

**INTEGRATING THE CORPORATE AND  
INDIVIDUAL TAX SYSTEMS: THE DIVIDENDS  
PAID DEDUCTION CONSIDERED**

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**HEARING**

BEFORE THE

**COMMITTEE ON FINANCE  
UNITED STATES SENATE**

ONE HUNDRED FOURTEENTH CONGRESS

SECOND SESSION

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MAY 17, 2016  
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**INTEGRATING THE CORPORATE AND  
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PAID DEDUCTION CONSIDERED**

TUESDAY, MAY 17, 2016

U.S. SENATE,  
COMMITTEE ON FINANCE,  
*Washington, DC.*

The hearing was convened, pursuant to notice, at 10:10 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Orrin G. Hatch (chairman of the committee) presiding.

Present: Senators Crapo, Thune, Isakson, Portman, Heller, Scott, Wyden, Stabenow, Cantwell, Carper, Cardin, Bennet, and Casey.

Also present: Republican Staff: Chris Campbell, Staff Director; Mark Prater, Deputy Staff Director and Chief Tax Counsel; Tony Coughlan, Tax Counsel; Chris Hanna, Senior Tax Policy Advisor; and Nicholas Wyatt, Tax and Nominations Professional Staff Member. Democratic Staff: Joshua Sheinkman, Staff Director; Ryan Abraham, Senior Tax Counsel; and Tiffany Smith, Senior Tax Counsel.

**OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S.  
SENATOR FROM UTAH, CHAIRMAN, COMMITTEE ON FINANCE**

The CHAIRMAN. The hearing will come to order. I would like to welcome everyone here this morning.

Even a cursory examination of the business tax system demonstrates clearly the problems that arise from the out-of-step corporate tax, which contributes significantly to our anti-competitive business climate and leads sophisticated tax planners to engage in costly efforts—which some would call gamesmanship or tax avoidance—to either minimize their taxes or manage competitive tax pressures from abroad. Without significant reforms to the corporate tax system, we will continue to see an erosion in our overall tax base along with diminished growth and diminished investment.

Among the most significant and inexplicable inefficiencies in our business tax system is the fact that a significant portion of U.S. business income is taxed more than once. Under the current system, income earned only once by corporations—on behalf of its shareholders—is taxed twice, thanks to a fiction created in the law that treats a business and its owners as two separate, taxable entities.

Specifically, when a corporation turns a profit, those earnings are taxed under the corporate income tax system, generally at a rate of 35 percent. When the corporation distributes a portion of those

earnings to its shareholders in the form of dividends, we tax those earnings a second time at the individual level, with a maximum dividend tax rate approaching 25 percent.

This, put simply, is a problem. We have this problem, in large part, due to the fact that rules for taxing corporations were written without taking into account the rules for taxing individuals, and vice versa. A better, more efficient system would be one that integrates the taxation of corporate and individual income. That is what we are here to discuss today.

The current system of double taxation has resulted in a number of unintended economic distortions that would not exist under a more integrated system. I will discuss just a few of those distortions here this morning. For example, the current system creates a bias in the choice of business entity, disfavoring the corporate model versus others. Of course, businesses—small and start-up businesses in particular—should have the flexibility to determine how to organize themselves. But our tax code should not punish any particular business with double taxation simply because it was organized a certain way.

Double taxation also discourages savings and investment and is a major factor in our current domestic savings and investment shortage. Savings and investment are essential to capital formation, increased job productivity, wage growth, and adequate retirement savings. Yet, we have created a system that essentially punishes those who save and invest. In addition, the current system explicitly favors debt-financed investment over equity-financed investment.

In the U.S., corporations can deduct interest paid to bond holders, but no similar deduction exists for dividends paid to stockholders. Now, in some situations, there may be strong reasons for a company to opt for debt financing, but there is no real reason why the tax code should favor debt over equity.

Double taxation also contributes to the problem of lock-out; that is, it discourages businesses from bringing income earned overseas back into the U.S. As many have already noted, with the highest corporate tax rate in the developed world, American multinational companies are often loath to repatriate their foreign earnings and subject them to U.S. taxes on top of the taxes they have already paid in foreign jurisdictions. Their shareholders rarely demand that they do so, because those earnings would be taxed again if and when they are ever paid out as dividends. As a result, experts estimate that U.S. corporations have over \$2 trillion in earnings that are locked out of the U.S. due, in large part, to our stupid tax system.

These problems—and there are many others—have been observed for years. As a result, many have argued for the elimination of double taxation and in favor of integrating the individual and corporate tax system. We are going to continue that discussion here today.

In any discussion of an integrated system, the fundamental design choice that has to be made is whether the single instance of taxation should fall on the corporation or the shareholders. Given the substantial burdens our corporate tax system already imposes on U.S. businesses, coupled with the relatively high mobility of cor-

porate residence in the age of globalization, as illustrated by the recent wave of inversions and foreign takeovers, some have questioned the wisdom of collecting the tax on the corporation side.

Another method of integrating the two systems would be to impose a single layer of tax at the shareholder level by allowing companies to deduct any dividends they pay out. As I see it, there are a number of benefits to this approach. I will mention just a few.

First, a deduction for dividends paid would allow businesses to cut their own effective tax rates. There is bipartisan agreement on the need to bring down corporate tax rates. A dividends paid deduction could accomplish the same goal without many of the trade-offs associated with a reduction in the statutory tax rate.

Second, this type of deduction would create greater parity between debt and equity. As I noted earlier, current law generally allows corporations to deduct earnings paid out as interest on debt obligations. A dividends paid deduction would provide similar tax treatment for earnings paid out as dividends to investors, allowing the companies to make debt-versus-equity decisions after considering market conditions instead of simply referencing biases in the tax code.

Third, a dividends paid deduction could help with some of our international tax problems by reducing the pressure on companies to invert and greatly reducing the lock-out effect.

To hopefully take advantage of these and other benefits, I have been working for over a year now on a tax reform proposal that would eliminate double taxation of corporate income by providing this type of deduction. While I plan to unveil that proposal here in the next several weeks, I am hoping we can inform this ongoing effort by having a more detailed discussion of these concepts and others during the course of today's hearing.

Before I conclude, I want to acknowledge that some groups—including tax-exempt entities and retirement plans—may have some concerns with a dividends paid deduction. However, at the end of the day, I believe we can craft a system where these parties will be treated in a manner that is comparable to current law or, in fact, in many cases, be better off. At the same time, our overall tax system will, in the opinion of many, be very much improved.

Still, I want everyone to know that I am preparing our integration proposal, and I am aware of the concerns that these and other groups might raise, and I am studying them very closely. Today, and going forward, we seek your comments and suggestions.

With that, I just want to say that I appreciate the fine panel of witnesses being here today, sharing their knowledge and expertise with the committee. I think this is going to be a very informative hearing.\*

[The prepared statement of Chairman Hatch appears in the appendix.]

The CHAIRMAN. With that, I will turn the time over to the distinguished ranking member, Senator Wyden, for his opening statement as well.

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\*For more information, see also, "Overview of Approaches to Corporate Integration," Joint Committee on Taxation staff report, May 13, 2016 (JCX-44-16), <https://www.jct.gov/publications.html?func=startdown&id=4913>.

**OPENING STATEMENT OF HON. RON WYDEN,  
A U.S. SENATOR FROM OREGON**

Senator WYDEN. Thank you very much, Mr. Chairman. I share your view that we have an excellent panel of witnesses and this is going to be a valuable morning.

Mr. Chairman and colleagues, we are going to discuss the concept today of corporate integration, which is not exactly a topic that comes up at summer picnics. But this issue is important to the tax reform debate, and I want to thank Chairman Hatch and his staff who have put an enormous amount of sweat equity into this topic.

I am glad the committee is going to have the opportunity to dig into the specifics about this issue. This morning I am going to focus primarily on questions about what corporate integration could mean for hardworking middle-class families and small businesses that are looking for opportunities to get ahead.

Now, by way of making sure everybody understands what it is we are talking about, corporate integration is about eliminating what some people call double taxation, where income is taxed once at the corporate level and again at the individual level. Once in place, this kind of tax change would allow companies to write off payments they make to shareholders in the form of dividends.

The theory goes, the profit corporations bring in would go out as dividends, and corporate tax bills would shrink. But to finance the big corporate tax cut, 35 percent of the money paid out in dividends and bond interest would be withheld automatically by the Treasury.

Now this raises, in my view, a number of questions. For example, I am particularly interested—as I indicated—in what this would mean for middle-class people, their retirement savings, and what it means for small businesses. Small businesses dominate the economic landscape of our country.

In my State, when you are done with a handful of big businesses, that is it for big business. We are overwhelmingly a small business State.

So I want to make sure that we drill deeply, and the chairman has talked to me about this. When his proposal is formally unveiled, he knows that our staff is going to look into it in great detail. So it is important to dig into these issues, and I am especially interested this morning in looking at retirement savings and small business.

Now it looks, on its face, like this proposal could go from double-taxing corporate income to double-taxing retirement plans. Let me be specific about it. Today, most middle-class savers put their money into retirement plans that are tax-deferred. It is a good deal for working families, and this country's savings crisis would probably be a lot worse without it.

Retirement plans invest in lots of stocks and bonds, but under a corporate integration plan, when you withhold a chunk of the dividends and interest payments that go to retirement plans, suddenly they could get hit with a big, new tax bill for the first time. Their special tax-deferred status—which today is the key that unlocks opportunities to save for millions of Americans—could go away.



Right now, most savers already face a tax bill when they take money out of their accounts. Corporate integration could often add a second tax hit up front. So if you are an electrician in Medford, OR or a teacher in Salem and you have an IRA or a 401(k), you are going to wonder if this system says that the dollar you socked away is worth less than it used to be.

If the math on retirement plans suddenly looks worse to small business owners, there is a possibility they might think twice about offering a plan to their employees.

Now, on the question of the impact on businesses, and particularly small businesses that, as I indicated, are the foundation of so much of the American economy, I think there are real questions about whether corporate integration, in effect, gets America into the business, once again, of picking winners and losers with respect to businesses.

Companies that run airlines and wind farms, which need capital to invest and operate, could face higher costs if interest rates jump. Start-ups may not necessarily want to pay dividends to shareholders because they need to turn their earnings into growth instead of dividends.

A corporate integration plan might look great to established companies with lots of cash on hand, but not so hot to the small businesses that I have indicated dominate the economic landscape in my State and hundreds of communities across the country.

So we have big issues to discuss today. I thank our witnesses.

Before I conclude, I want to recognize that we have one of our witnesses, Ms. Judy Miller, who is retiring at the end of the summer. She served as a senior pension advisor to this committee under Senator Baucus for 4½ years. She has testified before us a number of times. I think all of the members congratulate and thank Ms. Miller for her service and her valuable advice over the years, and wish her well.

So, Mr. Chairman, thank you, and I look forward to digging into these issues.

The CHAIRMAN. Well, thank you, Senator.

[The prepared statement of Senator Wyden appears in the appendix.]

The CHAIRMAN. We have a very impressive group of individuals here today. I would like to thank each of you for coming.

First we will hear from Mr. Michael Graetz, Wilbur H. Friedman professor and Columbia alumni professor of law at Columbia University. Prior to coming to Columbia Law School in 2009, Mr. Graetz served as the Justus S. Hotchkiss professor of law at Yale University, where he started teaching in 1983.

Prior to Yale, Mr. Graetz was a professor of law at the University of Virginia and the University of Southern California law schools. Before that, he served as professor of law in social sciences at the California Institute of Technology.

He is a prominent researcher in the tax field and has written far too many books and articles to list here today. Mr. Graetz also dabbled in government service when he served as Assistant to the Secretary and Special Counsel at the Treasury Department in 1992 and as the Treasury Deputy Assistant Secretary for Tax Policy from 1990 to 1991.

Next we would hear from Ms. Judy Miller, the director of retirement policy for the American Retirement Association and the executive director of the ASPPA College of Pension Actuaries. Prior to joining ARA, Ms. Miller served as the Senior Benefits Advisor on the staff of the Senate Finance committee from 2003 through 2007. We welcome you back.

Ms. MILLER. Thank you.

The CHAIRMAN. Before joining the Finance Committee staff, Ms. Miller provided consulting and actuarial services to employer-sponsored retirement programs for nearly 30 years. She is a member of ACOPA, a member of the Society of Actuaries, a member of the American Academy of Actuaries, and an enrolled actuary.

She received her bachelor of science degree in mathematics from Carnegie Mellon University.

Third, we will hear from Mr. Steve Rosenthal, senior fellow in the Urban-Brookings Tax Policy Center at the Urban Institute. Mr. Rosenthal's week primarily revolves around Federal income tax issues with a particular focus on business taxes.

In 2013, Mr. Rosenthal served as the staff director of the DC Tax Revision Commission. Before joining the Urban Institute, Mr. Rosenthal practiced tax law in the private sector for over 25 years, most recently as a partner at Ropes and Gray.

He also deserves a warm welcome back, because he previously served as legislative counsel with the Joint Committee on Taxation. Mr. Rosenthal is also the former chair of the taxation section of the District of Columbia Bar Association. He holds an A.B. and a J.D. from the University of California at Berkeley, and an M.P.P. from Harvard University.

Finally, we will hear from Mr. Bret Wells, associate professor of law at the University of Houston. Mr. Wells currently teaches at the University of Houston Law Center, where he specializes in the fields of tax and oil and gas law.

Prior to his current position, Mr. Wells served as the vice president, treasurer, and chief tax officer for BJ Services Company and as head of tax for Cargill Corporation. He received his bachelor's degree from Southwestern University and earned his law degree at the University of Texas School of Law.

I want to thank all of you for taking time out of your busy schedules to be in attendance today. We will hear from the witnesses in the order they were introduced.

So, Mr. Graetz, please proceed with your opening statement.

**STATEMENT OF MICHAEL J. GRAETZ, WILBUR H. FRIEDMAN  
PROFESSOR OF TAX LAW AND COLUMBIA ALUMNI PRO-  
FESSOR OF TAX LAW, COLUMBIA UNIVERSITY, NEW YORK,  
NY**

Mr. GRAETZ. Thank you, Mr. Chairman, Senator Wyden, and members of the committee. I thank you for inviting me to participate in today's hearing. I have been involved with the subject of corporate integration for 25 years now, in particular working on the Treasury report on this topic in 1992 and the ALI report in 1993.

In the 1990s, when integration was the topic du jour, domestic tax policy issues were the principal concern. They included things

like the chairman mentioned, including the relative treatment of income earned through corporations and pass-throughs, the comparative taxation of debt and equity, the relationship of entity taxation to investor taxation, the relative treatment of distributed and retained earnings, and the relative treatment of dividend and non-dividend transactions such as share purchases.

Today, international income issues have come to be also prominent. These include the relative treatment of domestic and foreign income, differences in the treatment of domestic and foreign corporations, the coordination of domestic and foreign taxes, and the problem of repatriation of foreign earnings to the United States. Needless to say, these domestic and international policy issues, in combination, make business tax reform a daunting task.

I strongly support corporate integration through a dividend deduction with withholding, but I want to make clear that while this would improve the system by shifting taxation from companies that are highly mobile to shareholders who are not, we should not regard this as a cure-all for all of the ills that ail the tax system.

As members of this committee know, I have long proposed a much lower corporate tax rate, as low as 15 percent. That kind of solution would eliminate incentives for investing abroad, for shifting income abroad, and for foreign takeovers. But I do not believe we can really fix our Nation's tax system without another revenue source.

I have been a supporter of the progressive consumption tax proposal of Senator Cardin, but that does not seem to be imminent. So the question is, "What should we do in the meantime?" I should also add that, in order to combat income shifting by U.S. corporations, I have argued that we ought to locate more profit in the country where the goods are sold, rather than where the IP is owned or used.

But these are not on today's agenda. So the key question is whether we move to these kinds of reforms or not—whether corporate integration could solve some of these questions that I began my testimony with, and that the chairman began with.

My written statement goes through all of the main issues of corporate integration, so I will just make a few limited remarks.

The first is that, when the Treasury and the ALI considered integration in detail in the 1990s, they both rejected a dividend deduction because it automatically extended to foreign shareholders and tax-exempt entities, at considerable revenue costs, the benefits of integration.

The staff of this committee and Senator Hatch deserve credit for recognizing that this problem can be solved through a nonrefundable withholding tax that retains the advantages of the dividend deduction, shifting the tax burden from corporations to shareholders, and lowering the effective tax rate for companies, while avoiding that revenue loss and the tax reductions that would otherwise occur for foreigners and tax-exempts.

This proposal has all of the benefits of shareholder or imputation credit integration, which is a system that has been proven to work well in European countries and in Australia and is a far better system than our current law, which imposes a low shareholder tax and a high corporate rate. Shifting the tax from corporations to

shareholders would be more advantageous and more progressive than the current system.

Let me just, with my limited amount of time, make one comment about one of the major design issues. Others, I am sure, will come up during the questions and answers, but I want to say something about the treatment of interest in this proposal.

Retaining a withholding tax on dividends of 35 percent is a way of avoiding a tax reduction for those tax-exempt and foreign shareholders who are now paying the corporate tax through nondeductible dividends. So it is not an increase in tax on those shareholders. On the other hand, a similar withholding tax on interest is an increase in tax on those shareholders, because that interest is now deductible and not taxed if you are tax-exempt or a foreign shareholder.

This raises some important questions. It is worth saying that you cannot equate debt and equity without making some changes in the way that tax-exempt and foreign shareholders are now treated. It is impossible to do so in the absence of that.

Let me just say that I am concerned about the fact that, if you have withholding on corporate interest but not withholding on other forms of interest, such as Treasury bills and bank accounts and so forth, this may induce portfolio effects by tax-exempt and foreign shareholders who will look for the interest in the form that has no withholding.

It seems to me that one thing we ought to think about is the option of limiting the deduction for interest as an alternative. It turns out, Senator Wyden, you have proposed eliminating the deduction for interest. Eliminating the deduction for interest and a 35-percent withholding tax on interest are, essentially, the same.

They have some differences for higher-income taxpayers, but they are very close. The biggest difference is that by eliminating the deduction, you do not reduce the effective rate at the corporate level, which you do with a dividend deduction. But it might avoid the kinds of portfolio realignments that would occur with withholding on interest, and it seems to me something that ought to be considered. Even though at first blush a full deduction for dividends with withholding and a partial or limited deduction for interest seems odd, it would actually better align the tax system.

I am sure this is an issue we will come back to. It is an important issue. It is one we struggled with at the Treasury Department, along with many other issues that Senator Wyden and others have raised. I am sure we will have a chance to talk about these other issues.

Thank you very much.

The CHAIRMAN. Thank you, Mr. Graetz.

Senator WYDEN. Mr. Chairman, just before we go on, on the point that you touched on with respect to eliminating the deduction for interest, Mr. Graetz, the bill that Senator Coats and I have would just take a tiny part of it, not the entire thing. Thank you.

[The prepared statement of Mr. Graetz appears in the appendix.]

The CHAIRMAN. Ms. Miller, we will turn to you.

**STATEMENT OF JUDY A. MILLER, DIRECTOR OF RETIREMENT POLICY FOR THE AMERICAN RETIREMENT ASSOCIATION AND EXECUTIVE DIRECTOR OF THE AMERICAN SOCIETY OF PENSION PROFESSIONALS AND ACTUARIES, COLLEGE OF PENSION ACTUARIES, ARLINGTON, VA**

Ms. MILLER. Thank you, Chairman Hatch, Ranking Member Wyden, and members of the committee, for the opportunity to talk with you about the impact of corporate integration on qualified retirement plans with an emphasis on retirement plans for small business.

Data clearly shows that workplace savings are critical to retirement security. In fact, workers earning between \$30,000 and \$50,000 are 15 times more likely to save if they have a plan at work than if they have to set up an IRA and save on their own. This means the impact of corporate integration on the establishment and maintenance of workplace retirement plans has to be considered when assessing the proposal's impact on the retirement security of American workers.

Two key features distinguish retirement savings tax incentives from other incentives in the Internal Revenue Code: the deferral nature of the incentive and the nondiscrimination rules that make employer-sponsored retirement plans efficient at delivering benefits across the income spectrum.

These incentives play an especially critical role in encouraging a small business owner to establish and maintain a retirement plan. When that small business owner decides to set up a 401(k) plan, they agree to take on administrative costs and responsibilities, including fiduciary liability for operating that plan, but that is not all. To comply with the nondiscrimination rules, they usually have to also make contributions for their employees. So they are not just putting money aside for themselves, they are putting money aside for their workers.

A corporate integration proposal that treats retirement plan assets the same as investments made outside of a plan would be a broadside hit on the tax incentives for establishing, maintaining, and participating in a retirement plan. The impact can be illustrated by considering a couple of examples.

For illustration purposes, I am assuming the proposal requires mandatory 35-percent withholding on dividends and interest paid on all domestic stocks and bonds, including those held in a retirement plan, with no ability to recover withholding. Also, I am assuming investment income is from dividends and interests, funds are initially invested 50-50 in equities and bonds, the annual rate is 5 percent, which is not terribly relevant, and the taxpayers marginal rate is 28 percent.

So first, let us look at somebody who has \$10,000 to invest, and they are considering, should I put it in the 401(k) plan or should I invest it outside of the plan? With corporate integration, both accounts are going to net the same amount after 20 years, so there would be no tax incentive for investing in the 401(k) plan instead of just putting it in your personal account.

Since money held in a 401(k) plan and other qualified retirement plans has a lot of withdrawal restrictions, you are actually tying up the money, giving yourself less flexibility, and possibly incurring

a 10-percent penalty if you need it before retirement by putting it in the plan. So there is actually a disincentive to save through a 401(k) plan if there is no tax incentive to do it.

Corporate integration looks even worse if you look at a small business owner deciding whether or not to set up a 401(k) plan. The business has been in operation for 5 years and is now turning a profit. There are five non-owner employees with total payroll of \$300,000. The owner takes \$10,000 a month during the year, so they have \$120,000 in compensation. At the end of the year, they take a bonus which is equal to profits. They "clean it out" so to speak. In the current year, it is \$65,000.

Without a retirement plan, the owner is going to pay individual income taxes on the bonus, at a marginal rate of 28 percent. So they would have \$46,800 left after tax that they could invest outside of the plan.

The retirement plan consultant recommends setting up a safe harbor 401(k) plan with an additional cross-tested contribution instead of taking the bonus. With this type of plan, the owner can contribute \$50,000 of the profits to the plan on her own behalf, and thanks to the nondiscrimination rules, the owner will also contribute \$15,000, 5 percent of pay, for the staff.

