



## Integrating Corporate and Shareholder Taxes

### Tax Notes,

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### Summary

In this article, Mr. Christian sets forth five criteria for evaluating methods for fully integrating the corporate and individual income taxes, and then examines five models of integration in light of these criteria. The article urges that integration be achieved in a manner that is least likely to introduce new distortions and most likely to enhance investment per dollar of revenue loss. To achieve these goals, an integrated system should operate to increase the amount of after-tax earnings available for retention and reinvestment in the business that generated the income.

The article observes that a corporate tax rate cut is implicit in the basic concept of integration at today's tax rates. Each of the integration models considered in the article either implicitly or explicitly reduces the corporate tax rate to 28 percent and excludes dividends from income. The article concludes that the essence of integration can be achieved by simply reducing the corporate tax rate to 28 percent and excluding dividends from income. The 1986 Act's elimination of the principal structural barrier to integration -- highly progressive individual income tax rates -- makes this type of integration possible now.

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## **Introduction**

Nearly all methods of integration will, one way or another, result in reducing the "corporate" rate to the top shareholder rate and excluding dividends from tax. This paper urges that we do it the easy way -- in the manner that is least likely to introduce new distortions and most likely to enhance investment per dollar of revenue loss.

## **New Ability to Achieve Integration**

The present rate structure should permit one or more simple methods of integration that satisfactorily accomplish the purpose of reducing -- to the normal level paid on other income - - the present high rate of tax on income from equity capital invested in corporate form. Past attempts foundered on complexity primarily because the corporate rate was lower than the top shareholder rate and higher than the low and intermediate shareholder rates. Simple approaches either fell far short or violated the then-prevailing canon of progressivity.

## **The Legacy of the 1986 Act**

The present ability to achieve tax integration may be the most important legacy of the 1986 Act. Because the rates for taxable shareholders are now so near to being flat and because the corporate rate is now higher instead of lower than the top individual rate, various flat-rate methods of integration are the most plausible options. Most of the traditional approaches to integration are of little practical relevance today. Indeed, most traditional methods would introduce far more complexities and distortions than are warranted by today's rate structure.

Because gains on stock are now fully taxed, the dimension of the problem presented by our two-tier system has also been expanded. Today, both retained and distributed earnings are taxed twice. Even so, integrating the corporate and shareholder taxes should be a far more manageable process than before. The key is not to seek perfection.

## **Organization and Assumptions**

First, the article states the tests for a proper form of tax integration under any rate schedule and briefly discusses the importance of taking into account the effect on corporate cash flow. Then the tests are applied to several methods of integration. To illustrate how much the situation has changed as a result of the 1986 Act, the text begins with the traditional Partnership Model (which is the most complex) and ends with the Dividend Exclusion Model (which is the simplest). In between lie several related methods, some familiar and some not so familiar -- such as the Basis Model and the Average Rate Model.(1)

Also discussed are some issues which seem fundamental to all methods of integration -- including gains on stock attributable to retained earnings, the treatment of foreign

shareholders, the treatment of tax-exempt shareholders in general, and the treatment of tax-exempt pension funds where there is a deferred tax. For the most part, transitional issues are ignored because the transition to a properly integrated system would be relatively uncomplicated.

A key issue is the average shareholder rate, i.e., what would be the aggregate amount of tax payable by shareholders as a group if total corporate taxable income were imputed and taxed to them in the year earned? The answer is critical to the Average Rate Model. The average shareholder rate on fully imputed taxable income is also important in comparing the results of the Partnership Model to the results of various flat-rate approaches such as the Basis Model and the Dividend Exclusion Model.

For purposes of this analysis, the weighted average federal income tax rate on fully imputed corporate taxable income is guesstimated to be around 20 percent.(2)

This average rate was estimated under the assumption that corporate taxable income imputed to tax-exempt and foreign shareholders would be treated the same as dividends under present law. In fact, taxable income imputed to such shareholders may be more akin to unrelated business taxable income (or effectively connected income in the case of foreigners) than to dividends.

