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Corporate Tax Integration: In Brief

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Summary

In January 2016, Senator Orrin Hatch, chairman of the Senate Finance Committee, announced plans for a tax reform that would explore corporate integration. Corporate integration involves the elimination or reduction of additional taxes on corporate equity investment that arise because corporate income is taxed twice, once at the corporate level and once at the individual level. Traditional concerns are that this system of taxation is inefficient because it (1) favors noncorporate equity investment over corporate investment, (2) favors debt finance over equity finance, (3) favors retained earnings over dividends, and (4) discourages the realization of gains on the sale of corporate stock. Increasingly, international concerns such as allocation of investment across countries, repatriation of profits earned abroad, shifting profits out of the United States and into tax havens, and inversions (U.S. firms using mergers to shift headquarters to a foreign country) have become issues in any tax reform, corporate integration included.

This report summarizes findings in CRS Report R44638, *Corporate Tax Integration and Tax Reform*, by Jane G. Gravelle. That report examines the effects of different tax treatment of the corporate and noncorporate sectors, the effect of tax preferences, the treatment of debt finance, and the treatment of foreign source income. Estimates suggest that there is little overall difference between corporate and noncorporate investment. A larger share of corporate assets benefits from tax preferences. Only a quarter of shares in U.S. firms is held by taxable individuals; the remainder is held by tax-exempt and largely tax-exempt pension and retirement accounts, nonprofits, and foreigners. Additionally, tax rates on individual dividends and capital gains are lower than ordinary rates.

Effective tax rates across assets differ markedly, with intangible assets most favored and structures least favored. Debt is treated favorably in both the corporate and noncorporate sectors, with large differences and in many cases negative tax rates. Differences in taxes affecting dividend payout choices or realization of capital gains on stock appear to be small because of low tax rates.

The report outlines several approaches to integration. Full integration would address both dividends and retained earnings. Tax could be imposed at the shareholder level with allocation of income and withholding (a modified partnership treatment). Credits for withheld taxes would be provided to shareholders, and credits could be made nonrefundable for tax-exempt and foreign shareholders. A different full integration approach would eliminate shareholder taxes and tax only at the firm level. A third would tax at the shareholder level and not the firm by imposing ordinary rates and taxing not only dividends and realized capital gains but also unrealized gains by marking shares to market prices (i.e., mark-to-market). Partial integration focuses on dividends and could provide either a dividend deduction by the firm (with a withholding tax and credits) or a dividend exclusion to the shareholder. Disallowing interest deductions in full or in part could be combined with most proposals.

The report compares these proposals with respect to impact on revenue, administrative feasibility, and effects on both traditional and international tax choices. Shareholder allocation or dividend deductions with refundable credits produce relatively large revenue losses, as does mark-to-market. Nonrefundability and making modifications in mark-to-market can substantially reduce these revenue losses. Most proposals would have modest efficiency gains or losses. Mark-to-market would tax economic income and potentially produce a number of efficiency gains but may not be feasible on administrative grounds. Disallowing or restricting deductions for interest would lead to efficiency gains on a number of margins and provide revenue to help achieve revenue-neutral reforms.

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Introduction

In January 2016, Senator Orrin Hatch, chairman of the Senate Finance Committee, announced plans for a tax reform that would explore corporate integration. Corporate integration involves the elimination or reduction of additional taxes on corporate equity investment that arise because corporate income is taxed twice. The corporation pays corporate tax (at 35% for large corporations) on its taxable income. Individuals pay individual income taxes on dividends and capital gains (which arise from corporate retained earnings) when realized. This system produces differential tax burdens, potentially discouraging the realization of gains on the sale of corporate stock and favoring noncorporate equity investment over corporate investment, debt finance over equity finance, and retained earnings over dividends. One goal of corporate integration is to reduce or eliminate these distortions. The focus on corporate tax integration differs from the approach in some recent tax reform plans that have proposed broadening the base of the corporate tax, reducing the corporate tax rate, and revising the tax treatment of foreign source income.

This report provides an overview of CRS Report R44638, *Corporate Tax Integration and Tax Reform*, by Jane G. Gravelle, which contains a detailed analysis of corporate tax integration issues, data sources, and documentation.

Corporate tax integration was the focus of a 1992 Treasury study,[1] which recommended approaches to integration that reduced or eliminated taxes at the shareholder level while retaining taxes at the corporate level, including an exclusion of dividends for shareholders. Over the years, taxes on shareholders have been reduced. Dividends and capital gains are typically taxed at rates of 15% or 20% (whereas the top ordinary income tax rate is 39.6%), plus, for some high-income taxpayers, an additional 3.8% tax that applies to passive investment income in general.

