Unlocking Business Tax Reform

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In this article, Graetz and Warren explain why integration should be on today's tax reform agenda and discuss how that change could be structured.

In conjuction with this article, Tax Analysts is republishing as an eBook, now available on Amazon, the 1998 volume of *Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports*, which includes two classic studies and an introduction to the issues by Graetz and Warren.

Business tax reform seems stymied despite important proposals by prominent political leaders from opposite sides of the aisle, including the president[1] and chairs of both congressional taxwriting committees.[2] Key business tax elements of these proposals are quite similar. They would all lower the corporate tax rate, repeal most, if not all, business income tax preferences, and revise the taxation of international income. Each represents a serious effort to reform business taxation. But these proposals have failed to move forward in either the House or Senate.

Shareholder integration offers a straightforward approach that could help resolve many of the most difficult issues and provide a key to unlocking business tax reform. The general idea is to at least partially integrate corporate and investor taxes by converting part of the corporate tax into a withholding tax that would be credited against individual shareholders' taxes due on dividends. This general reform of corporate/investor taxation was much discussed in the 1990s but was rejected by Congress in the 2003 dividend legislation, which instead lowered shareholder tax rates applicable to dividends and capital gains. Providing relief at the shareholder level generally followed the approach endorsed by the 1992 Treasury study of business income taxation.

Whether reducing taxes at the shareholder rather than the corporate level was appropriate in the 1990s, it is no longer a sensible component of business and investment taxation. Current law imposes two levels of tax on corporate-source income, with the larger portion imposed at the corporate level, where factors of production, items of income and deduction, as well as tax residence, are most internationally mobile, rather than at the far less-mobile shareholder level. A shareholder credit approach is a particularly good fit for our current circumstances.

What Serious Business Tax Reform Needs to Do

Serious reform of business taxation needs to address at least four important issues.

First, the U.S. corporate tax rate is the highest of any major developed economy. There seems to be a consensus among U.S. political leaders that the rate should be lowered substantially, with the revenue loss offset by reducing some business tax benefits, including accelerated depreciation and a host of other business preferences.

Second, the United States is one of the few remaining developed nations that continue to tax its home companies on their worldwide business income rather than just on business income earned in

[1]White House, "The President's Framework for Business Tax Reform, a Joint Report by the White House and the Department of the Treasury" (Feb. 2012).

[2]Max Baucus, "Summary of Staff Discussion Draft: International Business Tax Reform" (Nov. 19, 2013); Dave Camp, "Tax Reform Act of 2014 Discussion Draft" (Feb. 21, 2014); Ron Wyden and Dan Coates, "Bipartisan Tax Fairness and Simplification Act of 2011."

the national territory (often called territorial taxation). Business income earned by foreign subsidiaries of U.S. parent companies is not, however, generally taxed until it is repatriated, typically through dividend payments to the parent company. This system has led to retention of large amounts of earnings abroad by American corporations, now estimated at more than $2 trillion. Coupled with the exceptionally high U.S. statutory corporate rate, the tax system has also stimulated inversions of U.S. companies into foreign corporations, which typically will not be taxed on business income earned by their subsidiaries in third countries. Again, there seems to be a developing consensus among many political leaders to follow our trading partners and adopt a version of territorial taxation, coupled with new provisions to protect the U.S. tax base.

Third, the distinction between subchapter C corporations subject to an entity-level tax and passthrough entities has become increasingly problematic. For many years, the corporate-level tax was a necessary concomitant of limited liability for investors. The rise of limited liability companies substantially undermined that relationship. More recently, the ability to amass large amounts of capital from investors without going to the public equity market, such as from private equity and sovereign wealth funds, has facilitated the creation and maintenance of very large businesses operating as partnerships. Also, the ability to spin off assets into passthrough entities, such as real estate investment trusts, has further destabilized the border between taxable and passthrough entities.[3]

Serious business tax reform needs to address the resulting differences in taxation of business income that depend on the form of legal organization. President Obama has proposed taxing large partnerships as corporations, but the current congressional proposals have yet to address the different taxation of passthroughs and corporate businesses.

