PART V

TAXATION OF BUSINESS AND INVESTMENT INCOME

Part V discusses the income tax in relation to the major components of our business economy. Chapter Fourteen covers issues involving corporations and dividends. These issues require facing the fundamental question of who bears the corporate income tax: shareholders, employees, customers, the return on capital in the economy generally, or the corporations themselves. Assuming that all, or the major share, of the corporate income tax is borne by the shareholders, the next question is what, if anything, should be done about the double tax borne by shareholders. The numerous solutions that have been offered to the double tax are described. Finally, the implications of interest deductions by corporations and the retained earnings of corporations are discussed.

Chapter Fifteen deals with a perennial high-profile tax policy issue, the tax treatment of capital gains and losses. The unsettled history of their treatment is described. Unique features of capital gains are discussed, as are peripheral areas where capital gain treatment is accorded to income on the borderline between ordinary income and capital gains. Restrictions on use of capital losses are discussed. The politically-charged assertion that the tax treatment of capital gain is an important factor in determining national rates of saving and investment is explored. Finally, capital gain treatment is related to the treatment of gain and loss on sale of taxpayers' homes.

Chapter Sixteen goes to the fundamental question of how to measure taxable income in a climate of changing price levels. Present inflation adjustments to the tax rate structure are described. The more complex issue of whether, and how, to apply inflation adjustments to the measurement of gains, losses, interest deductions, and investments in debt instruments are discussed. Also, questions are raised as to the accuracy of existing measures of price level changes.

CHAPTER FOURTEEN
CORPORATIONS AND DIVIDENDS

*During the 1980s Congress produced five major facelifts of Subchapter C. * * * Each enactment reflected the noble goal of structural tax reform; none represented an obvious attempt to satisfy special interests. Yet despite these efforts, * * * calls for restructuring corporate taxation seem even more urgent.*[a]

A. INTRODUCTION

The taxes considered in this chapter generate significant revenue. The corporate income tax currently yields approximately 11 percent of total federal tax revenues, as compared to 43 percent for individual income taxes and 37 percent for social insurance taxes.[b] Moreover, dividends paid by C corporations and taxed to individual shareholders account for over three percent of taxable income under the individual income tax.[c]

The preeminent policy issues in the taxation of corporations and shareholders relate to the degree to which tax law should follow nontax law to treat corporations and their shareholders as separate taxable entities. C corporations are taxable entities, separate from their shareholders, in contrast to partnerships[d] and S corporations.[e] Because corporations are not allowed a deduction for dividends paid, and the dividends are fully subject to tax in the hands of individual shareholders, the result is a double tax on income earned by a corporation and distributed as dividends to its individual owners.

The second tax cannot necessarily be avoided by a corporate policy of not paying dividends, even if one ignores the slight possibility of imposition of the

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a. Paul B. Stephan, III, *Disaggregation and Subchapter C: Rethinking Corporate Tax Reform*, 76 VA. L. REV. 655, 655 (1990).

b. In 1994, federal receipts from corporate income taxes were $140 billion, individual income tax receipts were $543 billion and social insurance tax receipts were $462 billion. Total federal receipts amounted to $1.258 trillion. U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES, tbl. 518, at 334 (115th ed. 1995).

c. In 1992, dividends included in the adjusted gross income of individuals amounted to $78 billion; total taxable income of individuals was $2.396 trillion. *Id.* tbl. 533, at 345. (Not all adjusted gross income becomes taxable income, of course, because some is offset by deductions and personal and dependency exemptions. Nevertheless, it is the case for most individuals that if dividends were not included in the tax base, taxable income would be reduced by the amount of the dividends.)

d. Some publicly traded partnerships are treated as taxable entities under the same provisions that apply to corporations and their shareholders. Section 7704. *See infra* Note #8.

e. Hereinafter, the term "corporation" should be understood to refer to a C corporation unless otherwise indicated.

accumulated earnings tax.[f] To the extent that common stock of a corporation appreciates in value because of undistributed income that has been earned and taxed to the corporation, sale of the stock by the shareholders at a gain produces a second tax, though generally in the form of a capital gain. This does not occur, however, if a shareholder dies owning stock that has appreciated in value because the stock then takes a basis equal to its value at the date of the decedent's death. See section 1014 and Chapter Nine. The portion of a capital gain tax that is a second tax due to accumulated earnings is difficult to isolate and measure because the market value of common stock is affected by so many other factors.

Corporate shareholders are largely exempt from the second, shareholder-level, tax. The dividends-received deduction in section 243 reflects a decision largely to exempt the passage of earnings from one corporation to another until distribution is finally made to a noncorporate shareholder, who normally would be fully taxed. Such dividends are entirely tax free if the corporations are members of an affiliated group, which requires an 80-percent-ownership relationship while the earnings are accumulated and distributed. Otherwise, 80 percent of deductions can be deducted by a corporate shareholder that owns at least 20 percent of the stock of the dividend-paying corporation, and 70 percent of dividends are deductible if the corporate shareholder owns less than 20 percent of the payor. See section 243 and Note #5 for details and limitations.

Similar to the individual income tax, the corporate rate structure of section 11 is graduated, except for specified categories of personal service corporations. A corporation is taxed at 15 percent on the first $50,000 of income, 25 percent on income between $50,000 and $75,000, and 34 percent on income between $75,000 and $10 million. When a corporation's taxable income exceeds $100,000, however, a tax of five percentage points in addition to the 34 percent standard rate is applied to its income until this five-percentage-point tax amounts to $11,750. At this point, when the corporation's taxable income is $335,000, the five-percentage-point "notch" tax rate has absorbed all the advantage from the 15 percent rate and the 25 percent rate on the corporation's first $75,000 of income. The tax rate on income in excess of $10 million is 35 percent. Another notch rate of three additional percentage points, or a total rate of 38 percent, is applied to income in excess of $15 million until it absorbs the advantage of the 34 percent rate.

Notes and Questions

Tax rates

1. Discussion of corporate tax rates must take place against the

f. Sections 531 et seq. impose a tax on accumulations of earnings "beyond the reasonable needs of the business," but only if accumulations exceed $250,000.

background of substantially higher tax rates in a not-so-distant past. Before the Tax Reform Act of 1986 the top corporate tax rate was 46 percent and the top tax rate for individuals was 50 percent. The 1986 Act not only lowered rates for both individuals and corporations, but reversed the previous pattern of taxing corporations at rates lower than the top individual tax rate. Under the 1993 Act, however, the top individual tax rate (39.6 percent) again is higher than the top corporate rate (35 percent). Assuming that corporations should be taxable entities, what relationship (if any) should be maintained between corporate income tax rates and individual income tax rates?

2. In addition to the regular income tax, section 59A imposes a tax of 0.12 percent on income in excess of $2 million. The tax is designed to finance the fund to clean up the environment and is called the environmental tax. The income subject to this tax is a modified version of the corporation's alternative minimum taxable income.

3. All income of some personal service corporations is taxed at a flat 35 percent rate. These corporations perform health, law, engineering, architectural, accounting, actuarial, art performance, or consulting services. Such corporations are viewed as the alter egos of their typically high-income owner/employees, and the high flat rate prevents these individuals from benefitting from the graduated corporate tax structure.

4. There is no connection between a corporation's tax rate and the tax rates of its individual shareholders. Should there be such a connection? Should the corporate income tax have progressive rates?

5. *Dividends-received deduction.* The broad outline of the dividends-received deduction of section 243 is subject to qualifications. The deduction is reduced in the proportion that stock ownership is debt-financed. The apparent reason is to block a corporation's using debt financing to combine an interest deduction and dividend income taxed at preferential rates.

The 100 percent dividends-received deduction normally allowed if both the corporation paying the dividend and the corporate shareholder are members of the same affiliated group—that is, affiliated through 80 percent ownership—is limited to dividends paid out of earnings accumulated after 1963 while the two corporations were affiliated.

This treatment is flawed in that the definition of earnings out of which dividends are paid is not consistent with the definition of taxable income. Consequently, some dividends eligible for a dividends-received deduction have not been taxed at the corporate level at an earlier stage. If section 243 were perfected to reach only dividends paid out of previously taxed earnings, one might ask whether all such dividends (and not merely those paid to members of affiliated groups) should be eligible for the 100 percent

dividends-received deduction.

Affiliated corporations

6. Groups of affiliated corporations are permitted to file consolidated income tax returns instead of reporting income or loss separately. Dividends are eliminated when paid within an affiliated group of corporations filing a consolidated return. Treatment of consolidated returns is governed by extensive "legislative" regulations issued pursuant to section 1501.

7. Even if a consolidated return is not filed, if a corporation owns 80 percent or more of the stock of one or more other corporations, these corporations are combined for purposes of applying the graduated income tax rates. Section 1561. Corporations that are owned by the same small group of individuals also are combined for purposes of applying the graduated tax rates. Section 1563(a)(2). What is the purpose of these provisions?

8. *Entities taxable as corporations.* A corporation may have only one shareholder. Professional associations organized under a state's corporate laws can qualify as C corporations for tax purposes. Associations can be taxable as corporations even though they are not incorporated. Among the associations taxable as corporations are trusts with transferable interests. So long as they are not publicly traded partnerships described in section 7704, partnerships, even limited partnerships, generally do not fall in the category of associations taxable as corporations. Neither do organizations set up as limited liability companies. In Notice 95-14,[g] the Treasury Department proposed to allow associations to choose between partnership and corporation treatment (so long as they are not publicly traded partnerships described in section 7704).

In some instances dummy corporations set up to facilitate title transfers and the like are disregarded for tax purposes. If a corporation engages in any substantial activity, however, it is required to file a corporate income tax return and is treated as a separate taxable entity.

Limitations on deductions by corporations

9. *Interest.* The limits placed on interest deductions by individual taxpayers do not apply to most corporations, because interest paid by corporations ordinarily is considered paid in the course of trade or business. There are, however, some limits on interest deductions by corporations. In some instances interest in excess of $5 million a year on subordinated indebtedness incurred to permit the debtor corporation to acquire stock or a substantial majority of the operating assets of another corporation may not be deducted. Section 279. Interest on debt between related corporations and

g. 1995-1 C.B. 297.

between corporations and their over-50 percent owners may not be deducted until reported in income by the related creditor. Section 267. Also, corporations—as is the case with individuals—may not deduct interest on loans used to finance investments in tax-exempt bonds. Section 265(a)(2).

10. *Charitable contributions.* Section 170(b)(2) permits corporations to deduct charitable contributions in amounts up to 10 percent of taxable income.

11. *Losses.* Losses on transactions with over-50 percent shareholders are denied by section 267.

12. This Chapter does not discuss the alternative minimum tax, which applies lower tax rates to a broader base. Section 55 et seq. The Contract with America Tax Relief Act of 1995, in the form in which it passed the House of Representatives, provided for repeal of the alternative minimum tax on corporations after the year 2000.

B. WHO BEARS THE CORPORATE TAX?

FEDERAL TAX POLICY

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Pages 135-37, 141-45, 151-54 (5th ed. 1987)

The corporation income tax was enacted in 1909, four years before the introduction of the individual income tax. To avoid a constitutional issue, Congress levied the tax as an excise on the privilege of doing business as a corporation. The law was challenged, but the Supreme Court upheld the authority of the federal government to impose such a tax and ruled that the privilege of doing corporate business could be measured by the corporation's profits.

The corporation income tax produced more revenue than the individual income tax in seventeen of the twenty-eight years before 1941, when the latter was greatly expanded as a source of wartime revenue. From 1941 through 1967 corporation income tax receipts were second only to those of the individual income tax, but they were overtaken by payroll taxes in fiscal year 1968 and have since been declining in importance. The corporation income tax accounted for about 8 percent of federal receipts in 1986, compared with 28 percent in 1956. Since the end of World War II, the corporate tax rate has been reduced from a peak of 52 percent in 1952-63 to 34 percent beginning July 1, 1987. Corporate tax receipts should increase as a share of total tax collections as a result of the reforms enacted in 1986, but the share will remain significantly lower than it was in earlier postwar years.

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A business enterprise enjoys special privileges and benefits when it operates in the corporate form. These include perpetual life, limited liability of shareholders, liquidity of ownership through marketability of shares, growth through retention of earnings, and possibilities of intercorporate affiliations. Moreover, the modern corporation—particularly the large "public" corporation in which management and ownership are separated—generates income that nobody may claim for personal use. The growth of the corporate sector could not have taken place if the corporation had not been endowed with these valuable privileges. The Supreme Court's acceptance of the constitutionality of the corporation income tax was based on the view that the corporation owes its life, rights, and power to the government.

Few experts accept this rationale for a substantial tax on corporate profits. Instead, one justification seems to be that the corporation is a mechanism for accumulating capital that is managed by the corporate officers and directors, and is not really subject to the control of the owners—the stockholders. Proponents of the corporation tax believe that the earnings and economic power derived from this large stock of capital are a proper base for taxation.

Another reason for the corporation income tax is that it is needed to safeguard the individual income tax. If corporate income were not subject to tax, people could avoid the individual income tax by accumulating income in corporations. Short of taxing shareholders on their shares of corporate income whether the income is distributed or not (a method that has been proposed from time to time), the most practical way to protect the individual income tax is to impose a separate tax on corporate income. * * *

Despite its long history in the United States, the corporation income tax is the subject of considerable controversy. In the first place, there is no general agreement about who really pays it. Some believe the tax is borne by the corporations and hence by their stockholders. Others believe it depresses the rate of return to capital throughout the economy and is therefore borne by owners of capital in general. Still others argue that the tax is passed on to consumers through higher prices or may be shifted back to the workers in lower wages. Some believe that it is borne by all three groups—stockholders, consumers, and wage earners—in varying proportions. This uncertainty about the incidence of the tax makes strange bedfellows of individuals holding diametrically opposed views and often puts them in inconsistent positions. Some staunch opponents of a sales tax vigorously support the corporation income tax even though they profess to believe it is shifted to the consumer, while many who say that the corporation tax is "just another cost" (and is consequently shifted) demand that the tax be reduced and some form of consumption tax substituted for all or part of it.

