Corporate Tax Integration as an Answer to Tax Reform Needs

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I. Context setting: Senator Hatch looking to corporate integration to reduce corporate tax

Finance Committee Chairman Orrin Hatch (R-Utah) is expected to release a new corporate integration plan this month that integrates corporate taxation with shareholder taxation. It pushes corporate taxation to the shareholder level by a dividends paid deduction coupled with a shareholder dividend withholding tax. The U.S. Senate Committee on Finance has already held two hearings for this proposal: 1) "Integrating the corporate and individual tax systems: the dividends paid deduction considered," held on May 17, 2016; and 2) "Debt versus equity: corporate integration considerations," held on May 24, 2016. The Joint Committee on Taxation (the "JCT") is now working on revenue estimates for the plan.

To fully appreciate Hatch's approach in context, one needs a good basic understanding of corporate integration, and the many methods by which it may be achieved.

II. What is corporate integration, and how can it be achieved?

A. The distinction between classical double tax systems and integrated single tax systems for corporate taxation

Under current law, the U.S. follows the "classical system" of corporate tax. In this system, income earned by C corporations is taxed first at the corporate level, and then taxed again at the shareholder level when the corporation distributes earnings to shareholders in the form of dividends. In contrast, an "integrated system" coordinates the individual and corporate tax systems so corporate income is taxed only once (either at the corporate or shareholder level depending on the integration method).[1] There are many types of integrated systems,[2] many of which are in fact implemented by other countries.

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[1] "Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems - Taxing Business Income Once" (January 1992). Treasury issued its recommendation report in December 1992.
[2] See Section II.C. below.

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B. Why tax policy generally prefers integrated systems to classical systems

Tax policy experts generally prefer integrated systems over classical systems, because they avoid distorting people's choices. Specifically, integration reduces three distortions inherent in the current two-tier classical tax system:

1) The incentive to invest in non-corporate rather than corporate businesses, as non-corporate businesses are taxed only once;
2) The incentive to finance corporate investments with debt rather than new equity, as corporations get a deduction for paying interest but no deduction for dividends, and foreign investors can receive U.S. interest tax-free; and
3) The incentive to retain earnings or to structure distributions of corporate profits in a manner that avoids the double tax, such as by share repurchases, shifting and retaining earnings offshore, and inversion transactions.

These distortions have economic costs, as they reduce the efficiency of allocations of capital, reduce financial flexibility for corporations, and increase risks of bankruptcy caused by over-leveraging corporations.

The Department of the Treasury has emphasized four ways integration should reduce these distortions and thereby enhance neutrality. First, integration should make more uniform the taxation of corporate and non-corporate investments. Second, integration should make more uniform the taxation of returns earned on alternative financial instruments, particularly debt and equity. Third, integration should distort as little as possible the choice between retaining and distributing earnings. And fourth, integration should create a system that taxes capital income once.[3] However, integration addresses neither inter-assets distortions (e.g., the tax code arguably favors real property investment over stock investment), nor the overall tax rate on capital income, which arguably is too high.[4]

Treasury gave four further recommendations that an integration system should follow to avoid throwing off the balance of the rest of the U.S. tax system:

1) Integration should not result in the extension of corporate tax preferences to shareholders;
2) Integration should not reduce the total tax collected on corporate income allocable to tax-exempt investors;
3) Integration should be extended to foreign shareholders only through treaty negotiations, not by statute; and
4) Integration should treat foreign taxes paid by U.S. corporations identically to taxes paid to the U.S. government only through treaty negotiations, not by statute.[5]

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[3] *Id*. at page 13.
[4] *Id*. at page 13-14.
[5] *Id*. at page viii.

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C. General methods of integration

The Treasury Report, the JCT's Report,[6] and the Republican Staff Committee on Finance's Report[7] all review numerous integration systems. In general, integration systems may be divided into two types: those that trigger on or relate to distributions, and those that do not.[8] More specifically, distribution-related integration systems retain a separate corporate level tax on undistributed earnings but eliminate part or all of the corporate level tax on corporate earnings distributed to shareholders as dividends. Non-distribution-related systems instead focus on coordinating shareholder and corporate taxes so that shareholders are currently recognizing corporate income in lieu of the corporation doing so. Many varieties of these two types are discussed below.

i. Distribution-related integration systems

a. Dividend exclusion system:[9]

Under a dividend exclusion system, a corporation continues to calculate and pay its income tax as it would under current law rules. A shareholder that then receives dividends from that corporation can exclude the dividends from his or her gross income.

It has been thought that dividend exclusion systems are overly gameable by corporations, which are quite mobile. For instance, one could move a corporation overseas to avoid corporate-level tax, and then get an exclusion on the dividends coming from this corporation to inside the country. Similarly, shareholders are less mobile than corporations, and therefore form a more reliable tax base; dividend exemption systems ignore this fact and pass up shareholder tax to go after the more elusive corporate tax base.

b. Imputation credit system:[10]

Under an imputation credit system, corporations continue to pay corporate-level tax on their income. When corporations then distribute a dividend, each recipient shareholder includes in income the net dividend received, grossed-up by the corporate-level tax attributable to the dividend; each shareholder then claims a credit on his or her return for the corporate tax imputed to him or her.

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[6] "Overview of Approaches to Corporate Integration Scheduled for a Public Hearing Before the Senate Committee on Finance on May 17, 2016" by Joint Committee on Taxation (2016). Link to 5/17/16 hearing and to 5/24/16 hearing.
[7] "Comprehensive Tax Reform for 2015 and Beyond" by Republican Staff Committee on Finance, United States Senate (2014).
[8] *Id*. at page 15.
[9] *Id*. at page 17.
[10] *Id*. at page 95.

