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CORPORATE INTEGRATION: BACKGROUND AND PERSPECTIVE

Q: <u>What is "corporate integration"</u>?

"Corporate integration" is the general term that refers to the shift of the corporate income tax away from the current system of double taxation to a single-tier system.

Q: <u>In what respects is the corporate income tax a system of double taxation</u>?

The corporate income tax is a system of double taxation in several respects:

a. Corporate income is subject to the corporate income tax in the hands of the corporation. If distributed as dividends to individual shareholders, the income is subject to a second level of tax in the hands of the shareholders. (If distributed to corporate shareholders, the income may be subject to a second layer of corporate taxation, depending on the circumstances. However, the tax code includes features to allow corporations generally to avoid multiple levels of corporate tax.)

b. Corporate income that is taxed in the hands of the corporation and retained by the corporation normally is reflected in the value of the corporate stock. Sales of the stock by the shareholders trigger capital gains taxation on such increases in the value of the stock.

c. Distributions of property by corporations trigger the corporate tax on the excess of the value of such property over the adjusted basis of the property. Receipt of the property by the shareholders triggers a second level of tax at the shareholder level.

Q: <u>Does the corporate income tax apply only to entities that are organized formally as corporations</u>?

No. As a general rule, entities that are organized as partnerships (including limited liability companies electing to be taxed as partnerships) become subject to the corporate income tax if their shares become publicly traded. In other words, public trading is a key line of demarcation between partnership tax treatment and corporate tax treatment. Statutory exceptions from corporate tax treatment exist for publicly traded partnerships that earn primarily investment income or certain other types of income specified in the statute.

Q: <u>Are partnerships subject to double taxation</u>?

No:

a. The Income of partnerships is taxed directly to the partners, whether or not distributed by the partnership.

b. If a partnership retains its earnings, the tax code provides the partners with an increase in the basis of their interest in the partnership in the amount of those earnings, with the result of insulating the partners from capital gains taxation on increases in the value of their partnership interests reflecting the retained earnings.

c. With certain exceptions, distributions of property by partnerships to a partner do not trigger tax at either the partnership or partner level.

d. Of course, if a corporation is a partner in a partnership, then the corporation's share of partnership earnings could become subject to the double-tier corporate tax.

Q: Does the two-tier corporate tax system apply to small businesses or closely held businesses?

For the most part, no. Although any business can organize itself as a regular, taxable "C" corporation, the Treasury Department issued rules in the 1990s allowing non-publicly traded businesses organized as limited liability companies under state law to elect to be taxed as partnerships despite the limited liability conferred on the business by the LLC form of organization. Since that time, LLCs have become the preferred vehicle for new businesses in the United States, and an ever-increasing share of U.S. business income has become subject to partnership taxation and less and less to corporate taxation.

In addition, small and closely held businesses that organize as corporations have the option of electing S status for tax purposes. S corporations are taxed in a manner similar to partnerships, but with a variety of restrictions, including restrictions on the number of shareholders. (S elections are attractive for businesses operated in the past as regular C corporations. Such elections often enable the business to escape from corporate taxation at little or no tax cost, whereas the conversion of a C corporation to a partnership or LLC can trigger substantial tax.)

Q: What exceptions to the two-tier corporate tax system does the tax code currently provide?

In addition to S corporations and the publicly traded partnerships referred to above, prominent exceptions include:

a. **Real estate investment trusts**. REITS are corporations that meet certain income and distribution requirements specified in the tax code. The income of REITS is taxed to the REIT shareholders and not to the REIT since the REIT is entitled to a deduction for dividends paid.

b. **Real estate mortgage investment conduits**. REMICS are corporations (or other entities) that hold mortgages and pass through the income from the mortgages to investors. The income is taxed to the investors and not to the entity.

c. **Regulated investment companies**. RICs are mutual funds and other such investment vehicles the income of which, again, is taxed to the investors and not to the RIC, through a deduction available to the RIC for distributions to the investors.

Q: <u>Does the tax code currently include any features that constitute steps toward corporate integration</u>?

Yes:

a. The preferential tax rate on capital gains applies to sales of stock held by investors for more than one year. The preferential rate helps reduce the shareholder-level tax on retained, previously taxed corporate earnings reflected in stock values.

b. The same preferential rate also applies to dividends received by investors with respect to stock held for more than one year, thereby reducing the shareholder-level tax on the corporate earnings represented by such dividends.

Q: <u>Has the corporate income tax always been a system of double taxation</u>?

No, although the history of the corporate income tax goes back (off and on) to the Civil War, corporate dividends were exempt from tax until 1936. Additionally, until 1986, distributions of property by corporations in liquidation triggered only a single level of tax, not two levels. [1]

Q: <u>Tax writers in Congress have been pursuing a reduction in the corporate tax rate and the shift to a territorial system as ways of keeping U.S. corporations competitive with foreign corporations and lessening the incentive for inversions; are there reasons why tax writers should consider pursuing corporate integration instead</u>?

