OVERVIEW OF APPROACHES TO CORPORATE INTEGRATION

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on May 17, 2016

Prepared by the Staff
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INTRODUCTION

The Committee on Finance of the Senate has scheduled a public hearing on May 17, 2016, on Integrating the Corporate and Individual Tax Systems. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a discussion of present law and data relating to corporate integration, and of certain approaches to corporate integration.

[1] This document may be cited as follows: Joint Committee on Taxation, *Overview of Approaches to Corporate Integration* (JCX-44-16), May 13, 2016. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

I. PRESENT LAW

Overview

The taxation of business income generally depends on the choice of business entity. In 2012, there were approximately 1.6 million C corporations, 3.4 million partnerships, and 4.2 million S corporations. The number of passthrough entities (partnerships and S corporations) surpassed the number of C corporations in 1987 and has nearly tripled since then, led by growth in small S corporations (those with less than $100,000 in assets) and limited liability companies ("LLCs") taxed as partnerships.

The vast majority of businesses in the United States are organized for tax purposes as sole proprietorships. In 2012, there were more than 23.5 million nonfarm sole proprietorships and 1.8 million sole proprietorship farms out of 34.6 million total business returns. Unlike a C corporation, partnership, or S corporation, a sole proprietorship typically is not an entity distinct from its individual owner.[2] Rather, the business owner is taxed directly on business income, and files Schedule C (sole proprietorships, generally), Schedule E (*e.g.*, rental real estate and royalties), or Schedule F (farms) with his or her individual tax return.

C corporations

A C corporation[3] is subject to Federal income tax as an entity separate from its shareholders.[4] A C corporation's income generally is taxed when earned at the corporate level and is taxed again at the individual level when distributed as dividends[5] to its shareholders. Corporate deductions and credits reduce only corporate income (and corporate income taxes) and are not passed directly through to shareholders.

Corporate income that is not distributed to shareholders generally is subject to current tax at the corporate level only. To the extent that income retained at the corporate level is reflected in an increased share value, the shareholder may be taxed at capital gains rates upon sale or

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[2] A single-member unincorporated entity is treated as a disregarded entity for Federal tax purposes.

[3] A C corporation is so named because its Federal tax treatment is governed by subchapter C of the Internal Revenue Code of 1986, as amended (the "Code"). All section references are to the Code, unless otherwise stated.

[4] Specialized investment entities organized as C corporations, such as regulated investment companies, and certain interests in debt instruments, such as real estate mortgage investment conduits, are effectively subject to only one level of tax. These, and other specialized entities such as tax-exempt organizations and cooperatives, are beyond the scope of this discussion (but see subsequent brief discussion of real estate investment trusts).

[5] Distributions with respect to stock that exceed corporate earnings and profits are not taxed as dividend income to shareholders but are treated as a tax-free return of capital that reduces the shareholder's basis in the stock. Distributions in excess of corporate earnings and profits that exceed a shareholder's basis in the stock are treated as amounts received in exchange for the stock which, in general, are taxed to the shareholder at capital gains rates. Sec. 301(c).

exchange (including certain redemptions) of the stock or upon liquidation of the corporation.[6] Foreign investors generally are exempt from U.S. income tax on capital gains, but are subject to a 30-percent (or a reduced treaty rate of) tax on the gross amount of dividends; this tax is collected by withholding. Tax-exempt investors generally are not subject to tax on corporate distributions or on sales or exchanges of corporate stock.

The gain on appreciated corporate assets generally is subject to corporate-level tax if the assets are distributed to the shareholders, yielding the same tax result as if the assets had been sold by the corporation and the proceeds distributed to the shareholders.

For corporations, the tax rate depends on the amount of taxable income reported by the corporation, with marginal rates rising from 15 percent (for taxable income up to $50,000) to 35 percent (for taxable income over $10,000,000).[7] The intermediate rates are 25 percent and 34 percent. The benefit of graduated rates below 34 percent is phased out for corporations with taxable income between $100,000 and $335,000; for corporations with taxable income between $15,000,000 and $18,333,333, the benefit of the 34 percent rate is phased out as well (at a marginal rate of 38 percent). Thus, a corporation with taxable income between $335,000 and $10,000,000 is effectively subject to a flat tax rate of 34 percent, and a corporation with taxable income of $18,333,333 or more is effectively subject to a flat tax rate of 35 percent. No separate rate structure exists for corporate capital gains (making the maximum tax rate for corporate net long-term capital gains 35 percent).

Corporations are taxed at lower rates on income from certain domestic production activities. This rate reduction is effected by the allowance of a deduction equal to a percentage of qualifying domestic production activities income. The deduction is generally equal to nine percent of the income from manufacturing, construction, and certain other activities specified in section 199.[8]

Taxes at a rate of 20 percent (the top rate generally applicable to dividend income of individuals) may be imposed upon the accumulated earnings or personal holding company income of a corporation. The accumulated earnings tax may be imposed if a corporation retains earnings in excess of reasonable business needs. The personal holding company tax may be imposed upon the excessive passive income of a closely-held corporation. The accumulated earnings tax and the personal holding company tax, when they apply, in effect impose the

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[6] If stock is held until the death of the shareholder, the heirs are given a fair market value basis in the stock at death, resulting in no shareholder-level income tax on appreciation prior to death if the heirs sell the stock to a third party, or receive corporate distributions in the form of a redemption (*i.e.*, a sale of their stock to the corporation). Sec. 1014(a)(1).

[7] Sec. 11(b). Corporations are also subject to an alternative minimum tax ("AMT") that is payable, in addition to all other tax liabilities, to the extent that it exceeds the corporation's regular tax liability. Details of the AMT are beyond the scope of this discussion.

[8] With a nine percent deduction, a corporation is taxed at a rate of 35 percent on only 91 percent of qualifying income, resulting in an effective tax rate of 0.91 * 35, or 31.85 percent. A similar reduction applies to the graduated rates applicable to individuals with qualifying domestic production activities income.

shareholder-level tax in addition to the corporate-level tax on accumulated earnings or undistributed personal holding company income.

Passthrough entities

While a large portion of business income is taxed under the corporate income tax, some business income – such as that earned through sole proprietorships, partnerships, limited liability companies and S corporations – is taxed only at the individual level. In the case of individuals, the tax rate depends on the individual's filing status and income. For each filing status, the rate schedules are broken into several ranges of income and the marginal tax rate increases as a taxpayer's income increases (rising from 10 percent to 39.6 percent).[9] Capital gains and certain dividends are taxed at lower rates, up to a maximum of 20 percent.[10]

Partnerships

Partnerships generally are treated for Federal income tax purposes as passthrough entities, not subject to tax at the entity level.[11] Items of income (including tax-exempt income), gain, loss, deduction, and credit of the partnership are taken into account in computing the tax of the partners (based on the partnership's method of accounting and regardless of whether the income is distributed to the partners).[12] A partner's deduction for partnership losses is limited to the amount of the partner's adjusted basis in his or her partnership interest.[13] To the extent a loss is not allowed due to a limitation, it generally is carried forward to the next year. A partner's adjusted basis in the partnership interest generally equals the sum of (1) such partner's capital contribution to the partnership, (2) the partner's distributive share of partnership income, and (3) the partner's share of partnership liabilities, less (1) such partner's distributive share of losses allowed as a deduction and nondeductible expenditures not properly chargeable to such partner's capital account and (2) any partnership distributions.[14]

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[9] As in the case of a corporation, an AMT is imposed on an individual in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year. Details of the AMT are beyond the scope of this discussion.

[10] Investment income may be subject to additional tax or higher marginal rates by reason of the "Unearned Income Medicare Contribution" 3.8-percent tax under section 1411 and numerous phase-outs of tax benefits, such as the phase-out of the alternative minimum tax exemption (section 55(d)(3)), the overall limitation on itemized deductions (section 68), and the phase-out of personal exemptions (section 151(d)(3)).

[11] Sec. 701.

[12] Sec. 702(a). The recognition of income under this rule does not necessarily correspond with distributions from the partnership to cover the tax liabilities of individual partners.

[13] Sec. 704(d). In addition, passive loss and at-risk limitations limit the extent to which certain types of income can be offset by partnership deductions (sections 469 and 465). These limitations do not apply to corporate partners (except certain closely-held corporations) and may not be important to individual partners who have partner-level passive income from other investments.

[14] Sec. 705.

Partnerships provide partners with a significant amount of flexibility to vary their respective shares of partnership income. Unlike corporations, partnerships may allocate items of income, gain, loss, deduction, and credit among the partners, provided the allocations have substantial economic effect.[15] In general, an allocation is permitted to the extent the partner to which the allocation is made receives the economic benefit or bears the economic burden of such allocation and the allocation substantially affects the dollar amounts to be received by the partners from the partnership independent of tax consequences.

Limited liability companies

In the last 40 years,[16] States have enacted laws providing for another form of entity, the limited liability company ("LLC"). LLCs are generally treated as partnerships for Federal income tax purposes. They are neither partnerships nor corporations under applicable State law, but they generally provide limited liability to their owners for obligations of the business. Under regulations promulgated in 1996, any domestic non-publicly traded unincorporated entity with two or more members generally may elect to be treated as either a partnership or a corporation for Federal income tax purposes, while any single-member domestic unincorporated entity may elect to be treated as a corporation or to be disregarded (*i.e.*, treated as not separate from its owner[17]) for Federal income tax purposes.[18] These regulations, known as the "check-the-box" regulations, were a response, in part, to the growth of LLCs.

S corporations

For Federal income tax purposes, an S corporation[19] generally is not subject to tax at the corporate level.[20] Items of income (including tax-exempt income), gain, loss, deduction, and credit of the S corporation are taken into account in computing the tax of the shareholders (under the S corporation's method of accounting and regardless of whether the income is distributed to the shareholders). A shareholder's deduction for corporate losses is limited to the sum of the shareholder's adjusted basis in the S corporation stock and the indebtedness of the S corporation to such shareholder. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward to the next year. The shareholder's basis in the S corporation stock (and debt) is reduced by the shareholder's share of losses and (in the case of stock) by distributions and is

[15] Sec. 704.

[16] The first LLC statute was enacted in Wyoming in 1977. All States (and the District of Columbia) now have an LLC statute, though the tax treatment of LLCs for State tax purposes may differ.

[17] Thus, where the single member is an individual, such a disregarded LLC will be treated as a sole proprietorship. Where the single member is a corporation, the LLC will be treated as a branch.

[18] Treas. Reg. sec. 301.7701-3.

[19] An S corporation is so named because its Federal tax treatment is governed by subchapter S of the Code.

[20] Secs. 1363 and 1366.

increased (in the case of stock) by the shareholder's share of the S corporation's income and contributions to capital.[21]

Unlike a partnership, but like a C corporation, gain realized on the distribution of built-in gain property by the S corporation to shareholders is recognized. The shareholders take their shares of such gain into account on their individual tax returns.

