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INTEGRATION OF COPORATE AND SHAREHOLDER TAXES

Michael J. Graetz and Alvin C. Warren, Jr.*

Integration of the corporate and individual income taxes can be achieved by providing shareholders a credit for corporate taxes paid with respect to corporate earnings distributed as dividends. When such integration was previously considered in the United States, proponents emphasized that it could reduce or eliminate many of the familiar distortions of a classical corporate income tax. Integration would also provide a framework for addressing current concerns for tax incentives for U.S. companies to shift income to foreign affiliates in lower-taxed countries or to expatriate in "inversion" transactions. A recent Congressional proposal for a corporate dividend deduction coupled with withholding on dividends could achieve equivalent results, while also reducing effective U.S. corporate tax rates.

I. INTRODUCTION

Without even considering the international taxation of business income, corporate tax reform is complex because five key structural relationships are involved: (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 nondividend distributions. When one adds to this list the relative treatment of domestic and foreign income, differences in the treatment of domestic and foreign corporations, and the coordination of domestic and foreign taxes, business tax reform becomes even more daunting.

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* Michael J. Graetz: Columbia Law School, mgraet@law.columbia.edu), Alvin C. Warren, Jr.: Harvard Law School, warren@law.harvard.edu) We have relied on Graetz & Warren (1999, 2014a) for some material in this paper. We thank Peter Merrill for very helpful comments.

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In the early 1990s, a number of proposals were advanced for addressing the domestic distortions by integrating the corporate and individual income taxes. The U. S. Department of the Treasury (U.S. Treasury) proposed achieving greater neutrality by taxing business income once — at the business level (U.S. Treasury, 1992a, 1992b). This form of integration was advanced by President George W. Bush in 2003, but Congress instead lowered shareholders' income tax rates on dividends.[1]

Simultaneously with the Treasury Report, a reporter's study by Warren (1993) 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 are 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 Committee on Finance, 2015), drawing on an earlier in-depth staff study (U.S. Senate Committee on Finance, 2014). As of this writing, it is widely expected that Senator Hatch, the chairman of the Senate Finance Committee, will soon release a detailed proposal for a dividend deduction combined with withholding (Velarde, 2016). As emphasized in the various Senate Finance Committee documents, this combination could retain the advantages of shareholder-credit integration while also reducing effective corporate tax rates.

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

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When the U. S. 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.

We begin with a bit of history. Next we describe how a shareholder credit or a dividend deduction with withholding would work. We then review some of the major design issues to be considered (including extension of withholding to interest) and discuss how integration would address those issues. Finally, we briefly compare integration with some other proposals for corporate tax reform.

II. 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)

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suggested that those systems violated European Union (EU) 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 these 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, the U.S. Treasury published a comprehensive study of integration that discussed several alternative methods of corporate-shareholder integration (U.S. Treasury, 1992a), hereafter referred to as the “Treasury report.” It analyzed and described, but did not recommend, shareholder credits. Instead, the U.S. Treasury supported an

exclusion for dividends as the way to reduce double taxation of corporate income. In 1993, the American Law Institute (hereafter referred to as the "ALI report") 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.[2]

Congress eventually acted in 2003 and reduced shareholder tax rates, rather than accepting the exclusion of dividends then recommended by the U.S. Treasury. This approach left in place the separate corporate tax at the rate of 35 percent.

Remarkably (and contrary to the original 1992 U.S. Treasury study), the 2003 legislation reduced shareholder tax rates even on dividends that have not been subject to taxation at the corporate level. Reducing the shareholder tax on dividends that have not borne corporate tax is not a coherent approach to rationalizing the tax burden on corporate income. That approach provides a tax benefit for high-income shareholders on income that may not have borne any corporate-level tax.

Whatever the merits of the 2003 legislation at the time, it is no longer a sensible component of a system of business and investment taxation in the world of international competition now faced by American companies. Given the ability of multinational corporations to create new entities in low-tax jurisdictions, to shift items of income and deduction among countries to obtain tax advantages, and even to change the residence of the parent company, it is the corporate, not the shareholder, rate that needs to be reduced today. Shareholder residence is far less mobile than corporate income. In addition, because economists now agree that some

[2] For the Treasury report's discussion, see U.S. Treasury (1992a).

