ABA SECTION OT TAXATION 2016 JOINT CLE PROGRAM

Boston, Massachusetts

COMMITTEE ON TAX POLICY AND SIMPLIFICATION

Friday, Sept. 30, 2016

INTEGRATION OF CORPORATE AND SHAREHOLDER INCOME TAXES

INTRODUCTION

Integration of the corporate and shareholder income taxes has appealed to tax policy thinkers for decades, although this thinking has only attracted the serious interest of political figures periodically. The last such focus on integration occurred during the administration of President George W. Bush, whose proposal to exclude dividends from gross income led to the current reduced tax rate on the dividends of individual shareholders. Senate Finance Committee Chair Orrin Hatch has focused renewed attention on integration by asking the Finance Committee staff to develop a proposal, which will be discussed at this meeting. Anecdotal reports indicate the proposal is likely to move in a different direction, basically allowing corporations to deduct dividends paid and imposing a nonrefundable withholding tax paid by the corporation on distributions of both dividends and interest to shareholders and bondholders.

WHY INTEGRATION?

Stepping back, however, it is important to note that integration as a goal may mean many different things to different people. Some think of it as a simplification measure. However, while most tax lawyers might well applaud simplification of Subchapter C, whether adoption of an integration proposal would be net simplification is unclear. Clearly the transitional rules would not be a simplification. Transitional rules are a cost of major change, for better or worse.

Others view integration as an engine for a reduction in the aggregate tax rate on corporate profits, particularly domestic profits of U. S. corporations since foreign profits of U.S. corporations often remain untaxed by the United States for years if they remain unrepatriated. Full integration of shareholder and corporate taxes would mean elimination of one tax or the other, although it seems more likely that integration will apply to distributed corporate profits, with some level of corporate tax applying to undistributed corporate profits. In any event, it is generally easier to generate a fixed level of revenue from two taxes at lower rates than from one tax at a higher rate. Hence, integration might just be another tool in the tax cutter's toolbox.

However, reducing the aggregate tax rate on the domestic profits of U. S. corporations also appeals to integrationists as a way to equalize the tax treatment of profits earned through a corporate entity now taxed under Subchapter C and those earned through an entity taxed as a passthrough entity, whether under Subchapter S or Subchapter K. These integrationists argue that this non-neutral tax structure favors passthrough entities over corporations taxed under Subchapter C, thus reducing the use of C corporations as business entities. Assuming this is true, it is unclear if it is really a major problem. Some argue, furthermore, that corporations receive benefits from their legal status that justifies a separate tax.

Another rationale for integration focuses on the underlying cause of the corporate inversion activity, the relatively high level of the U.S. corporate income tax. If integration can reduce the U.S. tax burden on corporate sector domestic profits, the thinking is that the incentives for corporate inversions will be reduced or even eliminated. Indeed, Tax Notes reported on September 12 that Senator Hatch has been "signaling his intent to design a corporate inversion proposal as an alternative to anti-inversion efforts of the Obama administration and congressional Democrats."[1] However, Ed Kleinbard notes that the reduced or eliminated corporate tax that the Senate Finance Committee is working on is simply replaced by a nonrefundable withholding tax and, hence, that the incentive for inversion will remain.[2] And if not, perhaps our trading partners will reduce their corporate tax rates in response.

A further rationale for at least a dividends paid deduction integration plan is the prospect of tax parity in the treatment of dividends and interest, with both being deductible. To achieve this result, of course, both forms of payment would have to be deductible at the corporate level and taxed to the recipients in the same way. This appears to be the approach the Senate Finance Committee is pursuing. Although there are distinct differences between investments in corporate debt and investments in corporate equity, distinguishing the two for tax law purposes has been a source of difficulty, currently exemplified by the proposed regulations issued under IRC § 385.

---

[1] Steven K. Cooper and Dylan F. Moroses, Corporate Integration Plan Drafting 'May be Done,' Hatch Says, 152 TAX NOTES 1497 (2016).

[2] See Edward Kleinbard, The Trojan Horse of Corporate Integration, 152 TAX NOTES 957 (2016). For a response to Kleinbard, see John D. McDonald, Letter to the Editor, Hatch's Integration Plan: Trojan Horse or Reasonable Alternative? 152 TAX NOTES 1585 (2016).

