Statement of Alvin C. Warren
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at a Hearing of the Senate Finance Committee on
the Taxation of Business Entities
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Mr. Chairman, Senator Hatch, and Members of the Committee --

Thank you for inviting me to testify today on this challenging and important subject.[1] I want to emphasize three points: (1) the longstanding U.S. taxation of corporate and investor income needs to be reformed to reduce economic distortions; (2) the boundary between taxable and pass-through entities needs to be rethought to reflect changes in the legal environment and in the capital markets; and (3) reform of the taxation of business entities is extraordinarily complex because it requires consideration of a large array of different combinations of domestic and foreign income, entities, and investors.

I. Relationship between Corporate and Investor Taxation[2]

The United States has long had a "classical" income tax system, under which income is taxed to corporations and to shareholders as distinct taxpayers.[3] 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.

[1] I appear on my own behalf. This statement does not purport to represent the views of any institution with which I am affiliated.
[2] Some of the material in this section is taken from Michael Graetz & Alvin Warren, Integration of Corporate and Individual Income Taxes: An Introduction, 84 *Tax Notes* 1767 (September 27, 1999).
[3] Unless otherwise indicated, "corporation" in this statement means a corporation subject to federal income taxation, commonly called a "C corporation." See Internal Revenue Code of 1986, as amended (hereinafter IRC), §1361(a)(2).

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.

The current U.S. system of taxing corporate income distorts several economic and financial choices, of which the following structural distortions are sometimes said to be the most important:

> **1. Disincentive for investment in new corporate capital:** U.S. investors are discouraged from investing in new corporate equity because of the additional burden of the corporate tax, distorting the allocation of capital between the corporate and non-corporate sectors.
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> **2. Incentive for corporate financing by debt or retained earnings:** U.S. corporations are encouraged to finance new projects by issuing debt or using retained earnings, rather than by issuing new stock, in order to avoid an additional level of tax.
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> **3. Incentive to retain corporate earnings:** The tax system can encourage retention of earnings by corporations to avoid the tax on dividends.
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> **4. Incentive to distribute corporate earnings in tax-preferred forms:** The tax system encourages U.S. corporations to distribute earnings in tax-preferred transactions, such as stock repurchases that give rise to capital gains, rather than by paying dividends.[4]

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[4] Under current law, dividends are generally taxed at the same rate as capital gains, but only the latter allow a basis offset. IRC §§ 1(h)(11), 301(c)(1) 302(a)-(d).

In fact, the extent and direction of these distortions depend crucially 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 capital gains rate on the sale of corporate shares.[5] For example, if the corporate, dividend, and capital gains rates were sufficiently low relative to shareholder rates on ordinary investment income, the classical tax system could *encourage* investment in new corporate capital.[6] Similarly, if individual rates were significantly lower than corporate rates, the tax system could encourage *distribution*, rather than retention, of corporate earnings.[7] Although we cannot therefore specify the exact distortions of a classical corporate tax system without assuming particular rate relationships, we can say that the structure of such a system invariably leads to distortions of the type described here.[8]

In theory, there are a variety of ways in which the individual and corporate income taxes could be integrated to reduce these distortions. The corporate tax could, for example,

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[5] For further discussion of these relationships, see Alvin Warren, *Integration of the Individual and Corporate Income Taxes* 21-46 (American Law Institute, 1993), reprinted in Michael Graetz & Alvin Warren*, Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports* 617-635 (Tax Analysts, 1998).

[6] If the individual ordinary income tax rate were 40% and the dividend tax rate 10%, a taxpayer who invested $1000 in a noncorporate asset producing 10% annually subject to current taxation would have $1791 after 10 years: $1000 \times (1.06)^{10} = 1791$. If the same amount had been invested in a corporation earning the same rate of return and subject to an annual corporate tax of 10%, the corporation would have $2367 after ten years: $1000 \times (1.09)^{10}=2367$ A distribution of that amount would yield $2230 to the shareholder after paying dividend tax of $137 on the corporate earnings and profits of $1367. In this example, the tax system favors corporate investment over noncorporate investment.

[7] If the individual ordinary income and dividend tax rates were 10%, distribution of $1000 in retained corporate earnings would yield $900 to a shareholder after tax, which in turn would be worth $2130 after 10 years if invested at a 10% rate of return: $900 \times (1.09)^{10} = 2130$. If the corporation retained the $1000 and invested that amount at a 10% rate of return when the corporate tax rate was 30%, it would have $1967 after 10 years: $1000 \times (1.07)^{10} = 1967$. A distribution of that amount which would yield the shareholder $1770 after paying the dividend tax of $197. In this example, the tax system favors distribution of corporate earnings over retention.

