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at a hearing
"Integrating the Corporate and Individual Tax Systems:
The Dividends Paid Deduction Considered"
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Mr. Chairman, Senator Wyden, and Members of the Committee –

Thank you for inviting me to participate in today's hearing on integrating the corporate and individual tax systems.[1] I have been involved with the issue of corporate-shareholder integration for twenty-five years. I was intensely involved in the Treasury Department's 1992 Report on integration: *Taxing Business Income Once*, while serving as Deputy Assistant Secretary (Tax Policy); I served as a consultant on what became a reporter's study of integration by Harvard Law Professor Alvin Warren for the American Law Institute, published in 1993; and I have published several articles on the subject, co-authored with Professor Warren.

In the 1990s, when integration came to the fore, domestic tax policy issues were of principal concern. These include: (1) the relative treatment of income earned through corporations and pass-through entities, (2) the comparative taxation of debt and equity finance, (3) the relationship of entity taxation to investor taxation, (4) the relative treatment of distributed and retained corporate earnings, and (5) the relative treatment of dividend and non-dividend distributions, such as share repurchases. Today, international issues are also important. These include: (1) the relative treatment of domestic and foreign income, (2) differences in the treatment of domestic and foreign corporations, and (3) the coordination of domestic and foreign taxes. In combination, these domestic and international policy concerns make business tax reform a daunting task.

As this committee knows, I have long advocated a major restructuring of our nation's tax system. The "Competitive Tax Plan," described in my book *100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States*, has five key elements:

- First, enact a VAT, a broad-based tax on sales of goods and services, now used by more than 160 countries worldwide. Many English-speaking countries call this a goods and services tax (GST).
- Second, use the revenue produced by this consumption tax to finance an income tax exemption of $100,000 of family income—freeing more than 120 million American families from income taxation—and lower the income tax rates on income above that amount.
- Third, lower the corporate income tax rate to 15 percent.
- Fourth, protect low-and-moderate-income workers from a tax increase through payroll tax cuts.

[1] This testimony represents only the views of Michael J. Graetz and not any organization with which I am or have been affiliated.

- Fifth, protect low-and-moderate income families from a tax increase by substantially expanding refundable tax credits for children, delivered through debit cards to be used at the cash register.

Such a plan has major advantages for the United States, including the following:

- It would take advantage of our status as a low-tax country, making the U.S. a low income-tax country.
- Most Americans would owe no tax on their savings and all Americans would face lower taxes on savings and investments.
- Over the longer term, such a tax reform would make the United States a much more favorable place for savings, investment, and economic growth, without shifting the tax burden down the income scale.
- The vast majority of Americans would never have to deal with the IRS.
- By returning the income tax to its pre-World War II role as a relatively small tax on a thin slice of high income Americans, there would be no temptation for Congress to use tax breaks as if they are solutions to America's social and economic problems. We have tried that, and it doesn't work.
- Unlike other unique consumption tax proposals (e.g., the Flat Tax; David Bradford's X-Tax; George W. Bush's Panel's Growth and Investment Tax), this proposal fits well with existing international tax and trade agreements.
- A 15 % corporate tax rate would solve the problems caused by international tax planning by multinational corporations, corporate inversions, and competition for corporate investments among nations.
- By taxing imports and exempting exports, this plan would yield hundreds of billions of dollars for the U.S. Treasury from sales of products made abroad in the decade ahead--$600 to $700 billion at current trade levels.
- During the interval of up to two years between enactment and commencement of the VAT, Americans would accelerate their purchase of durables, such as cars and large appliances, providing a short-term boost to our economy.

Senator Benjamin Cardin has introduced a progressive consumption tax proposal that has much in common with my plan and I heartily endorse his efforts and his Progressive Consumption Tax Act of 2014.

But such a major restructuring of our nation's tax system may not be imminent and such a goal need not stand in the way of incremental reforms that could significantly improve our broken tax system. In my view, integration of the corporate and shareholder taxes presents an important opportunity for such improvement. Importantly, integration, done right, would move us in the right direction. Indeed a dividend deduction with withholding system of integration could improve our nation's tax system either as a stand-alone measure or as a part of a more comprehensive business tax reform.

When the Treasury and the ALI considered corporate-shareholder integration nearly twenty-five years ago, their emphasis was on domestic policy concerns—in particular, narrowing the income tax advantages for debt over new equity and for retained over distributed earnings, while creating greater parity between corporate and partnership taxation. Although reducing or even eliminating these distortions remains important, additional advantages of integration now include its potential to reduce incentives for U.S. multinationals to shift income abroad or to retain earnings abroad. Integration could also reduce incentives for U.S. businesses to change their domicile to a foreign jurisdiction in an "inversion" transaction and for foreign takeovers of U.S. businesses.

In the 1990s, principally because of its administrative advantages, the Treasury Department recommended taxing business income once—at the business level. This form of integration was advanced by President George W. Bush in 2003, but Congress instead simply lowered shareholders' income tax rates on dividends.[2] That approach is no longer apt today. Locating the income tax at the shareholder level would be more progressive and, given the mobility of business capital and operations, makes much more sense in today's global economy.