This does not suggest that tax-exempt and foreigner shareholders actually would be required to pay a net income tax on the amount of corporate taxable income imputed to them under the Partnership Model. Indeed, this analysis assumes that they would not. Therefore, the Partnership Model (and the comparable Credit Model with refundability) would produce a larger revenue loss than the flat-rate models (with the exception of the Average Rate Model where the additional revenue loss goes to enhance corporate cash flow instead of to tax-exempt and foreign shareholders).

The analogy to unrelated business taxable income and effectively connected income should be taken into account in evaluating flat-rate approaches such as the Basis Model and the Dividend Exclusion Model. For example, if a flat tax at a 28-percent rate were collected from corporations and dividends were by one means or another excluded from tax, that 28-percent tax should not necessarily be compared to the suggested 20-percent average shareholder rate on fully imputed taxable income. Instead, the flat 28-percent tax might more appropriately be compared to an average shareholder rate computed on the assumption that amounts imputed to tax-exempt and foreign shareholders were fully taxable. Such a recomputed average rate would be close to 28 percent. Viewed in that way, the flat-rate approaches would produce essentially the same tax result as if the shareholders had earned the income directly.

For purposes of this analysis, the top shareholder rate is assumed to be 28 percent. The five-percent surcharge, or bubble, has been ignored. The surcharge probably should be eliminated -- as indeed it would be if a flat tax at the top shareholder rate were collected from corporations and dividends were excluded. Even if the "bubble" still existed -- as it might under the Partnership Model or the Credit Model -- the five-percent surcharge serves only to

recapture the benefit of the 15-percent bracket. The maximum amount of tax payable by a shareholder can never exceed 28 percent of his taxable income.

The analysis also assumes that the amount of income earned in corporate form that is subject to tax under an integrated system would not be greater than under present law. Had the shareholders actually earned the income directly, they would have had the benefit of tax-exempt bond interest, the excess of accelerated over straight-line depreciation, and other similar provisions. Therefore, corporate taxable income, not earnings and profits, should be taxed to shareholders under imputation methods such as the Partnership Model.

Similarly, corporate taxable income is the tax base under the Average Rate, Basis, and Dividend Exclusion Models where the flat tax collected from the corporation is a proxy for the tax that would be payable by the shareholders had they earned the income directly.

The concept of earnings and profits can, however, be used to further assure that the shareholders are in the same position as if they had earned the income directly. Earnings available for distribution or retention typically will include both taxable income (minus tax) and amounts properly not included in taxable income. The clearest example is tax-exempt bond interest.

The Partnership Model would, at the least, increase shareholder stock basis by the amount of corporate taxable income. Thus, corporate taxable income distributed as a dividend would not be taxed to shareholders. Gains on stock attributable to retained taxable income would be offset by basis and would also not be taxed a second time.

The Basis Model illustrates one way to go the next step and assure that earnings and profits are not rendered taxable.<sup>(3)</sup> Shareholder stock basis would, in general, be further increased by positive adjustments to earnings and profits. For example, tax-exempt interest received by a corporation and distributed to shareholders would be a return of basis and be nontaxable to the shareholders just as if they had earned the interest directly. Gains on stock attributable to retained tax-exempt interest also would be offset by basis.

The simple Dividend Exclusion Model (and the Average Rate Model) automatically would eliminate all tax on dividends whether paid out of corporate taxable income or earnings and profits. The question presented by the Basis Model is whether it is necessary or practically feasible to add on the earnings and profits basis adjustment so as to achieve a symmetrical result with capital gains and dividends.

### **Criteria for an Integrated System**

A proper form of tax integration would: (i) result in the tax on income from equity capital invested in corporate form being no greater than if the shareholders had earned it directly; (ii) result in the tax on retained and distributed earnings being the same; (iii) be designed to maximize the amount of corporate cash flow available for retention and reinvestment; (iv) be evenhanded between corporations that do and do not pay dividends; and (v) not artificially influence dividend policies or otherwise interfere with the normal relationships between

corporations and their shareholders.

