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Integrating Business and Personal Income Taxes

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Though most Americans support reforming federal tax laws to encourage growth, there is no consensus on the best way to approach the issue. President Bush's proposal to reduce the capital gains tax has grabbed most of the headlines over the last several years, relegating other possibilities to the back pages. This *Economic Commentary* takes a look at reforming the corporate income tax, an idea raised by Presidents Carter and Reagan and the subject of a recent study by the Treasury Department.

"To tax and to please, no more than to love and be wise, is not given to men."

Edmund Burke's comment rings no less true today than it did in 1774. One need only observe political candidates' perennial attempts to tar their opponents with the "tax and spend" brush to know that Burke had gotten it right more than two centuries ago.

The Treasury Department brought the issue of corporate income taxes into the political forum early this year by releasing a detailed study of several proposals to "integrate," or merge, the corporate and individual income taxes.[1] Many Americans cling to the naive view that higher corporate taxes mean lower personal taxes. Ironically, the problem is just the opposite: As business taxes go up, individuals ultimately pay more.

This article first examines the problems surrounding the current corporate tax system and then looks at how these concerns are addressed in five specific reform proposals: 1) abolishing the corporate income tax altogether, 2) treating corporations like partnerships, with all net income and losses passed on to shareholders and handled like ordinary income, 3) allocating all net income to shareholders, but not net losses, 4) excluding dividend payments from shareholders' taxable income, and 5) continuing to tax corporations, but allowing shareholders to deduct both dividend and interest payments.

■ The Present System

Congress enacted the corporate income tax in 1909 as an excise tax on the privilege of using the corporate form. The presumption was that people would be willing to pay for the right to create a legally separate entity that provided them with limited liability.

Like "sin" taxes on alcohol and tobacco, the corporate tax has dual effects. That is, it raises revenue while discouraging use of the taxed item. In the case of business taxes, this means that the corporate form is discouraged relative to other types of business organization, such as sole proprietorship, partnership, or limited partnership.

Today, the federal government taxes corporate income at a 34 percent marginal rate. Shareholders then pay an individual tax of 15, 28, or 31 percent on dividends received, and on any appreciation of their shares at the point of sale.[2] Thus, income earned at the corporate level is subject to double taxation. (Although tax-exempt institutions such as pension funds hold a large share of corporate equity and bonds,

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the ultimate recipients of most of the earnings generated by these organizations do pay taxes.) In an effort to increase investors' returns, corporations endeavor to circumvent double taxation by finding and exploiting legal loopholes and timing options that reduce their own taxable income. Combined with lower business tax rates and dwindling profits, tax avoidance schemes have made corporate taxes a less important source of federal revenue, even though the corporate share of gross domestic product (GDP) has increased.

Between 1955 and passage of the Tax Reform Act in 1986, real corporate profits and income tax receipts zigzagged downward despite the nation's economic growth (see figure 1). In constant (1982) dollars, corporate taxes fell from an average of $85 billion yearly in the 1950s to $56 billion between 1980 and 1986.[3] As a fraction of the government's total tax receipts, this represents a drop of more than half, from above 20 percent to below 10 percent.

FIGURE 1 PRE-TAX CORPORATE PROFITS

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

Why Reform?

Given the transition costs associated with tax reform, any new proposal must be justified in terms of both equity and efficiency. Evaluating a tax means balancing a complex range of issues, since every tax has its own set of disadvantages, including financial distortions and collection costs. We believe that the correct test is whether the overall economy gains from a revenue-neutral tax reform (that is, one that keeps total revenue constant). Looking at the issue from this perspective avoids having to factor in spending cuts or deficit reductions.