So instead of taking home \$46,800 and sending the IRS a check for \$18,200, the owner would contribute \$50,000 to the plan on her own behalf and \$15,000 on behalf of the employees.

With corporate integration, the deduction for the contribution is still going to cover the cost of the contribution for the other staff, or largely cover it. If the owner just paid on the \$65,000 now and invested the difference, though, she would end up with significantly more savings 20 years from now than if she put in the 401(k) plan. That is even if she were to drop to a 15-percent marginal rate in retirement.

In this case, with the 28-percent rate in retirement, she can actually increase her savings by 30 percent by not putting in a 401(k) plan. Given all of the strings attached to withdrawing money from a 401(k) plan, she would also have more flexibility holding those savings outside of the plan.

In other words, with corporate integration, the owner would not only have less expense, less liability, and more flexibility, she would actually have more long-term savings by just saying "no" to putting in that 401(k) plan.

In summary, corporate integration may be good tax policy in theory, but it would be horrible retirement policy in practice if there is no incentive for a small business owner to set up and maintain a workplace retirement plan. Without a plan at work, most workers with modest income just are not going to save for retirement.

We would be pleased to work with the committee on how the proposal can be fashioned to preserve the tax incentives for retirement savings. Again, I want to thank you for inviting me, and I would be pleased to discuss this issue or answer any questions you may have. Thank you.

[The prepared statement of Ms. Miller appears in the appendix.]

The CHAIRMAN. Well, thank you.

Mr. Rosenthal?

**STATEMENT OF STEVEN M. ROSENTHAL, SENIOR FELLOW,  
URBAN-BROOKINGS TAX POLICY CENTER, URBAN INSTI-  
TUTE, WASHINGTON, DC**

Mr. ROSENTHAL. Chairman Hatch, Ranking Member Wyden, and other members of the committee, I am Steve Rosenthal, senior fellow at the Urban-Brookings Tax Policy Center. Thank you for inviting me to testify today.

I would like to highlight some new research which we published yesterday, and the implications of that new research on the effort to further integrate the corporate and individual tax systems.

Let me draw your attention to Figure 1 of my written testimony, which is displayed on the monitors to my left. My co-author, Lydia Austin, and I found a seismic shift of stock ownership from taxable accounts to nontaxable accounts over the last 50 years. We estimate that the share of U.S. corporate stock that is held in taxable accounts of individuals fell from 80 percent in 1965 to less than 25 percent in 2015, which is the gray shaded area at the bottom of the figure.

What happened? Nontaxable retirement accounts, the blue shaded area, and foreigners, the white at the top, displaced much of the stock holdings of taxable accounts. As a result of the downward trend in taxable stock ownership and the reduction in tax rates on individuals for qualified dividend income and long-term capital gain, corporate earnings now face a very low effective tax rate at the shareholder level. The base is small, and the tax rates are low.

I would like to highlight three important implications to further integrating taxes on corporate earnings. Corporate earnings are ostensibly taxed twice, but in practice rarely are.

By our calculations, more than three-quarters of the shelter base is untaxed, and those remaining face reduced tax rates. Second, taxing corporate earnings only at the corporate level is challenging in today's environment, as Chairman Hatch has noted. Corporations are mobile, and they can easily shift their earnings abroad.

To further integrate our tax system, we can either strengthen corporate taxes by closing corporate loopholes or shift taxes more aggressively to the shareholder level, as is being explored by staff today. But shifting taxes to shareholders is much more difficult if few shareholders pay tax.

The best policy answer is creating more taxable shareholders, which will be challenging politically. A nonrefundable withholding tax on dividends paid to shareholders would help.

Thank you for allowing me to speak at today's hearing. I am happy to answer any of your questions.

The CHAIRMAN. Well, thank you very much. We appreciate your work.

[The prepared statement of Mr. Rosenthal appears in the appendix.]

The CHAIRMAN. Mr. Wells, we will turn to you now for your statement.

**STATEMENT OF BRET WELLS, ASSOCIATE PROFESSOR OF  
LAW, LAW CENTER, UNIVERSITY OF HOUSTON, HOUSTON, TX**

Mr. WELLS. My name is Bret Wells, and I am an associate professor of law at the University of Houston Law Center. I too would like to thank Chairman Hatch, Senator Wyden, and the other members of the committee for inviting me to testify. I am testifying in my individual capacity, so my views do not necessarily represent the views of the University of Houston Law Center.

As both Chairman Hatch and Senator Wyden have said, our tax system is in need of fundamental reform. Finding a path to rationalizing the taxation of active business income in the United States is an important goal—a monumental goal, in fact—and the integration of shareholder and corporate taxation can achieve that goal. Corporate integration has been extensively studied for decades by prior administrations, the American Law Institute, and numerous highly respected academics, one of whom joins me on this panel.

As this committee staff has recently written, a broad consensus exists that significant efficiencies can be achieved through corporate integration. Thus, before one gets enmeshed in the important details of how to create an appropriately functioning corporate integration regime, it is important to say that reform along these lines can significantly improve our tax system.

Focusing specifically on the dividends paid regime, this particular method of achieving corporate integration would, as to distributed earnings, harmonize the tax treatment between debt and equity and would level the playing field between pass-through entities and C corporations. There is much to commend this proposal. But, notwithstanding the potential benefits of corporate integration, the reality is that business tax reform must carefully consider the international tax implications of any new paradigm, and to that end, the United States must ensure that its tax regime withstands at least three systemic international tax challenges.

First, a critical international tax challenge is the inbound earnings stripping challenge, and this earnings stripping challenge can be further categorized along the following types of tax base erosion strategies: related party interest stripping transactions, related party royalty stripping transactions, related party lease stripping transactions, supply chain restructuring exercises, and related party service stripping transactions.

The second key international tax challenge relates to corporate inversions. Corporate inversions are often categorized as a discrete stand-alone policy problem, but in my view, the corporate inversion phenomenon provides unmistakable evidence of the enormity of the inbound earnings stripping advantage that exists for all foreign-based multinational corporations.

A foreign-based multinational corporation can engage in an inbound related party interest stripping transaction, royalty stripping transaction, and an inbound related party lease stripping transaction without any concern for the U.S. subpart F rules, whereas these very same transactions would create subpart F inclusions if conducted by a U.S. multinational corporation.

Corporate inversions, rightly understood, represent an effort by U.S. multinational corporations to place their U.S. businesses into an overall corporate structure that affords them the full range of



inbound earnings stripping techniques without being impeded by the backstop provisions of the subpart F rules.

Third, fundamental tax reform must deal with the so-called lock-out effect.

As to the earnings stripping challenge and its alter ego, the corporate inversion phenomenon, the dividends paid deduction regime, by itself, does not equalize the tax position of the U.S. multinational corporation with that of a foreign-based multinational corporation. Even though the dividends paid deduction regime provides a corporate-level tax deduction for dividend payments, the dividend payment is subject to a corresponding withholding tax.

In comparison, a foreign-based multinational corporation can engage in all five of the enumerated earnings stripping strategies to create a comparable U.S. tax deduction without incurring a corresponding withholding tax. Thus, the dividends paid deduction regime does not eliminate the financial advantage that motivates earnings stripping or that fuels the inversion phenomenon.

In order to address those two key international issues, the United States must impose an equivalent withholding tax or a surtax or—building on the idea advanced by Professor Graetz in his earlier written testimony—disallow a deduction on all related party base erosion strategies. An expansive approach—and not just one that is focused on interest stripping transactions or royalty stripping transactions—is needed.

Let me conclude my oral statement by stating that an appropriately structured corporate integration regime has much to offer. The committee is to be commended for considering fundamental business tax reform, but at the same time, this committee must ensure that the dividends paid deduction regime is structured to withstand the systemic international tax challenges that face the United States.

Thank you for allowing me to speak at today's hearing. I would be happy to answer any of your questions.

[The prepared statement of Mr. Wells appears in the appendix.]

The CHAIRMAN. Thank you. All four of you have been very interesting to me, and I am sure to other members of the committee.

Mr. Graetz, this question is for you, but the other witnesses are certainly welcome if they want to weigh in with their thoughts as well. This relates to the international tax rules.

Specifically, we hear a lot about the \$2 trillion locked out from the United States because of our worldwide deferral tax system. There are over \$2 trillion that the foreign subsidiaries of U.S. corporations have that no U.S. tax has been paid on and that the companies are loath to bring back to the U.S. because of the high 35-percent U.S. corporate tax rate that awaits them.

Now, I have heard that the dividends paid deduction would lessen this lock-out effect, but not necessarily eliminate it. Do you agree or disagree?

Mr. GRAETZ. I agree with that. I think it would lessen the lock-out effect, especially for companies that are distributing their earnings to shareholders. They get the deduction and would not pay the 35-percent tax at the corporate level, so it would definitely help.

It is worth saying that integration systems of this sort can work well with either the foreign tax credit system that we now have or

with a territorial system which provides an exemption for foreign earnings. That is the system in Australia. They have a shareholder credit system and a territorial system, for example.

The CHAIRMAN. Mr. Rosenthal, in your written testimony, you note that "having two levels of tax distorts business decision-making in several important ways: whether to establish as a corporation, partnership, or other business form; whether to finance with debt or equity; and whether to retain or distribute earnings."

Now, I would like to focus on the second distortion that you note: whether to finance with debt or equity. Could you elaborate on the distortion created by the debt financing versus equity financing? And how would you eliminate that distortion?

Mr. ROSENTHAL. Yes. Under present law, corporations can take a deduction on the interest they pay to bondholders. By contrast, corporations cannot deduct the dividends they pay to shareholders. As a result, under present law, there is an incentive to issue more debt to reduce corporate taxes instead of issuing equity.

As I described in my testimony, effectively today, we collect most taxes at the corporate level and few at the shareholder level, which particularly exacerbates that incentive to issue debt over equity. If we were to shift to collecting taxes at the shareholder level through allowing a dividends paid deduction, that also would accomplish integration, collecting at the shareholder level rather than as we do today, principally at the corporate level.

That form of collection would eliminate the debt-equity bias that you have highlighted, Chairman Hatch.

The CHAIRMAN. Thank you. Mr. Wells, in your written testimony you write that "it is important to say that reform along the lines of corporate integration can significantly improve our tax system."

Now, you were formerly vice president of tax at a large publicly traded company. Now, how do the two levels of taxes of corporate earnings distort business decision-making, and would a dividends paid deduction eliminate some or all of those distortions, and how would it improve our tax system?

Mr. WELLS. For a company to distribute earnings, it would create a shareholder tax, a double tax on the distributed earnings that is avoided if the company simply reinvests the earnings back in the business. By having a corporate integration regime, the company would get a deduction currently, and there would be an offsetting withholding tax, and that would ensure that the company makes the most efficient decision as to what to do with that income.

There would not be a double tax cost. The decision of what to distribute to shareholders or to invest in the business would be solely one based upon the right economics for that company.

Today, companies suffer a double tax issue if they want to distribute earnings to their shareholders. That is a distortion that need not be there.

What is a better answer is to ensure that there is one level of tax and that it is taxed at the shareholder level at the high shareholder effective tax rate, whatever rate this committee wants to put in for individuals. That would be the most efficient system and the way to ensure a progressive tax system, in my view.

The CHAIRMAN. Well, thank you.  
Senator Wyden?

Senator WYDEN. Thank you very much, Mr. Chairman.

Ms. Miller, let us start with this question of the retirement plans, and particularly small employers, because I know you have done a lot of work with them over the years.

Hypothetically, let us say that you are the owner of ABC Plumbing in Coos Bay, OR, which has five employees. And you are beginning to have some success with your business. You are interested in putting some money aside.

How would these corporate integration ideas, 35-percent withholding proposals, impact my business in Coos Bay, OR and my decision on whether or not to set up a 401(k) plan?

Ms. MILLER. That is a great question. Thank you.

Right now, when that business gets to that point, they have their payroll, they feel like employees are fairly compensated, so when you are approaching that employer about putting in a plan, you are really talking, largely, about their personal tax situation. If they have profits, you can show on the current year's tax basis that they are going to make a contribution for employees, but the overall deduction is going to pretty much cover that cost.

But then you get into, okay, is this plan the right place for you to invest your money, or would you be better off just not setting up the plan and going elsewhere? That is where an example in my testimony comes into play, because under current law, if you put in the 401(k) plan, you get the current-year deduction, you feel very good about putting money in your employees' accounts as well—it is little net cost.

Then you project your retirement, and depending on what your effective tax rate is when you retire, you might have a little less than if you just invested outside the plan, but you might have more. It is pretty much a wash, so it is a good situation. You say, I would rather give the money to my employees than Uncle Sam, and you can put in the plan.

But with corporate integration—because you lose that inside tax-deferred buildup—you will actually find that the owner would be better off, by a substantial amount, to not put in the 401(k) plan at all. So if you are advising that employer—

Senator WYDEN. That is why the five employees ought to be concerned about this.

Ms. MILLER. Right. Exactly. The five employees should be concerned, because the employer probably is not going to put that plan in, and they are not going to get that contribution from the employer that they would be getting now.

Senator WYDEN. Let me ask you about another challenge that the chairman and I have talked about, all the members are talking about, and that is the ramifications for the multiemployer pension situation. As you know, there are many of these multiemployer pensions that are in financial peril, a number of them running out of money. The Pension Benefit Guaranty Corporation estimates that it would cost \$100 billion to provide full plan benefits for participants and multiemployer plans that are currently insolvent or expected to be insolvent over the next 20 years.

Describe what these proposals could mean in terms of the funding levels for these kinds of plans.

Ms. MILLER. That is a really critical point, in that if bond interest that is currently not taxable becomes taxable and dividends, to the extent that there is not an increase in the dividend amount to absorb the withholding—there is an argument that there would be, but possibly not. Basically, the investments you are now holding in the plan are worth less, so when you look at the underfunding in that plan, your assets will have shrunk. This proposal that has 35-percent withholding on dividends and interest without the ability to recapture it if you are in a qualified retirement plan trust, if it goes into effect today, tomorrow your bonds are worth less than they are today, and your underfunding has grown.

Senator WYDEN. Thank you.

One question for you, Mr. Rosenthal. You say that, “Ostensibly, corporate earnings are taxed twice.” The committee was told during our last tax reform hearing that less than a quarter of corporate equities are now subject to the so-called double tax.

Can you describe current situations in which corporate earnings may be taxed only once or not at all?

Mr. ROSENTHAL. Well, there is the theory, and then the practice. In theory, if a corporation issued a bond, and the bond was held by a tax-exempt, there would be no level of tax on the corporate earnings. If the corporation had issued equity to a tax-exempt shareholder, it would be taxed once at the corporate level.

In practice, as a result of carefully looking at the data, I believe that today we principally or overwhelmingly collect our tax on corporate earnings at the corporate level, and very little tax at the shareholder level. So I use the words “ostensibly taxed twice.” I think the important issue is not how many times we tax corporate earnings, but how much we tax corporate earnings.

Senator WYDEN. Mr. Chairman, my time is up. I have indicated to the chairman that I am going to work closely with him to explore any of the ideas he has. I just want to come back to the proposition that, to get tax reform passed, it is going to have to be bipartisan. That is how we are going to get to tax reform. To me, that means giving everybody in America a chance to get ahead, not just the fortunate few, but everybody. Small businesses and the middle class, especially, have to be part of that effort to give everybody a chance to get ahead. That will be the key, in my view, to getting a bipartisan bill.

Thank you, Mr. Chairman.

The CHAIRMAN. All right.

Senator Thune?

Senator THUNE. Thank you, Mr. Chairman. I think all of us would like to see comprehensive tax reform: business and individual done at the same time. I think moving to a territorial system—in a perfect world, that is what we would like to see happen here. In the more realistic world, it may be that we get some rifle-shot opportunities.

I guess my question kind of gets at the point you were making earlier, Mr. Wells; that is, is it possible to do corporate integration without creating a lot of unintended consequences—earnings stripping, the sorts of things that you described—where you would actually, perhaps, do more harm than good? Can this be done in a vacu-

um? Can we rifle-shot this, or does this have to be done in that broader context?

Mr. WELLS. It has to be done in a broader context. And the thought you need to have in your mind—I would urge, Senator—is that when you have a deduction at the corporate level under the dividends paid deduction regime that creates a 35-percent withholding tax, you have to compare that to the other earnings stripping opportunities.

And, if an inbound company has the opportunity to create a tax deduction in their U.S. affiliate at the same benefit but through interest stripping, royalties, and the rest, and those are not subject to a withholding tax, then there is a structural competitive advantage for that foreign-based multinational in the United States, even though they both get a corporate tax deduction.

So if we want to have horizontal equity between domestic corporations and foreign corporations, we need to ensure that the tax base will not be reduced through a deduction that avoids the withholding tax through intercompany arrangements for the inbound foreign company that does not exist for the U.S. multinational. As I said in my testimony, many of those earnings stripping techniques, if tried by a U.S. multinational, would be subject to the U.S. subpart F regime and would be currently taxed.

So today, there are earnings stripping opportunities to the inbound foreign-based multinational that give them a deduction with no withholding. If we want to have a level playing field, we need to make those not exist for one group of companies when they are not available for the other group of companies.

Senator THUNE. Mr. Graetz, you mentioned in your testimony that the form of corporate integration that was advanced by the Bush administration in 2003, which is taxing business income once at the entity level—you state that approach is no longer apt today.

So my question is, can you discuss why those corporate integration proposals from the 1990s and the early 2000s are no longer apt? What has changed since then?

Mr. GRAETZ. Yes, I can. I was responsible, in large part, for the 1992 proposal which would have located the single tax at the corporate level, which then was proposed again by President George W. Bush and became the blueprint for the 2003 legislation.

It is hard for me to admit I am wrong, so I am fond of saying, if I was right then, I am wrong now because the world has changed. The competition globally was not as much on our radar screen as it should have been at the time. Foreign takeovers were not nearly as important as they are now. There were not the non-repatriated profits sitting offshore that we are now looking at, and we did not have significant inversions of U.S. companies to speak of. They were very minor, and all they did was send paper to Bermuda instead of sending jobs to Europe. So, it was a very different world than we are in now.

Now I think it is a huge mistake to locate the high tax at the corporate level and the low tax or the zero tax at the shareholder level. We are much better off taxing the shareholders who are going to stay in the United States, who are going to be residents of the United States, than the corporations who will change their

residence through paper transactions and will also shift a tremendous amount of income abroad, as we have seen.

So we now have the tax at exactly the wrong place. We have a low tax on the shareholders and a high tax on the corporations.

Senator THUNE. Do you believe—and this is for any of you—that a dividends paid deduction coupled with withholding at the shareholder level can be done in a manner that is consistent with our existing tax treaties?

Mr. GRAETZ. If you withhold at 35 percent on foreign shareholders, you have treaty issues. If you do not withhold at 35 percent on foreign shareholders, you will have given a tax cut to those foreign shareholders and increased the revenue cost of the proposal. So it is a difficult issue.

I will say one thing, and that is that the United Kingdom in adopting its so-called “diverted profits tax,” and Australia in doing something similar, have claimed, oh well, that is just a different tax. That is not the same tax that we are talking about in the treaties. So maybe if you call this something other than withholding tax, you could make similar claims and then let everybody fight about the treaties subsequently and put us in a stronger negotiating position vis-à-vis our treaty partners, but you could not call it a withholding tax and not get into treaty issues.

Senator THUNE. All right. Thank you, Mr. Chairman.

The CHAIRMAN. Okay. Senator Scott?

Senator SCOTT. Thank you, Mr. Chairman. Thank you to the panelists for being here this morning to discuss this very important issue.

Without any question, when you think about the fact that we have the highest corporate tax rate in the world at 35 percent, we have the second-highest integrated tax rate on corporate income at 56.6 percent, it is no wonder that we find ourselves in the situation that we do today. Investment levels are not where they should be. Debt financing is preferred, and inversions will continue.

I applaud the chairman for his efforts to make any progress on this antiquated, outdated, should-be-obsolete tax code without any question. I am concerned, however, that absent a total overhaul of our tax code, the United States is going to become more and more uncompetitive in our global economy. Further, as the United States becomes less competitive and fewer domestic profits and revenue are realized, there will be a greater negative impact on middle-income Americans and poor and economically disadvantaged communities.

To me, one of the major focuses of tax reform must center on helping middle-income Americans and the poor. We know that so many families are just trying to find a way to the American dream. Too often, our policies at the Federal level are preventing that from happening. Actually, the inability for us to come together in a bipartisan fashion to eliminate the highest corporate tax rate, to allow for repatriation, and to eliminate this global form of taxation—as opposed to territorial taxation—is crippling job creators in this Nation.

One of the reasons why I have introduced new legislation, called the Investing in Opportunities Act, is to help more than 50 million Americans living paycheck to paycheck, and to look for ways to en-

courage and to incent trillions of dollars into these distressed communities. My legislation does not create new government programs but rather focuses on private-sector investment.

My home State of South Carolina has done a really good job attracting enormous growth and opportunities in the industrial, manufacturing, and high-tech economies that has helped those folks living in distressed communities consistently.

We still have a very long way to go, but I believe that my legislation and other tax proposals for lower rates on the over-burdened middle class will have a positive impact in improving regional economic conditions across the country. And while I certainly appreciate the hearing today, my thoughts are still the same, that ultimately, until we have a panoramic view of our tax code and drill into ways for us to reduce the overall corporate tax rate and then deal, as well, with our business organization—LLCs, other forms and entities in our business structure—we will still find ourselves struggling for a real solution.

Thank you, Mr. Chairman. No questions.

The CHAIRMAN. Thank you, Senator.

Senator Casey?

Senator CASEY. Thank you, Mr. Chairman. We appreciate the opportunity to talk about this subject.

Ms. Miller, I will start with you—not only because you went to Carnegie Mellon in Pittsburgh, but that always helps.

I was noting in your testimony, the first page of your testimony, that you said in pertinent part, “workers earning between \$30,000 and \$50,000 per year are 15 times”—and you emphasize those two words—“15 times more likely to save at work than to go out and set up an IRA to save on their own.” Your source for that was the Employee Benefits Research Institute.

So based upon that statement in your testimony—and I share a lot of your concerns, especially as it relates to nonprofits and retirement vehicles—can you walk through how corporate integration would reduce incentives for small business owners to set up, establish retirement plans for them and for their employees? How do you summarize that? I know you walked through some of it already.