There are several reasons for tax writers to consider pursuing corporate integration:

a. From a broad tax-policy perspective, the two-tier system of corporate taxation is arguably a relic of the past, especially given the growth in the use of the LLC vehicle.

b. The two-tier corporate tax system has evolved to constitute, arguably, an arbitrary price levied on U.S. businesses for obtaining access to the public equity markets.

c. Business groups representing small and closely held businesses – key GOP constituencies – have vetoed any discussion of a corporate rate cut without corresponding cuts in the individual tax rates. Proposals for individual rate cuts in the tax reform discussion open a contentious debate over the progressivity of the tax system and over the fate of many popular features of the individual income tax. The result is to sharply reduce (or eliminate)

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[1] In an article in 1986, I argued against the imposition of the two-tier corporate tax on property distributed in a corporate liquidation. James Gould, "General Utilities Repeal: Congress Should Pass It By," *Tax Notes*, July 14, 1986, p. 147.

the odds of passage of any tax reform bill in Congress (and extend the quarter century of tax reform failure in Congress). By contrast, an effort to achieve corporate integration would constitute merely an attempt to more closely conform the tax treatment of public corporations to the treatment of other U.S. businesses and would not necessitate a debate over the individual tax rates.

d. A shift of part or all of the corporate income tax to shareholders through integration could have the practical effect, from the point of view of corporate managers, of boosting the competitiveness of U.S. corporations against lower-taxed foreign corporations in the same manner as a rate cut or territoriality.

Q: <u>What are possible approaches Congress could take to achieve corporate integration</u>?

Students of tax policy commonly discuss several approaches to corporate integration:

a. Congress could create a tax exemption for dividends received by corporate shareholders (i.e., Congress could transform the current preferential tax rate on qualified dividends into a full exemption). Correspondingly, Congress could provide a tax basis increase to shareholders to reflect previously tax corporate earnings retained by the corporation. The basis adjustment would have the effect of eliminating or cutting the tax on capital gains realized by shareholders on stock value attributable to such earnings.

b. Congress could allow corporations to deduct dividends paid to shareholders and thereby reduce or eliminate the corporate-level tax. The dividends would be taxable to the shareholders.

c. Congress could create a mark-to-market system under which corporate shareholders would periodically recognize, and pay tax on, appreciation in the value of their stock (i.e., without the necessity of a sale) to reflect the value of corporate retained earnings. In return, the corporate tax would be eliminated or reduced.

d. Congress could create a credit-imputation system, common in other countries. Under such a system:

    i. The corporation would pay a corporate income tax;

    ii. The shareholders would include in their taxable income dividends received from the corporation, together with the amount of corporate tax associated with the dividends, and

    iii. The shareholders would receive a credit against the individual income tax for such amount of corporate tax.

The net effect of the credit-imputation system would be a single level of tax, partly paid at the corporate level and partly paid at the shareholder level based on each shareholder's marginal tax rate.

Q: <u>Instead of any of the foregoing approaches, why could lawmakers not simply let corporations elect to be taxed as partnerships in the same manner as LLCs, so that their income would be directly taxed to the shareholders</u>?

Tax observers generally agree that the application of partnership taxation to large public companies would create, at present, impossible administrative issues for corporations, shareholders, and the government. As one example, corporations would have to determine how to allocate items of income, gain, credit, deduction, etc. among potentially millions of shareholders during the year, some of whom may have held shares for only a few minutes and some of whom may have held shares at many different points during the year. Multiple classes of stock would compound the difficulty.

This is not to say that, over time, Congress and the Treasury could not conceivably reshape the partnership tax rules for the task. The government and corporations have the experience of publicly trade partnerships to draw on, and just last year Congress created new audit procedures permitting the government to collect tax deficiencies directly from partnerships, rather than having to collect from each partner. Nevertheless, few observers believe that the partnership model will soon be ready to deal with the many issues that would arise in an attempt to apply the model in a wholesale manner to the universe of large, complicated public companies.

Q: <u>Would corporate integration affect the debate over the possible adoption of a territorial system</u>?

Yes. As described previously, an integration plan that shifted much or all of the corporate tax to the shareholders could reduce or eliminate the perceived competitive disadvantages for U.S. corporations of the U.S. system of worldwide taxation and thereby reduce or eliminate the incentive for corporations to invert or otherwise take steps to avoid the corporate tax on foreign earnings. Of course, the design of such an integration plan would still have to deal with whether, or how, shareholders would pay tax on the corporation’s foreign earnings.

An integration plan that retained a corporate-level tax while eliminating or reducing the shareholder-level tax would continue to give corporations an incentive to try to avoid tax on foreign earnings and would presumably keep the debate over adoption of a territorial system fully alive.

Q: <u>Has the government tried in the past to enact corporate integration</u>?