By this standard, the corporate income tax is an expensive way to raise revenue. Beyond its direct costs (collection and enforcement), it also has high indirect costs that affect not only how corporations raise investment funds, but also how they distribute the proceeds.[4]

We know that the direct costs of administering the corporate tax are immense — U.S. companies devote more than 500 million hours a year to filling out tax forms. However, because economists are unable to pinpoint the paperwork burden of the alternatives, direct comparisons are difficult. Even harder to quantify and contrast are the indirect costs of tax avoidance, including lawyers and accountants hired to exploit the existing law, lobbyists hired to change the law, and campaign contributions aimed at making sure things go businesses' way on Capitol Hill.

The case against the corporate income tax rests on the financial distortions it causes. The current law favors noncorporate enterprises over corporations, debt over equity, and retained earnings over dividends, effects that can undercut the health and productivity of the entire economy. One major disadvantage of the tilt toward noncorporate business is that the corporate form is uniquely suited to undertaking large, risky projects (aeronautical and pharmaceutical research and development are good examples). Incorporation allows for limited liability, unlimited life, smooth transferability of ownership, and easy subdivision of risk, factors that allow corporations to become much larger than partnerships.[5] Thus, to the extent that business taxes discourage incorporation, large and risky projects will not be pursued.

Corporations have three ways of financing new investment: selling bonds (debt), selling stocks (equity), or retaining earnings. In any effort to balance the costs and benefits of these alternatives, the corporate income tax is a major consideration. Currently, firms can deduct interest payments, but not dividends, from their taxable income. Thus, a person holding bonds gets taxed only once on that income, while someone holding stock is taxed twice. Taxpayers even benefit if the firm retains its earnings. Then, stock prices rise and profits show up as a capital gain, which is taxed at a lower rate than ordinary income (28 percent versus 31 percent). Cutting the capital gains tax rate, another reform proposal currently on the table, would increase this bias against dividends.

The Alternatives

Do the disadvantages of corporate taxation really matter, once taxes are raised enough to compensate for the lost revenue? This question has both a short and a long answer. The short answer is yes, because the corporate income tax has inherent problems that make it worse than any likely alternative. Taxing business income not only discourages work effort and investment, as any income tax does, but also encourages debt accumulation and the other distortions discussed above.

The long answer, which we can only touch on here, is that this question demands a quantitative response that balances the gains of corporate tax reform against the losses from a higher tax rate somewhere else. The Treasury study does an admirable job of addressing this issue. Using three quantitative models that raise the tax rates on capital income to offset any losses from reform, the report finds that integrating business and income taxes would shift capital to the corporate sector, reduce corporate borrowing, boost dividend payments, and increase GDP by $3 billion to $30 billion.[6]

Below, we qualitatively evaluate five reform proposals (an initial benchmark and the four alternatives discussed at length in the Treasury study) based on how they would reduce both tax avoidance costs and the financial distortions caused by corporate taxation. We also look at how Treasury revenue would be affected.

Abolishing the corporate income tax. This proposal clearly eliminates double taxation and so removes the biases against equity, dividends, and the corporate form. It also erases both direct and indirect compliance and avoidance costs at the corporate level. Unfortunately, the plan has a fatal flaw: It promotes corporations as a tax dodge. Individual taxpayers could self-incorporate, declare their income as profits, and avoid the personal income tax altogether. A further drawback is that Treasury revenue is reduced by the full amount of the tax, almost $100 billion per year.

Pure conduit approach. This plan treats corporations like partnerships in that it allocates all net income and losses to shareholders, who must report these payments as ordinary income. To ensure neutrality between firms' retaining earnings or paying them out as dividends, shareholder capital gains (and losses) are calculated as the difference between the sale price and the purchase price, less the change in book value. This is known as the share basis adjustment.

Incentives to disguise income at the corporate level are reduced, since such hidden funds would eventually result in a taxable capital gain to the shareholder. Moreover, neutrality between the corporate and noncorporate organizational forms and between debt and equity finance is restored. The plan also reduces the costs of tax avoidance (but not of direct compliance) and lowers tax revenues, since it eliminates double taxation of dividends while allowing firms to pass losses on to their shareholders. Because the personal tax rate (especially the lower brackets) is below the corporate rate, Treasury revenue is reduced.

