Journal of Business & Technology Law

Volume 15 | Issue 2 Article 6

Double Tax is Double the Trouble: The Solution? Moving Toward a System of Corporate Integration

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INTRODUCTION

The United States tax system traditionally imposes a double tax on corporate income, whereby corporate income is taxed at both the corporate level and the individual level. The double tax, while recently modified by the Tax Cuts and Jobs Act of 2017, is inherently problematic because it tends to influence the way corporations—and people for that matter—invest their money. In an ideal world, the tax system should strive to be neutral. That is, it should neither encourage nor discourage certain investment decisions. Rather, investment decisions should be made on the basis of their economic merit, and their economic merit alone. Tax neutrality has been the principle focus of tax policy for quite some time, which is why tax policymakers continue to advocate for the integration of corporate taxes. Corporate integration supports the principle of tax neutrality by reducing or eliminating the disparities between favored and disfavored investment decisions. For this reason, corporate integration should be at the forefront of future tax reform regimes.

Section I of this paper will discuss the double tax on corporate income and explain the particular economic disparities that the double tax creates. Section II will examine corporate integration and detail the history of proposals to integrate the corporate tax. Finally, Section III will explore the viability of various corporate integration models while proposing that at least one of those models should be adopted.

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I. The "Double Tax" on Corporate Income

A. An Overview

In the United States, C corporations[1] are subject to a "double tax," whereby corporate income is taxed initially at the corporate level and then again at the individual level when income is distributed to shareholders as dividends.[2] Effectively, shareholders pay "taxes twice on the same income—once as [owners of the corporation] and again as part of their personal income tax."[3] Corporations, however, were not always taxed in this manner. In fact, history reveals that the double tax was neither "properly evaluated or devised" nor "designed to achieve the most efficient or equitable means to tax corporate income."[4]

Initially, only certain corporations were taxed.[5] Although these corporations did pay taxes on dividends and interest payments, shareholders were able to deduct payments already made by the corporation from their personal incomes.[6] Accordingly, taxes on dividends and interest payments acted not as a separate tax on corporations but as a withholding tax.[7] Indeed, subsequent iterations of the corporate tax "lent credence to the withholding interpretation" by requiring that undistributed corporate profits be taxed to shareholders.[8] Because shareholders paid taxes on all corporate income, regardless of whether or not the income was distributed, the corporate tax was effectively "integrated" with the individual tax.[9]

Later, Congress imposed a direct two percent tax on corporate income pursuant to the Tariff Act of 1894 ("the 1894 Act").[10] The 1894 Act also ensured that individual income would be taxed at the same rate.[11] Importantly, however, shareholders were able to exclude from their taxable income dividends received from

1. C corporations are named after the corresponding subchapter of the Internal Revenue Code. *See generally* 26 U.S.C. § 301 *et seq.* (2012).

2. Tax Pol'y Ctr., *Key Elements of the U.S. Tax System*, https://www.taxpolicycenter.org/briefing-book/corporate-income-double-taxed.

3. Daniel E. Palmer, *Double Taxation*, Encyclopedia Britannica, https://www.britannica.com/topic/double-taxation.

4. Meredith R. Conway, *Stealth Inequity: Using Corporate Integration to Ease Unfairness in the Tax Code*, 2 Wm. & Mary Pol'y Rev. 53, 62 (2010).

5. Marjorie Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 Ind. L. J. 53, 83 (1990). Specifically, only corporations "of a public nature such as those engaged in banking or transportation" were required to pay taxes. *Id.*

6. *Id.*

7. *Id.*

8. *Id.* at 84. The Act of June 30, 1864 "included in an *individual's* income 'the gains and profits of all companies, whether incorporated or partnership . . . .'" *Id.*

9. *Id.*

10. *See* Tariff Act of 1894, ch. 349, § 32, 28 Stat. 509, 556 (1894).

11. *See id.* § 27, at 553.

corporations that had already paid the two percent tax.[12] As a result, the corporate tax continued to be integrated with the individual tax.

After the Supreme Court ruled that the 1894 Act's income tax provisions were unconstitutional,[13] individual income all but escaped taxation. However, Congress "revived the corporate income tax concept" in 1909, when it adopted a federal excise tax on corporations ("the 1909 Act").[14] Although the 1909 Act was designed as a means for reaching individual income (and in particular, the income of wealthy shareholders), it "was never a threat to impose double taxation because … an individual income tax did not accompany the corporate tax."[15] Therefore, while the corporate excise tax acted in some respects as a "substitute for the individual income tax,"[16] the excise tax was actually a tax upon "the privilege of doing business in the corporate form."[17]

The Sixteenth Amendment was ratified in 1913,[18] allowing Congress to reinstate the individual income tax along with the corporate income tax with the passage of Tariff Act of 1913 ("the 1913 Act").[19] Under the 1913 Act, individual income was taxed at a flat rate of one percent (the "normal tax").[20] However, income that reached certain levels were taxed a second time at progressive rates (the "surtax").[21] Also, corporate income was taxed at a flat rate that expressly mirrored the normal tax rate.[22] Because the 1913 Act excluded dividends from the normal tax but not the surtax, corporate income was potentially subject to two levels of tax (the corporate level tax plus the applicable surtax after distribution).[23] Ultimately, the 1913 Act served as the precursor to the modern double tax.

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12. *See* Kornhauser, *supra* note 5, at 86–87.

13. The U.S. Supreme Court struck down the individual income tax in *Pollock v. Farmers' Loan & Trust Co.*, wherein the Court decided that a direct income tax violated the constitutional requirement that all "direct" taxes be apportioned between the states according to their respective populations. 157 U.S. 429, 580 (1895).

14. Steven A. Bank, *Is Double Taxation a Scapegoat for Declining Dividends – Evidence from History*, 56 TAX L. REV. 463, 478 (2003).

15. *Id.* at 478–79.

16. *Id.* at 478.