To be eligible to elect S corporation status, a corporation may not have more than 100 shareholders and may not have more than one class of stock.[22] Only individuals (other than nonresident aliens), certain tax-exempt organizations, and certain trusts and estates are permitted shareholders. A corporation may elect S corporation status only with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than 50 percent of the stock.[23]

There are two principal exceptions to the general passthrough treatment of S corporations. Both are applicable only if the corporation was previously a C corporation and are generally intended to prevent avoidance of otherwise applicable C corporation tax consequences. First, an S corporation is subject to tax on excess net passive investment income (but not in excess of its taxable income, subject to certain adjustments), if the corporation has subchapter C earnings and profits and has gross receipts more than 25 percent of which are passive investment income for the year.[24] Second, for the first five years after a corporation that was previously a regular C corporation elects to be an S corporation, certain net "built-in" capital gains of the corporation attributable to the period in which it was a C corporation are subject to tax at the corporate level.[25]

In general, an S corporation shareholder is not subject to tax on corporate distributions unless the distributions exceed the shareholder's basis in the stock of the corporation or the corporation was formerly a C corporation and has undistributed earnings and profits. To the extent of such earnings and profits, corporate distributions are treated as dividends of a C corporation and generally are subject to tax as such in the hands of the shareholders.

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[21] Sec. 1367.

[22] Sec. 1361. For this purpose, a husband and wife and all members of a family are treated as one shareholder. Sec. 1361(c)(1).

[23] Sec. 1362.

[24] Sec. 1375. C corporation earnings and profits generally refers to the earnings of the corporation prior to its subchapter S election which would have been taxable as dividends if distributed to shareholders by the corporation prior to its subchapter S election. If the S corporation continues to have C corporation earnings and profits and has gross receipts more than 25 percent of which are passive investment income in each year for three consecutive years, the S corporation election is automatically terminated. Sec. 1362(d)(3).

[25] Sec. 1374.

Regulated investments companies

In general, a regulated investment company ("RIC") is an electing domestic corporation that meets (or is excepted from) certain registration requirements under the Investment Company Act of 1940,[26] derives at least 90 percent of its ordinary income from specified sources considered passive investment income,[27] has a portfolio of investments that meet certain diversification requirements,[28] and meets certain other requirements.[29]

Many RICs are "open-end" companies (including mutual funds and most equity and fixed-income exchange-traded funds), which have a continuously changing number of shares that are bought from, and redeemed by, the company and are not otherwise available for purchase or sale in the secondary market.[30] Shareholders of open-end RICs generally have the right to have the company redeem shares at "net asset value." Other RICs are "closed-end" companies, which have a fixed number of shares that are normally traded on national securities exchanges or in the over-the-counter market and generally are not redeemable upon the demand of the shareholder.

In the case of a RIC that distributes at least 90 percent of its net ordinary income and net tax-exempt interest to its shareholders, a deduction for dividends paid is allowed to the RIC in computing its tax.[31] Thus, no corporate income tax is imposed on income distributed to its shareholders. Dividends of a RIC generally are includible in the income of the shareholders; a RIC can pass through the character of (1) its long-term capital gain income, by paying "capital gain dividends" and (2) in certain cases, tax-exempt interest, by paying "exempt-interest dividends." A RIC may also pass through certain foreign tax credits and credits on tax-credit bonds, as well as the character of certain other income received by the RIC.

Real estate investment trusts

A real estate investment trust ("REIT") is an entity that otherwise would be taxed as a C corporation but elects to be taxed under a special REIT tax regime. To qualify as a REIT, an entity must meet a number of requirements. At least 90 percent of REIT income (other than net capital gain) must be distributed annually;[32] the REIT must derive most of its income from

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26 Sec. 851(a) and (b)(1).

27 Sec. 851(b)(2).

28 Sec. 851(b)(3).

29 Secs. 851 and 852.

30 Exchange-traded funds ("ETFs"), issue shares only to large institutional organizations (known as authorized participants) in large, often multimillion-dollar, transactions. Investors buy shares in the secondary market, with authorized participants acting as market makers.

31 Sec. 852(a) and (b).

32 Even if a REIT meets the 90-percent income distribution requirement for REIT qualification, more stringent distribution requirements must be met in order to avoid an excise tax under section 4981.

passive, generally real-estate-related, investments; and REIT assets must be primarily real-estate related. In addition, a REIT must have transferable interests and at least 100 shareholders, and no more than 50 percent of the REIT interests may be owned by five or fewer individual shareholders (as determined using specified attribution rules). Other requirements also apply.[33]

If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its shareholders as a dividend or qualifying liquidating distribution each year is deductible by the REIT (whereas a regular C corporation cannot deduct such distributions).[34] As a result, the distributed income of the REIT is not taxed at the entity level; instead, it is taxed only at the investor level. Although a REIT is not required to distribute more than the 90 percent of its income described above to retain REIT status, it is taxed at ordinary corporate rates on amounts not distributed or treated as distributed.[35]

Although a REIT typically does not pay corporate-level tax due to the deductible distribution of its income, and thus is sometimes compared to a partnership or S corporation, REIT equity holders are not treated as being engaged in the underlying activities of the REIT as are partners or S corporation shareholders, and the activities at the REIT level that characterize its income do not generally flow through to equity owners to characterize the tax treatment of REIT distributions to them. A distribution to REIT shareholders out of REIT earnings and profits is generally treated as an ordinary income REIT dividend and is treated as ordinary income taxed at the shareholder's normal rates on such income.[36] However, a REIT is permitted to designate a "capital gain dividend" to the extent a distribution is made out of its net capital gain.[37] Such a dividend is treated as capital gain to the shareholders.[38]

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[33] Secs. 856 and 857.

[34] Liquidating distributions are covered to the extent of earnings and profits, and are defined to include redemptions of stock that are treated by shareholders as a sale of stock under section 302. Secs. 857(b)(2)(B), 561, and 562(b).

[35] An additional four-percent excise tax is imposed to the extent a REIT does not distribute at least 85 percent of REIT ordinary income and 95 percent of REIT capital gain net income within a calendar year period. In addition, to the extent a REIT distributes less than 100 percent of its ordinary income and capital gain net income in a year, the difference between the amount actually distributed and 100 percent is added to the distribution otherwise required in a subsequent year to avoid the excise tax. Sec. 4981.

[36] Because a REIT dividend is generally paid out of income that was not taxed to the distributing entity, the dividend is not eligible for the dividends received deductions to a corporate shareholder. Sec. 243(d)(3). A REIT dividend generally is not eligible for the 20-percent qualified dividend rate to an individual shareholder. Sec. 857(c).

[37] Sec. 857(b)(3)(C). Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the taxable year. Sec. 1222.

[38] A REIT may also retain its net capital gain without distribution, while designating a capital gain dividend for inclusion in shareholder income. In this case, the REIT pays corporate-level tax on the capital gain, but the shareholder includes the undistributed capital gain in income, receives a credit for the corporate-level tax paid, and steps up the basis of the REIT stock for the amount included in income, with the result that the net tax paid is the shareholder-level capital gain tax. Sec. 857(b)(3)(D).

REIT shareholders are not taxed on REIT income unless the income is distributed to them (except in the case of REIT net capital gain retained by the REIT and designated for inclusion in the shareholder's income as explained in the preceding footnote). However, since a REIT must distribute 90 percent of its ordinary income annually, and typically will distribute or designate its income as capital gain dividends to avoid a tax at the REIT level, REIT income generally is taxed in full at the shareholder level annually.

A tax exempt shareholder is exempt from tax on REIT dividends, and is not treated as engaging in any of the activities of the REIT. As one example, if the REIT borrowed money and its income at the REIT level were debt-financed, a tax exempt shareholder would not have debt-financed unrelated business income from the REIT dividend.

Except as provided by the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA")[39] a REIT shareholder that is a foreign corporation or a nonresident alien individual normally treats its dividends as fixed or determinable annual or periodical income that is subject to U.S. withholding tax, rather than as income that is effectively connected with the conduct of a U.S. trade or business,[40] regardless of the level of real estate activity of the REIT in the United States.[41] U.S. bilateral income tax treaties generally allow lower rates of withholding tax on REIT dividends than the otherwise applicable Code rate. In treaties with special provisions for dividends paid by REITs, the minimum rates of withholding tax on REIT dividends typically exceed the withholding tax rates on other dividends (reflecting that REIT earnings out of which dividends are paid generally are not subject to U.S. corporate tax).

Taxable income of businesses

Taxable income of businesses generally is comprised of gross income less allowable deductions, with the specific rules depending on the choice of business entity. Gross income generally is income derived from any source, including gross profit from the sale of goods and services to customers, rents, royalties, interest (other than interest from certain indebtedness issued by State and local governments), dividends, gains from the sale of business and investment assets, and other income.

Allowable deductions include ordinary and necessary business expenditures, such as salaries, wages, incidental materials and supplies, contributions to profit-sharing and pension plans and other employee benefit programs, repairs, bad debts, taxes (other than Federal income

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[39] Pub. L. No. 96-499. FIRPTA treats income of a foreign investor from the sale or disposition of U.S. real property interests as effectively connected with the operation of a trade or business in the United States. Such income is taxed at regular U.S. rates and withholding obligations are imposed on payors of the income. Secs. 897 and 1445.

[40] Sec. 1411.

[41] As noted above, REITs are not permitted to receive income from property that is inventory or that is held for sale to customers in the ordinary course of the REIT's business. However, REITs may engage in certain activities, including acquisition, development, lease, and sale of real property, and may provide "customary services" to tenants.

taxes), contributions to charitable organizations (subject to an income limitation), advertising,[42] interest expense, certain losses, selling expenses, and other expenses. Expenditures that produce benefits in future taxable years to a taxpayer's business or income-producing activities (such as the purchase of plant and equipment) generally are capitalized and recovered over time through depreciation, amortization, or depletion allowances. A net operating loss incurred in one taxable year generally may be carried back two years and carried forward 20 years. A corporation may not deduct the amount of capital losses in excess of capital gains for any taxable year. Disallowed capital losses may be carried back three years and forward five years. Moreover, as previously noted, a deduction is allowed for a portion of the amount of income attributable to certain manufacturing activities.

Certain expenditures may not be deducted, such as dividends paid to shareholders, expenses associated with earning tax-exempt income,[43] certain entertainment expenditures, certain executive compensation in excess of $1,000,000 per year, a portion of the interest on certain high-yield debt obligations of corporations that resemble equity, as well as fines, penalties, bribes, kickbacks, and illegal payments.

Businesses may reduce their tax liability by any applicable tax credits. Tax credits applicable to businesses include credits for biofuels and renewable power, investment tax credits (applicable to investment in certain renewable energy property and the rehabilitation of certain real property), the research credit, the low-income housing credit (applicable to investment in certain low-income housing projects), the empowerment zone employment credit (applicable to wages paid to certain residents of, or employees in, empowerment zones), the work opportunity credit (applicable to wages paid to individuals from certain targeted groups), and the disabled access credit (applicable to expenditures by certain small businesses to make the businesses accessible to disabled individuals).[44] Unused credits generally may be carried back one year and carried forward 20 years. A foreign tax credit is available, subject to limitations, for certain foreign income taxes paid or accrued. Foreign income taxes limited in a tax year may be carried back one year or forward ten years.

Domestic corporations that are affiliated through 80 percent or more corporate ownership may elect to file a consolidated return in lieu of filing separate returns. Corporations filing a consolidated return generally are treated as a single corporation; thus, the losses of one

[42] Advertising expenses generally are deductible as ordinary and necessary business expenses in the year in which they are paid or incurred.

[43] For example, the carrying costs of tax-exempt State and local obligations and the premiums on certain life insurance policies are not deductible.

