

**Statement of Alvin C. Warren**  
**Ropes & Gray Professor of Law, Harvard Law School**  
**at a Hearing of the Senate Finance Committee on**  
**Integration of the Individual and Corporate Income Taxes**  
**May 24, 2016**

Chairman Hatch, Ranking Member Wyden, and Members of the Committee --

Thank you for inviting me to testify today on the treatment of corporate debt and equity under proposals to integrate the individual and corporate income taxes.<sup>1</sup> I would like to emphasize three points: (1) current law creates significant distortions between debt and equity finance for U.S. companies, (2) integration could substantially reduce or eliminate those distortions, but (3) reduction of those distortions requires careful attention to other discontinuities under current law, such as the taxation of investment income of exempt entities, including retirement plans.

1. Current Law

The United States has long had a "classical" income tax system, under which income is taxed to corporations and to shareholders as distinct taxpayers. Interest paid to suppliers of corporate debt capital is deductible by the corporation, but dividends paid to shareholders are not. Taxable income earned by a corporation and then distributed to individual shareholders as a dividend is thus taxed twice, once to the corporation, and again to the shareholder on receipt of the dividend. As a result, the current regime is often characterized as a "double tax" system.

The actual U.S. tax system is considerably more complex. For example, some income earned through corporate enterprise is taxed only once, at the corporate level. This is the result for corporate taxable income distributed as dividends to tax-exempt shareholders, such as pension funds and charitable endowments. Other income earned through corporate enterprise is taxed only once, at the investor level. This occurs when corporate earnings are distributed as deductible interest payments to taxable debtholders. Finally, some income earned through corporate enterprise is not taxed in the U.S. at either the corporate or investor level. This is the result for deductible interest paid to certain foreign and tax-exempt holders of U.S. corporate debt. Accordingly, domestic corporate income is sometimes taxed twice in the U.S., sometimes once, and sometimes not at all.

---

<sup>1</sup> I appear on my own behalf. This statement does not purport to represent the views of any institution with which I am affiliated. In preparing this testimony, I have drawn freely on my previous writings on the subject.

This system creates many financial and economic distortions, which can include (1) a disincentive for investment in new corporate capital, (2) an incentive for corporate financing by debt or retained earnings, (3) an incentive to retain (or distribute) corporate earnings, and (4) an incentive to distribute corporate earnings in tax-preferred forms. The extent and direction of these distortions depend on the relationship of four tax rates: the rate on corporate income, the rate on individual investment income, the rate on dividend receipts, and the rate on the sale of corporate shares. The U.S. rate of tax on corporate income is currently significantly higher than in many other major economies, which creates incentives to shift income abroad, including by converting U.S. companies into foreign entities.

This hearing is focused on distortion (2), particularly the tax preference for corporate debt over equity. Economists tend to emphasize the deleterious economic consequences of the distortion, such as the difficulties faced by highly leveraged companies in economic downturns. Lawyers tend to emphasize the wasteful transactional costs of designing complex financial instruments to fall on one side or the other of the fuzzy border between debt and equity.

## 2. Integration by Shareholder Credit

How would integration of the individual and corporate taxes reduce or eliminate the tax preference for corporate debt? Consider first shareholder-credit integration. Under this approach, the corporate tax would be 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% 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 the \$65 cash dividend is paid to a domestic shareholder whose individual tax rate is 20%, 25% or 40%. 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,<sup>2</sup> the ultimate tax burden would be the same as if the shareholders had earned the business income directly.

---

<sup>2</sup> Example 1 is taken from Michael J. Graetz & Alvin C. Warren, *Integration of Corporate and Shareholder Taxes*, *National Tax Journal* (forthcoming, 2016), current version: <http://ssrn.com/abstract=2780490>

**Table 1**  
**Shareholder-Credit Integration**  
**\$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. As corporate interest payments are currently so taxed, shareholder-credit integration could reduce or eliminate the differential treatment of corporate debt and equity under current law.