Second, the proper relation between individual and corporation income taxes has never been settled in the United States. At various times,

dividends have been allowed as a credit or deduction in computing the tax on individual income. Currently, there is no deduction for dividends, but there is still considerable agitation to moderate or eliminate the so-called double taxation of distributed corporate earnings.

A third set of issues has to do with the effect of the corporation tax on the corporate sector and on the economy in general. It has been argued that the tax places a heavy burden on corporations and thus curtails business investment and reduces the nation's growth rate. Since interest paid is deductible in computing taxable corporation profits but dividends paid are not, the tax is said to favor debt over equity financing and to encourage the retention of earnings rather than paying them out in dividends. Some question the desirability of a tax that discourages the corporate form of business; others believe that alternative tax sources yielding the same revenue would be more harmful to the economy.

Fourth, the introduction of tax incentives for investment has sharply reduced the yield of the corporation income tax. When corporate income was not measured or taxed uniformly, effective rates of tax varied widely among firms and industries. Beginning in 1987, the elimination of the investment tax credit and the adoption of depreciation rates that more nearly resemble economic depreciation will greatly reduce the variation in tax rates. However, the corporate tax continues to distort the allocation of investment and reduce economic efficiency.

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Shifting and Incidence of the Tax

There is no more controversial issue in taxation than the question, "Who bears the corporation income tax?" On this question, both economists and businessmen differ among themselves. The following quotations are representative of these divergent views:

> Corporate taxes are simply costs, and the method of their assessment does not change this fact. Costs must be paid by the public in prices, and corporate taxes are thus, in effect, concealed sales taxes. (Enders M. Voorhees, chairman of the Finance Committee, U.S. Steel Corporation, address before the Controllers' Institute of America, New York, September 21, 1943.)

> The initial or short-run incidence of the corporate income tax seems to be largely on corporations and their stockholders. . . . There seems to be little foundation for the belief that a large part of the corporate tax comes out of wages or is passed on to consumers in the same way that a selective excise [tax] tends to be shifted to buyers. (Richard Goode, *The Corporation Income Tax*, Wiley, 1951, pp. 71-72.)

> . . . The corporation profits tax is almost entirely shifted; the

government simply uses the corporation as a tax collector. (Kenneth E. Boulding, *The Organizational Revolution*, Harper, 1953, p. 277.)

It is hard to avoid the conclusion that plausible alternative sets of assumptions about the relevant elasticities all yield results in which capital bears very close to 100 percent of the [corporate] tax burden. (Arnold C. Harberger, "The Incidence of the Corporation Income Tax," *Journal of Political Economy*, vol. 70, June 1962, p. 234.)

. . . An increase in the [corporate] tax is shifted fully through short-run adjustments to prevent a decline in the net rate of return [on corporate investment], and . . . these adjustments are maintained subsequently. (Marian Krzyzaniak and Richard A. Musgrave, *The Shifting of the Corporation Income Tax*, Johns Hopkins Press, 1963, p. 65.)

. . . There is no inter-sector inefficiency resulting from the imposition of the corporate profits tax with the interest deductibility provision. Nor is there any misallocation between safe and risky industries. From an efficiency point of view, the whole corporate profits tax structure is just like a lump sum tax on corporations. (Joseph E. Stiglitz, "Taxation, Corporate Financial Policy, and the Cost of Capital," *Journal of Public Economics*, vol. 2, February 1973, p. 33.)

. . . If the net rate of return is given in the international market place, the burden of a tax on the income from capital in one country will not (in the middle or long run) end up being borne by capital (which can flee) but by other factors of production (land, labor, and to a degree, perhaps, old fixed capital). (Arnold C. Harberger, "The State of the Corporate Tax: Who Pays It? Should It Be Replaced?" in Charls E. Walker and Mark A. Bloomfield, eds., *New Directions in Federal Tax Policy for the 1980s*, Ballinger, 1983.)

Unfortunately, economics has not yet provided a scientific basis for accepting or rejecting one side or the other. This section presents the logic of each view and summarizes the evidence.

The Shifting Mechanism

One reason for the sharply divergent views is that the opponents frequently do not refer to the same type of shifting. It is important to distinguish between short- and long-run shifting and the mechanisms through which they operate. The "short run" is defined by economists as a

period too short for firms to adjust their capital to changing demand and supply conditions. The "long run" is a period in which capital can be adjusted.

The Short Run

The classical view in economics is that the corporation income tax cannot be shifted in the short run. The argument is as follows: all business firms, whether they are competitive or monopolistic, seek to maximize net profits. This maximum occurs when output and prices are set at the point where the cost of producing an additional unit is exactly equal to the additional revenue obtained from the sale of that unit. In the short run, a tax on economic profit should make no difference in this decision. The output and price that maximized the firm's profits before the tax will continue to maximize profits after the tax is imposed. (This follows from simple arithmetic. If a series of figures is reduced by the same percentage, the figure that was highest before will be the highest after.)

The opposite view is that today's markets are characterized neither by perfect competition nor by monopoly; instead, they show considerable imperfection and mutual interdependence or oligopoly. In such markets, business firms may set their prices at the level that covers their full cost *plus* a margin for profits. Alternatively, the firms are described as aiming at an after-tax target rate of return on their invested capital. Under the cost-plus behavior, the firm treats the tax as an element of cost and raises its price to recover the tax. (Public utilities are usually able to shift the tax in this way, because state rate-making agencies treat the corporation tax as a cost.) Similarly, if the firm's objective is the after-tax target rate of return, imposition of a tax or an increase in the tax rate—by reducing the rate of return on invested capital—will have to be accounted for in making output and price decisions. To preserve the target rate of return, the tax must be shifted forward to consumers or backward to the workers or partly forward and partly backward.

It is also argued that the competitive models are irrelevant in most markets where one or a few large firms exercise a substantial degree of leadership. In such markets, efficient producers raise their prices to recover the tax, and the tax merely forms an "umbrella" that permits less efficient or marginal producers to survive.

When business managers are asked about their pricing policies, they often say that they shift the corporation income tax. However, even if business firms intend to shift the tax, there is some doubt about their ability to shift it fully in the short run. In the first place, the tax depends on the outcome of business operations during an entire year. Businessmen can only guess the ratio of the tax to their gross receipts, and it is hard to conceive of their setting a price that would recover the precise amount of tax they will eventually pay. (If shifting were possible, there would be some instances of firms shifting more than 100 percent of the tax, but few economists believe

that overshifting actually occurs.)

Second, businessmen know that should they attempt to recover the corporation income tax through higher prices (or lower wages), other firms would not necessarily do the same. Some firms make no profit or have large loss carry-overs and thus pay no tax; among other firms, the ratio of tax to gross receipts differs. In multi product firms, the producer has even less basis for judging the ratio of tax to gross receipts for each product. All these possibilities increase the uncertainty of response by other firms and make the attempt to shift part or all of the corporation income tax hazardous.

The Long Run

In the long run, the corporation income tax influences investment by reducing the rate of return on corporate equity. If the corporation income tax is not shifted in the short run, net after-tax rates of return are depressed, and the incentive to undertake corporate investment is thereby reduced. After-tax rates of return tend to be equalized with those in the noncorporate sector, but in the process corporate capital and output will have been permanently reduced. Thus, if there is no short-run shifting and if the supply of capital is fixed, the burden of the tax falls on the owners of capital in general. If the depressed rate of return on capital reduces investment, productivity of labor decreases and at least part of the tax may be borne by workers.

Where investment is financed by borrowing, the corporation tax cannot affect investment decisions because interest on debt is a deductible expense. If the marginal investment of a firm is fully financed by debt, the corporation tax becomes a lump-sum tax on profits generated by previous investments and is borne entirely by the owners of the corporation, the stockholders. In view of the recent large increase in debt financing (see the section on equity and debt finance below), a substantial proportion of the corporation income tax may now rest on stockholders and not be diffused to owners of capital in general through the shifting process just described.

The Corporation Tax in an Open Economy

The foregoing analysis assumed that the corporation tax was imposed in a closed economy. In an open economy, the rate of return on capital is set in the international marketplace. If the tax in one country is higher than it is elsewhere, capital will move to other countries until the rate of return is raised to the international level. Thus the burden of the tax would not be borne by capital but by other factors of production (land, labor, and old fixed capital) that cannot move. Since labor is the largest input into corporate products, wage earners would bear most of the burden of the corporation tax through lower real wages.

In the years immediately after World War II, most countries imposed tight capital controls and currencies were not convertible. As capital controls were dismantled and many foreign currencies other than the U.S. dollar became acceptable in international transactions, the open economy model

became more realistic. During this later period, the effective corporation tax rates have been declining in the United States. It follows that recent U.S. tax policy has probably reduced any adverse effect of the corporation income tax on real wages, not increased it as some allege.

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Equity and Debt Finance

Corporations are allowed to deduct interest payments on borrowed capital from taxable income, but there is no corresponding deduction for dividends paid out to stockholders in return for the use of their funds as equity capital. At the 34 percent tax rate, a corporation must earn $1.52 before tax to be able to pay $1 in dividends, but it needs to earn only $1 to pay $1 interest. This asymmetry makes the cost of equity more expensive for the corporation than an equal amount of borrowed capital. In fact, in combination with the accelerated cost recovery system and the investment tax credit, the allowance of an interest deduction provided a substantial subsidy to investment in the early 1980s.

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Financial experts discourage large amounts of debt financing by corporations. Debt makes good business sense if there is a safe margin for paying fixed interest charges. But business firms may be tightly squeezed when business falls off, and the margin will evaporate rapidly. At such times, defaults on interest and principal payments and bankruptcies begin to occur. Even though borrowed capital may increase returns to stockholders, corporations try to finance a major share of their capital requirements through equity capital (mainly retained earnings) to avoid these risks.

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Resource Allocation

If the corporation income tax is not shifted in the short run, it becomes in effect a special tax on corporate capital. This does not necessarily mean that the tax permanently reduces rates of return on capital in the corporate sector relative to returns in the noncorporate sector. Capital may flow out of the taxed industries into the untaxed industries, and rates of return will tend to equalize. In the process, the allocation of capital between corporate and noncorporate business will be altered from the pattern that would have prevailed in the absence of the tax.

How much capital, if any, has left the corporate sector as a result of the corporation income tax is not known. It is possible that the corporate form of doing business is so advantageous for nontax reasons that, for the most part, capital remains in the corporate sector despite the tax. To the extent that corporate investment is financed by debt, the corporation income tax does not affect investment incentives because interest on debt is deductible as a business expense. The same is true if the capital-consumption allowances are so liberal as to be the equivalent of expensing (as they were before the Tax Reform Act of 1986 was passed). In addition, the preferential

treatment of capital gains under the individual income tax provided an offsetting incentive to invest in the securities of corporations that retained earnings for reinvestment in the business. These earnings showed up as increases in the price of common stock rather than as regular income. In any case, the corporate sector has been getting larger, both relatively and absolutely, for decades. The discouragement of investment in the corporate form induced by the tax system, if any, must have been comparatively small.

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Distortions may also take place if the tax is shifted in the short run. If prices increase in response to an increase in the tax, they rise in proportion to the use of corporate equity capital in the various industries. Consumers will buy fewer goods and services produced by industries using a great deal of corporate capital because the prices of these products will have risen most, and they will buy more goods and services produced by industries with less corporate capital. Within the corporate sector, profits will fall in the "capital-intensive" industries as a result of the decline in sales and will rise in the "labor-intensive" industries. In the end, not only will less capital be attracted to the corporate sector, but less will be attracted to the capital-intensive industries in that sector, and the economy will suffer a loss in efficiency as a result. The quantitative effect of this process is heavily dependent, of course, on the degree to which the noncorporate form of doing business can be substituted for the corporate form and production can be transferred from capital-intensive to labor-intensive industries. As in the nonshifting case, even a shifted corporate tax would tend to distort the composition of output.

Major distortions were introduced by the pre-1986 allowances for investment and the deduction for interest on borrowed capital. The depreciation allowances under the accelerated cost recovery system (ACRS) plus the investment credit were equivalent on average to expensing of capital equipment, which can be shown to be equivalent to a zero tax on investment under certain conditions. If the investment was financed by debt, the tax was actually converted to a subsidy. Moreover, the investment tax credit was allowed only for equipment, and the depreciation allowances under ACRS were much less generous for buildings than for equipment. The result was that machinery was treated much more favorably than plant and other structures, inventories, and intangibles. Thus the effect of the capital allowances and the interest deduction differed greatly among different assets and industries. * * * These distortions were greatly reduced, though not entirely eliminated, by the tax reforms enacted in 1986.

Notes and Questions

13. In deciding who bears the corporate income tax, consider the possibility that the incidence of the tax might be changed by changing the structure of the tax or the tax treatment of other business entities, such as partnerships.

14. Is a business corporation an appropriate taxable entity in its own right? Is the decision to tax it based on anything more than administrative feasibility?

15. What different categories of people might conceivably bear all or a portion of the burden of the corporate income tax?

16. State regulators allow public utilities to pass on their corporate income taxes to their ratepayers as a cost of operations. Who bears the corporate tax imposed on public utilities?

17. What is the incidence of the tax on corporations that are in direct competition with individual proprietors, partnerships, limited liability companies, and S corporations that do not owe corporate tax?

18. In the long run, who bears the burden of income tax imposed on corporations for which capital is not a significant income-producing factor?