Modified conduit approach. Here, net income is allocated to shareholders, but net losses are not. Corporations still pay taxes, but shareholders receive a nonrefundable tax credit for their share of the tax paid. Capital gains are adjusted on a share basis.

Economically, this plan is similar to the pure conduit approach, especially if companies can carry losses forward as an offset against future income. Politically, however, it is one step behind, since collecting taxes from corporations rather than shareholders means that many wealthy people will pay little or no individual income tax.

Dividend exclusion. Under this approach, individuals do not have to pay taxes on dividend income. This reduces, but does not eliminate, debt-versus-equity and corporate-versus-noncorporate distortions, since firms can still deduct interest. It also cuts into Treasury revenues and introduces a new bias against retained earnings. If corporate managers have better information about certain investment opportunities than do their shareholders, total investment funds drop off.

The comprehensive business income tax (CBIT). Here, corporations are still taxed, but shareholders are entitled to deduct both dividend and interest payments from their tax bills. CBIT would apply to all but the smallest businesses and makes no distinctions based on organizational form.

All investment returns are treated identically under this plan, whether financed by debt or equity or produced by a corporation or partnership. Like the conduit and dividend exclusion plans, CBIT requires a share basis adjustment to prevent a bias against retained earnings. The comprehensive nature of this tax, coupled with its reduced financial distortions, means that Treasury revenues would actually increase.

■ Conclusion

All five of the reform proposals discussed here have the virtue of reducing the financial distortions caused by the current corporate tax system. None of them is as simple as its proponents claim, however, since each requires a share basis adjustment to avoid biasing the system away from retained earnings.

The proposals requiring all taxes to be paid at the corporate level (modified conduit, CBIT, and dividend exclusion) would result in the highly publicized spectacle of extremely rich individuals paying no direct taxes to the Internal Revenue Service — a daunting political obstacle. The CBIT has the additional problem of a 10-year phase-in period due to the substantial dislocations it would cause (eliminating the deductions for interest and dividend payments would require extensive changes in the tax code). Thus, even if this proposal is adopted, its chances of surviving the implementation period are questionable.

Our preference is for a modified conduit approach with a twist on the Treasury's proposal: We believe that taxes should be paid at the shareholder rather than the corporate level. This would do the best job of minimizing distortions on all fronts, avoid the long, uncertain adjustment period associated

with the CBIT, and eliminate the revenue and administrative problems connected with passing losses on to shareholders. Not insignificantly, it would also preclude the politically untenable situation in which wealthy individuals pay no personal income tax at all.

Edmund Burke was right: Taxes will never please. Evidence suggests, however, that integrating the corporate and personal income taxes can lower costs, boost investment, and reduce unnecessary risk.

Footnotes

1. See the U.S. Treasury Department's report to Congress entitled "Integration and Individual and Corporate Tax Systems: Taxing Business Income Once," January 1992.

2. Tax timing options and other offsets can reduce, but rarely eliminate, the individual income tax on dividends.

3. See U.S. Treasury report (footnote 1), p. 156.

4. Looking at direct and indirect costs emphasizes the efficiency criterion. Equity issues are harder to decipher, since they depend on who pays the tax, as well as on its incidence. Economists are unsure about how much of the corporate tax is borne by shareholders and how much is passed on to workers and customers.

5. General Motors, the largest U.S. corporation, had sales of $124 billion in 1991, while Exxon, number two, was at $103 billion. By contrast, the sales figures for the two biggest partnerships, the University of California research labs, hospitals, and bookstores and Star Enterprises (an oil company) were $10 billion and $8 billion, respectively.

6. The models differ only in movement of production between the corporate and noncorporate sectors and in whether individuals can shift their investment in housing and durable goods in response to changes in the tax code.

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