APPROACHES TO INTEGRATION

There are a number of approaches that are often considered in evaluating whether to move forward with integration. One would simply exclude dividends received from shareholder income. This approach was proposed by the George W. Bush administration and led to a reduction in the tax rate imposed on dividends received by individuals, what might be described as partial integration. The exclusion of dividends received had been proposed by the Treasury Department even earlier, back in 1992. The dividend exclusion approach offers the political appeal of a tax cut for affected individuals without requiring any major change in the treatment of tax exempt organizations or qualified pension plans and IRAs.

A second approach, used by a number of other countries, is to give shareholders a credit for the taxes paid by the corporation. This would be somewhat more complex than the dividend exclusion model, particularly if the shareholder credit depended on the shareholder's tax rate.

The Senate Finance Committee is apparently working with a third approach, a corporate deduction for dividends paid, coupled with a nonrefundable withholding tax on dividends paid. In addition, the design seems to envision treating interest payments in the same way.

Other approaches to full or partial integration have received scholarly attention. Most recently, Harry Grubert and Rosanne Altshuler, in a paper that reviews other proposals, compared three integration plans. (1) a plan that would tax individuals on dividends and "the annual change in the value of publicly traded financial assets" at ordinary income tax rates, but eliminate the corporate income tax; (2) a plan proposed by the ALI in which the corporate income tax becomes a dividend withholding tax (this may bear a modest resemblance to what the Senate Finance Committee is developing) and (3) a plan that lowers the corporate tax rate to 15 percent and taxes dividends and capital gains as ordinary income, with interest charges when an asset is sold on taxes deferred during the capital gains holding period.[3] The interest charges are supposed to reduce the incentive the ordinary income tax rates would provide for deferring realizations of capital gains. The third proposal would only result in partial integration.

ISSUES

Any integration plan will ultimately involve considerable attention to a number of political, policy and technical issues in addition to the issues reviewed in

[3] Harry Grubert and Rosanne Altshuler, Shifting the Burden of Taxation from the Corporate to the Personal Level and Getting the Corporate Tax Rate Down to 15 Percent (June 28, 2016). NATIONAL TAX JOURNAL, Vol. 69, No. 3, 2016. Available at SSRN: http://ssrn.com/abstract=2802109.

”WHY INTEGRATION?” above. Some of these issues are briefly reviewed below. A list of recent articles follows.

Incidence of the Tax

Nobody really knows who bears the burden of the corporate income tax, rank and file employees (collectively “labor”), managers and executives, shareholders, investors as a whole, customers of the corporation or some mix. An integration plan may superficially shift the tax burden to shareholders, but that doesn’t necessarily mean they will actually bear the burden of the tax, although it would presumably make it less likely that labor would be bearing the burden. It would be helpful, if unlikely, to have a better sense of who bears the burden of the tax and how a given integration plan would change the incidence of the tax.

Impact on Foreign Investors and Consequences

Many U.S. corporations have substantial numbers of foreign investors. The tax rate on the dividends they receive is often addressed (and reduced) in applicable tax treaties. If an integration proposal reduces or eliminates the corporate income tax in favor of an increased tax on shareholder dividends, the potential conflict between treaties and the new shareholder tax will need to be addressed. Congress may want to override the treaties on this issue because of the revenue a stake, but this might have serious international political implications.

Impact on Debt Markets

An integration plan that treats distributions of dividends as deductible, thus achieving parity between debt and equity in this respect is likely to have a substantial impact on the debt market. This is especially so if both kinds of payments are subject to the suggested nonrefundable withholding tax. New debt would be priced and issued taking the change into account, but the value of outstanding corporate debt is likely to suffer if not protected by effective transitional rules.

Effects on Decision-Making by Corporate Management

John D. McDonald argues that the dividends paid deduction form of integration will change management’s focus in decision-making because the focus will no longer be on reducing the U.S. corporate income tax, since the tax will be borne by shareholders.[4] He believes the “managers will be more inclined to make decisions on a pre-U.S. tax basis.”[5] And that this will reduce decisions to recommend inversions because managers make such decisions, not the shareholders. Ed Kleinbard, as noted earlier, disagrees with these conclusion.