[44] Certain of these credits are scheduled to expire in 2016 or later. For more information on expiring provisions of the Internal Revenue Code, see Joint Committee on Taxation, *List of Expiring Federal Tax Provisions 2016-2025* (JCX-1-16), January 8, 2016.

corporation can offset the income (and thus reduce the otherwise applicable tax) of other affiliated corporations.[45]

[45] Extensive consolidated return regulations under section 1502 prevent double taxation of income earned within the group, allocate tax assets or other attributes when corporations that were members leave the group, and prevent avoidance of tax as a result of shifting of attributes in the course of intragroup transactions.

II. DATA AND ANALYSIS

A. Data on Business Income

For tax purposes, businesses may be organized in various forms, including as C corporations, partnerships, S corporations, RICs, REITs, or as sole proprietorships. The IRS's Statistics of Income division ("SOI") tabulates tax returns filed by different forms of business organizations. SOI compiles statistical data to form the SOI Integrated Business Dataset ("IBD"). The IBD is assembled from the annual SOI cross-sectional studies of corporations (including C corporations, S corporations, RICs, and REITs), partnerships, and nonfarm[46] sole proprietorships.[47] The dataset combines data from these types of organizations to enable examination of changes in business composition.

A business ventures organized (or reorganized) as a separate legal entity is generally taxable as a C corporation, S corporation, or partnership for Federal tax purposes. A major tax difference between C corporations on the one hand and S corporations and partnerships on the other is that business ventures organized as C corporations are subject to tax at the entity level, with the owners subject to tax on subsequent distributions of income from the C corporation, while ventures organized as S corporations or partnerships are not subject to tax at the entity level. The income of S corporations and partnerships passes through to the owner or partner in whose hands it is subject to tax. Special rules, described above, apply to RICs and REITs, such that they generally do not pay tax at the entity level.

Table 1 reports the share of total net income (less deficit)[48] earned by businesses in each form.[49] Since 1980, C corporations have accounted for the largest share of net income of all business forms in all but three years (2001, 2002, and 2008), when partnerships accounted for a

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[46] Data from farm sole proprietorships are not included. For this purpose, farm sole proprietorships are measured solely by reference to those individuals who report income (or loss) on Schedule F of Form 1040. Other individuals engaged in agricultural enterprises may conduct their farm business through a separate legal entity. When this occurs, the data reported below report that entity among the totals for C corporations, S corporations, or partnerships.

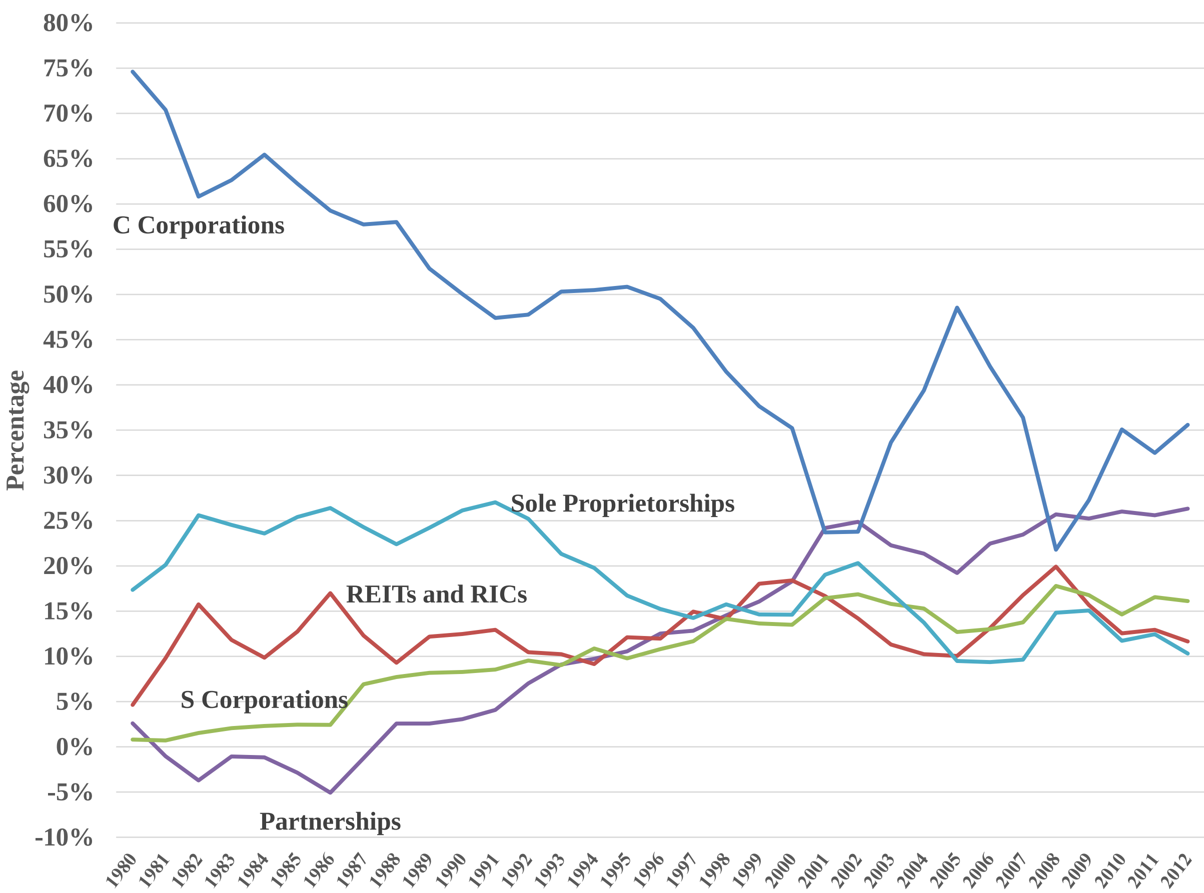
[47] Data from exempt organizations with unrelated business income (Form 990-T) are not included. For 2012, over 46,000 organizations filed Form 990-T to report unrelated business income. Of these, 35,523 returns reported approximately $362.7 million of unrelated business taxable income (less deficit).

[48] Unlike data in some SOI tabulations, net income (less deficit) used here is the more comprehensive "total net income" for S corporations for tax years after 1986. This concept includes trade or business income plus portfolio income, as well as real estate and rental activity incomes distributed directly to shareholders. For partnerships, net income (less deficit) includes ordinary business income (or loss), interest income, dividend income, royalties, net rental real estate income (or loss) from Form 8825, and other net rental income (or loss), but does not include net short-term capital gain or net long-term capital gain.

[49] Data may include some double counting because items may be passed through from passthrough entities to the returns of a C corporate partner or a partner that is itself a passthrough entity. For example some partnerships are partnerships of C corporations, some are partnerships of other partnerships, and some are partnerships of individuals and C corporations or other partnerships. Estimates suggest that approximately five percent of the amount of total net income of partnerships is income passed through to other partnerships.

larger share; however, that share has varied significantly. At the beginning of the period, C corporations accounted for nearly three-quarters of all business profits, followed by nonfarm sole proprietorships with 17.3 percent, while REITs and RICs, S corporations, and partnerships together accounted for less than 10 percent. Throughout the early 1980s, the C corporate share of business net income fell, as did that of partnerships, while the other business forms' shares increased or held steady. Partnerships during this period actually had net losses, consistent with many tax shelters being organized in this form. Following passage of the Tax Reform Act of 1986, C corporations continued their decline while sole proprietorships, S corporations, and partnerships rose.

Figure 1.−Share of Business Net Income (Less Deficit) by Form of Business, 1980-2012



Source: Internal Revenue Service Statistics of Income and JCT staff calculations.

Beginning in the early 1990s, partnerships began to increase their share of business net income, first at the expense of sole proprietorships, whose share of net income peaked at 27.0 percent in 1991, but then at the expense of C corporations. C corporations earned approximately 50 percent of net income from 1989 through 1996, with a brief dip for the recession in 1991 through 1992. Over the subsequent five years, C corporations would see their share of net income fall in half from 46.3 percent in 1997 to 23.7 percent in 2001. That year marks the first time the partnership share of net income exceeded the C corporate share of net income. By 2005, C corporations experienced a rapid increase in profitability, earning about half of all net income that year. However, in 2008, C corporations would account for the smallest share of net income recorded since 1980, before recovering to about one-third of net income of all businesses.

B. Reduction in the Shareholder-Level Tax

In form, at least, business income earned through a corporation is taxable at two levels − first at the corporate level, when earned, and subsequently at the shareholder level, when distributed as a dividend, or when stock is sold as capital gain. To the extent that the corporate form actually results in two levels of tax, the increase in the cost of capital can lead to lower aggregate capital formation, reducing future output and productivity. At the same time, the desire to avoid double taxation leads businesses and investors to seek opportunities to reduce one or both levels of tax. In practice, present law does not always result in the actual payment of two levels of tax on corporate earnings as businesses seek to take advantage of differences in the relative tax situations of the corporation and its shareholders, distorting the allocation of capital.

The shareholder-level tax is eliminated entirely for C corporate income distributed as dividends to tax-exempt shareholders (such as charitable organizations) or individual shareholders with taxable income that would otherwise be taxed at a rate below 25 percent ("low-bracket shareholders").[50] For other shareholders, the burden may be substantially reduced even for amounts distributed to taxable shareholders by the lower rates applicable to dividends paid to individuals and to amounts treated as capital gains (*e.g.*, amounts paid in certain stock redemptions).[51] Certain foreign shareholders of U.S. corporations may also be subject to a lower rate of tax on dividends to the extent allowed by treaty.[52]

Table 2 reports holdings of total corporate equities issued by U.S. corporations, or issued by foreign corporations and purchased by U.S. persons. As of December 31, 2015, the market value of these corporate equities totaled $35.7 trillion, of which $2.8 trillion was S corporation equity. At least one-third of the $32.8 trillion of corporate equities other than S corporate equities was held by parties not subject to a full second level of tax. Foreign investors held $5.7 trillion of U.S. corporate equities, or 17.4 percent. Government retirement funds, including Federal government employee defined benefit plans and the Thrift Savings Plan, and State and local government defined benefit and defined contribution plans, held $2.6 trillion of corporate equities (both foreign and U.S.). Private pension funds, including private defined benefit plans and defined contribution plans (*e.g.*, 401(k) type plans), held $2.4 trillion of foreign and U.S. corporate stock. These tax-favored public and private retirement plans account for 15 percent of the $32.8 trillion of corporate equities. Federal, State, and local governments hold another $213.8 billion, or 0.7 percent. Together, these tax-preferred shareholders represent 33.1 percent

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[50] Sec. 1(h)(1)(B) and (h)(11).

[51] The dividends-received deduction available to corporate shareholders also reduces the effective tax rate on dividend income received by corporations, but its purpose is to avoid greater-than-double taxation of corporate earnings by minimizing the effect of tax imposed at two or more corporate levels.

[52] Dividends of U.S. corporations received by foreign persons are generally subject to tax on a gross basis at a rate of 30 percent, which is collected by withholding at the source of the payment. The 30-percent withholding tax may be reduced or eliminated by a tax treaty between the United States and the country in which the recipient of income otherwise subject to withholding is resident. For example, in 2011 dividend income subject to withholding was taxed at an average rate of 14.5 percent. Scott Luttrell, "Foreign Recipients of U.S. Income, 2011," *Statistics of Income Bulletin*, Winter 2015, p. 2, available at https://www.irs.gov/pub/irs-soi/soi-a-init-id1501.pdf.

of ownership of the aforementioned $32.8 trillion of corporate equities other than S corporate equities.

