The evolution of general business credits and implications for the effective marginal corporate tax rate
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In 2014, C Corporations earned $1.59 trillion in positive pre-tax profits and paid $333 billion in corporate taxes. This is consistent with an effective corporate tax rate of 21%, which is much smaller than the highest marginal corporate tax rate of 35%. Often overlooked are the tax deductions and credits earned by businesses that offset positive tax liability. In 2014, for example, $197 billion in taxable income escaped taxation thanks to losses carried forward from previous periods, and an additional $232 billion in tax liability was wiped out by foreign tax credits and general business credits.

General business credits are a primary fiscal tool for policy makers to incentivize specific business activities. For example, firms undertook $13 billion worth of activity eligible for the Research and Experimentation tax credit and $9 billion worth of investment in low-income housing, both credits that are believed to be pigouvian in nature. However, due to previously opaque administrative data, little is known about the ability of firms to utilize any tentative credits in the same tax year in which they are earned, and even less is understood about the stocks of these credits that are carried forward by firms from one tax year to the next. In 2011, the IRS undertook a significant revision to Form 3800, requiring firms to report tentative credits earned and stocks of credits carried forward separately for the more than 35 different GBCs.

With these new data, researchers can now grapple with the magnitude of GBC stocks carried from one period to the next: firms hold 300% of their tentative R&E GBC credits as carry-forward stock and 300% of their tentative LIH GBC credits as carry-forward stock. This raises serious questions about the efficacy of legislative measures intended to stimulate the macroeconomy in the short run through expansion of current GBCs. Most recently, Congress voted to permanently extend the R&E GBC in the Protecting Americans from Tax Hikes Act of 2015 after having strung together a serious of one year extensions to provide continuity for the credit.

In this paper, we explore the evolution of the stock of GBCs that are carried forward from one year to the next, and the impact that these stocks have in dampening the effect of GBCs on qualified activity. Further, we consider the interactive effect of net operating loss deductions and general business credits, both of which serve to reduce tax liability and impact the MTR for corporations, and the option value of carry these offsets forward. This analysis will provide an important input in the policy discussion of which GBCs, if any, merit inclusion in a reformed business tax code.