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.[3] 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

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

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.

III. HOW INTEGRATION BY A SHAREHOLDER CREDIT OR A DIVIDEND DEDUCTION WITH WITHOLDING WOULD WORK

A. 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 percent. A taxable individual shareholder in the top bracket will owe 23.8 percent tax on the dividend, and a foreign shareholder would owe from zero to 30 percent, 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 percent for the tax-exempt shareholder, 50.5 percent for the taxable top bracket U.S. individual,[4] and from 35 percent to 54.5 percent for foreign shareholders.[5] 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 percent 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 percent, which can sometimes be avoided). Foreign partners will pay tax at the U.S. rate (up to 39.6 percent), perhaps with a credit against their domestic taxes. In 2011, 54.2 percent of U.S. business income was earned by partnerships (or other pass-through entities) compared to 20.7 percent in 1980 (Cooper et al., 2015). Today, only

[4] The 50.5 percent figure reflects the corporate tax of 35 percent plus a 23.8 percent individual level tax on the $65 dividend.
[5] The 54.50 percent figure reflects the corporate tax of 35 percent plus a 30 percent withholding on the $65 dividend.

about 25 percent of U.S. corporate stock is held in individual taxable accounts (~~Austin, Berman, and~~ Rosenthal and Austin, 2016).

B. 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 with 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 here>

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 percent 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.

C. 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 would have largely benefited only distributed earnings.[6] 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 tax-exempt shareholders. However, by coupling a deduction for dividends with withholding on dividends, results can be achieved that combine the benefits of shareholder-credit integration with reduction of effective corporate tax rates (U.S. Senate Committee on Finance, 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.

[6] 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 (1992a) and Warren (1993) . 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 to the recommendation, see Sullivan (2005).

In addition, a deduction for dividends financed from 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 here>

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 percent (assuming that book income also equals $100), rather than 35 percent under the imputation credit. In both cases, the government receives total payments from the corporation of $35 and a total 40 percent 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 percent. 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 here>

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

IV. SOME MAJOR DESIGN ISSUES

Adoption of a shareholder credit or a dividend deduction with withholding has the potential for rationalizing and simplifying the taxation of business income. Like any significant reform of corporate taxation, such a change raises a series of design issues. The most important of these issues have been extensively analyzed in the ALI and Treasury studies, which were

recently republished in electronic form (Graetz and Warren, 2014b), as well in the recent Senate Finance Committee studies (U.S. Senate Committee on Finance, 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.

A. 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 tax 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 (U.S. Senate Committee on Finance, 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.[7] By requiring that withholding apply to every dividend distribution, the proposal under discussion in the Senate Finance Committee reaches a similar result.[8] The major disadvantage of not allowing individual shareholders the benefit of corporate tax preferences would be a continued difference in the treatment of corporate and noncorporate businesses in this regard.

B. 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.[9] It is sometimes suggested that the second problem could be addressed by retaining preferential taxation of gains

[7] A subsequent version of a dividend exclusion proposed by U. S. Treasury includes some pass-through of corporate preferences (U.S. Treasury, 1992b).
[8] 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.
[9] Whether there is multiple taxation would depend in part on the availability of offsetting capital losses in the future; see the discussion in Warren (1993).

on corporate stock, but such a preference would be too broad, because not all gains on corporate stock are due to taxable retained corporate earnings.

The ALI and Treasury reports addressed both problems by providing for constructive dividend and reinvestment plans, which are sometimes identified by the acronym DRIP (dividend reinvestment plan). 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 re-contributed 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 U.S. Treasury recommended a DRIP option in its 2003 dividend exclusion proposal, but Congress rejected the idea.[10]

C. Tax-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 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 income distributed as 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-

[10] Burman and Rohaly (2003) provide an overview of the proposal including the DRIP option.

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). 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 U.S. 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).

D. 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 (Warren, 1993). 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 U.S. 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 (U.S. Treasury, 1992a). 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 United States 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 United States should not enact such a change unilaterally. The U.S. Treasury estimated that allowing foreign tax credits to

offset the single level of tax in an integrated system in 1992 would have entailed a revenue loss of $17 billion a year, or 19 percent of corporate tax revenues.[11]

Limiting shareholder credits to the amount of U.S. corporate taxes paid on income distributed as dividends has the advantage of reducing incentives for 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).