[8] Particular rate relationships may eliminate certain distortions while leaving others in place. If in the example in the preceding note, the corporate and shareholder tax rates were the same, there would be no incentive to retain or distribute dividends, whatever the rate of dividend taxation. Assume a corporate and individual tax rate of 25% and a dividend tax of 10%. If the corporation distributed the $1000 in retained earnings, the shareholder would have $1855 after 10 years: $900 \times (1.075)^{10} = 1855$. If the corporation retained the earnings, it would have $2061 after 10 years: $1000 \times (1.075)^{10} = 2061$. A dividend in that amount would again yield the shareholder $1855 after paying the dividend tax of $206.

be repealed and shareholders taxed currently on corporate earnings, but that approach would require a complex annual allocation of undistributed corporate income to a myriad of capital interests. Alternatively, the corporate tax could be repealed and shareholders or corporations taxed annually on changes in share values, but that approach would require abandonment of the realization criterion of income taxation. For these reasons, the shareholder allocation and annual valuation approaches have not generally been pursued in the U.S. or abroad. Instead, attempts to integrate corporate and investor taxes have usually involved one of the following distribution-related approaches:

> **1. Shareholder credit for corporate taxes paid**: When a shareholder receives a taxable dividend, the shareholder would also receive a tax credit for corporate taxes previously paid with respect to the dividend amount, just as a wage earner now receives a credit for income taxes withheld by the employer. If fully implemented, this approach would convert the corporate tax into a withholding levy for income ultimately to be taxed at the shareholders' tax rates.
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> **2. Corporate deduction for dividends paid**: Dividends, like interest, would be deductible when paid by the corporation. Under this approach, any previously paid corporate tax would in effect be refunded to the corporation when dividends are paid to shareholders. Essentially similar results could be obtained by imposing a lower corporate tax rate on distributed earnings than on retained earnings.
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> **3. Shareholder exemption for dividends received:** Dividends would be exempt from taxation at the shareholder level, so that the corporate tax would be a final tax on income earned on corporate equity. This approach could also be applied to debt capital, so interest would be nondeductible to corporate borrowers and nontaxable to corporate debtholders.
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> **4. Rate alignment:** Investor tax rates on dividends and capital gains on sales of corporate stock would be reduced as a partial offset to the additional tax at the entity level.

Each of these approaches has advantages and disadvantages. The shareholder credit was proposed in an American Law Institute study in 1993, on the grounds that it offers the fullest solution to the defects of current law.[9] This approach was once

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[9] Warren, *supra* note 5.

widespread among our major trading partners, but has largely been abandoned in recent years in Europe, due to EU treaty restrictions that do not apply to the U.S.[10]

The dividend deduction produces the same general result as a shareholder credit (final taxation at the investor level), but without the compliance advantage of corporate withholding. Moreover, a dividend deduction without withholding would automatically and unilaterally reduce U.S. taxes on corporate income distributed as dividends to tax-exempt and foreign shareholders. If withholding on dividends were considered important to assure compliance, a deduction for dividends would be the equivalent of a shareholder credit, because the withholding credit could fulfill the same function as the shareholder credit.

In the 1992, the Treasury Department proposed a Comprehensive Business Income Tax (CBIT), under which corporate interest and dividend payments would be neither deductible nor taxable.[11] The corporate tax would therefore be a final tax on income earned through taxable entities. In 2003, the Treasury Department proposed legislation that would exempt dividends paid out of income that had been taxed at the corporate level.[12]

Both a shareholder credit and a dividend exemption would result income earned through corporations being taxed once, but only once. The principal difference is that the

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[10] The Court of Justice of the European Union has interpreted the foundational treaties of the EU to prevent tax-system discrimination against income or investors from other member states. Since shareholder credits were generally not available for either foreign income or foreign investors, many member states feared that their credits would violate the nondiscrimination requirement. See Richard Vann, Trends in Company/Shareholder Taxation: Single or Double Taxation? -- General Report, 88A *Cahiers de droit fiscal international* 21, 66 (2003); Michael Graetz and Alvin Warren, Income Tax Discrimination and the Political and Economic Integration of Europe, 115 *Yale Law Journal* 1186, 1208-1212 (2006).

[11] U.S. Treasury Department, *Report on Integration of the Individual and Corporate Tax Systems -- Taxing Business Income Once* 39-60 (1992), reprinted in Michael Graetz & Alvin Warren, *Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports* 119-161 (Tax Analysts, 1998).

[12] U.S. Treasury Department, *General Explanation of the President's Fiscal Year 2004 Revenue Proposals* 11-22 (February 2003).

shareholder's tax rate would apply under the credit, whereas a standard rate would apply to all corporate income under the exemption.