Under existing law, income currently earned and distributed to the active owner of a passthrough entity can be taxed at the top rate of 39.6 percent. Income currently earned and distributed to a corporate shareholder can be subject to a top rate of 50.47 percent (35 percent at the corporate level plus 23.8 percent of the remaining 65 percent at the shareholder level). Deferral of distributions can, of course, change these results, particularly if gains are subject to a step-up in basis at death. Nonetheless, Treasury estimates that subchapter C corporations face a 32 percent effective marginal tax rate on new investments, while passthrough entities face a 26 percent effective rate. Since 1980, the share of total business receipts of C corporations has fallen from nearly 90 percent to just over 60 percent.[4] There is no sensible reason to make the rate of tax on business income depend on the form of business organization.

Fourth, serious business tax reform needs to address well-known, long-standing defects in corporate-level taxation. Interest is deductible, but dividends are not, so there is a powerful tax incentive to finance by debt rather than equity. And at the high U.S. corporate tax rate, there is an incentive for a multinational company to locate interest deductions in the United States. Treasury estimates that the marginal corporate tax rate on equity-financed investment is 37 percent, while the marginal corporate tax rate on debt-financed investment is *negative,* due to the combination of accelerated depreciation, full deductibility of interest, and nondeductibility of dividends.[5]

Dividends and capital gains are not taxed at the shareholder level until the corporation distributes its earnings or a shareholder disposes of stock. So there can be a tax incentive either to retain or to distribute earnings, depending on the relationship of corporate, individual, and capital gains tax rates. Given a decision to distribute corporate earnings, share buybacks are tax-preferred over dividends, albeit less so than in the past, when higher rates applied to dividends than to capital gains.

There is no reason for serious tax reform to maintain the existing distortions produced by these differences in taxation.

How Shareholder Credit Integration Works

Under a shareholder credit method of business taxation, sometimes called imputation, all or a portion of the corporate tax is simply converted into a withholding tax that is creditable against the shareholder tax due on dividends. Below we will describe a particular proposal that seems appropriate for current circumstances, but first we shall describe generally how a shareholder credit works for readers not familiar with this structure.

By way of example, assume that the corporate tax rate is 25 percent and dividends are taxed as ordinary income. A company that earns $100 of income would pay $25 in corporate tax, leaving $75 for distribution as a dividend. Assume now that a $75 dividend is paid to a shareholder whose individual tax rate is, alternatively, 20 percent, 25 percent, or 40 percent. Individual shareholders would

[3]Martin A. Sullivan, "The Economic Inefficiency of REIT Conversions," *Tax Notes*, Sept. 15, 2014, p. 1229.

[4]Jason Furman, "Business Tax Reform and Economic Growth," *Tax Notes*, Oct. 6, 2014, p. 121 (speech delivered at New York University School of Law (Sept. 22, 2014)).

[5]*Id*.

include $100 in their taxable income (just as employees include pre-withholding wages in income), apply their normal tax rate, and offset the resulting tax by a credit for the $25 corporate tax (just as employees receive a credit for taxes withheld by their employers).

As shown in the chart below, the result is that the ultimate tax burden is the same as if the shareholders had earned the business income directly:

$75 Dividend Out of $100 Corporate Income After $25 Corporate Tax Payment			
Shareholder tax rate	**20 Percent**	**25 Percent**	**40 Percent**
1. Taxable income	100	100	100
2. Initial tax	20	25	40
3. Tax credit	25	25	25
4. Final tax (refund) (line 2 - line 3)	-5	0	15
5. Net shareholder cash ($75 - line 4)	80	75	60

As illustrated in this example, a shareholder credit system incorporates the entity-level business tax into the progressive individual income tax. The resulting integration of the two taxes would further the goal of ultimately taxing income, from whatever source derived, at an individual's personal tax rate.

Shareholder credit integration also offers a promising approach for addressing all of the issues described above. In the example, the tax burden on income received by individual investors does not depend on the form of business organization. As there is no double taxation of corporate income, the discontinuities between debt and equity finance, between retention and distribution of earnings, and between different forms of distributions would be reduced. Indeed, as more fully described below, this withholding approach could be extended so those discontinuities could be essentially eliminated.