Several important factors in considering proposals have changed since 1992, aside from the lower shareholder taxes. One is the increased importance of a global economy and multinational firms with investments and activities in many countries. These firms' choices about the location of investment and profits are affected by firm-level rather than shareholder-level taxes. A second is that the fraction of shareholders who are not subject to U.S. shareholder taxes has increased. Currently only about a quarter of the corporate stock of U.S. firms is estimated to be owned by shareholders subject to U.S. individual tax (compared with about half in 1992). Inflation has declined, affecting tax rates. Tax-favored intangible assets, which are more important in the corporate sector, have also grown in importance.

Corporate Tax Differentials Under Current Law

The Corporate "Double" Tax

The United States has a "classical" corporate tax system, modified by lower taxes on dividends and capital gains. Corporate taxable profits are subject to a 35% rate for large corporations. Firms distribute after-tax profits as dividends or retain earnings for investment; the latter increases the firm's value, creating capital gains.

[1] U.S. Department of the Treasury, Integration of The Individual and Corporate Tax Systems at https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Integration-1992.pdf.

If all profits were taxed at the statutory rate, distributed as a dividend, and then taxed at ordinary rates to a shareholder in the 35% bracket, the total tax on a corporate investment would be 58% (a 35% corporate tax and an additional 35% on the remaining 65% of profit) compared with a tax rate of 35% on noncorporate investment, for a 23 percentage point difference. Those effects, however, are smaller because of favorable treatment of dividends and capital gains (the top rate is 23.8%); options to invest stock through tax-exempt accounts, such as retirement plans, that pay no shareholder-level tax; and tax preferences that lower the effective corporate tax rate more than the effective noncorporate rate.

Tax treatment at the shareholder level depends on the type of shareholder. As noted above, most stock is held in forms not subject to U.S. individual income tax. Shareholders are treated differently if they are (1) U.S. individuals (a 25% share), paying an estimated tax rate of 13.7%; (2) U.S. tax-exempt entities and tax deferred entities (a 50% share) paying no tax, or (3) foreign shareholders (a 25% share) paying a 3.2% estimated U.S. tax rate. The tax rates at the shareholder level are paid on income net of the corporate effective tax rate (estimated to be about 20% overall for new investment).

The data on shareholder distribution do not include U.S. subsidiaries of foreign firms, whose holdings are estimated at 79% of the holdings of foreign shareholders in U.S. parented firms.

Income of pass-through (referred to as noncorporate) businesses is subject only to the individual tax, with income allocated to each owner. These firms include sole proprietorships, partnerships (including limited liability corporations), and Subchapter S firms that are corporations but elect to be taxed as pass-throughs. The overall statutory tax rate is estimated to be 28% (although the effective rate is lower).

Tax Preferences and Effective Tax Rates

In determining the effect of the business tax system and in designing integration proposals, an important issue is that of tax preferences: provisions that cause the effective tax rate to be less than the statutory rate. The most important tax preference that affects burdens on domestic investment is accelerated depreciation, which allows deductions for costs to be recovered faster than is justified by the economic decline in the value of the asset (including an immediate deduction for investment in intangibles).[2] Other preferences are the production activities deduction, which allows a deduction for domestic production in certain industries, and the tax credit for intangible investment in research. Foreign source income is also taxed at a lower rate.

Treatment of Debt Finance

If firms borrow to finance investments, the interest is deducted. The deduction of interest goes beyond eliminating the corporate tax on profits attributable to debt finance, because the rate at which profit is effectively taxed is lower than the rate at which interest is deducted due to tax preferences and inflation. Interest income, including the inflation portion of the nominal interest rate, is subject to tax by creditors, but the tax rates are lower than the corporate rate (estimated at 24%). In addition, only a small fraction of that interest, 19%, is estimated to be subject to tax. Interest paid to foreign persons is subject to a negligible withholding tax.

[2] Also in effect on a temporary basis is bonus depreciation, which allows the immediate expensing of half of the cost of investment in equipment. Bonus depreciation has been periodically extended since enactment in 2008; it is currently scheduled to be phased out after 2019.

Treatment of Foreign Source Income

The growth in the importance of foreign source income has changed the way corporate integration is viewed, compared with the focus in 1992. The U.S. corporate level tax is largely imposed on a source basis, reflecting the taxes in the jurisdiction where the activity takes place. Thus, a lower corporate tax generally encourages more equity (although not necessarily debt-financed) investment in the United States as compared with foreign countries. The shareholder and creditor taxes are imposed on a residence basis and apply regardless of investment location.