Ms. MILLER. It really relates to the growth of the investment during the deferral period, what is now a deferral period, to the extent that the investment income is interest and dividends. Corporate integration is going to modify it. In fact, that is going to be reduced somewhat.

But in addition, to the extent that there is now double taxation, and there would not be outside of the program, there will be kind of a bump-up in how their savings would grow if they were outside of the program as opposed to inside the program.

So if you were only looking at an individual, it is going to pretty much equalize things inside and outside of the plan. But when you are looking at a small business owner—because they have to make that contribution for other employees as well—you are really, under current law, kind of counting on the tax-deferred inside buildup to kind of make up what they have spent by making those contributions for other people.

So it really just shifts what looks like a good place to put your money to, "Do not put it in that plan. Let us take the money and just invest it outside of the plan."

Senator CASEY. In terms of a broader, more particular concern about access to retirement vehicles and savings rates, what would you conclude about those two issues?

Ms. MILLER. Well, I think there are a certain number of people who save no matter what, but they tend not to be people that we are most concerned about. For people in the more modest income level, there is lots of evidence, not just that data, about the need to have automatic savings to enroll them at work, and to the extent that you do not have those programs at work, the savings rate will fall. I do not have an estimate of how much, but it is clear that there would be a dramatic drop for people who are in those more modest income levels.

Senator CASEY. Mr. Rosenthal, I was noting in your testimony on page 3 that, in reference to the work that you and your colleague did, you say, "The share of corporate stock issued by U.S. corporations that is held in taxable accounts fell by more than two-thirds over a period of 50 years from 83.6 percent in 1965 to 24.2 percent in 2015."

Is it fair to conclude from those numbers that—and this is an opinion—but, based upon those numbers, is it fair to say that relatively few shareholders pay at that second level of taxation?

Mr. ROSENTHAL. Yes, Senator. That is the inference that I draw from the data. You can see the decline on the monitor to your right. The taxable ownership dropped quite considerably from 1965 to 2015.

I think the decline changes the way we look at a lot of the different tax issues that this committee and the Congress address.

Senator CASEY. And in particular, can you walk through for us—and I know you have been through this a little bit already—the type of taxpayers who might be subject to withholding tax under corporate integration?

Mr. ROSENTHAL. Well, as our research illustrates, only about 25 percent of shareholders are taxable, and the balance are tax-exempt. They fall in different categories; most principally, retirement plans and then foreigners.

If we shift to a dividends paid deduction with a withholding tax, the issue arises as to whether that withholding tax would be refundable or nonrefundable. I think most expect it would be nonrefundable for a variety of revenue and policy reasons, but the consequence of that—as Ms. Miller has observed—would be to collect a withholding tax at the corporate level that would not be of any value to the retirement plans or presumably to foreigners, and that is going to put a lot of stress on shifting the tax on corporate earnings from the corporate level to the shareholder level, how we can address that issue.

Senator CASEY. Thank you. I know I am over time. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Portman?

Senator PORTMAN. Thank you, Mr. Chairman.



Thank you all for being here. This is a terrific group of witnesses. We are talking about an issue that is incredibly important to America's economy right now. We have a tax code that is not competitive, and we need to do a number of things to change it, and quickly; otherwise, we will continue to lose jobs and investment.

We also have a retirement system, as Ms. Miller has talked about, that is in need of restoring. Senator Cardin and I worked a lot on this over the years, together. You are absolutely right. We do not want to create disincentives for people to save for their retirement at a time when we need more and more people to be saving—10,000 baby boomers retiring every day and a Social Security system that is incredibly important, but also in trouble based on the fiscal outlook.

My biggest concern right now, frankly, is what is going on with our companies taking their jobs and investment overseas. Professor Graetz, you have been terrific on this issue over the years. I am going to take you back in time here to an article that you wrote that I pulled up. It was in December, at the end of year. It was about what is going on right now. Right now, as we sit here, the European Commission is taking state aid cases against U.S. companies that are overseas in European countries, although this is happening more broadly with the BEPS project with all OECD and G20 countries.

But with regard to these state aid cases, we are looking at the possibility of U.S. companies being told that whatever arrangement they have worked out with another country is no longer valid on a retroactive basis, to the tune of millions if not billions of dollars. This is money that, frankly, comes out of the U.S. Treasury, because that is where it, otherwise, should go. So, because we have a worldwide tax system—that is true—but also because of the reform efforts that Senator Schumer and I and others have been talking about—now Speaker Ryan, former Chairman Ryan, and others—you have a toll charge on your earnings overseas, and that is how you pay for going to a territorial system, which I think we all should agree is the way to go. I will just presume that is the way you all feel.

That will not be there if these state aid cases continue, and they will. There are another 300 cases, we are told, that are on the docket.

I guess my concern is, what is happening now is not working. I think, frankly, both governments are looking at the symptoms of the problem rather than the problem. Our own Treasury Department has just issued these new regulations under section 385 for earning strippings that I think are an overreach. I am against inversions. I want to stop them, but I want to stop them by dealing with the underlying problem, and, frankly, it has some unintended consequences, what is going on right now.

So I am bringing you right up to the present. This is what is happening. Both the EU and the United States government are reacting to the problem in ways that I think are counterproductive to our interests as Americans to create more jobs and opportunity here. So I would ask you to comment on that, and in the area of corporate integration, how does that work with what we know we have to do on the international side?

I think this is urgent. The house is on fire. We need to get the fire truck up there to start putting it out quickly. Some of you have probably read the *Wall Street Journal* story—I think it appeared yesterday—where Ernie Christian, who has worked with Mr. Graetz over the years on tax policy and other issues, just laid out what is happening with these foreign transactions. So it is not just about inversions. That is almost the tip of the iceberg.

There are companies in the United States that, because of our tax code, are targets for takeover because these foreign companies can pay a premium, and it is escalating every year—again this year.

So I guess I would start with you, Mr. Graetz. And you have commented on this briefly, but do you not think we have a crisis here that you have written about, and how does this corporate integration idea help or hurt in terms of dealing with this underlying problem we have, which is a corporate international tax code that is not competitive and leads to job loss here in this country?

Mr. GRAETZ. Thank you, Senator. As you know, I agree entirely we have a crisis. We have a terrible tax system. Its distortions and complexities and inefficiencies would take us more time to list than we have. The state aid cases are troubling, both for their retroactivity and for, I think, their potential discrimination against U.S. corporations. There are some European corporations that are also under investigation, but they seem to be small potatoes compared to what the European Commission is going after with U.S. companies.

Senator PORTMAN. Five big ones right now, and four are U.S. companies, and the fifth is Fiat with huge U.S. holdings.

Mr. GRAETZ. Yes, exactly. The foreign tax credit means that any additional taxes that are paid will be borne not by the companies, but by the U.S. taxpayer. So it is a reason for concern.

All of the things that you mentioned, I think, are reasons for concern. Yes, there is a crisis.

I was thinking, as Senator Wyden was talking, about a variety of issues. Integration is not penicillin. It is not a cure-all. It is not a new antibiotic. It is a step—I think an important step—in the right direction in terms of improving the U.S. tax system.

I regard it, as I said in my testimony, as a useful step and an important step, but not a cure-all. I have said this many times—I think the only solution for the U.S. is a very low corporate rate. I think in order to do that, we probably have to tax consumption more than we are taxing it.

Senator PORTMAN. But you have also said we need to go to a territorial system.

Mr. GRAETZ. I have. I have, because I think that this current system, which creates a disincentive for bringing money home to invest in America, is foolish at the current time.

Senator PORTMAN. My time has expired. I appreciate it. Mr. Chairman, I hope we will have a hearing also on the international tax issues and, specifically, what Treasury is doing with these new regulations and the unintended consequences of the section 385 changes, and hopefully we can deal with this immediate problem that we have. If we do not, I think we will see our corporate com-

munity and our businesses and jobs continue to go overseas. Thank you, Mr. Chairman.

The CHAIRMAN. I intend to do that, Senator. I agree with you on that and have been one of the pushers for that.

Mr. Wells, let me ask you this question. There have been several questions regarding corporate integration and retirement plans and small businesses. Would you like to comment on anything like that?

Mr. WELLS. Okay. From my perspective, this is not a disadvantage to anyone, is the way you ought to think about it. When you take a distortion away from a group of taxable shareholders and you make them not suffer a double tax, then those who are benefitted under current law because they don't suffer from that double tax distortion are not disadvantaged. The reform is simply removing a double tax distortion that makes taxable shareholders less efficient. It is only in that sense that tax-exempts can say that the reform proposal is a relative disadvantage to them.

I think what this committee ought to understand—and I think the corporate inversion phenomenon is getting us to understand—is the following: if we allow one group the opportunity to erode the corporate tax base as a subsidy, whether that is an inbound earnings stripping advantage, whether that is this particular technique, then the result will be a source of market inefficiency going forward.

I think what is a better system—a thoughtful system that this committee ought to adopt—is to collect one level of tax on active business income. When the dividends paid deduction regime imposes the 35-percent withholding tax, it is only because the tax system has given a dividend deduction that eliminated the corporate tax. There is not a net increase. With the 35-percent withholding tax, all we are saying is that we want to preserve the corporate tax base to be taxed once at the shareholder level.

Senator Hatch, I will conclude by saying this: if you tell me the one person who can get a dividend under the dividend reduction regime without a corresponding withholding tax, I will tell you to whom everyone in the market will sell their stock the day before the deductible dividend is paid, and then from whom everyone will buy the stock back from that preferred person the day after the deductible dividend has been paid. That person will be the source of eroding the corporate tax base.

From a tax policy perspective, I think this committee needs to say that we need to preserve one level of efficient tax on active business income. Having that active business income taxed at the shareholder level assures individual progressivity. That is a wonderful goal.

If we take the distortions out of who the owner is, whether that is a foreign-based multinational or a pension or the others, that creates the tax symmetry that I think the system needs.

The CHAIRMAN. It seems to me corporate integration helps us to get there.

Mr. WELLS. It absolutely is the vehicle to get there, whether it is the dividends paid deduction regime or other forms of integration, but I think it is absolutely a wonderful first step. The committee is to be commended for thinking through it.

The CHAIRMAN. Thank you.

Mr. Graetz, in your written testimony you note that, with respect to tax-exempt shareholders and debtholders, "The approach of the ALI report was to subject these entities to a tax on investment income. 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."

Now 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. Now, some have suggested that under a corporate integration proposal, tax-exempts would bear the same tax burden on corporate earnings as taxable shareholders and bondholders. Would a modest tax on the investment income of tax-exempts alleviate such concerns?

Mr. GRAETZ. Mr. Chairman, I actually think it would. Just to be clear about this, at least as I understand Ms. Miller's testimony, the way in which dividends would be treated under integration would be the same for these retirement funds and tax-exempts as under current law. They are paying the corporate level tax, and the same would be true of retained earnings.

I think what is pressing the numbers that she has given us—if I understand them—is interest withholding, where you are putting in a new tax that is now not paid by tax-exempt organizations or retirement funds, and that is the additional tax burden.

So the question that we asked at the Treasury and that the ALI asked was, at what rate are tax-exempts now taxed because they are paying tax at the corporate level on their ownership of corporate equity? We ran some estimates when I was at the Treasury—it was the early 1990s—and we concluded it was about 6 to 8 percent. That is as you said, what is their investment income? It is about a 6- to 8-percent tax.

It is now completely imposed on corporate equity. There is a zero tax on debt. If you put in a 6- or 7- or 8-percent tax—I do not know what the number would be today; you would have to ask the Joint Committee or the Treasury, but it is probably about the same. If you put in that kind of tax, you could then make the withholding refundable to tax-exempts and to lower-bracket taxpayers and not have the revenue costs. Now it would be an explicit tax on tax-exempts, so it may raise some political problems. We certainly thought there were some political problems at the Treasury.

But the goal was to equate debt and equity, treat them the same, without increasing the tax burden on tax-exempts. That was the goal. In order to do that, you either have to raise the tax on interest or lower the tax on dividends, or both. We concluded that doing it on an evenhanded basis, a 7- to 8-percent tax, and then allowing a refund of the credits would get you to about the same place as you are today for those taxpayers.

I think if you are really considering providing withholding on the interest side, this is certainly something that is worthy of consideration.

The CHAIRMAN. Thank you. This question is for Mr. Graetz and Mr. Rosenthal. But the other witnesses, if you care to, feel free to weigh in.

Would the dividends paid deduction coupled with a withholding tax simply make more transparent to tax-exempt entities the current corporate tax that they are bearing?

Mr. ROSENTHAL. I would say, yes, that if we had a dividends paid deduction with a nonrefundable withholding tax, that would make quite clear the tax that a tax-exempt such as a retirement fund or foreigner is paying.

I would just add that I agree with Professor Wells and Professor Graetz that if we collect one tax from taxable entities, we will inevitably disadvantage tax-exempts if we also tax them once, whereas today, we tax taxable entities twice and tax-exempts once. That is inevitable.

But I cannot see us move to a system in which business profits are not taxed at all. Our tax code is framed around collecting one level of tax on profits from a trade or business, and we make sure of collecting with our UBIT on the profits of a trade or the business of tax-exempts. We also tax the effectively connected income of a U.S. trade or business of foreigners. We make sure of that, by and large, with the way we tax capital gains.

So the notion of trying to exempt completely wide classes of taxpayers from any tax on a trade or business, I think would be a huge revenue loss and a mistake.

The CHAIRMAN. Mr. Graetz?

Mr. GRAETZ. I basically agree with what Mr. Rosenthal has said. I think that the question is—as I said earlier—at what rate are we now taxing tax-exempts? We are taxing them on the retained earnings and the dividends that are paid by corporations when they invest in equity.

I do think there are some questions about what would happen to dividend payments. Ms. Miller has raised them, and we talk about them in our testimonies. I talk about them in my testimony—what would happen to interest rates, especially corporate interest rates which are subject to withholding, and whether those rates would have to go up. Ms. Miller, I think, assumes in her examples that interest rates are the same as they now are for corporations and that they would not go up.

But I think if there is going to be this kind of withholding, in order to sell bonds, interest rates are going to have to go up in some manner. So I think that there are issues here. But I basically agree with Mr. Rosenthal.

The CHAIRMAN. Thank you.

Senator Cardin, I will turn to you.

Senator CARDIN. Well, thank you, Mr. Chairman. Thank you for continuing the questions so I could get back into the committee room. I appreciate it.

Let me thank the entire panel. I did hear your testimony. I am ranking member on Senate Foreign Relations, which is meeting at the same time. So I apologize for not being here for the entire hearing. I appreciate all of your testimony.

Ms. Miller, you raised some very important points on retirement issues. We have been working a long time to make sure our tax code, at a minimum, does not hurt the current incentives that we have for retirement savings, considering we still do not have enough retirement security in this country.

We would certainly like to do better, but we do not want to do worse. I think your point about corporate integration and how it impacts the incentives for retirement savings is a point that needs to be taken into consideration.

The easiest way to deal with that is to follow Professor Graetz's point of changing the reliance on our revenues from income to consumption, at least doing that in a more balanced way. I guess my first question, Professor Graetz, would be that, if we get corporate tax rates to a level that you are suggesting, which is, I think, 10 percent or somewhere on that level, or legislation that I filed which gets it down to 17 percent, and you get the individual rates down by at least 10, 11, 12 points, we really do not run into the same problems of discriminating how business sets up its tax structure, because the tax rates become much less significant.

Mr. GRAETZ. Senator Cardin, as you know, I agree entirely with your proposal and with the direction that you are going. Frankly, I do not think there is any other solution to the problem we now have. The British have now announced that they are moving their corporate rate down to 17 percent. I have suggested 15 percent.

We are now taxing earnings domestically at the 35-percent rate in many cases, and we are taxing, at least, equity-financed investment in the U.S., and we are now taxing foreign earnings at a very low rate. This makes absolutely no sense, because we have created an incentive for U.S. companies to invest abroad rather than domestically, and we have inhibited our ability to attract foreign investment with a high corporate tax rate. The evidence is increasing that a greater and greater share of the corporate tax is being borne by labor because capital is so mobile in the current economy. So it is not as progressive as taxing the shareholders directly on their earnings, on their dividends, on their interest, on their capital gains, and so forth.

So, I think this is the only solution that is a solution to fix our current system. I think it is worth saying, just given the nature of this hearing, that integration of the sort that is being discussed here is compatible with a lower-rate corporate tax. In the same way, you would have a lower-rate withholding tax if you lowered the corporate rates.

So there is nothing that is incompatible with doing integration and moving to a lower tax rate, but as I said—I think while you were in the Foreign Relations Committee—integration is not penicillin and it is not going to solve our problems.

Senator CARDIN. I agree. I think you are absolutely correct in that the only way you are going to deal with this is through some type of proposal that we are suggesting. You are not going to solve it otherwise. We will move the chairs around the deck a little bit, but we are not going to really deal with the fundamental problems.

Ms. Miller, did you want to comment more on the retirement aspect of this?

Ms. MILLER. Thank you. I mentioned earlier that the issue is really with interest and not with dividends, and it is actually with dividends to the extent that there is double taxation of dividends now because we are talking about a relative advantage to investing in a qualified retirement plan over investing outside the plan. So to the extent that somebody outside the plan is paying that second

level of tax and now they will only be paying one, they have bumped up. You have given an advantage to investing outside the plan. So the issue is both dividends and interest. So it is really on both sides.

Senator CARDIN. I just really want to throw one thing out, Mr. Chairman, that I do not think has been mentioned yet, and that is, as we look at these proposals, we also have to look at the impact they have on tax credits that we currently have in law. I have been a strong proponent of the New Market Tax Credits. Their value will change under this proposal. What impact does it have on those, and historic tax credits?

I think those issues need to be understood, the impact they would have. In trying to reform our current tax structure in an important way, but a modest way on the overall structure, and in a way that has an impact on incentives that may be unintended, I think we need to understand those issues.

Mr. Wells, I see you are very anxious to reply.

Mr. WELLS. I am. I just want to—what I would urge you to also consider is that, if you drop the tax rate to 15 percent, you should consider that high net wealth individuals are not going to earn active business income outside of the C corporation at substantially higher individual tax rates. So we will have laborers paying individual taxes at a high rate, and corporations paying taxes at a 15-percent rate.

The wonder of this proposal, this integration regime, is it gets us a zero corporate rate as to distributed corporate earnings, and it gets that income at the shareholder level to pay tax at a progressive individual rate schedule. So if you really want to get to a zero corporate tax result, I think corporate integration does that.

Senator CARDIN. If you use the model that we are using, there will be an individual tax as the money is taken out of the C corporations.

Mr. WELLS. But I will not do that until I die, and my stock goes—

Senator CARDIN. Not necessarily. It depends on the type of structure that you have, and that is why most people in that circumstance have used pass-through entities rather than using the C corporation. So I think it really argues against your point. The point is that, if you are a large company, you are organized as a C, and you are not the one holding the wealth in the company because your impact is much smaller. If you are a small company, you are more likely to be holding wealth, but you are using it through pass-through entities, by and large. So you are already paying the individual rate.

So I do not see the lower corporate rate—and again, the difference between the C rate and the pass-through individual rates in the models that we are using is about the same as it is today. So we really are not changing the equation of an individual deciding whether to use a pass-through entity or using C rates.

I do not quite follow your point, but I appreciate that exchange.

The CHAIRMAN. Thank you, Senator.

Let me just ask you—this is a question for each of you, and it can be answered “yes” or “no,” I believe. Do you agree that there

would be a behavioral response to a dividends paid deduction? I will start with you, Mr. Graetz.

Mr. GRAETZ. All right. Yes, if you want a "yes" or "no" answer.

The CHAIRMAN. Well, if you want to add more, that is fine with me.

Mr. GRAETZ. Well, I think it does reduce the burden for repatriations, which is an important point, because you get to deduct the dividends at the corporate level. I think it would, perhaps, increase the distribution of earnings as dividends. It would certainly increase the distribution of earnings as dividends versus share repurchases, which are now favored. So it would certainly change that balance, and one would hope that it would change the debt-equity balance, which of course, is one of the important reasons to go forward.

So I think it would reduce all of the distortions that you began this hearing with and also have some international advantages. It would not eliminate all of these problems, but it would certainly make them less important.

The CHAIRMAN. Well, I am not bringing up corporate integration as a cure-all of all problems, but I bring it up as something that would put us in the right direction and solve a number of problems, and then we could work on the rest of them as we go along. Ms. Miller, what do you think about that?

Ms. MILLER. I think there definitely would be problems. As I have said, my concern is that it be structured such that it is not a negative behavioral change.

The CHAIRMAN. Sure. Okay.

Mr. ROSENTHAL. Yes, Mr. Chairman, there would be a big change to our tax system, and we could expect behavioral consequences. I would worry about unintended consequences. For instance, if the committee goes down the path of having a nonrefundable withholding tax so that tax-exempts, in effect, bear a U.S. tax on corporate income but perhaps avoid a foreign tax on corporate income or a U.S. tax by moving the corporation abroad to a tax haven, you might see more inversions depending on the structures that are pursued.

So we have to be careful in the way we change our rules, because there are various issues that could pop up.

The CHAIRMAN. Okay. Mr. Wells?

Mr. WELLS. Yes, I think there would be a definite response. I think that the parity this committee is attempting to achieve is wonderful and would be a good avenue for corporate tax reform.

I think where the real difficulty will be, Chairman Hatch, will be the earnings stripping, the deductions we can get at the corporate level, where the income goes to someone who is not taxable on that income, and if we need to protect the corporate tax base to one level of tax, that is where the complexity is going to be.

What I would urge you to consider is that, as soon as you let one avenue of those profits be deducted and paid to someone without a comparable withholding or surtax, then you have created a market distortion. But I agree, this is a step towards correcting systemic distortions that the current system has.

The CHAIRMAN. Am I correct in believing that there would be appreciatively more dividends under a DPD system with withholding?



Mr. GRAETZ. I would assume that the companies would increase their dividends, to some extent at least, to gross up the benefit of the dividend deduction. I think there you would certainly see a substitution of dividend payments for share repurchases, which I think is a very important beneficial step given the current advantages for nondividend distributions over dividend distributions.

The CHAIRMAN. It seems to me that every company would want to get their shareholders to reinvest those dividends in the company, which would help the company to expand or, at least, do much better than it, perhaps, had been doing. At least, that is one of the goals that we would have, I would think, with this program.

Mr. GRAETZ. Both the Treasury Department and the ALI proposals had a reinvestment option in them, which both Professor Warren and I thought was a useful and important piece of the proposal.

The CHAIRMAN. Let me ask you just another question, Mr. Graetz. In your written testimony you note that, "A deduction for dividends and 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."