E. Nondividend Distributions

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

[11] 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).

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 (Warren, 1993). 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.[12]

F. Transition to the New System

As with any major change in tax law, integration might be made immediately effective, phased-in over time, or accompanied by exceptions for preexisting transactions. With respect to the last possibility, some have argued that integration should be available only for income on post-enactment equity contributions, on the assumption that the capital markets have discounted the price of corporate equity to take into account the burdens of current law. Given this hypothesis, integration for pre-enactment equity would result in windfall gains to current shareholders. To avoid this possibility, a 1982 American Law Institute Reporter's

[12] We are indebted to Peter Merrill for this point.

recommendation for a dividend deduction developed a proposal limited to pre-enactment equity (American Law Institute, 1982).

In the interest of simplicity, the ALI, the Treasury report, and the proposal under discussion in the Senate Finance Committee all recommend implementing the new system for all dividends (perhaps after a phase-in period), rather than attempting to limit integration to dividends on post-enactment equity. Even after a full phase-in, shareholder credits for corporate taxes or corporate deductions for dividends would be limited to post-enactment corporate taxes or income.

G. 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 U. S. 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. A disallowance of interest deductions with a corporate rate of 35% is similar to a nonrefundable withholding tax of 35% but it avoids looking like a tax on foreign or tax-exempt lenders and makes clear that the additional costs of debt finance are likely to be borne by the corporate borrowers. A full or partial disallowance of interest deductions should avoid the kinds of portfolio realignments by foreign and tax-exempt lenders 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.[13] 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.

H. Noncorporate Taxpayers

By relieving the double taxation of corporate income, integration would reduce the current law advantages of operating in partnership or other noncorporate forms. As we have emphasized, however, in the absence of a new tax applicable to tax-exempt or foreign investors, integration with nonrefundable dividend withholding would preserve an advantage for debt investments 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

[13] See Internal Revenue Code sections 163(j) and 385, as well as U.S. Treasury (2015, 2016), and the discussion in the OECDs early Base Erosion and Profit Shifting (BEPS) discussion draft for a similar proposal (OECD, 2014).

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.

V. INTEGRATION COMPARED WITH OTHER PROPOSALS FOR CORPORATE TAX REFORM IN THIS FORUM

The other two proposals offered for corporate tax reform in this *NTJ* Forum have as their centerpiece lowering the corporate tax rate to 15 percent (Grubert andAltshuler, 2016; Toder and Viard, 2016). Grubert and Altshuler would fund this rate reduction by taxing individuals on dividends and capital gains as ordinary income and by imposing an interest charge based on the holding period of dispositions by individuals of corporate shares and all other assets. Losses would similarly be increased by an interest charge. Step-up in basis at death would be repealed for corporate shares and all other assets, so death would become a realization event, triggering the interest charge. Finally, there would be a per-corporation limit on distributions that could be taxed as dividends in any given year, with the excess subject to the interest-charge regime applicable to gains and losses on shares. The imposition of the interest charge is intended to approximate accrual taxation of shareholders. Repeal of step-up in basis at death for corporate shares and the limitation on dividends are necessary in order to prevent easy avoidance of the basic proposals.[14]

Toder and Viard (2016) would fund their corporate rate reduction in large part by taxing U.S. shareholders on changes in the value of publicly-traded shares of American and foreign

[14] The ALI report suggests a much more limited modification of step-up in basis at death in order to prevent retroactive elimination of corporate taxes. Warren (1993) discusses this issue in more detail.

corporations on an accrual basis. The resulting gain would be taxed as ordinary income. Reductions in the value of shares in such companies would be fully deductible from ordinary income. In the most general version of the proposal, all publicly-traded securities (including debt) held by U.S. investors would be taxable on an accrual basis, as would derivatives on those securities.