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The dividend imputation credit system was popular in Europe several decades ago, until the European Court of Justice held it incompatible with EU laws.[11] Supporters believe the history proves that many major economies had successfully implemented the imputation credit system, and the demise of the system in EU has no relevance for U.S.[12]

c. Dividend deduction system:[13]

Under a dividend deduction system, corporations deduct dividends paid to shareholders, and shareholders include dividends in gross income subject to ordinary income tax rates.

Hatch's proposal is a variation of this system, which combines this dividend deduction with a corporation-collected withholding tax on distributed dividends.[14] As things currently stands, the tax would be collected at a flat 35% rate, including from dividends going to tax-exempt institutions and foreign investors. Hatch's plan may ultimately extend the withholding and deduction treatment to interest as well. Shareholders would receive a nonrefundable credit for the tax withheld on their behalf by the distributing corporation.

d. Split rates on undistributed and distributed income:[15]

Another technique to cause integration is to have split rates between undistributed and distributed income. Generally, a higher tax rate would be applied to undistributed income, and a lower tax rate to distributed income.

Lower tax rates on distributed earnings would partially relieve economic distortions caused by the two-tier classical tax system. A zero percent corporate tax rate on distributed earnings is equivalent to a dividend deduction, and would arguably achieve its purpose better. Moreover, eliminating corporate tax on distributed earnings would not have the negative effects of a zero tax rate on all corporate earnings (e.g. incentivizing firms to retain rather than to distribute earnings).

e. The Comprehensive Business Income Tax (CBIT) system:[16]

The CBIT system would extend a dividend exclusion system to payments of interest in order to equalize the treatment of debt and equity and would tax corporate and non-corporate businesses in the same manner.

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11 *Id*.

12 "Integration of Corporate and Shareholder Taxes" by Michael Graetz and Alvin Warren (June 8, 2016).

13 "Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems - Taxing Business Income Once" at page 107 (January 1992).

14 "The Trojan Horse of Corporate Integration" by Edward D. Kleinbard (June 29, 2016).

15 "Comprehensive Tax Reform for 2015 and Beyond" by Republican Staff Committee on Finance, United States Senate (2014).

16 "Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems - Taxing Business Income Once" at page 39 (January 1992).

The CBIT would apply to both corporations and non-corporate entities (except small businesses). The CBIT would not allow deductions for dividends or interest paid to the shareholders and debtholders.

ii. Non-distribution related integration systems

a. Business Enterprise Income Tax (BEIT) system:[17]

The Business Enterprise Income Tax (BEIT) system is a variation on the CBIT system. Under BEIT, a business entity (either corporate or non-corporate) first computes its taxes under current laws, then deducts a time value of money charge on capital (either debt or equity) invested in the business as a "cost of capital allowance" (COCA). (There would be no interest deductions allowed, thereby equalizing the treatment of debt and equity.) This time value of money charge represents the risk-free rate of return. The business's investors would include a time value of money return on their investment in the business (either debt or equity) in their gross income. Generally, all returns exceeding this risk-free rate of return would be taxed to the business.

As a result, the income of the business would generally subject to one level of tax, either at the business level or the investor level depending on the return on capital. However, sales of securities (debt or equity) or large distributions greater in value than the risk free rate of return would be taxed to the shareholder without corresponding deduction by the corporation, creating some degree of double taxation.

b. Shareholder allocation system:[18]

Shareholder allocation systems extend integration to retained earnings by taxing both distributed and retained corporate earnings at the shareholder's tax rate. This is done by having the shareholders include allocated amounts in income, with a credit for corporate taxes paid. Shareholders would increase basis in their shares by the amount of income allocated, less the amount of credit. Distributions would be treated as a return of capital to the extent of a shareholder's basis and thereafter, as capital gain.

The Treasury Report did not recommend this method because it would produce undesired administrative complexities and policy results (i.e., extending corporate tax preferences to shareholders and exempt foreign source income).

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[17] "Comprehensive Tax Reform for 2015 and Beyond" by Republican Staff Committee on Finance, United States Senate (2014).

[18] "Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems - Taxing Business Income Once" at page 107 (January 1992).

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c. Mark-to-market for publicly traded stock and flow-through for non-publicly traded entities system:[19]

The mark-to-market system would repeal the corporate income tax on publicly traded corporations by imposing an annually assessed mark-to-market taxing system. (Debt and equity securities would both be subjected to this new tax system.) In addition to the annually assessed mark-to-market stock or debt, investors would still be taxed on any dividend they received from the corporation.

At the same time, to fully eliminate all corporate-level income taxes, non-publicly traded companies would be placed on a flow-through taxing regime where corporate earnings flow-through to shareholders. The flow-through regime would be modeled on but supersede the current subchapter S regime.

[19] *Id*. at 199-201.

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CORPORATE INTEGRATION APPROACHES

1. Dividend exclusion***
2. Shareholder allocation (flowthrough)***
3. Imputation or shareholder credit***
4. Comprehensive Business Income Tax
5. Business enterprise income tax
6. Dividend paid deduction***
7. Mark-to-market for publicly traded stock
8. Split rates for distributed and undistributed corporate income
9. No corporate level tax
10. Reduce tax rate on dividends and capital gains (current approach)

*** commonly suggested approaches

EVALUATION CRITERIA

A. Who bears the corporate tax – corporation, shareholders or both?
B. Level of complexity
C. How is tax-exempt income of corporation taxed?
D. Treatment of tax-exempt and foreign shareholders
E. Will it encourage issuance of dividends?
F. Any cash flow concerns for taxpayer?
G. Tax year concerns?
H. State tax concerns?