Now as you know, erosion of the U.S. tax base is a significant concern, as are corporate inversions. Could you elaborate on your statement that a dividends paid deduction could address both base erosion and inversions?

Mr. GRAETZ. Well, Mr. Chairman, with regard to base erosion, I would cite the experience in Australia, where Australia has had very good success in its integration system because, in order to be eligible for the integration system, you have to pay domestic taxes. It sort of puts a floor on the domestic tax that has been paid.

There is also an empirical study by Dan Amiram and some colleagues at the Columbia Business School in which he investigates both the European experience and the Australian experience, and he found that base erosion increased after the repeal of integration systems in Europe, which was due to a series of decisions by the European Court of Justice at the time. He found that the Australian system does protect against base erosion.

When I was in Australia last winter, I spoke to people at the Treasury and in the business community who all agreed that the Australian companies, at least, were much less likely to look to shifting their taxes and income abroad because of the integration system. In Australia, this is referred to as an integrity benefit. I think it is real.

It would also, I think, help with the inversion problem. Although again, I do not think it is a complete solution to either of these problems, but it would help with the inversion problem, because U.S. companies paying U.S. dividends to U.S. shareholders would be able to pay considerably more dividends under more advantageous circumstances than foreign companies. And by eliminating the barrier on repatriating for those companies that distribute their earnings, that also takes some of the pressure off of inversions.

As long as foreign rates are dramatically lower than U.S. rates and as long as other countries have a territorial system and looser

Controlled Foreign Company or subpart F rules than we do, there are going to continue to be advantages for foreign parents over domestic parents, however.

The CHAIRMAN. Well, thank you. I want to thank our fantastic panel of witnesses for appearing here today.

Professors Graetz and Wells, I think you made compelling cases for taking the next steps on exploring corporate integration.

Ms. Miller, thank you for pointing out some important design issues with respect to the impact of corporate integration on retirement plans.

Mr. Rosenthal, I want to thank you and the Tax Policy Center for all of your research on domestic corporate stock ownership trends. That has been very important. Your research is very informative.

My take is, it shows that investors and management are voting with their feet. The double tax burden is driving taxable shareholders away from corporate shares. It is driving management towards debt financing. Once more, it shows the premium put on transactions to minimize exposure to U.S. corporate tax, like corporate inversions.

I take it TPC would agree with the Treasury Department, the Joint Committee on Taxation, and the Congressional Budget Office that driving economic activity towards debt financing and other techniques to minimize the corporate tax would lead to more distortions. More distortions mean less growth, fewer jobs, and loss of the U.S. tax base.

I also want to thank my colleagues for their participation as well. I think we can all agree here today that the system needs to be changed.

I hope that my colleagues on both sides of the aisle will work with me to ensure that my proposed changes take as many perspectives into account as possible. The more I get to hear from each of you, the better my proposal will likely be. Now, it is up to each of us to try to get the system right for the first time since World War II.

Now, let me just say that this may be a small step, but it is a step that would be pretty impressive over the long run if we could actually get both sides to agree to work together to get this done. If anything, this committee has shown that we can do a lot of bipartisan work together.

Last year, we passed 37 bipartisan bills out of this committee. Most of them are law today. Some are being made law this year. This year we have had a pretty impressive year as well.

I just hope we can all work together in the best interest of our country. Clearly, we are not going to be able to do comprehensive tax reform this year. I would love to do it, but there is no way that I think with the current makeup of Congress we are going to be able to do that, as complex as that would be. It took 3 years last time. I do not think it needs to take 3 years, but I think if we could do something like corporate integration, that would let people know that we are making headway, that we are moving forward, that true tax reform is something that is not only a possibility, but a probability.

To that extent, I think your testimonies here today have really been helpful to the committee, and certainly to me. So I want to thank you for being here and tell you I appreciate each one of you making the effort to be here. I hope you will continue to enlighten the committee as much as you can, because I think we can do some really great work together if we can just get rid of all of the partisan crap around here and work together as people who love to do bipartisan work.

Thank you so much. With that, let me just say that we will recess this committee until further notice, but we will ask that any questions for the record be submitted by Tuesday, May 31, 2016.

With that, the hearing is adjourned. Thanks so much.  
[Whereupon, at 11:55 p.m., the hearing was concluded.]



## APPENDIX

### ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

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PREPARED STATEMENT OF MICHAEL J. GRAETZ, WILBUR H. FRIEDMAN PROFESSOR OF TAX LAW AND COLUMBIA ALUMNI PROFESSOR OF TAX LAW, COLUMBIA UNIVERSITY

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.<sup>1</sup> I have been involved with the issue of corporate-shareholder integration for 25 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.
- 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.

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

- 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 2 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 25 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.<sup>2</sup> 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.

<sup>2</sup>Internal Revenue Code section 1(h)(11).

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 and 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.

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 and 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.<sup>3</sup>

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.

<sup>3</sup>For the Treasury report's discussion, see U.S. Treasury (1992a), in Graetz and Warren (2014b) at Amazon Location 1771.

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.<sup>4</sup> 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).

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,<sup>5</sup> and from 35% to 54.5% for foreign shareholders.<sup>6</sup> 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

<sup>4</sup>See, for example, Liu and Altshuler (2013), Cronin et al. (2013), and Altshuler, Harris, and Toder (2010).

<sup>5</sup>Thirty-five percent plus 23% tax on \$65 dividend equals 54.47%.

<sup>6</sup>Thirty-five percent 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 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 United States in the past, corporate managers have been unenthusiastic—in part because integration proposals have largely benefited only distributed earnings.<sup>7</sup> 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 share-

<sup>7</sup>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 and Warren (2014b) at Amazon Location 3273 and Warren(1993), in Graetz and 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).

holder-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.

**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>U.S. 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 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
<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	\$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%
<b>U.S. SHAREHOLDER</b>			
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
<b>COMBINED CORPORATE AND SHAREHOLDER TAXES</b>			
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 as 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.<sup>8</sup> By requiring that withholding applies to every dividend distribution, the proposal under discussion in the Senate Finance Committee reaches a similar result.<sup>9</sup> The major dis-

<sup>8</sup>A subsequent version of a dividend exclusion proposed by Treasury includes some pass-through of corporate preferences (U.S. Treasury, 1992b).

<sup>9</sup>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.

advantage 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.<sup>10</sup> It is sometimes 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.<sup>11</sup>

#### *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).<sup>12</sup> 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).

<sup>10</sup> 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 and Warren (2014b) at Amazon Location 10309.

<sup>11</sup> For an overview of the proposal including the DRIP option, see Burman and Rohaly (2003).

<sup>12</sup> For more, see the discussion in Part 6, Proposal 9 in Warren (1993), and in Graetz and 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.<sup>13</sup> 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 United States. 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.<sup>14</sup> 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 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.<sup>15</sup>

<sup>13</sup> See Part 7 in Warren (1993), available in Graetz and Warren (2014b) at Amazon Location 10959.

<sup>14</sup> See the discussion in Chapter 7 in U.S. Treasury (1992a), in Graetz and Warren (2014b) at Amazon Location 2853.

<sup>15</sup> 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).

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 United States 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 and 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 non-corporate 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.<sup>16</sup> 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 dividends taxed at ordinary income rates and the capital gains preference retained for repurchases.<sup>17</sup>

#### *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

<sup>16</sup> See Part 4, Proposal 7 in Warren (1993), in Graetz and Warren (2014b) at Amazon Location 10667.

<sup>17</sup> We are indebted to Peter Merrill for this point.

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.<sup>18</sup> 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 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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<sup>18</sup> 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).



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PREPARED STATEMENT OF HON. ORRIN G. HATCH,  
A U.S. SENATOR FROM UTAH

WASHINGTON—Senate Finance Committee Chairman Orrin Hatch (R-Utah) today delivered the following opening statement at a hearing to examine corporate integration, and specifically, how allowing corporations to deduct dividends could create a more efficient and fairer system of taxation of corporate profits:

I'd like to welcome everyone here this morning.

Even a cursory examination of the business tax system demonstrates clearly the problems that arise from our out-of-step corporate tax, which contributes significantly to our anti-competitive business climate and leads sophisticated tax planners to engage in costly efforts—which some would call gamesmanship or tax avoidance—to either minimize their taxes or manage competitive tax pressures from abroad. Without significant reforms to the corporate tax system, we will continue to see an erosion in our overall tax base along with diminished growth and investment.

Among the most significant—and inexplicable—inefficiencies in our business tax system is the fact that a significant portion of U.S. business income is taxed more than once. Under the current system, income earned only once by corporations—on behalf of its shareholders—is taxed twice, thanks to a fiction created in the law that treats a business and its owners as two separate, taxable entities.

Specifically, when a corporation turns a profit, those earnings are taxed under the corporate income tax system, generally at a rate of 35 percent. When the corporation distributes a portion of those earnings to its shareholders in the form of dividends, we tax those earnings a second time at the individual level, with a maximum dividend tax rate approaching 25 percent. This, put simply, is a problem.

We have this problem, in large part, due to the fact that rules for taxing corporations were written without taking into account the rules for taxing individuals, and vice versa. A better, more efficient system would be one that integrated the taxation of corporate and individual income.

That's what we're here to discuss today.

The current system of double taxation has resulted in a number of unintended economic distortions that wouldn't exist under a more integrated system. I'll discuss just a few of those distortions here this morning.

For example, the current system creates a bias in the choice of business entity, disfavoring the corporate model versus others. Of course, businesses—small and start-up businesses in particular—should have the flexibility to determine how to organize themselves. But, our tax code shouldn't punish *any* particular business with double taxation simply because it was organized a certain way.

Double taxation also discourages savings and investment and is a major factor in our current domestic savings and investment shortage. Savings and investment are essential to capital formation, increased job productivity, wage growth, and adequate retirement savings. Yet, we've created a system that essentially punishes those who save and invest.

In addition, the current system explicitly favors debt-financed investment over equity-financed investment. In the United States, corporations can deduct interest paid to bond holders, but no similar deduction exists for dividends paid to stockholders. Now, in some situations, there may be strong reasons for a company to opt for debt-financing, but there is no real reason why the tax code should favor debt over equity.

Double taxation also contributes to the problem of lock-out; that is, it discourages businesses from bringing income earned overseas back into the U.S. As many have already noted, with the highest corporate tax rate in the developed world, American multinational companies are often loath to repatriate their foreign earnings and subject them to U.S. taxes on top of the taxes they've already paid in foreign jurisdictions. And, their shareholders rarely demand that they do so, because those earnings will be taxed again if and when they are ever paid out as dividends. As a result, experts estimate that U.S. corporations have over \$2 trillion in earnings that are locked out of the United States due, in large part, to our tax system.

These problems—and there are many others—have been observed for years. And, as a result, many have argued for the elimination of double taxation and in favor of integrating the individual and corporate tax systems. We're going to continue that discussion here today.

In any discussion of an integrated system, the fundamental design choice that has to be made is whether the single instance of taxation should fall on the corporation or the shareholders. Given the substantial burdens our corporate tax system already imposes on U.S. businesses, coupled with the relatively high mobility of corporate residence in the age of globalization, as illustrated by the recent wave of inversions and foreign takeovers, some have questioned the wisdom of collecting the tax on the corporation side.

Another method of integrating the two systems would be to impose a single layer of tax at the shareholder level by allowing companies to deduct any dividends they pay out. As I see it, there are a number of benefits to this approach. I'll mention just a few.

First, a deduction for dividends paid would allow businesses to cut their own effective tax rates. There is bipartisan agreement on the need to bring down corporate tax rates. A dividends paid deduction could accomplish the same goal without many of the trade-offs associated with a reduction in the statutory tax rate.

Second, this type of deduction would create greater parity between debt and equity. As I noted earlier, current law generally allows corporations to deduct earnings paid out as interest on debt obligations. A dividends paid deduction would provide similar tax treatment for earnings paid out as dividends to investors, allowing companies to make debt-vs.-equity decisions after considering market conditions instead of simply referencing biases in the tax code.

Third, a dividends paid deduction could help with some of our international tax problems by reducing the pressure on companies to invert and greatly reducing the lock-out effect.

To hopefully take advantage of these and other benefits, I've been working for over a year now on a tax reform proposal that would eliminate double taxation of corporate income by providing this type of deduction. While I plan to unveil that proposal here in the next several weeks, I'm hoping we can inform this ongoing ef-

fort by having a more detailed discussion of these concepts and others during the course of today's hearing.

Before I conclude, I want to acknowledge that some groups—including tax-exempt entities and retirement plans—may have some concerns with a dividends paid deduction. However, at the end of the day, I believe we can craft a system where these parties will be treated in a manner that is comparable to current law or, in fact, in many cases, be better off. And at the same time, our overall tax system will, in the opinion of many, be very much improved.

Still, I want everyone to know that, as I am preparing my integration proposal, I am aware of the concerns that these and other groups might raise and I am studying them very closely. Today, and going forward, we seek your comments and suggestions.

With that, I just want to say that I appreciate this fine panel of witnesses being here today, sharing their knowledge and expertise with the committee. I think this is going to be a very informative hearing.

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PREPARED STATEMENT OF JUDY A. MILLER, DIRECTOR OF RETIREMENT POLICY FOR THE AMERICAN RETIREMENT ASSOCIATION AND EXECUTIVE DIRECTOR OF THE AMERICAN SOCIETY OF PENSION PROFESSIONALS AND ACTUARIES, COLLEGE OF PENSION ACTUARIES

The American Retirement Association (“ARA”) thanks Chairman Hatch, Ranking Member Wyden, and the other members of the Senate Finance Committee for the opportunity to testify regarding the impact of corporate integration on small business qualified retirement plans.

The ARA is an organization of more than 20,000 members nationwide who provide consulting and administrative services to retirement plans that cover millions of American workers and retirees. ARA members are a diverse group of retirement plan professionals of all disciplines, including financial advisers, consultants, administrators, actuaries, accountants, and attorneys. The ARA is the coordinating entity for its four underlying affiliate organizations, the American Society of Pension Professionals and Actuaries (“ASPPA”), the National Association of Plan Advisors (“NAPA”), the National Tax-deferred Savings Association (“NTSA”) and the ASPPA College of Pension Actuaries (“ACOPA”). ARA members are diverse but united in a common dedication to America's private retirement system.

A workplace retirement plan is the single most important factor that determines whether or not workers accumulate significant savings for retirement. Data from the Employee Benefits Research Institute shows that workers earning between \$30,000 and \$50,000 per year are *15 times* more likely to save at work than to go out and set up an IRA to save on their own. Because moderate income earners almost exclusively save at work through plans like the 401(k)—the most widely known section of the tax code—it is not surprising that Internal Revenue Service data shows that nearly 80% of participants in 401(k) and other profit sharing plans make less than \$100,000 per year, and 43% of participants in these plans make less than \$50,000 per year. Simply stated, saving at work, works. That is why it is so critical that businesses, especially small businesses, be encouraged to maintain workplace retirement plans.

The tax incentives for employer-sponsored plans in place today do an efficient and effective job in allowing Americans across the income spectrum to build a secure retirement. These incentives play a critical role in encouraging small business owners to establish and maintain a qualified retirement plan. Nondiscrimination rules combined with compensation and contribution limits assure that non-highly compensated employees also benefit from these programs. Proposals such as corporate integration that would reduce the incentives for small business owners to save for themselves through a qualified retirement plan will discourage the establishment and maintenance of these retirement plans, and so reduce the availability of workplace retirement savings.

#### BACKGROUND

*What are the current tax incentives?*

Employer contributions made to qualified retirement plans are deductible to the employer when made. Income tax on investment earnings on those contributions is deferred until amounts are distributed from the plan. When a distribution is made

to a plan participant, all amounts are subject to ordinary income tax. Employer contributions made on a participant's behalf are not subject to FICA. In addition, individuals with adjusted gross income ("AGI") of less than \$30,750, and married couples with AGI of less than \$61,500, may qualify for a Saver's Credit ranging from 10% to 50% of the first \$2,000 the individual contributes to an IRA or employer-sponsored defined contribution plan.

Limits are placed on contributions to defined contribution plans, and on benefits payable from defined benefit plans:

- Certain defined contribution plans permit employees to contribute on their own behalf by electing to have a certain dollar amount or percentage of compensation withheld from pay and deposited to the plan. These "elective deferrals" are excludable from income for income tax purposes, but FICA is paid on the amounts by both the employer and the employee. For 2016, the maximum elective deferral to a 401(k) or similar plan is \$18,000. Employees age 50 or over can also make a "catch-up contribution" of up to \$6,000. Elective deferrals to a SIMPLE plan are limited to \$12,500, plus a \$3,000 catch-up contribution for those age 50 or over.
- If the employer also contributes to a defined contribution plan (such as a 401(k) plan), the maximum contribution for any employee is \$53,000. This limit includes any elective deferrals other than catch-up contributions. This means a participant that is age 50 or over, and who makes the full \$6,000 catch-up contribution, would have a total limit of \$59,000.
- The maximum annual benefit payable from a defined benefit plan cannot exceed the lesser of the average of 3 year's pay or \$210,000. If retirement is before age 62, the dollar limit is reduced. Employers can deduct the amount required to fund promised benefits.
- Annual IRA contributions are limited to \$5,500, plus "catch-up" contributions of \$1,000 for those age 50 or over.

Compensation in excess of \$265,000 cannot be considered in calculating contributions or in applying nondiscrimination rules under either defined benefit or defined contribution plans. For example, if a business owner makes \$400,000, and the plan provides a dollar for dollar match on the first 3% of pay the participant elects to contribute to the plan, the match for the owner is 3% of \$265,000, not 3% of \$400,000.

*What are the current nondiscrimination rules?*

The higher contribution limits for qualified retirement plans—both defined contribution and defined benefit plans—come with coverage and non-discrimination requirements. For example, a small business owner with several employees cannot simply put in a defined contribution plan and contribute \$53,000 to his or her account. Other employees who have attained age 21 and completed 1 year of service with at least 1,000 hours of work must be taken into consideration, and the employer must be able to demonstrate that benefits provided under the plan do not discriminate in favor of "Highly Compensated Employees" ("HCEs"), which would include the owner.

Generally, contributions or benefits that are proportionate to an individual's compensation are considered fair. Age can also be considered when determining the amount of contributions that can be made on a participant's behalf. A larger contribution (as a percentage of pay) can be made for older employees because the contribution will have less time to earn investment income before the worker reaches retirement age (usually age 65). Safe harbors are also available. For example, if all employees covered by a 401(k) plan are provided with a contribution of 3% of pay that is fully vested, the HCE can make the maximum elective deferral, regardless of how much other employees choose to contribute on their own behalf.

These nondiscrimination rules, coupled with the limit on compensation that can be considered under these arrangements, are designed to ensure that qualified employer-sponsored retirement plans do not discriminate in favor of HCEs. *Nondiscrimination rules do not apply to other forms of tax-favored retirement savings.* For example:

- IRAs share the incentive of tax deferral. However, if a small business owner makes a personal contribution to an IRA, there is no corresponding obligation to contribute to other employees' IRAs. However, under the current rules, the contribution limit for IRAs is set low enough (and the limit for employer-sponsored plans high enough) to make a qualified retirement plan attractive to a business owner who can afford it.

- Annuities purchased outside of a qualified plan share the benefit of “inside buildup”—the deferral of income tax on investment earnings until distributed from the arrangement—but have no limit on contributions or benefits, and no non-discrimination requirements.

*This means the attraction of a qualified retirement plan for a small business owner is heavily dependent on the interaction of non-discrimination rules and the tax incentives for saving through a qualified retirement plan.*

#### CORPORATE INTEGRATION

For purposes of this discussion, we consider a corporate integration proposal under which mandatory 35% withholding would apply to dividends and interest paid on all domestic stocks and bonds, regardless of the tax status of the holder of the securities. Taxpayers with a marginal tax rate of less than 35% would not be able to recover any portion of the withholding.

*How would corporate integration affect the tax incentives for qualified retirement plans?*

The tax incentive for saving through a qualified retirement plan is the deferral of income tax on the contributions made to the plan, and on investment earnings on those contributions, for so long as the funds are held in trust by the plan. Distributions from the plan are then included in ordinary income when payments are made from the plan, usually when the plan participant has retired. Corporate integration would result in taxation of dividends and interest earned by the plan's investments while held in the plan, with the contributions and remaining investment earnings taxed again when the amounts are withdrawn from the plan. The result would be a substantial reduction in the tax incentive to save through a qualified retirement plan relative to current law.

For example, consider a small business owner with \$10,000 to contribute to a traditional account in a 401(k) plan. Assume the contribution earns a 5% annual rate of investment return. The initial investment is 50% stocks and 50% bonds, with dividends and interest reinvested in the same type of security. Under current law, the contribution and investment earnings will accumulate tax free until the employee terminates employment and begins to withdraw the account balance. If the accumulation period is 10 years, the account balance attributable to that contribution will have grown to \$16,289. In 20 years, the balance would be \$26,533. Income tax will be paid upon withdrawal. Assuming a marginal rate of 28%, the after-tax balance attributable to that contribution would be \$11,728 after 10 years and \$19,104 after 20 years.

If the business owner chose not to contribute the \$10,000 to the 401(k) plan, but invested the after-tax amount outside of a plan, the initial investment would be \$7,200 (\$10,000 less \$2,800 income tax). Dividends received would be taxed at a 15% rate, and interest at 28%, so the net rate of return on stocks would be 4.25%, and 3.6% on bonds. The balance after 10 years would be \$10,586, which is \$1,142 less than the after-tax 401(k) plan amount. The balance after 20 years would be \$15,579, which is \$3,535 less than the after-tax amount from the 401(k) plan after 20 years. In other words, assuming 5% rates of return, the business owner would gain 22.6% over 20 years by investing in the 401(k) plan.

Now assume a corporate integration proposal with mandatory 35% withholding is adopted. Instead of earning 5% per year, net investment return on the amount invested in the 401(k) plan is only 3.25% (65% of 5%). After 10 years with 3.25% rates of return, the \$10,000 contribution would accumulate to \$13,769. After 20 years, the balance would be \$18,958. Income tax will still be paid upon withdrawal. Assuming a marginal rate of 28%, the after-tax balance attributable to that contribution would be \$9,914 after 10 years and \$13,650 after 20 years.