17. Reuven Avi-Yonah, *Corporate Income Tax Act of 1909*, ENCYCLOPEDIA.COM, https://www.encyclopedia.com/history/encyclopedias-almanacs-transcripts-and-maps/corporate-income-tax-act-1909 (last updated Nov. 1, 2019). *See also* Conway, *supra* note 4 at, 53, 62–63 (stating that "the separate corporate income tax was justified because corporations received various legal protections due to their classification as a separate entity. The corporate income tax thus served as a tax on the benefit of limited liability.").

18. *See* U.S. CONST. amend. XVI.

19. *See generally* Tariff Act of 1913, ch. 16, 38 Stat. 114, 166-72 (1913).

20. *Id.* at 166.

21. *Id.* The highest tax rate under the Tariff Act of 1913 was 6 percent. *Id.*

22. *See Id.* at 172 ("The normal tax hereinbefore imposed upon individuals likewise shall be levied, assessed, and paid … to every corporation . . . .").

23. *Id.* at 167.

The 1913 Act was viewed as an "imperfect withholding tax on a shareholder's portion of corporate profits."[24] Specifically, it allowed Congress to tax shareholder wealth in addition to the individual income tax and in lieu of the individual income tax in "cases where it was being evaded."[25] There were, however, concerns "that corporations would become tax avoidance vehicles for high income shareholders" by retaining earnings instead of distributing them as dividends (where earnings were subject to the higher individual surtax rates).[26] Therefore, in an effort to reach more retained earnings through the corporate income tax, Congress raised the corporate tax rate substantially.[27] By 1936, Congress imposed a maximum corporate tax rate of fifteen percent and also removed the normal tax exemption for distributed dividends.[28] Consequently, corporate income was subject to two full layers of tax while "income from other sources was only subject to one layer of tax."[29]

Despite subsequent changes to the corporate tax rate and the taxation of dividends, the double tax on corporate income has largely remained in place.[30] Clearly, the rationale behind the adoption of the double tax—grounded on the premise that the corporate tax is a tax upon the "privilege of doing business" as a corporation—is no longer uniquely applicable to the corporate form.[31] Indeed, the advent of limited liability companies, limited partnerships, and S corporations have allowed a variety of businesses to hold massive amounts of investor wealth while limiting investor liability. Even so, corporations continue to be assessed an extraordinarily high tax burden via the double tax.

B. The Economic Impact of Double Taxation

Prior to the enactment of the Tax Cuts and Jobs Act of 2017 ("TCJA"),[32] the United States boasted the highest combined[33] corporate tax rate among all Organisation

24. Conway, *supra* note 4, at 63.

25. *Id.*

26. Bank, *supra* note 4, at 490.

27. *Id.* at 505.

28. *Id.* at 513–14. By that time, the normal tax rate had increased to 4 percent. *Id.* at 513.

29. *Id.* at 514.

30. Beginning in 1954, dividends were taxed at ordinary rates with an initial amount being exempt from taxation. *A Brief History of Dividend Tax Rates*, DIVIDEND.COM (Sept. 9, 2014), https://www.dividend.com/taxes/a-brief-history-of-dividend-tax-rates/. By 1985, however, dividends were fully taxable to shareholders as ordinary income. *Id.* It was not until 2003 that dividends were first subject to long-term capital gains rates, which is the methodology used under the current tax system. Bank, *supra* note 4, at 465 n.11.

31. *See supra* note 17 and accompanying text.

32. Pub. L. No. 115-97, 131 Stat. 2054 (2017). The Tax Cuts and Jobs Act reduced the corporate income tax rate from thirty-five percent to twenty-one percent. *Id.* at 2096.

33. The combined corporate income tax rate is essentially the federal corporate income tax rate plus the average of state corporate income tax rates. *See* Kyle Pomerleau, *The United States' Corporate Income Tax Rate is Now More in Line with Those Levied by Other Major Nations*, TAX FOUND. (Feb. 12, 2018), https://taxfoundation.org/us-corporate-income-tax-more-competitive/.

for Economic Co-Operation and Development ("OECD")[34] countries at that time.[35] However, after the TCJA reduced the corporate tax rate from thirty-five percent to twenty-one percent, the combined corporate tax rate dropped substantially, placing the United States closer to the OECD average.[36]

By lowering the federal corporate tax rate, Congress clearly intended to influence economic decision-making, albeit indirectly. Taxes impact decisions regarding both the amount of money people are willing to invest and how people to invest their money.[37] Low corporate tax rates simultaneously reduce the motivation for corporations to relocate abroad and incentivize domestic investment.[38] Additional investment lowers the cost of capital, thereby leading to more output, employment, and higher wages over a period of time.[39] Nevertheless, the corporate tax is fundamentally flawed because it exacerbates the disparities between favored and disfavored investment decisions: (1) debt versus equity finance, (2) corporate versus noncorporate forms, and (3) retained earnings versus distributions.

The double tax encourages corporations to invest in debt rather than equity, thereby distorting the choice between debt and equity finance.[40] Specifically, equity-financed investments are taxed twice—at both the corporate level and the shareholder level. For example, suppose that an investor provides capital to a corporation with one shareholder. If the corporation earns a $1,000 return on the investment, that income is subject to a twenty-one percent tax at the corporate level, or $210. The corporation is then left with $790 in after-tax profits, which are taxed again at the individual level when the corporation distributes these earnings as dividends. Assuming a twenty percent individual tax rate for qualified dividend income, the shareholder must pay $158 in taxes, reducing the total after-tax income to $632.