Table 1.−Holdings of Corporate Equity, 2015
(Amounts in Billions of Dollars)

Sector	Market Value	Percent
Corporate equities	35,687.2	−
S corporation equity	2,838.4	−
Corporate equities less S corporation equity	32,848.8	100.0
Households and nonprofit organizations	10,472.5	31.9
Federal, State, and local governments	213.8	0.7
U.S.-chartered depository institutions	100.8	0.3
Insurance companies	2,086.6	6.4
Private pension funds	2,362.8	7.2
Government retirement funds	2,555.4	7.8
Mutual funds	7,327.0	22.3
Closed-end funds	99.6	0.3
Exchange-traded funds	1,756.4	5.3
Brokers and dealers	166.8	0.5
Foreign investors	5,706.9	17.4

Source: Board of Governors of the Federal Reserve System, *Financial Accounts of the United States Fourth Quarter 2015*, March 10, 2016, Tables L.223 and L.101.a and JCT staff calculations.

However, these totals may understate the share of corporate distributions that are not subject to a full second level of tax. They do not include the share of corporate equities held by nonprofit organizations.[53] Mutual funds, closed-end funds, and exchange-traded funds may ultimately be held by entities not subject to tax, or subject to tax at reduced rates, on distributions with respect to the corporate equities they hold. Estimates above include the value of real estate investment trusts, which generally are not subject to tax at the corporate level by design. Household ownership of corporate equities reported above includes holdings through individual retirement accounts, section 529 savings accounts, and other tax-favored accounts, as well as direct holdings that are taxed at zero percent to low-bracket shareholders.

[53] For the period 1988 through 2000, the Federal Reserve Board estimated asset holdings by nonprofit organizations separate from the household sector based on data from the Internal Revenue Service SOI Division. These estimates do not include religious organizations or organizations with less than $25,000 in gross annual receipts. During this period holdings by nonprofit organizations averaged 9.0 percent of holdings by households and nonprofits organizations and 4.5 percent of all corporate equities. If nonprofit organizations held the same percentages of corporate equities as of December 31, 2015, as they held during the period from 1988 through 2000, an additional $1.2 trillion to $1.6 trillion of corporate equities (3.6 percent to 4.9 percent of the 31.9 percent reported for the households and nonprofit organizations sector collectively in Table 2) may not have been subject to a second level of tax.

Furthermore, the share of corporate distributions that are not subject to a full second level of tax may be understated because of the inclusion of foreign stock in the data above. The $32.8 trillion of equities include $6.732 trillion of equities issued by foreign corporations held by U.S. persons.[54] The total stock of U.S. corporations other than S corporations ("domestic corporations") is therefore only $26.1 trillion.[55] To calculate the share of this $26.1 trillion of domestic corporations owned by each group of investors identified in Table 2 requires separate adjustments for foreign investors and for U.S. persons. After adjusting for stock of foreign corporations as described below, the share of domestic corporations held by all of the tax-preferred groups (*i.e.*, foreign investors, government retirement funds, private pension funds, and Federal, State, and local governments) may be as high as 36.6 percent. Alternatively, no more than 63.4 percent of stock of domestic corporations is held by U.S. taxable investors.[56]

The Federal Reserve does not track the holdings by foreign persons of equities issued by foreign corporations. Therefore, all $5.7 trillion of stock held by foreign investors listed in Table 2 is stock of domestic corporations, or 21.9 percent of the total. The percentage of stock of U.S. corporations owned by foreign investors is about one-quarter higher than the 17.4 percent of U.S. and foreign stock they own shown in Table 2.[57]

Stock of foreign corporations held by U.S. persons represents 24.8 percent of the total non-S-corporation equity holdings of U.S. persons.[58] Because U.S. persons hold a higher percentage of their portfolios in stock of foreign corporations than the percentage of foreign investors hold of their portfolios in domestic corporations, the percentage of stock of U.S. corporations owned by U.S. persons is lower than the percentage shown in Table 2. If the percentage of each identified U.S. shareholder group's portfolio that is composed of foreign stock were 24.8 percent, then the percentage of stock of domestic corporations owned by each U.S. group would be approximately five percent lower than the percentage shown in Table 2.[59]

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[54] Board of Governors of the Federal Reserve System, *Financial Accounts of the United States Fourth Quarter 2015*, March 10, 2016, Tables L.223.

[55] $32,848.8 - $6,732.0 = $26,116.8 billion.

[56] However, this figure does not take into account the adjustments described above for: nonprofit organizations; ultimate holders of mutual funds, closed-end funds, and exchange-traded funds; real estate investment trusts; household holdings through individual retirement accounts, section 529 savings accounts, and other tax-favored accounts; or household holdings that are taxed at zero percent to low-bracket shareholders.

[57] Foreign stock is 20.49 percent of the total of $32.848 trillion of non-S corporate equities in Table 2. Thus the percentage for foreign investors in Table 2 may be adjusted by multiplying the 17.37 percent by 1/(1-.2049) =.2185. This is the same as $5706.9/$26,116.8=.2185. The ratio of $32,848.8/$26,116.8 = 1.2577.

[58] ($6,732/(32,848.8-5,706.9))=.2480. Because the Federal Reserve does not track the holdings by foreign persons of equities issued by foreign corporations, all $6.732 trillion of stock of foreign corporations represents holdings by U.S. persons. Total holdings by U.S. persons of all corporate equities other than S corporation equities is $27.1 trillion ($32,848.8-5,706.9) because foreign persons may not hold S corporation stock.

[59] To obtain the market value of holdings of domestic corporations held by each U.S. group of investors, the amounts in Table 2 need to be reduced by the assumed amount of stock of foreign corporations held by each group (assumed to be constant at 24.8 percent). The total market value of domestic corporations is 20.49 less than

For example, government retirement funds may have held only 7.4 percent of the $26.1 trillion of stock of domestic corporations—compared to the reported total of 7.8 percent of the $32.8 trillion of stock of corporations (both U.S. and foreign) other than S corporations—after adjusting for stock of foreign corporations.

the $32,848.8 billion total market value of non-S corporate equities reported in Table 2. Thus, the percentage of domestic corporations held by each U.S. group is (1-.2480)/(1-.2049)=.9458 of the percentage reported in Table 2.

C. Corporate Income Tax Distortions

The present law structure of a separate entity level tax on C corporate income has long been recognized to create a variety of economic distortions.[60] The two levels of tax on corporate form income (entity and shareholder level), as compared to the single level of tax imposed on passthrough entities (such as S corporations or partnerships), create a bias against the corporate form of organization, even in situations where nontax considerations indicate that corporate form would otherwise be preferable.[61] Second, there may be incentives for the retention of earnings in the corporation, which may lead to distortions in the allocation of capital to the extent that corporations with current earnings have less favorable investment opportunities than would their shareholders. An additional distortion resulting from the present law corporate income tax rules is the incentive to finance new investments from debt rather than equity on account of the deductibility of interest payments on debt but no comparable deduction for dividends paid on equity. Over-reliance on debt financing can increase bankruptcy risk. In addition, present law results in considerable complexity and tax planning as taxpayers seek to structure the most tax-favorable form of doing business and providing returns to investors.

Elimination of the second level of tax on corporate income and these associated corporate income tax distortions requires careful consideration regarding the situations in which at least one level of tax should be collected and the level (corporate or shareholder) at which that tax should apply. While the corporate tax could be eliminated entirely, it still would be necessary to choose from among the various passthrough alternatives; moreover, passthrough treatment may be unworkable for some types of businesses, such as publicly traded corporations with complex business operations. Alternatively, these distortions could be mitigated by making adjustments within the corporate tax regime to reduce or eliminate the separate corporate and shareholder levels of tax (referred to as "corporate integration"), but this too involves significant policy decisions.[62]

1. Distortions between investment in corporate versus noncorporate sector

Along with other factors, the choice of entity may be influenced by the tax burden on income earned in that form. In general, one may expect capital to flow to the sector (*e.g.*,

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[60] For early examples, see Fred Rogers Fairchild, "Suggestions for Revision of the Federal Taxation of Income and Profits," *American Economic Review*, vol. 10, no. 4, December 1920, pp. 785-799, and Roy G. Blakey, "The New Income Tax," *American Economic Review*, vol. 4, no. 1, March 1914, pp. 25-46. Hereinafter, "corporate" and "corporation" refers to "C corporate" and "C corporation" unless otherwise explicitly noted.

[61] As a practical matter, businesses that expect to raise equity capital in the public markets generally choose the corporate form. Partnerships can raise equity capital in the public markets, but they are subject to restrictions on the nature of their income so as not to be taxed as corporations. See section 7704.

[62] For earlier discussions of the background, issues, and alternatives with respect to corporate integration, see Joint Committee on Taxation, *Present Law and Background Relating to Selected Tax Issues* (JCX-41-06), September 19, 2006; Michael J. Graetz and Alvin C. Warren, Jr. (eds.), *Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports*, Tax Analysts, 1998; and Joint Committee on Taxation, *Federal Income Tax Aspects of Corporate Financial Structures* (JCS-1-89), January 18, 1989.

corporate versus noncorporate) that is most lightly taxed. Changes in the burden of taxation alter the incentives to organize business activity in a certain form and may result in some businesses changing their form in response to these changing incentives.

The presence of a separate entity-level tax creates a disincentive to organize in corporate form, notwithstanding potential restrictions on access to the capital markets. This in turn limits investors' access to publicly traded equity investment, which may impose a particular burden to smaller portfolio investors who are less likely to have significant access to equity investments in passthrough entities. To the extent that the two levels of tax impose a higher level of tax on investment generally, the incentive to save is reduced. The resulting increase in the cost of capital needed to finance new investment leads to lower capital formation, thereby reducing future output and productivity.[63] The magnitude of these effects depends on the ultimate incidence of the corporate income tax, whether on shareholders in the form of reduced after-tax returns to capital, consumers in the form of higher prices, employees in the form of lower wages, suppliers in the form of lower prices for inputs, or some combination thereof.[64]

A proper analysis of the tax burden includes the effect of taxation of income not only at the entity level, but also at the investor/owner level. Distributions of corporate income in the form of dividends may be subject to additional taxation at the shareholder level. Retained corporate earnings may increase the value of corporate stock resulting in capital gains that may be taxed upon sale of the stock. However, a shareholder may be a tax-exempt entity or a foreign person and not bear any additional U.S. income tax on such gains.

An analysis of the effect of taxation on entity choice depends on the marginal corporate income tax rate, the marginal individual income tax rate on noncorporate business income, the marginal individual income tax rate on dividend distributions by a corporation, and the capital gains tax rate. The marginal tax rates applicable to a particular corporation or individual may vary based on the source and amount of taxable income.

For most of the history of Federal income taxation, the top individual income tax rate has not been less than the top marginal corporate income tax rate. This has been the case except for the period from 1987 through 1992 following enactment of the Tax Reform Act of 1986.[65]

[63] Suppose an investment project may be undertaken with a rate of return of 10 percent. In the absence of a corporate income tax, the investor is indifferent between investing through a corporation or through a passthrough entity. However, if the corporate tax rate is 35 percent, the investment in the corporation only yields 6.5 percent. To make the investor indifferent, the corporation must undertake projects with a rate of return of 15.4 percent to yield an after-tax return of 10 percent. Capital flows out of the corporate sector until the rate of return of the marginal project just makes investors indifferent. Some projects that would otherwise take place, do not.