Under a territorial system, the current U.S. tax on corporate income earned in the United States by foreign shareholders could be maintained by limiting the credit to U.S. taxpayers. Similarly, corporate income earned and taxed abroad, but not in the United States, need not qualify for shareholder-level credits in the United States. This approach is superior to proposals for mark-to-market taxation of U.S. shareholders of public companies,[6] which would generally abandon U.S. taxation of business income earned in the United States by foreign companies, foreign portfolio investors, and domestic tax-exempt entities. These results seem particularly undesirable for returns generated from locational advantages for U.S. investment (what economists call ''rents'').

The real world is considerably more complicated than this introductory example, so a number of design issues would have to be addressed, such as the appropriate treatment of interest payments, retained earnings, domestic tax-exempt shareholders, foreign shareholders (who might complain that denial of the credit to them would be in some sense discriminatory), corporate income that has not borne U.S. corporate tax, distributions other than dividends (such as share repurchases), large unincorporated businesses, and so on. As described below, substantial work has already been done on all of these issues.

A Bit of History

If shareholder credit integration offers such promise, why has it not already been enacted? The answer involves a bit of history regarding corporate taxation in Europe, the United States, and Australia.

Shareholder credit integration was originally developed after World War II in western Europe, where it is often known as imputation because corporate taxes are imputed to the shareholders as credits.[7] France, Germany, and the United Kingdom, for example, all adopted some variant of the system.

By 2003, these European countries had all repealed (in form or substance) their shareholder credit systems in response to decisions by the European Court of Justice[8] indicating that those systems violated European Union treaties.[9] Tax policy decisions concerning income taxes at the EU level require unanimity of the member states, so those decisions are extremely rare and are typically quite limited in scope. Given that void, the ECJ has become a major arbiter of national income tax policies by applying fundamental treaty principles that prohibit discrimination against cross-border investments and ensure the free movement of capital within the EU.

Consider a French investor in a German company in the shareholder credit example above. Should Germany refund the credit to the French

[6]*See*, *e.g.*, Eric Toder and Alan D. Viard, ''Major Surgery Needed: A Call for Structural Reform of the U.S. Corporate Income Tax'' (2014), *available at* http://www.taxpolicycenter.org/publications/url.cfm?ID=413090.

[7]Hugh J. Ault, ''International Issues in Corporate Tax Integration,'' 10 *Law & Pol'y Int'l Bus.* 461-494 (1978); and Ault, ''Corporate Integration, Tax Treaties, and the Division of the International Tax Base: Principles and Practices,'' 47 *Tax L. Rev.* 565-608 (1992).

[8]Now known as the Court of Justice of the European Union.

[9]Michael J. Graetz and Alvin C. Warren Jr., ''Income Tax Discrimination and the Political and Economic Integration of Europe,'' 115 *Yale L. J.* 1186-1255 (2006).

investor who is not otherwise subject to German taxation? Should France give a credit for the German corporate taxes that France did not receive? Notwithstanding years of analysis and debate, EU member states were unable to come to unanimous agreement on those questions. That failure left shareholder credit systems vulnerable to attack under the ECJ's treaty jurisprudence. Several adverse ECJ decisions — unrelated to any underlying tax policy — eventually led to the repeal of shareholder credit integration systems by the national legislatures.[10]

We draw two conclusions from this history. First, shareholder credit systems have been successfully implemented in numerous major economies. Second, the reason for their demise in the EU has no relevance for the United States, which obviously is not a party to the European treaties and is not subject to the constraints imposed by European courts.

Integration of corporate and investor taxes was intensively studied in the United States in the 1990s. In January 1992, Treasury published a comprehensive study of integration that discussed several alternative methods of corporate shareholder integration.[11] It analyzed and described, but did not recommend, shareholder credits. Instead, Treasury supported an exclusion for dividends as the way to reduce double taxation of corporate income. In 1993, the American Law Institute published a comprehensive analysis and proposal for shareholder credit integration in the United States.[12]

Neither study proposed extending the partnership system of directly allocating earnings to investors. The complex capital structures of many public companies, along with the frequency and volume of changes in share ownership, make such allocation impractical.

Congress eventually acted in 2003 and reduced shareholder tax rates, as then recommended by Treasury.[13] This approach left in place the separate corporate tax at the rate of 35 percent. Remarkably (and contrary to the original 1992 Treasury study), the 2003 legislation reduced shareholder tax rates even on dividends that have not been subject to taxation at the corporate level.

