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The Corporate Minimum Tax Proposal

The Inflation Reduction Act of 2022 (H.R. 5376), which passed the Senate on August 7, 2022, would impose a minimum tax of 15% on the adjusted financial statement income of large corporations. Corporations would pay the larger of the minimum tax or the regular tax. This tax would apply to taxable years beginning after December 31, 2022.

Coverage of Firms

The minimum tax would apply to corporations with $1 billion or more in average annual earnings, calculated over a three-year period, in any of the previous three years. In the case of U.S. corporations that have foreign parents, it would apply only to income earned in the United States of $100 million or more, calculated over a three-year period (and apply when the international financial reporting group has income of $1 billion or more). It would apply to a new corporation in existence for less than three years based on the earnings in the years of existence.

The provision would exclude Subchapter S corporations (corporations with a limited number of shareholders that elect to be taxed under the individual income tax). It would also exclude regulated investment companies (RICs, such as mutual funds) and real estate investment trusts (REITs). These entities also pass through income to individual investors to be taxed under the individual income tax. Income from private equity firms would be covered, except portfolio companies owned by these firms.

Tax Based on Financial (Book) Income

The tax would be based on financial statement or book income, with some adjustments. Firms that file consolidated tax returns would include income allocable to the firm from related firms, including controlled foreign corporations (and any disregarded entities); for other related firms, dividends would be included. The provision would allow special deductions for cooperatives and Alaska Native Corporations. It would make adjustments to conform financial accounting to tax accounting for certain defined benefit pension plans. It would apply with respect to items under the unrelated business income tax for tax-exempt entities.

The additional tax would equal the amount of the minimum tax in excess of the regular income tax plus the additional tax from the Base Erosion and Anti-Abuse tax. Financial statement income would be increased by federal and foreign income taxes to place income on a pretax basis.

Losses would be allowed in the same manner as with the regular tax. Under the regular income tax, losses are carried over to offset income in future years, with loss carryovers limited to 80% of taxable income. Losses would also be carried over under the minimum tax, limited to 80% of financial income.

Credits Allowed

Credits would be allowed for the minimum tax. Domestic credits under the general business tax (such as the R&D credit) would be allowed to offset up to 75% of the combined regular and minimum tax. Foreign tax credits would be allowed based on the allowance for foreign taxes paid in a corporation's financial statement. A credit for additional minimum tax could be carried over to future years to offset regular tax when that tax is higher.

Revenue Effects and Scope

The corporate minimum tax is a major revenue raiser in the proposed legislation. It was originally projected to raise $313 billion over 10 years but that revenue gain is reduced to $258 billion, according to news reports, by changes made in allowing tax recovery for the depreciation and wireless spectrum provisions. It does not apparently reflect the exemptions for portfolio companies of private equity firms, which news reports indicate would reduce the yield by $35 billion. The Joint Committee on Taxation's estimate of a gain of $222 billion is consistent with these reports.

Relatively few corporations would be affected by the tax. An analysis by the Joint Committee on Taxation of the proposal before the recent adjustments estimated that about 150 taxpayers would be subject to the minimum tax each year. These results indicate that about 30% of the Fortune 500 could be subject to the minimum tax. About half the tax in that version would be collected from manufacturing (with about 16% from chemical manufacturing) and about 11% each from information and holding companies.

Based on projections of $4,755 billion in corporate revenues for FY2023-FY2032 by the Congressional Budget Office, the $222 billion revenue projection indicates an increase in corporate tax revenues of 4.7%.

Precedents and Other Examples of a Minimum Tax on Financial Income

A corporate alternative minimum tax was imposed in various forms beginning in 1969, although it was repealed in 2017. During most of this period, the tax base was not financial statement income but was the regular income tax base with various preferences added back. A minimum tax on financial statement or book income was included as part of the corporate AMT preferences in 1986. It was intended to be temporary and applied for three years, 1987-1989.

Currently, the global minimum tax (GLoBE) proposed by the Organisation for Economic Co-operation and Development (OECD) and the G-20 would be based on financial statement income. See CRS Report R47174, *The Pillar 2 Global Minimum Tax: Implications for U.S. Tax Policy*, by Jane G. Gravelle and Mark P. Keightley, for a discussion.