In other words, corporate integration will have reduced the value of a retirement contribution by 15% after 10 years, and 27% after 20 years. In fact, *corporate integration without recovery of amounts withheld on dividends and interest paid to a qualified retirement plan's trust effectively eliminates the tax incentive for saving through a qualified retirement plan to the extent investment earnings are attributable to dividends and interest.* Assume the \$10,000 is not contributed to a 401(k) plan. Income tax at the 28% rate would be paid on that amount, leaving \$7,200 to be invested. After 10 years with a net investment earnings rate of 3.25%, the \$7,200 would accumulate to \$9,914—the same as the after-tax accumulation in the 401(k) plan. After 20 years, the accumulation outside the plan would be \$13,650—same as the 401(k) plan. Amounts invested outside of a qualified retirement plan are not

subject to the restriction for accessing monies in a 401(k) or similar account, so without the tax incentive, investing outside of the 401(k) plan could be more attractive than contributing to the plan.

In theory, with corporate integration, dividends could be grossed up to reflect that the corporation no longer has to pay income tax on the dividends. If that were true, the net dividend paid with corporate integration would equal amount of dividend that would have been paid under current law. Assuming this is true, the accumulated balance attributable to the \$10,000 contribution to the 401(k) plan would be \$15,029 after 10 years and \$22,746 after 20 years. Assuming a 28% rate, the after-tax amounts would be \$10,821 and \$16,377 respectively. The reduction in the value of the contribution as compared to current law would be 7% after 10 years and 14% after 20 years. However, *the tax incentive for saving through a 401(k) plan instead of outside of the plan would still be eliminated.* An investment of \$7,200 outside of the plan would also yield \$10,821 after 10 years and \$16,377 after 20 years.

For simplicity, these examples assume all investment earnings are comprised of interest and dividends on domestic securities. To the extent investment earnings include capital gains, the impact would be lessened.

*How would the reduced tax incentive affect small business retirement plans?*

The current tax incentives play a critical role in encouraging small business owners to establish and maintain a qualified retirement plan. Because of the nondiscrimination rules, a business owner can only save through the plan if other employees are also benefitting. As a result, a decision to establish and maintain a plan such as a 401(k) plan not only involves taking on fiduciary responsibilities and administrative costs, but often the cost of making contributions for the non-highly compensated employees who participate in the plan. For example, very small employers are often “top heavy,” and are required to make contributions of 3% of pay for all eligible non-key employees—whether or not the employees contribute on their own behalf. Other small business owners contribute 3% of pay to satisfy a 401(k) nondiscrimination testing safe harbor. Still others contribute 5% of more to be eligible to apply other nondiscrimination testing approaches. The cost of these contributions can be significant, and the availability of the tax incentives to offset all or part of the cost is critical to the decision to maintain a qualified retirement plan.

Consider the following situation:

ABC Company has been in operation for 5 years. The owner has some retirement savings in an IRA, but has never taken time to think about retirement. The business has five other employees earning from \$35,000 to \$75,000, with total payroll of \$300,000. The owner takes compensation of \$10,000 per month during the year, then takes a year-end bonus of the amount of company profits, which amount to \$65,000 for the current year. The owner will pay individual income taxes on the full amount of the profits at a marginal rate of 28%, leaving \$46,800 after paying taxes in the amount of \$18,200.

Before taking the bonus, the owner meets with a retirement plan consultant. The owner is older than most of the other workers, so the consultant recommends a safe harbor 401(k) plan with an additional “cross-tested” contribution. With this type of plan the owner could contribute \$50,000 of the profits to the plan on her own behalf. Thanks to the nondiscrimination rules that apply to qualified retirement plans, putting \$50,000 of the profits into the 401(k) plan for the owner means the owner must contribute at least 5% of pay for the employees, which is \$15,000. So, instead of taking home \$46,800 and sending IRS a check for \$18,200, the owner will contribute \$50,000 to the plan on her own behalf and \$15,000 for the employees. A tax credit for the cost of setting up and operating a new plan will help defray any startup and initial operating costs.

Under current law, the arrangement makes sense for the small business owner. Instead of sending a check to IRS, she can make a contribution of \$15,000 for her employees. The deferral of tax on investment earnings means the amount the owner will have accumulated in after-tax savings in 20 years is similar to what she would have if she paid taxes now on the \$65,000, and invested the remainder outside of the qualified plan. If the owner is in the 28% tax bracket at retirement, she will have about \$10,000 less from the plan than if she saved outside of the plan, but if she is in a lower tax bracket, she will come out ahead because she chose to set up and contribute to the plan. In short, both the owner and the employees are on the road toward a secure retirement.

How would this scenario change with corporate integration? The deduction for the contribution would still largely cover the costs of the contribution, but the longer-

term view would lead to a very different conversation. The owner would be advised that if she just paid tax on the \$65,000 now and invested the difference without setting up a plan, she would end up with significantly more savings 20 years from now than if she put in the plan, *even if she is down to a 15% marginal rate in retirement.* She would also have more flexibility by holding those savings outside of a qualified plan. If she put the money in a 401(k) plan and needed it before she reached retirement age, she would have to prove hardship, or even go through the formal process of terminating the plan, in order to get to her account. She would also have to pay a 10% penalty if she chose to withdraw it before retirement, death or disability. *In other words, with corporate integration the owner would have less expense, less liability, more flexibility and more long term savings by just saying "no" to setting up a 401(k) plan.*

The following table summarizes the 20-year projections of the value of the owner's contributions based on both 28% and 15% marginal rates at retirement. For purposes of this illustration, it was assumed that with corporate integration, dividends would be increased to absorb the 35% mandatory withholding. Note that if the owner is in the 28% bracket at retirement, under the proposal she could increase her savings by 30% by not sponsoring a 401(k) plan.

Table 1

	Invested amount	20-year balance	Net amount with marginal rate at retirement of	
			28%	15%
<b>Current law</b>				
401(k) plan	\$50,000	\$132,665	\$95,520	\$112,765
Nonqualified account	\$46,800	\$101,264	\$101,264	\$101,264
<b>Proposal</b>				
401(k) plan	\$50,000	\$113,728	\$81,884	\$96,670
Nonqualified account	\$46,800	\$106,450	\$106,450	\$106,450

The loss of deferral of income tax on dividends and interest with corporate integration would significantly reduce, and for more conservative investors even eliminate, the tax incentive for saving through a qualified retirement plan. Given the costs and obligations that come with sponsoring a qualified retirement plan, the result would be a reduction in the number of plans sponsored by small businesses, and a loss of coverage, and retirement security, for small business employees.

Small business employees would not be the only ones to suffer, however. The lack of deferral of income tax on dividends and interest will reduce the account balances of any participant whose account is invested in an asset that pays interest (or dividends to the extent dividends payable on the investments held by the plan do not increase sufficiently to cover the withholding), and do serious harm to the retirement security of American workers.

## SUMMARY

Access to a retirement plan at work is the key to successfully preparing for retirement. Reducing the tax incentives to save through a qualified retirement plan will discourage small business owners from establishing and maintaining qualified retirement plans, and so reduce the availability of workplace savings. A corporate integration proposal under which mandatory 35% withholding would apply to dividends and interest paid on all domestic stocks and bonds, regardless of the tax status of the holder of the securities, including securities held in qualified retirement plans would substantially reduce the tax incentives for these plans, and so discourage plan formation and maintenance.

We thank you for the opportunity to submit these comments. The ARA would be pleased to work with this Committee to assure the tax incentives for qualified retirement plans are maintained or enhanced as this or other proposals move forward.



PREPARED STATEMENT OF STEVEN M. ROSENTHAL,<sup>1</sup> SENIOR FELLOW,  
URBAN-BROOKINGS TAX POLICY CENTER, URBAN INSTITUTE

Chairman Hatch, Ranking Member Wyden, and members of the committee, thank you for inviting me to appear today to discuss integrating the corporate and individual tax systems.

In my testimony, I first describe how taxes on corporate earnings have dropped because of corporate moves to avoid taxes and because of shareholder shifts from taxable to nontaxable accounts. Both trends are important to thinking about corporate tax integration—particularly in the form of a dividends paid deduction. The shareholder shift is less obvious because the published data are hard to parse, leading even sophisticated analysts to overstate the taxable share of U.S. stock.

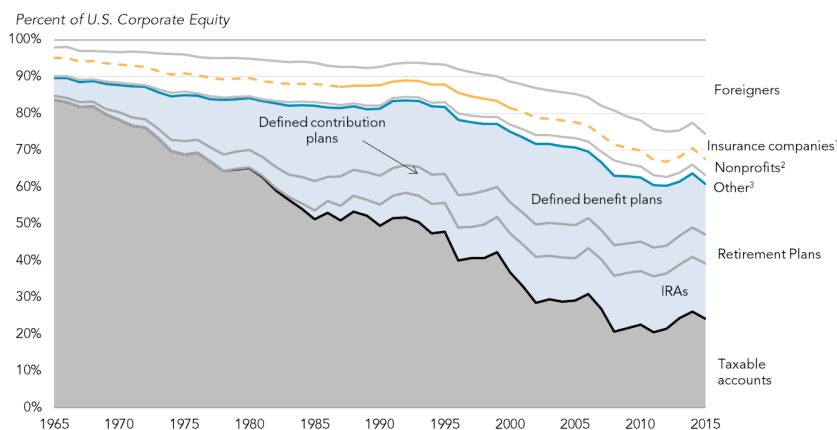
Second, I describe how a lower estimate of the taxable share of U.S. stock complicates attempts to integrate corporate and individual taxes further. Finally, I suggest some areas for further research on the competitiveness of U.S. corporate taxes.

U.S. STOCK OWNERSHIP TRENDS

The usual story we tell is that corporate earnings are generally subject to two levels of tax: first, the company pays the corporate income tax; second, the shareholders pay individual income tax on dividends and realized capital gains. Yet reality may differ from that simple story.

Many commentators have noted the sharp decline at the first level: corporate tax receipts fell from 3.6 percent of gross domestic product in 1965 to 1.9 percent in 2015. However, observers have overlooked the substantial erosion at the second level of taxation of corporate income. Over the same 50-year period, U.S. retirement accounts and foreigners have largely displaced taxable accounts as the owners of stock issued by U.S. corporations (figure 1).<sup>2</sup> As a result, corporate earnings are largely exempt at this level.

FIGURE 1  
Ownership of U.S. Corporate Stock, 1965-2015  
Direct and Indirect Holdings



Source: Board of Governors of the Federal Reserve System, "Financial Accounts of the United States," Investment Company Institute, 2016, "The U.S. Retirement Market, Fourth Quarter 2015," Barclay Hedge; Prequin; Tax Policy Center calculations.

(1) Stock held in non-taxable segregated reserves to fund annuity contracts and whole life insurance.

(2) Dashed lines indicate TPC estimates

(3) Primarily government holdings, but includes equities in 529 savings plans.

<sup>1</sup>The views expressed are my own and should not be attributed to the Tax Policy Center or the Urban Institute, its board, or its funders. I would like to acknowledge the suggestions of Alan Auerbach, Lydia Austin, Richard Auxier, Len Burman, Frank Clemente, Howard Gleckman, Joe Rosenberg, Frank Sammartino, Steve Shay, Eric Toder, and Bob Williams.

<sup>2</sup>For a complete discussion, see Steven M. Rosenthal and Lydia S. Austin, "The Dwindling Taxable Share of U.S. Corporate Stock," *Tax Notes* (May 16, 2016). I attach this article for the record.

My colleague Lydia Austin and I estimate that the share of corporate stock issued by U.S. corporations that is held in taxable accounts fell more than two-thirds over the past 50 years, from 83.6 percent in 1965 to 24.2 percent in 2015.<sup>3</sup> Our estimates are based on data from the Federal Reserve Board's Financial Accounts of the United States (often called the Flow of Funds Accounts) and other sources. The Flow of Funds Accounts, which go back to 1965, are the most common source used to measure U.S. stock ownership.

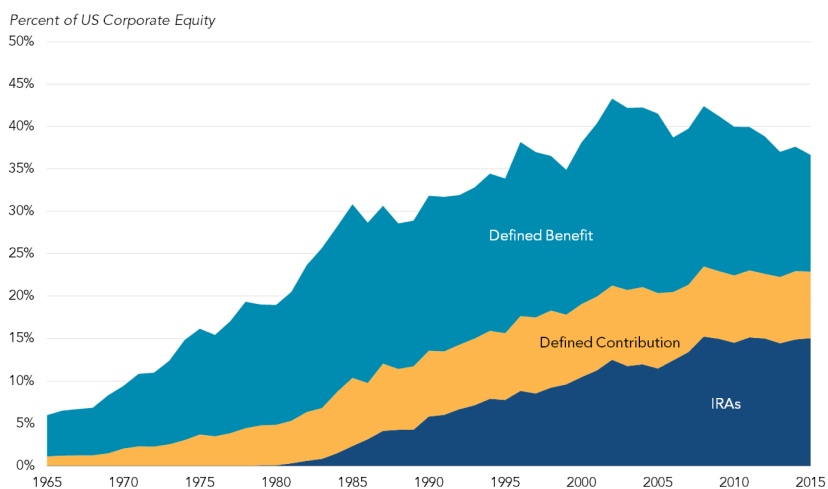
#### U.S. STOCK OWNERSHIP HIGHLIGHTS

There are two major factors in the decline in the share of corporate stock held in taxable U.S. accounts. The first is the increase held in tax-favored retirement accounts such as IRAs, 401(k) plans, and traditional defined-benefit pension plans. We estimate that share is now about 37 percent of U.S. corporate stock. The second is the increase in portfolio investment by foreigners; that share is about 26 percent of corporate stock (the foreign share would be greater if we included foreign direct investment, which is a controlling interest in a U.S. corporation, 10 percent or more). Foreigners generally pay no U.S. tax on capital gains from the sale of U.S. corporate stock, and the U.S. withholding taxes they pay on dividends are often reduced greatly by treaty.

#### *Retirement Account/Plan Holdings*

Retirement accounts and plans held about 37 percent of U.S. stock in 2015, worth roughly \$8.4 trillion. Over the past 30 years, IRAs grew faster than other components, largely because of rollovers of assets from defined contribution plans (figure 2).

**FIGURE 2**  
Pension Plans' Holdings of U.S. Corporate Stock, 1965-2015  
Direct and Indirect Holdings



Source: Board of Governors of the Federal Reserve System, "Financial Accounts of the United States."

Income accrued within retirement accounts, including both (i) Roth and traditional IRAs and (ii) defined-contribution and defined-benefit retirement plans, is effectively tax-free. In general, investment returns in these retirement accounts are tax-free in two different manners. Contributions to Roth IRAs and Roth 401(k) are nondeductible, and withdrawals are nontaxable. Alternatively, contributions to traditional IRAs or 401(k) plans are deductible and earnings are taxable upon withdrawal. If account owners face the same tax rate when they contribute to or withdraw from their accounts, the two forms of retirement savings are economically

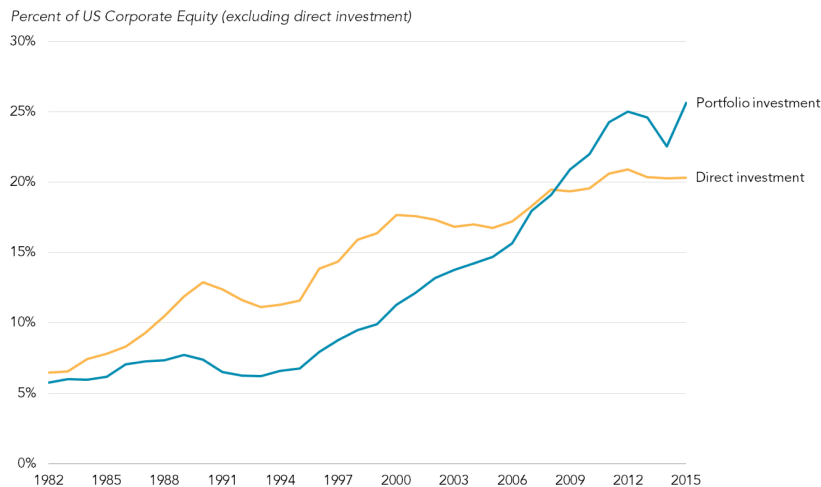
<sup>3</sup>In constant (2015) dollars, we estimate that total household ownership increased slightly from \$4.5 trillion to \$5.5 trillion from 1965 to 2015, while total outstanding stock increased more than fourfold from \$5.4 trillion to \$22.8 trillion. I am attaching this paper for the record.

equivalent to the individual (given the same after-tax contribution); the benefit of a Roth plan's full tax exclusion for withdrawals equals the benefit of a traditional IRA or 401(k) plan's tax deduction for contributions.

#### *Foreign Holdings*

Foreigners owned about 26 percent of U.S. stock in 2015, worth about \$5.8 trillion (figure 3). Foreign multinational corporations own another \$4.6 trillion of "direct" investments in U.S. companies. Like the Fed, we counted portfolio stock in corporate equity but not foreign direct investment, although direct investment is growing as fast as portfolio investment.<sup>4</sup>

**FIGURE 3**  
Foreigners' Holdings of U.S. Corporate Stock, 1965-2015  
Direct and Portfolio Holdings, Market Value



Source: Board of Governors of the Federal Reserve System, "Financial Accounts of the United States."

We treat foreigners as nontaxable, as their income from stock generally is not subject to U.S. tax—or subject to just a little tax. Their stock gains almost always are exempt from taxation. Their dividends are subject to a 30 percent U.S. withholding tax for portfolio investments, which is typically reduced by treaty to 15 percent or, for direct investment, to 5 percent (or sometimes to zero).

#### IMPLICATIONS FOR CORPORATE INTEGRATION

As I observed at the start, corporate earnings are ostensibly taxed twice, first to the corporation and second to the shareholders. Having two levels of tax distorts business decision-making in several important ways: whether to establish as a corporation, partnership, or other business form; whether to finance with debt or equity; and whether to retain or distribute earnings.

Many reformers propose to end double-taxation by integrating corporate and shareholder taxes on corporate earnings. For example, the United States could tax corporate earnings (1) just to the corporation, (2) just to the shareholders, or (3) to both the corporation and the shareholders, but with a credit to the shareholders for taxes paid by the corporation.

In 2003, Treasury proposed the first option: to tax corporate earnings just to corporations by excluding dividends to shareholders from taxation at the individual level.<sup>5</sup> At that time, Congress chose instead to reduce the top tax rate on qualified

<sup>4</sup> Similarly, we and the Fed do not count U.S. intercompany holdings.

<sup>5</sup> See Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2004 Budget Proposal*, JCS-7-03 (2003), at 18-33.

dividends to the same rate permitted for long-term capital gains.<sup>6</sup> Both are now taxed at a maximum rate of 23.8 percent (rather than the 43.4-percent tax rate that applies to other forms of income).

Because of the trends in stock ownership, and the reduction in tax rates, corporate earnings now face a very low effective tax rate at the shareholder level. Three-fourths goes untaxed, by our estimate, and much of the rest faces low rates. Further, the tax on any gain can be deferred or eliminated if the stock is held until death or donated to charity. So, the United States effectively tries to collect the bulk of the tax on corporate earnings at the corporate level.

But many commentators have observed that taxing earnings only to corporations is problematic in today's environment, and I agree. Corporations are mobile—generally more so than individuals.<sup>7</sup> As a result, some U.S. corporations have shifted their residence abroad to avoid U.S. taxes (“inversions”). Others shift their income to lower-taxed jurisdictions through transfer pricing. The United States makes this possible by delaying the tax on these overseas earnings until they are repatriated (“deferral”). U.S. multinationals now have stockpiled huge amounts of earnings overseas—\$2.4 trillion by some estimates.<sup>8</sup>

An alternative approach would tax corporate earnings only to shareholders, who cannot expatriate easily or shift their income to foreign affiliates.<sup>9</sup> The United States could move to such a system in a couple of different ways.

The United States could allow corporations to deduct dividends paid to shareholders. That would reduce the taxable income of corporations and increase that of shareholders. By our calculations, however, only about a quarter of dividends are paid to taxable accounts. So, the shift might generate relatively little revenue. To keep reform revenue neutral, Congress would need to substantially increase the tax rate on dividends and capital gains—perhaps both to individuals and tax-exempt accounts and institutions.<sup>10</sup>

Equivalently, the United States might tax corporate earnings at the entity level but allow the shareholders to claim a credit for the tax paid by the corporation (or, alternatively, permit a dividends paid deduction coupled with a withholding tax on dividends paid to shareholders).<sup>11</sup> Presumably, the credit or withholding tax would be nonrefundable to prevent a windfall for tax-exempt shareholders. But if these taxes were nonrefundable, tax-exempt shareholders, who represent the largest block of shareholders, might still pressure their corporations to shift income to lower-tax jurisdictions—or to move abroad.<sup>12</sup>

FINAL THOUGHTS FOR BUSINESS INCOME TAX REFORM:  
IS THE U.S. CORPORATE INCOME TAX UNCOMPETITIVE?

A key reason often given to pursue business tax reform is to lower U.S. corporate tax rates in order to make U.S. corporate taxes more competitive with the corporate taxes of other countries. Many commentators gauge U.S. corporate tax competitiveness by comparing U.S. corporate income taxes to foreign corporate income taxes (whether statutory, effective, or marginal).<sup>13</sup> But, as noted earlier, the effective tax rate on corporate earnings depends on both the corporate and shareholder income taxes. Today, in the United States, relatively few shareholders pay the second level

<sup>6</sup>Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108–27, 108th Cong., 1st Sess. (May 28, 2003).

<sup>7</sup>Avi-Yonah, Reuven, “And Yet It Moves: Taxation and Labor Mobility in the Twenty-First Century,” 67 *Tax. L. Rev.* 169 (2014).

<sup>8</sup>Citizens for Tax Justice, “Fortune 500 Companies Hold a Record \$2.4 Trillion Offshore,” March 4, 2016, [http://ctj.org/ctjreports/2016/03/fortune\\_500\\_companies\\_hold\\_a\\_record\\_24\\_trillion\\_offshore.php#.VzMBv4QrJD8](http://ctj.org/ctjreports/2016/03/fortune_500_companies_hold_a_record_24_trillion_offshore.php#.VzMBv4QrJD8). See also Richard Rubin, “U.S. Companies Are Stashing \$2.1 Trillion Overseas to Avoid Taxes,” Bloomberg, March 4, 2015, <https://www.bloomberg.com/news/articles/2015-03-04/u-s-companies-are-stashing-2-1-trillion-overseas-to-avoid-taxes>.

<sup>9</sup>Individuals face an exit tax on expatriating under Code sec. 877A, which Congress passed unanimously as part of the Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART Act), Pub. L. No. 110–245, 110th Cong., 2nd Sess. (June 17, 2008).