19. Dr. Pechman stated that the corporate tax will not adversely affect investment incentives if capital investments can be "expensed," or fully deducted when made, "as they were before the Tax Reform Act of 1986 was passed." This assertion requires explanation on two points. First, although pre-1986 law did not allow capital expenditures to be expensed (except for relatively small amounts under section 179), Pechman apparently agrees with economists who argued that the combination of the short depreciation periods and the 10 percent investment tax credit then in effect were as favorable as expensing.

The second point is to examine why immediate expensing of capital expenditures is said to completely eliminate, and not merely reduce, the impact on investment incentives of any income tax (including the corporate income tax). The detailed explanation of Professors Alan Gunn and Larry Ward follows:

> [A]llowing an immediate deduction for the cost of a long-lived income-producing asset produces the same effect as capitalizing the cost and exempting the income the asset earns from taxation. * * * Consider a taxpayer who pays $100,000 for a machine with a ten-year life and no salvage value. The machine will generate $20,000 in revenue each year (a 20-percent pre-tax return on the $100,000 cost), all of which (except for income taxes) the taxpayer will spend on consumption. Assume that the taxpayer has a large amount of other income, and that the taxpayer is subject to a flat-rate 40-percent income tax. If the taxpayer capitalizes the cost of the machine and takes straight-line depreciation, the taxpayer's decision to purchase the asset rather than to spend its purchase

price on consumption amounts to a decision to give up $100,000 of consumption in the year the machine was bought in exchange for $16,000 annual consumption[c] over a ten-year period.

Now suppose the taxpayer is offered a tax exemption for the earnings from the machine. Because the machine produces no taxable income, no depreciation is allowed. The taxpayer will be able to spend $20,000 a year for ten years.

If, instead of an exemption for the machine's earnings, an immediate deduction for the purchase price of the machine (and of similar machines) were allowed, the taxpayer would still be able to spend $20,000 a year for ten years. We have assumed that the taxpayer was willing to give up $100,000 of current consumption to buy a non-deductible machine. If the cost of machines is deductible, the taxpayer can buy $166,666.67 worth of machines by giving up $100,000 of consumption (because the out-of-pocket cost of an immediately deductible $166,666.67 investment to a 40-percent taxpayer is $100,000). The gross return on this investment will be $33,333.33 (20-percent of $166,666.67) a year. This amount will be fully taxable (no depreciation being allowed because the cost of the machine was deducted at the time of purchase). Therefore, the taxpayer will be able to spend 60-percent of this sum, or $20,000, each year.

The equivalence between an immediate deduction and an exemption for return on investment holds for any constant rate of return and tax rate.[h]

C. THE DOUBLE TAX ISSUE

The six excerpts of this subchapter discuss varying answers to the same core question: Assuming the present "double tax" system imposed on corporations and their individual shareholders to be improper, what tax treatment should replace it? The mechanics of the various alternatives for ending or reducing double taxation of corporate earnings are illustrated by this example: Suppose a corporation starts with one shareholder who contributes $1,000 for stock. In the first year the corporation has $100 of taxable income, after deducting interest and other expenses. Under present law suppose the corporate tax is 34 percent, or $34, leaving current earnings and profits of $66. If the entire $66 is paid out as a dividend and the

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c. The machine will generate a $20,000 annual cash return, but only $10,000 in taxable income (because of the $10,000 annual depreciation deduction). Each year's income tax will be $4000, leaving the taxpayer $16,000 to spend. [Footnote c was in the original source. (Eds.)]

h. ALAN GUNN & LARRY D. WARD, CASES, TEXT AND PROBLEMS ON FEDERAL INCOME TAXATION 280-81 (3d ed. 1992). Professors Gunn and Ward state that "[t]he equivalence between current deductibility and exemption of return was first noted in Brown, Business-Income Taxation and Investment Incentives; in L. Metzler et al., Income, Employment and Public Policy; reprinted in R. Musgrave & C. Shoup, Readings in the Economics of Taxation (1959)."

shareholder is taxed at 39.6 percent, the individual income tax on the dividend will be $26.14, leaving a net amount after taxes of $39.86. Total taxes will take $60.14, or 60 percent of the $100 net income.

One method, that of "pure integration," would tax corporations as though they were partnerships—i.e., income and deductions completely integrated with those of the shareholder. If the corporation described above were so taxed, the entire $100 of corporate taxable income, whether or not distributed, would be taxed at the individual shareholder's 39.6 percent tax rate, for a total tax of $39.60. (If the corporation had a loss for the year, presumably the shareholder could deduct it currently—a privilege not now available to shareholders of C corporations.)

Another technique for integration of distributed income is to treat the corporate tax apportioned to dividends as a tax withheld from the shareholder's dividend, similar to the wage withholding tax. In the example, if the entire $100 were declared as a dividend, the entire $34 of corporation tax would be treated as withheld tax. The shareholder would report as income the $66 net amount received plus the $34 withheld, or a total of $100. (This treatment of the amount of tax paid by the corporation on the shareholder's behalf as part of the dividend is referred to as a grossed-up dividend.) The shareholder's tax on $100 at 39.6 percent would be $39.60, and the shareholder would claim a credit of $34 (the amount withheld at the corporate level) against this tax liability. If the shareholder's marginal tax rate were below 34 percent, presumably the additional tax withheld would be allowed as a credit against the shareholder's tax on other income or would be refunded to the shareholder.

A simpler alternative would be to allow corporations to deduct dividends, much as they deduct interest now. In the example, payment of a $100 dividend would reduce corporate taxable income to zero, shareholder income would be $100, and tax on that amount at 39.6 percent would be $39.60. In this example, the result would be the same as partnership treatment, but if a corporation did not pay out all its earnings as dividends the result would be vastly different because, under partnership treatment, the shareholder would be taxed whether earnings are distributed or not.

Another alternative would be to exclude dividends from the individual shareholder's income; thus, the double tax would be eliminated, and the sole tax would be paid by the corporation. To assure that the dividends bear a full tax at one level, the exclusion could be limited to dividends paid from corporate earnings that have borne tax at the top corporate rate. In the example, a dividend of $100 paid from earnings that have been taxed at 34 percent would be excluded from the shareholder's income, so the total tax would be $34.

Yet another alternative would be to exclude dividends from the individual shareholder's income; thus, the double tax would be eliminated, and the sole tax would be paid by the corporation. To assure that the

dividends bear a full tax at one level, the exclusion could be limited in the case of dividends that have not borne a corporate tax equal to the top individual rate. In the example, 34/39.6, or 85.86 percent, of the $100 dividend paid from earnings that have been taxed at 34 percent would be excluded from the shareholder's income. The shareholder, therefore, would be allowed to exclude $85.86, and would be taxed on the remaining $14.14. This would result in a corporate tax of $34 and a shareholder tax of $5.60, so the total tax would be $39.60.

TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH ("TREASURY I")

United States Department of the Treasury

Vol. 1, at 118-19 (1984)

With a comprehensive corporate income tax base, income derived from equity investment in the corporate sector would be taxed twice—once when earned by a corporation and again when distributed to shareholders. The double taxation of dividends has several undesirable effects. It encourages corporations to rely too heavily on debt, rather than equity finance. By increasing the risk of bankruptcy, this artificial inducement for debt finance increases the incidence of bankruptcies during business downturns.

The double taxation of dividends also creates an inducement for firms to retain earnings, rather than pay them out as dividends. There is however, no reason to believe that firms with retained earnings are necessarily those with the best investment opportunities. Instead, they may have more funds than they can invest productively, while new enterprises lack capital. If retained earnings are used to finance relatively low productivity investments, including uneconomic acquisitions of other firms, the quality of investment suffers. In addition, both corporate investment and aggregate saving are discouraged, because the double taxation of dividends increases the cost of capital to corporations and reduces the return to individual investors.

These problems cannot be solved by simply eliminating the corporate income tax. If there were no corporate tax, dividends would be taxed properly, at the tax rates of the shareholders who receive them, but earnings retained by the corporations would not be taxed until distributed, and thus would be allowed to accumulate tax-free. As a result, there would be a substantial incentive to conduct business in corporate form, in order to take advantage of these benefits of tax exemption and deferral.

Nor can the corporate and individual income taxes be fully integrated by treating the corporation as a partnership for tax purposes. Technical difficulties * * * preclude adoption of this approach. The Treasury Department thus proposes that the United States, following the practice of many other developed countries, continue to levy the corporate income tax on earnings that are retained, but provide partial relief from double taxation of

dividends.

There are two alternative ways to provide dividend relief. The approach more commonly employed in other countries is to allow shareholders a credit for a portion of the corporate tax attributable to the dividends they receive. The credit is generally available only to residents, although it is sometimes extended to foreigners by treaty. The credit can be denied tax-exempt organizations, if that is desired.

The simpler method, and the one proposed by the Treasury Department, will allow corporations a deduction for dividends paid similar to the deduction for interest expense. Dividends paid to nonresident shareholders will be subject to a compensatory withholding tax, equivalent to the reduction in tax at the corporate level. The proposal will not impose such a compensatory tax where it would be contrary to a U.S. tax treaty; nor will the compensatory tax apply to dividends paid to U.S. tax-exempt organizations. However, the initial decision to extend the benefits of dividend relief to these two groups of shareholders will be subject to continuing review.

Despite the advantages of full relief from double taxation of dividends, the Treasury Department proposal would provide a deduction of only one-half of dividends paid from income taxed to the corporation. This decision is based primarily on considerations of revenue loss, and can be reconsidered once the proposal is fully phased in.

The deduction would not be allowed for dividends paid from income that had not been subject to corporate tax; firms wishing to pay out tax-preferred income will not receive a deduction, but dividends will be presumed to be paid first from fully taxed income. For this purpose, income that did not bear a corporate tax because of allowable credits, including foreign tax credits, will not be eligible for the deduction.

Reduction of the double taxation of corporate equity income will tend to increase initially the market value of existing corporate shares of companies that distribute an above-average proportion of current earnings as dividends. It will reduce the current tax bias against equity finance in the corporate sector and make equity securities more competitive with debt. Because dividend relief will also reduce the tax bias against distributing earnings, corporations will be likely to pay greater dividends and to seek new funds in financial markets. Corporations will therefore, be more subject to the discipline of the marketplace and less likely to make relatively unproductive investments simply because they have available funds. Similarly, the pool of funds available to new firms with relatively high productivity investment opportunities will be larger. As a result, the productivity of investment should be improved substantially.

Dividend relief will be phased in gradually in order to match the phase-in of the correct rules for measurement of corporate income and to minimize unjustified windfall profits to current shareholders. Moreover, phasing in

dividend relief will prevent a large loss of tax revenue and any associated reduction in the tax burden of high-income shareholders.

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AMERICAN LAW INSTITUTE REPORTER'S STUDY OF CORPORATE TAX INTEGRATION: SUMMARY AND PROPOSALS

Alvin C. Warren,* Reporter

Pages 1-8, 12 (1993)

The United States has long had what is usually called a classical income tax system, under which income is taxed to shareholders and corporations as distinct taxpayers. As a result, taxable income earned by a corporation and then distributed to individual shareholders as a dividend is taxed twice, once to the corporation and once to the shareholder on receipt of the dividend. Corporate taxable income distributed as dividends to exempt shareholders is taxed only at the corporate level. In contrast, earnings on corporate debt capital are nontaxable at the corporate level to the extent they are distributed as deductible interest payments. Whether interest is taxed to the recipient depends on the recipient's status, with foreign and tax-exempt lenders generally nontaxable on such receipts.

Integration of the individual and corporate income taxes refers to various means of eliminating the separate, additional burden of the corporate income tax, in favor of a system in which investor and corporate taxes are interrelated so as to produce a more uniform levy on capital income, whether earned through corporate enterprise or not. *The integration proposals in this study would convert the separate U. S. corporate income tax into a withholding tax with respect to income ultimately distributed to shareholders.*

There are two principal reasons for studying this subject. First, the current system has long been the subject of criticism, for which integration has often been offered as a solution. * * *

The second reason for studying the subject is that most other major developed countries have in recent decades adopted various forms of integration. As the American economy becomes less separable from these other economies, it becomes more important to understand the potential advantages and disadvantages of integration for the United States and for U.S. companies.

* * *

The approach throughout the study is to develop proposals that provide as complete a response as possible to the defects of current law by converting the corporate tax into a withholding device. * * *

Defects in Current Law

In general, the classical system can (a) discourage individual investors

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from investing in new corporate equity; (b) encourage corporations to finance new projects with retained earnings and debt, rather than by issuing new stock; and (c) encourage corporations to distribute earnings in tax preferred transactions, such as redemptions, rather than by paying dividends. Whether the classical system encourages retention or distribution of corporate earnings depends on the rate relationships among corporate, shareholder, and capital gains rates, as well as assumptions about the operation of the capital markets. The tax-induced distortions of current law are undesirable to the extent they have deleterious economic effects (such as over reliance on debt finance by corporations) or create unadministrable legal distinctions (such as that between debt and equity). Integration would reduce or eliminate these undesirable effects.

System of Integration

There are a variety of ways in which the individual and corporate income taxes could be integrated to reduce the distortions of current law. The corporate tax could, for example, be repealed and shareholders taxed currently on all corporate earnings, but that approach would require annual attribution of undistributed corporate income to a myriad of complex capital interests. Alternatively, the corporate tax could be repealed and shareholders taxed annually on changes in stock values, which would require abandonment of the realization criterion of income taxation. Another approach would be for shareholders simply to exclude corporate dividends from their taxable income, but that approach would preclude application of graduated shareholder tax rates to dividend income. Finally, on receipt of a dividend, shareholders could receive a tax credit for corporate taxes previously paid with respect to that dividend. Shareholder credit integration along these lines is the approach most widely adopted abroad and is the system developed in this study. If withholding on dividend payments is considered desirable for compliance purposes, a corporate deduction for dividend payments is essentially equivalent to the recommended form of shareholder credit integration.

