifies that inequity. The Executive Office of the President, The Office of Management and Budget (2015) provides historical tax revenue and government spending data. This data enabled further analysis of deficits and recent trends. KPMG (2015) similarly provides valuable raw data on current global income taxes for over 130 nations. The OECD (2015) provides information on its member nations.

3. United States corporate income tax rates in the global marketplace

Since Japan's recent stepwise reductions in corporate tax rate from 41% to 33% in 2015, the United States now has the second highest statutory corporate tax rate of over 135 countries (KPMG, 2015) and the highest in the 34-nation Organization for Economic Cooperation and Development (OECD, 2015). Rush and Mincieli (2010) detail the widening gap between the US and other developed countries. They calculate that between 1998 and 2009, the US rate went from being 5% lower than the weighted average G-7 rate to being 5.5% higher than the G-7 average. When expanded to the 34 OECD countries, the 2009 gap widens to 8%. More recent analysis puts this gap at 15% when state and local taxes are included (McKinnon, 2013). Fig. 1 below details that trend continuing with the G7 nations from 2006 until 2015. Within the G-7, only France and the United States have not lowered statutory tax rates (Wagaman and Duquette, 2013). This widening gap as a result of the stagnant tax rate has made the United States less competitive globally (Knoll, 2008). The reason behind the lack of a competitive edge is that the higher tax rates result in a higher cost of capital. This in turn results in an increased discount rate for investments (Knoll, 2008). When a domestically based corporation makes investment decisions, the discount rate in the US will discourage local investment and further encourage investment abroad.

The implications of such a stagnant policy in the face of increased competition are creating concern among some analysts. Most analysts agree that the current, high US corporate tax rates are limiting US firms' competitiveness versus foreign firms. Many contend that this tax rate has directly influenced the decline in US manufacturing and that lowering the tax rate is a requirement to stop this decline. Failure to act will result in further loss of competition and a more rapid erosion of corporate tax revenue (Donohoe et al., 2013).

In addition to lost competitive advantage, one other major impact of the high US income tax is the high cost of repatriating foreign earnings back to the US marketplace. By keeping this money outside of the US, firms often find that it is less costly to use domestic debt financing than their own capital (Djankov et al., 2010). Current tax law creates a financial advantage for debt financing beyond avoiding repatriation costs. The US tax code allows for deductions to be taken on interest from debt-financing. This incentive further pushes the domestic businesses to keep their foreign earnings in the foreign nation (Knoll, 2008). These earnings often have already been taxed in the country where they were gained; however, US tax code does not easily enable the corporation to avoid a double taxation on that money (Rixen, 2011). Hanlon, Lester, and Verdi (2015) use quantitative analysis tools to determine if the repatriation tax costs are value enhancing or value decreasing for US corporations. Not surprisingly their research reveals that rather than returning this money to the US for domestic investment, the funds are more often used for further foreign investment. This calls into question the logic of the US tax policy. There is some positive information from their analysis. When the lowered repatriation costs enabled by the American Jobs Creation Act (AJCA) of 2004 are included in the analysis, the foreign investment trend reverses (Hanlon et al., 2015). Added to a tax penalty, there is also a barrier against foreign investment.

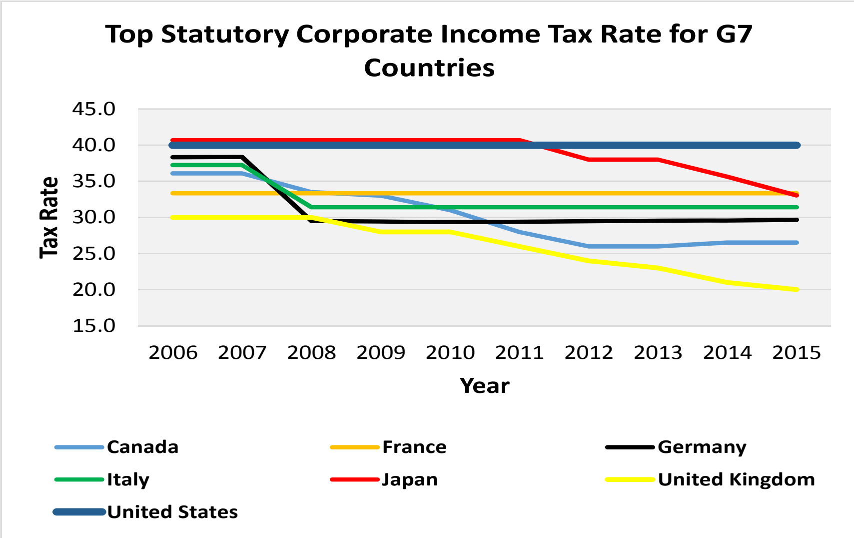

Fig. 1: Top statutory corporate income tax rate for G7 (KPMG, 2015)

