Distributed Profits Tax

A distributed profits tax is a business-level tax levied on companies when they distribute profits to shareholders, including through dividends and net share repurchases (stock buybacks).

How Does It Work?

A distributed profits tax is a cash-flow tax model for business taxation. A business only faces tax when it distributes profits to its shareholders. In other words, if a business retains its earnings, it faces no tax.

In the U.S. context, a distributed profits tax would treat pass-through firms—such as partnerships, sole proprietorships, and S corporations—identically to C corporations.

A distributed profits tax is equivalent to providing full expensing for new investments and unlimited net operating loss (NOL) carryforwards and carrybacks. It effectively ignores interest at the business level. The tax generally only applies to profit distributions from domestic companies; profits earned abroad are generally only subject to applicable foreign taxes.

Why a Distributed Profits Tax?

A distributed profits tax would reduce complexity and boost growth by simplifying U.S. business taxes and reducing marginal tax rates on investment.

Under the current U.S. corporate income tax, businesses calculate taxable income by accounting for deductible expenses, depreciation, amortization, limitations on deductions, exclusions, exemptions, credits, and complex rules for foreign income on an annual basis. Pass-through businesses face an entirely different set of rules for paying taxes under the individual income tax system.

By contrast, instead of annually paying taxes on business profits, a distributed profits tax requires all businesses to pay a tax only when they distribute profits to shareholders. Equalizing the tax

treatment between all business forms simplifies the tax system. It also reduces economic distortions and eliminates incentives for tax avoidance as well as the need for related anti-avoidance rules.

Relative to the current U.S. tax system, a distributed profits tax would reduce, but not zero out, the tax burden on new investments. It would eliminate the tax subsidy for borrowing that exists in the current tax system, a major simplification that would treat debt-financed investment the same as investment financed by retained earnings (which in practice faces no tax at the margin). But if a firm plans to distribute the profits of a new equity-financed investment, it will face the full 20 percent tax at the margin.

Estonia's adoption of a distributed profits tax led to outperformance in investment, labor productivity, firm resiliency, and other measures. Tax Foundation modeling finds that if the U.S. were to adopt a similar system, it would increase long-run economic output, American incomes, the capital stock, wages, and employment. The lower marginal tax rate on business investment drives the economic benefit by making more investments economically feasible. A higher level of investment in turn leads to greater worker productivity, spurring higher output, jobs, and wages over time.