Conversely, debt-financed investments are generally not taxed twice. Because corporations are able to deduct from their taxable income interest payments they

34. The OECD, or Organisation for Economic Co-Operation and Development, is an international think tank comprised of thirty-six member nations that support free market economics. *Organisation for Economic Co-Operation and Development (OECD)*, INVESTOPEDIA, https://www.investopedia.com/terms/o/oecd.asp (last updated Apr. 3, 2019). It functions to "publish[ ] economic reports, statistical databases, analyses and forecasts on the outlook of economic growth worldwide." *Id.*

35. Erica York, *The Benefits of Cutting the Corporate Income Tax Rate*, TAX FOUND. (Aug. 14, 2018), https://taxfoundation.org/benefits-of-a-corporate-tax-cut/. The combined corporate income tax rate for the United States in 2017 was 38.91 percent. *Table II.1. Statutory Corporate Income Tax Rate*, OECD, https://stats.oecd.org/Index.aspx?QueryId=78166.

36. The current combined corporate income tax rate for the United States is 25.89 percent. *Table II.1. Statutory Corporate Income Tax Rate*, OECD, https://stats.oecd.org/Index.aspx?QueryId=78166.

37. York, *supra* note 35.

38. Reuven S. Avi-Yonah et al., *Is Corporate Integration a Good Idea?*, TAX NOTES: STAR FORUM (June 20, 2016) (available at https://www.taxpolicycenter.org/publications/corporation-integration-good-idea).

39. York, *supra* note 35.

40. Pomerleau, *supra* note 33.

make to lenders, the corporate tax does not apply to that portion of the return that is paid back as interest (the interest payment, however, is taxable to the lender as interest income). For example, suppose that the corporation above issues a corporate bond and recoups a $1,000 return on the investment. Assuming that the corporation pays $1,000 in interest, the corporation is able deduct the interest payment from its taxable income. As a result, the corporation owes no corporate income tax. Because of this differential tax treatment, corporations are more likely to finance through debt rather than equity.[41]

The double tax also encourages investment in noncorporate entities rather than corporations, thereby distorting the allocation of capital between corporate and noncorporate forms.[42] Unlike traditional corporations, noncorporate entities such as partnerships, limited liability companies, and S corporations are not taxed at the entity level.[43] Instead, profits are "passed through" to the owners or members who

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41. *Id.* The distortion between debt and equity is especially relevant today, considering the current United States debt crisis. Student loan debt has tripled within the last decade, totaling $1.6 trillion, Gillian Tett, *America's Debt-Laden Students Need Better Policy Solutions*, FIN. TIMES (Sept. 5, 2019), https://www.ft.com/content/3e7e1b9c-cfda-11e9-99a4-b5ded7a7fe3f, outstanding auto loan debt has skyrocketed to nearly $1.3 trillion, Mayra Rodriguez Valladares, *As Auto Lending Delinquencies Rise, Discrimination is Even More Dangerous to the Economy*, FORBES (May 1, 2019, 1:45 PM), https://www.forbes.com/sites/mayrarodriguezvalladares/2019/05/01/as-auto-lending-delinquencies-rise-discrimination-is-even-more-dangerous-to-the-economy/#318a34f270e3, and total credit card debt is at its "highest point ever," exceeding $1 trillion. Jessica Dickler, *Consumer Debt Hits $4 Trillion*, CNBC (Feb. 21, 2019, 8:28 AM), https://www.cnbc.com/2019/02/21/consumer-debt-hits-4-trillion.html. In addition to the roughly $4 trillion in total consumer debt, total corporate debt is approximately $15.5 trillion—seventy-four percent of the nation's GDP. Mayra Rodriguez Valladares, *U.S. Corporate Debt Continues to Rise as do Problem Leveraged Loans*, FORBES (July 25, 2019, 2:38 PM), https://www.forbes.com/sites/mayrarodriguezvalladares/2019/07/25/u-s-corporate-debt-continues-to-rise-as-do-problem-leveraged-loans/#191a501e3596. Commentators have warned that these massive increases in both consumer and corporate debt, fueled in part by artificially low interest rates, John Mauldin, *Opinion: When the U.S. Falls into a Recession, a Credit Bubble will Explode*, MARKETWATCH (Mar. 20, 2019, 10:49 AM), https://www.marketwatch.com/story/when-the-us-falls-into-a-recession-a-credit-bubble-will-explode-2019-03-20, and a surge in bank lending, Mayra Rodriguez Valladares, *U.S. Corporate Debt Continues to Rise as do Problem Leveraged Loans*, FORBES (July 25, 2019, 2:38 PM), https://www.forbes.com/sites/mayrarodriguezvalladares/2019/07/25/u-s-corporate-debt-continues-to-rise-as-do-problem-leveraged-loans/#191a501e3596, have created a 'credit bubble' reminiscent of the housing market bubble prior to the 2008 financial crisis. Reshma Kapadia, *Sheila Bair Sees the Seeds of Another Financial Crisis*, BARRON'S (Mar. 1, 2018, 10:02 AM), https://www.barrons.com/articles/sheila-bair-sees-the-seeds-of-another-financial-crisis-1519916556. Indeed, many economists fear that another economic recession is imminent. *See* Jonnelle Marte, *3 out of 4 Economists Predict a U.S. Recession by 2021, Survey Finds*, WASH. POST (Aug. 19, 2019, 5:40 PM), https://www.washingtonpost.com/business/2019/08/19/out-economists-predict-us-recession-by-survey-finds/ ("Most economists believe that the United States will tip into recession by 2021, a new survey shows . . . ."). Considering the foregoing, there can be little doubt that the double tax system's distortion of debt and equity financing contributes to the proliferation of debt in America.