Yes, among other attempts:

a. The Eisenhower administration offered proposals for corporate integration that led to the enactment of subchapter S in 1958.

b. The Treasury Department in 1977 issued a report proposing to expand eligibility for subchapter S to all corporations. Congress did not enact the proposal.

c. The Reagan administration championed a dividend deduction in its tax reform proposals leading to the Tax Reform Act of 1986. Congress did not include the proposal in the act.

d. The Treasury Department issued a report in 1992 calling for a tax exemption for dividends received by shareholders from previously taxed corporate income. Congress did not advance the proposal.

e. President George W. Bush in 2003 similarly proposed a tax exemption for dividends received by shareholders from previously tax corporate income, together with a stock basis adjustment for shareholders to reflect previously taxed retained corporate earnings. The former proposal ended up as a reduction in the capital gains rate in the Jobs Act of 2004.

Q: Would corporate integration be costly for the government?

As is usually the case with tax legislation, the devil would be in the details, and there would be dozens of details for lawmakers to deal with. In general, an integration plan that ensured the imposition of one full level of tax on all corporate income (measured broadly) might be less expensive than many observers might think because, at present, some corporate income is not subject to even one full level of tax, and little corporate income is actually subject to two levels of tax because shares of public companies are held mainly by endowment funds and other tax exempt organizations.

Q: Would corporate integration be all-or-nothing, or could Congress accomplish it incrementally?

There is no inherent reason why Congress could not take an incremental approach to most forms of corporate integration. Additionally, Congress certainly could mix multiple forms of integration (such as a partial dividends paid deduction and a partial exemption for dividends received by shareholders) based on political, budgetary, and procedural factors.

Q: Would corporate integration affect the debt-equity mix of corporations?

Depending on how it was accomplished, corporate integration clearly could increase the attractiveness of equity and thereby decrease the relative attractiveness of debt.

Q: What are some of the difficult design or conceptual issues in corporate integration?

The following are a few of the difficult issues involved in designing a corporate integration plan:

a. **Tax exempt shareholders**. For budgetary reasons (if for no other reasons), any corporate integration plan adopted by Congress would presumably have to ensure the collection of at least one level of tax on corporate income. Thus, if the integration plan were structured to eliminate or sharply cut the corporate-level tax and shift the tax to the shareholders, Congress would need to provide for the collection of tax on dividends from tax-exempt recipients, such as endowment funds and charities. Such tax could be accomplished by treating the dividends as unrelated business taxable income, in the same manner that dividends from REITs currently constitute UBTI (to ensure the collection of at least one level of tax on REIT income).

b. **Incentive to pay dividends**. If Congress were to include a dividends-paid deduction in an integration plan, the deduction would presumably act as an incentive for corporations to pay dividends and thereby reduce their corporate-level tax liability. Lawmakers could debate whether it is appropriate for the tax laws to be structured to create such an incentive.

c. **Non-dividend-paying companies**. Some profitable companies retain and reinvest earnings rather than distribute them to shareholders. A dividends-paid deduction would not provide corporate integration for such companies. For such companies, Congress could consider a mark-to-market approach, a retained earnings basis-adjustment approach, or the partnership model (all discussed previously).

d. **Liquidity**. A general issue for any integration approach (such as the mark-to-market approach) that would trigger a shareholder-level tax other than in conjunction with the payment of dividends is how the shareholders would pay the tax. In other words, unless shareholders are receiving dividends, they may not have the funds with which to pay the tax on the corporate earnings.

e. **Foreign shareholders**. As in the case of tax-exempt shareholders, if Congress were to adopt a dividends-paid deduction, Congress would presumably need to provide for the collection of tax from foreign shareholders (through withholding) to ensure the imposition of at least one level of tax on corporate income. Under current U.S. tax treaties with other countries, many foreign shareholders enjoy a full or partial exemption from tax on dividends from U.S. companies. An integration plan may need to override treaty obligations.

f. **Progressivity**. Integration achieved through an exemption for dividends received by shareholders would have the effect of reducing the progressivity of the tax system and face obvious political and tax-policy objections.

g. **Foreign tax credit and foreign income**. If an integration plan preserved the taxability of overseas earnings at either the corporate or shareholder level, then the foreign tax credit would continue to serve its purpose. A shift of the corporate tax to shareholders would raise the question of exactly how the credit would apply to the shareholders. Further, in any such shift, Congress would face the question of the timing of taxation of foreign earnings (i.e., whether to continue the current deferral mechanism).

h. **Corporate tax benefits**. Finally, if Congress were to decide to shift most or all of the corporate income tax to shareholders, a question would arise as to how corporate tax benefits would survive in the hands of shareholders. For example, how would the corporate credit for research expenditures be passed through to shareholders? Currently, dividends are taxable to shareholders if paid from the broad measure of a corporation’s economic income referred to in the tax code as "earnings and profits." Congress would need to specify how tax incentives would affect the taxability of dividends.

Q: <u>Would transition be a significant issue for corporate integration</u>?

Transition undoubtedly would be a serious issue since integration could affect the operation of U.S. securities markets. To avoid creating market uncertainty or otherwise affecting securities pricing and trading, tax writers would need to be cautious about advancing proposals without an adequate transition period and adequate notice. The securities-market risks that could be created by an undisciplined legislative process may militate toward an incremental approach to integration.

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