<sup>10</sup>For example, Congress could treat part or all of the dividends and capital gains from stock of U.S. corporations as unrelated business taxable income for tax-exempts.

<sup>11</sup>For a discussion, see Republican Staff of the Senate Finance Committee, *Comprehensive Tax Reform for 2015 and Beyond*, at 201–203, 113th Cong. S. Prt. No. 113–31 (Dec. 2014).

<sup>12</sup>Congress might also treat part or all of the dividends and capital gains from stock of foreign corporations as unrelated business taxable income to address this problem.

<sup>13</sup>See, for example, Jane G. Gravelle, *International Corporate Tax Rate Comparisons and Policy Implications* (Washington, DC: Congressional Research Service, 2014), comparing and describing corporate statutory, effective, and marginal tax rates, but not shareholder tax rates.

of tax on corporate earnings. Those that do, face a reduced rate on qualified dividends and long-term capital gains.

To fully compare the U.S. tax burden on corporate earnings to foreign tax burdens, we should also compare the combined corporate and shareholder effective taxes. In some instances, this comparison may provide a better gauge of U.S. tax competitiveness. For example, some countries may tax corporate earnings more fully at the shareholder level, and that could increase the cost of corporate capital in their countries (if their corporations depend substantially on local capital markets). More research is necessary to gauge the effective combined U.S. and foreign tax burden on corporate earnings.

Table 1. Comparing Effective Tax Rates Across Countries 2015

	Corporate Income Tax Rate	Personal Dividend Income Tax Rate	Capital Gains Tax Rate	Effective Corporate and Shareholder Tax Rate	Integrated Tax System
Canada	26.3%	39.3%	22.6%	?	Full credit imputation
France	34.4%	44.0%	34.4%	?	Partial dividend exemption
Germany	30.2%	26.4%	25.0%	?	Classical
Italy	27.5%	26.0%	26.0%	?	Classical
Japan	32.1%	20.3%	20.3%	?	Modified classical system
United Kingdom	20.0%	30.6%	28.0%	?	Partial credit imputation
United States	39.0%	30.3%	28.7%	?	Modified classical system
G7 excluding U.S.*	29.1%	29.1%	25.5%	?	

\*Weighted by 2015 GDP.

Sources: OECD Tax Database, Tables II.1 and II.4; OECD Quarterly National Accounts: Historical GDP—expenditure approach; Tax Foundation, “Eliminating Double Taxation through Corporate Integration.”

Note: Tax rates are combined national and subnational.

## SPECIAL REPORT

### Tax Notes

May 16, 2016

#### The Dwindling Taxable Share of U.S. Corporate Stock

By Steven M. Rosenthal and Lydia S. Austin

Steven M. Rosenthal is a senior fellow and Lydia S. Austin is a research assistant at the Urban-Brookings Tax Policy Center. The authors wish to thank Leonard Burman for his encouragement and suggestions on earlier drafts. They are also grateful to Alan Auerbach, Gerry Auten, Richard Auxier, Paul Burnham, Tim Dowd, Howard Gleckman, John McClelland, Robert McClelland, Peter Merrill, Jim Nunns, Frank Sammartino, Mike Schler, Steve Shay, Eric Toder, and Bob Williams. The views and mistakes herein are the authors’ and not those of the Tax Policy Center, the Urban Institute, the Brookings Institution, or any other entity or person.

In this report, Rosenthal and Austin demonstrate that the share of U.S. stocks held by taxable accounts has declined sharply over the last 50 years, and they urge lawmakers to carefully consider this shareholder base erosion when determining how best to tax corporate earnings.

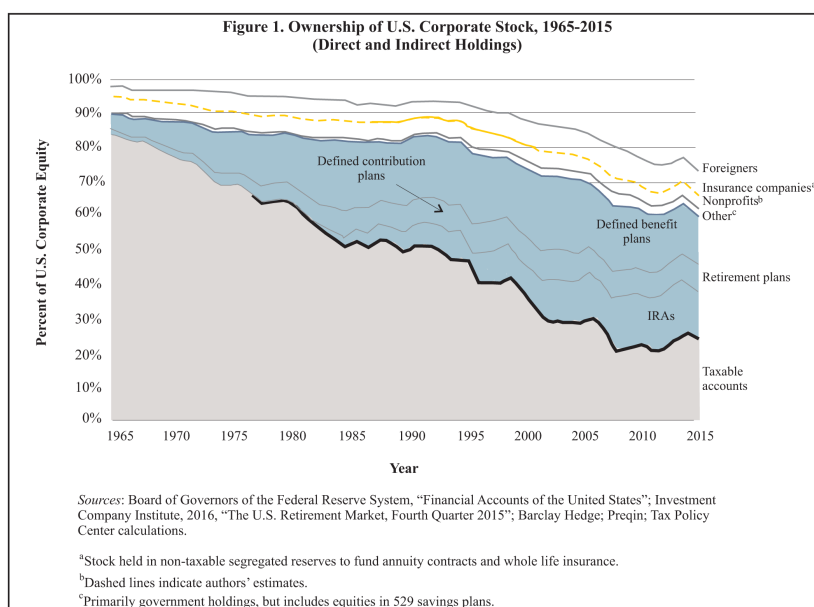
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#### I. Introduction

Corporate earnings are generally subject to two levels of tax—first, the company pays a corporate income tax; second, the shareholders pay an individual income tax on dividends and capital gains.

Many commentators have noted the sharp decline at the first level: corporate tax receipts fell from 3.6 percent of GDP in 1965 to 1.9 percent in 2015.<sup>1</sup> However, observers have overlooked the substantial erosion at the second level of taxation of corporate income. Over the same 50-year period, retirement plans and foreigners displaced taxable accounts as the owners of U.S. stocks. (See Figure 1.) As a result, corporate earnings are largely exempt at this level.<sup>2</sup>

We estimate that the share of U.S. corporate stock held in taxable accounts fell more than two-thirds over the last 50 years, from 83.6 percent in 1965 to 24.2 percent in 2015.<sup>3</sup> We document this decline using data from the Federal Reserve's "Financial Accounts of the United States," previously the "Flow of Funds Accounts," which is the most commonly used data source for measuring U.S. stock ownership. Figure 1 reflects data back to 1965, but we focus on stock held in 2015, the year for which the most recent data are available.



Understanding the erosion of the taxable shareholder base is critical for determining how best to tax corporate earnings—and capital more generally.<sup>4</sup> Acknowledging the decline is particularly important for evaluating proposals to reform (or eliminate) the corporate income tax and collect taxes exclusively from shareholders.<sup>5</sup> These corporate tax reforms are much more difficult if few shareholders pay tax.

Prior literature suggests that taxable stock ownership ranges from 44 percent to 68 percent, which we review in Section II of this report. Our estimates are 22 percent to 37 percent for the corresponding years, and we describe our estimates in Sec-

<sup>1</sup>Office of Management and Budget, "Table 2.3—Receipts by Source as Percentages of GDP: 1934–2021."

<sup>2</sup>Also, the returns on the stock of the remaining shareholders are taxed lightly. The tax rates are reduced for qualified dividends and long-term capital gains. Tax on gains from appreciated stock is deferred until the stock is sold or disposed—and gains are eliminated if the stock is held until death.

<sup>3</sup>In constant (2015) dollars, we estimate that total taxable ownership increased slightly from \$4.5 trillion to \$5.5 trillion, while total outstanding stock increased more than fourfold from \$5.4 trillion to \$22.8 trillion.

<sup>4</sup>Congressional Budget Office, "Taxing Capital Income: Effective Marginal Tax Rates Under 2014 Law and Selected Policy Options" (December 2014).

<sup>5</sup>See, e.g., Michael J. Graetz and Alvin C. Warren Jr., "Unlocking Business Tax Reform," *Tax Notes*, November 10, 2014, p. 707; Harry Grubert and Rosanne Altshuler, "Shifting the Burden of Taxation From the Corporate to the Personal Level and Getting the Corporate Tax Rate Down to 15 Percent" (2015); and Eric Toder and Alan D. Viard, "Major Surgery Needed: A Call for Structural Reform of the U.S. Corporate Income Tax," American Enterprise Institute (2014).

tion III (and the appendices). Our estimates are only approximations, based on the best available data and reasonable assumptions. In Section IV, we analyze the sensitivity of our estimates by varying the assumptions. Finally, at the end of this report, we suggest areas for further research in light of our new estimates.

## II. Previous Estimates

The Fed reported that “households” own most of the value of the outstanding stock issued by U.S. corporations.<sup>6</sup> Many view the household share of corporate equity holdings as a good proxy for the taxable share of ownership. However, the Fed included a substantial amount of equity in the households category that is not subject to income tax.

The Fed reported both the ownership of all stock issued by U.S. corporations and the holdings by U.S. investors of stock issued by foreign corporations.<sup>7</sup> It then disaggregated these figures into stock ownership by different categories of institutional and foreign investors:<sup>8</sup> state and local governments, defined benefit and contribution plans, life insurance companies, foreigners, and others (including mutual funds, exchange-traded funds (ETFs), and closed-end funds (CEFs)).<sup>9</sup> The Fed allocated the remaining balance to households, including stock held in IRAs and by non-profit institutions. In other words, the Fed treated households as “a plug for all assets not classified into other sectors.”<sup>10</sup>

The Fed reported that in 2015, households directly owned 37.3 percent of corporate equity.<sup>11</sup> Households owned another 13 percent indirectly through mutual funds (and more through ETFs and CEFs).<sup>12</sup> In total, the Fed reported that households owned more than 50.3 percent of the value of outstanding U.S. stock.

The economics literature generally uses the Fed’s figures for household ownership, including both direct and indirect holdings, as a measure of equities held in taxable accounts. James M. Poterba added stock owned directly by the household sector with stock beneficially held through mutual funds—and estimated that the taxable household share of corporate equity was 57.2 percent in 2003.<sup>13</sup> In so doing, Poterba counted stock owned by IRAs and nonprofits in his taxable sector.

Similarly, Alan J. Auerbach estimated that U.S. households (including IRAs) directly owned about 42 percent of the market value of U.S. corporations and 26 percent more through mutual funds in 2004.<sup>14</sup> In his paper, Auerbach flagged the difficulty of tracing corporate taxes through to individual shareholders using the Fed data.<sup>15</sup>

Goldman Sachs observed that the Fed’s “broad category definitions can make it difficult to use Flow of Funds data to analyze trends in the domestic public equity market.”<sup>16</sup> Instead, Goldman used company-specific ownership data from LionShares to estimate that retail investors (including IRAs) directly owned 23 percent of public U.S. single-stock equities in 2013 (and indirectly owned much more through mutual funds and pension funds).

<sup>6</sup>Federal Reserve, “Financial Accounts of the United States: Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts, Fourth Quarter 2015,” March 10, 2016.

<sup>7</sup>The Fed counts only the U.S. residents’ ownership of foreign stock, not the foreign residents’ ownership of foreign stock. Foreign stock includes American depository receipts, which are trust interests that trade in the United States that represent beneficial ownership of shares in a foreign corporation.

<sup>8</sup>Chris William Sanchirico, “As American as Apple Inc.: International Tax and Ownership Nationality,” 68(2) *Tax L. Rev.* 207 (2015) (discussing the challenge of distinguishing categories of shareholders, including problems with classifications in the data).

<sup>9</sup>Federal Reserve, *supra* note 6, at Table L.223, line 11. These holdings are generally not taxable, except that taxable individuals may own, indirectly, the stock held by insurance companies and mutual funds.

<sup>10</sup>See Amanda Sneider et al., “An Equity Investor’s Guide to the Flow of Funds Accounts,” Goldman Sachs Group Inc., March 11, 2013.

<sup>11</sup>Federal Reserve, *supra* note 6, at Table L.223, line 11.

<sup>12</sup>*Id.* at Table B.101.e, line 14.

<sup>13</sup>Poterba, “Taxation and Corporate Payout Policy,” 94(2) *Am. Econ. Rev.* 171 (2004). For 2003 we estimated that taxable accounts held 29.6 percent of U.S. corporate stock.

<sup>14</sup>See Auerbach, “Who Bears the Corporate Tax? A Review of What We Know,” in Poterba (ed.), *Tax Policy and the Economy, Volume 20*, 1–40, Table 1 (2006). By comparison, for 2004, we estimate that taxable accounts held 28.9 percent. Auerbach netted the U.S. resident holdings of foreign equity against foreign resident holdings of U.S. equity, and we do not.

<sup>15</sup>See *id.* at 4–8.

<sup>16</sup>See Sneider, *supra* note 10, at 8.

In lieu of using Fed data, William G. Gale<sup>17</sup> and Joseph Rosenberg<sup>18</sup> used data from tax returns to estimate the taxable share of U.S. stock by individuals.<sup>19</sup> They measured the ratio of total qualified dividends reported on individual tax returns (Forms 1040) divided by total dividends.<sup>20</sup> Gale estimated that individuals received 46 percent of dividends paid by U.S. corporations in 2000, and Rosenberg estimated 44 percent in 2009.<sup>21</sup> Gale and Rosenberg included both domestic and foreign dividends in the qualified dividends received by U.S. individuals in their numerator but only dividends paid by U.S. corporations in their denominator.<sup>22</sup>

### III. Our Estimate

The Fed's household sector is too broad for our purposes and thus overestimates the ownership of U.S. stock in taxable accounts. To more accurately measure taxable ownership, we adjusted the Fed's data in several important respects:

1. We excluded foreign equity held by U.S. residents—and measured only U.S. stock.<sup>23</sup>
2. We measured only the stock of corporations that are separately taxable under subchapter C of the IRC.<sup>24</sup> We excluded passthrough corporations such as mutual funds, S corporations, ETFs, CEFs, and real estate investment trusts, which generally are not separately taxable.<sup>25</sup>
3. We excluded stock held by nonprofits from the household sector.
4. We excluded stock held by IRAs and section 529 accounts (as well as defined benefit and defined contribution plans, which the Fed already does).
5. We added back stock that taxable individuals held beneficially through mutual funds, ETFs, and CEFs (that is, in the underlying portfolios of these passthrough corporations).<sup>26</sup>

The first two steps isolate the stock of corporations that are subject to U.S. tax and, potentially, a double layer of U.S. taxation. Step 3 removes extraneous amounts from the residual household sector. Step 4 excludes holdings in IRAs and section 529 accounts, which is consistent with the Fed's method. Finally, step 5 combines indirect ownership with direct ownership by taxable accounts.

After these adjustments, we reallocated stock ownership to several categories: taxable accounts, foreigners, insurance companies, nonprofits, defined benefit plans, defined contribution plans, IRAs, and other investors.<sup>27</sup> We followed the procedures

<sup>17</sup>Gale, "About Half of Dividend Payments Do Not Face Double Taxation," *Tax Notes*, November 11, 2002, p. 839.

<sup>18</sup>Rosenberg, "Corporate Dividends Paid and Received, 2003–2009," *Tax Notes*, September 17, 2012, p. 1475.

<sup>19</sup>See also Jane G. Gravelle and Donald J. Marples, "The Effect of Base-Broadening Measures on Labor Supply and Investment: Considerations for Tax Reform," Congressional Research Service, at 27 (October 22, 2015) (estimating that 25 percent of U.S. dividends appear on U.S. personal returns by comparing dividends received by individuals (as reported by the IRS Statistics of Income division) and dividends reported in the National Income and Product Accounts). Gravelle and Marples offer little information on their methods.

<sup>20</sup>Gale used dividends reported in the National Income and Product Accounts, and Rosenberg used dividends reported on corporate tax returns (Form 1120).

<sup>21</sup>Rosenberg, *supra* note 18. We estimate 36.9 percent and 21.7 percent for 2000 and 2009, respectively.

<sup>22</sup>We can reduce Rosenberg's number to 34 percent by subtracting foreign dividends from his numerator, assuming foreign dividends/total dividends equals foreign stock/total stock (23.3 percent, the share of foreign equity in 2009). In practice, the dividend yield on foreign stock may be much higher than the yield on U.S. stock. If so, we would reduce the estimate further.

<sup>23</sup>Our estimate (24.2 percent in 2015) of taxable holdings is most appropriate to evaluate an integration plan with shareholder credits limited to U.S. taxes paid, as under the plan suggested by Graetz and Warren, *supra* note 5. If individual taxes on capital gains and dividends are increased as part of an integration plan, a more appropriate estimate (28.6 percent) would include U.S. holdings of foreign stock. Grubert and Altshuler, *supra* note 5.

<sup>24</sup>There are also S corporations and M corporations (regulated investment companies, REITs, ETFs, and CEFs), which are generally not separately taxable—and are named based on their location in the tax code.

<sup>25</sup>We simply look through to attribute the underlying stock held by these passthrough corporations to the beneficial owners of the passthrough corporations, which is how the Fed treats mutual funds. That is, the Fed already excludes mutual funds, which are also passthrough corporations, from its issuers of corporate equity.

<sup>26</sup>We do not add back stock for REITs, which generally hold only real estate and mortgages.

<sup>27</sup>We treat only accounts of investors that are subject to tax on their capital gains and dividends as "taxable accounts." We consider the other categories nontaxable. For example, insur-



detailed below (and in Appendix 1) to estimate ownership for 2015 as well as for previous years back to 1965. We calculated that the total value of outstanding U.S. corporate stock is \$22.8 trillion, of which \$5.5 trillion is held in taxable accounts, or 24.2 percent of the total.

#### A. Outstanding C Corporation Stock

The Financial Accounts data for 2015 show a total of \$35.7 trillion of corporate equity, which excludes U.S. intercorporate holdings of public stock and foreign direct investments in U.S. companies.<sup>28</sup>

The Fed included (1) some foreign stock held by U.S. residents and (2) stock issued by U.S. passthrough corporations.<sup>29</sup> Because we wanted to measure only the outstanding stock of corporations that are taxable by the United States, we subtracted both.<sup>30</sup> As a result, we estimated that \$22.8 trillion of stock issued by domestic C corporations was outstanding in 2015 (see Table 1).<sup>31</sup>

**Table 1. C Corporation Equity Outstanding**  
(2015, market value in billions)

Total foreign and domestic corporate stock (including stock issued by C and S corporations, ETFs, CEFs, and REITs)	\$35,687
• Foreign stock held by U.S. residents	(\$6,732)
• Stock issued by passthrough entities	
• S corporations	(\$2,838)
• Exchange-traded funds	(\$2,106)
• Closed-end funds	(\$260)
• REITs	(\$939)
<b>All outstanding C corporation stock</b>	<b>\$22,812</b>

#### B. C Corporation Stock in Taxable Accounts

The Fed allocated corporate stock to households but not to taxable accounts. We estimated that taxable accounts held \$5.5 trillion in 2015, 24.2 percent of the \$22.8 trillion of outstanding C corporation stock (see Table 2).<sup>32</sup> We detail these adjustments in Appendix 1.<sup>33</sup>

ance companies hold stock in segregated reserves to fund annuity contracts and whole life insurance of their beneficiaries, but the companies themselves are not subject to tax on the income from the segregated accounts. Rather, the beneficiaries themselves will generally be subject to tax to the extent payments exceed basis.

<sup>28</sup>Direct investments are controlling blocks of stock in a company, which means 10 percent or more ownership. For example, foreign multinational corporations often hold direct investments in stock of their U.S. affiliates.

<sup>29</sup>Passthrough corporations are corporations that are generally not subject to the U.S. corporate income tax, such as S corporations, mutual funds, ETFs, CEFs, and REITs.

<sup>30</sup>Federal Reserve, *supra* note 6, at Table L.223. At our request, the Fed recently published its estimate of the value of stock issued by S corporations from 1996 to 2015 (Table L.223, line 30), which we subtract. The Fed also estimates the value of stock issued by ETFs and CEFs (Table L.123) but not REITs, which we obtained back to 1971 from the National Association of Real Estate Investment Trusts, all of which we subtract.

<sup>31</sup>The Fed already subtracts stock issued by mutual funds. *See id.* at Table L.223, n.1.

<sup>32</sup>By comparison, for 2013, the Fed's Survey of Consumer Finances determined that households held \$8 trillion of both domestic and foreign equity outside retirement accounts. Federal Reserve, "2013 Survey of Consumer Finances," October 20, 2014. The Fed conducts the survey every 3 years, independent of its Financial Accounts estimates. If we estimate and subtract the foreign equity, the survey estimate is only \$6.16 trillion. For 2013, we estimated \$5.4 trillion in taxable accounts.

<sup>33</sup>We describe our methods, data sources, and assumptions in more detail in Appendix 1.

**Table 2. Total Taxable Holdings of C Corporation Stock**  
(2015, market value in billions)

<b>Outstanding C corporation stock (from Table 1)</b>	<b>\$22,812</b>
Less:	
Stock held by pensions, mutual funds, insurance companies, and others	\$11,487
Stock held by foreign residents	\$5,543
<b>Equals: C corporation stock held directly by U.S. residents</b>	<b>\$5,781</b>
Less:	
Stock held directly by U.S. nonprofits	\$956
<b>Equals: C corporation stock held directly by U.S. households</b>	<b>\$4,826</b>
Less:	
Stock held in IRAs	\$1,479
Stock held in section 529 plans	\$89
<b>Equals: Taxable C corporation stock held directly in U.S. taxable accounts</b>	<b>\$3,274</b>
Plus:	
Taxable C corporation stock held indirectly by U.S. households	\$2,268
<b>Equals: Total holdings of taxable C corporation stock in U.S. taxable accounts</b>	<b>\$5,525</b>

The Fed's household category includes the U.S. stock holdings of U.S. partnerships. It excludes the U.S. stock holdings of foreign partnerships, which the Fed counts in the holdings of foreign residents. Thus, the classification of the U.S. stock of a partnership (such as a hedge fund or a private equity fund) turns on the domicile of the partnership, not the domicile of the beneficiaries.

We did not distribute the stock held through hedge funds and private equity (or the tax-exempt holdings through these funds), as we explain in Appendix 2. (In short, we believe we can reasonably net the share of the U.S. stock of foreign funds that is held beneficially in U.S. taxable accounts against the share of U.S. stock of U.S. funds held beneficially by nontaxable accounts.)

#### IV. Sensitivity Analysis

Although we varied our assumptions in several ways, we found only a few adjustments that are potentially significant.