42. Emil M. Sunley, *Corporate Integration: An Economic Perspective*, 47 TAX L. REV. 621, 635 (1992).

43. Note, however, that publicly-traded partnerships are treated as corporations for federal tax purposes, unless certain requirements are met. *See generally* Internal Revenue Code, 26 U.S.C. § 7704.

pay the individual income tax. As a result, noncorporate entities receive a higher rate of return on investment. Consider a corporation that earns a $1,000 return on investment. Like the example above, the corporation must pay a twenty-one percent tax at the corporate level, or $210. The remainder is distributed to the corporation's sole shareholder, who pays $118.50 in taxes at the individual level.[44] The total after-tax income pursuant to this transaction is $671.50. Next, consider a limited liability company that earns the same return on investment. The $1,000 return is passed through to its sole member, who pays a twenty-two percent tax at the individual level, or $220. Here, the total after-tax income is $780, which is a higher rate of return.[45] Because the marginal rate of return is, for the most part, higher for noncorporate investment than it is for corporate investment, capital is largely misallocated between the two business forms.[46]

Finally, the double tax encourages corporations to retain corporate income rather than distribute it, thereby distorting the choice between retaining and distributing earnings.[47] Tax policymakers ultimately disagree about whether changes in the way dividends are taxed affect corporate distribution policies.[48] However, the double tax on corporate income should generally encourage corporations to retain earnings "because leaving the earnings in the corporation allows them to grow subject to only one level of taxation, [thereby] avoiding the second dividend level tax."[49]

Ultimately, these economic disparities illustrate that particular economic activities are taxed at higher rates than others. Because particular segments of the economy are taxed at higher rates, corporations and individuals are likely to make decisions "based on tax considerations, rather than the economic merits," which leads

44. Here, assume that the shareholder is subject to a fifteen percent rate for qualified dividend income. The tax rate on qualified dividends for individuals whose ordinary income is taxed at 22 percent, twenty-four percent, or thirty-two percent is fifteen percent. *See* Tax Cuts and Jobs Act of 2017, 131 Stat. at 2057–58.

45. In this simplified example, there is one instance in which the rate of return for a corporate entity exceeds that for a noncorporate entity – when the individual tax rate is thirty-seven percent, and the corresponding capital gains rate is twenty percent. Of course, this caveat holds true only when the income at issue is subject to the favorable capital gains rate.

46. Pomerleau, *supra* note 33. Indeed, business activity in the United States has largely shifted to pass-through businesses over the past three decades. Scott Greenberg, *Corporate Integration: An Important Component of Tax Reform*, TAX FOUND. (April 20, 2016), https://taxfoundation.org/corporate-integration-important-component-tax-reform/. Pass through business activity accounted for only twenty percent of total business income in 1980; however, that activity accounted for sixty-four percent of total business income in 2012. *Id.* The rise in pass through business activity ultimately coincides with an overall decline in the number of C corporations in the United States, which has "fallen to a historically low level." William McBride, *America's Shrinking Corporate Sector*, TAX FOUND. (Jan. 6, 2015), https://taxfoundation.org/america-s-shrinking-corporate-sector/.

47. Sunley, *supra* note 42, at 635.

48. *See* Conway, s*upra* note 4, at (comparing traditional and modern views with regard to the effect of taxes on distribution and retention policies).

49. *Id.* at 68.

to economic inefficiency.[50] This type of economic decision making works counterintuitively to the guiding principle of tax neutrality, which holds that "a tax system should neither encourage nor discourage specific economic decisions."[51] Therefore, tax reform efforts aimed at restoring parity within the tax system should focus on eliminating or, in other words, "integrating" the double tax on corporate income.[52]

II. Corporate Integration, Generally

A. What is Corporate Integration?

The double tax arbitrarily imposes a higher tax burden on a single category of business income—income that is earned by corporations and distributed to shareholders.[53] As a result, corporations bear a higher tax burden than noncorporate entities and corporate shareholders bear a higher tax burden than corporate bondholders.[54] The double tax, along with the economic disparities that it creates, can be reduced or eliminated altogether through corporate integration, which generally refers to any method that standardizes "the taxation of business income across business forms and methods of financing."[55]

There are two overarching models for corporate integration: full integration and partial integration. Full integration is grounded on the premise that corporate income should be "taxed only once … at the shareholder level whether or not the income is distributed."[56] In essence, the full integration model purports to tax shareholders on both corporate distributions and retained earnings, like a pass-through tax. A fully-integrated corporate tax would likely achieve the goals of corporate integration. Shareholders would be effectively treated as partners for tax purposes, meaning that "the current level of taxes would not hinge on whether or not the income was distributed."[57] Rather, all corporate income would be taxed once at the individual level. Therefore, full integration wholly eliminates the disparities between debt and equity, the corporate and noncorporate forms, and retained earnings and distributions.[58]

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50. Greenberg, *supra* note 46.

51. *Id.*

52. *See* Avi-Yonah et al., *supra* note 38 (explaining that the elimination of the double tax would remove economic distortions that favor debt over equity financing, noncorporate over corporate investment, and retaining earnings over dividends).

53. *See supra* Section I(B).

54. *See supra* Section I(B).

55. Greenberg, *supra* note 46.

56. Sunley, *supra* note 42, at 625.

57. *Id.*

58. *See id.*

However, the administrative difficulties associated with the installation of such a fully-integrated system likely renders the adoption of the full integration model unfeasible. For example, "allocating earnings among various classes of stock" and discerning "[c]hains of corporate ownership" would add unneeded complexity to the tax system.[59] Even though similar issues already exist under partnership rules, such issues would be significantly exacerbated in the corporate context.[60] Thus, the only viable means of corporate integration is partial integration.