Simultaneously with the Treasury Report, a reporter's study by Alvin Warren for the American Law Institute (ALI) recommended integrating corporate and shareholder taxes by converting the corporate tax into a withholding levy on income ultimately distributed to shareholders, who would receive a credit for the corporate tax. This option was also discussed in the Treasury report. Shareholder-credit integration—also known as imputation-credit integration because corporate taxes are imputed to shareholders as credits—is not a new or untried idea, as there have been many years of experience with this form of taxation in developed economies.

In 2015, a working group of the Senate Finance Committee discussed integration of corporate and shareholder taxes by combining a corporate dividend deduction with withholding on dividends (U.S. Senate 2015), based on an earlier in-depth staff study (U.S. Senate 2014). As emphasized in the various documents released by this committee, this combination could retain the advantages of shareholder-credit integration while also reducing effective corporate tax rates.

The remainder of my written testimony here is taken from an article on corporate-shareholder integration, co-authored with Professor Alvin Warren, to be published in the *National Tax Journal* this fall. We begin with a bit of history; next we describe how a shareholder credit or a dividend deduction with withholding would work; then we review some of the major design issues to be considered (including extension of withholding to interest) and discuss how integration would address those issues.

A Bit of History

If 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 (or imputation) integration was originally developed after World War II in Western Europe. (Ault 1978, 1992). 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 after decisions by the Court of Justice of the European Union (CJEU) suggested that those systems violated European Union treaties. (Graetz & Warren 2006). Tax policy changes concerning income taxes at the EU level require unanimity of the member states, so such changes are extremely rare and are typically quite limited in scope. Given that void, the CJEU has become a major arbiter of national income tax policies by applying to member state income tax laws the fundamental treaty principles that prohibit discrimination against cross-border investments and ensure the free movement of capital within the EU.

[2] Internal Revenue Code Section 1(h)(11).

Consider a French investor in a German company in an integrated shareholder-credit system. Should Germany refund the credit to a French investor who is not otherwise subject to German taxation? Should France give a credit for German corporate taxes that France did not receive? Notwithstanding years of analysis and debate, EU member states were unable to reach unanimous agreement on those questions. That failure left shareholder-credit systems vulnerable to attack under the CJEU's treaty jurisprudence. Several adverse CJEU decisions—unrelated to any underlying tax policy—eventually led to the repeal of shareholder-credit integration systems by the national legislatures. (Graetz & Warren 2006, 2007).

Two conclusions emerge 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.

As we have said, 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. (U.S. Treasury 1992a). 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. (Warren 1993).

Neither study proposed extending to corporations a 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.[3]

Congress eventually acted in 2003 and reduced shareholder tax rates, rather than accepting the exclusion of dividends then recommended by Treasury. 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. 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 benefit for high-income shareholders on income that may not have borne any corporate-level tax.

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 among countries 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 than corporate income. In addition, because economists now agree that some portion of the corporate tax is borne by labor (although they disagree over how much), shifting income tax from the corporate to the shareholder level could increase the progressivity of the tax system.[4] Locating the ultimate business tax at the shareholder level could therefore be both more efficacious and more progressive than the current system. (Altshuler, Harris, and Toder 2010).

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[3] For the Treasury report's discussion, see U.S. Treasury (1992a), in Graetz & Warren (2014b) at Amazon Location 1771.

[4] See, for example, Liu and Altshuler (2013), Cronin et al. (2013), and Altshuler, Harris & Toder (2010).

In the 1990s, most U.S. corporate managers did not favor shareholder-credit integration. They generally preferred a tax reduction for retained rather than distributed earnings and were particularly interested in preserving certain tax preferences, which might have been eliminated on payment of dividends under shareholder-credit integration. (Arlen and Weiss 1995). 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 considering briefly the experience in Australia, which for many years has combined territorial taxation for its companies with a shareholder credit for dividends. (Vann 2013). The credit is generally refundable to Australian resident individuals and to pension funds (which are usually taxable at lower rates than individuals 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. A recent study of European and Australian shareholder-credit systems found that erosion of the domestic corporate tax base increased in European countries after repeal of imputation, while such erosion has decreased under the Australian integration system. (Amiram, Bauer, and Frank, 2014). While the American and Australian economies are obviously different, the Australian experience offers important evidence that shareholder credits can be both practical and beneficial.