##### A. Stock Issued by Passthrough Corporations

We subtracted the stock issued by passthrough corporations and distributed the stock held by these corporations to their beneficial owners. If we did not subtract the stock issued by S corporations, ETFs, CEFs, or REITs (but subtracted only the stock issued by mutual funds, as the Fed had done), all U.S. corporate equity would total \$29 trillion in 2015, and taxable accounts would hold \$9.6 trillion, or 33.3 percent. Thus, subtracting stock issued by passthrough corporations substantially reduced our estimate.

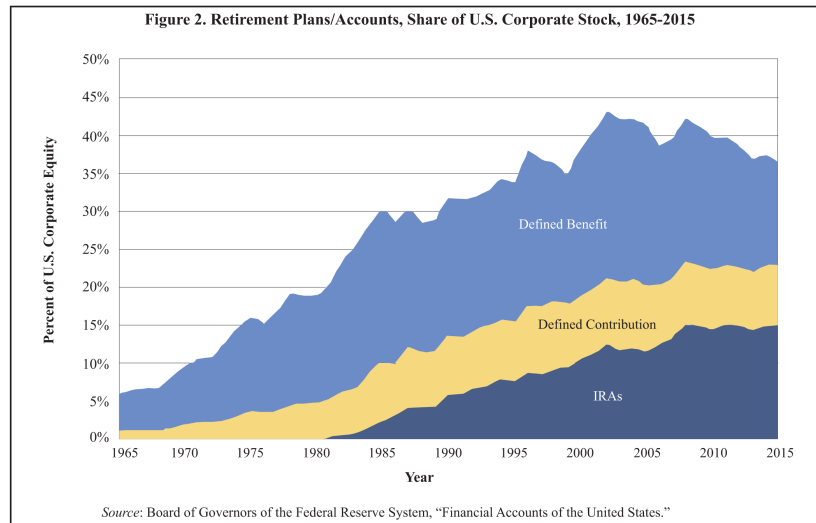
##### B. Beneficial Ownership

To distribute the equity held by passthrough corporations to their beneficial owners, we used the ownership proportions for mutual funds to estimate the ownership proportions of ETFs and CEFs. The Fed provided data only on ownership of mutual

funds, and we could not find data on ETFs and CEFs elsewhere.<sup>34</sup> In 2015 the Fed reported “households” owned about 63 percent of mutual funds, so we assumed that households also owned 63 percent of ETFs and CEFs, and we distributed the equity holdings accordingly. If we instead assumed that households held less (50 percent) or more (70 percent) of passthrough corporations, we would decrease our estimate to 22 percent or increase it to 25.8 percent. Thus, our estimate of taxable ownership of corporate equity is somewhat sensitive to our assumptions about ownership of CEFs and ETFs.

### C. Nonprofit Ownership

Our estimate of taxable ownership is sensitive to our calculation of nonprofit ownership, which was \$1.4 trillion, or 4.9 percent of corporate equity. For example, if we shifted our estimate of nonprofit share from 4.9 percent in 2015 to 4.4 percent or 5.7 percent in 2015 (which is the range we observed for 1987–2001), we would increase or reduce our estimate of taxable share to 24.7 percent or 23.4 percent.<sup>35</sup>



## V. Areas for Further Research

### A. Retirement Account and Plan Holdings

Retirement accounts and plans held about 37 percent of U.S. stock in 2015, worth roughly \$8.4 trillion. Over the last 30 years, IRAs grew faster than other components, partly due to rollovers of assets from defined contribution plans.

Retirement accounts are effectively nontaxable, including both (i) Roth and traditional IRAs and (ii) defined-contribution and defined-benefit retirement plans. In general, investment returns in these retirement accounts are tax-free in two different manners: either (1) contributions to Roth IRAs and Roth 401(k) plans are nondeductible and earnings are nontaxable; or (2) contributions to traditional IRAs or 401(k) plans are deductible and earnings are taxable upon withdrawal. If account owners face the same tax rate when they contribute to or withdraw from their accounts, the two forms of retirement savings are economically equivalent; the benefit of a Roth plan’s full tax exclusion for withdrawals equals the benefit of a deductible plan’s tax deduction for contributions.

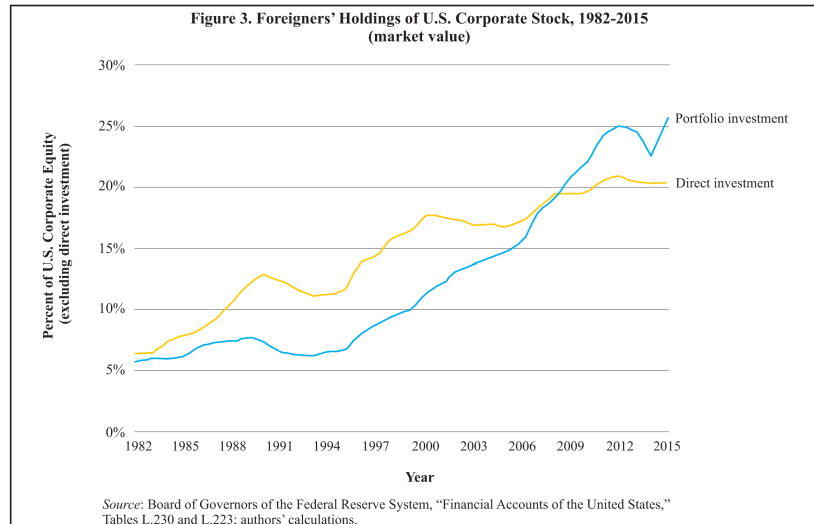
<sup>34</sup> Federal Reserve, *supra* note 6, at Table L.224. ETFs, CEFs, and mutual funds are very similar: they are diversified pools of stocks and bonds and are taxed identically under subchapter M of the code.

<sup>35</sup> Our 4.9-percent estimate seems about right because we estimate for 2012 that nonprofits owned about \$1.06 trillion of U.S. stock, while the IRS estimated for 2012 that nonprofits owned \$1.04 trillion of public securities—and the IRS estimate included Treasury and corporate bonds and excluded other securities like private equity and hedge funds, which would offset.

## B. Foreign Holdings

Foreigners owned about 26 percent of U.S. stock in 2015, worth about \$5.8 trillion. Foreign multinational corporations owned another \$4.6 trillion of “direct” investments in U.S. companies (direct interests are controlling interests in U.S. companies, 10 percent or more). Like the Fed, we counted portfolio stock in corporate equity but not foreign direct investment (just as we do not count U.S. intercompany holdings).<sup>36</sup>

We treated foreigners as nontaxable as their income from stock generally is not subject to U.S. tax—or subject to just a little tax.<sup>37</sup> Their stock gains almost always are exempt from taxation. Their dividends are subject to a 30 percent U.S. withholding tax for portfolio investments, which is typically reduced, by treaty, to 15 percent, or for direct investment, to 5 percent (or sometimes to zero). Further research is necessary to unravel the foreign ownership trend, especially the sizable increase in direct ownership (which might suggest more foreign multinational holdings of U.S. companies, perhaps resulting from inversions).<sup>38</sup>



## C. Nonprofit Holders

From 1988 to 2000, the Fed used data from the IRS and surveys to separate holdings of corporate equities by nonprofits from holdings by households. We could not find better data on holdings by nonprofits, so we extended the 4.9 percent average from the earlier nonprofit Fed data to more recent estimate holdings. However, in recent years, nonprofits have shifted the mix of equities they own. Starting in 2006, the IRS separated security holdings of nonprofits into publicly traded securities (which include both stock and bonds) and other securities (which include holdings of private equity funds and hedge funds). Over the 6-year period for which data are available, nonprofit holdings of other securities have nearly tripled. Further research might help unravel this trend.

## D. Cost of Corporate Capital Across Countries

A key reason to pursue business tax reform is to lower U.S. corporate tax rates, in order to make U.S. corporate taxes more competitive with other countries. Many

<sup>36</sup> Individuals typically make portfolio investments. Corporations, such as foreign multinationals, typically make direct investments, which are controlling interests of a U.S. company. The Fed’s exclusion of foreign direct holdings is consistent with its exclusion of intercompany holdings of public securities.

<sup>37</sup> In limited instances, foreign shareholders are subject to tax on their gains under section 897 (the 1980 Foreign Investment in Real Property Tax Act).

<sup>38</sup> If we added foreign direct investment to our denominator, the taxable ownership of U.S. stock would fall from 24.2 percent to 19.9 percent. If we added U.S. intercompany holdings, our share would drop even further.

commentators gauge U.S. tax competitiveness by comparing just corporate income taxes to foreign corporate income taxes (whether statutory, effective, or marginal).<sup>39</sup> But, as noted earlier, the effective tax rate on corporate earnings depends on both the corporate and shareholder income taxes. Today, in the United States, relatively few shareholders pay the second level of tax on corporate earnings. Those few only pay at the reduced rate for qualified dividends and long-term capital gains.

To fully compare the U.S. tax burden on corporate earnings to foreign tax burdens, we might also compare the combined corporate and shareholder effective taxes. In some instances, this comparison may provide a better gauge of U.S. tax competitiveness. For example, some countries may tax corporate earnings more fully at the shareholder level, which could increase the cost of corporate capital in their countries (if their corporations depend substantially on local capital markets). More research is necessary to determine the relative U.S. and foreign tax burden on corporate earnings.

**Figure 4. Comparing Effective Tax Rates Across Countries, 2015**

	Corporate Income Tax Rate	Personal Dividend Income Tax Rate	Capital Gains Tax Rate	Effective Corporate and Shareholder Tax Rate	Integrated Tax System
Canada	26.3%	39.3%	22.6%	?	Full credit imputation
France	34.4%	44%	34.4%	?	Partial dividend exemption
Germany	30.2%	26.4%	25%	?	Classical
Italy	27.5%	26%	26%	?	Classical
Japan	32.1%	20.3%	20.3%	?	Modified classical system
United Kingdom	20%	30.6%	28%	?	Partial credit imputation
United States	39%	30.3%	28.7%	?	Modified classical system
G-7 excluding U.S.*	29.1%	29.1%	25.5%	?	

\*Weighted by 2015 GDP.

Note: Tax rates are combined national and subnational.

Sources: OECD Tax Database, Tables II.1 and II.4; OECD Quarterly National Accounts: Historical GDP—Expenditure Approach; Tax Foundation, “Eliminating Double Taxation Through Corporate Integration.”

## VI. Conclusion

The Fed’s Financial Accounts data, as well as economic observers, report that households own most of the market value of outstanding corporate equity. While correct, that category is much different from taxable accounts. After adjusting the data in several important respects, we estimated that taxable accounts held only 24.2 percent of C corporation equity in taxable accounts in 2015. Our exercise revealed that the share of U.S. stocks held by taxable accounts declined sharply over the last 50 years, by more than two-thirds.

This sizable decrease affects many of the current tax policy debates, including how to structure a revenue-neutral corporate integration regime and, more generally, how we tax capital. We believe policymakers should carefully consider this decline.

### Appendix 1: Methods, Data Sources, and Assumptions

To estimate the fraction of C corporation stock held in taxable accounts, we started with the measure of corporate equity reported by the Fed and subtracted the foreign and passthrough equity issues. We next subtracted stock holdings of nonprofits, IRAs, and section 529 accounts. Finally, we added the stock held in taxable accounts (indirectly) through mutual funds, CEFs, and ETFs. In total, for 2015, we estimated

<sup>39</sup>Jane G. Gravelle, “International Corporate Tax Rate Comparisons and Policy Implications,” Congressional Research Service, Jan. 6, 2014 (comparing and describing corporate statutory, effective, and marginal tax rates, but not shareholder tax rates).

that taxable accounts held \$5.5 trillion of the \$25.8 trillion of C corporation stock, or 24.2 percent.

First, we subtracted the \$6.7 trillion of foreign stock held by U.S. residents from the \$35.7 trillion of total outstanding corporate stock. We assumed that U.S. investors held the same proportion of domestic and foreign stock and, thus, subtracted the \$6.7 trillion proportionately from their holdings. We did not subtract any foreign stock from the \$5.7 trillion of foreign holders because the Fed does not count the foreign stock held by foreigners.<sup>40</sup>

### Step 1. Subtract Foreign Stock Held by U.S. Residents

(2015, market value in billions of dollars)

	All Corporate Equity	–	Foreign Equity	=	U.S. Equities
All holders	\$35,687		(\$6,732)		\$28,955
Household and nonprofit	\$13,311		(\$2,989)		\$10,322
Insurance companies	\$2,087		(\$469)		\$1,618
Defined benefit plans	\$3,295		(\$740)		\$2,555
Defined contribution plans	\$1,623		(\$364)		\$1,258
Foreigners	\$5,707		\$0		\$5,707
Other	\$481		(\$108)		\$373
Mutual funds	\$7,327		(\$1,645)		\$5,682
Closed-end funds	\$100		(\$22)		\$77
Exchange-traded funds	\$1,756		(\$394)		\$1,362

### Step 2. Subtract Passthrough Holdings From Investors

(2015, market value in billions of dollars)

	Take Out Passthroughs							U.S. C Corporation Equity
	U.S. Equities	–	S Corporation Equity	ETFs	CEFs	REITs	=	
All holders	\$28,955		(\$2,838)	(\$2,106)	(\$206)	(\$939)		\$22,812
Household and nonprofit	\$10,322		(\$2,838)	(\$1,331)	(\$164)	(\$207)		\$5,781
Insurance companies	\$1,618			(\$43)	(\$5)	(\$131)		\$1,439
Defined benefit plans	\$2,555			(\$297)	(\$37)	(\$33)		\$2,189
Defined contribution plans	\$1,258			(\$275)	(\$34)	(\$33)		\$917
Foreigners	\$5,707			(\$95)	(\$12)	(\$56)		\$5,543
Other	\$373			(\$64)	(\$8)	(\$56)		\$245
Mutual Funds	\$5,682					(\$310)		\$5,372
Closed-end funds	\$77							\$77
Exchange-traded funds	\$1,362					(\$113)		\$1,249

<sup>40</sup> See Federal Reserve, *supra* note 6, at Table L.223, n.5. Thus, foreign stock is 22.45 percent of the holdings of U.S. residents ( $\$6,732 / (\$35,687 - \$5,707)$ ).

Second, we subtracted the value of stock issued by S corporations, ETFs, CEFs, and REITs. Because only individuals and some nonprofits hold S corporation stock, we subtracted the \$2.8 trillion of S corporation equity from only the household and nonprofit categories.<sup>41</sup>

The Financial Accounts data do not allocate ETF and CEF equity across owners. Instead, we assumed investors owned the ETFs and CEFs in the same proportions as the investors that own mutual funds, which the Fed reports. For 2015 households and nonprofits held 63 percent of mutual funds, so we assumed the households and nonprofits likewise held 63 percent of ETFs and CEFs, or \$1.5 trillion.<sup>42</sup>

We estimated the investor ownership of REITs based on a 2015 Citibank report.<sup>43</sup> According to that report, mutual funds and ETFs are the predominant owners of REITs.<sup>44</sup> We subtracted \$207 billion of outstanding REIT issues in 2015 from the household sector and another \$732 billion from other investors, after redistributing the mutual fund and ETF holdings of REITs.<sup>45</sup>

Third, we subtracted nonprofit holdings from the Fed's household category. From 1988 to 2000, the Federal Reserve estimated corporate equities held by nonprofits based primarily on Forms 990 that nonprofits filed with the IRS.<sup>46</sup> During that period, the share of equities held by nonprofits as a share of all domestic and foreign C corporation equities ranged from 4.4 percent to 5.7 percent. From 2001 to 2015 and before 1988, we used the 4.9 percent average ratio to estimate domestic and foreign equity holdings of nonprofits, which totaled \$1.5 trillion in 2015.

We added our estimate of \$327 billion of foreign equities held by nonprofits to the \$1.5 trillion to avoid removing those equities twice (once as foreign stock and again as nonprofit stock). We also adjusted nonprofit holdings by \$49 billion to reflect that we previously subtracted issues of CEFs, ETFs, and REITs from the household and nonprofit sector.

We also added back to our estimate of nonprofit equity their holdings of S corporation equity through employee stock ownership plans, using data from EY and the Labor Department.<sup>47</sup> We estimated that the market value of ESOPs was double the amount of net assets and attributed this entire amount, \$124 billion in 2015, to the nonprofit sector.<sup>48</sup>

### Step 3. Subtract Stock Held by Nonprofits

(2015, market value in billions of dollars)

Total household and nonprofit holdings of C corporation equity	\$5,781
– Nonprofit holdings of corporate equity (other than mutual funds)	(\$1,455)
+ Foreign stock held by nonprofits, already subtracted	\$327
+ ETFs held by nonprofits, already subtracted	\$18
+ CEFs held by nonprofits, already subtracted	\$2

<sup>41</sup> As a general matter, nonprofits do not own S corporations because of a special tax on the income of S corporations for nonprofits—which does not apply to employee stock ownership plans.

<sup>42</sup> Federal Reserve, *supra* note 6, at Table L.224.

<sup>43</sup> See Citi Research, “REITs for Sale,” at Figure 4 (September 11, 2015) (available upon request). REITs own a pool of real estate assets, not stocks. Moreover, the profile of the investors that own REITs differs somewhat from the profile of investors in mutual funds, ETFs, and CEFs.

<sup>44</sup> The other cross-holdings are small. Legally, mutual funds, ETFs, and CEFs can hold only a small amount of shares of each other. See section 12(d)(1) of the Investment Company Act of 1940.

<sup>45</sup> Later, we distribute some of the mutual funds' and exchange-traded funds' holdings of REITs to the household sector.

<sup>46</sup> See Federal Reserve, *supra* note 6, at Table L.101.a, lines 13–14. Total securities from IRS Forms 990 included U.S. and foreign stocks and bonds.

<sup>47</sup> See EY, “Contribution of S ESOPs to Participants' Retirement Security” (March 2015).

<sup>48</sup> The Fed follows this method to value closely held stock.

**Step 3. Subtract Stock Held by Nonprofits—Continued**

(2015, market value in billions of dollars)

+ REITs held by nonprofits, already subtracted	\$28
+ S Corp shares held by ESOPs, already subtracted	\$124
Household direct holdings of C corporation equities	\$4,826

Fourth, we subtracted the stock held in self-directed IRAs based on data from the Investment Company Institute, which lists IRA assets by type of institution: mutual funds, bank and thrift deposits, life insurance companies, and “other assets” (self-directed accounts).<sup>49</sup>

To estimate the amount of C corporation equity in other assets, we took a few extra steps:

1. We assumed that 75 percent of the other assets are stock held through self-directed accounts.<sup>50</sup>
2. We assumed that equity in self-directed accounts comprises C corporation equity, ETF equity, CEF equity, and REIT equity. We focused on C corporation equity (because we had previously removed the other issuances). We assumed self-directed accounts held C corporation equity in the same proportion as the equity universe.<sup>51</sup> In 2015 that was 87 percent.
3. We reduced our estimate for foreign equity ownership (assuming that all U.S. investors held the 22.45 percent of their equity in foreign equity). As a result, we removed \$1.5 trillion of C corporation equity held in IRAs from the household sector.

We also subtracted equity holdings of section 529 accounts that are included in the residual household sector. The Fed separates assets held in section 529 college plans into assets held in college savings plans and assets held in prepaid tuition plans.<sup>52</sup> We assumed that half of the assets in college savings plans were C corporation equity and subtracted \$89 billion from household holdings in 2015.

**Step 4. Subtract Holdings by IRAs and Section 529 Accounts of C Corporation Stock**

(2015, market value in billions of dollars)

Household direct holdings of C corporation equities (from Step 3)	\$4,826
• Corporate equities in self-directed IRAs	(\$1,479)
• Corporate equities held in 529 plans	(\$89)
Taxable direct C corporation holdings	\$3,257

Finally, we added the stock that taxable accounts held beneficially through mutual funds, CEFs, and ETFs.

The Fed categorized mutual funds as a separate holder of corporate equity.<sup>53</sup> We added \$1.6 trillion of the mutual funds’ holdings of corporate stock to taxable accounts. We did not add the stock holdings of mutual funds that are attributable to nonprofits, IRAs, insurance companies, pension funds, and foreigners.

<sup>49</sup>See Investment Company Institute, “Report: The U.S. Retirement Market, Fourth Quarter 2015,” at Table 7 (March 24, 2016).

<sup>50</sup>Brad M. Barber and Terrance Odean, “Are Individual Investors Tax Savvy? Evidence From Retail and Discount Brokerage Accounts,” 88 *J. Pub. Econ.* 419 (2003) (finding that 74 percent of brokerage assets were stock).

<sup>51</sup>(C corporation equity/(the sum of C corporation equity, REIT equity, ETF equity, and CEF equity)).

<sup>52</sup>Federal Reserve, *supra* note 6, at Table B.101.

<sup>53</sup>*Id.* at Table B.101.e.



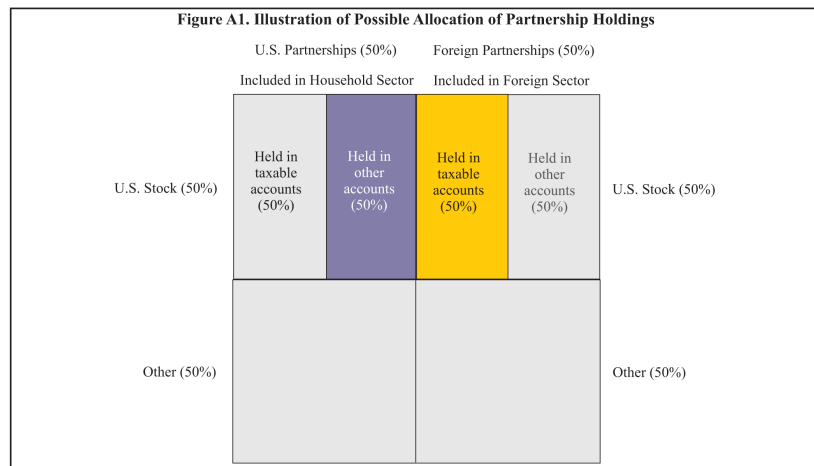
The Fed also separately listed ETFs and CEFs as owners of corporate equity.<sup>54</sup> We assumed that the household sector held 63 percent of ETF and CEF assets. Thus, we added \$645 billion of CEF and ETF holdings to the household sector (but excluded the equity holdings of nonprofits, IRAs, insurance companies, pension funds, and foreigners).