Partial integration can be achieved in a variety of ways. One method of partial integration is the "dividends-paid deduction," which proposes that a corporation receives a deduction for dividends paid to its shareholders who then pay tax on the dividend income they receive.[61] A second method of partial integration is the "credit imputation," which requires that a corporation and its shareholders both pay taxes on their respective income, but allows shareholders to receive either a full or partial refundable tax credit to offset taxes already paid at the corporate level.[62] The final notable method of partial integration is the "dividend exclusion," which proposes that corporate income be taxed at the corporate level and then tax exempt when passed to shareholders as dividends.[63]

Each option for partial integration purports to tax corporate income only once, either at the shareholder or the corporate level. The dividends-paid deduction would place the burden of the corporate income tax at the shareholder level, because it would allow corporations to deduct distributions. Conversely, the credit imputation method would place the tax burden at the corporate level, because it would grant shareholders a refundable tax credit for taxes already paid. Importantly, however, credit imputation ensures that corporate income is taxed at the marginal tax rate of the shareholder, whether or not the individual rate is higher or lower than the corporate rate.[64]

Assume, for example, that a corporation earns a profit of $1,000. After the corporation pays its corporate income tax of $210 (twenty-one percent), the corporation is left with an after-tax profit of $790, which it distributes to its sole shareholder. Under the credit imputation system, the shareholder grosses-up the dividend by adding $210 back to their taxable dividend income. If the shareholder faces a marginal tax rate of fifteen percent for qualified dividend income, the shareholder's tentative tax is $150. However, the shareholder is also granted a refundable tax credit, which reduces their tax liability by the amount the corporation already paid—$210. Because the amount of the tax credit exceeds the shareholder's

59. *Id.*
60. *Id.*
61. Pomerleau, *supra* note 33.
62. *Id.*
63. *Id.*
64. *Id.*

tentative tax liability, the difference ($60) is refunded. Thus, the total marginal tax rate on the $1,000 in corporate income is fifteen percent, or $150 (the $210 corporate tax minus the $60 tax refund), which is equivalent to the shareholder's marginal rate. Alternatively, assume that the shareholder above faces a thirty-two percent tax rate for ordinary dividend income. The shareholder's tentative tax becomes $320 after grossing-up the dividend, but the shareholder also receives a tax credit of $210—the amount already paid by the corporation. Because the shareholder's tentative tax liability exceeds the amount of the tax credit, no refund is granted. Instead, the shareholder's tax liability is reduced by the amount of the tax credit. As a result, the shareholder's total tax liability is equal to $110 (the $320 tentative tax minus the $210 tax credit), and the shareholder's after-tax income is equal to $680 (the $790 dividend minus the $110 shareholder tax). The total marginal tax rate on the $1,000 in corporate income is now thirty-two percent, or $320 (the $1,000 in corporate income minus the $680 in after-tax income), which is, again, equivalent to the shareholder's marginal rate.

Like the credit imputation method, the dividend exclusion would place the burden of the corporate income tax at the corporate level, because dividends are simply excluded from taxation. Unlike credit imputation, however, the total tax on corporate income under the dividend exclusion is equal to the corporate income tax rate.

The dividends-paid deduction, credit imputation, and dividend exclusion are all viable methods of partial integration. In fact, tax policymakers have proposed at one point or another that the United States incorporate at least one of these models into its tax system.[65]

B. Integration Proposals in the United States

Corporate integration is not a novel concept to tax policymakers. In fact, there have been multiple proposals to integrate corporate taxes over the years. In the mid-1980s, the U.S. Treasury Department (the "Treasury") issued two reports assessing the viability of incorporating an integration scheme into the corporate tax system ("Treasury I"[66] and "Treasury II"[67] respectively). Pursuant to Treasury I, the Treasury recommended that the U.S. "continue to levy the corporate income tax on earnings that are retained, but provide partial relief from double taxation of dividends [by allowing] corporations to deduct a portion of the dividends paid out of previously-

65. *See infra* Section II(B).

66. U.S. Dep't of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth* (1984) (available at https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Tax-Reform-v1-1984.pdf) (hereinafter referred to as "Treasury I").

67. The White House, *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (1985) (available at https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Reform-Proposal-1985.pdf) (hereinafter referred to as "Treasury II").

taxed earnings."[68] In essence, the Treasury proposed that the U.S. adopt the dividends-paid deduction model for partial integration. In justifying its proposal, the Treasury cited to various "undesirable effects" with regard to the double taxation of corporate income, including encouraging "corporations to rely too heavily on debt rather than equity finance," discouraging corporate investment, and inducing corporations "to retain earnings[ ] rather than pay them out as dividends."[69] Notably, these are the same economic disparities discussed in Section I *supra*.

Further, the Treasury expressly rejected adopting a full integration model, citing "[t]echnical difficulties" that "preclude the adoption of this approach."[70] It also rejected a credit imputation model for similar reasons, describing the dividends-paid deduction as "[t]he simpler method."[71] Importantly, the dividends-paid deduction would subject shareholders to a "compensatory withholding tax, equivalent to the reduction in tax at the corporate level."[72] This means that rather than shareholders paying taxes on dividends they receive, the shareholders' portion of the taxes are instead "withheld from the dividend proceeds … at the time the funds are distributed."[73] The Treasury noted, however, that while dividend relief would remedy the economic biases of the double tax, revenue loss would be a consequential concern.[74] Therefore, the Treasury suggested that a dividends-paid deduction would have to allow corporations to deduct only fifty percent of dividends paid, instead of the full amount.[75]

Treasury II also recommended that the U.S. adopt a dividends-paid deduction model for reasons similar to those explained in the Treasury I report.[76] A key distinction between the reports, however, is that Treasury II endorsed a ten percent corporate deduction for dividends paid, rather than a fifty percent deduction.[77] Again, revenue concerns were at the forefront of this decision.[78] Despite the proposed limitations on dividend relief, it is clear that both Treasury I and Treasury II

68. Treasury I at xiv.

69. *Id.* at 118.

70. *Id.*

71. *Id.*

72. *Id.* at 119.

73. *Tax Reform: Corporate Tax Integration and Philanthropy – a Deeper Dive*, COUNCIL ON FOUNDS., https://www.cof.org/page/tax-reform-corporate-tax-integration-and-philanthropy-deeper-dive.

74. Treasury I at 119. Revenue loss is, in fact, a fundamental concern with regard to corporate integration proposals; thus, as discussed in Section III *infra*, it is important that future proposals incorporate measures to hedge against this potential loss.

75. *Id.*

76. *See* Treasury II at 121–22.