Whatever the merits of the 2003 legislation at the time, it is no longer a sensible component of a system of business and investment taxation in the world of international competition now faced by American companies. Given the ability of multinational corporations to create new entities in low-tax jurisdictions, to shift items of income and deduction to obtain tax advantages, and even to change the residence of the parent company, it is the corporate, not the shareholder, rate that needs to be reduced today. Shareholder residence is far less mobile.

Moreover, reducing the shareholder tax on dividends that have not borne corporate tax is not a coherent approach to rationalizing the tax burden on corporate income. That approach provides a tax break for high-income shareholders on income that may not have borne any corporate-level tax. Locating the ultimate business tax at the shareholder level would be both more efficacious and more progressive than the current system.[14]

In the 1990s, some U.S. corporate managers did not favor shareholder credit integration. They were particularly interested in preserving certain tax preferences, which might have been eliminated on payment of dividends under some versions of a shareholder credit. Today, most of these preferences seem certain to be eliminated or reduced in any business tax reform, and it is the high U.S. corporate tax rate that most concerns corporate management.

The potential of shareholder credit integration for business tax reform in the United States is demonstrated by briefly considering the experience in Australia, which for many years has combined territorial taxation for its companies with a shareholder credit for dividends.[15] The credit is generally refundable to Australian resident individuals and pension funds (which are taxable in Australia). Individuals and pension funds are significant holders of shares in Australian companies, so Australian corporations distribute a large proportion of their profits as dividends with shareholder credits attached. Because Australia allows no shareholder credits for foreign corporate taxes, Australian companies have considerably less incentive to shift corporate taxable income abroad than under the current U.S. system. The result is a corporate tax that operates both as a final tax on foreign investors and as a withholding tax on Australian investors.

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[10] Graetz and Warren, "Dividend Taxation in Europe: When the ECJ Makes Tax Policy," 44 *Common Mkt. L. Rev.* 1577-1623 (2007).

[11] Treasury, "Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once" (Jan. 1992).

[12] Warren, *Integration of Individual and Corporate Income Taxes* (American Law Institute, 1993).

[13] Section 1(h)(11). Treasury, "A Recommendation for Integration of the Individual and Corporate Tax Systems" (Dec. 1992), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/recommendation-for-integration.pdf. Treasury, "General Explanation of the President's Fiscal Year 2004 Revenue Proposals 11-22" (Feb. 2003).

[14] Rosanne Altshuler et al., "Capital Income Taxation and Progressivity in a Global Economy," 30 *Va. Tax Rev.* 355-388 (2010).

[15] Richard J. Vann, "Corporate Tax Reform in Australia: Lucky Escape for Lucky Country?" *Brit. Tax Rev.*, No. 1, 59-75 (2013).

While the American and Australian economies are obviously different, the Australian experience offers important evidence that shareholder credits can be both practical and beneficial.

An Illustrative Proposal

Assume that the corporate tax rate is reduced to 25 percent through the elimination or curtailment of business tax preferences, while the top individual rate remains at about 39 percent. Now consider introducing a shareholder credit of 80 percent of corporate taxes paid. Given the corporate rate of 25 percent, the shareholder credit would be 20 percent. A corporation that earns $100 would pay $25 in taxes, which would permit a cash dividend of $75. Upon payment of such a dividend, the shareholder would include $95 in income ($75 in cash plus $20 of credit). If the shareholder is in the top bracket, his tentative tax would be $37 (0.39 x $95), which would be reduced by the $20 credit to $17. There would be total taxes of $42 on the corporation's income, whereas income earned directly by the shareholder or through a partnership would bear a tax of $39.[16]

This partial shareholder credit approach would substantially reduce differences in taxation because of the form of legal organization. An approach along the lines of the example above would partially incorporate business taxation into the progressive individual tax because shareholder rates would ultimately apply to some income earned through business entities. The credit would not be available to foreign investors (or, at most, in limited circumstances through treaty negotiation) in order to protect the U.S. territorial corporate tax base. The credit would also not be available to domestic tax-exempt entities, which would already enjoy the reduction in the corporate tax rate to 25 percent.