How Integration by a Shareholder Credit or a Dividend Deduction with Withholding Would Work

Present Law

Let us briefly describe present federal law. If a U.S. corporation earns $100 of domestic taxable income and distributes its after-tax income as a dividend to its shareholders, the corporation will owe corporate tax of 35%. A taxable individual shareholder in the top bracket will owe 23.8% tax on the dividend, and a foreign shareholder would owe from zero to 30%, depending on its circumstances and any relevant tax treaties. A tax-exempt domestic shareholder, of course, would owe no tax on the dividend. In combination, the current tax burden is 35% for the tax-exempt shareholder, 50.5% for the taxable U.S. individual,[5] and from 35% to 54.5% for foreign shareholders.[6] By comparison, partnerships will owe no entity-level tax on business income, and taxable individual partners who materially participate in the business will be taxed at a top rate of 39.6% on the partnership's income. Tax exempt organizations will not be taxed (unless the income is subject to the unrelated business income tax of 35% which often can be avoided). Foreign partners will pay tax at the U.S. rate (up to 39.6%), perhaps with a credit against their domestic taxes. In 2011, 54.2% of U.S. business income was earned by partnerships (or other pass-through entities) compared to 20.7% in 1980. (Cooper et al., 2015). Today, only

[5] 35% plus 23% tax on $65 dividend equals 54.47%.
[6] 35% plus 30% withholding on $65 dividend equals 54.5%.

about 25% of U.S. corporate stock is held in individuals' taxable accounts. (Austin, Berman, and Rosenthal, 2014).

Shareholder-Credit Integration

Under shareholder-credit integration, the corporate tax is essentially converted into a withholding tax that is creditable against the shareholder tax due on dividends. By way of example, assume that the corporate tax rate is 35 percent and dividends are taxed as ordinary income. A company that earns $100 of income would pay $35 in corporate tax, leaving $65 for distribution as a dividend. Assume now that a $65 cash dividend is paid to a domestic shareholder whose individual tax rate is, alternatively, 20 percent, 25 percent, or 40 percent. Individual shareholders would include $100 in their taxable income (just as employees include pre-withholding wages in income), apply their normal tax rate, and, assuming that the credit is refundable, offset the resulting tax by a credit for the $35 corporate tax (just as employees receive a credit for taxes withheld by their employers).

As shown in Table 1 below, the result would be that the ultimate tax burden would be the same as if the shareholders had earned the business income directly:

Table 1
$65 Cash Dividend Out of $100 Corporate Income after $35 Corporate Tax Payment

Shareholder tax rate	**20%**	**25%**	**40%**
1. Shareholders' taxable income	100	100	100
2. Initial tax	20	25	40
3. Tax credit (35% x line 1)	35	35	35
4. Final tax or refund (line 2 – line 3)	-15	-10	5
5. Net shareholder cash ($65 – line 4)	80	75	60

As this example illustrates, a refundable shareholder credit would incorporate the entity-level business tax into the graduated individual income tax. The resulting integration of the two taxes would advance the goal of ultimately taxing income, from whatever source derived, at an individual's personal tax rate, thereby reducing the differences in partnership and corporate taxation described above.

If no refunds of imputation credits were allowed, corporate income would be taxed at the 35% corporate rate (as under present law), unless the individual shareholder's rate is higher, in which case the higher rate would apply. As Table 2 on page ___ shows, an integrated tax at the highest current individual rate would be lower than the combined corporate and shareholder taxes of present law, even given the current low rate applied to dividends.

Dividend Deduction Integration with Withholding

When integration has been proposed for the U.S. in the past, corporate managers have been unenthusiastic—in part because integration proposals have largely benefited only distributed earnings.[7] Some corporate managers have preferred a dividend deduction, which would permit corporations to deduct dividends when paid. By directly reducing corporate taxes and thus a company's tax expense for financial reporting purposes, a dividend deduction could have the effect of reducing effective corporate tax rates and thereby increasing a company's earnings per share.

The Treasury and the ALI Reports rejected dividend-deduction integration because it would automatically extend the tax reductions of integration to foreign and exempt shareholders. However, by coupling a deduction for dividends with withholding on dividends, results can be achieved that combine the benefits of shareholder-credit integration with reduction of effective corporate tax rates. (U.S. Senate 2014, 2015). The withholding credits in this case would fulfill the same function as imputation credits and, if nonrefundable, would eliminate the automatic tax reduction for foreign and exempt shareholders that would occur with a deduction for dividends without withholding. This, of course, would also reduce the revenue cost of integration.

In addition, a deduction for dividends of domestic earnings could serve as a full or partial substitute for rules directly limiting erosion of the U.S. corporate income tax base and for rules explicitly directed at curtailing or prohibiting corporate inversions. (Sullivan 2016a, 2016b). A dividend deduction would also permit U.S. multinationals to repatriate foreign earnings to the United States free of any residual U.S. corporate tax when those earnings were distributed as dividends to shareholders.

To demonstrate how a dividend deduction with withholding might achieve results similar to shareholder-credit integration, we consider a corporation that earns $100 and distributes $30 of cash as a dividend to its shareholders. Table 2 shows the results under present law, shareholder-credit integration, and a dividend deduction with withholding for a top bracket individual U.S. shareholder.

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[7] The 1992 Treasury Report and the ALI proposal included recommendations for dividend reinvestment plans that, in effect, would have extended the benefits of integration to retained earnings. See U.S. Treasury Department (1992a), in Graetz & Warren (2014b) at Amazon Location 3273 and Warren (1993), in Graetz & Warren (2014b) at Amazon Location 10451. President Bush's 2003 dividend exclusion recommendation also included such a feature but it was widely criticized for its complexity and not adopted by Congress. A discussion of the recommendation can be found in Joint Committee on Taxation (2003). For analysis of the opposition see Sullivan (2005).