The proposed approach would convert the separate corporate income tax into a withholding tax with respect to dividends. Because some dividends will not have borne a corporate tax prior to distribution, an auxiliary dividend withholding tax is necessary to assure that shareholders do not receive tax credits for taxes that have never been paid at the corporate level. No double tax would result, because payments of regular corporate tax would be considered prepayments of this auxiliary tax. On the other hand, certain dividends may be free of corporate tax as a result of deliberately enacted corporate tax preferences that should be passed through to shareholders. Finally, in order to minimize differential treatment of debt and equity, a withholding tax on corporate interest payments would be desirable. Four proposals implement this basic system of integration:

1. A withholding tax will be levied on dividend distributions;

payments of corporate tax will be fully creditable against this withholding tax.

2. Shareholders will receive a refundable tax credit for the dividend withholding tax.
3. Certain corporate tax preferences can be passed through to shareholders.
4. A withholding tax will be levied on payments of corporate interest; that tax will be fully creditable by and refundable to the recipients of such interest payments.

Retained Earnings

If the corporate income tax became part of a withholding system, retained earnings would present two problems. First, shareholders whose marginal tax rates were below the corporate rate would be disadvantaged by corporate retentions, creating a tax incentive for distributions of corporate earnings. Second, taxation of shareholder capital gains due to retained corporate earnings could, as under current law, constitute multiple taxation of the same gain. The second problem could be eliminated by preferential taxation of gains on corporate stock, but such a preference would be overbroad because not all gains on corporate stock are due to taxable corporate earnings. Both problems would be addressed by a constructive dividend option, under which shareholder tax credits would be available to shareholders without the requirement of an actual dividend distribution. If the withholding and corporate tax rates were equal to the highest individual rate, such constructive dividends could only benefit shareholders, who would either pay no taxes or receive a refund. The increase in shareholder basis due to the constructive reinvestment would eliminate the potential of double taxation on sale of the stock. These ideas are implemented by Proposals 5 and 6, which can be summarized as follows:

5. Corporations could make shareholder credits available to shareholders at any time through constructive dividends and reinvestments.
6. Sales of stock will be fully taxable to shareholders, with deductions for stock losses limited to dividends, realized stock gains, and the excess of realized stock losses over net unrealized stock gains.

Nondividend Distributions

There are a variety of transactions other than dividends by which corporate income can be distributed to shareholders, including repurchases by a corporation of its stock, purchase by one corporation of stock in a second corporation from noncorporate shareholders, and payments in liquidation. Under current law, the tax treatment of such nondividend distributions to individuals is usually less onerous than that of dividends, because basis recovery and a capital gains preference may be available with respect to the former, but not the latter. Corporate shareholders, on the other hand, would generally prefer to characterize distributions as dividends to take advantage

of the dividends received deduction. In a shareholder credit system of integration, the principal issue presented by nondividend distributions is the extent to which shareholder credits will be available In such distributions. The approach taken in Proposal 7 is to maintain the distinction under current law between dividends and exchanges, with the latter generally carrying out a portion of previously paid corporate taxes. Where it is difficult to identify the recipient of a nondividend distribution, the appropriate tax credit will be available to the distributing corporation.

7. Nondividend redemptions and liquidations will be treated as exchanges with basis recovery, and will carry out a *pro rata* portion of previously paid corporate taxes. Other nondividend distributions will result in a refund to the corporation of previously paid corporate taxes.

Intercorporate Transactions

In general, shareholders that are corporations can be treated like other shareholders under integration. However, a special problem arises in the case of intercorporate dividends of previously untaxed corporate income because application of the dividend withholding tax would require payment of a corporate tax prior to distribution of corporate earnings to noncorporate shareholders. Proposal 8 provides for an election to defer this tax in the case of significant intercorporate investment until a distribution is made to noncorporate shareholders:

8. Major corporate investors will have the option to treat intercorporate dividends as nontaxable and noncreditable.

Exempt Shareholders and Creditors

Nominally exempt suppliers of corporate capital, such as charitable organizations and pension funds, do not always receive their share of corporate income free of tax under current law. The portion of corporate income distributed to such investors is sometimes taxed (due to the corporate tax on income distributed as dividends) and sometimes not (due to the corporate deduction for interest payments and to corporate preferences for some income distributed as dividends). Because one of the goals of integration is elimination of such discontinuities, any comprehensive system of integration will necessarily affect currently exempt shareholders. The approach of these proposals is to maintain a single level of tax on corporate income received by such investors, and to rationalize that tax to eliminate tax-induced distortions in investment decisions. Accordingly, entities that are nominally exempt under current law would be subject to an explicit tax on corporate investment income, against which the shareholder and creditor withholding credits could be used, with any excess refundable. The basic idea of this proposal is that the rate of tax on income from corporate investment received by an exempt entity should be uniform and explicitly determined as a matter of tax policy. That rate could be set to maintain the same level of revenue that is currently collected on corporate income

distributed to exempt shareholders, or at a higher or lower rate. The resulting proposal can be summarized as follows:

9. A new tax will be imposed on the corporate investment income of exempt organizations, which will be allowed credits for corporate taxes on the same basis as other investors.

* * *

Transition

As with any major change in tax law, integration could be made immediately effective, phased-in over time, or subject to certain exceptions for per-existing transactions. With respect to the last possibility, it is sometimes argued that integration should be available only for corporate equity acquired after the date of enactment, on the theory that capital markets have already discounted the price of pre-enactment corporate equity to reflect the classical system, so that integration for pre-enactment equity would result in unjustified windfalls to current shareholders. The proposals are not limited to post-enactment corporate capital, in part because recommendations implementing such limitations have already been developed in prior Institute studies. Instead, Proposal 12 develops a method for transition to full integration over time. * * *

The net effect of the * * * proposals summarized above is that the US. corporate income tax would no longer function as a separate, additional tax. Rather, it would be part of an integrated system under which investors in corporate enterprise would be taxed once, but only once, on income from investment in corporate capital. The only rate of tax ultimately applicable to corporate income distributed to a shareholder or creditor would be that investor's rate. * * *

[W]hat follows is a long and complicated study[i], but it is based on a simple and straightforward idea: *conversion of the separate U.S. corporate income tax into a withholding tax would reduce economic distortions and troublesome legal distinctions that arise under current law.*

STATEMENT OF TAX POLICY: INTEGRATION OF THE CORPORATE AND SHAREHOLDER TAX SYSTEMS

American Institute of Certified Public Accountants

Pages 18-19, 63-67 (1993)

The Objectives of Integration

A system of integration would lower the cost of capital and mitigate many of the distortions and inequities created by the present classical system by taxing corporate income only once. There are several methods or approaches available to relieve the double taxation of corporate profits.

In evaluating the alternative methods available, the AICPA has

i. Professor Warren is referring to the entire Reporter's Study. Only the Summary and Proposals are excerpted. (Eds.)

identified five basic objectives that an integrated system should seek to achieve:

* A more uniform taxation of income earned in the corporate and noncorporate sectors
* A reduction in the tax bias favoring debt financing
* A reduction of tax incentives for corporations to retain rather than distribute their profits
* An easy interface with foreign integrated tax systems
* No significant additional complexity for the tax system

Brief Overview of Alternative Methods

This study analyzes the three principal alternative methods of implementing an integration system: (1) the flow-through method; (2) the dividends-paid deduction method; and (3) the shareholder-credit method. However, three variants of these principal methods have also been considered: (1) the repeal of the corporate tax; (2) the split-rate corporate-level tax; and (3) the dividend-exclusion method.

A brief overview of the three principal alternatives follows. * * *

Flow-Through Method

The flow-through integration method achieves complete integration of all corporate earnings by allocating all items of income to shareholders in a manner similar to the allocation of partnership and S corporation income under the current system. This method taxes all income at the shareholder level when earned, whether or not distributed. The flow-through method represents the purest form of integration because it subjects all corporate income to only one level of tax, at the shareholder rates.

Dividends-Paid Deduction Method

The dividends-paid deduction method allows a corporation to deduct all or part of dividends paid from taxable income. Under this method, the benefits of integration inure to the corporation, since shareholders still report dividends received as income. To the extent that corporations make fully deductible distributions, one level of tax at the shareholder's tax rate should result. This method does not extend integration benefits to retained earnings.

Shareholder-Credit Method

The shareholder-credit method imposes a corporate-level tax on all earnings, but grants a credit to shareholders for a portion of the corporate tax paid that is allocated or imputed to dividends. This method generally requires shareholders to "gross up" their dividend income by the amount of credit allowed. Integration is achieved by eliminating or reducing the tax on dividends at the shareholder level. Therefore, the benefits of integration inure to the shareholder. As with the dividends-paid deduction method, double-tax relief applies only to distributed income. Therefore, integration benefits are not granted to retained income.

* * *

Conclusions and Recommendations

Each of the three principal methods has been evaluated to determine whether it achieves five basic objectives for an integrated system and whether and how easily it can be designed to handle certain key issues. Each of these principal methods would achieve more neutral taxation by (1) providing more uniform taxation of income between the corporate and noncorporate sectors; (2) reducing the tax bias favoring debt investment; and (3) reducing the incentives to retain rather than distribute earnings. Accordingly, the AICPA believes that an integration method must be chosen primarily on the basis of its ease of administration, its compatibility with foreign integrated systems, and its flexibility in addressing the key issues of tax preferences, tax-exempt investors, and international transactions.

Theoretically, the flow-through method is the purest form of integration; however, it would be considerably more difficult to administer and implement. Broadening the eligibility of the S corporation election by expanding the number of allowable shareholders would offer one alternative to the use of the flow-through method, but the use of the S corporation rules would not be practical for large, widely held corporations. Moreover, if policy makers were to decide not to extend integration benefits to tax-exempt and foreign shareholders, the flow-through method would need to include an appropriate withholding mechanism, further complicating implementation of the method. After careful review, the flow-through method was not chosen as a viable option because of the numerous problems in administering the method, its lack of flexibility in dealing with the key issues, and its incompatibility with foreign integrated systems.

Both of the other two alternatives, the dividends-paid deduction and the shareholder-credit methods, would offer a more practical and realistic means of achieving integration. The public's perception of the equity of each method may be an important factor in determining whether either is adopted. The public may perceive that the dividends-paid deduction method would confer all of the benefits on the corporation. The shareholder-credit method is likely to be more acceptable, since the public may perceive that the shareholder would receive a greater benefit than under the current system or the dividends-paid deduction method. On the other hand, the public may perceive that integration benefits only high-income taxpayers.

The United States could adopt either the deduction or the credit method with substantially the same tax results.[99] However, to achieve this equality, it must be assumed that the corporate-dividend policy would be comparable under both methods. In addition, the deduction method would be assumed to include a withholding mechanism and credits under both methods would be refundable.

Proponents of the dividends-paid deduction method argue that (1) it is simpler and easier to administer than the shareholder-credit system, (2) it handles the debt-equity problem more effectively, and (3) it can more easily restrict integration benefits to new equity. The simplicity and ease of administration of the dividends-paid deduction method is its most significant advantage. However, the modifications (including withholding) required to implement adjustments for foreign and tax-exempt shareholders, credits, and tax preferences would complicate this method greatly. Without these modifications, greater revenue loss, reduced compliance, and a decrease in the value of tax preferences could result. Consequently, such a modified deduction method would provide no significant advantages over a shareholder-credit method.

Another advantage of the dividends-paid deduction method is that it would provide for more neutral tax treatment of debt and equity. The shareholder-credit method would not achieve the same result, since the shareholders, not the corporation, would receive the benefits of integration. Therefore, under the credit method, corporations may continue to prefer debt because interest would be deductible, whereas dividends would not.

Proponents of the shareholder-credit method argue that it is preferable to the dividends-paid deduction method because (1) it would achieve a higher level of compliance with less effort, (2) it would be more flexible in dealing with foreign and tax-exempt shareholders and corporate tax preferences, (3) it would more easily conform to the integrated systems of other countries,

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99. For example:

	Credit	Deductions
Corporate Level		
Net income	$1,000	$1,000
Cash dividend	660	1,000
Dividend deduction	0	1,000
Taxable income	1,000	0
Corporate tax (34%)	340	0
Withholding tax (31%)	0	310
Shareholder Level		
Cash dividend received	$660	$690
Gross-up inclusion	340	310
Shareholder income	1,000	1,000
Tax before credit	310	310
Credit	340	310
Refundable credit	(30)	0
Net Cash to Shareholder	$690	$690

and (4) it would not affect the corporation's financial statements.

The shareholder-credit method should have a higher level of compliance than the dividends-paid deduction method, unless the deduction method includes a withholding mechanism. The level of compliance would be higher under the credit method because taxpayers would report dividend income before receiving the benefit of the credit, whereas under the deduction method, the corporation would be permitted to take a deduction for dividends even if some shareholders failed to report the dividend income.

The shareholder-credit method can more easily be designed either to extend or to limit benefits for foreign and tax-exempt shareholders, and either to pass through or to limit the pass- through of tax preferences to shareholders. Although the deduction method, too, can be designed to address these issues, the credit system would handle them with far less complexity. A special provision for corporate tax preferences would make both methods more complex, but implementation of rules relating to tax preferences would be more difficult under the dividends-paid deduction method.

If policy makers decide not to extend integration benefits to tax-exempt shareholders, the shareholder-credit method could make the credit nonrefundable to tax-exempt organizations, whereas the dividends-paid deduction method would have to tax dividends as unrelated trade or business income (or include a withholding mechanism) to achieve the same result. Making the credit nonrefundable is easier to implement, and certainly less complex, than requiring withholding or taxing dividends as unrelated trade or business income.