The corporate tax is technically imposed on worldwide income, but tax is not paid on the earnings of foreign subsidiaries in most cases until and if income is repatriated (or paid as a dividend to the U.S. parent). Because a fraction of profits is reinvested permanently (as plant and equipment), some share of this income is never taxed. In addition, foreign source income is eligible for credits against U.S. tax liability for taxes paid to foreign governments. Because excess credits from higher-tax countries can be used to offset U.S. tax liability from low-tax countries, the U.S. effective tax rate is small. Overall, the average tax rate paid on foreign source income is estimated at 17.4%, 14.1% paid in foreign taxes and a residual tax of 3.3% paid to the United States.

Estimates of Differential Effective Tax Rates

One objective of corporate tax integration is to reduce the distortions caused by the current tax treatment. The estimated magnitude of the distortions arising from the corporate tax and other elements of the tax system can be shown through effective tax rates on the returns to new investment at the margin. Estimates presented are the effective corporate tax alone (the firm-level tax), an effective total corporate tax including shareholder or creditor taxes, and an effective tax rate on unincorporated businesses including all taxes. **Table 1** shows the effective tax rates using the basic assumptions about shareholder and noncorporate average statutory tax rates and the Congressional Budget Office's (CBO's) alternative set of assumptions of these statutory tax rates.[3]

Table 1. Effective Tax Rates on Corporate and Noncorporate Investments

(in percentages)

Type of Tax Rate	Corporate Firm	Corporate Total	Corporate Total: CBO Assumptions	Noncorporate	Noncorporate: CBO Assumptions
Equity Financed	19.7	22.4	26.5	21.1	25.6
Debt Financed	-53.5	-44.0	-23.0	-20.6	2.4
Weighted Equity and Debt Financed	5.7	9.6	15.1	11.8	21.8

Source: CRS Report R44638, *Corporate Tax Integration and Tax Reform*.

For domestic equity investments, the overall effective tax rate at the firm level is estimated at 19.7%, or only 56% of the statutory rate of 35%. Across groups of assets, tax rates range from -63.3% for intangible investments in research to 30.8% for nonresidential structures. These

[3] The Congressional Budget Office (CBO) assumptions differ primarily because they focus on domestic shareholders and exclude retirement accounts that are already at the limit and cannot be increased, thus increasing the share of taxable shareholders. Its tax rates on dividends, capital gains, and noncorporate businesses are also slightly higher. The CBO assumptions also have lower shares of debt.

rates compare to estimated marginal rates on foreign investment of 13%. Additional shareholder taxes add less than three percentage points. The total corporate tax rate is estimated at 22.4%, only slightly above the rate on unincorporated business of 21.1%.

Returns on debt-financed investment in the corporate sector are subject to firm level negative effective tax rates of -53.5%; shareholder tax rates lower the negative tax (or subsidy) to -44%. The return on investment by unincorporated business is estimated to have a negative tax rate of -20.6%.

A weighted average of debt and equity has a firm-level tax of 5.7%, an overall corporate tax rate of 7.8% and a rate on unincorporated business of 11.8%.

These estimated rates show a small difference in tax burden overall between equity invested in the corporate versus the noncorporate sector, but show large differences across assets and large differences between debt and equity.

Under current law, the incentive to retain earnings because part of capital gains (estimated at half) generated by those earnings escapes tax is small, both because of the low rates and the significant share of stock held by nontaxable entities. For individuals subject to the income tax, the estimated tax rate is 17% and half of that rate is 8.5%. For foreign shareholders, dividends are taxed at 5.9% on average and capital gains are not taxed, so the differential is 5.9%. Weighted for all taxpayers the difference between the tax on dividends and capital gains is 3.6%. Similarly, the incentive not to realize gain on stocks is likely small because of the low rate of 17% is paid by only a quarter of shareholders, for a weighted average of 4.25%.

Methods of Addressing Corporate Tax Distortions

A number of approaches to integration are possible. These approaches can be divided into three basic types: (1) full integration; (2) partial integration, which addresses only dividends; and (3) proposals that also address the treatment of interest. They also depend on many other features, including the pass-through of preferences, which are addressed in more detail in CRS Report R44638, *Corporate Tax Integration and Tax Reform.*

Full Integration

Full integration would eliminate one of the levels of taxation and apply both to dividends and retained earnings. Some approaches include taxing only at the shareholder level, some include taxing only at the corporate level, and some include a combination of both.

Taxing at the Shareholder Level: Modified Partnership

A modified partnership treatment would impute corporate taxable income to shareholders based on who receives dividends. The income would be taxed at ordinary rates. Tax preferences would be passed through to shareholders. The corporation would collect a withholding tax that could then be credited to shareholders. The tax could be made refundable, so that tax-exempt investors would pay no tax, or it would be nonrefundable, so that foreigners and tax-exempt shareholders would pay the corporate level tax, and taxable individuals would pay tax at the individual rate. For administrative reasons, and because shareholders may face taxes larger than their distributions, a standard partnership treatment is not generally believed to be feasible.