Table 2
Comparison of Present Law, Shareholder Credit, and Dividend Deduction with Withholding
Cash Dividend of $30

Assumptions: Corporate and withholding tax rates are 35%. Shareholder tax rate is 20% under current law and 40% with a shareholder credit or dividend deduction. The corporation receives $100 in taxable income and pays a cash dividend of $30 (i.e., a dividend that reduces corporate cash by $30 and increases shareholder cash by $30).

Taxpayer	Present Law	Imputation credit	Dividend deduction and withholding tax
CORPORATION			
1.Taxable income before dividend	$100.00	$100.00	$100.00
2. Corporate tax before dividend	$35.00	$35.00	$35.00
3. Corporate cash before dividend	$65.00	$65.00	$65.00
4. Declared dividend	$30.00	$30.00	$46.15
5. Corporate tax to be imputed to shareholder (35/65 x line 4)	NA	$16.15	NA
6. Dividend withholding (35% x line 4)	NA	NA	$16.15
7.Tax reduction due to dividend deduction (35% x line 4)	NA	NA	$16.15
8.Total corporate tax (line 2- line 7)	$35.00	$35.00	$18.85
9. Remaining corporate cash (line 3 - line 4 + line 7)	$35.00	$35.00	$35.00
10.Reduction in corporate cash (line 3 - line 9)	$30.00	$30.00	$30.00
11. Effective corporate tax rate* (line 8/line 1)	35%	35%	18.85%
US SHAREHOLDER			
12. Cash dividend (line 4 - line 6)	$30.00	$30.00	$30.00
13. Taxable dividend (line 4 + line 5)	$30.00	$46.15	$46.15
14. Shareholder tax before imputation or withholding credit	$ 6.00	$18.46	$18.46
15. Imputation or withholding credit (line 5 or 6)	0	$16.15	$16.15
16. Net shareholder tax (line 14 - line 15)	$ 6.00	$ 2.31	$ 2.31
17. Net shareholder cash (line 12 - line 16)	$24.00	$27.69	$27.69
COMBINED CORPORATE AND SHAREHOLDER TAXES			
18. Total tax (line 6 + line 8 + line 16)	$41.00	$37.31	$37.31
19. Corporate tax on distributed income [(35/65 x line 10) - line 7]	$16.15	$16.15	0
20. Shareholder tax on distributed income (line 16 + line 6)	$ 6.00	$ 2.31	$18.46
21. Total tax on distributed income (line 19 + line 20)	$22.15	$18.46	$18.46
22. Pre-tax distributed income (line 10/.65)	$46.15	$46.15	$46.15
23. Total effective tax rate on distributed income* (line 21/line 22)	48%	40%	40%

* Assumes book and taxable income are the same

As Table 2 illustrates, identical results can be reached under a shareholder credit and a dividend deduction with withholding. There are, however, several important differences in the characterization of those results even when they are identical. Notice first that the declared dividend under the deduction in Table 2 is higher, because it includes the withholding tax of $16.15. As compared to the shareholder credit, the dividend deduction reduces the "corporate" tax to $18.85. The company's effective tax rate would therefore be 18.85% (assuming that book income also equals $100), rather than 35% under the imputation credit. In both cases, the government receives total payments from the corporation of $35 and a total 40% tax on the distributed earnings, but, as shown in lines 6, 16 and 19, those amounts are classified differently, as among corporate, withholding and shareholder taxes.

Table 2 illustrates the proposal for the dividend deduction with withholding under discussion in the Senate Finance Committee, given a corporate and withholding tax rate of 35%. The proposal is, of course, fully compatible with other rates. Table 2 displays the results for a declared dividend of $46.15. To explore further how such a system would work, Table 3 displays the results for a similar analysis for a declared dividend of $30. Once again, identical results could be obtained under a shareholder credit, but some of the elements of those results would be characterized differently.

Table 3
Comparison of Present Law, Shareholder Credit, and Dividend Deduction with Withholding
Deductible Dividend of $30
Assumptions: Corporate and withholding tax rates are 35%. Shareholder tax rate is 20% under current law and 40% with a shareholder credit or dividend deduction. The corporation receives $100 in taxable income and pays a cash dividend of $19.50 (i.e., a dividend that reduces corporate cash by $19.50 and increases shareholder cash by $19.50).