[64] The incidence of the corporate income tax is beyond the scope of this discussion. All that is important for the following analysis is that the burden of taxation is related to the marginal tax rates in the corporate and noncorporate sector. For a discussion of the incidence of the corporate income tax, see Joint Committee on Taxation, *Modeling the Distribution of Taxes on Business Income* (JCX-14-13), October 16, 2013.

[65] Pub. L. No. 99-514.

Issues when the individual rate is higher than the corporate rate

The corporate income tax may serve as a backstop to the individual income tax in the case of retained corporate earnings. Without a passthrough system analogous to the S corporation model, a deemed distribution system analogous to the taxation of controlled foreign corporations, or a substantial corporate tax on retained earnings, income could be accumulated within the corporate entity without bearing similar income tax compared to the amount of tax that would be paid if the income were earned directly by individuals. On the margin, when the individual income tax rate is substantially higher than the corporate income tax rate, it may create an incentive to organize business activity in corporate rather than passthrough form.

For example, if there were either no corporate tax or a corporate tax imposed at a much lower rate than the individual tax, individuals would be able to invest assets in corporations where those assets would earn and accumulate income that was not taxed currently (or taxed at low rates currently). Such undistributed corporate income, to the extent reflected in increased value, would be taxed on a deferred basis to the individuals, perhaps at capital gains rates or perhaps not at all in the case of an individual who holds appreciated stock at death.[66] Thus, some contend that absent full integration, the imposition of a substantial corporate tax on undistributed corporate earnings may be necessary to prevent deferral or complete avoidance of tax. If the corporate rate is significantly below the individual's marginal rate (for example, because of the graduated corporate income tax rate structure), the value of deferring shareholder-level tax by not distributing corporate income can more than offset the extra burden of the corporate income tax. Present law provides a disincentive to the accumulation of undistributed income at lower corporate rates by imposing accumulated earnings tax or personal holding company tax on a corporation that does not distribute its income in certain limited circumstances, as discussed in section II of this document. If these taxes apply, they are payable in addition to the regular corporate tax and are imposed at the maximum rate applicable to an individual's receipt of a dividend. Such taxes are intended to compensate for the shareholder-level deferral that may occur when corporate income is not distributed.

Issues when the corporate rate is higher than the individual rate

Conversely, the incentive to organize in passthrough form to avoid entity-level tax is made stronger when the corporate income tax rate rises relative to the individual income tax rate, because the burden of the corporate tax rises. When the corporate income tax rate is higher than the individual income tax rate, it may also distort decisions to retain or to distribute corporate earnings. If the effective tax rate on shareholders is significantly lower than the corporate effective tax rate there may be an incentive to distribute earnings rather than retain them at the corporate level. This can create an economic distortion if a corporation is better able to invest capital than its shareholders (for example, due to economies of scale). If the corporation and its

[66] Sec. 1014. A taxpayer who receives assets from a decedent generally receives a basis equal to the fair market value of the asset as of the decedent's death. As a result, any appreciation that occurred during the decedent's life is never subject to income tax.

shareholders are both able to make the best possible investments, no inefficiency necessarily results from incentives to retain or distribute earnings or to organize in one form or another.

2. Distortions in corporate dividend policy, to distribute or to retain earnings

The two-tier tax on dividend distributions can make it more desirable for a corporation to use retained earnings rather than new equity for its investments. Shareholders may find such earnings retention attractive (subject to the accumulated earnings tax and personal holding company tax rules), if the shareholder expects to defer tax on capital gains for a substantial period or to hold stock until death (so that appreciation can be passed to his heirs free of individual income tax).

There also may be an incentive under present law to retain earnings if the corporation's effective tax rate on reinvestment is lower than the shareholder’s effective tax rate on distributed earnings. By contrast, if the shareholder's tax rate is significantly lower than the corporation’s effective tax rate – for example, if the shareholder is a tax-exempt entity, is entitled to a corporate dividends-received deduction or to the lower rates on dividends to individuals, or if the distribution can be structured as a stock buyback eligible for capital gains rates and basis recovery – there may be a tax incentive to distribute earnings or a reduced incentive to retain earnings.

This behavior distorts the allocation of capital to the extent that a corporation’s investment opportunities are more limited than those of its shareholders. While the presence of the corporate tax generally raises the required pre-tax rate of return of investment, the disincentive to distribute can cause the firm to undertake projects with a lower pre-tax rate of return than are available to the shareholder outside the corporation. Suppose a shareholder has access to a $100 investment outside the corporation that yields 10 percent, but the corporation only has access to a project that yields 9.5 percent. Before tax considerations, the shareholder would prefer to allocate $100 of capital away from the corporation and towards the outside project. However, if the corporation pays a dividend of $100, the shareholder may only have $76.20 to invest after paying tax on the dividend at 23.8 percent.[67] Investing the $76.20 yields a pre-tax return of $7.62 and $4.60 after ordinary income tax at 39.6 percent. If the corporation instead makes the investment with retained earnings, the investment yields a pre-tax return of $9.50, and $6.18 after corporate income tax at 35 percent. If the corporation then pays out the $6.18 as a dividend, the investor has $4.71 after paying tax on the dividend. The investor prefers the lower pre-tax rate of return project, which reduces overall output in the economy.

3. Distortions in firm capital structure

The earnings on an equity-financed corporate business activity are subject to the double tax, to the extent they are paid out, because the corporation is taxed when it earns the income,

[67] This includes the maximum individual rate of 20 percent plus the net investment income tax rate of 3.8 percent. It does not include the effect of any other tax provisions, such as the overall limitation on itemized deductions, on the effective marginal tax rate.

and the taxable holders of the equity (shareholders) are taxed when the income is distributed to them. Thus, equity-financing a project may have a relatively high tax cost.

The earnings on a debt-financed corporate business activity, by contrast, are generally not subject to two levels of tax to the extent paid as interest, because the interest on the debt is deductible and shelters the income earned at the corporate level from the corporate tax. The only level of tax paid on such earnings is paid by the person to whom the income is distributed. To the extent the income is paid in the form of interest to the lender, and the lender is a taxable entity, the income is subject to tax in the lender's hands. Some lenders (such as pension funds) may be tax-exempt, however, so income on debt-financed corporate activities that is paid to a tax-exempt lender escapes both levels of tax normally applicable to income earned in a corporation. To the extent that corporate income is not paid out as interest but is used to amortize principal or otherwise exceeds the deductible interest amounts, it may be taxed at the corporate level (as well as to the shareholder). Because the overall tax cost of debt-financing a project is less than equity-financing it, it is said that debt financing is a less costly method of financing than is equity financing.

Corporations may also use retained earnings to finance their business activities. Retained earnings generally represent after-tax income of the corporation, but to the extent these amounts are not distributed to shareholders, and instead are used to finance income-producing activities of the corporation, only the earnings from the income-producing activity (to the extent they are distributed to shareholders) are subject to two levels of tax; the amounts used to finance the project are subject to only the corporate level of tax (which under present law is lower than the individual rate). The price of the corporation's stock may, however, reflect the retention of earnings, and thus market turnover in the stock (for the period of retention) will generate taxable gains.

The fact that interest is generally deductible while dividends are not encourages corporations to finance investments with debt rather than equity capital to reduce the corporate-level tax.[68] This incentive is increased by the availability of tax-exempt and foreign investors; where corporate earnings are paid as deductible interest to tax-exempt or foreign holders of corporate debt, no U.S. tax is paid at either the corporate or the investor level (although the investor may incur some foreign home country tax on the interest received).

Some investors, however, may prefer equity to debt. An individual holder of corporate equity is currently eligible for a maximum tax rate of 23.8 percent on qualified dividend income or long-term capital gain from the sale of corporate stock (compared to a maximum tax rate of

[68] One way to measure the potential inefficiency in the allocation of capital is to calculate the effective marginal tax rate on investment. The Congressional Budget Office has estimated that the marginal tax rate on an all debt-financed corporate investment is -6 percent versus 38 percent on an all equity-financed corporate investment. Congressional Budget Office, *Taxing Capital Income: Effective Marginal Tax Rates under 2014 Law and Selected Policy Options*, December 2014.

43.4 percent[69] on interest income). A corporation that owns stock in another corporation is generally allowed a dividends received deduction that in effect excludes between 70 percent and 100 percent of the dividend from the recipient's income. At the lowest percentage deduction, applicable to stock ownership of less than 20 percent, the maximum tax rate on dividends received is currently 10.5 percent (35 percent maximum corporate tax rate multiplied by the 30 percent of the dividend that is taxable).

Clearly, there are nontax reasons to finance investment at least partially with debt, including the potential to generate a higher rate of return on equity capital if the investment succeeds. However, the additional tax incentive to raise capital in the form of debt encourages higher leverage levels than would exist absent the tax inducement. The tax inducement to over-leverage increases both the risk of financial distress and the tolerance of corporate equity owners for operational risk (by reducing the extent to which their equity capital is at stake).

4. Examples

In general

Consider two corporations that are identical in every respect except that one, ABC, is organized as a C corporation and the other, QRS, is organized as an S corporation.[70] Taxpayer T, owns one-tenth of one percent of the stock in both ABC and QRS and has sufficient other income to be in the highest marginal individual income tax bracket, τ_i. ABC is taxed at the marginal corporate tax rate, τ_c, dividends paid to shareholders are taxed at the dividends tax rate, τ_d, and capital gains are taxed at the capital gains tax rate, τ_g. Each corporation is financed entirely by equity (*i.e.*, there are no tax deductible payments of interest), has taxable income of *TI*, and retains after-tax corporate profits of *RE*. Retained earnings increase the value of the corporate stock producing a capital gain for shareholder T.[71]

Under these assumptions, the combined corporate and individual income taxes paid on an investment in ABC by Taxpayer T and ABC are equal to

$$ABC\ tax = \tau_c TI + \tau_d[TI(1-\tau_c) - RE] + \tau_g RE$$

Since all of the income of QRS is passed through to its shareholders, the total taxes paid on an investment in QRS by T and QRS are equal to

[69] This includes the maximum individual tax rate of 39.6 percent plus the net investment income tax rate of 3.8 percent. It does not include the effect of any other tax provisions, such as the overall limitation on itemized deductions, on the effective marginal tax rate.

[70] These simplified examples assume that QRS is not subject to entity-level tax under section 1374 or 1375.

[71] While sales of S corporation stock may generate capital gains, the amount of gain in these examples is equal to zero because the shareholder receives an increase in basis equal to the amount of earnings previously taxed at the shareholder level.