Provisions That Affect Book-Tax Differences

A variety of rules that differentiate between financial statement and taxable income could contribute to imposition of tax under the minimum tax proposal. Some of these provisions, such as net operating losses and timing differences arising from depreciation, interest, and bad debts, are addressed in the proposal as discussed below.

Other provisions have a permanent effect on financial statement versus taxable income. One provision is the exclusion of foreign source income under the current global intangible low-taxed income (GILTI). GILTI excludes a deemed return on tangible assets from income as well as a fraction of the remaining income (currently 50%, scheduled to fall to 37.5% after 2025). This exclusion of foreign source income is made artificially larger if firms engage in profit shifting to locate profits in low-tax foreign jurisdictions.

There are also deductions for foreign derived intangible income (FDII) designed to make holding intangible assets in the United States more attractive given the benefits of GILTI. Another provision is the treatment of executive stock options, which are recognized for book purposes when granted but generally deducted on exercise (and in larger amounts) for tax purposes. Another permanent difference is from tax-exempt interest on state and local government bonds.

Specific Issues Addressed in the Proposal

The objective of a minimum tax is to ensure that firms pay some tax when they are making a profit. Several issues arise surrounding a minimum tax based on financial statement income, which are addressed in the proposal.

Net Operating Losses

One of the most important differences between financial and taxable income is the treatment of losses. The tax system bounds income at zero, and firms that experience losses carry the losses forward to offset taxable income in the future. The offset is limited to 80% of taxable income. In the case of financial income, firms report current losses and profits. The minimum tax proposal adjusts for this treatment by carrying forward financial losses to offset against future financial income in a manner similar to the income tax system. The proposal also limits the loss offset to 80% of taxable income as measured by the financial income base.

Depreciation and Spectrum Rights

Financial income is adjusted to allow the treatment of depreciation and spectrum auction licenses for tax purposes. Depreciation deductions are normally taken earlier for tax than for book purposes. Financial income generally does not allow the recovery of the cost of spectrum licenses, which are recovered over 15 years for tax purposes.

Timing Differences

Some of the differences between book and tax income arise from timing. One factor that can cause timing differences is interest deductions, which are currently subject to limits. Net interest deductions are limited to 30% of adjusted income (which is income before taxes and interest). Any unused interest deductions are carried forward. Financial income allows full deduction of interest costs, and interest deductions that give rise to a minimum tax could also be lost.

Firms may also recognize bad debt earlier on financial statements than they do for tax purposes, which has been identified by researchers as potentially contributing to book-tax differences over the business cycle.

While provisions affected by timing defer rather than forgive taxes, ongoing expenditures that lead to these differences create ongoing differences between book and tax income.

To address these timing issues, minimum taxes paid can be carried forward to years when taxable income is larger than financial income and offset regular tax liability.

Defined Benefit Pension Plans

The proposal also addresses an issue with defined benefit pension plans, which are treated differently for financial purposes. For instance, under mark-to-market accounting, firms report gains and losses in pension assets that are not included in regular corporate income for tax purposes. The proposal would adjust financial income to remove income or expense associated with defined benefit pension plans.

General Issues

While using financial income can more broadly capture profits than taxable income, researchers have expressed some concerns that financial accounting is outside the control of the Internal Revenue Service and that firms may manipulate financial income to reduce tax liability. Researchers found some evidence that manipulation occurred during the 1980s. Financial accounting is governed by generally accepted accounting principles (GAAP) governed by the Financial Accounting Standards Board (FASB). The Securities and Exchange Commission recognizes FASB as setting the standards for publicly traded companies. While companies may want to minimize income for tax purposes, companies may simultaneously be reluctant to adopt practices that reduce reported profits to shareholders.

The proposed corporate minimum tax contains a cliff in that it applies to firms that earn an average of $1 billion or more in profits over a three-year period. This treatment may appear unfair to firms near the $1 billion measure and could also produce incentives to reduce reported profits by firms just above that level, although this effect is moderated somewhat by the averaging provision.

For additional discussion of minimum taxes on business income, see CRS Report R46887, *Minimum Taxes on Business Income: Background and Policy Options*, by Molly F. Sherlock and Jane G. Gravelle.

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