Taxpayer	Present Law	Imputation credit	Dividend deduction and withholding tax
CORPORATION			
1.Taxable income before dividend	$100.00	$100.00	$100.00
2. Corporate tax before dividend	$35.00	$35.00	$35.00
3. Corporate cash before dividend	$65.00	$65.00	$65.00
4. Declared dividend	$19.50	$19.50	$30.00
5. Corporate tax to be imputed to shareholder (35/65 x line 4)	NA	$10.50	NA
6. Dividend withholding (35% x line 4)	NA	NA	$10.50
7.Tax reduction due to dividend deduction (35% x line 4)	NA	NA	$10.50
8.Total corporate tax (line 2- line 7)	$35.00	$35.00	$24.50
9. Remaining corporate cash (line 3 - line 4 + line 7)	$45.50	$45.50	$45.50
10.Reduction in corporate cash (line 3 - line 9)	$19.50	$19.50	$19.50
11. Effective corporate tax rate* (line 8/line 1)	35%	35%	24.5%
US SHAREHOLDER			
12. Cash dividend (line 4 - line 6)	$19.50	$19.50	$19.50
13. Taxable dividend (line 4 + line 5)	$19.50	$30.00	$30.00
14. Shareholder tax before imputation or withholding credit	$ 3.90	$12.00	$12.00
15. Imputation or withholding credit (line 5 or 6)	0	$10.50	$10.50
16. Net shareholder tax (line 14 - line 15)	$ 3.90	$ 1.50	$ 1.50
17. Net shareholder cash (line 12 - line 16)	$15.60	$18.00	$18.00
COMBINED CORPORATE AND SHAREHOLDER TAXES			
18. Total tax (line 6 + line 8 + line 16)	$38.90	$36.50	$36.50
19. Corporate tax on distributed income [(35/65 x line 10) - line 7]	$10.50	$10.50	0
20. Shareholder tax on distributed income (line 16 + line 6)	$ 3.90	$ 1.50	$12.00
21. Total tax on distributed income (line 19 + line 20)	$14.40	$12.00	$12.00
22. Pre-tax distributed income (line 10/.65)	$30.00	$30.00	$30.00
23. Total effective tax rate on distributed income* (line 21/line 22)	48%	40%	40%

* Assumes book and taxable income are the same

In this example, with a smaller dividend deduction of $30, the corporation's effective tax rate would be 24.5%. The amount withheld would be 35% of the dividend or $10.50. An individual shareholder in the 40% bracket would include $30 in income, owe $12 of tax and receive credit for the $10.50 withheld, paying a total of 40% on the pre-tax dividend of $30. Again, the total corporate and withholding taxes equal 35% of the company's income.

Notice that in both of the dividend deduction examples of Tables 2 and 3, the total taxes collected from the corporation on its $100 of earnings are the same: in the first case, $18.85 as corporate tax and $16.15 of withholding tax for a total of $35, and in the second case a corporate tax of $24.50 and $10.50 of withholding, again for a total of $35. The individual shareholder's taxes are different: the shareholder owes a residual tax of $2.31 in the first case and $1.50 in the second. The individual shareholder's after-tax cash is also different in the two cases: $27.69 in the first case and $18.00 in the second. This reflects the fact that the corporation pays a pre-tax dividend of $46.15 in the first case and of $30.00 in the second, a difference that also shows up in greater retained earnings by the corporation in the second case.

Together these two examples show that a corporation may achieve results equivalent to a shareholder credit if it increases its declared dividend by the amount of withheld taxes. If it does not increase the declared dividend by that amount, both its retained earnings and its corporate tax rate will be higher. The key point for our purpose here is to demonstrate the close relationship between a shareholder credit and a dividend deduction with withholding.

Either of these two integration methods offers a promising approach for mitigating the distortions of present law described in our introduction. As illustrated in these examples, the tax burden on income received by individual investors would become less dependent on the form of business organization. The discontinuities between debt and equity finance, between retention and distribution of earnings, and between different forms of distributions would also be mitigated. Moreover, as in the Australian system, the incentives for corporations to shift their income or their domicile abroad could be reduced.

The real world is considerably more complicated than these introductory examples, so a number of important design issues would have to be addressed, including the treatment of corporate income that has not borne U.S. corporate tax, retained earnings, tax-exempt shareholders, foreign income, foreign shareholders, distributions other than dividends (such as share repurchases), and interest payments. As described below, substantial work has already been done on addressing these issues.

Some Major Design Issues

Adoption of a shareholder credit or a dividend deduction with withholding has the potential for rationalizing and simplifying the taxation of business income. Like any significant reform of corporate taxation, such a change raises a series of design issues. The most important of these issues have been extensively analyzed in the ALI and Treasury studies, which were recently republished in electronic form. (Graetz and Warren 2014b), as well in the recent Senate Finance Committee studies. (Senate Finance Committee 2014, 2015). Here we are able only to sketch the major design issues and describe some potential resolutions. The key point is that integration provides a very flexible framework for addressing the major tax policy issues regarding domestic and international corporate taxation.

Untaxed Corporate Income

How would integration take account of the fact that some corporate income is distributed to shareholders without bearing a full corporate tax? There are two basic approaches. The first would apply at the corporation level, so that shareholder treatment would not depend on whether the dividend had borne corporate tax. For example, the ALI report follows the approach of some previous European systems in requiring a compensatory corporate tax if untaxed income is distributed to shareholders. Similarly, a dividend deduction could be limited to undistributed corporate taxable income. (Senate Finance Committee, 2014)

A different approach, which would apply at the shareholder level, was recommended in the 1992 Treasury report. (U.S. Treasury 1992a). Instead of requiring a withholding tax on any dividends paid by the corporation, individual taxpayers would be allowed to treat dividends as taxable or nontaxable, based on a statement from each corporation regarding the amount of its dividends that had borne corporate tax. This is similar to the law in Australia and New Zealand. Such a system would require a corporate-level account to keep track of what income has borne corporate taxes.