77. *Id.*

78. *See* Treasury II, Summary at 7 (iterating the importance of maintaining revenue neutrality when considering tax reform proposals).

sought to move at least some of the tax liability for corporate income to corporate shareholders.

A variety of integration proposals followed Treasury I and Treasury II, but despite the best efforts of tax policymakers, no proposal has been successfully adopted.[79] More recently, the Senate Finance Committee held hearings on May 17, 2016[80] and May 24, 2016[81] to consider then-Senate Finance Committee Chairman Senator Orrin Hatch's proposal to integrate the corporate tax. Senator Hatch, a well-known proponent of corporate integration, recommended that the U.S. adopt a dividends-paid deduction, which would allow corporations to deduct dividends paid to shareholders.[82] Like the proposals set forth in the Treasury I and Treasury II reports, Senator Hatch's proposal purported that corporations should withhold taxes at the corporate rate on dividends distributed.[83] Importantly, however, his proposal differed substantially from the Treasury's reports with regard to the maintenance of revenue neutrality. Treasury I and Treasury II hedged against the loss of tax revenue by recommending that the corporate dividend deduction be limited to fifty percent and ten percent of dividends paid, respectively.[84] By contrast, Senator Hatch suggested that revenue loss could best be avoided by subjecting tax-exempt shareholders—such as nonprofit organizations and retirement plans—to the corporate withholding tax.[85] In effect, Senator Hatch's proposal would amount to a direct tax on dividend income received by previously tax-exempt shareholders, which obviously raised a variety of public policy concerns.[86] To alleviate these concerns, Senator Hatch emphasized that under the classic double tax system, "tax-exempt shareholders already bear [at least some of] the burden of the corporate level of tax" because corporate earnings are taxed at the corporate rate, regardless of whether or not

79. *See, e.g.*, U.S. Dep't of the Treasury, *Integration of the Individual and Corporate Tax Systems* (1992) (available at https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Integration-1992.pdf); U.S. Senate Comm. on Fin., *Comprehensive Tax Reform for 2015 and Beyond* (2014) (available at https://www.finance.senate.gov/imo/media/doc/Comprehensive%20Tax%20Reform%20for% 202015%20and%20Beyond%20(C).pdf).

80. *Integrating the Corporate and Individual Tax Systems: The Dividends Paid Deduction Considered: Hearing Before the S. Comm. on Finance*, 114th Cong. (2016).

81. *Debt Versus Equity: Corporate Integration Considerations: Hearing Before the S. Comm. on Finance*, 114th Cong. (2016).

82. Alexandrea Minkovich, *Corporate Integration: Chairman Hatch's Straightforward Approach to Tax Reform*, 68 TAX EXECUTIVE 41, 42 (2016).

83. *Id.*

84. *See supra* notes 75, 77 and accompanying text.

85. *Integrating the Corporate and Individual Tax Systems: The Dividends Paid Deduction Considered: Hearing Before the S. Comm. on Finance*, 114th Cong. 7 (2016) (statement of Michael J. Graetz, Professor of Tax Law, Columbia University).

86. *See Integrating the Corporate and Individual Tax Systems: The Dividends Paid Deduction Considered: Hearing Before the S. Comm. on Finance*, 114th Cong. 11 (2016) (statement of Steven A. Rosenthal, Senior Fellow, Urban-Brookings Tax Policy Center) (emphasizing that imposing withholding taxes on tax-exempt shareholders would be "challenging politically").

the income is distributed.[87] Thus, the dividends-paid deduction model would merely "make more transparent how much tax tax-exempt shareholders are already subject to."[88] Moreover, commentators have stressed that "if tax-exempt shareholders are not subject to a withholding tax in a [dividends-paid deduction] system, the [tax] base is too small and the tax rate too low for corporate integration to avoid losing revenue."[89]

Indeed, the share of U.S. corporate stock held in taxable accounts has declined substantially over the past fifty years.[90] Steven M. Rosenthal and Lydia S. Austin of the Urban-Brookings Tax Policy Center estimated that in 1965, taxable accounts held 83.6% of corporate stock,[91] but that by 2015, that number had dropped significantly to 24.2%, or $5.5 trillion, of the $25.8 trillion in total corporate stock.[92] Of the 75.8% of corporate stock held by non-taxable accounts in 2015, roughly 4.9% came from nonprofit ownership,[93] thirty-seven percent came from ownership by retirement accounts,[94] twenty-six percent came from ownership by non-taxable foreigners,[95] and the remainder came from other non-taxable sources. Because approximately three-fourths of corporate earnings avoid taxation at the shareholder level under the traditional double tax system, it is important that integration proposals (and specifically, those that place the corporate tax burden on corporate shareholders) properly account for potential revenue deficits. As Senator Hatch recognized, the revenue losses associated with the dividends-paid deduction can be mitigated or avoided entirely by expanding the corporate tax base—that is, by subjecting tax-exempt shareholders to the corporate withholding tax.[96] Despite support from tax policymakers, Senator Hatch ultimately failed to introduce legislative language detailing his proposal for corporate integration before he resigned from the United States Senate in early 2019.[97] Even so, Senator Hatch's proposal, along with previous corporate integration proposals, set the groundwork for viable integration legislation.

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87. Minkovich, *supra* note 82, at 42.

88. *Id.*

89. *Id.* at 44.

90. Steven M. Rosenthal & Lydia S. Austin, *The Dwindling Taxable Share of U.S. Corporate Stock*, TAX NOTES: SPECIAL REPORT (May 16, 2016) (available at https://www.taxpolicycenter.org/publications/dwindling-taxable-share-us-corporate-stock/full).

91. *Id.* at 923.

92. *Id.* at 930.

93. *Id.* at 927.

94. *Id.* at 928.

95. *Id.*

96. *See supra* note 85 and accompanying text.