In addition to accrual taxation of changes in share values, shareholders would be taxed on dividends from U.S. and foreign companies. Dividends from U.S. companies would be subject to shareholder-credit integration, along the lines discussed at length in this paper. The proposed method of expressing the credit differs slightly from that shown in Table 1, because it is based on the cash received, rather than the taxable dividend. Consider a corporation that earns $100, pays corporate taxes of $15 and distributes the remaining $85 in cash. The analysis in Table 1 would result in shareholder income of $100 and a credit of $15, which is 15 percent of the taxable income. Toder and Viard would compute the credit on the cash amount of $85. A $15 credit would therefore imply a credit of 15/85 or 17.65 percent of the cash dividend. The proposal rounds the credit percentage to 17.5 percent, which produces a credit of $14.87 for a cash dividend of $85. The shareholder's taxable income would therefore be $99.87, the sum of the cash dividend and the credit.

Imputation credits would be available on stock, as well as on cash, dividends, along the lines of the DRIP proposal described above. Credits would not be refundable, so tax-exempts and foreign shareholders would not automatically receive a tax reduction due to integration. Individual U.S. shareholders would be able to carryforward unused amounts of the nonrefundable credit. The proposal also provides for a 15 percent withholding tax on interest paid to exempt entities, including retirement plans.

To reduce volatility, neither accrued gains nor dividends would be taxed currently. Instead, they would be added to a pool of unrealized appreciation, of which 20 percent would enter the tax base each year, smoothing shareholder inclusions and deductions. Imputation credits would be subject to the same smoothing routine.

Income and gains relating to nonpublicly-traded companies would continue to be taxed on realization, rather than accrual. Toder and Viard provide special rules for companies that change from nonpublicly- to publicly-traded status, or vice versa. Previously untaxed amounts in the pool of unrealized appreciation would be taxed at death. Step-up in basis at death would also be repealed for all other assets, with the gain taxed at a preferred rate.

One way to think about this ambitious proposal is that it implicates all of the design issues relating to: (1) a shareholder credit discussed above; (2) accrual taxation of some, but not all, capital income; (3) a tax smoothing regime; and (4) issues related to the interaction of the three proposals. We are not sure that we fully understand how the pieces would fit together in complex cases, but we tentatively offer the following example of how we think the system would work in a very simple case, based on Toder and Viard (2016):

> Consider a corporation that has $100 of taxable income in year 1 and pays $15 in corporate tax. In year 2, it has no income and pays a cash dividend of $85. Without the smoothing provisions, shareholders would have $85 of accrued gain in share value in year 1, $85 of accrued loss in share value in year 2, along with $99.87 of taxable dividend income and a tax credit of $14.87 (17.5 percent of $85).
>
> With smoothing, $17 (20 percent of the accrued gain) would be taxed to the shareholders in year 1. The remaining $68 would be added to the pool of unrecognized income. In year 2, the pool would increase to $82.87 ($68–

$85+$99.87),[15] of which $16.57 would be taxable, subject to a tax credit of $2.97 (20 percent of $14.87). The other 80 percent of the credit would be available in later years (at the smoothing rate of 20 percent). The allowable credit of $2.97 in year 2 would not be refundable, but any unused amount could be carried forward by an individual U.S. shareholder.

In the interests of illustrating how the proposal would work in the simplest of cases, the foregoing analysis assumes that the value of the shareholder credit is not reflected in share values. A fuller explication of even this simple case would have to include the expected impact of the credit on share prices, particularly given the smoothing regime.

There is much to be learned from all of the proposals in this forum. They would all shift income from corporations to investors, as suggested at the beginning of this paper. Each contains ideas that might be sensible quite apart from business tax reform, such as repeal of step-up in basis, further mark-to-market taxation, further use of deferral charges, and a significant reduction of the corporate tax rate.

With respect to the last point, one of us has proposed such a change, funded (along with major reforms of individual income taxation) by a value-added tax (Graetz, 2010, 2014). We are not convinced that the proposals advanced by Grubert and Altshuler (2016) or Toder and Viard (2016) for funding such a reduction in the corporate income tax rate have either political or economic advantages over a value-added tax, but a discussion of that question is beyond the scope of this paper.