$QRS\ tax = \tau_i TI$

Numerical examples

In 1980, the top marginal individual income tax rate was higher than the top marginal corporate income tax rate. The top individual rate (including on distributed corporate dividends) was 70 percent, the top corporate rate was 46 percent, and the top capital gains tax rate was 28 percent. Assume that ABC and QRS each had $100 million of taxable income and ABC had a policy to retain all after-tax earnings ($RE = [TI(1-\tau_c)]$) for future investment opportunities. Assume that Taxpayer T disposed of his share of stock in ABC and was eligible for the 28-percent rate on long-term capital gains. Total taxes on an investment by Taxpayer T in ABC and QRS, respectively, would have been:

$$ABC\ tax_{1980} = .46(100{,}000) + .70\ [0] + .28[100{,}000(1-.46)] = \$61{,}120$$

$$QRS\ tax_{1980} = .70\ (100{,}000) = \$70{,}000.$$

In 1988, the top marginal corporate tax rate dropped to 34 percent, while the top individual income tax rate, the dividends tax rate, and the capital gains tax rate were all 28 percent. Given the same fact pattern above, total taxes on an investment by Taxpayer T in ABC and QRS, respectively, would have been:

$$ABC\ tax_{1988} = .34(100{,}000) + .28\ [0] + .28[100{,}000(1-.34)] = \$52{,}480$$

$$QRS\ tax_{1988} = .28\ (100{,}000) = \$28{,}000.$$

In 2016, the top marginal corporate tax rate is 35 percent and the top individual income tax rate applicable to a passive shareholder of an S corporation is 43.4 percent, while dividends and long-term capital gains are both taxed at 23.8 percent.[72] Given the fact pattern above, total taxes on an investment by Taxpayer T in ABC and QRS, respectively, would be:

$$ABC\ tax_{2016} = .35(100{,}000) + .238\ [0] + .238[100{,}000(1-.35)] = \$50{,}470$$

$$QRS\ tax_{2016} = .434\ (100{,}000) = \$43{,}400.$$

[72] These rates include the effect of income tax rates under sections 1 and 11 and the net investment income tax under section 1411, but not the effect of phase-outs of itemized deductions or personal exemptions, or the deduction for income attributable to domestic production activities.

Effect of dividend payout ratio

If the rate on capital gains and dividends differs, the relative tax burden of an investment in a C corporation versus an S corporation also depends on the corporate policy with respect to dividend payouts. If ABC had a policy to pay out half of its after-tax earnings as dividends ($RE = \left[\frac{TI(1-\tau_c)}{2}\right]$), instead of retaining all its after-tax earnings, the total tax result for ABC in 1980 would have been:

$$ABC\ tax_{1980} = .46(100{,}000) + .70\left[\frac{100{,}000(1-.46)}{2}\right] + .28\left[\frac{100{,}000\,(1-.46)}{2}\right] = \$72{,}460.$$

The additional burden of the corporate tax on earnings distributed as dividends may have made a company prefer to organize as an S corporation, and incur a $70,000 total tax liability as calculated above, rather than as a C corporation, and incur the $72,460 total tax liability calculated here. The tax results would be unaffected for 1988 and 2016 because the tax rate on dividends equals the tax rate on capital gains in those years.

Effect of deferring or eliminating capital gains taxes

The present value of the tax on capital gains may be reduced by delaying the sale of corporate stock. In the extreme case, tax on capital gains may be eliminated if a taxpayer holds appreciated shares of stock until death. The ability to reduce or eliminate the tax on capital gains offsets some of the disincentive effect of the second level of tax on distributed C corporation earnings. Consider the tax result for ABC in 1980 if Taxpayer T died on December 31, 1980 (so taxable capital gain is zero), and ABC paid out half of its after-tax earnings as dividends.

$$ABC\ tax_{1980} = .46(100{,}000) + .70\left[\frac{100{,}000(1-.46)}{2}\right] + .28[0] = \$64{,}900$$

In this circumstance, a C corporation is more attractive from a tax standpoint than an S corporation, as in the first numerical example above. Thus, the negative effect of the increased dividend payout ratio is partially offset by the ability to reduce the capital gains tax.[73]

[73] If capital gains taxes are deferred rather than eliminated, the total tax paid on an investment in ABC would still be reduced, though not as much. In this example, if the effective capital gains tax rate were reduced below 18.89 percent ($70,000-$64,900) / $\left[\frac{100{,}000(1-.46)}{2}\right]$), the total tax paid on an investment in ABC would be less than on an investment in QRS. Assuming a discount rate of 10 percent, this could be accomplished by deferring the gain for at least five years.

5. Evidence from the economics literature

<u>Organizational form</u>

Economists have studied the effect of taxes on entity choice from a number of angles, but typically have done so by looking at changes in activity between the corporate sector (excluding S corporations) and various entities in the noncorporate sector (including S corporations). One of the earlier studies in the literature found that differences between personal and corporate tax rates discouraged firms from incorporating, but that nontax considerations dominated tax considerations in the choice of organizational form.[74] Moreover, efficiency losses created by distortions in entity choice were relatively small.[75] Another study, examining data on organizational form from 1900 to 1939 (when fewer organizational forms, such as S corporations, were permitted), also found that taxes exerted a relatively small effect on organizational form, with comparatively small efficiency losses.[76] One paper using more recent data found that differences between individual and corporate tax rates have significant effects on the share of firms operating as corporations versus partnerships and sole proprietorships.[77]

Studies that have analyzed entity choice at a narrower level, such as the choice between organizing a business as an S corporation as opposed to a C corporation, have found larger effects. A Treasury study looking at the effects of the Tax Reform Act of 1986 found that the increase in the gap between individual and corporate tax rates increased the likelihood that a firm would convert from a C corporation to an S corporation.[78] This was particularly the case for newer firms, who had tended to be smaller and required less access to capital relative to older, more established firms.[79] While the results of this study suggest that nontax factors were important in determining organizational form, it is possible that some C corporations did not convert to S status because they were unable to meet the requirements for S status, and a

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[74] Jeffrey K. MacKie-Mason and Roger H. Gordon, "How Much Do Taxes Discourage Incorporation," *Journal of Finance*, vol. 52, no. 2, June 1997, pp. 477-505.

[75] *Ibid.*

[76] Austan Goolsbee, "Taxes, Organizational Form, and the Deadweight Loss of the Corporate Income Tax," *Journal of Public Economics*, vol. 69, no. 1, January 1998, pp. 143-152.

[77] Austan Goolsbee, "The Impact of the Corporate Income Tax: Evidence from State Organizational Form Data," *Journal of Public Economics*, vol. 88, no. 11, November 2004, pp. 2283-2299. This study likely underestimates the effect of taxes on organizational form as the data do not differentiate S corporations from C corporations.

[78] Robert Carroll and David Joulfain, "Taxes and Corporate Choice of Organizational Form," Office of Tax Analysis Working Paper 73, October 1997. Other tax factors may influence the decision to convert from a C corporation to an S corporation. For example, an S corporation has restrictions on the type and number of shareholders it may have, is limited to a single class of stock, and may be subject to tax on built-in gains upon conversion to another organizational form.

[79] *Ibid*.

conversion to the more flexible partnership passthrough form would have been a taxable transaction.

Another consideration is the interaction between other tax attributes with changes in tax rates. For example, one study suggests that simultaneous changes in the tax treatment of built-in gains as part of the Tax Reform Act of 1986 significantly reduced conversions from C corporations to S corporations in the natural resource industry.[80] Another study finds that small firms choose to operate as S corporations rather than C corporations when they experience losses in the early years of operation, in part because these losses are passed through to the investors immediately.[81] Looking at changes that allowed banks to convert to S corporations,[82] one study finds that banks are more likely to convert when they pay higher dividends, have less built-in gains, have fewer corporate tax loss carryforwards, or may be subject to the alternative minimum tax.[83]

Dividend payout policy

In a world without taxes and perfect and complete markets, it can be demonstrated that firms are valued based on their operating cash flows, and whether a company retains or pays out profits is irrelevant to firm value as is the form of payout.[84] If different classes of investors ("clienteles") are taxed differently and firms have differing payout policies, it is still possible for taxes not to affect payout policy and dividend policy.[85]

Several studies have tested the proposition that higher dividend payout ratios negatively affect firm value if dividends are highly taxed or highly taxed relative to capital gains with mixed

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[80] Thomas C. Omer, George A. Plesko, and Marjorie K. Shelley, "The Influence of Tax Costs on Organizational Choice in the Natural Resource Industry," *Journal of the American Taxation Association*, vol. 22, no. 1, Spring 2000, pp. 38-55.

[81] Ben Ayers, C. Bryan Cloyd, and John R. Robinson, "Organizational Form and Taxes: An Empirical Analysis of Small Businesses," *Journal of American Taxation Society*, 18, 1996 Supplement, pp. 49-67. Interpretation of these results is a little unclear as the authors do not find a significant affect for the choice between C corporations and sole proprietorships and partnerships, where losses are also passed through. This may suggest that nontax considerations dominate the decision in this case.

[82] Section 1361 of the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, allows a bank to elect to be treated as an S corporation unless such institution uses a reserve method of accounting for bad debts.

[83] Leslie Hodder, Mary Lea McAnally, and Connie D. Weaver, "The Influence of Tax and Nontax Factors on Banks' Choice of Organizational Form," *The Accounting Review*, vol. 78, no. 1, January 2003, pp. 297-325.

[84] Merton Miller and Franco Modigliani, "Dividend Policy, Growth, and the Valuation of Shares," *Journal of Business*, vol. 34, no. 4, October 1961, pp. 411-433.

[85] Potential arbitrage by tax-exempt institutional investors in the model ensures one price for all firms regardless of their dividend payout policy. Franklin Allen and Roni Michaely, "Payout Policy," in George M. Constantinides, Milton Harris, and Rene M. Stulz (eds.), *Handbook of the Economics of Finance*, vol. 1A, North-Holland Publishing Col., 2003, pp. 337-429.

results. Some find no relationship between dividend yield and firm value.[86] Others have found a positive association between dividend payouts and firm value, though the interpretation of these results is unclear. Even if the positive association between firm value and dividends can be established, it may only be sustained in the very short-run (perhaps only the week the dividend is paid) and may not be attributable to taxes.[87] If firms use dividend payments to signal future profitability, higher dividend payments might be positively associated with firm value. Also, if tax-exempt investors are the marginal investors in dividend paying firms, then one would not expect a negative relationship between firm value and highly taxed dividends.

Other studies have examined whether firms pay out more, either as dividends or through share repurchases, when investor-level payout taxes decrease, or if the form of payout changes when the relative taxation of dividends and capital gains changes. One study finds that as the taxation of dividends relative to capital gains increases, corporations shift away from dividends and towards share repurchases.[88] Firms with more taxable shareholders or a greater share of senior managerial shareholders are more likely to respond to increases in the relative tax penalty of dividends by switching to share repurchases. Several studies that examine the reduction in the tax rate applied to qualified dividends in 2003 find that the tax reduction led to increased dividend payouts by firms, with greater effects for firms with a larger share of individual shareholders and smaller effects for firms for which the largest shareholder was an institution unaffected by the tax rate reduction.[89]

Capital structure

In the absence of taxes and bankruptcy costs, and with perfect and complete markets, the market value of any firm is independent of its capital structure.[90] Leveraged companies cannot

[86] Fisher Black and Myron S. Scholes, "The Effects of Dividend Yield and Dividend Policy on Common Stock Prices and Returns," *Journal of Financial Economics*, vol. 1, no. 1, May 1974, pp. 1-22; Merton H. Miller and Myron S. Scholes, "Dividends and Taxes: Some Empirical Evidence," *Journal of Political Economy*, vol. 90, no. 6, December 1982, pp. 1118-1141.