97. *See generally*, *Integrating the Corporate and Individual Tax Systems: The Dividends Paid Deduction Considered: Hearing Before the S. Comm. on Finance*, 114th Cong. 7 (2016); *Debt Versus Equity: Corporate Integration Considerations: Hearing Before the S. Comm. on Finance*, 114th Cong. (2016).

III. Assessing the Viability of Corporate Integration Strategies

A. The Dividends-Paid Deduction

As explained in Section II(A) *supra*, the dividends-paid deduction model would allow a corporation to receive either a full or partial deduction for dividends it distributes to shareholders. The corporation would act as a withholding vehicle, meaning that the taxes owed by shareholders are withheld by the corporation at the time of distribution. As a result, distributions are taxed at the shareholder rate, and although taxes are collected at the corporate level, the burden of the corporate income tax largely rests with the shareholders.

On its face, the dividends-paid deduction would reduce or eliminate the three economic disparities inherent to the double tax. The bias in favor of debt finance would be reduced because the dividends-paid deduction allows a corporation to deduct both dividends and interest payments, subjecting each to only one level of tax at the shareholder (or bondholder) level.[98] The bias favoring noncorporate investment would be reduced for similar reasons; specifically, because all capital would be taxed once, whether or not said capital was allocated toward corporate or noncorporate purposes. Finally, the bias in favor of retaining earnings would be eliminated because earnings would be taxed either once at the corporate level (if retained), or once at the shareholder level (if distributed). There is room to question, however, whether the dividends-paid deduction model would create an opposite bias favoring the distribution of earnings. If the corporate tax rate exceeds the individual rate, as is the case under the TCJA, corporations may be incentivized to increase dividend payments—at the expense of retaining earnings that would otherwise be used finance corporate growth—to lower the effective tax rate on corporate income.[99]

Coupling the incentive to distribute earnings with the fact that three-fourths of corporate distributions go untaxed at the shareholder level,[100] it is clear that a significant portion of corporate income under the dividends-paid deduction model would avoid taxation entirely.[101] Therefore, to prevent potentially significant losses

98. Notably, the dividends-paid deduction would not entirely eliminate the distortion between debt and equity, because "interest is deductible as it accrues while dividends are deductible only when paid." U.S. Dep't of the Treasury, *Integration of the Individual and Corporate Tax Systems* (1992) 107 (available at https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Integration-1992.pdf).

99. Minkovich, *supra* note 82, at 44–45.

100. *See supra* Section II(B), regarding the allocation of corporate stock between taxable and tax-exempt shareholders.

101. The corporate income tax is currently the nation's third-largest source of federal tax revenue, comprising approximately six percent of all federal tax revenue in 2018. *Policy Basics: Where do Federal Tax Revenues Come From?*, Ctr. on Budget & Pol'y Priorities, https://www.cbpp.org/research/federal-tax/policy-basics-where-do-federal-tax-revenues-come-from (last updated June 20, 2019). Under the dividends-paid deduction model, all corporate income that is earned and subsequently distributed will avoid taxation at the corporate

in tax revenue, integration strategies incorporating the dividend-paid distribution must seek to apportion "the tax burden from the missing revenue among the taxpayers that should properly bear the tax burden."[102] That is, the corporate tax burden must be apportioned among all corporate shareholders, whether taxable or tax-exempt.

In his 2016 integration proposal, Senator Hatch recommended that the corporate withholding tax apply to tax-exempt shareholders.[103] While this is a necessary component of any viable dividends-paid deduction scheme, other economic variables must be considered. Specifically, if tax-exempt shareholders are taxed on income from corporate investment, these shareholders will likely invest more heavily in noncorporate businesses, where their returns on investment are still tax-exempt. Likewise, if tax-exempt shareholders are taxed only on equity investment, these shareholders will probably invest more heavily in debt, where interest payments can be received tax-free. Thus, to retain tax neutrality, a dividends-paid deduction proposal must ensure that all income received by tax-exempt shareholders is subject to at least one level of tax, whether that income is derived from corporations or noncorporate entities, or equity or debt finance.[104]

Considering the foregoing, achieving viable integration via the dividends-paid deduction may require a comprehensive reworking of the Internal Revenue Code. As a result, the corporate income tax—particularly as it applies to tax-exempt shareholders—would bear little resemblance to the tax under current law. Because other integration models place the burden of the corporate tax at the corporate, rather than the shareholder level, these models do not require modification of the tax treatment of tax-exempt shareholders. Therefore, the more feasible models for corporate integration are the credit imputation and dividend exclusion.

B. Credit Imputation

The credit imputation model would require that a corporation and its shareholders each pay taxes on their respective income, but would allow shareholders a tax credit to offset taxes already paid at the corporate level. The tax credit would be refundable for taxable shareholders but nonrefundable for tax-exempt

level, and much of this income will avoid taxation at the shareholder level. As a result, less corporate income tax will be collected, significantly reducing an important source of federal tax revenue.

102. Conway, *supra* note 4, at 103.

103. *See supra* Section II(B).

104. Conway, *supra* note 4, at 103. Tax-exempt organizations are subject to an unrelated business income tax ("UBIT") "on income derived from a business that is unrelated to the entity's exempt purpose." Sunley, *supra* note 42, at 629 n. 49. Under current law, many forms of passive income (e.g. dividends, interest income, and capital gains) are not treated as UBIT. Julia Kagan, *Unrelated Business Taxable Income (UBTI)*, INVESTOPEDIA, https://www.investopedia.com/terms/u/ubti.asp (last updated Dec. 11, 2019). However, under the dividends-paid deduction model, parity could be achieved if income derived from interest payments and dividends were "treated in the same manner as UBIT income." Sunley, *supra* note 42, at 629 n.49.

shareholders. As a result, the burden of the corporate income tax is placed at the corporate level, although distributed income is ultimately taxed at the shareholders' marginal tax rate. Importantly, because the tax credit would be nonrefundable for tax-exempt shareholders, corporate income distributed to such shareholders will have already been fully taxed at the corporate level.[105]