The shareholder-credit method also can be more easily tailored to other specific types of shareholders. This feature is especially important when determining the proper treatment of foreign shareholders, and may be the reason why other countries have preferred the shareholder-credit instead of the deduction method. Conversely, the main drawback to the dividends-paid deduction method is that it would apply to all categories of shareholders equally. Under the credit method, the United States could make the credit nonrefundable to foreign shareholders and extend integration benefits to foreign shareholders only through bilateral treaty negotiations. The only way to prevent the granting of integration benefits to foreign shareholders under the deduction method would be to increase the withholding rate on dividends paid to such shareholders. However, such an increase could be very difficult, if not impossible, to achieve under the provisions of many existing tax treaties.

Another advantage of the shareholder-credit system is that it would not change the amount of net income a corporation reports in its financial statements. Because the corporate income tax liability would not change under this method, there would be no consistency problems with reporting the prior year's operations and cash flows, such as those that would occur

under the deduction method.

International conformity, however, may be the most important advantage of the shareholder-credit method. All other major industrialized nations that have adopted integration use this method. This international experience not only would benefit the United States in designing and implementing an integration system, it also would make it easier to interface the U.S. system with foreign systems. Adopting the shareholder-credit method also would facilitate bilateral treaty negotiations on providing reciprocal integration benefits.

In summary, since both the credit and deduction methods can be structured to produce substantially equivalent tax results, the United States should consider other advantages and disadvantages when selecting the appropriate method. The single most important factor in this decision seems to be the international ramifications, particularly the method's ability to work within the framework of bilateral tax treaties. Flexibility in treaty negotiations, particularly in dealing with foreign tax credits and the extension of integration benefits to foreign shareholders, would give the credit system a decisive advantage.

The shareholder credit also would allow for greater flexibility in handling the key policy issues involved in the treatment of tax preferences and tax-exempt investors. This flexibility would facilitate the adoption of an integrated system, because it would more easily allow policy makers to reach the compromises that necessarily are a part of the legislative process. Although some forms of the shareholder-credit method may be relatively complicated to implement, international experience suggests that even the most complex forms of the method can be administered without substantial difficulty.

On balance, the AICPA concludes that the shareholder-credit method best achieves the objectives of an integrated system, and therefore recommends its adoption by the United States.

REPORT ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS

United States Department of the Treasury

Pages vii-x (1992)

Currently, our tax system taxes corporate profits distributed to shareholders at least twice—once at the shareholder level and once at the corporate level. If the distribution is made through multiple unrelated corporations, profits may be taxed more than twice. If, on the other hand, the corporation succeeds in distributing profits in the form of interest on bonds to a tax-exempt or foreign lender, no U.S. tax at all is paid.

The two-tier tax system (i.e., imposing tax on distributed profits in the hands of shareholders after taxation at the corporate level) is often referred to as a classical tax system. Over the past two decades, most of our trading

partners have modified their corporate tax systems to "integrate" the corporate and shareholder taxes to mitigate the impact of imposing two levels of tax on distributed corporate profits. Most typically, this has been accomplished by providing the shareholder with a full or partial credit for taxes paid at the corporate level.

Integration would reduce three distortions inherent in the classical system:

(a) *The incentive to invest in noncorporate rather than corporate businesses.* Current law's double tax on corporations creates a higher effective tax rate on corporate equity than on noncorporate equity. The additional tax burden encourages "self-help" integration through disincorporation.

(b) *The incentive to finance corporate investments with debt rather than new equity.* Particularly in the 1980s, corporations issued substantial amounts of debt. By 1990, net interest expense reached a postwar high of 19 percent of corporate cash flow.

(c) *The incentive to retain earnings or to structure distributions of corporate profits in a manner to avoid the double tax.* Between 1970 and 1990, corporations' repurchases of their own shares grew from $1.2 billion (or 5.4 percent of dividends) to $47.9 billion (or 34 percent of dividends). By 1990, over one-quarter of corporate interest payments were attributable to the substitution of debt for equity through share repurchases.

These distortions raise the cost of capital for corporate investments; integration could be expected to reduce it. To the extent that an integrated system reduces incentives for highly-leveraged corporate capital structures, it would provide important non-tax benefits by encouraging the adoption of capital structures less vulnerable to instability in times of economic downturn. The Report contains estimates of substantial potential economic gains from integration. Depending on its form, the Report estimates that integration could increase the capital stock in the corporate sector by $125 billion to $500 billion, could decrease the debt-asset ratio in the corporate sector by 1 to 7 percentage points and could produce an annual gain to the U.S. economy as a whole from $2.5 billion to $25 billion.

Prototypes

This Report defines four integration prototypes and provides specifications for how each would work. Three prototypes are described in Part II: (1) the dividend exclusion prototype, (2) the shareholder allocation prototype, and (3) the Comprehensive Business Income Tax (CBIT) prototype. * * * For administrative reasons that the Report details, we have not recommended the shareholder allocation prototype (a system in which all corporate income is allocated to shareholders and taxed in a manner similar to partnership income under current law). Simplification concerns led us to prefer the dividend exclusion to any form of the imputation credit prototype.

In the dividend exclusion prototype, shareholders exclude dividends from income because they have already been taxed at the corporate level. Dividend exclusion provides significant integration benefits and requires little structural change in the Internal Revenue Code. When fully phased in, dividend exclusion would cost approximately $13.1 billion per year.

CBIT is, as its name implies, a much more comprehensive and larger scale prototype and will require significant statutory revision. CBIT represents a long-term, comprehensive option for equalizing the tax treatment of debt and equity. It is not expected that implementation of CBIT would begin in the short term, and full implementation would likely be phased in over a period of about 10 years. In CBIT, shareholders and bondholders exclude dividends and interest received from corporations from income, but neither type of payment is deductible by the corporation. Because debt and equity receive identical treatment in CBIT, CBIT better achieves tax neutrality goals than does the dividend exclusion prototype. CBIT is self-financing and would permit lowering the corporate rate to the maximum individual rate of 31 percent[j] on a revenue neutral basis, even if capital gains on corporate stock were fully exempt from tax to shareholders.

Policy Recommendations

In addition to describing prototypes, the Report makes several basic policy recommendations which we believe should apply to any integration proposal ultimately adopted:

(a) *Integration should not result in the extension of corporate tax preferences to shareholders.* This stricture is grounded in both policy and revenue concerns and has been adopted by every country with an integrated system. The mechanism for preventing passthrough of preferences varies; some countries utilize a compensatory tax mechanism and others simply tax preference-sheltered income when distributed (as we recommend in the dividend exclusion prototype). Both of these mechanisms are discussed in the Report.

(b) *Integration should not reduce the total tax collected on corporate income allocable to tax-exempt investors.* Absent this restriction, business profits paid to tax-exempt entities could escape all taxation in an integrated system. This revenue loss would prove difficult to finance and would exacerbate distortions between taxable and tax-exempt investors.

(c) *Integration should be extended to foreign shareholders only through treaty negotiations, not by statute.* This is required to assure that U.S. shareholders receive reciprocal concessions from foreign tax jurisdictions.

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j. The top corporate rate no longer exceeds the top individual rate. The maximum corporate rate is now 35% (excluding notch rates), compared to a maximum individual rate of 39.6%. (Eds.)

COMPARISON OF THE FOUR PRINCIPAL INTEGRATION PROTOTYPES

	DIVIDEND EXCLUSION	SHAREHOLDER ALLOCATION	CBIT	IMPUTATION CREDIT
Rates				
a) Distributed Income	Corporate rate	Shareholder rate[1]	CBIT rate (31 percent)	Shareholder rate[1]
b) Retained Income	Corporate rate (additional shareholder level tax depends on the treatment of capital gains)	Shareholder rate[1]	CBIT rate (additional investor level tax depends on the treatment of capital gains)	Corporate rate (additional shareholder level tax depends on the treatment of capital gains)
Treatment of non-corporate businesses	Unaffected	Unaffected	CBIT applies to non-corporate businesses as well as corporations, except for very small businesses.	Unaffected
Corporate tax preferences	Does not extend preferences to shareholders. Preference income is subject to shareholder tax when distributed.	Extends preferences to shareholders.	Does not extend preferences to investors. Preference income is subject to compensatory tax or investor level tax when distributed.	Does not extend preferences to shareholders. Preference income is subject to shareholder tax when distributed.
Tax-exempt investors	Corporate equity income continues to bear one level of tax.	Corporate equity income continues to bear one level of tax.	A CBIT entity's equity income and income used to pay interest bear one level of tax.	Corporate equity income continues to bear one level of tax.
Treatment of debt	Unaffected	Unaffected	Equalizes treatment of debt and equity	Unaffected (unless bondholder credit system adopted)

1. Plus 3 percentage points of corporate level tax not creditable because the prototype retains the 34 percent corporate rate but provides credits at the 31 percent shareholder rate. [The 34% and 31% rates were the maximum corporate and individual rates when this report was published. (Eds.)]

(d) *Foreign taxes paid by U.S. corporations should not be treated, by statute, identically to taxes paid to the U.S. Government.* Absent this limitation, integration could eliminate all U.S. taxes on foreign source profits in many cases.

A table summarizing the characteristics of each of the prototypes [is on the preceding page].

A PROPOSAL FOR ELIMINATING DOUBLE TAXATION OF CORPORATE DIVIDENDS

Fred W. Peel, Jr.*

39 Tax Lawyer 1, 1-6 (1985)

Introduction

This article develops in detail a proposal for eliminating double taxation of corporate dividends by excluding dividends from gross income at the individual shareholder level if the dividends are paid from income previously taxed at the corporate level. In brief, the proposal is to adopt a single corporate income tax rate equal to the maximum individual tax rate and permit shareholders to exclude from income dividends paid out of corporate earnings that have been taxed at the single corporate rate. It is submitted that the proposal would advance tax simplification, while taxing corporate profits on a more rational basis.

The past decade has seen wide discussion of methods integrating the corporate and individual income taxes—either completely or partially. Full integration would treat corporate income as though it had been earned initially by the shareholders as individuals. Partial integration plans are designed to achieve that result for all or part of the dividends distributed to individual shareholders, either by crediting the shareholders with the corporate tax or by allowing corporations to deduct all or part of their dividends.

Exclusion of dividends from the income of individual shareholders heretofore has generally been dismissed out-of-hand.[5] There appear to have been three reasons for the lack of interest in the dividend exclusion approach. First, until the maximum individual tax rate on investment income was reduced to 50%, the wide disparity between the corporate tax rate and the higher individual rates would have meant that exclusion of dividends would discriminate unacceptably in favor of corporate income. With a maximum individual tax rate of 50%, however, the gap has been narrowed significantly. Now it is feasible to suggest that the two rates be made the same, at some rate between 46% and 50%, or perhaps at some lower rate if one of the current base-broadening plans is enacted.[k] Regardless of the adjustment, the

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5. *See, e.g.*, C. MCLURE, MUST CORPORATE INCOME BE TAXED TWICE? 5 (1979).

k. Since this article was written, the maximum rate applicable to individuals has fallen from 50% to 39.6%, and the maximum rate applicable to corporations has fallen from 46% to 35%.

proposed dividend exclusion requires a nonprogressive corporate tax rate that equals the maximum individual rate.

Second, because some dividends, defined in terms of earnings and profits, may not have been taxed at the corporate level, exclusion of all dividends would permit some corporate income to escape tax altogether. The proposal here will exclude dividends at the individual shareholder level only when distributed from previously taxed income, and only from income earned by the corporation after the proposal has been put into effect.

Third, there has been widespread confusion between two different policy objectives—integration of corporate and shareholder taxes, on the one hand, and elimination of double taxation of dividends, on the other hand. Although their consequences overlap to some degree, the objectives of integration and of elimination of double taxation differ sharply. For example, full integration, by treating corporate income as though earned directly by the shareholders, would not merely eliminate the double tax but also all tax when the shareholder is an exempt organization (unless the tax is reimposed on exempt organizations as a corollary to the tax on unrelated business income, or as an extension of the tax now imposed on investment income of some exempt organizations, such as social clubs). In essence, integration assumes that the corporation is not an appropriate taxpayer and that its role should be, at most, that of a tax withholding agent for its shareholders. In contrast, eliminating double taxation of dividends treats the corporation as a viable and appropriate taxpayer. After the corporate tax has been imposed, however, no further tax should be imposed on the same income when, diminished by the corporate tax, it is distributed to the shareholders

The Objections to Double Taxation

Put simply, the double tax on corporate dividends is unfair. It violates the principle of horizontal equity. A shareholder who is taxed on a dividend out of earnings that already have been taxed at the corporate level is bearing a heavier tax burden than an individual in the same tax bracket receiving equivalent income through an S corporation, through a partnership, or directly as a sole proprietor.

It is true that in some circumstances the C corporation shareholder may be treated better than his counterparts, at least when the income is initially earned. This occurs when the corporation's earnings are not distributed as dividends and the tax paid at the corporate level is at a lower rate than the shareholder would pay if he or she had received the income directly. For this reason, the present system has been described as biased in favor of retained corporate earnings. This bias has been reduced by the 50% maximum individual rate and would be eliminated altogether under the proposal by taxing corporate income in full at the maximum individual rate.

Accordingly, the proposed equalization now would presumably fall in the range of 35% to 39.6%, the marginal corporate and individual rates. (Eds.)

In addition to its unfairness, the incidence of the double tax is inconsistent because of the escape routes open to some shareholders in lieu of receiving taxable dividends. For example, the second tax can be cut by 60% by selling the stock at a capital gain equivalent to the accumulated corporate earnings.[l] The same result can be achieved by liquidating the corporation or by stock redemptions within the bounds of section 302(b). Some publicly held corporations have combined tender offers for, or market purchases of, their own stock with a policy of declaring little or no cash dividends.[15] In addition, if a shareholder holds stock in a corporation until his death and the value of the stock reflects the accumulated earnings, the basis of the stock will be stepped up by the amount of the accumulated earnings so that the stock can be sold or redeemed by the heirs without any second tax on earnings accumulated during the decedent's ownership.