Congress rejected the dividend exemption proposal in 2003, in part because of complexities intended to prevent exemption at the shareholder level for dividends paid out of income that had not been taxed at the entity level. Instead, the dividend tax rate was aligned with the maximum capital gains tax rate (generally 15 percent),[13] and the requirement that tax had been paid at the corporate level was dropped.

The trouble with this approach is that it is an incomplete and haphazard response to the distortions described above. To begin with, the lower rate on dividends does not depend on the income having been taxed at the entity level. Corporate debt is still generally favored over corporate equity. Corporate income is still sometimes taxed once, sometimes twice, and sometimes not at all. Finally, a substantial reduction of the corporate tax rate, as is currently under discussion, would reduce some of the distortions described above, but might exacerbate others, depending on the new alignment of corporate, individual, dividend and capital gains rates.[14]

The longstanding problems in the relationship of the corporate and investor taxation described above thus remain unresolved. My personal view continues to be that a shareholder credit for corporate taxes would be the best resolution because it would assure that capital income earned through corporate entities was taxed once and only once,[15] at the same graduated rates applied to capital income earned by the investor

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[13] Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27), §302.

[14] See, e.g., Daniel Halperin, Mitigating the Potential Inequity of Reducing Corporate Taxes, 126 *Tax Notes* 641 (February 1, 2010) (analyzing rate relationships necessary to prevent use of corporations by high-bracket individuals to shelter income from services or investments after a substantial reduction in the corporate tax rate).

[15] At least one well-know previous proponent of a dividend exemption has subsequently come to the view that capital income should be taxed primarily to investors, rather than exclusively to entities. See *Statement*

outside such entities.[16] Such a credit would eliminate the need for special tax rates for dividends and capital gains on the sale of corporate shares.

II. Relationship between Taxable and Pass-through Business Entities

The longstanding unsolved problems described in the preceding section have been exacerbated in recent years by two developments. The first is the dramatic rise in the use of pass-through entities to conduct business in the United States. The income of these entities, such as partnerships and subchapter S corporations, is not taxed at the entity level, but is included in the income of the entity's owners. In 1987, the number of pass-through entities surpassed the number of taxable corporations and has nearly tripled since then.[17] More importantly, business income earned through pass-throughs, which represented less than one quarter of net business income in 1980, had grown to more than 70 percent of such income by 2008.[18] Finally, pass-throughs are apparently much more important in the U.S. economy than in other OECD countries.[19]

The growth in the importance of pass-throughs has included the creation by the states of a new form of business entity, the limited liability company (LLC), which have proliferated since their inception 35 years ago.[20] LLCs are not corporations under state law, but generally provide limited liability to their owners. Under the "check the box"

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of Michael J. Graetz, Professor of Law, Columbia Law School, at a Hearing of the Senate Finance Committee on Tax Reform 7 (March 8, 2011).

[16] Proposals to transform the corporate tax from a tax on income to a tax on consumption or valued added are beyond the scope of this statement. See, e.g., Alan Auerbach, *A Modern Corporate Tax* (Hamilton Project, 2010).

[17] Joint Committee on Taxation, *Selected Issues Relating to Choice of Business Entity* 1 (JCX-20-12), March 5, 2012.

[18] *The President's Framework for Business Tax Reform, A Joint Report by the White House and the Department of the Treasury* 7-8 (February 2012).

[19] U.S. Treasury Department, *Treasury Conference on Business Taxation and Global Competitiveness: Background Paper* 16-17 (July 23, 2007).

[20] Joint Committee on Taxation, *supra* note 17, at 23.

regulations promulgated by the Treasury Department in 1996, domestic unincorporated entities with two or more members that are not publicly traded may generally elect to be treated as either a partnership or a corporation for federal income tax purposes.[21] LLCs generally choose to be taxed as partnerships, marrying limited liability with pass-through taxation. Publicly traded partnerships must in principle be taxed as corporations, but there is an important exception for entities that receive almost all of their income from certain kinds of investments.[22]

The second development that has compounded the difficulties of taxing business entities has been the growth of private equity. Over the past several decades, private equity funds, venture capital funds, hedge funds, and similar investment vehicles have attracted large amounts of capital investment from institutional investors such as pension funds and charitable endowments, as well as from wealthy individual investors.[23] These investment funds are generally structured as partnerships, sometimes organized in foreign jurisdictions.