---

[4] See note 2, supra. This may only be true of the tax on distributed profits.
[5] Id. at p. 1586

Nonetheless, it seem likely that adoption of an integration plan will have some effect on corporate management decision-making. Data on changes in dividend distribution decisions following the reduction in the individual dividend tax rate during the George W. Bush administration might provide useful insight.

Impact on Tax-Exempt Organizations

Most sizable tax-exempt organizations have substantial portfolios that include shares of stock in corporations that pay dividends. Any integration will have to address the impact of a change on these organizations. Currently, corporate profits distributed to such organizations are only subject to a corporate income tax. It is unclear how realistic shifting this tax to such shareholders would be under any integration plan.

Impact on Qualified Pension Plans and Retirement Accounts (IRAs, etc.)

Pension plans and retirement accounts raise a similar issue to that with tax-exempt organizations, except that income from the dividends will ultimately be taxed to the retiree when distributed following retirement. Theoretically, a shift of the corporate income tax to the retirees through a plan like that being considered by the Senate Finance Committee could be accomplished by allowing a credit for the retiree's share of the nonrefundable withholding tax against the retiree's income distribution. There may be other alternatives that can be worked out.

Revenue and Other Economic Effects

The revenue effects of an integration proposal are crucial to its success. Most shares of publicly traded U.S. corporations are not held by taxable individual shareholders. If a revenue neutral integration plan will principally benefit this small group of shareholders, where will the replacement revenue come from?

Effects on Investment

If an integration plan will affect corporate decision-making, but will have to raise sufficient revenue to offset any loss of revenue from the reduction in tax revenue from distributed corporate profits, how will the plan affect corporate investment? Will a plan actually improve corporate investment by making more funds available at lower cost? Or might it turn out that the additional tax burden of the double tax on corporate profits is not as big a factor in decisions on corporate investment as people think?

Effects on Corporate Preferences/Incentives

The corporate income tax structure includes numerous preferences designed to incentivize certain corporate behavior. The greater the extent that an integration plan shifts the tax on corporate profits to shareholders, at least for distributed corporate profits, the less effective these incentives will become. Depending on the merit of the preferences, this may be a benefit or drawback of integration. In many, perhaps most, cases shifting the incentives to the shareholder tax is likely to be unworkable.

Some Recent Integration Articles of Interest

"Is Corporate Integration a Good Idea?" Star Forum with Reuven S. Avi-Yonah, David Burton, Curtis Dubay, David S. Miller, Steven T. Miller, Stuart L. Rosow, Eric Toder, Alan D. Viard and Richard A. Westin, 151 TAX NOTES 1697 (June 20, 2016).

Harry Grubert and Rosanne Altshuler, Shifting the Burden of Taxation from the Corporate to the Personal Level and Getting the Corporate Tax Rate Down to 15 Percent (June 28, 2016). NATIONAL TAX JOURNAL, Vol. 69, No. 3, 2016. Available at SSRN: http://ssrn.com/abstract=2802109. The article includes an excellent list of integration references, particularly works by economists, at the end.

Edward D. Kleinbard, "The Trojan Horse of Corporate Integration," 152 TAX NOTES 957 (Aug 15. 2016).

Martin A. Sullivan, "Economic Analysis: Cut the Corporate Rate or Integrate?" 150 TAX NOTES 156 (Jan. 11, 2016).

Martin A. Sullivan, "Economic Analysis: Corporate Investment Would Tilt Investment to the U.S." 150 TAX NOTES 739 (Feb. 15, 2016).

Dana Trier, "Corporate Integration in a World of Tax Competition," 94 TAXES-THE TAX MAGAZINE 195 (Mar. 2016).

Bret Wells, "International Tax Reform By Means of Corporate Integration" (April 18, 2016). Forthcoming, FLORIDA TAX REVIEW (Fall 2016); U of Houston Law Center No. 2016-A-6. Available at SSRN: http://ssrn.com/abstract=2766618. This article provides an extensive collection and review of the relevant scholarly literature.