Any integrated system which reduced the tax to the normal level paid on other income -- as if the shareholders had earned it directly -- would result in a large revenue loss. Even so, revenue considerations did not constrain the range of choices discussed in this paper. Instead, the analysis seeks to identify the integration method that is most likely to enhance economic growth per dollar of revenue loss and least likely to disrupt capital markets.

### **The Importance of the Cash Flow Test**

The integrated system should operate -- much in the manner of a corporate rate cut -- to increase the amount of after-tax earnings available for retention and reinvestment in the business which produced the earnings to start with. Whether all or part of the corporation's after-tax earnings actually are retained for reinvestment in the business or are distributed to be consumed or reinvested elsewhere by the shareholders should be left to the corporation and its shareholders. Increases or decreases in the amount distributed should not be dictated by the mechanical operation of the particular method of integration.

From a capital formation standpoint, many observers would argue for enhancing retained earnings. Any integrated system that reduces the present high rate of tax on income earned in corporate form will leave additional dollars in the private sector that are available for savings, consumption, or some combination of both. To the extent that these additional dollars are saved instead of being consumed and result in greater capital investment, economic growth will ensue. Retained earnings are by definition savings that are concentrated directly and immediately at the point where most business capital investment is made, where nearly all research and development occurs, and where essentially all competition in international markets is undertaken. Therefore, the combination of greater retained earnings and a lower cost of capital -- which is presently extraordinarily high in part because of the high rate of tax on income earned in corporate form -- should result in the greatest degree of economic growth per dollar of Treasury revenue loss.(4)

From a structural standpoint, the present rate schedule leads naturally -- perhaps inevitably -- to an integration method which operates much in the manner of a corporate rate cut. The function of an "integrated" tax is, after all, to collect tax at the shareholders' rates in the year income is earned in corporate form.

When, as now, the corporate rate (34 percent) is higher than the top shareholder rate (28 percent), the first result of any properly integrated system is automatically to reduce the maximum tax on income earned in corporate form to a level which is less than the corporate rate that applied in the nonintegrated system. The administratively feasible way to assure current collection is to require the corporation to pay the tax under one of the flat-rate methods -- just as it previously paid the separate corporate tax. The difference is the rate of tax (28 percent instead of 34 percent). Provided the income is not taxed again when dividends are paid, no further adjustment would be necessary to assure that the corporation has not underpaid any shareholder's tax.

Overpayments of tax might be said to occur with respect to shareholders who would not be taxed at a 28-percent rate if they had earned the income directly. Under the present rate schedule, any such overpayments are an imperfection that probably can be ignored. The average rate of tax payable by fully taxable shareholders on fully imputed income probably is pretty close to 28 percent anyway. It is primarily tax-exempt and foreign shareholders who might be said to be overpaid. While it would hardly seem necessary, any overpayments by 15- percent bracket shareholders could be handled under a flat-rate system. For example, they could be allowed a refundable credit when dividends are paid.(5)

Even though it is correct to say that a flat-rate 28-percent tax collected at the corporate level would result in little overpayment for fully taxable shareholders, there would be, in the aggregate, a substantial "overpayment" of tax if it is assumed that income earned in corporate form by foreigners and tax-exempt entities should not be taxed at all. Elimination of that overpayment obviously would result in a substantial additional revenue loss. The magnitude of that additional loss is indicated by comparing the 28-percent flat tax to the suggested 20-percent average tax rate on fully imputed corporate taxable income. But for the large amount of stock owned by tax- exempt pension plans, etc., the average shareholder rate would be close to 28 percent.

The overpayment could be eliminated by a corporate-oriented approach such as the Average Rate Model, where the corporation would pay tax at the 20-percent (or whatever) average shareholder rate. The additional revenue loss would be channeled into corporate cash flow available for reinvestment or for proportionate distribution to shareholders of all categories.