[87] Robert H. Litzenberger and Krishna Ramaswamy, "The Effect of Personal Taxes and Dividends on Capital Asset Prices: Theory and Empirical Evidence," *Journal of Financial Economics*, vol. 7, no. 2, June 1979, pp. 163-195; Eugene F. Fama and Kenneth R. French, "Taxes, Financing Decisions, and Firm Value," *Journal of Finance*, vol. 53, no. 3, June 1998, pp. 819-843; Avner Kalay and Roni Michaely, "Dividends and Taxes: A Re-examination," *Financial Management*, vol. 29, Summer 2000, pp. 55-75.

[88] William J. Moser, "The Effect of Shareholder Taxes on Corporate Payout Choice," *Journal of Financial and Quantitative Analysis*, vol. 42, no. 4, December 2007, pp. 991-1019.

[89] Jennifer L. Blouin, Jana S. Raedy, and Douglas A. Shackelford, "Dividends, Share Repurchases, and Tax Clienteles: Evidence from the 2003 Reductions in Shareholder Taxes," *The Accounting Review*, vol. 86, no. 3, May 2011, pp. 887-914; Raj Chetty and Emmanuel Saez, "The Effects of the 2003 Dividend Tax Cut on Corporate Behavior: Interpreting The Evidence," *American Economic Review*, vol. 96, no. 2, May 2006, pp. 124-129; Brandon Julio and David L. Ikenberry, "Reappearing Dividends," *Journal of Applied Corporate Finance*, vol. 16, no. 4, Fall 2004, pp. 89-100.

[90] Franco Modigliani and Merton H. Miller, "The Cost of Capital, Corporation Finance, and the Theory of Investment," *American Economic Review*, vol. 48, no. 3, June 1958, pp. 261-297.

command a premium over unleveraged companies because investors can replicate the borrowing of the firm by putting the equivalent leverage into their portfolio directly by borrowing on their own account. The combination of the unleveraged company and the individual borrowing replicates the risk and return of holding a leveraged company. Arbitrage opportunities between these two equivalent portfolios prevent a leveraged firm from being valued more highly than an unleveraged firm. Similarly, leveraged companies cannot sell at a discount to unleveraged companies because investors have the opportunity of undoing the leverage by holding the bonds of the leveraged company in their portfolio in proportion to the debt of the leveraged company. The combination of the leveraged company and its bonds is equivalent to an unleveraged company. Arbitrage opportunities between these two equivalent portfolios prevent an unleveraged firm from being valued more highly than a leveraged firm. Thus, under these assumptions, the value of a firm does not depend on whether or to what extent it is leveraged.

In the presence of a tax system in which interest is deductible, a firm can increase its value by taking on debt. The value of the leveraged firm is equal to the value of the unleveraged firm plus the present value of the tax savings associated with the interest deductions on the debt.[91] The deductibility of interest means that a firm can reduce its tax bill by the amount of interest it pays multiplied by the tax rate. In valuing the benefit of these reduced tax payments to the firm, the stream of tax savings is discounted at the interest rate on the debt, such that the increase in the value of the leveraged firm is equal to the tax rate multiplied by the amount of debt outstanding. This implies that the optimal capital structure of the firm might be all debt.

This analysis does not, however, consider the numerous additional factors that influence a firm's choice of capital structure. For example, the tax benefits of higher debt levels must be balanced with the associated costs, such as the cost of financial distress,[92] agency costs of debt,[93] or underinvestment costs.[94] Whatever the costs, the incentive to finance with debt increases as the corporate tax rate increases and firm value increases up to the point where the marginal cost of an additional dollar of debt financing equals the marginal benefit. The optimal capital structure thus varies across firms with each firm's marginal tax rate.[95] High personal taxes on

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[91] Franco Modigliani and Merton Miller, "Corporate Income Taxes and the Cost of Capital: A Correction," *American Economic Review*, vol. 53, no. 3, June 1963, pp. 433-443.

[92] Alan Kraus and Robert H. Litzenberger, "A State-Preference Model of Optimal Financial Leverage," *Journal of Finance*, vol. 28, no. 4, September 1973, pp. 911-922; Gregor Andrade and Steven N. Kaplan, "How Costly is Financial (Not Economic) Distress? Evidence from Highly Levered Transactions that Became Distressed," *Journal of Finance*, vol. 53, no. 5, October 1998, pp. 1443-1493; Heitor Almeida and Thomas Philippon, "The Risk-Adjusted Cost of Financial Distress," *Journal of Finance*, vol. 62, no. 6, December 2007, pp. 2557-2586.

[93] Agency costs arise when the interests of owners of the firm diverge from the interests of the managers of the firm. These may, for example, lead bondholders to impose restrictions on companies via bond indentures. Jules H. van Binsbergen, John R. Graham, and Jie Yang, "The Cost of Debt," *Journal of Finance*, vol. 65, no. 6, December 2010, pp. 2089-2136.

[94] Stewart C. Myers, "Determinants of Corporate Borrowing," *Journal of Financial Economics*, 5, 1977, pp. 147-175.

[95] If a firm has reduced taxable income to zero via other deductions or reduced tax liability to zero as a result of tax credits, it benefits less from additional interest deductions attributable to higher debt levels. Harry

interest income relative to personal taxes on equity income also reduce the incentive to finance with debt. Thus the overall debt and equity in the economy is a function of the relative corporate and individual tax rates.[96]

Research has shown that corporate debt usage is positively affected by corporate tax rates.[97] It has also been demonstrated that personal taxes affect corporate capital structure.[98] One study finds a reduction in debt ratios following the reduction in taxes on both dividends and capital gains in 2003.[99] To some extent these effects depend on the characteristics of the marginal investor in debt and equity. Finally, aggregate corporate debt ratios seemed to respond to changes in the relative corporate and individual tax rates as part of the Tax Reform Act of 1986.[100]

DeAngelo and Ronald Masulis, "Optimal Capital Structure under Corporate and Personal Taxation," *Journal of Financial Economics*, vol. 8., no. 1, 1980, pp. 3-29, and E. Han Kim, "Optimal Capital Structure in Miller's Equilibrium," in S. Bhattacharya and George Constantinides (eds.), *Financial Markets and Incomplete Information*, Rowman and Littlefield, 1989, pp. 36-48.

[96] Merton H. Miller, "Debt and Taxes," *Journal of Finance*, vol. 32, no. 2, *Papers and Proceedings of the Thrity-Fifth Annual Meeting of the American Finance Assocation*, May 1977, pp. 261-275.

[97] For a review of recent empirical evidence on taxes and firm capital structure, see John Graham, "Do Taxes Affect Corporate Decisions? A Review," in George M. Constantinides, Milton Harris, and Rene M. Stulz (eds.), *Handbook of the Economics of Finance*, vol. 2A, North-Holland Publishing Col., 2013, pp. 123-210, especially pp. 141-150.

[98] John R. Graham, "Do Personal Taxes Affect Corporate Financing Decisions?," *Journal of Public Economics*, vol. 73, no. 2, August 1999, pp. 147-185. Mara Faccio and Jin Xu, "Taxes and Capital Structure," *Journal of Financial and Quantitative Analysis*, vol. 50, no. 3, June 2015, pp. 277-300.

[99] Richard H. Fosberg, "Capital Structure and the 2003 Tax Cuts," *Journal of Business, Economics and Finance*, vol. 1, no. 2, 2012, pp. 5-20.

[100] Roger H. Gordon and Jeffrey K MacKie-Mason, "Effects of the Tax Reform Act of 1986 on Corporate Financial Policy and Organizational Form," in Joel Slemrod (ed.), *Do Taxes Matter?: The Impact of the Tax Reform Act of 1986*, MIT Press, 1990, pp. 91-131.

III. APPROACHES TO CORPORATE INTEGRATION

A number of methods could be used to achieve full or partial integration, each of which has associated policy and administrative considerations.[101] There are two broad categories of integration: (1) complete integration and (2) dividend relief. Complete integration eliminates double taxation of both dividends and retained corporate earnings. For example, S corporations are taxed under a regime of complete integration since earnings of an S corporation, whether retained or distributed, are treated as income of the shareholders for tax purposes. Dividend relief, unlike complete integration, only reduces (but does not in all cases eliminate) the double taxation of corporate earnings, and may be accomplished by reducing tax at either the corporate or shareholder level. At the corporate level, the tax burden on distributed earnings can be alleviated by means of a dividends-paid deduction or a lower corporate income tax on distributed versus retained earnings (*i.e.*, a split-rate corporate income tax). At the shareholder level, the tax burden on dividends may be reduced by lower rates (or exemption) or by crediting shareholders with tax paid by the corporate distributee (*i.e.,* the imputation method).

A. Complete Integration

<u>In general</u>

Relief from the two-tier tax can be achieved by eliminating the corporate tax and including undistributed, as well as distributed, earnings in shareholders' gross income. Under this approach, a corporation's undistributed earnings would be deemed to have been distributed to and reinvested by the shareholders each year. Tax could be collected at the corporate level (in effect using the corporation as a withholding agent for shareholders), or tax could be collected solely at the shareholder level without withholding. Shareholders would be subject to income tax on their allocated earnings and would adjust basis in their shares accordingly.

In one form of this mechanism, all corporations would be treated in a manner similar to either partnerships or S corporations; this treatment would include the passing through of credits and losses as well as the character (ordinary or capital gain) and source (domestic or foreign) of income. Other versions could provide for the pass through of net income but not losses in excess of income.

Full integration generally is considered to be the most theoretically desirable method of providing relief from the two-tier tax, since all income earned at the corporate level would be taxed directly and currently to the shareholders, leaving none of the possible distortions between corporate and noncorporate investment, debt and equity finance, or retention and distribution of corporate income. However, such a system is also considered to be difficult to implement. One traditional objection to this form of relief is the concern that imposition of tax at individual rates

[101] For a more extensive discussion of the background and issues relating to integration, see Joint Committee on Taxation, *Present Law and Background Relating to Selected Tax Issues* (JCX-41-06), September 19, 2006, pp. 26-30; Michael J. Graetz and Alvin C. Warren, Jr., *Integration of the U.S. Corporate and Individual Income Taxe*s (Tax Analysts, 1998); Joint Committee on Taxation, *Federal Income Tax Aspects of Corporate Financial Structures,* JCS-1-89 (January 18, 1989).

on allocated corporate income (that is not actually distributed) may result in liquidity problems, particularly for shareholders whose marginal rates exceed the rate of tax collected at the corporate level. Considerable administrative difficulties are inherent in a system of full integration. For example, the need to allocate a corporation's tax attributes among all its shareholders (where share ownership changes and tax attribute adjustments are common), as well as the resulting need for individuals to account for potentially complex items (such as foreign tax credits, intangible drilling costs and the like), pose what many consider to be insurmountable obstacles to the general implementation of this system.

S corporations

For example, the U.S. system for imposing income tax on S corporation shareholders with respect to the S corporation's income is a form of full corporate integration. An S corporation generally is not subject to tax at the corporate level. Items of income (including tax-exempt income), gain, loss, deduction, and credit of the S corporation are taken into account in computing the tax of the shareholders, without regard to whether the income is distributed to the shareholders. The shareholder's basis in the S corporation stock (and debt) is reduced by the shareholder's share of losses and (in the case of stock) by distributions and is increased (in the case of stock) by the shareholder's share of the S corporation's income and contributions to capital.

Because the use of S corporations is restricted by capital structure and the number and type of permitted shareholders, the S corporation rules do not have to address the administrative difficulties or complexity that could arise in a broadly applicable system of full integration. Rules requiring one class of stock, excluding corporations and certain foreign persons as shareholders, and limiting the total number of shareholders to 100 serve to restrict the breadth of use of S corporations. No asset- or income-based size restriction applies, however, with respect to electing and maintaining S corporation status.