Historically, business owners have chosen to incorporate in order to receive certain non-tax advantages, including limited liability and access to the public capital markets.[24] The tax result of such incorporation was usually the entity-level federal income tax. With the rise of LLCs, incorporation is no longer necessary to achieve limited liability. With the rise of private equity, incorporation is no longer necessary to have access to large pools of capital. Given the passive income exception from corporate tax classification for publicly

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[21] T.D. 8697, Treasury Regulations §301.7701-3.
[22] IRC § 7704(c).
[23] Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I* at 2 (JCX-62-07), September 4, 2007.
[24] Joint Committee on Taxation, *supra* note 17, at 1.

traded partnerships, incorporation is not even necessary for some entities to tap the public capital markets.

Under current law, the boundary between pass-throughs and taxable corporations generally depends on public trading.[25] Given the developments described above, this boundary needs rethinking. Limited liability, number of owners, type of activity, and size of the business have all been suggested as alternatives.[26] Of those, the size of the business seems most appropriate to me, given the growth of large businesses conducted in pass-throughs in recent years.[27] Of course, this boundary has to be informed by the structure of the tax applicable to corporations. One of the advantages of a shareholder credit is that pressure on the distinction between corporations and pass-throughs would be substantially less, since all entity income would eventually be taxed at investor rates.

III. Relationships among Domestic and Foreign Income, Entities, and Investors

So far, I have argued that the longstanding challenges of structuring a system for taxing corporations and their investors have been exacerbated in recent years by growth of pass-through entities and the rise of private equity. I now want to argue that those challenges are made even more difficult by the continuing globalization of the economy. Not only do more American businesses have more foreign income, but more American investors are investing in foreign entities. Similarly, foreign entities and foreign individual investors are likely to continue their penetration into the U.S. economy.

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[25] The requirements for particular types of pass-through entities, such as regulated investment companies (RICs), real estate investment trusts (REITs), and real estate mortgage investment conduits (REMICs) are beyond the scope of this statement.

[26] See Joint Committee on Taxation, *supra* note 17, at 61-67.

[27] For similar views, see President's Advisory Panel on Federal Tax Reform*, Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* 126-131 (November 2005); *The President's Framework for Business Tax Reform, supra* note 18, at 10.

For analytical purposes, let us consider a world in which there are two categories of income (U.S. and foreign), four categories of entities (U.S. corporations, U.S pass-throughs, foreign corporations, and foreign pass-throughs), and three categories of equity investors (U.S. taxable individuals, U.S. exempt organizations, and foreign investors). In that world, any change in the U.S. tax law relevant to entities and their investors will impact 24 different cases, only two of which Congress can ignore in writing legislation (foreign investors in foreign corporations and in foreign pass-throughs):

	US Income				Foreign Income			
	US corporation	US pass-through	Foreign corporation	Foreign pass-through	US corporation	US pass-through	Foreign corporation	Foreign pass-through
US taxable investor	1	2	3	4	5	6	7	8
US exempt investor	9	10	11	12	13	14	15	16
Foreign investor	17	18	19	20	21	22	---	---

Consider, for example, a proposal to reduce U.S. corporate tax rates, to be paid for by increasing rates applicable to U.S. shareholders. On balance, that might be neutral (or even detrimental) for U.S. taxable investors in U.S. corporations (case 1), while it would unambiguously beneficial for U.S. exempt investors in such corporations (case 9), as well as for foreign investors in foreign corporations operating in the U.S. (case 19). Now consider a reduction in corporate taxation, to be paid for by curtailing accelerated depreciation. Depending on the details, the results could be neutral in cases 1 and 9, but those results would be unambiguously negative for taxable investors in pass-through entities that benefit from accelerated depreciation (case 2).

Alternatively, consider a proposal to provide a shareholder credit for corporate taxes paid on income distributed as dividends. Such a proposal would reduce the disparity in treatment of income earned through U.S. corporations and U.S. pass-throughs, bringing cases 1 and 2 into alignment. On the other hand, it is not clear that the proposal should apply in cases 9, 11, 17 and 19, if exempt and foreign investors are not paying a shareholder-level tax to the U.S. Treasury.

Finally, consider a proposal to tax large domestic pass-through entities as corporations. That would eliminate differences in treatment of large businesses between the following pairs of cases: 1 and 2, 9 and 10, 17 and 18.

The foregoing are but a few examples of the multitude of proposals for tax reform that will affect entity and investor taxation. The table above shows that reform of the taxation of business entities is extraordinarily complex, because every proposal for legislative change requires examination of a large array of different combinations of domestic and foreign income, entities, and investors. Depending on the proposal, some of the cases shown will be more important than others in terms of their effects on economic production, distributional fairness, and government revenues. The table does not, however, exhaust the possibilities, because in the interests of manageability, it is limited to equity investors. Doubling the categories of investors to include U.S. taxable debt-holders, U.S. exempt debt-holders, and foreign debt-holders would double the number of cases to be considered.