The alternative is to resort to one of the traditional shareholder-oriented methods such as the Partnership Model or the Credit Model, where the additional revenue loss would go directly to the tax-exempt and foreign shareholders. Indeed, the only discrete purpose served by the Partnership Model and the Credit Model is to funnel large amounts of cash to tax-exempt and foreign shareholders at the expense of both Treasury and corporate cash flow. All other purposes served by the Partnership Model and the Credit Model could better and more simply be accomplished by other methods.

As a general proposition, the Partnership Model and the Credit Model would influence dividend payments, provide the cash flow equivalent of a greater corporate rate cut to one corporation than to another, and result in the total amount of tax on one incorporated business being greatly different from the tax on another otherwise identical incorporated business.

### **The Partnership Model of Full Integration**

A corporation's taxable income would be imputed and taxed to the shareholders in the year earned. Shareholder stock basis would be increased by the amount of the corporation's taxable and tax-exempt income. Dividends paid out of taxable and tax-exempt income would be a return of basis and excluded from further tax. Gains on stock attributable to retained taxable or tax-exempt income would be offset by basis and excluded from further tax. To put shareholders entirely in the same position as if they had earned the income directly, stock

basis also should be adjusted for the tax deferrals included in earnings and profits. See discussion of the Basis Model. The idea of adjusting stock basis for corporate debt, and the alternative of providing for a negative basis, both seem to go beyond reason -- particularly in the case of a method of integration which is only of academic interest anyway.

Although corporations would have to pay no tax as such -- and in that sense the result is the same as repeal of the corporate tax -- they would have to pay an additional "tax-compensation" dividend sufficient to permit the top bracket shareholders to pay their tax on imputed retained income. Because corporations cannot pay disproportionate per share dividends to shareholders of the same class, they would have to pay a combined regular and tax-compensation dividend equal to 28 percent of imputed taxable income -- not only to 28-percent bracket shareholders, but to tax-exempt and foreign shareholders as well.(6)

Because a corporation which now pays no dividend would have to pay a tax-compensation dividend equal to 28 percent of its taxable income, the effect of the Partnership Model on its pre-dividend cash flow would be exactly the same as if the corporate tax rate had been reduced from 34 to 28 percent. A corporation which now is paying a dividend would have to pay a proportionately smaller tax-compensation dividend, would experience a proportionately greater increase in its pre-dividend cash flow and, therefore, would receive the equivalent of a larger corporate rate cut.(7) A closely held corporation entirely owned by tax-exempt, foreign, and low rate domestic shareholders would have to pay little or no tax-compensation dividend. The effect on it would be essentially the same as outright repeal of the present 34-percent corporate tax.

A more typical situation might be where 50 percent of the corporation's stock is owned by a combination of foreign and tax- exempt shareholders. Wholly apart from whatever effect the Partnership Model might finally have on that corporations' retained cash flow, it is clear that the income from its business would be taxed at a much lower rate than the income from some otherwise identical business where there were very few tax-exempt or foreign shareholders.

Therefore, not only is the Partnership Model the most complex method; it also appears to fail nearly all the tests for a proper form of integration.

### **The Credit Model of Full Integration**

The traditional structure, often referred to as the partnership- withholding method, is as follows: (i) the corporation pays tax at the top shareholder rate (28 percent) in the year taxable income is earned; and (ii) the corporation's taxable income is imputed and taxed to the shareholders who are allowed refundable credits for the tax paid by the corporation on their behalf. As in the case of the Partnership Model, shareholder stock basis should at least be adjusted for imputed taxable income (in this case 72 percent of taxable income or taxable income minus credits) and, more correctly, should be adjusted for earnings and profits.

The redundancy in allowing both credits to eliminate shareholder tax on imputed income and a basis adjustment to eliminate shareholder tax on dividends (and gains attributable to

retained earnings) emphasizes that the Credit Model serves primarily to provide large refunds to tax-exempt and foreign shareholders. An amount equal to the disproportionately large tax-compensation dividends paid by corporations to tax-exempt and foreign shareholders under the Partnership Model would be paid as tax to Treasury, which would then refund that amount to tax-exempt and foreign shareholders. (Refunds also would be made to 15-percent bracket shareholders although, under today's rate schedule, that seems more coincidental than anything else.)