The system illustrated in Table 1 has been used in many major economies and was recommended for the U.S. in a 1993 study of the American Law Institute.<sup>3</sup>

### 3. Integration by Dividend Deduction and Withholding

The Committee staff has been developing a related proposal for the Chairman.<sup>4</sup> Under this approach, corporations would deduct dividend payments and withhold a shareholder tax on those payments. The result can be similar or identical to shareholder-credit integration, because the withholding tax and credit function similarly to a shareholder credit for corporate taxes. Table 2 provides an example of identical cash flows under the two approaches, assuming a corporate and withholding tax rate of 35%.<sup>5</sup>

<sup>3</sup> Alvin C. Warren, *Reporter's Study of Corporate Tax Integration* (American Law Institute), reprinted in Michael J. Graetz and Alvin C. Warren, *Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports* (Tax Analysts, 1998; Amazon.com e-book, 2014).

<sup>4</sup> U.S. Senate, Committee on Finance, *The Business Income Tax -- Bipartisan Tax Working Group Report* (July, 2015); U.S. Senate, Committee on Finance, Republican Staff, *Comprehensive Tax Reform for 2015 and Beyond* (December, 2014).

<sup>5</sup> Example 2 is taken from Graetz & Warren, *supra* note 2. For similar examples, see Warren, *supra* note 2 at 54-55; U.S. Senate, Committee on Finance (2014), *supra* note 4 at 202-203.

**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
<b>CORPORATION</b>			
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%
<b>US SHAREHOLDER</b>			
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
<b>COMBINED CORPORATE AND SHAREHOLDER TAXES</b>			
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 cash flows can be reached under a shareholder credit and a dividend deduction with withholding. There are, however, important differences in the characterization of those results. 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. If the accounting authorities agreed with that characterization, the company's effective tax rate would be 18.85% (assuming that book income also equals \$100), rather than 35% under the shareholder 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.

This example shows that a corporation may achieve results equivalent to a shareholder credit if it increases its declared dividend by the amount of withheld taxes. Most importantly for our subject today, a dividend deduction would eliminate the current preference for corporate debt due to the deduction for interest payments. Given the proposed withholding tax on dividends, a new distinction between debt and equity could be eliminated by extending withholding to payments of interest.

#### 4. Interrelated Design Issues, Particularly with Respect to Exempt Entities

As illustrated in the foregoing examples, the tax preference for debt over equity finance could be eliminated or substantially reduced under integration. The real world is, of course, much more complicated than these 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 (including retirement accounts), foreign income, foreign shareholders, and distributions other than dividends (such as share repurchases). Substantial work has already been done on these issues, many of which are interrelated.

Given its importance, I want to focus here on the relationship between eliminating the corporate debt bias of current law and the taxation of exempt entities, particularly retirement accounts. To clarify the discussion, I would like to make a distinction between the absolute tax burden and the relative tax advantage of exempt entities relating to their corporate investments.

### a. Absolute Tax Burden

By absolute tax burden, I mean simply the total taxes due on income ultimately realized by an exempt entity from its corporate investments. As indicated above, current law imposes a tax at the company level on dividends out of corporate taxable income, but no tax on interest payments out of corporate income. As exempt investors pay no tax in either case, the result is a discontinuity not only at the corporate level, but also at the investor level. We cannot eliminate the first discontinuity without affecting the second.

Suppose, for example, we adopted a shareholder credit (as in Table 1) that was refundable to exempt shareholders. That form of integration would *decrease* the absolute tax burden on corporate income distributed to exempt investors, because dividends would now be burdened by a tax at neither the corporate nor the investor level. Now suppose we adopted a dividend deduction with withholding at the corporate tax rate (as in Table 2). If the dividend withholding were nonrefundable, the amount an exempt entity would receive from a dividend out of corporate taxable income would *neither increase nor decrease*. Further suppose that we adopted nonrefundable withholding on corporate payments of interest as well as dividends. Assuming first that such interest payments were not increased to reflect the new withholding tax, that tax would *increase* the absolute burden on corporate income distributed to exempts. Now assume that competitive pressure from other sources of interest on which there was no withholding induced corporations to increase interest payments, so that investors received the same net amount they had received without the withholding tax. That result would effectively increase corporate-level taxes, while leaving unchanged the amount of interest received by exempt entities