Both of the foregoing approaches would prevent pass-through of corporate tax preferences to shareholders, If, on the other hand, Congress wanted to pass certain tax preferences through to shareholders, it would be possible to allow certain dividends to be free of corporate tax. The ALI report describes a method to accomplish this result, although neither the ALI report nor the Treasury report recommended doing so. The Treasury report explicitly rejected passing through corporate tax preferences to shareholders, which current law avoids, principally on the ground that allowing individuals to take advantage of corporate tax preferences would produce a large revenue loss that would have to be offset by raising other taxes.[8] By requiring that withholding applies to every dividend distribution, the proposal under discussion in the Senate Finance Committee reaches a similar result.[9] The major disadvantage of not allowing individual shareholders the benefit of corporate tax preferences would be a continued difference in the treatment of corporate and noncorporate businesses in this regard.

Retained Earnings

Under a shareholder credit or a dividend deduction with withholding, retained corporate earnings raise two problems. First, even if withholding credits are refundable, shareholders whose marginal tax rates are below the corporate tax rate would be disadvantaged by such retentions. Corporate earnings would compound at the lower after-corporate-tax rate of return, potentially creating an incentive to distribute earnings. Making credits nonrefundable would increase the disadvantage to lower-bracket shareholders.

Second, taxation of shareholder capital gains due to retained corporate earnings could, as under current law, in some cases constitute multiple taxation of the same gain.[10] It is sometimes

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[8] A subsequent version of a dividend exclusion proposed by Treasury includes some passthrough of corporate preferences. (U.S. Treasury, 1992b).

[9] A corollary to this treatment would be that unused deductions for dividends out of untaxed income should not be added to corporate net operating loss carryovers.

[10] Whether or not there was multiple taxation would depend in part on the availability of offsetting capital losses in the future. See the discussion in Part 3 of Warren (1993), in Graetz & Warren (2014b) at Amazon Location 10309.

suggested that the second problem could be addressed by retaining 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 retained corporate earnings.

The ALI and Treasury addressed both problems by providing for constructive dividend and reinvestment plans, which are sometimes identified by the acronym DRIP. Under such an option, corporations could make tax credits available to shareholders without the necessity of a cash distribution. The corporation could elect to treat retained earnings as if they had been paid to shareholders as dividends and immediately recontributed as equity to the corporation. The increase in shareholder basis resulting from the constructive reinvestment would eliminate the possibility of double taxation on sale of the stock. The Treasury recommended a DRIP option in its 2003 dividend exclusion proposal, but Congress rejected the idea.[11]

Exempt Shareholders and Creditors

Current law taxes corporate income without regard to the tax status of shareholders, so tax-exempt suppliers of corporate capital, such as charitable endowments and pension funds, do not now necessarily receive their share of corporate income free of tax. The portion of corporate income distributed to such investors is sometimes taxed (due to the corporate tax on income distributed as dividends) and sometimes is not (due to the corporate deduction for interest payments and to corporate preferences for some dividends). Since one of the goals of integration is to reduce such discontinuities, any system of integration will necessarily affect tax-exempt shareholders. Neither the ALI report (Warren 1993), the Treasury report (1992a), nor the dividend deduction proposal under discussion in the Senate Finance Committee recommends elimination of taxation of corporate-source income attributable to tax-exempt investors. Indeed, none of these proposals recommends refunding withholding taxes to such investors unless an explicit tax is imposed on their income.

The approach of the ALI report is to subject entities that are nominally exempt under current law to a tax on investment income, subject to shareholder (and debtholder) withholding and credits, with any excess credits potentially refundable. This would maintain a single level of tax on corporate income received by such investors, at whatever rate Congress deems appropriate, and could serve to eliminate tax-induced distortions between debt and equity. The rationale for this proposal is that the rate of tax on income from corporate investment received by exempt entities should be uniform and explicitly determined as a matter of tax policy. (Warren 1993).[12] The tax rate on tax-exempt investors might be set to maintain a similar amount of revenue as is currently collected on corporate income attributable to exempt shareholders, to increase that amount, or to decrease it.

The Treasury report (1992a) also discusses a uniform tax on tax-exempt investors' investment income along similar lines, but does not propose such a tax, probably because the Treasury did not regard that tax as politically viable. The Treasury report estimated that in 1992 a uniform tax of 6 to 8 percent would have approximated the tax burden on investment income received by tax-exempt shareholders ($29 billion in 1992, or about a third of corporate tax revenue).

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[11] For an overview of the proposal including the DRIP option, see Burman and Rohaly (2003).
[12] For more, see the discussion in Part 6, Proposal 9 in Warren (1993), in Graetz & Warren (2014b) at Amazon Location 10906.