Compared to the Partnership Model, the only purpose served by the Credit Model is to permit Treasury to audit and collect a single tax at the corporate level.<sup>8/</sup> Otherwise, the Credit Model produces the same overall results as the Partnership Model -- including the same lack of evenhandedness among corporations that do and do not pay dividends.<sup>(9)</sup>

Even though for the purpose of illustration, the Credit Model allows full refunds to all shareholders, it seems improbable that refunds actually would be allowed to tax-exempt and foreign shareholders. It is one thing to say that such shareholders would not themselves be required to pay a regular tax on income attributed to them under the Partnership Model. Political and treaty considerations probably would prevent it. Giving cash refunds to tax-exempt and foreign shareholders for taxes paid at the corporate level is quite another matter.<sup>(10)</sup>

If the credits were not refundable, the Credit Model would serve no purpose that could not better be accomplished by other means. The Credit Model is essentially an anachronism that should be disregarded. If adopted, it would fail nearly all the tests for a proper form of integration.

### **The Basis Model of Full Integration**

Although there are several variations on the same theme, the Basis Model would be structured as follows. Corporations would pay a flat 28-percent tax on taxable income in the year earned. No amount of corporate earnings would be imputed and taxed to shareholders. Shareholder stock basis, however, would be increased by the amount of the corporation's earnings and profits (i.e., taxable income plus positive adjustments to earnings and profits in excess of taxable income minus tax paid by the corporation on taxable income).

Dividends would be a return of basis and effectively excluded from tax.<sup>11/</sup> Gains on stock attributable to retained earnings also would be a return of basis. Thus, there would be no second tax at the shareholder level under either of the two alternative means by which equity holders can realize a return on their investment.

Although the basis adjustment effectively excludes dividends from tax, the basis adjustment does not produce the same result as exempting from tax all gains on stock -- and is not intended to. The proposition is that a dollar of earnings retained and reinvested by a corporation is equal to the discounted present value of the future income stream that the corporation expects to be produced by that dollar. Therefore, only gains on stock attributable to retained earnings would be excluded from tax as each increment of that income stream is,

when realized by the corporation, added to the basis of stock. The taxable gains realized by shareholders would consist of (i) built-in gains on stock purchased prior to the effective date; (ii) inflation gains; and (iii) gains attributable to real appreciation in the value of assets which has not been realized at the corporate level.

The effect of the basis adjustment with respect to both dividends and capital gains generally is to produce the correct results under an integrated tax system: (i) the amount of income earned in corporate form that is subject to tax is no greater than if the shareholders had earned it directly; and (ii) the rate of tax is no higher than if the shareholders had earned the income directly. On the assumption that corporate earnings allocable to shares owned by tax-exempt or foreign shareholders is closely akin to unrelated business taxable income or effectively connected income, the only real departure from the norm is in the case of 15-percent bracket shareholders. If necessary, that defect could be handled easily within a system that already undertakes to allocate earnings and profits on a per-share basis.

But for the complexity of allocating basis among the constantly changing group of shareholders in a publicly held corporation and concerns about the potential effects on markets of the new "changing basis" factor, the Basis Model has great merit.

While it would never be simple, the process of allocating basis to shareholders may be manageable. Drawing upon experience with master limited partnerships, it may be that the Treasury study will show that large corporations could handle a system similar to the Basis Model -- much in the same way they now handle information reporting on dividends. Although the scope of the task is larger and more complex in the case of big publicly held corporations, they are probably more able to handle it than smaller companies. If imputation of income is feasible, so is imputation of basis.