This barrier comes from double taxation for foreign-owned banks. Banks that operate in geographies with double taxation in place – like the US – will experience lowered foreign direct investment (FDI). This is a logical result of the increased cost of doing business in these geographies (Huizinga et al, 2014). Given the US position atop the global corporate income tax rate pyramid and the further impact of forcing debt-financing for capital investment, the US tax policy needs reform.

Corporate tax reform is particularly crucial in light of the lack of governance in global tax competition (Rixen, 2011). His analysis plainly calls the "empirical record of international tax governance … poor." Specifically the OECD's efforts at reform have failed (Rixen, 2011). The United States' stubborn stance of maintaining corporate tax rates in an attempt to retain revenues has only resulted in further distancing the US from global competition. High taxes will continue to limit investment and stagnate the economy (Brodwin, 2012). These analyses indicating lowered competitive edge and calls for reform have focused mostly on the statutory tax rate. It is also important to consider effective tax rates for US businesses.

4. Effective tax rates and reduction methods

With the US statutory tax position clarified, it is important to analyze how these statutory rates translate into effective tax rates. Brodwin (2012) contends that there is a large gap between the effective tax rate and the statutory tax rate. Reform should focus on that effective rate as well as the statutory rate. He claims that real US corporate tax rates are some of the lowest in the world and further reductions will not result in any further growth (Brodwin, 2012). Data from the USGAO (2013) and further analysis by Quantria (2013) support this statement. In 2010, for large corporations, the average effective tax rate is 20.2% ($570 billion in taxes on $2.8 trillion in net income).

The current US tax code is complex and has multiple provisions for credits and multiple methods for avoiding tax. A firm with talented tax professionals can readily exploit these methods to reduce its effective tax burden (Brodwin, 2012). One key method for reducing this tax burden is through transfer pricing arrangements (Wagaman and Duquette, 2013). Holtzman and Nagel (2014) detail the process as having a high impact on corporate income taxation. It works by effectively fixing the price when a good moves within a corporation between two geographies. The corporations are supposed to employ an arm's length approach between the two subsidiaries and the controlled price should match the free-market price (Holtzman and Nagel, 2014). In reality the existing methods allow for a broad range of acceptable transfer prices, which effectively enables firms to manipulate prices to move income and the associated tax from a high-tax geography to a low-tax one (McClure, 2008).

To provide a practical example, consider two firms: Firm A and Firm B. Firm A operates exclusively in the US. Firm B is based in the United States, but also does business outside the US. If Firm A manufactures a good in the US at a cost of $4 and sells it for $10, the corporation will net a profit of $6 on the item. As this entire sale takes place within the US, the tax rate is 40% on that $6 for a cost of $2.40. If Firm B makes the same good yet claims that the free market cost of the item in the US is $3, it can claim a $1 loss on the manufacture in the US by transferring the good to the UK for $3. Firm B then sells the good to a customer at the equivalent to $10 in British pounds. It pays the UK tax at a rate of 20% of $1.40 on the $7 profit. The net result would be that the corporation pays $1 total in taxes between the $1.40 in the UK and the ($0.40) in the US. Firm A pays 40% tax, while Firm B pays 17% tax. Each firm made the good for $4 and sold it for $10, yet one pays 58% less tax. This simplified example describes the general advantage that global corporations enjoy. Through this method and various other provisions in the tax code, a skilled global firm can greatly reduce its effective tax rate. McClure (2008) indicates that over 80% of major corporations consider transfer pricing to be an important issue.

5. Tax burden by business type

If the overall effective corporate income tax rate is approximately 20% for US business, is there a particular type of business that is more likely to benefit? Rotella and Van Roekel (2012) contend that complexities in tax code enable major corporations to avoid paying the full statutory corporate tax rates. The aforementioned complexities of transfer pricing do typically require resources (Hampshire, 2008). Further complicating the landscape is the political clout that major corporations can leverage through effective government lobbying (Rotella and Van Roekel, 2012). This funding to influence legislation benefits the major corporations more directly over time. In addition to lobbying clout, major corporations have more options to fully leverage the current tax code.