Individual shareholders of publicly held corporations can sell their stock and attempt to realize a capital gain equivalent to their share of the accumulated earnings. If, however, the stock is sold to other individuals who are no better positioned to extract the accumulated earnings without dividend tax, the stock price will be discounted by the potential of an eventual dividend tax. Individual investors who hold stock in publicly held corporations and have chosen dividend-paying stocks in order to have current income are the principal victims of the double tax. There is no compelling policy reason for penalizing these people as a class.

The dividend tax, therefore, seriously distorts the pricing mechanism for stock in publicly held corporations. In essence, there are at least two markets for the stock, with widely divergent prices. One market is made up of individual investors, who must discount the value of the dividend income stream by the individual income tax they will have to pay. The second market is comprised of corporations that, at most, must discount the value of the dividend income stream by a tax on only 15%.[m] (Exempt organizations, such as pension trusts, might be considered as composing another market.)

If a corporate buyer acquires 80% or more of the stock of a target corporation, it may elect a 100% dividends-received deduction on distributions of future earnings of the target. Alternatively, the acquiring corporation may file a consolidated return with the target, eliminating all dividends from it, or liquidate the target and receive the earnings from its operations directly thereafter. The corporate buyer can recover the cost of

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l. Under present law, long term capital gain income is taxed at a maximum rate of 28 percent, or 71 percent of the 39.6 percent maximum tax rate on ordinary income. (Eds.)

15. For example, Teledyne, Incorporated, a corporation that does not pay dividends, repurchased 8.66 million shares of its own common stock for $200 a share under a June 1984 tender offer.

m. When this article was written, corporations could deduct 85 percent of dividends received from other corporations (100 percent if the corporations were affiliated.) Under present law the general deduction is 70 percent. Section 243. (Eds.)

stock of a target corporation tax free through dividends paid by the target corporation out of the latter's earnings, whereas an individual buying and holding stock must recover his or her investment out of after-tax dollars from dividends. A takeover bid by another corporation lifts the stock out of the low-priced market of individual investors who must pay tax on their dividends and places it in the market of corporate buyers who can recover the price of the shares out of tax free dividends. For this reason, among others, we have the phenomenon of sudden increases in the price of stocks when corporations become takeover candidates. This possibility, in turn, encourages investors to seek out corporations that are likely to become takeover candidates.

The double tax clearly discourages dividends by publicly held corporations. From the point of view of corporate management, retained earnings are available for reinvestment in the business after bearing only one tax. Distributed earnings, however, are diminished by the second tax at the shareholder level. Consequently, even if distributions are put back in the distributing corporation, the amount available for reinvestment is much smaller. Many shareholders invest willingly in publicly held corporations that pay few or no dividends, preferring to gamble that retained earnings will increase the value of the stock. By deferring tax until sale, they can realize capital gains at lower rates rather than incurring an immediate tax on dividends at ordinary income rates. This confers upon corporate management the power to direct investment of corporate earnings, rather than allowing shareholders to exercise that power through reinvestment of dividends.

The additional corporate tax on unreasonable accumulations is designed to curb corporate retention of earnings and to force dividend payments. It applies only to accumulations that cannot be justified by the needs of a new or existing business, however, and in any event a business corporation may accumulate $250,000 without penalty. In the vast majority of cases, a business use can be found for accumulated earnings. The postponement or eventual avoidance of the double tax, however, is as real and advantageous as for the shareholder of a corporation that accumulates earnings without a business use. Meanwhile, the Service is saddled with the tremendous administrative job of finding and penalizing the corporations that cannot adequately excuse their accumulations. Although in the past the tax on unreasonable accumulations was applied only to closely held corporations, it may now apply to publicly held corporations as well.

The double tax on dividends also distorts the corporate choice between debt and equity financing. Because interest on debt is deductible, corporate earnings applied to payment for the use of borrowed capital are taxed only once—to the lender. Debt and equity capital are by no means interchangeable when the debt is owed to persons other than shareholders, so the choice in that case between the two types of financing is not based

merely on tax considerations. Moreover, the tax differential can be minimized by not paying out dividends. Nonetheless, for a corporation that *must* pay dividends for use of its equity capital, the double tax on dividends favors raising capital by borrowing.

It might be thought that the bias would remain under the proposal because dividends still will not be deductible by the corporation. If there is a sufficiently close identity between corporate management and shareholders, however, exclusion by the shareholder is as good as deduction by the corporation. Even in the absence of identity between management and ownership, the cost of equity capital will be reduced as a result of the dividend exclusion, balancing the ability to deduct interest paid on indebtedness.

In addition to distortion of the debt-equity ratio for corporations borrowing from persons other than their shareholders, the present tax treatment of corporate debt and equity has created an apparently insuperable problem of distinguishing between debt and equity owned by the same persons. It is advantageous for shareholders in closely held corporations to hold as much of their investment as possible in the form of debt to avoid double tax on payments for the use of the capital and to permit additional withdrawals to be characterized as repayment of debt. Short of treating all debt owed to controlling shareholders as equity, there does not seem to be any workable (or logical) standard that can be applied to distinguish shareholder-owned debt from equity. Congress' attempt in 1969 to delegate authority to draw the line by regulation so far has failed.[26] The problem appears to be unavoidable so long as interest is taxed once and earnings paid out as dividends are taxed twice.

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SELF-HELP INTEGRATION (LLCs) OR OTHERWISE

Bernard Wolfman*

62 Tax Notes 769, 769-70 (1994)

By year-end 1993, 36 states had passed laws authorizing limited liability companies (LLCs). The number doubled in only one year. In the past two months alone, the IRS has published revenue rulings holding that firms formed under the recently adopted LLC statutes of close to 10 states would be treated as partnerships (and not as associations taxable as corporations). Yet until 1988, when the IRS put its imprimatur on a Wyoming LLC, the Service had declined to approve any.

For almost two decades, the Service, with the Tax Court's blessing, has

26. The Treasury Department has so far been unsuccessful under section 385, added by section 415(a) of the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 613, in issuing regulations to distinguish stock from indebtedness. Regs. § 1.385-1 to -10 were finally adopted in 1980, but were later withdrawn by T.D. 7920, 1983-2 C.B. 69.

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made it possible to organize partnerships that possess up to two of the four characteristics that are the usual marks of a corporation (and not historically those of an unincorporated business) without being treated as a corporation for federal income tax purposes. The four familiar attributes are limited liability, transferability of interest, continuity of life, and centralized management. The test is simply arithmetical, not at all qualitative. With up to two of those attributes but no more, the entity avoids tax treatment as a corporation; with more than two, the entity enters the double tax world of the C corporation.

The most popular and customary form used to achieve partnership status, while assuring the nonmanaging investors that their liability will be limited to their investment, has been the limited partnership formed under the Uniform Limited Partnership Act. Those entities can easily avoid continuity of life if they wish, and they may provide for a restricted form of transferability of the limiteds' interests. Usually they avoid centralized management and limited liability. Although management is vested in the general partner, that vesting is by reason of his status as general partner and not by appointment or election of the generals and limiteds together. The limited partners, to be sure, are not exposed to liability beyond their investment in the firm, but since the general partner is liable for partnership debts without limitation, the partnership is not treated as having the corporate attribute of limited liability.

The code does not restrict the number of partners a partnership may have and still receive partnership treatment, but it provides that the organization will be treated as a corporation if its interests are publicly traded (section 7704). An S corporation will avoid the "double taxation" of the C corporation and its shareholders, and it will assure limited liability to its investors along with centralized management (through a shareholder-elected board), but an S corporation may not have more than 35 shareholders or foreign shareholders or more than a single class of stock. Both the partnership and the S corporation limit the passthrough of losses to the investor's basis, but in the case of the partnership (and not the S corporation) the investors include in basis their share of "inside" (partnership) liabilities.

The LLC is fast becoming the vehicle of choice, especially for real estate and personal services. The recent increase in the top marginal tax rate of individuals, above the top corporate rate, may slow the pace of change for other profitable businesses for which the C corporation may provide a degree of shelter.

In states where the LLC is available, it provides a form of self-help integration, a "single tax" enterprise without a fixed statutory limit on the number of members, where outside basis is augmented by inside liabilities, and the "special allocation" rules of subchapter K provide the flexibility generally available to limited partnerships. Transferability of interest can

be avoided by requiring membership approval before a transferee may be recognized as such and acquire the perquisites of membership, although a transferee will be entitled to the distributions and profit interest of the transferor without membership approval. The IRS will treat delegation of management to an appointed or elected manager or management committee as creating centralized management, but centralized management may be avoided by providing for management to be vested in all of the members. Since there is limited liability for all investors (no "general partner" or equivalent need be liable beyond his investment in the firm), two of the other three corporate attributes must be shunned to achieve partnership tax status. Although I am unaware of any statistics on the subject, my impression is that many LLCs opt for transferability of interest and, of course, limited liability, but they avoid continuity of life and centralized management, while others adopt a form of centralized management and limit transferability of interest sufficiently to avoid being tainted with that corporate attribute. As with partnerships generally, of course, public tradeability of members' interests would, by itself, bring on corporate tax status.

Until all of the states, or at least all of the leading commercial and financial states, adopt legislation recognizing or authorizing LLCs, there will be hesitation about adopting the LLC form if the enterprise will be doing business in a non-LLC state or if it has members living or doing business in such a state. The reason is that it is unclear whether, as a matter of law, a non-LLC state must recognize the limited liability status of an LLC investor. * * * Lawyers' opinions on this issue differ, and there is no governing judicial precedent. There is no federal law to resolve the question, but by the end of 1994 it may well be that California, New York, Pennsylvania, and Massachusetts will themselves have adopted LLC legislation—they and others are now considering it, and if Jimmy the Greek were asked he might well quote odds that point to approval.

Because publicly traded partnerships will be treated as C corporations and because S corporations are limited to 35 shareholders, current law does not offer an integrated "single tax" regime to corporations with a substantial number of shareholders or to publicly traded partnerships. Proposals have been made to increase the permissible number of shareholders in S corporations, and some of them may be adopted, but no pending legislation will eliminate the double tax for publicly held enterprises. To do so, it will be necessary for Congress to face head-on the issue of integration, the elimination in one way or another of a federal income tax hitting both the entity and the investor.

Two major studies have emerged in the past few years proposing integration schemes, one by the Bush Treasury and the other by an American Law Institute (ALI) Reporter.[n] The ALI study would convert the corporate

n. Both studies are excerpted earlier in this subchapter. (Eds.)

tax into a withholding tax under which shareholders would take credit on their Forms 1040 for their share of the corporate tax after grossing up their dividends to include the corporate tax paid. The Treasury would permit domestic shareholders to exclude dividends from their gross income. This is but a simplistic contrasting summary of the two most important integration studies. They deserve the careful attention of tax professionals. The issue of integration will not go away, but it will not receive full congressional consideration until the professionals and their clients have given it theirs and then urge Congress to take the subject seriously.

Not all students of the subject favor integration for publicly traded enterprises, faulting both the Treasury and the ALI proposals. Indeed, an earlier ALI study (1989) makes a strong, persuasive case for a reformed, "double tax" subchapter C, but one in which corporations would be able to deduct both interest on debt and, with respect to newly contributed equity, dividends as well—in effect, a proposal for a form of partial integration. Just as they have neglected the major integration studies, however, tax professionals have not paid sufficient attention to basic reform of subchapter C. Until they do, neither their clients nor Congress will.

Corporate tax simplification and subchapter C restructuring ought not be viewed as polar antagonists. They can and they should go together. For the non-publicly traded firm, the evolving LLC is a reform being achieved without congressional participation, and it is one that promises integration, simplification, and flexibility. Until there is sustained congressional focus on comprehensive corporate tax reform, however, including the proposals for partial or full integration for publicly traded companies, piecemeal code amendments, hit-or-miss legislation, further complexity, and a lack of coherence are likely to remain the order of the day.

Notes and Questions

20. Tax rate changes in recent years, by bringing the top rates for individuals and for corporations closer together, have made ending the double tax on dividends more acceptable.

21. Is a double tax eventually imposed on corporate earnings that are retained and reinvested? Is the capital gains tax on sale of corporate stock a double tax where reinvested earnings have increased the market price of a corporation's stock?

22. Can the double tax be avoided or minimized by closely held C corporations? How?

23. Treasury I asserts that by encouraging use of debt rather than equity, present law leads to increased numbers of bankruptcies during recessions. Why might this be so?

24. If the double tax were ended, would the attitude of stockholders be changed toward management's choice between retaining earnings and paying them out as dividends?

25. If corporations could deduct dividends, as they can deduct interest now, could corporate management resist pressure to distribute earnings?

26. Adoption of any of the proposals would be likely to encourage more liberal dividend policies, because corporate directors could no longer point to the double taxation of dividends as a reason to retain earnings. Corporate expansions would more often be financed by issuing new debt or equity rather than through retained earnings. Would these developments be desirable, as Treasury I asserts?

27. Professor Warren writes that adoption of his proposals "would convert the separate U.S. corporate income tax into a withholding tax with respect to income ultimately distributed to shareholders." What does this mean?

28 If shareholders were allowed to credit corporate income tax allocable to their dividends, why should the shareholders be required to "gross up," or increase, the dividends they receive by the amount credited? For example, if a corporation earned $100, paid $34 in tax, and distributed the remaining $66 in dividends, the shareholders would be required to report $100 of dividends, rather than $66, and would be granted a $34 credit against tax.

29. Why does Professor Warren propose that corporations that have not distributed dividends be allowed to make "constructive distributions," which then would be deemed to have been reinvested in the stock of the corporation?

30. The AICPA asserts that addressing the double tax problem through the shareholder-credit method would result in a higher level of taxpayer compliance than would the dividend-deduction method. Why?

31. According to the AICPA, what is the most important reason to prefer the shareholder-credit method over the dividend-deduction method?