The larger difficulty with the Basis Model may be the uncertainty and potential for disruption, at least during a transition period. A shareholder's basis would be constantly fluctuating in amounts that could not be determined exactly until months after a sale of stock. Even if corporations published quarterly "capital changes" basis adjustment reports, basis would be subject to substantial redetermination and revision after year-end. Whether speculation about large swings in basis adjustments would be a major new factor in evaluating stocks is a question left to experts. Perhaps there would not be a problem. To the extent that earnings and profits may correspond to financial earnings, the amount of any tentative basis adjustment as of any quarterly date (and any predicted changes therein) may be merely the flip side of tentative earnings as of that quarterly date (and any predicted changes therein).

### **The Average Rate (AR) Model**

The AR Model imposes a flat-rate tax at the corporate level and excludes dividends from tax at the shareholder level. Corporations would pay tax at the average shareholder rate determined by Treasury for shareholders in the aggregate, assuming full imputation of corporate taxable income (i.e., total shareholder tax payable expressed as a percentage of total corporate taxable income).

Primarily, the AR Model illustrates that the large benefits to tax-exempt and foreign shareholders under traditional methods can be redirected to corporate cash flow. The AR Model also illustrates the paradigm for integration -- a system which produces the same overall tax and corporate cash flow result as if the corporation's taxable income had been distributed and taxed to the shareholders and, net of tax and any actual dividends, reinvested in the corporation.

On an economy-wide basis, taking into account tax-exempt and all other shareholders, the average shareholder rate on fully imputed corporate taxable income probably is about the same as the average rate on interest income and noncorporate business income, and higher than the average rate on labor income.

The average shareholder rate, however, would be less than the top rate on interest income, noncorporate business income, and labor income. Although the top rate on retained corporate earnings was for many years prior to the 1986 Act lower than the top rate on other income, the combined corporate/shareholder tax on distributed earnings was much higher than the top rate on other income.

Given the potential distortions involved (and the obvious political problem in taxing corporate earnings at an average rate which is, by definition, lower than the top rate), the AR Model, as such, probably is not a practical approach. Taxing income from corporate equity capital at a rate that is substantially lower than the highest marginal rate of tax on interest could distort capital markets.

Setting aside politics and the large revenue loss, the AR Model might be a more reasonable option if an "equalizing" tax were imposed on dividends paid to top bracket shareholders -- in order that the top bracket tax on income earned in corporate form would be the same as the top bracket tax on interest income, labor income, etc.

### **The Dividend Exclusion Model of Full Integration**

All the foregoing discussion, including the similarities, differences, and imperfections of the various models, leads to the conclusion that the essence of integration today can be accomplished by reducing the corporate rate to 28 percent and excluding dividends from tax.

Indeed, a lower "corporate rate" probably is the inevitable result if an integrated system is going to confront and resolve the problem that has always been at the heart of the matter -- how to collect a tax at the shareholders' rates in the year income is earned despite the facts that (i) all corporations can and must accumulate substantial portions of their earnings; and (ii) shareholders hardly can be expected to pay tax on income they have not received.

All the models implicitly or explicitly reduce the "corporate rate" to 28 percent and exclude dividends. Whether one goes further and engrafts onto dividend exclusion the earnings and profits basis adjustment under the Basis Model is an option. Whether one undertakes to compensate 15-percent bracket shareholders through a refund when dividends are paid also is an option.

The only thing wrong with outright dividend exclusion is the absence of any handy, precisely accurate way to prevent a second tax on retained earnings when stock is sold. Perhaps some way of approximating the results of a basis adjustment could be devised.

### **The Issue of Pension Funds That Own Stock**

Up to this point, pension funds have been lumped in with tax- exempt charities, etc. The tax benefit accorded pension funds is only a deferral of tax insofar as concerns the annuitants and other beneficiaries of such funds. Ultimately, dividends and gains on stock received by such funds will be taxed, although at some real rate which is -- after taking into account the deferral -- less than the present statutory rates of 15 and 28 percent.

Given the fact that pension funds own such large amounts of stock, their presence will affect tax integration in numerous ways. Some results are fairly obvious. If dividends are by one means or another excluded from tax, dividends allocated to an employee's account should be treated as a previously taxed employee contribution and not taxed again when distributed by the fund. If corporate taxable income were imputed and taxed to pension plans (without refunds) or dividends and other investment income of pension plans were taxed, a similar "basis" adjustment would occur.