Brodwin (2012) further elaborates that major corporations are more effective at exploiting the loopholes and complexities of US tax code. They can much more easily use international operations to further reduce tax liability. His claims are resoundingly supported in the analysis from the USGAO (2013) and Quantria (2013). In Fig. 2 below the breakdown of net income between the four primary business types shows that major corporations account for 63% of all US net income. If these business types shared the tax burden equally, then the tax burden chart would be similar. It is significantly different, as detailed in Fig. 3 below. C-corporations shoulder a disproportionately smaller piece of the tax pie.

Put more plainly, partnerships and S-corporations average a 31% effective tax rate, while C-corporations average an 18% effective tax rate (Quantria Strategies, 2013). If small businesses are providing more new private sector jobs and are the primary employment in many parts of the US, this tax strategy is not conducive to employment growth (Brodwin, 2012). Equally important is the impact that this disproportionate balance has on those who must then shoulder the tax burden through either higher taxes or debt financing of government. The middle class must then pay a greater share of the cost of defense, healthcare, and other key government programs (Rotella and Van Roekel, 2012). This imbalance also has forced government to cut spending on curriculum programs that more heavily impact small businesses in training costs (Rotella and Van Roekel, 2012). If C-corporations paid the same rate as S-corporations and partnerships, the budget deficit would be cut in half. This is clearly not practical as that would have a severe impact on the US economy. The imbalance seen here does give guidance to possible solutions for reform.

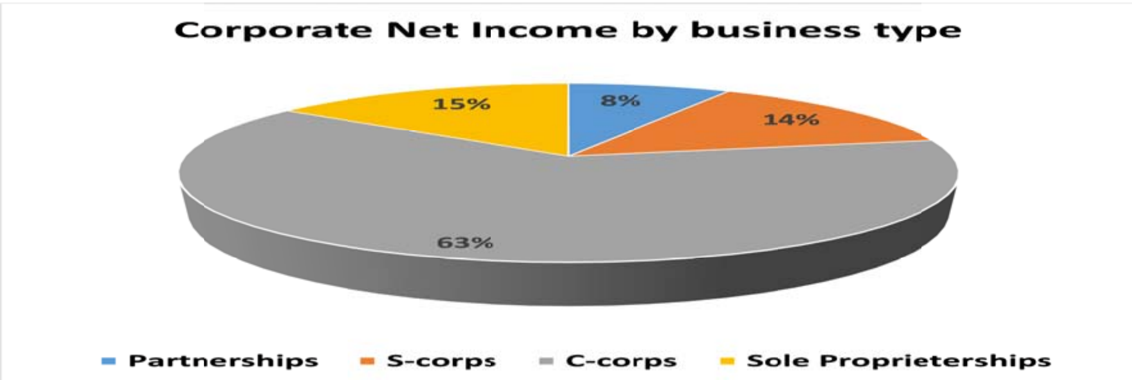

Fig. 2: US corporate net income by business type 2010 (Qantria Strategies, 2013)

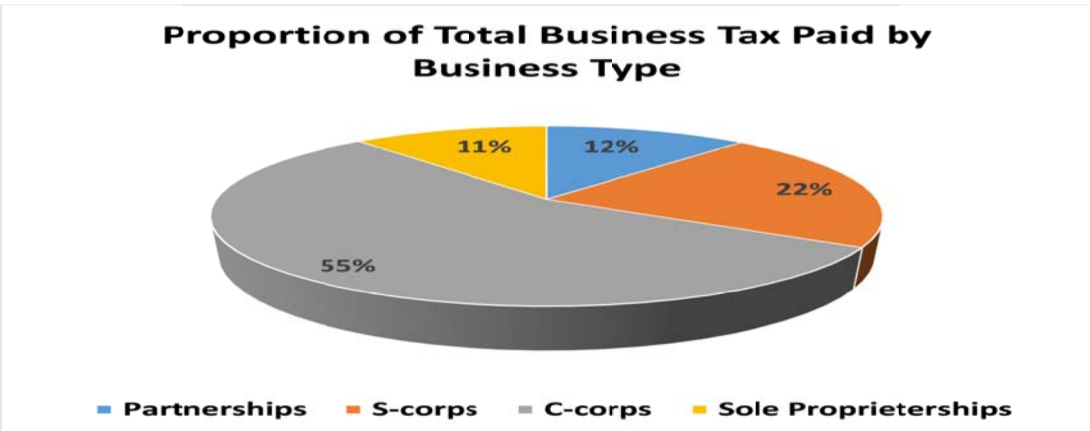

Fig. 3: Proportion of total business tax paid by business type 2010 (Quantria Strategies, 2013)