32. The first paragraph of the excerpt from the 1992 Treasury proposal refers to the distribution of profits in the form of interest on bonds. This is overly broad. Interest paid to bondholders is a cost, not a distribution of profits, unless the bondholders also own the equity interest in the distributing corporation—in which case the distinction between profit and

interest expense can be considered artificial.

33. Should dividends paid from income that has been subject to foreign corporate income tax be eligible for whatever shareholder credit or exclusion is provided? What is the view of the 1992 Treasury proposal?

34. Peel argues that the double tax on dividends makes it possible for another corporation to offer a higher price for stock of a target corporation than individual stockholders would offer. Why?

35. Like other proponents of change, Peel argues that the present double-tax system leads to various economic problems. He also asserts, however, that the classic treatment of dividends—separate taxes at the corporate and shareholder level—is "unfair." Do you agree?

36. How should tax-exempt organizations be treated if the double tax system is ended? Under present law, if Irene Individual and the First Methodist Church each owns 100 shares of AT&T stock, each bears the same portion of the corporate tax, but only Irene pays a shareholder-level tax. Should integration or dividend relief result in the church being relieved of all tax with respect to AT&T earnings?

37. Under the shareholder-credit model, the corporation would pay the corporate income tax, which would generate a credit for shareholders. If this model were adopted, should a tax-exempt shareholder receive a refundable credit (and thus a check from the government, because it presumably would not have any tax liability to absorb the credit)? Note that Professor Warren would impose a tax on dividends (as well as interest) received by tax-exempt organizations, then allow the credit with any excess credit being refundable.

38. Can a fully integrated system—taxing shareholders on all corporate income, distributed or undistributed—be devised that is practical? Would it help to make the corporation a withholding agent for its shareholders?

39. Professor Wolfman explains how the recent emergence of limited liability companies (LLCs) has changed the taxation landscape. Why? Why are publicly held companies not able to achieve the benefits of LLCs?

40. One consequence of the Hall-Rabushka flat tax proposal, which is excerpted in Chapter Seven, would be to eliminate tax on dividends whether or not they are paid out of previously taxed corporate earnings.

41. Can it be argued that present stockholders are not penalized by the double tax because the price they paid for their stock already reflects a

discount for the double tax? Would a change in the law be a windfall for such shareholders?

42. Of the various reform proposals to address the problem of double taxation, which do you find most attractive? Why?

D. INTEREST DEDUCTIONS AND RETAINED EARNINGS

In contrast to the usual focus on the double tax on shareholders, Professor William Andrews, Reporter for the American Law Institute's Subchapter C Project, took the second, or shareholder, tax as given and derived from that assumption the conclusion that the system is biased in favor of equity capital to the extent the shareholder tax is postponed by the corporation retaining and reinvesting earnings that have borne only corporate tax. This point had more force before the 1981 Act, when the top corporate tax rate was substantially lower than the top individual tax rate, so that retained and reinvested corporate earnings bore substantially less tax than income earned and reinvested by partnerships or sole proprietors. The differential before the 1981 Act was 20 percentage points (70 percent versus 50 percent). As a result of the 1981 Act the differential fell to four percentage points (50 percent versus 46 percent), and is now 4.6 percentage points (39.6 percent versus 35 percent).

Section 302 treats as a sale, thus allowing capital gain treatment, stock redemptions by a corporation "if the redemption is not essentially equivalent to a dividend." Examples of qualifying redemptions are those in which the shareholder's entire interest is redeemed, or the shareholder's proportionate ownership is reduced to such a degree that the redemption is "substantially disproportionate."[o] This treatment seems correct if we focus only on the redeeming shareholder. However, Professor Andrews looks at the shareholders as a group, and is concerned that a redemption enables them to remove earnings from the corporation without imposition of a second tax at ordinary income rates. Some of Professor Andrews' proposals are directed at this perceived abuse.

The shift from equity to debt in corporate financial structures was of particular concern to Professor Michael Graetz (Assistant Secretary of the Treasury for Tax Policy in the Bush Administration) because such a large share of corporate bonds is owned by organizations that pay little or no tax on their interest income. Thus, the corporate deduction for interest expense is not compensated for by tax at the creditor level. The net result is no tax, as contrasted to the double tax on corporate earnings paid out as dividends

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o. Section 302(b). Even if the shareholder's interest is not entirely ended by the redemption, a redemption is normally "substantially disproportionate" if, after the redemption, the shareholder owns less than 50% of the stock, and his percentage ownership is less than 80% as great as his pre-redemption percentage ownership.

to taxed shareholders. (This situation may call for a reexamination of tax exemptions for charities, pension funds, and foreign investors, as well as for study of the policy of allowing corporations to deduct their interest expense.)

AMERICAN LAW INSTITUTE REPORTER'S STUDY OF THE TAXATION OF CORPORATE DISTRIBUTIONS, APPENDIX TO SUBCHAPTER C PROPOSALS

William D. Andrews,* Reporter

Pages 327-33 (1982)

Throughout this century the United States has pursued the classical system of taxing corporate earnings, in which corporations and shareholders are treated effectively as separate income taxpayers. Corporations are taxed as such on corporate income, whether or not distributed. Shareholders, on the other hand, are taxed on their dividends without any significant credit for corporate taxes paid on the earnings from which they come. Distributed corporate earnings are therefore said to be doubly taxed, first to the corporation that earns them and then to the shareholders to whom they are distributed.

This treatment of dividend income is to be contrasted with the treatment of corporate interest payments and nondividend distributions to shareholders. Interest on corporate debt is fully taxable to the recipient, but it is deductible by the corporate payor; corporate revenue distributed as interest is therefore only taxed once, to the investor-distributee, not to the corporation. * * *

These differences in tax treatment generate both economic distortions and legal problems. The deductibility of interest and nondeductibility of dividends create an inducement to raise money by issuing debt instruments rather than stock, and they generate a legal problem of differentiating between debt and equity interests. Similarly, capital-gain treatment of nondividend distributions creates an inducement to seek nondividend modes of distribution and avoid paying dividends, and generates a problem of differentiating between nondividend and dividend-equivalent distributions. These problems are central problems in the taxation of corporations and shareholders and are the subject of this Study.

One approach to these problems would be to accept as given the treatment described for each of these modes of distribution, but try to provide a better definition of the boundary lines between them. In particular, this would involve constructing a better way to differentiate between debt and equity for tax purposes, and better ways of measuring dividend equivalence in the case of boot and redemption distributions.

This approach has been taken in much valuable prior work. The trouble

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with this approach, however, is that it cannot eliminate or even much mitigate the disparities in treatment with which it deals; wherever the lines are drawn, substantial disparities will persist along with the economic and legal pressures they generate.

A bolder approach, widely discussed in the recent past, would seek to temper these disparities by eliminating or reducing double taxation of distributed earnings through integration of corporate and individual shareholder taxes. * * *

Any of these methods of integration would indeed reduce disparities among modes of distribution, by eliminating or reducing the double taxation of dividend income. But that objective would only be accomplished at a substantial cost in revenue and progressivity, since a high proportion of dividends flow to high-income, wealthy individuals. The initial effect of complete dividend relief would be almost to double the after-tax income of shareholders from dividends if aggregate corporate disbursements for taxes and dividends were held constant.

The approach explored in this Study runs along less familiar lines somewhere in between more general integration and mere refinement of existing boundaries. The basic distribution of tax burdens imposed by the existing classical system has been taken as given, and there is no proposal, therefore, to eliminate or even reduce the burden of double taxation on dividend income from existing equity investment. On the other hand, it has not been taken as given that the existing disparity in treatment between debt and equity or between dividend and nondividend distributions should be maintained. Rather than redefining boundaries between debt and equity or between dividend and nondividend distributions, this Study proposes that disparities in treatment be reduced by making substantive changes. Specifically, it is proposed to reduce or eliminate the disparity between debt and equity by giving particular limited relief for dividends on newly issued shares, and to reduce the disparity between dividend and nondividend distributions by imposing a compensatory excise on the latter.

The proposals in this Study * * * are published here solely as a Reporter's Study. One main reason for pursuing this course is the close relationship between these proposals and more general integration, which made it unrealistic to seek formal approval of the former without a full-scale study of the latter. On the other hand, these proposals are somewhat more radical than some would be prepared to approve under the banner of mere refinement of the existing system.

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Summary of Reporter's Distribution Proposals

This Study deals with the tax treatment of corporate distributions to investors. The subject includes deductibility by the corporation—deductible interest and rent as compared with nondeductible dividends. It also includes taxability to the investor—ordinary income treatment of dividends as

compared with capital-gain treatment of nondividend distributions. Finally, it embraces the special problems surrounding intercorporate investments and distributions—the intercorporate dividend deduction and cognate provisions. There is one proposal on each of these three topics.

1) *Newly contributed equity capital.* Existing law discriminates in favor of debt over newly issued equity by allowing a deduction for interest payments but not for dividends. This bias is familiar in theory and in practice, and it lies at the root of the seemingly intractable legal problem of differentiating satisfactorily between debt and equity for tax purposes.

Less obviously, perhaps, existing law also discriminates in favor of internally generated equity capital over contributed capital, by deferring individual income taxes on accumulation of the former. The effect of that deferral is similar to the benefit that would be conferred if individuals were allowed a deduction for purchasing newly issued shares. This bias is less familiar, stated this way, than the bias in favor of debt, but it is equally consistent with common experience. The main source of equity capital for most corporations other than regulated utilities is accumulation of earnings.

Because of this second bias, the existing discrimination in favor of debt can be defined more narrowly than at first appears. In effect, it is only a discrimination against newly contributed equity capital, not all equity, since accumulated earnings enjoy the compensatory advantage of individual tax deferral.

Reporter's Proposal R1 is to relieve this discrimination, thus narrowly defined, by treating newly contributed equity capital like debt, allowing a deduction for dividends paid up to some specified rate on the amount of capital contributed. In effect, the proposal is to treat all newly contributed debt and equity capital alike by making its cost largely deductible.

This proposal bears some resemblance to schemes for partially integrating corporate and individual taxes by allowing some deduction or credit for all dividends. But the focus of this proposal is narrower, and its revenue cost and redistributional impact are very much less, since it would not permit any deduction for dividends attributable to income from capital accumulated by retention of earnings. Moreover, it is not even proposed to allow any deduction for dividends from earnings on contributed capital invested prior to the proposal's effective date. The primary aim of the proposal is simply to remove the bias against future equity contributions; it is too late to pursue that objective with respect to past contributions.

By mitigating or eliminating the bias against new issues of stock, the proposal would go a long way toward resolving the legal problem of differentiating between debt and equity. The proposal would go even further in that direction by introducing limitations on the corporate interest deduction to correspond with limitations in the proposed deduction for dividends on newly contributed equity capital.

2) *Nondividend distributions.* Much of existing law is built around the

notion that a distribution in complete redemption of a shareholder's interest in a corporation is to be taxed in the same manner as proceeds from a sale of his shares to another investor. This entails a subtraction of basis from the redemption proceeds and application of relatively favorable capital-gain rates to any remaining profit. Less-than-complete redemptions may be taxed like complete redemptions or like dividends, primarily according to their effect on proportionate ownership rights. Drawing the line between redemption distributions to be taxed as sales and those to be taxed as dividends has been a continuing source of difficult controversy.

But even a complete redemption, when viewed in a broader perspective than that of the redeeming shareholder alone, has important similarities to a dividend, which distinguish it from a sale to new investors. Like a dividend, any redemption distribution has the effect of liberating the distributed funds from the prospective burden of a corporate income tax on earnings from their investment. Moreover, any redemption distribution has the exact effect of a dividend together with purchases and sales of shares among shareholders. As a result, even complete redemptions serve as a substitute for dividend distributions, in practice as well as theory. For many corporations long-range plans are made and carried out whose effect is to substitute share redemptions for dividends to a very considerable extent.

The substantial disparity in tax treatment between dividend and nondividend distributions, despite these functional similarities, creates, for many corporations, a strong bias against the former and in favor of the latter. This bias imposes uneven tax burdens on shareholders in different corporations, presumably distorts behavior, and generates considerable controversy in differentiating between dividend and nondividend distributions.

It is proposed in this Study to deal directly with this bias by raising the level of tax on nondividend distributions to something more nearly like that on dividends. There are several ways this could be done.

One possibility would be just to make the capital-gain rates inapplicable to stock redemptions. But that would induce low-basis shareholders to sell to other investors from whom the corporation could redeem shares at little gain. Alternatively, it could be provided that a proportionate part of accumulated earnings would be taxed as a dividend on any redemption, whether or not at a gain. But that would create an inducement for corporations to make redemptions from tax-exempt or low-bracket shareholders, and for other shareholders to sell to tax-exempt investors.

Another possibility is to tax any nondividend distribution as a dividend pro rata to all shareholders (or to continuing shareholders), as if there had been a dividend together with purchases and sales of shares among shareholders. Such a tax might not be readily understood or accepted by shareholders who merely hold their shares while others redeem, but the likely effect of such a provision would be to deter corporations from making

redemption distributions in any event.

Another possibility is a simple, flat-rate excise on nondividend distributions, to be paid by the distributing corporation. The purpose and effect of such an excise would be to make burdens on dividend and nondividend distributions roughly comparable, without getting into the complications of treating a distribution to one shareholder as a dividend to another. This would have the effect of drastically reducing distortions of behavior and inequities of treatment under existing law while preserving the radical simplicity of the rule that shareholders are only taxed on what they receive. Moreover, this would permit repeal of much of the present law of dividend equivalence, so that a shareholder could treat a sale of shares as a sale without regard to the identity of the purchaser.

Reporter's Proposal R2 is to impose a compensatory excise on nondividend distributions. As a corollary, the proposal would also simplify standards of dividend equivalence in several respects.

3) *Intercorporate investments and distributions.* Dividends paid by one corporation to another that holds its shares are wholly or largely exempt from income tax by reason of the dividend-received deduction. The rationale for this deduction is that the earnings from which such dividends are paid have already been subject to corporate income tax, and that one round of corporate tax is enough.