Finally, suppose that we wanted to eliminate the debt-equity distortions of current law without increasing or decreasing the overall absolute tax burden on exempt entities. Nearly 40 years ago, the Assistant Secretary of the Treasury for Tax Policy raised this issue using a paradoxical question: "at what rate of tax are tax-exempts tax exempt?"<sup>6</sup>

One approach would be to determine the corporate taxes paid on dividends to exempt entities and then to enact an explicit tax on their income from corporate investments, against which corporate taxes (or withholding) would be creditable and refundable. The level of the new tax could be set to maintain, decrease or increase the current tax burden on corporate income received by exempt entities. In 1992, the Treasury estimated that such a tax in the range of 6% to 8% would approximate the then current

---

<sup>6</sup> Statement of Acting Assistant Secretary of the Treasury for Tax Policy Donald C. Lubick, *The President's 1978 Tax Reduction and Reform Proposals: Hearings Before the House Committee on Ways and Means*, 95th Congress, 2d Session at 6254 (1978).

corporate tax on dividends paid to exempt entities.<sup>7</sup> This general approach, which was recommended in the 1993 American Law Institute study, has the advantage of minimizing tax differentials. Some would say it has the disadvantage of recognizing explicitly the rate of tax at which tax-exempts are taxed on their investment income.

The foregoing discussion suggests that the method chosen to reduce the corporate-level distortion between debt and equity could have significant effects on the taxation of exempt entities, including tax-preferred retirement accounts. Given the important role played by tax-preferred accounts in the Nation's savings, it is therefore crucial that careful attention be paid to the effects of integration on the absolute tax burden on retirement savings to achieve whatever results are considered appropriate for such savings.

#### b. Relative Tax Advantage

Even if there is no increase in the absolute tax burden of exempts, integration might affect their relative tax advantage. Consider again a dividend deduction with nonrefundable withholding at the corporate tax rate. Cash dividends paid out of corporate taxable income to a qualified retirement account would neither decrease or increase if dividends were grossed-up to reflect the deduction (as shown in Table 2). On the other hand, after-tax amounts from dividends received by taxable shareholders could increase, because the credit could eliminate or reduce the additional investor-level tax due under current law. For example, a shareholder whose tax rate on dividends did not exceed the corporate rate would no longer owe any investor-level tax.

Should the resulting reduction in the relative advantage of investing through a qualified account be considered a defect of integration in such a case? Assuming tax rates do not change, the key advantage of qualified retirement accounts is that investment income compounds at a zero rate of tax. (This is the well-known present-value equivalence of qualified accounts and Roth IRAs).<sup>8</sup> The relative advantage of compounding at a zero rate of tax (or any other preferred rate) necessarily declines if the tax burden on investments outside qualified accounts goes down. In my view, the resulting decline in the relative tax advantage of tax-preferred accounts should not be regarded as a reason to oppose a reduction in taxes on other forms of saving. The logic of

---

<sup>7</sup> U.S. Treasury Department, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* at 71 (1992), reprinted in Michael J. Graetz and Alvin C. Warren, *Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports* (Tax Analysts, 1998; Amazon.com e-book, 2014).

<sup>8</sup> See, e.g., Michael J. Graetz and Deborah H. Schenk, *Federal Income Taxation: Principles and Policies* 275-281, 696 (7th edition, 2013).

such opposition would lead to supporting the highest possible tax rate for investment income outside qualified retirement accounts.

By the same token, the fact that an integration structure could reduce taxes for investments outside qualified accounts, while holding constant the absolute tax burden inside retirement accounts, should not be considered a defect. The policy of encouraging retirement saving through tax-preferred accounts should not require opposition to reducing taxes on other forms of saving.

## 5. Conclusions

Integration, whether by shareholder credit or a dividend deduction with withholding, could substantially reduce many distortions and problems of current law (including certain international problems, which are not the subject of today's hearing). In particular, integration could reduce or eliminate important distortions caused by differences in the taxation of corporate debt and equity. Any integration proposal should, however, be carefully crafted to achieve the desired results regarding the absolute tax burden on income earned by exempt entities (including retirement accounts) from their investment in corporate debt and equity.