### Step 5. Add Indirect Holdings of C Corporation Equity

(2015, market value in billions of dollars)

Taxable C corporation holdings	\$3,257
+ Mutual fund holding of equities (except those mutual funds held by nonprofits, IRAs, insurance companies, pension funds, and foreigners)	\$1,600
+ Closed-end fund holding of equities (except those CEFs held by nonprofits, IRAs, insurance companies, pension funds, and foreigners)	\$39
+ ETF holding of equities (except those ETFs held by nonprofits, IRAs, insurance companies, pension funds, and foreigners)	\$630
Taxable account direct and indirect C corporation holdings	\$5,525

Thus, we calculated that taxable accounts hold \$5.5 trillion, or 24.2 percent of the \$22.8 trillion in taxable accounts of C corporation stock.



### Appendix 2: Hedge Fund/Private Equity Holdings

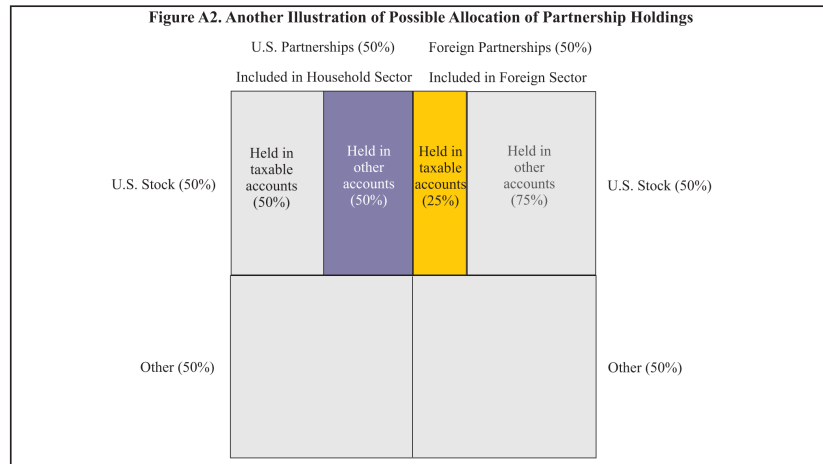
In theory, we should (1) subtract from taxable accounts the share of U.S. stock of U.S. funds held beneficially by nontaxable accounts (the blue box in Figure A1) and (2) add to taxable accounts the share of the U.S. stock of foreign funds that is held beneficially by U.S. taxable accounts (the orange box in Figure 6). However, the actual holdings, owners, and residence of the funds are not publicly available, so we could not estimate the size of the boxes. Because we lacked detailed data, we did not adjust for the misallocation of the partnership holdings in our main estimates.

<sup>54</sup> *Id.* at Table L.223, lines 18 and 19.

As illustrated in Figure A1, for our estimate, we could assume the assets, owners, and residence funds are split evenly.<sup>55</sup> As a result, the blue and orange boxes are the same size and cancel each other out. Thus, by adjusting in this manner, our estimate would remain at 24.2 percent.<sup>56</sup>

We could test the sensitivity of our estimate by varying the split of assets, owners, and residence of hedge funds and private equity funds. From industry sources, we estimated that the total assets managed by hedge funds and private equity funds were \$5.8 trillion in 2015.<sup>57</sup> In Figure A2, we again split the assets and residence of the hedge funds and private equity funds evenly—but assumed only 25 percent U.S. taxable owners of the foreign funds. With this change, our taxable share fell to 22.7 percent in 2015.

However, U.S. and foreign assets under the management of hedge funds and private equity funds have increased greatly over the last few years—highlighting their growing importance for stock ownership (see Figure A3). Further research and data on their assets, partners, and residence would help provide a clearer picture of who owns U.S. corporate stock.<sup>58</sup>

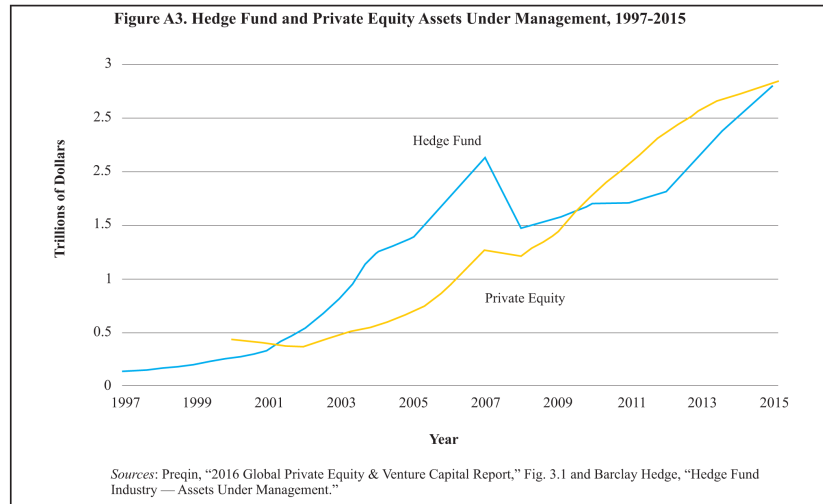


<sup>55</sup> U.S. and foreign funds with 50 percent U.S. taxable partners are plausible, because both U.S. general partners and U.S. limited partners may be U.S. taxable investors. For example, a general partner often gets a profits interest to manage a fund (the “20” in “2 + 20”). As a result, a U.S. general partner typically earns capital gains and dividend income on its profits interest, which is taxed at reduced rates. That said, U.S. limited partners generally invest through U.S. funds, and nonprofits and foreigners generally invest through foreign funds.

<sup>56</sup> In theory, we still ought to slightly adjust the holdings of subcategories of tax-exempt owners (e.g., nonprofits, foreigners, etc.)—which we lack the data to accomplish.

<sup>57</sup> Preqin, “2016 Global Private Equity and Venture Capital Report”; and BarclayHedge, “Hedge Fund Industry—Assets Under Management.”

<sup>58</sup> Michael Cooper et al. recently tried to untangle the ownership of partnerships, with some difficulty. They explain that partnerships “constitute the largest, most opaque, and fastest growing type of pass-through.” Cooper et al., “Business in the United States: Who Owns It and How Much Tax Do They Pay?” (October 2015).



PREPARED STATEMENT OF BRET WELLS, ASSOCIATE PROFESSOR OF LAW,  
LAW CENTER, UNIVERSITY OF HOUSTON

My name is Bret Wells, and I am an Associate Professor of Law at the University of Houston Law Center. I would like to thank Chairman Hatch, Senator Wyden, and the other members of the committee for inviting me to testify. I am testifying in my individual capacity, and so my testimony does not represent the views of the University of Houston Law Center or the University of Houston. I request that my full written testimony be included in the record.

Our tax system is in need of fundamental tax reform. Finding a path to rationalize the taxation of active business income in the United States is an important goal, and integration of shareholder and corporate taxation can achieve that goal. Corporate integration has been extensively studied for decades by prior administrations, the American Law Institute, and numerous highly respected academics—one of whom joins me on this panel.<sup>1</sup> As this committee's staff has recently written,<sup>2</sup> a broad consensus exists that significant efficiencies can be achieved through corporate integration. Thus, before one gets enmeshed in the important details of how to create an appropriately functioning corporate integration regime, it is important to say that reform along these lines can significantly improve our tax system. Focusing specifically on the dividends paid deduction regime, this particular method of achieving corporate integration would, as to distributed earnings, harmonize the tax treatment between debt and equity and would level the playing field between pass-through entities and C corporations.<sup>3</sup> There is much to commend this proposal.

I. THREE KEY INTERNATIONAL TAX CHALLENGES

But, notwithstanding the potential benefits of a corporate integration regime, the reality is that business tax reform must carefully consider the international tax implications of any new paradigm, and to that end the United States must ensure that its tax regime withstands at least the following three systemic international tax challenges.<sup>4</sup>

<sup>1</sup>See e.g., Michael J. Graetz and Alvin C. Warren, *Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and the American Law Institute Reports* (1998).

<sup>2</sup>See Republican Staff of the Senate Finance Committee, *Comprehensive Tax Reform for 2015 and Beyond* at 122–237, 113th Cong., S. Prt. No. 113–31 (December 2014).

<sup>3</sup>See Joint Committee on Taxation, *Overview of Approaches to Corporate Integration* at 32 (JCX–44–66) (May 13, 2016).

<sup>4</sup>These same tax challenges exist whether or not Congress adopts a dividends paid deduction regime, retains its classic double taxation of corporate earnings, or bolts on a territorial tax re-

Continued

First, a critical international tax challenge is the inbound earning stripping challenge,<sup>5</sup> and this earning stripping challenge can be further categorized along the following types of base erosion strategies: (1) related party Interest Stripping Transactions; (2) related party Royalty Stripping Transactions; (3) related party Lease Stripping Transactions; (4) Supply Chain restructuring exercises; and (5) related party Service Stripping Transactions.

The second key international tax challenge relates to corporate inversions.<sup>6</sup> Corporate inversions are often categorized as a discreet, stand-alone tax policy problem, but, in my view, the corporate inversion phenomenon provides unmistakable evidence of the enormity of the inbound earning stripping advantage that exists for all foreign-based multinational corporations. A foreign-based multinational corporation can engage in an inbound related party Interest Stripping Transaction, an inbound related party Royalty Stripping Transaction, and an inbound related party Lease Stripping Transaction without any concern about the U.S. subpart F regime, whereas these very same inbound transactions would create a subpart F inclusion if conducted by a U.S. multinational corporation. Corporate inversions represent an effort by U.S. multinational corporations to place their U.S. businesses into an overall corporate structure that affords them the full range of inbound U.S. earning stripping techniques without being impeded by the backstop provisions of the U.S. subpart F rules.

Third, fundamental tax reform must deal with the so-called lock-out effect.

## II. INTERNATIONAL IMPLICATIONS OF DIVIDENDS PAID DEDUCTION REGIME<sup>7</sup>

As to the earning stripping challenge and its alter ego the corporate inversion phenomenon, the dividends paid deduction regime, by itself, does not equalize the tax position of a U.S. multinational corporation with that of a foreign-based multinational corporation. Even though the dividends paid deduction regime provides a corporate level tax deduction for dividend payments, the dividend payment is subject to a corresponding shareholder withholding tax. In comparison, a foreign-based multinational corporation can engage in all five of the previously enumerated earning stripping strategies to create a comparable U.S. corporate tax deduction without incurring a corresponding withholding tax. Thus, the dividends paid deduction regime does not eliminate the financial advantages that motivate earning stripping or that fuel the corporate inversion phenomenon. In order to address these two key international tax challenges, the United States must impose an equivalent withholding tax, or a surtax, on all of the related party base erosion strategies and not just on Interest Stripping Transactions or Royalty Stripping Transactions.

As to the lock-out effect, the dividends paid deduction regime should substantially eliminate the lock-out effect with respect to the repatriation of low-tax foreign earnings. For companies that repatriate a significant amount of low-tax foreign income, the dividends paid deduction regime will likely represent a net benefit versus existing law. But, outside that low foreign tax context, the interplay of the dividends paid deduction regime with the U.S. foreign tax credit regime creates complex trade-offs. In particular, where a high percentage of a company's total income constitutes foreign income that has been subjected to high foreign taxes, the dividends paid deduction regime likely represents a net cost over existing law.<sup>8</sup>

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gime to either of these two paradigms. For a more in-depth analysis of my views of the base erosion and profit shifting challenges created under a territorial tax regime, see Bret Wells, "Territorial Taxation: Homeless Income is the Achilles Heel," 12 *Hous. Bus. and Tax L.J.* 1 (2012).

<sup>5</sup>My views on the genesis of the "Homeless Income mistake" and its solution are set forth in Bret Wells and Cym Lowell, *Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin*, 65 *Tax Law Rev.* 535 (2012).

<sup>6</sup>For a more in-depth discussion of my views on the corporate inversion phenomenon and what it means to U.S. tax policy, see Bret Wells, "Corporate Inversions and Whack-a-Mole Tax Policy," 143 *Tax Notes* 1429 (June 23, 2014); Bret Wells, "Cant and the Inconvenient Truth About Corporate Inversions," 136 *Tax Notes* 429 (July 23, 2012); Bret Wells, "What Corporate Inversions Teach Us About International Tax Reform," 127 *Tax Notes* 1345 (June 21, 2010).

<sup>7</sup>For a more in-depth assessment of my views on the international tax implications of a dividends paid deduction proposal, see Bret Wells, "International Tax Reform By Means of Corporate Integration," 19 *Fla. Tax Rev.* (2016) (forthcoming), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2766618](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2766618).

<sup>8</sup>Consequently, companies in this posture may forgo the dividend deduction allowed under the dividends paid deduction regime and instead rely on the U.S. foreign tax credit regime to offset a substantial portion of its corporate level tax and in turn might then distribute cash to shareholders through share repurchases that are eligible for section 302 treatment. This strategy would provide shareholders the potential for favorable capital gains treatment and in any event

Finally, under a dividends paid deduction regime, a new tax design challenge will be added to our tax laws. In this regard, to the extent that the shareholder withholding tax can be cross-credited against the shareholder's residual income tax liability arising from other income, the marketplace will attempt to structure transactions that will exploit that cross-crediting opportunity and, if successful, will create a new set of tax distortions to plague the U.S. tax laws. Thus, if a dividends paid deduction regime were adopted, it would be important to ensure that the incidence of the shareholder dividend withholding tax cannot be shifted, cross-credited against other shareholder income, monetized, or reduced. Congress is likely to receive pleas from various constituencies to exempt specific sympathetic groups from the shareholder dividend withholding tax or the complimentary taxes that would need to be imposed on all base erosion payments, but Congress must resist those calls or else another source of tax distortions will be created through the tax system.

### III. CONCLUSION

Let me conclude my oral testimony by stating that an appropriately structured corporate integration regime has much to offer. The committee is to be commended for considering fundamental business tax reform, but at the same time this committee must ensure that the dividends paid deduction regime is structured to withstand the systemic international tax challenges that face the United States. Thank you for allowing me to speak at today's hearing. I would be happy to answer any of your questions.

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#### PREPARED STATEMENT OF HON. RON WYDEN, A U.S. SENATOR FROM OREGON

This morning the Finance Committee will discuss the concept of corporate integration, which isn't exactly a topic that comes up at summer picnics. But this issue is important to the tax reform debate, and I want to thank Chairman Hatch and his staff for putting a whole lot of sweat equity into this topic. I'm glad the committee will have this opportunity today to dig into the specifics. Today I want to begin mostly with questions about what corporate integration would mean for middle-class families and small businesses looking for opportunities to get ahead.

Corporate integration is about eliminating what some people call double taxation, where income is taxed once at the corporate level and again at the individual level. Once in place, this kind of tax change would allow companies to write off payments they make to shareholders in the form of dividends. The theory goes, the profit corporations bring in would go out as dividends, and corporate tax bills would shrink. But to finance that big corporate tax cut, 35 percent of the money paid out in dividends and bond interest would be withheld automatically by the Treasury.

Now this raises a question with respect to retirement savings.

It looks, on its face, like this proposal could go from double taxing corporate income to double taxing retirement plans. Here's why. Today, most middle-class savers put their money into retirement plans that are tax-deferred. It's a good deal for workers, and this country's savings crisis would probably be a lot worse without it. Retirement plans invest in a lot of stocks and bonds. But under a corporate integration plan, when you withhold a chunk of the dividends and interest payments that go to retirement plans, suddenly they could get hit with a big, new tax bill for the first time. Their special tax-deferred status—which today is the key that unlocks opportunities to save for millions of Americans—would go away.

Right now, most savers already face a tax bill when they take money out of their accounts. Corporate integration could often add a second tax hit up front. So if you're an electrician in Medford or a teacher in Salem and you've got an IRA or a 401(k), you'd have to wonder if this system says the dollar you socked away is worth less than it used to be. If the math on retirement plans suddenly looks worse to small business owners, there's a possibility they might think twice about offering a plan to their employees.

There is another question whether corporate integration could wind up picking winners and losers in how it affects businesses. Companies that run airlines and wind farms, which need capital to invest and operate, would face higher costs if in-

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avoids the new shareholder dividend withholding tax. The interplay of whether to utilize the foreign tax credit regime to offset corporate level tax or instead to rely on the dividend paid deduction regime creates a new complexity.

terest rates jump. And start-ups may not necessarily want to pay dividends to shareholders because they need to turn their earnings into growth instead of dividends. A corporate integration plan might look great to established companies with lots of cash, but not so hot to the small businesses that dominate the economic landscape in Oregon and in hundreds of communities across the country. These are big issues to discuss today.

I want to thank our witnesses for being here this morning, and I look forward to hearing their testimony. And before I conclude, I want to recognize one of our witnesses today, Judy Miller, who is retiring at the end of the summer. Judy served as a senior pension advisor to this committee under Senator Baucus for 4½ years. She's also testified before the committee a number of times. I'd like to congratulate and thank Judy for her service and invaluable advice over the years and wish her well in the future.

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## COMMUNICATION

CENTER FOR FISCAL EQUITY  
237 Hannes Street, Silver Spring, Maryland 20901

### Comments for the Record by Michael Bindner

Chairman Hatch and Ranking Member Wyden, thank you for the opportunity to address this topic. The Center for Fiscal Equity believes that dealing with the question of taxing dividends is a key issue in constructing tax reform legislation and ultimately in achieving comprehensive deficit reduction.

As always, our proposals come within the context of our four-point tax reform and deficit reduction plan:

- A Value Added Tax (VAT) to fund domestic military spending and domestic discretionary spending with a rate between 10% and 13%, which makes sure very American pays something.
- Personal income surtaxes on joint and widowed filers with net annual incomes of \$100,000 and single filers earning \$50,000 per year to fund net interest payments, debt retirement and overseas and strategic military spending and other international spending, with graduated rates between 5% and 25% in either 5% or 10% increments. Heirs would also pay taxes on distributions from estates, but not the assets themselves, with distributions from sales to a qualified ESOP continuing to be exempt.
- Employee contributions to Old-Age and Survivors Insurance (OASI) with a lower income cap, which allows for lower payment levels to wealthier retirees without making bend points more progressive.
- A VAT-like Net Business Receipts Tax (NBRT), essentially a subtraction VAT with additional tax expenditures for family support, health care and the private delivery of governmental services, to fund entitlement spending and replace income tax filing for most people (including people who file without paying), the corporate income tax, business tax filing through individual income taxes and the employer contribution to OASI, all payroll taxes for hospital insurance, disability insurance, unemployment insurance and survivors under age 60.

We do not believe that providing a tax cut for dividends to corporations is appropriate at this or any other time. Such a tax cut could not be duplicated for pass-through businesses, partnerships and sole proprietorships—the majority of business taxpayers. It would foreclose the possibility of enacting consumption taxes, which tax labor and capital at the same rate. Indeed, such a deduction would essentially turn consumption taxes into a payroll tax, provided that all profits were distributed as dividends (which is actually a proposal for followers of Louis Kelso and his Two Factor Theory). This proposal is exactly the wrong way to go in this Congress, where it would be vetoed by the sitting President.

The Center for Fiscal Equity believes that lower dividend, capital gains, and marginal income taxes for the wealthy actually destroy more jobs than they create. This occurs for a very simple reason—management and owners who receive lower tax rates have more an incentive to extract productivity gains from the work force through benefit cuts, lower wages, sending jobs offshore or automating work. As taxes on management and owners go down, the marginal incentives for cost cutting go up. As taxes go up, the marginal benefit for such savings go down. It is no accident that the middle class began losing ground when taxes were cut during the Reagan and recent Bush administrations, both of which saw huge tax cuts. Keeping these taxes low is also part of why we are experiencing a recovery performing at half speed now.

**As long as management and ownership benefit personally from cutting jobs, they will continue to do so. Tax reform must reverse these perverse incentives.**

Tax cuts on capital also produce a host of bad investments that would not otherwise occur. Every major asset bubble, including the 2008 recession, arose from dividend and capital gains taxes that were too low. If capital is needed for business because of a demand driven expansion, the Federal Reserve is quite able to make this happen. Fiscal policy is not, and never has been, the answer to making credit available for expansion.

Our Principal Analyst served on the Computer-Aided Manufacturing—International Cost Management System Project, part of which was the Multi-Attribute Decision Model for investment. Cost of capital was not a major driver. Customers who are able and willing to spend had a much greater impact on why investment should take place. There is one word which typifies an investment manager who follows supply-side economic theory in recommending business investments: unemployed.

**Double-taxation of dividends by taxing as value-added and as income to the shareholder is a myth, and a bad one at that.**

If corporate income taxes were expanded to be a subtraction VAT or net business receipts tax that all firms pay, an additional tax on shareholders is merely a surtax paid because there is no other way to fully tax profit at the business level without doing major damage to equity and privacy.

In testimony before the Senate Budget Committee, Lawrence B. Lindsey explored the possibility of including high income taxation as a component of a Net Business Receipts Tax. The tax form could have a line on it to report income to highly paid employees and investors and pay surtaxes on that income.

The Center considered and rejected a similar option in a plan submitted to President Bush's Tax Reform Task Force, largely because you could not guarantee that the right people pay taxes. If only large dividend payments are reported, then diversified investment income might be under-taxed, as would employment income from individuals with high investment income. Under collection could, of course, be overcome by forcing high income individuals to disclose their income to their employers and investment sources—however this may make some inheritors unemployable if the employer is in charge of paying a higher tax rate. For the sake of privacy, it is preferable to leave filing responsibilities with high income individuals.

Accomplishing deficit reduction with income and inheritance surtaxes recognizes that attempting to reduce the debt through either higher taxes on or lower benefits to lower income individuals will have a contracting effect on consumer spending, but no such effect when progressive income taxes are used. Indeed, if progressive income taxes lead to debt reduction and lower interest costs, economic growth will occur as a consequence.

Using this tax to fund deficit reduction explicitly shows which economic strata owe the national debt. Only income taxes have the ability to back the national debt with any efficiency. Payroll taxes are designed to create obligation rather than being useful for discharging them. Other taxes are transaction based or obligations to fictitious individuals. Only the personal income tax burden is potentially allocable and only taxes on dividends, capital gains and inheritance are unavoidable in the long run because the income is unavoidable, unlike income from wages.

Even without progressive rate structures, using an income tax to pay the national debt firmly shows that attempts to cut income taxes on the wealthiest taxpayers do not burden the next generation at large. ***Instead, they burden only those children who will have the ability to pay high income taxes. In an increasingly stratified society, this means that those who demand tax cuts for the wealthy are burdening the children of the top 20% of earners, as well as their children, with the obligation to repay these cuts. That realization should have a healthy impact on the debate on raising income taxes rather than carving out even more tax breaks for the wealthy, such as making dividends deductible in the corporate income tax.***

Thank you for the opportunity to address the committee. We are, of course, available for direct testimony or to answer questions by members and staff.