6. Reform methodologies

The literature provides three globally used corporate tax methods. These are referred to as territorial, worldwide, and mixed or hybrid systems (Rush and Mincieli, 2010). Exploring the first two methods is primarily an academic exercise, as countries do not typically use a purely territorial or purely worldwide approach to their tax structures. They do, however, tend to favor one method more than the other.

The United States uses a predominantly worldwide system of taxation (Knoll, 2008). This type of tax system levies taxes on all corporate earnings – both domestic and international (Wagaman and Duquette, 2013). There is also usually a tax levied by the foreign nation where this income is earned, which results in double-taxation. In order to lower some of this cost, the home country typically grants tax credits to offset the foreign tax (Rush and Mincieti, 2010). The major advantage of this type of system is that it tends to lead to economic efficiency in "capital export neutrality." A primary criticism of this method is that it puts the home country at a competitive disadvantage because it makes doing business more expensive (Donohoe et al., 2013). In contrast to the worldwide tax structure is the territorial structure.

By comparison a territorial tax system is one where a country levies taxes only on domestic earnings. This type of system is more straightforward, but it also results in a much lower tax base and is functionally impractical (Rush and Mincieti, 2010). The system does, however, create the benefit of "capital import neutrality" where foreign funds are welcome without barrier into the host nation. The nations of the world tend toward a mixed system between territorial and worldwide. Recent global legislative changes have resulted in most countries favoring more of a territorial approach to taxation. Specifically there has been a transition in the OECD where the number of territorial-heavy systems has increased from 50% of the nations to >80% of the nations (Wagaman and Duquette, 2013). In its stagnation with respect to tax reform the United States has put itself into a position that is less competitive. Rather than true reform, the US has continued to add complexity to the system (Knoll, 2008).

7. Final discussion

At the heart of a discussion on US corporate income tax is the goal of any reform. Is the goal to spur economic growth and to reap the resulting benefits or is the goal to directly influence the US budget deficit? This discussion favors achieving both with an emphasis on economic growth. Previous analysis suggests that the US statutory tax rate puts it in a place that is competitively unfavorable (McKinnon, 2013). The suggestion to lower the US statutory corporate income tax rate would be met with a favorable political response from businesses (Wagaman and Duquette, 2013). While this reduction would make an impact in the perception of US corporate taxes being high, if poorly executed, it may have no impact at all on the overall effective tax rate (Brodwin, 2012). The effective tax rate is what is far more important to businesses. If the reform is to be successful, it will need to stimulate growth without sacrificing overall tax revenue. This can be achieved by more evenly distributing the tax burden between business types.

Instead of continuing to subsidize special interests and large corporations, the tax burden should be more equally distributed between business types (Brodwin, 2012). The reform must manage both perceptions and reality (i.e. statutory and effective rates) and seek to simplify the tax code to close the gap between statutory and effective tax rates. This may actually result in bringing up the overall revenue while still lowering the statutory rate (Wagaman and Duquette, 2013). A change in statutory rates would create a perception that the US is more competitive on a global level. The simplification of the code, base broadening, and resulting increase in overall tax revenue will close the funding gap for much needed investment in corporate productivity and competitiveness (Brodwin, 2012). Such a result is not unprecedented. In Homburg's (2008) analysis of the German tax reform, the country lowered tax rates and simultaneously broadened the base through effective reform. A similar strategy should be employed in the US. The broadened base and harmonized effective rate on C-corporations would offset a lowered effective rate on S-corporations and partnerships. The net effect could actually be an increase in tax revenue and a positive impact on economic growth (Homburg, 2008). This type of reform would redistribute the burden more evenly across businesses. The increase in revenue would also narrow the US deficit.