Such a shareholder credit system would substantially reduce the differential between equity and debt finance. The remaining difference could be eliminated by extending a similar withholding tax system to interest payments. There should be serious consideration of allowing shareholder credits for constructive dividends and share repurchases, which, as described in the American Law Institute and Treasury studies, would more closely align the treatment of retained earnings and redemptions with that of dividends. The withholding approach could be extended (at the same credit rate) to all large unincorporated entities to eliminate remaining distortions based on the form of legal organization. This would, for example, reduce any remaining advantages of the partnership form enjoyed by foreign and tax-exempt investors. Finally, if desired, future rate reductions could be accomplished by increasing the credit rate, which would not automatically benefit shareholders who earn U.S. business income not subject to U.S. taxation.

The partial shareholder credit approach would serve to protect the U.S. territorial tax base. The experience of other OECD countries suggests that a shareholder credit system would also reduce the incentives for corporate managers to engage in tax avoidance.[17] Reduction of the corporate tax rate would also improve the international competitive position of U.S. companies and promote growth within the U.S. economy.[18]

As indicated above, the corporate community was not enthusiastic when shareholder credit integration was discussed in the 1990s.[19] But the current situation is quite different. First, a move from a foreign tax credit system to an exemption for dividends from foreign subsidiaries should eliminate potential concerns about allowing shareholders of the parent company to credit foreign taxes. Secondly, and more importantly, instead of defending tax preferences such as accelerated depreciation as they did in the 1990s, the leaders of major American companies today are primarily concerned about the high U.S. corporate tax rate and the various distortions we have discussed above.

[16]The example in the text is obviously a simple one. We selected a 20 percent shareholder credit rate because that rate closely aligns the top rates of tax on income earned in corporate and noncorporate businesses. In fact, a partial shareholder credit system offers a great deal of flexibility for business tax reform. In the illustration above, where 80 percent of the corporate tax is allowed to be grossed up and credited at the shareholder level, each dollar of corporate tax paid would produce 80 cents of potential shareholder credits. If the corporate rate were 28 percent and the credit rate remained at 20 percent, each dollar of U.S. corporate tax would allow 71.4 cents (20/28) to be grossed up and credited. If the corporate rate were 25 percent and the partial credit were limited to 15 percent, each dollar of U.S. corporate tax would produce 60 cents (15/25) of shareholder income and credits. Revenue and distributional considerations might well result in a different level of credit than illustrated here. Our key point is the opportunity that shareholder credits offer to reduce or eliminate the distortions we have discussed and thereby to facilitate business tax reform.

[17]Dan Amiram et al., "Tax Avoidance at Public Corporations Driven by Shareholder Demand: Evidence From Changes in Shareholder Dividend Tax Policy" (2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2111467; Catherine Ikin and Alfred Tran, "Corporate Tax Strategy in the Australian Dividend Imputation System," 28 *Australia Tax Forum* 523 (2013).

[18]*See* Treasury, *supra* note 11, and OECD, *Tax Policy Reform and Economic Growth* (2010).

[19]Jennifer Arlen and Deborah M. Weiss, "A Political Theory of Corporate Taxation," 105 *Yale L. J.* 325-391 (1995).

Those distortions would be substantially reduced if rate reduction were coupled with a partial shareholder credit, as in the illustrative proposal above. That proposal is, however, only offered as an example of the way in which a partial shareholder credit could be structured. The corporate rate might be other than 25 percent, the 3.8 percent investment tax might remain applicable to dividends and capital gains, the shareholder credit might be other than 20 percent, and so on.[20]

Design of a shareholder credit involves myriad decisions, virtually all of which are addressed in the ALI and Treasury studies mentioned above. To make those studies more widely available, Tax Analysts republished them in a single volume in 1998.[21] The introduction to that volume, which includes an overview of the major issues, was also published in *Tax Notes*.[22] For readers who would like to learn more about the subject, the introduction remains timely. For readers who are prepared to dive further into the subject, please see the 1998 book, now available on Amazon as an eBook.

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[20]*See* the discussion, *supra* note 16.

[21]Graetz and Warren (eds), *Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports* (Tax Analysts, 1998).

[22]Graetz and Warren, ''Integration of Corporate and Individual Income Taxes: An Introduction,'' *Tax Notes*, Sept. 27, 1999, p. 1767.