### **Issues Not Discussed**

Several issues have not been addressed: debt versus equity, foreign income and taxes, or the conundrum of the corporate alternative minimum tax.

The purpose of integration is not to make debt the same as equity -- they are different.(12) Eliminating the present large penalty on the income from equity capital will eliminate the artificial bias in favor of corporate debt that arises from the two- tier tax. Nothing else can or should be done. Even if all businesses were conducted in proprietorship form, the deduction for interest paid still would be significant and necessary. Allowing corporations to deduct interest as well as dividends has a certain superficial symmetry about it, but fails nearly all tests for a proper system of integration. Excluding dividends from tax seems a far better approach. Whether dividend exclusion would result in major shifts between debt holders and equity holders and/or cause various discontinuities is another question left to experts.

Insofar as foreign-source income and tax credits are concerned, the dividend exclusion or some version thereof presents the minimum amount of difficulty. Credit for foreign taxes paid would be allowed at the entity level, just as it is today. The Treasury study of integration, of course, would provide the opportunity for a proper sorting out of how we are going to tax foreign-source income in a global economy. Many of the concepts reflected in the foreign income rules today appear to be as much of an anachronism as a nonintegrated set of corporate and shareholder taxes.

The AMT is a puzzle. It seems to be a double tax that would apply to some income earned in corporate form and not to other such income. Its primary function would continue to be to add

on tax when profits decline relative to capital investment or capital investment increases relative to profits. Given the present corporate taxable income base after the 1986 Act, the AMT serves no positive purpose anyway and should be discarded. If political thinking ever catches up sufficiently with good economics to permit an integrated tax to be enacted, the AMT probably also could be dispensed with.

## **Conclusion**

It is certainly no newly discovered secret that the equivalent of a corporate rate cut is implicit in applying the basic concept of integration to today's rate schedule. It is also obvious that the 1986 Act eliminated the principal structural barrier to integration -- the need to deal with highly progressive individual rates that exceed the corporate rate. The ability to achieve an integrated tax now is a reality.

Because elimination of the double tax on distributed and retained earnings need no longer be such a complicated task, those who earlier worked on integration in the context of the classical corporate tax have to unlearn a great deal. On the other hand, many observers in the business community and elsewhere continue to view integration primarily in terms of past experience -- overly complex systems that fail nearly all the tests for integration mentioned above. Others probably assume that the normal consequences of applying integration concepts to the present rate structure never will be permitted to occur, i.e., that integration would be accompanied by a combination of rate increases and base broadening that would tend to reintroduce many of the complexities, distortions, and controversies associated with integration in the past. An emasculated version that perpetuated the present high level of tax on income earned in corporate form probably would not be worth the trouble and turmoil involved.

Still others may foresee attempts to achieve total symmetry between debt and equity financing, to impose some concept of economic income for tax purposes, or to address other perceived imperfections that seem naturally to be brought into focus by the fundamental kind of thinking involved in an integration study.

Very likely the Treasury study will contain a sophisticated analysis of many of the collateral issues raised by integration -- including the deficiencies of the present foreign-source income rules.

We can hope that the Treasury study also will cut through to the bottom line and fully focus everyone's attention on the real point -- the primary purpose of integration now can be readily and simply achieved. Whether we can afford the revenue loss or can find some substitute revenue source that does not distort and substantially defeat the process of integration is a separate question. Curing any additional imperfections in present law also is a separate matter that can come after integration. The important thing is the first step. At this particular point in time, we have the unique opportunity.

## **FOOTNOTES**

1. Only "full integration" or what seems to be an appropriately expanded definition of that

term is discussed. Under today's rate schedule, various versions of the dividend exclusion approach to integration would come very close to producing the same overall tax result as if the shareholders had earned the income directly. Traditional methods of "partial" integration such as dividend deductibility and the gross-up/credit method are inherently deficient under the tests applied here, and are mentioned only in passing. The same is true of the OECD variations discussed by Sijbren Cossen in 1984 (International Bureau of Fiscal Documentation Bulletin, Vol. 38, No. 11).