But exemption of intercorporate dividends creates distortions when a corporation simply invests surplus funds in shares of other corporations, because it means that the corporate investor can secure a tax-free return on investments whose price is likely to be based on market evaluation of a taxable return. Moreover, a corporate purchase of all the shares of another corporation is equivalent in effect to a purchase of assets and liquidation of the transferor. It is in effect another means by which corporate funds can be distributed to noncorporate investors without being taxed as a dividend.

Reporter's Proposal R3 is to curb the intercorporate dividend deduction by disqualifying mere portfolio investments, and to treat payment for the acquisition of any direct investment, which still qualifies for the deduction, as a nondividend distribution subject to the excise in Proposal R2. Reporter's Proposal R3 also deals with the technical problem of coordination between a dividend-received deduction and the deduction in Proposal R1 for dividends paid on newly contributed capital.

THE TAX ASPECTS OF LEVERAGED BUYOUTS AND OTHER CORPORATE FINANCIAL RESTRUCTURING TRANSACTIONS

Michael J. Graetz*

42 Tax Notes 721, 721-26 (1989)

There apparently is little evidence that recent mergers and acquisitions have been predominantly motivated by tax reasons. * * * The tax aspects of leveraged buyouts (LBOs) and other corporate financial restructuring, however, play a very significant role in how the transactions are structured, and are a worthy subject for congressional attention for both long- and short-term reasons.

Corporate Tax Base Problems

The immediate fiscal problem is the potential erosion of the corporate tax base. * * *

From both an immediate and a longer term, or structural, perspective of the corporate income tax, the most serious problem seems to be the long-lamented fact that the tax burden on income earned by a corporation and distributed to shareholders as dividends bears a heavier tax burden than corporate income distributed in other forms or to other suppliers of capital —most importantly, amounts distributed to bondholders as interest. Unlike dividends, interest is deductible at the corporate level and, therefore, bears no corporate income tax. This disparity creates tax incentives for raising corporate capital through debt rather than equity and for substituting debt for equity. * * * [D]uring the period 1984 through 1987, corporate equity apparently decreased by more than $300 billion, while corporate debt increased in excess of $600 billion. These numbers alone obviously portend major revenue effects from substitutions of corporate debt for equity and, potentially, from restructuring the corporate income tax law.

The tax issue is further complicated by the relationship of tax burdens on retained versus distributed earnings and by the tax consequences of various corporate financial transactions to the recipient. With regard to the latter, amounts of corporate income distributed to suppliers of capital as interest and dividends generally are taxed in a similar manner to the recipient—as ordinary income, subject to rates ranging from a low of zero on pension funds and other tax-exempt organizations to a high of 33 percent [now 39.6 percent] for some individuals. In contrast, earnings distributed by corporations to their shareholders in exchange for stock typically are treated as stock purchases and sales, and an offset is allowed to the recipient for her basis in the stock, with any gain taxed at the shareholder's normal tax rate [now not in excess of 28 percent]. Amounts distributed to bondholders as principal repayments are untaxed.

Needless to say, this number of potential variables, coupled with great

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flexibility in structuring corporate finance, make it extremely difficult either to obtain and maintain a firm grasp of the matters at stake or to devise a solution that cannot readily be undone by tax planners for the corporate and investment communities. These difficulties are further compounded by our general reliance on similar tax rules to govern the taxation of huge multinational corporations and small corporate businesses.

Substituting Debt for Equity

Such complexities, however, should not be permitted to obscure the potential impact of corporate financial restructuring on the Federal revenues. A back-of-the-envelope calculation demonstrates the critical points. The corporate income tax today generates nearly $100 billion of revenues, and additional revenues are produced by shareholder and creditor level taxes on dividends, interest, and stock and bond sales. These also are significant potential sources of revenues for state governments, many of which are confronting fiscal crises of their own.

At the extreme, $100 of corporate income distributed as dividends to a shareholder taxed at the top 33-percent marginal rate can produce as much as $55.78 of Federal income taxes ($34 at the corporate level plus $21.78 at the shareholder level (33 percent of the distributed $66 of after-tax income)). If the dividends are distributed to a 28-percent shareholder, the Federal government collects $52.48 of taxes ($34 plus $18.48); if the dividends are distributed to a tax-exempt shareholder, the government collects only the $34 of corporate income taxes. By comparison, $100 of corporate income distributed as interest to bondholders bears no tax at the corporate level and is subject to a maximum of $33 of total Federal tax if distributed to the highest marginal bracket individual, $28 if paid to a 28-percent taxpayer, and no tax at all if distributed to a tax-exempt creditor. Corporate income that is retained at the corporate level normally bears a 34-percent corporate income tax.

Depending on the corporation's method of raising capital, therefore, the Federal government's taxes on corporate-source income can range from zero to nearly 56 percent. If a single level tax were levied either in the form of a corporate income tax or at the top marginal rate applicable to individuals, the Federal government's tax would be roughly equal to one-third of the income, while about two-thirds would stay in private hands.

In 1985, the last year for which IRS data is available, corporate taxable income before interest deductions for domestic nonfinancial corporations totaled nearly $440 billion. A single Federal tax imposed at a 33-percent rate on such income would have produced about $145 billion of revenues, a number that seems to be at least as great as that year's combined corporate and individual level income taxes on all corporate-source income (by which I mean, simply, the net pretax income earned by corporations before it is divided among those who have contributed to the corporation the capital with which the income was earned, *viz.* the creditors and shareholders).

Federal Reserve estimates suggest that about one-half of corporate equity at the end of 1987 was held by individuals, while the other half was held by charitable organizations, pension funds, foreign investors, or life insurance companies, which are likely to receive favorable Federal income tax treatment. By contrast, only about five percent of corporate bonds are thought to be owned by individuals. Thus, a shift from equity to debt as a source of corporate capital will serve to avoid corporate income taxes and, in addition, will tend to reduce or eliminate individual income tax revenues.

* * *

Inadequate Solutions

It is no small irony that this year marks the twentieth anniversary of two well-known "solutions" to the kinds of problems we are discussing here today. The first is section 385, added to the Internal Revenue Code in 1969, which, as every schoolchild knows, delegated to Treasury regulatory authority to resolve the question how to distinguish between debt and equity. The Treasury Department failed to produce as much as a whimper in this regard until it issued proposed regulations in 1980 that ultimately were withdrawn in 1983 when the enterprise attempting to distinguish debt from equity based on their economic substance once again returned to a moribund state.

The 1969 Tax Reform Act also added section 279 to the Code in an effort to restrict deductibility of interest on acquisition indebtedness, apparently on the view that, like construction period interest, such interest is in the nature of a capital expenditure. Corporate financiers, however, apparently have not found section 279 to be even a tiny barrier to corporate financial restructuring or LBOs.

The two decades of experience with these laws suggest great caution in attempting to enact solutions that require the recharacterization of debt as equity or that attempt to limit a disallowance of interest to indebtedness incurred for a particular purpose, such as a hostile (or even any) takeover. The past two decades also teach that there is little gain and no stability to be had from such marginal tinkering as opposed to beginning to address the underlying fundamental income tax problems. One cannot help but wonder where we would be today if Congress in 1969 or even in 1978—when Congressman Ullman, then chair of the House Ways and Means Committee, advanced such a proposal—had begun to phase in an integrated corporate tax that eliminated, or at least narrowed, the corporate income tax treatment of debt and equity.

* * *

A Single Tax on Corporate Income

Congress should reject gerrymandered ad hoc solutions designed to preserve the status quo, and, instead, seize this opportunity to move—slowly perhaps, but with a clear sense of direction—toward true corporate income tax reform by embarking on a path that ultimately would provide equal

corporate income tax treatment for debt and equity—in other words, to move in the direction of an integrated corporate income tax.

What needs to be done, I think, is to begin now to move toward a single tax on corporate-source income—by which I again simply mean a single tax on the net pretax income earned by a corporation before it is divided among the creditors and shareholders who have contributed to the corporation the capital with which the income was earned. As indicated earlier, such a single tax should produce revenues at least equal to the combined corporate and individual income taxes now imposed on all corporate-source income, and, in addition, would ensure that the Federal government would share in any future growth in such income.

I do not mean to suggest by this observation that this is an appropriate occasion for raising additional revenues from taxes on corporate income, although it does seem the proper moment to halt the ongoing disappearance of the corporate tax base. There are a variety of revenue-neutral ways to begin to move toward the goal of a single tax on corporate income, and I think that it is important that steps be taken clearly in this direction now, indeed, far more important than the precise contours of such steps. My preferred solution, however, would be to phase in a shareholder-credit type integration of corporate dividends, financed through an identical bondholder-credit approach to interest payments. This would be an important first step toward equal treatment for corporate debt and equity.

Such a proposal is grounded in the lessons learned from thinking in some detail about corporate tax integration. In particular, we have learned that a dividend and interest deduction or, as an alternative, a shareholder and bondholder credit are essentially equivalent methods of eliminating the corporate tax burden on distributed earnings with respect to debt or equity contributed or owned by shareholders or bondholders who are allowed the credit.

In brief outline, a tax credit could be provided to shareholders for some portion or all of the corporate tax paid with respect to corporate earnings distributed to shareholders as dividends. Likewise, in lieu of the interest deduction, a similar tax credit could be provided to bondholders for some portion or all of the corporate tax paid with respect to corporate earnings distributed to bondholders as interest. The shareholder or bondholder would include both the amount of the tax and the cash dividend or interest in income and receive a tax credit for the amount of the tax.

* * *

To be sure, if the credit were not refundable, much of the burden of shifting from an interest deduction to a bondholder credit system would be borne by foreign creditors and tax-exempt bondholders, while the benefits of the shareholder credit would tend to accrue to individual shareholders who now bear the burden of the double corporate tax. However, many of the benefits of elimination of the corporate tax from substitution of debt for

equity in leveraged buyouts and other corporate recapitalization transactions are now accruing to those same nontaxable persons and entities. Moreover, to the extent that the tax would be borne by corporate defined benefit pension plans, corporations and their shareholders, rather than the beneficiaries of such plans, would tend to suffer the tax. In any event, the result of such a proposal, as mentioned earlier, would be to take a major step in the direction of a single tax on corporate income without regard to who contributed to the corporation the capital with which the income was earned, and regardless of whether the capital contributed was debt or equity.

Previous proposals for corporate tax integration, whether through dividend deductions or shareholder credits, have received a lukewarm reception from the corporate community. But much of the corporate community's previous opposition to corporate tax integration may have been due to the fact that on every prior occasion where such integration has been before Congress, it would have been financed through tax increases on *retained* earnings, in particular through reduction or repeal of investment tax credits or of accelerated depreciation or through higher corporate tax rates. Needless to say, corporate managers prefer not to reduce the tax on income distributed to shareholders as dividends at the cost of higher taxes on income they retain in corporate solution. Today, however, we are talking about financing a tax reduction for shareholders by increasing taxes on another form of *distributed* earnings, namely, amounts paid to bondholders as interest. The reception in the corporate community might well be more positive, although it may be naive to expect the corporate and investment communities to welcome any effective barrier to their ability to shed the corporate income tax through restructuring their financial systems or by leveraged buyouts. As Treasury Secretary Brady told the Senate Finance Committee, the corporate community seems to have found its own way to integrate the corporate tax.

In any event, this idea merits the serious attention of Congress, because it implies a corporate income tax that would not distinguish between debt and equity and that, by providing such equal treatment, would eliminate the potential provided by current law to erode the corporate tax by substituting debt for equity. It has the additional advantage of abandoning the fruitless quest of the past two decades for a workable distinction between debt and equity. It would represent an important step toward neutrality between corporate and noncorporate investments, neutrality between debt and equity finance at the corporate level, and neutrality between retention and distribution of corporate earnings. At the same time, it avoids any effort to permit or disallow interest deductions based on the purpose of incurring a debt; such an enterprise is inevitably complex and ultimately will prove unsuccessful. If some basic structural change along these lines suggested here is not begun now, I fear that we simply can look forward to future years and perhaps decades of half-solutions or nonsolutions.

* * *

Notes and Questions

43. Corporations postpone the double tax by retaining and reinvesting earnings and, for most years, pay a single income tax at a rate lower than the top individual income tax rate. Does this justify imposing an additional corporate tax when corporations distribute their accumulated earnings in liquidation?

44. How does present law discriminate in favor of debt financing as contrasted with equity financing?

45. Professor Andrews points out that a nondividend redemption distribution has the effect of liberating the distributed funds from the burden of a corporate income tax on future earnings from their investment. Does this justify imposing a tax at the time of the stock redemption?

46. Professor Andrews is concerned with potential avenues of escape from a full tax on corporate earnings at the shareholder level. His concern arises from the ability of corporations to reinvest their accumulated earnings without their having been subjected to a second tax at the shareholder level.

47. Should discrimination against corporate equity compared to corporate debt be ended by denying corporations the right to deduct bond interest as well as dividends, and perhaps allowing credit to both bondholders and stockholders for corporate tax paid? Would such treatment have to be extended to interest on other types of corporate debt as well? Would similar treatment have to be given to partnerships? To sole proprietorships?

48. If corporations were denied a deduction for interest payments, would it also be necessary to deny a deduction for rent? After all, interest is simply rent for one category of property—money. What would prevent shareholders who wanted to keep personal ownership of property used by the corporation, and remove money from the corporation in a form deductible by the corporation, from achieving these ends by renting property to a corporation rather than lending it money at interest?

49. As discussed in Note #9, present law contains several limitations on interest deductions by corporations.

50. Professor Graetz makes a significant point that much of the corporate community has opposed previous legislative attempts to ameliorate the double tax on dividend income. Given a choice, corporate management

would prefer a cut in corporate income tax rates.

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