International Income

Under the current classical tax system and longstanding treaty practice, taxes on corporate income are collected primarily by the source country, while taxes on interest and dividends are collected primarily by the investor's country of residence. (Ault 1992). Integration of the corporate and individual taxes generally shifts taxes from corporations to shareholders and in some cases might undermine this historical division completely by collapsing the two levels of tax into one. The trend in Europe, after the collapse of integration systems due to decisions of the CJEU has been to reduce corporate tax rates and make up for the revenue lost through higher income or consumption taxes on individuals.

Two important international questions must be considered in designing an integration system for the United States. First, what should be the extent of U.S. taxation of U.S. corporate income paid to foreign investors and parent companies? Second, how should foreign taxes paid by U.S. companies or their subsidiaries on foreign income affect the U.S. taxation of U.S. shareholders on distribution of those earnings? Resolution of these issues is complicated by the existence under current law of nonrefundable "withholding" taxes on U.S. dividends and interest paid to certain foreign recipients. These taxes theoretically substitute for the income tax applicable to domestic recipients of such income, but are generally eliminated or reduced to low levels by bilateral income tax treaties or by statute.

The approach of the ALI report with respect to foreign parent companies and investors is similar to that for domestic exempt investors. Foreign parents and investors would be subject to a new withholding tax on their U.S. investment income and would receive potentially refundable integration credits. This tax would replace the current nonrefundable withholding tax, which applies to some, but not all, U.S. corporate income distributed abroad. The rationale for this proposal is again to make the rate of tax on U.S. income uniform and explicitly determined as a matter of U.S. tax policy, first by legislation and then through treaty negotiation.[13] The uniform tax developed in the ALI report would be an innovation in international taxation and would therefore require discussion and perhaps coordination with our trading partners. The Treasury report considered the possibility of a uniform tax on foreign parent companies and investors along these lines, but ultimately concluded that such changes should not be made legislatively by the U.S. The Treasury recommended instead that withholding be imposed on dividends paid to foreign shareholders but not refunded to them except by treaty, thereby preserving our bargaining power in treaty negotiations with our trading partners.[14] The dividend deduction under discussion in the Senate Finance Committee also imposes withholding taxes on dividends paid to foreign shareholders and does not provide for refunds.

With respect to foreign income of U.S. companies, shareholder-credit integration is compatible with either the traditional U.S. foreign tax credit or replacement of the credit with an exemption for dividends paid to U.S. parents out of their subsidiaries' foreign business income. The Senate Finance Committee proposal for a dividend deduction with withholding is also designed to be compatible with either a tax credit or exemption for foreign income.

If the U.S. were to adopt integration and retain a foreign tax credit, conversion of the U.S. corporate tax into a withholding tax would pose the question whether credits for foreign taxes paid by U.S. companies should be passed through to U.S. shareholders on distribution of

[13] See Part 7 in Warren (1993), available in Graetz & Warren (2014b) at Amazon Location 10959.
[14] See the discussion in Chapter 7 in U.S. Treasury (1992a), in Graetz & Warren (2014b) at Amazon Location 2853.

dividends out of the foreign income. Passing through foreign taxes would be approximated under the ALI report with considerably less complexity by treating an appropriate amount of corporate foreign income as tax exempt when distributed as dividends. As with the recommendation regarding foreign investors, this proposal could be limited to income from countries that agreed to reciprocal treatment for U.S. shareholders. The Treasury report discusses the possible pass-through of foreign tax credits, but concludes that the U.S. should not after such a change unilaterally. The Treasury estimated that allowing foreign tax credits to offset the single level of tax in an integrated system would in 1992 have entailed a revenue loss of $17 billion a year, or 19 percent of corporate tax revenues.[15]

Limiting shareholder credits to the amount of U.S. corporate taxes paid on income distributed as dividends has the advantage of reducing incentives of dividend-paying U.S. corporations to shift their income from the U.S. to lower tax foreign jurisdictions. In Australia, this “integrity” benefit of integration is important. (Australian Government, 2015). As described above, this limitation can be achieved either by maintaining a taxes-paid account or by imposing withholding on all dividend distributions. Limiting the allowance of dividend deductions to U.S. taxable income would decrease the incentive for U.S. corporations to re-domicile to a foreign jurisdiction, although such a limitation might raise issues under the nondiscrimination provisions of our income tax treaties. (Verlarde & Basu 2016), (Herzfeld 2016), (Sullivan 2016b).

Nondividend Distributions

There are a variety of transactions other than dividends by which corporate income may be distributed to shareholders, including repurchases by a corporation of its stock, purchases by one corporation of the stock of another corporation from noncorporate shareholders, and payments in liquidation. Under current law, the tax treatment of such nondividend distributions to individuals can be less onerous than that of dividends, because selling shareholders benefit from basis recovery. Since 2003, qualified dividends have been taxed at capital gains rates, but under either an imputation credit or a dividend deduction with withholding, the rationale for this preferential treatment of dividends (reduction of double taxation) would disappear, so the regular individual income tax rates should apply to dividends.