In seeking to narrow the gap between US revenue and spending, previous studies have recommended an 85/15 split between spending cuts and tax increases in order to decrease this deficit (Matthews and Driver, 2013). Based on estimates from the Office of Management and Budget (2015), this gap will average $500 billion annually over the next seven years. If 15% of this gap is targeted with tax increases, the required increase is $75 billion. As only 11% of federal tax revenue is from corporate income taxes, changing the corporate tax rate may have limited direct impact on the overall revenue. The majority of the revenue comes from personal income tax (46%) and payroll tax (34%) (CBPP, 2015). If the simplification of the tax code resulted in increased economic growth, more of the revenue would come from increased personal income tax revenue. This impact is the primary reason that corporate tax reform should focused less on closing deficits than on keeping the United States competitive in the global marketplace. Pure tax cuts may not also boost the economy anyway. Economists concur that when effective tax rates are below 30%, additional cuts do not create more growth (Brodwin, 2012). Quantitative analysis supports this approach to focusing on corporate income tax rate reductions.

Data from Mertens and Ravn's (2013) quantitative study on the impact of reductions in average personal income tax rates (APITRs) versus reductions of average corporate income tax rates (ACITRs) supports the understanding that corporate tax rates have less of an impact on deficits. If only the corporate income tax is reduced by 1%, the positive impact to GDP per capita is 0.6% after a year. If only the personal income tax is reduced by 1%, the GPD per capita increases by 1.8%, or three times as much after a year (Mertens and Ravn, 2013). This analysis might lead to the declaration that the US should cut personal tax rates to have the most impact on GPD. Since personal income tax accounts for 4.5 times as much revenue as corporate income tax, the opposite is actually true (CPBB, 2015). When the dollar-for-dollar impact of a tax reduction is fully considered, corporate tax reduction makes more sense than personal tax reduction. Mertens and Ravn's (2013) analysis also supports the previous discussion that the tax revenue impact in reducing business tax rates is neutral. Homburg (2008) agrees that a reduction would be offset by broadened base. A final key element of the reform discussion is the move away from a worldwide structure toward a territorial structure.

Knoll (2008) would contend that both purely territorial and purely worldwide tax approaches are competitively neutral; however, neither tax approach is practical. Coupled with Rixen's (2011) observation that there is little global regulation in terms of tax regimes from country to country, the US would be best served by making changes to enhance its competitive position. Similarly McClure (2008) summarizes the European Community's stated position that corporate tax rates should not be harmonized and that they want to see continued sovereignty of member nations to drive competition between markets. The US should not expect other countries to become less competitive. If anything, other nations have become more aggressive in their moves toward territorial tax structures. Bipartisan US legislation proposes a move toward a territorial structure with heavy exemptions for repatriated earnings (Donohoe et al, 2013). This should continue to be the future direction for US tax reform.

8. Summary and conclusion

In reviewing the perception of the United States' statutory corporate income tax, there is clear evidence that the rate is too high to be competitive. This is the result of a failure to adjust to global competition. The stagnation of the US corporate tax code is causing a loss of competitive edge in the global marketplace. High corporate tax rates also force US businesses to keep foreign earnings outside of the US due to high repatriation costs. This barrier to access a corporation's own earnings leads to debt rather than equity financing. All of this is in turn eroding the US corporate tax base by pushing earnings outside of the country.

Even though the United States statutory tax rate is the highest in the developed world, the effective tax rate within the US is significantly lower than its statutory rate. Much of this reduction is achieved through the employment of talented resources which understand the depths of the US tax code. Methods like transfer pricing are very effective at reducing the tax burden for global corporations. Any reform strategy would need to examine and simplify this element of the tax law.

Even though the effective tax rate is much lower than the statutory rate, there is a great deal of inequity between different sizes of businesses with respect to the overall tax burden. Smaller businesses bear a disproportionately higher tax burden than major corporations. Any reform would need to make the tax structure more equitable, as the smaller businesses often drive a great deal of employment. In pursuing a more equitable tax structure the double-taxation penalty of the worldwide tax structure also must be a priority.

The reform of corporate taxes would likely need to focus on a more territorial strategy and a simplification of the code. The US should seek to re-gain a competitive edge by employing strategies to gain global investment rather than keep it out. The current system has made it decreasingly attractive for new business to set up in the United States and increasingly expensive for existing business to invest in the US.

Finally any reform of corporate tax should focus more on stimulating growth than on closing budget deficits. The corporate tax impact is simply too small to achieve that close. It would be more effective to stimulate growth by lowering or simplifying corporate taxes and pushing the earnings into personal income tax, which has a much larger impact.

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