2. Extrapolations from various data sources seem to indicate that somewhere around 70 percent of dividends are received, directly or indirectly, by fully taxable persons or corporations. Calculations for this paper assume that 75 percent of imputed corporate taxable income ultimately would go to fully taxable persons and on the average be taxed at pretty close to a 28-percent rate.

3. If applied under the Partnership Model, section 705 also would increase partners' (shareholders') basis by the amount of tax- exempt interest received by the corporation. The Basis Model would further increase shareholder stock basis by other positive adjustments to earnings and profits, including tax deferrals.

4. The rate of tax as well as the rate of depreciation and other factors are taken into account in measuring the impact of taxes on the cost of capital. This is discussed by Don Fullerton and others in a paper at p. 173 of Compendium of Tax Research 1987, Office of Tax Analysis, Department of the Treasury. The cost of capital in the U.S. is higher than desirable and, at least in the case of most capital equipment, is higher than before the 1986 Act. See, for example, Christian and Raboy, Increase in the Cost of Capital: Quantitative and Other Results of the Tax Reform Act of 1986, The Tax Foundation, 1987.

5. Even though actually excluded from income under the Dividend Exclusion Model, dividends could be grossed-up and presumed to be taxable for the purpose of determining the amount of the refund.

6. Essentially the same effect as a disproportionate dividend could be achieved if the corporation knew each shareholder's top rate. Under the hypothetical Variable Rate Method, corporate taxable income would be allocated to shareholders. The corporation would pay tax on each particular shareholder's portion at a variable rate determined as follows: (The Shareholder's Tax Rate) x (Undistributed Taxable Income/Total Taxable Income). The entire amount of taxable income allocated to a shareholder would be imputed and taxed to the shareholder who would be allowed a credit for the tax paid by the corporation. If the entire amount of taxable income allocated and imputed to the shareholder had been retained by the corporation, the credit always would equal the shareholder's tax. If a portion had been distributed, the credit would equal the shareholder's tax on the undistributed amount. The shareholder would pay the tax on the distributed amount.

7. A dividend-paying corporation in effect gets credit against its tax-compensation dividend for the tax already being paid by its top bracket shareholders on regular dividends.

8. Such a system still would be complex. As in the case of the Partnership Model, the complexities arise primarily in the case of large publicly held corporations where there is a constantly changing group of shareholders, where there often are several classes of stock, and where there may be several tiers of domestic and foreign corporations involved.

9. Under the Credit Model, a corporation which is presently paying a dividend could reduce the amount of its dividend to reflect the value of the shareholder credit to the top bracket shareholders, and thereby obtain a larger cash flow benefit and the equivalent of a larger corporate rate cut. Such interference with dividend policies is common to all methods of integration which use refundable credits.

10. Full refunds could be allowed to 15-percent bracket shareholders. Tax-exempt and foreign shareholders could be allowed partial refunds, e.g., a refund based on the assumption that corporate taxable income imputed to them is taxable at the suggested average shareholder rate of 20 percent. Alternately, the revenue loss associated with those partial refunds could be channeled into corporate cash flow by a version of the Variable Rate Method. With little or no change in present law, corporations could determine which of their shareholders are tax-exempt or foreign. Corporations could pay tax at a 20-percent rate on the portion of taxable income allocable to shares owned by tax-exempts and foreigners. Such shareholders, of course, would become valuable commodities. If corporations are to any extent allowed the benefit of having such shareholders, the benefit should be spread among all corporations, as under the Average Rate Model.

11. Dividends in excess of cost basis and earnings and profits basis would be taxable. As a practical matter, the result is the same as excluding all dividends.

12. There is a suggestion to impose an entity tax on a base that includes interest paid and to exclude both interest and dividends from tax at the bondholder and shareholder level. While interesting, any such approach to integration seems outside the scope of a discussion focused primarily on enhancing corporate cash flow.