In the political arena, now retired congressman Dave Camp, when he was chairman of the House Ways and Means Committee, released a tax reform plan in February 2014 that, with

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[15] We believe that it is the taxable amount of the dividend that is added to the smoothing account. If it is in fact the cash dividend, this amount should be $85 rather than $99.87.

extensive base broadening proposals, would have reduced the corporate rate to 25 percent (Camp, 2014). A 25 percent rate is also the goal of a large coalition of U.S. multinational companies (Alliance for Competitive Taxation, 2016). President Obama's Framework for Business Tax Reform, initially released in 2012 and updated in 2016, suggested broad proposals that would reduce the corporate rate to 28 percent. (The White House and U.S. Treasury, 2012, 2016). In the short-run, at least, a reduction of the corporate rate to the 25–28 percent range may be a more realistic goal than the 15 percent recommended in the more ambitious proposals.

We have discussed integration 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 was lowered.

Grubert and Altshuler (2016) reject integration principally for two reasons: (1) because of the amount of corporate equity held in the tax-exempt sector; and (2) because, they claim, integration would be ineffective in addressing shifting of income by U.S. multinationals to low foreign tax jurisdictions. As we have discussed, the latter of these claims is contrary to the Australian experience and some empirical evidence. The unique size and corporate holdings of the U.S. tax-exempt sector does, as we have described, pose challenges for the design of an integration system, but we have offered here explicit suggestions as to how those challenges can be addressed.

One thing we know for certain: shareholder-credit integration has been adopted successfully in many developed countries around the world. Neither the accrual system with

smoothing suggested by Toder and Viard nor an interest charge on the scale proposed by Grubert and Altshuler have been subjected to any such real-world tests. Nor have there been the kind of detailed studies of those proposals like those conducted with respect to integration by the ALI, the Treasury, and the Senate Finance Committee that identify and test the practical issues that will necessarily arise under either of these two proposals. Although both are interesting, we hesitate to endorse either in the absence of such work.

VI. CONCLUSION

Each of the proposals in this symposium has components that could improve the U.S. tax system under the appropriate circumstances. Nevertheless, in the absence of another revenue source that would permit a drastic reduction in the corporate tax rate (e.g., the VAT considered by Graetz, 2010), we continue to believe that a shareholder credit or a dividend deduction with withholding provides the best framework 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 discussed at the beginning of this paper. 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, forthcoming). 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.

DISCLOSURE

The authors have no financial arrangements that might give rise to conflicts of interest with respect to the research reported in this paper.

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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

Table 2

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

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

Notes: Corporate and withholding tax rates are 35 percent. Shareholder tax rate is 20 percent under current law and 40 percent 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). Also assumes book and taxable income are the same.

Table 3

Comparison of Present Law, Shareholder Credit, and Dividend Deduction with Withholding -- Deductible Dividend of $30

Taxpayer	Present Law	Imputation Credit	Dividend Deduction and Withholding Tax
CORPORATION			
1.Taxable income before dividend	$100.00	$100.00	$100.00
2. Corporate tax before dividend	$35.00	$35.00	$35.00
3. Corporate cash before dividend	$65.00	$65.00	$65.00
4. Declared dividend	$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%
U.S. SHAREHOLDER			
12. Cash dividend (line 4 – line 6)	$19.50	$19.50	$19.50
13. Taxable dividend (line 4 + line 5)	$19.50	$30.00	$30.00
14. Shareholder tax before imputation or withholding credit	$ 3.90	$12.00	$12.00
15. Imputation or withholding credit (line 5 or 6)	0	$10.50	$10.50
16. Net shareholder tax (line 14 – line 15)	$ 3.90	$ 1.50	$ 1.50
17. Net shareholder cash (line 12 – line 16)	$15.60	$18.00	$18.00
COMBINED CORPORATE AND SHAREHOLDER TAXES			
18. Total tax (line 6 + line 8 + line 16)	$38.90	$36.50	$36.50
19. Corporate tax on distributed income [(35/65 x line 10) – line 7]	$10.50	$10.50	0
20. Shareholder tax on distributed income (line 16 + line 6)	$ 3.90	$ 1.50	$12.00
21. Total tax on distributed income (line 19 + line 20)	$14.40	$12.00	$12.00
22. Pre-tax distributed income (line 10/.65)	$30.00	$30.00	$30.00
23. Total effective tax rate on distributed income* (line 21/line 22)	48%	40%	40%

Notes: Corporate and withholding tax rates are 35 percent. Shareholder tax rate is 20 percent under current law and 40 percent 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). Also assumes book and taxable income are the same.