The principal tax policy issue presented by nondividend distributions in the design of an integration system is whether any of the benefits of integration should be available for such distributions in order to achieve neutrality with dividends. The ALI report recommended that nondividend distributions should carry out some shareholder credits to approximate parity with dividends.[16] To the contrary, the Treasury report concluded that no change in the current law treatment of nondividend distributions would be necessary, because the incentive to engage in such distributions would be reduced under integration. (U.S. Treasury, 1992a).

Under the proposal under discussion in the Senate Finance Committee illustrated in Tables 2 and 3, the dividend deduction could increase reported earnings per share, if the accounting authorities classified withholding as shareholder, rather than corporate, taxes. Companies that used share repurchases under current law to increase earnings per share might therefore find the current law advantage of share repurchases over dividends reversed, even with

[15] A subsequent Treasury recommendation proposed unilateral pass-through of some foreign tax credits to U.S. shareholders, presumably in an effort to make the proposal more attractive to U.S. multinational corporations. (U.S. Treasury 1992b).

[16] See Part 4, Proposal 7 in Warren (1993), in Graetz & Warren (2014b) at Amazon Location 10667.

dividends taxed at ordinary income rates and the capital gains preference retained for repurchases.[17]

Debt

An important goal of integration is to reduce the differential income tax treatment of corporate equity and debt. Equivalent treatment would be achieved under the ALI report (Warren, 1993) by imposing a withholding tax on corporate interest payments. The proposal under discussion in the Senate Finance Committee might also include a withholding tax on certain interest payments. The withholding credit for interest would then function in the same manner as a shareholder or withholding credit for dividends. However, as discussed above (and recommended in the ALI report), achieving equivalence for debt and equity for tax-exempt and foreign investors under such a system requires imposing a separate tax on their U.S. investment income.

In the absence of a tax on U.S. investment income of tax-exempt organizations and foreign shareholders (coupled with refundability of the withholding tax on interest), extending withholding to corporate suppliers of debt financing could raise serious economic concerns. If, for example, nonrefundable withholding on interest applied only to corporate debt, portfolio shifts by foreigners and tax-exempt investors might occur. Corporate interest payments would be subject to a nonrefundable withholding tax, but interest paid by the Treasury bonds, by banks or other financial institutions, or by foreign corporations would not bear such a tax. In such a case, foreigners and tax exempt investors would likely prefer debt not subject to withholding since they would receive no benefit from credits for withheld taxes.

A less disruptive option might be to deny deductions for all or part of interest payments at the corporate level. This could avoid the kinds of portfolio realignments that might accompany nonrefundable withholding on interest and could be achieved in a number of ways, including by tightening the provisions of current law regarding interest deductibility.[18] A full deduction for dividends with withholding, coupled with limited deductions for interest without withholding, might seem an odd combination, but it might achieve a better balance of incentives for debt and equity finance than current law while avoiding potential disruptions in the debt markets.

Noncorporate Taxpayers

By relieving the double corporate tax, integration would reduce the current law advantages of operating in partnership or other noncorporate form. As we have emphasized, however, in the absence of a new tax applicable to tax exempt or foreign shareholders, integration with nonrefundable withholding would preserve an advantage for investments in noncorporate entities by tax exempt and foreign investors. The growth in businesses organized outside of corporate form in the quarter century since the Treasury and ALI reports suggests eliminating the distinction between corporate and noncorporate business entities, at least for businesses of a certain size. Absent such a change, an alternative would be to extend nonrefundable withholding to noncorporate income, but none of the proposals have yet advanced

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[17] We are indebted to Peter Merrill for this point

[18] See Internal Revenue Code sections 163(j) and 385, as well as U.S. Treasury (2015, 2016). See also the discussion in the OECD"s early BEPS discussion draft for a similar proposal. (OECD, 2014).

such a recommendation. Thus, integration seems likely to reduce, but not eliminate, differences in the taxation of corporate and noncorporate entities.

We have discussed integration here in the context of present law, with its 35 percent rate and foreign tax credit, rather than assuming a lower rate and an exclusion for dividends paid to a U.S. parent from a foreign subsidiary. But, as previously discussed, either a shareholder credit or a dividend deduction with withholding is fully compatible with a territorial system of taxing foreign source income or a lower corporate rate. The magnitude of the distortions of current law would of course be reduced as the corporate rate is lowered.

Conclusions

In the absence of another revenue source that would permit a drastic reduction in the corporate tax rate (see, e.g., Graetz, 2010), we continue to believe that a shareholder credit or a dividend deduction with withholding provides an important avenue for corporate tax reform today. Depending on a series of design decisions to be made, transforming the corporate tax into a withholding levy would reduce or eliminate the vexing domestic and international tax distortions with which we began this testimony. To be sure, the integration framework does not eliminate all the problems of current law, such as international transfer pricing, but it is fully consistent with additional measures to address such problems. (Wells 2016). Foreign experience has shown that a shareholder credit can be effectively implemented in a major economy, and significant work has already been done on designing a shareholder credit or a dividend deduction with withholding for the United States.

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