Generally, the credit imputation model would reduce or eliminate the three economic disparities that integration intends to address. Under the traditional system of double taxation, interest payments are effectively taxed once at the shareholder level because corporations may deduct the amount of the interest payment. Similarly, credit imputation ensures that dividend distributions are also taxed once at the corporate level, but at the marginal rate of the shareholder. As a result, both equity and debt would be taxed at the shareholder's rate under the credit imputation model, eliminating the bias in favor of debt finance. For the same reasons, credit imputation would also eliminate the bias favoring noncorporate investment. Lastly, the bias in favor of retaining earnings would be eliminated, because corporate earnings would be subject to tax at the corporate level, whether or not the earnings are retained or distributed.[106]

It is necessary, however, to consider corporate distributions to tax-exempt shareholders when assessing the viability of any integration proposal. Pursuant to the double tax system, tax-exempt shareholders (or in this case, bondholders) who receive interest payments from a corporation are not required to pay tax on the interest income, and the corporation is permitted to deduct the amount of the payment. In this scenario, corporate income generated from the issuance of debt largely escapes taxation. Conversely, under the credit imputation model's nonrefundable credit scheme, returns on equity that are subsequently distributed to tax-exempt shareholders are fully taxed at the corporate level. In this regard, corporations may actually be likely to favor traditional debt finance over equity finance. To resolve this conundrum, a credit imputation strategy cannot merely remove the corporate deduction for interest payments. Doing so would ensure that interest paid to tax-exempt bondholders is taxed once at the corporate level; however, it would also ensure that interest paid to taxable bondholders is taxed twice (at both the corporate level and the bondholder level), exacerbating the disparity between

105. U.S. Dep't of the Treasury, *Integration of the Individual and Corporate Tax Systems* (1992) 95 (available at https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Integration-1992.pdf).

106. Note that credit imputation could, like the dividends-paid deduction, encourage corporations to distribute earnings that would have otherwise been retained, for the purpose of lowering the tax rate on corporate income. However, the effects of this phenomenon are more pronounced under the dividends-paid deduction, since corporate earnings distributed to tax-exempt shareholders would escape taxation entirely. By contrast, the credit imputation model ensures that corporate earnings distributed as dividends to tax-exempt shareholders are taxed at least once.

debt and equity.[107] Thus, in addition to disallowing a corporate level deduction for interest, the credit imputation model would have to incorporate a bondholder credit imputation scheme.[108]

Pursuant to this approach, the corporate-level tax paid on corporate earnings distributed as interest payments or dividends "would be passed through to bondholders and shareholders as imputation credits."[109] The interest and dividend payments would be included in the income of bondholders and shareholders who could then use tax credits to offset the taxes on such payments.[110] Like the ordinary credit imputation model, tax credits extended to tax-exempt bondholders and shareholders would be nonrefundable, ensuring that both debt and equity are taxed once at the corporate level.[111]

C. Dividend Exclusion

The dividend exclusion model would require that a corporation pay corporate tax on income it receives but would allow shareholders to exclude dividend distributions from their gross income. Because the shareholder-level tax on dividends paid from fully-taxed corporate income would be eliminated entirely, the burden of the corporate income tax is placed primarily at the corporate level.

The dividend exclusion model would also reduce or eliminate the three economic distortions of the traditional double tax system. Because the dividend exclusion removes the shareholder-level tax, the total tax on distributed earnings would be equivalent to the corporate rate. As a result, the disparities between debt and equity finance and between noncorporate and corporate investment would be reduced. Moreover, since corporate income would be taxed fully at the corporate rate, regardless of whether or not such income is retained or distributed, the dividend exclusion model eliminates the disparity between retaining and distributing corporate earnings.[112]

Like the credit imputation model the dividend exclusion model must sufficiently address corporate distributions to tax-exempt bondholders. As discussed in Section III(B) *supra*, corporate returns generated from debt finance largely escape taxation because a corporation may deduct interest payments to tax-exempt bondholders who pay no tax on the interest income they receive. To remedy this blatant

107. U.S. Dep't of the Treasury, *Integration of the Individual and Corporate Tax Systems* (1992) 105 (available at https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Integration-1992.pdf).

108. *Id.*

109. *Id.*

110. *Id.*

111. *Id.*

112. Unlike the dividends-paid deduction and credit imputation models, which, to some extent, encourage the distribution of dividends for the purpose of subjecting corporate income to a marginally-lower rate, no such incentive exists under the dividend exclusion model.

disparity, a viable dividend exclusion strategy must both remove the corporate-level deduction for interest payments and extend a bondholder-level exclusion to interest income received. By doing so, the dividend exclusion option would subject interest income, like dividend income, to one level of tax at the corporate level.

D. Which Integration Strategy is the Most Viable?

Considering the modified credit imputation and dividend exclusion models above, it is clear that the dividend exclusion strategy is relatively straightforward and easier to implement. Although both models achieve similar results economically, the credit imputation strategy adds additional complexity by requiring the adoption of an entirely new regime for taxing corporate distributions. By contrast, the dividend exclusion model applies principles that already exist under the current tax system, such as taking away deductions and providing exclusions. Ultimately, the modified dividend exclusion approach could be the most viable method of integrating the corporate income tax.

Conclusion

The double tax creates economic disparities that favor particular economic activities over others and encourages individuals to make economic decisions based on taxes rather than on the economic merits. By standardizing the taxation of corporate income through corporate integration, the United States can move closer toward achieving a more economically efficient system. Not all integration proposals are treated equally, however. The dividends-paid deduction model, while appealing on its face, is unworkable in effect. The credit imputation model, while more feasible than the dividends-paid deduction method, adds unnecessary complexity to the treatment of corporate distributions. Thus, if corporate integration is ever to be achieved, tax policymakers should adopt a modified dividend exclusion model.