Some features of S corporation rules vary from the simplest concept of corporate integration. Under the S corporation rules, losses pass through to shareholders subject to a limitation related to the shareholder's basis in his stock. That is, a shareholder's deduction for corporate losses is limited to the sum of the shareholder's adjusted basis in the S corporation stock and the indebtedness of the S corporation to such shareholder. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward to the next year.

Like a C corporation whose income and gain is taxed at the entity level, gain realized on the distribution of built-in gain property by the S corporation to shareholders is recognized. The shareholders take their shares of such gain into account on their individual tax returns.

B. Dividend Relief at the Corporate Level

1. Deduction for dividends paid

The double taxation of corporate income may be alleviated at the corporate level by allowing a deduction for dividends paid to shareholders. Dividend payments reduce taxable income of the payor corporation, and shareholders include dividends received in gross income. Thus, corporate income currently distributed is taxed at only the shareholder level; retained corporate earnings, however, may be subject to a second level of tax upon distribution, depending on whether the dividends-paid deduction creates a net operating loss, when (if ever) the earnings are distributed, and the tax treatment of capital gains.

The mechanism of a dividends-paid deduction is influenced by design considerations relating to the rate at which corporate income is subject to tax. In the absence of any other provision, the result of allowing a dividends-paid deduction is to subject retained earnings to the corporate tax and distributed earnings to tax at the shareholder's marginal rate. To ensure that corporate earnings bear not less than one level of tax at the corporate rate, the dividends-paid deduction must be limited to corporate earnings subject to full corporate taxation. In other words, dividends paid out of earnings not subject to full taxation by reason of corporate tax preferences should not give rise to a dividends-paid deduction. One option is for corporations to track such fully-taxed earnings in a special account.[102] Another is for all dividends to be subject to a withholding tax (*e.g.*, at a rate equal to the corporate tax rate), with shareholders receiving a credit.[103]

Allowing a dividends-paid deduction brings the treatment of equity closer to that of debt, to some extent eliminating the preference in the tax law in favor of the latter.

REITs

Under present law, entities taxed as REITs may deduct dividends paid. Although nominally subject to the corporate tax, REITs must distribute 90 percent of their income currently (95 percent to avoid an excise tax), and often distribute more. For that reason, REITs

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[102] In 1985, the Administration proposed a deduction of 10 percent of the dividends paid from the earnings of a domestic corporation that have borne the regular corporate tax. A similar proposal was included in the House-passed version of the 1986 Act. Under those proposals, dividends are eligible for the dividends paid deduction only to the extent that such dividends do not exceed the amount of a Qualified Dividend Account ("QDA"). Generally, the QDA consists of the amount of corporate earnings that have been subject to the corporate tax for taxable years after the effective date. For a more detailed description of the Administration's proposal, and a comparison with the House-passed version, see Joint Committee on Taxation, *Federal Income Tax Aspects of Corporate Financial Structures* (JCS-1-89), January 18, 1989, pp. 90-93, and Committee Report to accompany H.R. 3838, Tax Reform Act of 1985, H.R. Rep. No. 99-426 Part 1, December 7, 1985, pp. 237-242.

[103] In 1993, the American Law Institute published a proposal involving a credit system based on the model used by a number of other countries. Alvin C. Warren, Jr., *Integration of Individual and Corporate Income Tax*es (American Law Institute, 1993). This study and a general introduction on corporate integration can be found reprinted in Graetz and Warren, *supra*.

generally pay little corporate tax, if any; as a result, REIT income generally is taxed in full at the shareholder level annually.

REIT dividends paid out of net capital gain of the REIT and designated as capital gain dividends are treated as capital gain to the shareholders; other REIT dividends are treated as ordinary income taxed at the shareholders' normal rates (and not the preferential rates for qualified dividend income). REIT dividends paid to foreign shareholders are subject to U.S. withholding tax. While U.S. bilateral income tax treaties generally allow lower rates of withholding tax on REIT dividends than the otherwise applicable Code rate, in treaties with special provisions for dividends paid by REITs, the minimum rates of withholding tax on REIT dividends typically exceed the withholding tax rates on other dividends (reflecting that REIT earnings out of which dividends are paid generally are not subject to U.S. corporate tax).

As described above, a REIT is required to distribute at least 90 (or 95) percent of its REIT taxable income (plus certain net income from foreclosure property, if any). This distribution must be treated as a deductible dividend paid to the REIT's shareholders in order to eliminate taxable income at the REIT level. In general, a dividend is paid from a corporation's earnings and profits, an amount which is related to, but can differ from, taxable income in any year.

Earnings and profits can be higher, or lower, than a REIT's taxable income in any particular year. Thus, the amount of deductible dividends a REIT may pay in any given year is not strictly related to its taxable income. The REIT rules ensure that the dividends-paid deduction equals, but does not exceed, REIT taxable income in any year. First, when a REIT's earnings and profits exceed its taxable income, the REIT could pay deductible dividends in excess of its taxable income, possibly giving rise to a net operating loss that could be carried forward to offset REIT taxable income in a subsequent taxable year. Present law does not permit this, however; the net operating loss carryover of a REIT does not include the dividends-paid deduction.[104]

Second, when a REIT's taxable income exceeds its earnings and profits, distributions of amounts in excess of earnings and profits might not qualify as deductible dividends. Thus, tax would not be eliminated at the REIT entity level. Present law does not give this result, however; rather, earnings and profits of a REIT are treated as being increased by the excess of taxable income over earnings and profits,[105] so that the distributions are treated as deductible dividends and serve to eliminate taxable income at the REIT level.

2. Reduction of corporate tax rate on distributed earnings

The tax burden on distributed corporate earnings could also be relieved, in part, by reducing the corporate income tax rate on those earnings (*i.e.*, a split-rate corporate income tax). This method of providing relief from the two-tier tax could reduce concerns about incentives for

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[104] Sec. 172(d)(6).

[105] Sec. 562(e)(1).

debt financing and inadequate investment in the corporate sector. However, such concerns would not be eliminated so long as the corporate tax rate on distributed earnings exceeds zero. Reducing the rate on those earnings to zero is equivalent to allowing a dividends-paid deduction. The effect of a zero tax rate on distributed earnings, however, is not the same as the effect of a zero tax rate on all corporate earnings. The effect of the latter is to turn corporations into the equivalent of nondeductible individual retirement accounts, since retained earnings and reinvestment income accumulate tax-free within the corporation. Moreover, the lower the effective corporate tax rate on retained earnings relative to the individual effective tax rate, the greater the incentive is for a corporation to retain rather than to distribute earnings. Lower rates on distributed corporate earnings have the opposite effect.

C. Dividend Relief at the Shareholder Level

1. Imputation credit

In general

Another approach to corporate integration is to give shareholders an income tax credit to reflect all or a portion of the corporate-level tax paid with respect to dividends. The amount of the credit may be adjusted based on the degree to which partial (or full) relief from the two-tier tax is desired. Under such a system, shareholders who receive dividends are required to "gross up" the dividend by the amount of the credit for corporate taxes paid, and include the grossed-up amount in income, while using the credit as an offset to their tax liability. The gross-up and credit mechanism is analogous to the credit for taxes withheld on wages under present law. Gross-up and credit systems, also known as "imputation" systems, are used by several countries, including Australia, Canada, and Mexico.[106] A number of these countries grant the shareholder a credit only to the extent that the corporation actually has paid tax on dividends (which is accomplished by a corporate minimum tax on distributions).

The imputation system of corporate integration provides a credit to shareholders for tax paid by the corporation. In general, the credit is allowed only to resident shareholders, and only with respect to corporate tax the resident corporation pays to its home country. Those residency requirements have the effect of excluding foreign shareholders from participating in the benefits of corporate integration. They also prevent foreign corporations from participating, and even resident corporations are prevented from integrating the corporate tax with respect to profits taxed in a different country.

Australia

For example, under Australia's imputation system for distributed corporate income, Australian corporations (called companies) are subject to tax at the entity level. The corporate income tax rate is a flat 30 percent (in 2016), and a shareholder imputation credit generally is allowed for shareholders that are Australian residents. The top individual tax rate in Australia is 45 percent (in 2016).

The Australian imputation system allows a credit with respect to distributions to Australian resident shareholders by resident companies from profits taxed in Australia. The resident company keeps a "franking account" in which it keeps track of tax paid. When the company distributes a dividend to shareholders, it may attach a franking credit to the dividend and debit the franking account by the amount of the credit. An Australian resident shareholder includes the dividend in income and uses the franking credit to offset tax liability; thus, an Australian resident shareholder in the top 45-percent bracket pays an extra 15 percent on franked dividends, for a total tax rate on distributed corporate income of 45 percent. In the case of

[106] In part to comply with European Union rules forbidding countries from discriminating against residents of other European Union countries, some European countries (such as Germany) have abandoned their imputation systems because, for instance, the credits under the systems had been available only to resident shareholders.

corporate shareholders subject to the 30-percent flat corporate income tax, this system eliminates a second level of tax on distributed intercorporate dividends.

Tax is imposed on capital gains generally at regular rates. There is a 50-percent deduction (called a discount in Australian tax terminology) for net capital gains recognized by individuals, however. The capital gains discount is not available for capital gains recognized by companies.

The availability of sources of government revenue (beyond income tax revenue) influences the rate at which to apply a single level of tax on corporate income. In Australia, in addition to the income taxes described above, revenue is raised through a 10-percent goods and services tax known as the GST (a value-added tax or VAT). The GST has the effect of imposing tax at the consumer level, and generally applies with respect to businesses on a credit and invoice basis, whether the business is in corporate or passthrough form.[107]

2. Reduction of shareholder tax rates

The tax burden on both distributed and retained corporate income could also be relieved, in part, by reducing the tax rate on dividends and the tax rate on capital gains on stock sales.

Under any system of corporate integration, one question is whether dividends and capital gains should be subject to tax at the same or a similar rate. If dividends and stock sales are considered as alternative methods for shareholders to realize corporate profits, then the question arises whether, and how closely, to coordinate the tax rate on capital gains from sales of corporate stock with the tax rate on corporate distributions. Disparate tax rates on dividends and on gains may create an unintended incentive to either hold or sell stock. More broadly, disparate corporate and individual tax rates may create an incentive to organize business activities in corporate or noncorporate form. On the margin, when the individual income tax rate is substantially higher than the corporate income tax rate, it may create an incentive to organize business activity in corporate rather than passthrough form.

Under present law, individual holders of corporate equity are generally eligible for a maximum tax rate on qualified dividend income equal to the capital gains rate, which is generally below the rate on ordinary income. The legislative history for the provision establishing the reduced rate suggests that Congress was at least in part motivated by concerns about economic distortions related to "corporate financial decisions" favoring debt over equity, "financial engineering to achieve interest deductions from financial instruments with substantial equity characteristics[,]" and incentives "to retain earnings rather than to distribute them as taxable dividends … even if the shareholder might have an alternative use for the funds that could offer a higher rate of return than that earned on the retained earnings."[108]

[107] Australian Government, Australian Taxation Office, *GST*, QC 22410 (last modified June 16, 2015), http://www.ato.gov.au/Business/GST/ .

[108] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05), May 2005, p. 24.