Taxing at the Shareholder Level: Mark to Market

Mark to Market would repeal the corporate tax for publicly traded firms, tax dividends and capital gains at ordinary rates, and mark the value of stock to market—that is, tax capital gains on the stock regardless of whether it was sold. This approach would eliminate preferences. Privately traded firms would receive pass-through treatment. Mark-to-market would impose a tax on tax-exempt shareholders at any level (although a tax could be imposed on them directly). One issue with this approach is that shareholders would be taxed on income not received.

Taxing Corporate Income at the Corporate Level

An alternative to taxing shareholders and eliminating the corporate level tax is to impose the corporate level tax and eliminate taxes on dividends and on capital gains from corporate stock. This approach would lose some revenue, but would simplify the tax system. Probably the major objection to this approach is that the firm level tax determines the allocation of investment for multinational firms, and this approach would not reduce that tax. The current reduced rates on dividends and capital gains have taken a step in this direction.

Taxing Dividends at the Shareholder Level and Retained Earnings at the Corporate Level

The final full integration proposal would tax dividends to shareholders by allowing a corporate dividend deduction, while eliminating capital gains tax on corporate stock. This treatment is identical to the partial integration dividend deduction proposals, with the added effect of eliminating capital gains taxes.

Partial Integration: Dividend Relief

The second major category of proposals removes the double tax on corporate income only for dividends. As with full integration, the alternative is to tax at the firm level or individual level.

Taxing at the Shareholder Level: Dividend Deductions

One approach would allow a dividend deduction with a withholding tax. Shareholders would pay tax on dividends plus the withholding tax and receive credits for the withholding tax (which could be refundable or nonrefundable). Dividend relief proposals often limit the relief to dividends paid out of taxable income. There are indications that Chairman Hatch is considering this approach.

Taxing at the Firm Level: Dividend Exclusion

This approach would allow dividends to be excluded from shareholders' income and thus only the corporate tax would apply. As with the dividend deduction, preferences could be dealt with by allowing excluded dividends paid out of taxable income. This approach was proposed in 1992 although currently it may be less attractive because of global concerns.

Approaches Also Addressing Debt

Some integration proposals have also encompassed debt. In 1992, one Treasury proposal was to disallow interest deductions for both corporate firms and unincorporated businesses. Disallowing interest deductions could be combined with integration approaches, except for mark-to-market.

Issues

Three basic issues that relate to corporate integration policy are the revenue impacts, the administrative concerns, and the economic efficiency effects.

Revenue impacts are an important consideration in any tax reform proposal. **Table 2** provides estimates for the proposals (in the form of effective average tax rates), which show the cost as a percentage of current corporate tax revenues.

Table 2. General Magnitude of Effective Tax Rates and Revenue Loss from Integration Approaches

(in percentages)

Tax Regime	Effective Total Corporate Tax Rate (%)	Estimated Reduction in Corporate Tax Revenues (%)
Current Law	25.7	
Modified Partnership, Refundable Credits	2.5	102
Modified Partnership, Nonrefundable Credits	22.6	14
Dividends and Mark-to-Market Gains at Ordinary Rates	6.5	85
Corporate Level Tax Only	22.7	13
Dividend Deduction, Refundable Credits	5.8	88
Dividend Deduction, Nonrefundable Credits	23.6	10
Dividend Exclusion	24.0	8

Source: CRS Report R44638, *Corporate Tax Integration and Tax Reform*.

These estimates suggest that allowing refundable credits or mark to market do not appear feasible if revenue neutrality is an objective. Although the other proposals lose revenues, offsetting them with restrictions on debt or other base-broadening provisions would be possible. Mark to market could also be feasible if taxes are imposed directly on exempt or largely exempt firms.

Some proposals face considerable administrative barriers, especially mark to market, which would require tax payment when income is not realized. Most proposals would add complications for shareholders, but mark to market would simplify at the corporate level. Providing tax credits to creditors if interest is subject to a withholding tax might be difficult because of the tracing of interest payments.

Efficiency gains reflecting the traditional goals of integration are limited, with the exception of reducing the debt-equity distortion and potentially eliminating distortion across assets within the corporate sector under mark to market.

Similarly, most proposals would not have significant effects on the international allocation of capital, repatriation, profit-shifting and inversions. Disallowing deductions for interest would eliminate some methods of profit shifting and make inversions less attractive. Mark to market would create a residence-based tax, which would provide efficiency gains in all areas: allocation of capital, repatriation, profit-shifting, and inversions.

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