Corporate Tax Integration as an Answer to Tax Reform Needs

The Joint Committee on Taxation (the "JCT") is now working on revenue estimates for the plan.

To fully appreciate Hatch's approach in context, one needs a good basic understanding of corporate integration, and the many methods by which it may be achieved.

Under current law, the U.S. follows the "classical system" of corporate tax. In this system, income earned by C corporations is taxed first at the corporate level, and then taxed again at the shareholder level when the corporation distributes earnings to shareholders in the form of dividends. In contrast, an "integrated system" coordinates the individual and corporate tax systems so corporate income is taxed only once (either at the corporate or shareholder level depending on the integration method).[1] There are many types of integrated systems,[2] many of which are in fact implemented by other countries.

Tax policy experts generally prefer integrated systems over classical systems, because they avoid distorting people's choices. Specifically, integration reduces three distortions inherent in the current two-tier classical tax system:

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The Treasury Report, the JCT's Report,[6] and the Republican Staff Committee on Finance's Report[7] all review numerous integration systems. In general, integration systems may be divided into two types: those that trigger on or relate to distributions, and those that do not.[8] More specifically, distribution-related integration systems retain a separate corporate level tax on undistributed earnings but eliminate part or all of the corporate level tax on corporate earnings distributed to shareholders as dividends. Non-distribution-related systems instead focus on coordinating shareholder and corporate taxes so that shareholders are currently recognizing corporate income in lieu of the corporation doing so. Many varieties of these two types are discussed below.

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Under a dividend exclusion system, a corporation continues to calculate and pay its income tax as it would under current law rules. A shareholder that then receives dividends from that corporation can exclude the dividends from his or her gross income.

It has been thought that dividend exclusion systems are overly gameable by corporations, which are quite mobile. For instance, one could move a corporation overseas to avoid corporate-level tax, and then get an exclusion on the dividends coming from this corporation to inside the country. Similarly, shareholders are less mobile than corporations, and therefore form a more reliable tax base; dividend exemption systems ignore this fact and pass up shareholder tax to go after the more elusive corporate tax base.

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Under an imputation credit system, corporations continue to pay corporate-level tax on their income. When corporations then d tthe4-16(y)20(c)4.nsssss

The dividend imputation credit system was popular in Europe several decades ago, until the European Court of Justice held it incompatible with EU laws.[11] Supporters believe the history proves that many major economies had successfully implemented the imputation credit system, and the demise of the system in EU has no relevance for U.S.[12]

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Under a dividend deduction system, corporations deduct dividends paid to shareholders, and shareholders include dividends in gross income subject to ordinary income tax rates.

Hatch's proposal is a variation of this system, which combines this dividend deduction with a corporation-collected withholding tax on distributed dividends.[14] As things currently stands, the tax would be collected at a flat 35% rate, including from dividends going to tax-exempt institutions and foreign investors. Hatch's plan may ultimately extend the withholding and deduction treatment to interest as well. Shareholders would receive a nonrefundable credit for the tax withheld on their behalf by the distributing corporation.

The CBIT would apply to both corporations and non-corporate entities (except small businesses). The CBIT would not allow deductions for dividends or interest paid to the shareholders and debtholders.

The Business Enterprise Income Tax (BEIT) system is a variation on the CBIT system. Under BEIT, a business entity (either corporate or non-corporate) first computes its taxes under current laws, then deducts a time value of money charge on capital (either debt or equity) invested in the business as a "cost of capital allowance" (COCA). (There would be no interest deductions allowed, thereby equalizing the treatment of debt and equity.) This time value of money charge represents the risk-free rate of return. The business's investors would include a time value of money return on their investment in the business (either debt or equity) in their gross income. Generally, all returns exceeding this risk-free rate of return would be taxed to the business.

As a result, the income of the business would generally subject to one level of tax, either at the business level or the investor level depending on the return on capital. However, sales of securities (debt or equity) or large distributions greater in value than the risk free rate of return would be taxed to the shareholder without corresponding deduction by the corporation, creating some degree of double taxation.

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Shareholder allocation systems extend integration to retained earnings by taxing both distributed and retained corporate earnings at the shareholder's tax rate. This is done by having the shareholders include allocated amounts in income, with a credit for corporate taxes paid. Shareholders would increase basis in their shares by the amount of income allocated, less the amount of credit. Distributions would be treated as a return of capital to the extent of a shareholder's basis and thereafter, as capital gain.

The Treasury Report did not recommend this method because it would produce undesired administrative complexities and policy results (i.e., extending corporate tax preferences to shareholders and exempt foreign source income).

CORPORATE INTEGRATION APPROACHES

1. Dividend exclusion***
2. Shareholder allocation (flowthrough)***
3. Imputation or shareholder credit***
4. Comprehensive Business Income Tax
5. Business enterprise income tax
6. Dividend paid deduction***
7. Mark-to-market for publicly traded stock
8. Split rates for distributed and undistributed corporate income
9. No corporate level tax
10. Reduce tax rate on dividends and capital gains (current approach)

*** commonly suggested approaches